

FISCAL DECENTRALISATION AND GRANT TRANSFERS IN TRANSITION COUNTRIES: A CRITICAL PERSPECTIVE

Edited by
Željko Šević



NISPAcee

THE NETWORK OF INSTITUTES AND
SCHOOLS OF PUBLIC ADMINISTRATION
IN CENTRAL AND EASTERN EUROPE

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The Network of Institutes and Schools of Public Administration
in Central and Eastern Europe

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Edited by

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Table of Contents

Preface.....	5
Acknowledgements.....	9
Chapter 1: Decentralisation: Issues of Inter-governmental Grant Transfers and Fiscal Co-operation <i>Željko Šević</i>	11
Chapter 2: Fiscal Decentralisation in the Czech Republic: Current Issues and Problems <i>Phillip J. Bryson and Gary C. Cornia</i>	32
Chapter 3: Fiscal Decentralisation in Poland <i>Bartłomiej Gurba</i>	55
Chapter 4: Grant Transfers in Financing Local Governments in Poland <i>Piotr Bury and Pawel Swianiewicz</i>	98
Chapter 5: The Role of Municipal Bonds as a Repayable Source of Financing Territorial Self-government Units <i>Maria Jastrzębska</i>	119
Chapter 6: Grant Transfers and Financial Supervision in Lithuania <i>Mark Chandler</i>	128
Chapter 7: Grant Transfers and Financial Supervision in Estonia <i>Annika Jaansoo and Eliko Pedastsaar</i>	150
Chapter 8: Grant Transfers and Supervision of Finances in Latvia <i>Mudite Priede and Solvita Klapare</i>	176
Chapter 9: Grant Transfers and Financial Supervision in Bulgaria: Principles and Practice <i>Svetlana Alexandrova</i>	212
Chapter 10: Grant Transfers and Financial Supervision in Romania: A Focus on Major Reforms Introduced by the Law on Local Public Finance <i>Clare Romanik and Francis Conway</i>	233
Chapter 11: The Byelorussian Public Sector Finance System: Problems of Over-centralisation <i>Leonida Pliskevich and Željko Šević</i>	252
Chapter 12: Intergovernmental Fiscal Relations in Armenia <i>David Tumanyan</i>	265
Chapter 13: Grant Transfers and Financial Supervision in Kyrgyzstan <i>Nazira Tiuliundieva</i>	283
Chapter 14: Decentralisation and Structural Adjustment in Hungary <i>József Hegedüs</i>	306
Chapter 15: Unanticipated Budgetary Consequences of Devolution: The General and the Specific <i>Herrington J. Bryce</i>	336

Preface

The late 1980s saw a new term being introduced into social science literature – “transition”. It is widely accepted as a synonym for a transformation from socialism to capitalism.¹ Transition was perceived to be significantly different from “reform” and “transformation” – the words used in the 1960s and 1980s to describe changes in real-socialism countries at that time. Reforms and transformations were, in fact, periodic attempts of the socialist nomenclature to initiate certain changes to the socialist system which, at first sight, improved the overall efficiency of the said system, but did not deter the supreme rule of the Communist Party and its satellite organisations. It was only with the dismantling of the ultimate power of the ruling party in a mono-party political system that real opportunities for democratisation emerged.

At the beginning of the transition process there existed a more or less classic socialist society, which was to be “*converted*” into a more democratic society. This process has proved to be quite complex, requiring prior knowledge of not only the classic theory, but also the theory and practice of socialist development, in order to address the existing deficiencies of the socialist legacy more effectively. The initial focus of transition has been on economic transition, on changing the property rights regime and on the liberalisation of the economy. Social transition followed, but initially and for a number of years, the transition of the public sector was somewhat neglected. The problems of public sector transition became focal in the mid-1990s, when it became clear after the publication of the Copenhagen criteria what the EU expected from the public administrations in those countries aspiring to join the EU.

The primary focus, in fact, was on decentralisation as it was (quite rightly) believed that the former socialist state was heavily centralised. In order to bring about transformation and modernisation, decentralisation was necessary. In many countries of former real-socialism, decentralisation became a burning issue on the political agenda and decentralisation and regionalisation exercises were frequently carried out. In contrast, in the former Yugoslav Republics which, prior to the 1990s, were amongst the most decentralised countries in the world, a centralisation process took place. This was often mistakenly seen as being a process of nation-building (or at least nation-strengthening). As part of the process of decentralisation, the relative importance of ‘grass-root democracy’ became evident. A citizen could express his/her interest in the best way in a local community and local politics had to become more citizen-oriented, rather than central government pleasing. In order to ensure the capacity of the local

1 We are fully aware that this statement may be widely disputable, but we opted for it because of its conciseness; although it could be seen that CEECs strive to make the change from a restrained and repressed society towards a more democratic type of social organisation.

government to deliver what was stipulated by law, fiscal decentralisation had to be exercised. However, the political motives of central and local government were often conflicting. One might have expected to see very eager local governments taking on local taxation powers and original sources of their revenues, but often, local politicians were more interested in securing grant transfers from central government in the amounts necessary to carry out local government duties, than to engage in local taxation. This has been very well documented in the volume by our Polish colleagues. Mayors did not want to take ultimate responsibility for inputs and outcomes of local government policies, but to keep a *status quo*, where the central government would remain in charge of funding activities of local government and ultimately be responsible for any output failures (which could then be explained to citizens as chronic under-funding of the local government by the centre). It would appear that anecdotally, the same can be found in other CEE countries.

The process of transition, *per se*, has not been an easy one and different groups of countries were assembled based on the level of their transitional 'graduation'. The Baltic states and Central European countries are regarded as being 'advanced transitional countries/economies' which have done very well in reforming their economies and fairly successfully completed transition towards a democratic society with full regard for rule of law and respect for individual and collective human rights. All of these countries became members of the European Union on May 1st 2004. The situation is slightly different in the Balkans (South-Eastern Europe) and in Eastern Europe, but, even some of these countries (for instance Croatia) are doing well in advancing towards EU accession. This 'stratification' of countries can be perceived as an additional challenge for scholars. Comparative research on the dissemination of 'good practices', tried and tested in 'advanced transitional economies', can open a new window of research opportunities. However, one should be aware that research on public sector finance and accounting in the Region is still in a relatively nascent phase.

In fact, although decentralisation and financial management reform became very topical in the latter part of the 1990s, fairly limited research was conducted on these issues. Political aspects of changes, human resource management and civil service organisational issues were more of interest to scholars in both Central and Eastern Europe (CEE) and outside the target region. In order to fill the gap, a group of scholars from both East and West initiated the creation of a research group that would focus on promoting research and best practices in public sector finance and accounting in CEE. The group was founded at the 9th NISPA-cee (Network of Institutes and School of Public Administration in Central and Eastern Europe) Conference held in Riga (Latvia) in 2001. At this conference, the group discussed the major issues facing public sector accounting and finance reform, but the discussion was rather general and the papers represented a variety

of interests and scholars' focus. It was agreed that for the next conference, scheduled to be held in Krakow (Poland) in 2002 the Group would develop a detailed research proposal, so that a number of comparative papers on local government finance in respective target countries could be written following a common template. The results of this research protocol, developed in late 2001, are presented in this book. There are over ten papers in this volume, exploring various issues of local government financial transition, but at the same time, trying to provide a true picture of sub-national finance in various countries. The authors attempted to provide their own insights into the problem and in so doing, exhibited a pretty high degree of diversity, demonstrating indirectly the capacity for carrying out academic research in the targeted countries. Some papers are fairly descriptive, especially those from the outside 'advanced transitional countries' and those written by Western scholars members of the Group, whilst others are more policy relevant and written in a more analytical manner. Some may perceive this as being the weakness of this volume. To a large extent, they may be right. However, if one goes back to reading research produced in Western countries when public sector finance and accounting was a nascent academic discipline, there a similar situation will be found. As Professor Garten of Yale University and former Under Secretary for International Trade in the US Department of Commerce, nicely put it in 1996 when writing about BEM – big emerging markets:

'As always, history offers valuable lessons. We need only to recall the example of the most important BEM of a century ago: a nation rich in resources and promise that lacked infrastructure, depended on foreign investment to finance its growth, experienced multiple stock market panics and saw a traumatic political assassination. Even as its great resources of gold, oil, agriculture and manufacturing capacity were becoming known to the world, it was torn apart by civil war. That big emerging market was, of course, the United States' (Garten, 1996).

We had to begin somewhere and greatly appreciated the capacity to conduct research in the different countries in the Region. The role of the Group has been perceived as a significant force to promote good research practices and collaboration amongst its members, especially those working in the West and those working in the East. Annual meetings of the Group, traditionally held under the auspices of the NISPAcee annual conferences, have been regular meeting places for the presentation of individual and joint research projects and their results, and also for discussing issues regarding teaching public sector accounting and finance in different countries. To this extent, the Group extended its remit beyond the initially agreed scope. Therefore, the critical reader should be aware of the limitations that we clearly acknowledged and take a supportive view of the strengthening of public sector finance and accounting research in the Region. The Group will attempt to regularly publish volumes of its work, and we hope that the progress and improvement will be visible in the volumes to come. Cer-

tainly, this book enabled a number of Eastern European scholars to meet (and survive) a peer-review process.

All papers in this book have been peer-reviewed and to large extent the authors followed recommendations given by the referees and the editor. Also, both authors and editor have greatly benefited from comments provided by Dr Gabor Peteri at the time the Research Director of OSI/LGI. As usual, for books of this type (edited volumes), all the good points should be considered as being a major success for each of our contributors, whilst all the flaws are the sole responsibility of the editor, and he apologises (upfront) for that.

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London, Summer 2004

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1. Decentralisation: Issues of Inter-governmental Grant Transfers and Fiscal Co-operation

*Željko Šević**

1.1 Introduction

The end of the 1980s was marked by the fall of Communism in Central and Eastern Europe, symbolically marked by the destruction of the Berlin Wall. The former Communist countries then entered the process which later became known as transition (see review of current literature in Šević, 1999). This term had to encapsulate the fact that the process would lead to the full transformation of the (former) socialist regimes, in contrast to the 'reforms' often initiated in the socialist countries and which had failed to bring about any changes, as they did not address the main shortcomings of socialism (see: Šević, 1999). Transition has been understood as a societal change that has many dimensions: economic, political, social, etc. Economic transition has led to a market-oriented economic regime, political transition to a multi-party democratic society, and social transition to the transformation of the social micro-sphere, strengthening individuals' rights and liberalising social relations. Economic, political and social transition has led to a number of changes in many areas including culture, sport, education, etc. Transition has become the process which embraces society as a whole with its main aim being a better society.

Economic and political transition took the prime positions. Initially, the main focus was on the economic and political aspects of a changing society. With only a few days' delay, the process of changing public administration began. The socialist countries, especially those that closely followed the Soviet model, were highly centralised and their public administration system mirrored the political party structure and vice versa. The process began with decentralisation and delegation at central government level, whilst local government reform lagged behind. The local government reforms which were initiated in most central and eastern European countries in the early 1990s are still in the process of implementation. The focus was more on organisational decentralisation and delegation of activities by the central government, than on financial and accounting reforms. Financial reforms were initiated in the mid-1990s and are still in the process of implementation. However, not all the countries proceeded with the same speed and scope of reform. Whilst the Central European and Baltic countries progressed well in their reforms of the public sector, and their reform of the public finance system, the South-East European countries lagged behind, due to the armed conflict, which ended in 1995 with the Dayton Peace Agreement. In

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South-East Europe, the trends were different to the remainder of the European transitional economies. The former Yugoslavia was a fairly decentralised country that paid a lot of attention to local communities and their capacity for sustainable local development. However, centralisation was perceived in those countries as nation state building, and was pursued without reservation. So, the most decentralised socialist countries became the most centralised transitional countries. Only in the late 1990s did the process of decentralisation begin, however, we are still awaiting the results. *De jure*, decentralisation took place and in practice, municipalities received their duties and rights, but it was not followed up by any real financial decentralisation. In all central and eastern European countries, *de jure*, operational and personnel decentralisation has now taken place, but the extent and the forms of financial decentralisation differ widely from country to country. It has been reported (see: Bury and Swianiewitz in this volume) that (Polish) municipalities are not genuinely interested in fiscal decentralisation and their capacity to raise funds locally. It seems that in Polish political settings, it is better (read more lucrative) to work out the funding model that will improve your municipality grant transfers.

In this chapter we will focus on financial decentralisation, expressed through the design and implementation of a model of intergovernmental transfers and the way in which the central government can and may control the financial functions and activities of sub-national level governments. We will focus on the goals, aims and objectives of fiscal decentralisation, expressed *primarily* through intergovernmental transfers; forms of intergovernmental transfers and the reasons for choosing a particular option and finally, why and how financial (fiscal) supervision can be exercised in a fully decentralised model.

1.2 Challenges of Democratic (Financial) Decentralisation

Decentralisation as an instrument of democratisation has been popular with many developing and transitional countries. A number of developing countries experimented in one way or another with decentralisation. Decentralisation, per se, can be defined as the transfer of powers and resources from higher to lower levels in a political system. Current experience has shown that there are three main types of decentralisation:

- de-concentration,
- delegation, and
- devolution.

De-concentration is perceived as a process of administrative decentralisation, in which the agents in higher levels of government move to lower levels, whilst fiscal decentralisation occurs when higher levels of government transfer influence over budgets and fiscal decision-making to lower levels. Devolution, as a form of decentralisation, appears when resources, powers and quite often,

tasks, are transferred to lower level government authorities, which are mainly independent from higher authorities, and are in turn democratically empowered (Manor, 1999). Democratic decentralisation, in order to succeed, requires the creation of settings in which lower levels of government have substantial powers and resources and strong accountability mechanisms. The success of the democratisation process can be supported by a number of useful but unnecessary features, such as a free press, multiparty system, a lively civil society, experience with democratic politics, and respect for law and order.

Decentralisation theoretically supports the feeling of ownership over the government and engages stakeholders more closely. One problem which may emerge is that many civil servants and politicians find it difficult to realise that decentralisation delivers and they see this change as an effective loss of power. Decentralisation shortens the distance between citizens and lower government levels, ensuring a better flow of information and (theoretically) empowering local civil servants, thus allowing them to act more quickly, being supported by the local communities. Better information flows from citizens to public administration, enhance the responsiveness and effectiveness of government. With time, both politicians and civil servants may buy into decentralisation practices, as they see that decentralisation delivers and their relative positions are not endangered. With the strengthening of the decentralisation framework, more enthusiasm from all involved is to be expected and therefore more consensual, transparent and responsive policy processes and governance models are developed.

Decentralisation does not only empower the government, but also empowers the people. The people, as major stakeholders, gain a sense of ownership of the development processes, the elected representatives may be in a position to make the necessary decisions and local projects are more locally controlled and locally owned, and therefore more manageable. Ownership of the local programmes by the people is an important feature which is expected where people take active roles in their local communities. In a democratic society, elected representatives must explain their actions and it is more effective if the issues are explained by locally elected (and accountable) representatives where the power distance should be shorter. People's ownership over programmes is an important characteristic of a civil society, as they may exercise their ownership both as individuals and members of the group. Civil society *per se* is supported by the network of non-governmental (NGOs) and civic organisations that enjoy significant independence from the state. In developed democratic countries, the civil society infrastructure is well-developed and comprises an impressive number of organisations (NGOs), pressure groups, political parties and groups, national and other associations and citizens' groups, whilst in developing countries, the infrastructure is often in a nascent phase and there are only a handful of national organisations with many of them in the early developmental stage. While ownership by the people is

primarily seen as an exercise of stakeholder powers by individuals and informal groups, civil society comprises civil initiatives that have been largely formalised and whose influence within society is more structured. Practice has, however, shown that civil society can sometimes have adverse effects, as it can present itself as disorganised and conflict-ridden. Recently, the issue of civic associations' accountability has been raised, but no sustainable response has as yet been offered. Civil society organisations are not fully accountable even to their members, let alone the wider society. Nevertheless, it is believed that decentralisation empowers civil society and vice versa (civil society encourages and supports decentralisation). When significant powers and resources are delegated to the lower levels of government, the associations present in the field become more active and generally engage more intensively with government bodies, encouraging the creation of new associations.

In a civil society, the degree of closeness to the 'grassroots' is very important. The less the power distance between the elected representatives and the community that elected them, the more effective civil society will be and the more engaging the bodies of civil society. With this greater and more complex influence comes the more direct and effective exercise of ownership and appreciation of local and regional specifics. As a rule, with greater influence over local programmes comes a greater sense of societal (communal) ownership over programmes that are not necessarily those favoured by the respective local community. Having people buy into different and diverse initiatives is an important feature of an open and citizen-centred public policy process. Civil society organisations can make government-induced projects more effective by ensuring that they are appropriate for local conditions and reflect implicit and explicit local preferences. As decentralisation requires more transparent politics and policy-making, civic organisations may find it easier to engage citizens in programme monitoring, including even those who often resent participation in social actions, claiming that they are rather 'abstract'.

Decentralisation *per se* does not create civil society and does not lead to the direct accountability of all stakeholders, including the main players within civil society. What decentralisation delivers (amongst other good things) is a shorter power distance, which enables closer interaction between local bodies, citizens and their civic organisations. The well-developed civic society net enables better social communication on the one hand, whilst decentralisation can ease bottlenecks and delays in the process of (social) intermediation, reducing (to some extent) the overall social cost. Decentralisation requires better co-ordination and policy focus. Decentralisation of government functions and the physical transfer of civil servants to regional centres require re-defining the relationship between regionally elected governments and the officials of central government working in regional centres. Without decentralisation, 'detached' civil servants were loose-

ly supervised by senior civil servants working from the centre, whilst now, on the other hand, they have to respond formally to both physically remote senior civil servants and to locally elected government bodies.

Decentralisation usually strengthens not only collaboration and co-ordination between local/regional government bodies and detached and headquarters-based central government officials/task units, but also between the bodies operating at the same level. Often if a problem is of regional/local importance, the central government bodies may be forced to create inter-departmental committees and groups, and to engage in a process that they often see as annoying, limiting their powers. Decentralisation can also be rewarding as they can influence the final outcome and through that, be in a position to prevent measures that can be damaging to the overall project. However, decentralisation does not only foster co-operation between bodies within the public sector (widely defined) but also between the public and private sectors, with the full engagement of civil society infrastructure. It is generally perceived that elected public officials will be more likely to co-operate with businesses than civil servants; but this is not something that has recently been documented. The belief stems from the fact that the State had a monopoly or near-monopoly on many infrastructure projects, and that it is normal to expect civil servants to be rather reluctant to relinquish their powers. In contrast, members of locally elected bodies are often engaged in entrepreneurial activities themselves, or know local entrepreneurs and are generally interested in bringing local business (non-core public services) to local enterprises. This can get out of control, as the early American experience has shown and contracts can be granted to relatives, party supporters and others who would not be winners in a competitive tender if one were organised. So, partisanship and cronyism are serious defaults of the decentralisation model in the area of local provision of non-core public services.

The usual solution is to strengthen multi-party local government and ensure that local governments have opposition parties represented, and they should be able, in the long run, to ensure compliance with regulations and to play the role of whistle-blower, if and when necessary. However, if there is a closed circuit of local politicians changing offices, which is especially likely to happen in small communities, even the opposition can be lured to keep its silence, through sharing lucrative contracts with those in power. Buying-off the opposition is often a norm of behaviour at the local level of governing. However, one should be aware that these problems really make sense only if formal decentralisation is followed by real fiscal decentralisation. If formal decentralisation is not accompanied or at least followed by fiscal decentralisation, it is most unlikely that local governments will have the capacity to finance the discharge of delegated and *de jure* original functions.

Decentralisation can be promulgated by law, but cannot be exercised if the law is the only driving force. It is expected that the 'decentralising society' will ensure the existence of a number of so-called structural concerns, such as transparency, openness, accountability, probity, well-supervised financial systems, social programmes, and violence and social unrest (i.e. the lack of). It is very difficult to say what should be 'the right mix' of these seven 'concerns', but it is clear that in their synergy they ensure that the decentralisation effort will yield some desired and meaningful results. It is believed that transparency can make the overall government processes more visible and intelligible to ordinary citizens. The shorter the power distance, the easier it is for people to control their representatives and, via elected politicians, supervise the civil service and the way they apply the law and discharge their functions. However, increased transparency may have adverse effects. People may believe that increased transparency is only a decoy and that nothing in fact has changed. Also, making some actions transparent in developing societies may have an adverse effect, as we may not be really sure of people's final reactions. For instance, the disclosure of very low-ranking civil servants' salaries could be perceived as an implicit call to offer a bribe. Transparency is related to openness. With the sharing of information between interested stakeholders, the system becomes more open and meaning becomes more inclusive. Citizens can approach different legislators, different regulators and influence them. The increase in communication intensity between citizens and governments of different levels ensures a more open system.

With the increased rights (through delegation), the issue of accountability unavoidably emerges. Accountability is one of the categories that is very difficult to define, despite obvious linguistic clarity. Being accountable means, in brief, being responsible for one's own actions, and the resulting outcomes and outputs. With the shortening of the power distance, the locally elected officials are perceived to be more accountable as the local community knows them well and they are, anyway, part of that community. The pressure is not only on locally elected officials, but also on detached civil servants who are suddenly supervised by locally elected politicians. However, one should not be under the illusion that the very promulgation of formal accountability will mean the creation of an accountability framework. It will take a lot of time, effort and resources before the accountability system becomes properly rooted within a transitional/developing society.

The problem of probity has not been resolved through decentralisation. Corruption outlived decentralisation but, if the latter is well-implemented, there is a chance of ensuring that corruption will not increase (perhaps decrease). Locally imposed democratic control ensures better allocation of scarce resources and enables the public participation in the decision making process, preventing

to some extent the emergence of corruption. With well-rooted democratisation, the problems of corruption should diminish.

Decentralisation may make sense only if accompanied by fiscal decentralisation. This is a necessary requirement for successful decentralisation. Local/regional (or in one word 'sub-national') level governments cannot perform any functions if not given material and other resources to meet their targets. With the capacity to deliver, the issues of accountability will be unavoidably raised. As a rule, regional and local governments have limited funds. As the local revenue base is usually pretty thin (inadequate and/or inaccessible), sub-national level governments are very dependent on inter-governmental transfers. Those transfers invoke both administrative and economic costs, but are necessary in the vast majority of countries, especially in transition and developing countries. Fiscal transfers can be one form of inter-governmental fiscal co-operation, but the central governments, as a rule, are very suspicious of the local/regional government ability to manage funds (delegated or not) in an effective and efficient manner. This is especially a problem with delegated ministry budgets allocated to the Ministries' regional offices, which should be under the scrutiny of locally elected officials. The resistance to delegation exercised by well-entrenched civil servants is one of the main reasons why local public government finance decentralisation and building the capacity for local revenue raising abilities of local/regional governments (see Šević, 2005) reforms have been lagging behind all other reforms in former communist societies.

Decentralisation should also support the development and implementation of social programmes. Again, social programmes can be 'hijacked' by elites who may focus on ensuring their dominance at the central level, which can then hamper the position of unprivileged people (see: Fabian and Straussman, 1994). Decentralised bodies may decide on committing funds to infrastructure projects, rather than social programmes, especially in rural and under developed areas (see: Dillinger, 1994). However, decentralised bodies may be more effective and efficient than central bodies in the selection of beneficiaries of social programmes. In an ideal situation, local officials should consult the wider community in the process of selecting beneficiaries, but in practice, this often does not happen and people are still fairly rarely involved in adapting social programmes to their local conditions. Another issue to be considered when developing decentralisation programmes is the (eventual) existence of violence and social unrest. If there are serious problems with the upholding of law and order, accompanied by serious social unrest, it is very difficult, if not essentially impossible, to ensure the introduction of decentralisation programmes. In contrast, decentralisation can be a solution (or part of it) in the situation where social unrest is a reaction to under-representation of various regional and national groups. It is claimed that

decentralisation can spark political competition and conflict, but it can also calm already initiated competitive processes (see: Robinson, 1988).

Decentralisation should improve access to education, health and water. It can enhance the outcomes of these programmes, as the main stakeholders are more capable of defining their local needs than a bureaucrat in the central office. Specialised local knowledge and local arrangements for management of the decentralised programmes should ensure both the effectiveness and efficiency of the delegated programmes (see: Narayan, 1994). Decentralisation can be a tool to alleviate poverty; especially poverty arising from disparities between different localities and regions. Poorer regions in a decentralised model can be given additional resources which should ensure their capacity to deliver. Also, decentralisation should provide elected representatives from poorer areas with democratic legitimacy and ensure that they are heard, something that may not be the case in a centralised system, driven primarily by contributions made to the state (central) budget. However, whilst decentralisation may assist in eradicating disparities within localities and regions, it cannot address the problem of inequalities between those regions and sub-regions. In other words, decentralisation cannot be a replacement for regional policies and other forms of ensuring equal and sustainable development within the country in case. The political organisation of poorer people within the country may not be the consequence of, or something stirred up by decentralisation, but this action certainly enables underprivileged groups to exercise some social (political) powers within civil society and to ensure that the main social problems are focused upon and addressed to some extent.

Decentralisation supports and influences a range of other developmental concerns. If employed properly, democratisation should foster sustainable development, as people at the grassroots feel that they have to preserve their inner environment and ensure that it will be sustainable in the longer run. This is especially important with natural resources projects and they are of the utmost importance for overall societal sustainability. This social influence can be far better exercised at local government level. Decentralisation contributes to monitoring government performance, as local residents are interested in the outcomes of government policies that influence their immediate environment. Engaging local stakeholders should ensure a focus on longer-term perspectives on policies, where locally elected politicians have to take into account how their local electorate feels and whether they are satisfied. This leads to better sequencing of policies, programmes and projects.

Decentralisation is an indispensable element of any democratic public administration reform. Properly defined and implemented central government reform requires a rethinking of the organisation of sub-national level governments and of the authorities vested in them. It is also observed that decentralisation (at least, in central and eastern European countries– CEECs) played an important

role in assisting citizens to tolerate the stresses of economic reform. Local elections may give the impression to citizens that they actually better control their destiny and the way in which government functions are performed. Evidence from many countries has shown that well-executed decentralisation really enhances government legitimacy and popular support. However, as we have already pointed out, decentralisation in the political sphere has to be accompanied by decentralisation in the fiscal sphere. If decentralised bodies are to be starved of financial and other resources, then it is most unlikely that the decentralisation experiment will work. The decentralised (delegated) bodies need sufficient funds to break down popular distrust in government and government activities, especially if pure liberal or rather libertarian views are employed in the country. Also, fiscal decentralisation should not only be seen as an exercise in which tax collection is delegated to local governments. Central tax bodies should use their organisational structure to detach some units and attach them to local governments. Fiscal decentralisation must develop a clear-cut model for sharing resources, and defining the rights and duties of both central bodies and sub-national level governments and their bodies. With the delegation of duties, the financial resources have to be committed. The allocation of resources for recently delegated duties should have, as a point of departure, the existing financial model and the amounts that were allocated in the central budget and actually spent by the central bodies in meeting these obligations. Certainly, through delegation and decentralisation the central government may try to control expenses, which should be supported, but the sub-national level government and their bodies should not be left starved of cash and unable to do what is expected of them. Therefore, in order to ensure that decentralisation works, it is necessary to devise an effective and efficient fiscal decentralisation model.

1.3 Fiscal Decentralisation and Delegation

Decentralisation cannot exist only in the political sphere, but must be accompanied by fiscal (financial) decentralisation. Fiscal decentralisation assumes empowering sub-national level governments to collect fiscal revenues directly, and through inter-governmental transfers. As the latter are larger and more important (at the current stage of decentralisation in many developed and all developing/transitional countries), they present the main sources of finance for local and regional government. Also, when they are transferred by the central government, the level of accountability is higher and the central government is more interested in monitoring performance and spending allocations, than with the original local/regional government revenues (primarily local taxes, charges and fees). Inter-governmental transfers, as a rule, are the major source of local government revenue in fairly centralised countries and unified (non-federalised) states. Inter-government transfers allow the central government to retain control over the fiscal system, whilst at the same time offering financial support and the

illusion of financial independence to sub-national level governments, especially those at a local level (especially if directly elected).

An 'ideal' fiscal decentralisation would be a combination of both the sub-national government revenue sources and revenues coming from inter-government transfers. The former are to be, in principle, collected and independently spent by local governments (within the limits set out by the law), whilst in the case of the latter, the local government is accountable to the central government, which is ultimately responsible for the use of those fiscal resources. The original local government revenues (local taxes, user charges and fees) are usually introduced as a payment for a particular service provided by the local government. So, a citizen has the feeling that he or she received something directly back from the government for money paid. With general taxes, this is not the case. They go to one fund, and then, depending on the government spending policy, the resources will be allocated to the final uses. One of the aspects of this comprehensive spending policy is the allocation of centrally collected revenues to sub-national level governments.

Inter-governmental fiscal transfers take many different forms, and it is often a problem to define the best mix in order to achieve the best policy outcomes. There are good and not so good reasons for the introduction of fiscal decentralisation. The bottom line is that fiscal decentralisation cannot be politically dominated, although it can be (and usually is) politically triggered. The relative political power of a certain interest (pressure) group can initiate the process of fiscal decentralisation, and often influences the choice of decentralisation forms and instruments, but this should not be the main factor for the assessment of the success of fiscal decentralisation. A well-designed fiscal decentralisation model takes into consideration four criteria:

- 1) Vertical balance,
- 2) Equalisation,
- 3) Externalities, and
- 4) Administrative justification(s).

It is generally (and rightly) perceived that there is an imbalance between the expenditure responsibilities of sub-national governments and their original revenue raising abilities. The general rule is that in nascent states, the public sector focuses on ensuring (social) infrastructure development, provision of *basic* (public and quasi-public) *goods* and the protection of economic stability, and that only fiscal centralisation can deliver good results. As society develops, there is a significant policy shift, as the government (and societal) focus moves onto the services primarily delivered by local governments, such as social services, public utilities, etc. In those situations, the central governments face a serious choice of whether to improve local government capacity for the original revenue raising or to introduce and/or redefine the share of local governments in

centrally collected (and accounted for) revenues. In developed countries, the original sub-national government revenues are the most important source of revenue, as is the case in the US where transfer finance contributes less than 25 per cent to the total financial resources at the states' disposal. One of the reasons for fiscal decentralisation is to ensure the existence of vertical fiscal balance, which should close the gap between the revenues available to sub-national governments and their expenditure needs. This gap is something really difficult to estimate, as it is almost impossible to judge what the 'expenditure needs' of a government are. The usual approach is to agree the minimum level of service and to see that fiscal transfers complete the estimated gap. However, there is also a problem with the relationship between the reliance of local governments on fiscal transfers and efficiency considerations that have been taken into account when government funds are committed.

Equalisation is the second justification for fiscal decentralisation. In countries with economic disparities between regions, fiscal disparities are the rule. If the sub-national governments are empowered with revenue raising powers, this will simply confirm the economic disparities between different regions, if not widening the gap further. The only way to equalise inter-regional differences is to introduce inter-governmental transfers. The potential to equalise does not mean that equalisation will occur, or that equalisation is a good policy choice for a particular country. In deciding on an optimum equalisation policy, one must consider the question of how transfers will be financed, of what services are entrusted to sub-national governments and their remits, and what distribution formula will be used to allocate resources and of the justification for a particular formula choice.

Fiscal transfers are introduced to offset externalities. Local governments may decide to under-spend on services where there are substantial external benefits, if they are left to decide on their own. There are certain minimum standards that the central government puts forward for the nation as a whole, and sub-national governments may fall behind, neglecting the policy priorities of the government of the day. Conditional grants may ensure that the sub-national governments meet the minimum service level put forward by the central government. Externalities as a motive for fiscal decentralisation raise many issues to be considered by the policy-makers. First of all, how much subsidy is required? Then, how much expenditure response will be required from the sub-national governments? The answer to these questions will tell us the ideal size of the grant. Similar problems arise with multi-tier fiscal federalism. The grant given to an immediately lower level of government may not reach the level that is in fact responsible for delivery of a particular service. Therefore, using other, mainly administrative measures, the central government has to ensure the delivery of services.

Administrative justifications are usually politically motivated and legally defined. The theoretical underpinning is that the central government has a capacity to assess and collect taxes more easily than sub-national governments. Consequently, the argument says, it is cheaper for central government to collect taxes and then allocate revenues to different sub-national level governments. Although theory claims that centralised collection is more efficient, it may not be entirely true. Taxes and non-tax revenue sources that are closely related to local government service delivery are far more efficiently collected by local bodies than by the central government body. Local officials know people better, know their habits and financial situation and therefore are usually more efficient in collecting the outstanding tax dues. Also, the general belief that local fiscal revenue collection is, by definition inefficient, may hamper the fiscal revenue raising capacity of local governments, as the local government will not be interested in attracting tax collection and may not work on improving its general institutional capabilities.

However, in practice, often the listed four 'good' reasons for decentralisation will be overshadowed by reasons that are predominantly politically initiated. Intergovernmental transfers may hamper local government autonomy. The central government may decide to make all sub-national level governments exclusively reliant on inter-government transfers and, therefore, disinterested in attracting any revenue raising powers. Also, it may have adverse effects on local government fiscal accountability, in that local government will simply receive funds and spend them as central government wants, but will not feel responsible for the policy outcomes and outputs. Often this over-emphasis on inter-government fiscal transfers might be an attempt to maintain and/or enforce uniformity. For the sake of simplicity, central government may promote a policy of uniformity forbidding sub-national governments to differ in the ways they implement their policies and spend allocated resources. This is usually a problem in countries with strong bureaucratic traditions, where routines dominate policy implementation processes. There is also a possibility that the central government believes local governments to be inefficient and corrupt, as they are too close to their respective local community, and therefore too inept to collect revenue sources to the desired extent. Of course, it is possible that the local government may be influenced by the narrow interest of some prominent members of the local community, but this is also a possibility at the central level, where big businesses' interests are presented by very strong lobbies and lobbying companies. Also, what about the small and island states where the central government is similar in size to local governments in other jurisdictions (see: Šević, 2001).

The central government may devise inter-governmental fiscal transfers as a means of transferring a budget deficit to local governments. The primary duty on behalf of the central government is to set the objectives of the transfer system and to clearly state what is expected from the local government for that money.

There is always a vertical dimension to inter-governmental transfers (distribution between the central and local governments), but there is also a horizontal dimension, i.e. the allocation of transfers amongst the recipient units themselves. The central government has a few approaches to transfers. Often the size of the grant is determined as a share of some central government revenue source (often related to the aggregate amount of tax collected in a given territory), on an *ad hoc* basis, following a request by the local government and finally it can be done on the basis of cost reimbursement. As for the horizontal dimension, local governments may retain a share of taxes collected on their territory, or receive grants distributed by formula, cost reimbursement or an *ad hoc* method.

The central government has, for its part, to define the entire grant pool. There is the possibility of drawing on the resources of the central tax pool based on the principle of shared tax. The central government allocates a proportion of the entire tax collection to sub-national governments. A political decision has to be taken as to what taxes will be shared. Cross-country analysis will not yield a commonly accepted solution. The bottom line is that probably most countries will go for a share of VAT collections and a part of company tax. As the tax sharing system has to be somehow objective, a generally accepted formula has to be developed, taking into consideration the political realities in the country.

Ad hoc transfers may be appealing to the central government, as they can be allocated by the grace of the higher government, but their fairness can be questioned from quite a few standpoints. First of all, does the central government have all the information required to make the transfer, or only the information the local (sub-national) government is willing to supply? This system can lead to a serious problem with political cronyism and more effort can be put into lobbying than in really justifying requests put before the central government. Certainly, an *ad hoc* method can initiate problems of adverse selection and moral hazard. This model leads to uncertainty, which seriously affects the capacity of sub-national governments to pursue strategic planning. Technically it is appealing to central government as it provides flexibility outside changing the budget law, and exercising more powers than would otherwise be possible.

The cost disbursement method is in itself very appealing as the central government may define the level of service that it is ready to fund, although there is a possibility of not putting an upper limit, where the central government will fund whatever level of service is provided by the sub-national, primarily local government. Cost reimbursements are usually conditional, depending on the prior or ex-post approval by the funding agency. Developing a comprehensive model for cost reimbursement, the central government can clearly stipulate its priority areas and point local government in the desired direction, without using other policy measures. They can also ensure the uniformity of behaviour across the country, etc. However, they can compromise the local and central government priorities,

especially in countries where there is no culture of dialogue and public participation in policy making.

To ensure the horizontal balance, the government has to answer the question of how to distribute the pool of available resources. Usually, governments go for the derivation approach, as we have pointed out earlier. The total grant pool is determined as a share of a national tax, and each of the local governments will be entitled to receive an amount based on collections of that tax within their geographic boundaries. The derivation tax model is very popular with transitional and developing countries as it is believed that they may improve the efficiency and effectiveness of local tax collections. However, it does not seem that all the taxes can be subjected to this model, especially in those situations where local governments can influence behaviour in such a way that can shift the burden on residents in other sub-national jurisdictions. However, the papers presented in this volume show that shared revenues or derivation based tax revenues in fact do not increase the effectiveness of tax collection, as the taxes are still collected by the central fiscal administration, even those that are nominally local taxes. Usually, theory states that VAT and company tax are not suitable for the application of the derivation approach. Also, the derivation of taxes does not ensure equalisation, whilst shared taxes might stimulate some increase in tax effort, although this is not something that can be taken for granted. Derivation is very useful from a strategic financial planning point of view, as the sub-national governments can introduce better planning, although it may discourage local autonomy, as the central government decides predominantly on the mode employed.

The introduction of formula grants is another very common model, and often practised, especially in federalist countries. Theoretically, formula grants use some objective, quantitative criteria to allocate the aggregate level of resources available to sub-national governments. The formula is usually the result of negotiation and lobbying; although it must be based on some publicly endorsed objective criteria. This model requires a very high level of transparency to be publicly supported and therefore be effective. The positive outcome of the model's implementation has to be higher levels of transparency and higher levels of certainty, as the sub-national government can relatively easily calculate how much will be given to them. In deciding upon the formula, the central government has to decide on its elements, minimum data requirements and their quality and reliability, costs associated with the model's implementation and finally any conditionality attached to it. The formula must reflect regional specifics and needs, taking into consideration, amongst other criteria, population, physical factors, concentration of population, infrastructure developments and needs, the relationship of regional development level to the overall country development, etc. The second approach to the formula model revolves around income, as the model tries to ensure more money for jurisdictions that have a relatively

weaker capacity to collect taxes. Consequently, the model attempts to allocate funds according to the level of average income in the area, or to the level of some indicator of the size of the tax base. This is trying to figure out what tax would be raised locally, if the national benchmark criteria were to be employed. But, one should not neglect the measure of tax effort. Some sub-national governments may work hard to ensure tax compliance in their respective areas and, in doing so, may raise more revenue than otherwise. This should be awarded in the model. The formula model can also reflect the difference between revenue raising capacity and expenditure needs. If this is done, a standard must be introduced for the normal level of revenue and normal level of expenditure. This targeted benchmark level can be linked to the past with some adjustments, or can be a result of the policy orientation of the government.

Transfer formula models usually face problems with data, and this represents their biggest difficulty. Some data may not be available at all, whilst others can be modified in order to yield the desired policy outcome. Some data may be limited in terms of geographic coverage, and may not be available in other jurisdictions and therefore can prevent comparisons. Administrative and monitoring costs in the case of formula models must not be neglected. There is a need to maintain a large national database, and this is the cost that is often forgotten with the general belief that it will be borne anyway by the central government in its pursuance of national statistical functions. There are also costs of processing data, calculating variables that behave outside the main model, specific problems with some jurisdictions that stem from their political importance, remoteness, different cultural standards, political astuteness, etc. As formula models have to be calculated every year, the costs of monitoring are also to be considered. It is difficult to perceive the formula remaining unchanged (and unchallenged) for a long period of time... In order to deliver the best, the model has to be challenged every year and performance measured against current policy objectives on a regular basis. If the model (that is formula), remains unchanged for a number of years, there will be a big problem with the objectivity of the model and relevance of the policies promoted by it. Therefore, regular periodic evaluation of the formula model is not only recommended, but also required. In the process of review, both the method of determining the grant pool and the formula used for distribution have to be challenged.

Some grants can be block grants and as such are given to local governments to spend as they see fit, of course within the general guidelines provided by the central government. However, some grants may have conditions attached to them, and then sub-national governments have to ensure that the money is spent in a manner requested by the central government on the purposes outlined by the central government. In other words, conditional grants are generally based on the reimbursement of costs of specified services, and the central government, in

this case, accepts to reimburse the entire or part of the costs incurred in delivery of that particular service. The central government may put forward the list of costs that it is ready to reimburse, or it can opt for an open-ended solution, where all technically eligible costs will be covered without many questions.

Full reimbursement may be justified in some cases, especially those where central government is interested in having a particular service delivered to the population, due to various reasons (international, political, moral, etc.). The idea in this case may be to stimulate the provision of certain services by effectively lowering their marginal cost to nil and by requiring a minimum level of service. Often this is done with local teachers' salaries in many both developed and developing countries. Central government will cover teachers' salaries, whilst local governments will bear school general maintenance costs. This may make the life of local government easier, but at the same time it does not force them to play a proactive role and try to control the costs and deliver services more efficiently (assuming that effectiveness is already there). The solution may be introducing the policy of matching funds, where the central government pays an amount which equals the commitment of the local government. Conditional grants require, however, regular evaluation and re-assessment, with periodical redefinition of the targets that sub-national government has to achieve in order to be funded in the future.

Central governments often resort to *ad hoc* distributions. The government can give grants from one large pool, determined by a shared tax, or simply have some resources set aside and those distributed on an *ad hoc* principle. Horizontal equalisation aims can be more easily achieved if the *ad hoc* method is applied, as the executive retains some flexibility in distributing resources when and if needs emerge. But, again, an *ad hoc* method can be based on judgement more than on objective criteria, and, therefore, the logic behind it can be seriously questioned, as it leaves the way open for corruption to emerge. Nevertheless, an *ad hoc* principle is very useful if special needs emerge, such as natural disasters, riots, etc. and local governments themselves cannot cope with newly emerged situations. Also, major economic downturns, and major infrastructure projects of (relative) national importance are amongst those items that *ad hoc* grants do support very well.

The usual problem in grant transfers is the issue of equalisation. The question is always what the objectives of equalisation are and how far one should go in 'equalising'. One may consider, for instance, income levels, fiscal capacity, expenditure needs, state of development, etc. A related issue is the level of tax effort. It is possible that local governments may lose motivation to be more effective in collecting revenues, expecting the central government to cover the gaps. All these 'political' issues are normally reflected in the formula and consequently are the result of a serious negotiation process and objective criteria can be somewhat

murky in the very process of designing the formula. It is general believed that the grant transfer models which are based on formulae will be effective in equalising, but there is very little (if any) empirical evidence to support this claim. As some contributors show, there is, in fact, very little equalising in formulae, despite the claims of their equalising qualities.

There are also issues as to what extent local government should lay their hands on collected revenues and, if so, should 'less fortunate' sub-national governments participate more in tax sharing than those that are richer and more urban. Further, there are problems with the conditionality of grants and to what extent the set conditions are a motivation instead of an instrument of blackmail (for short-term political gains). Certainly, the improvement in transparency may solve some problems with the incentive structure, but also may clearly show the arbitrariness of *ad hoc* grants and the process of their distribution. The process of monitoring resolves the problem, but then the question remains of how one should design the monitoring process. So, all in all, there are too many problems with the design of the model for inter-governmental transfers. There are too many issues raised and too many, fairly diverse, interests to be observed.

Financial supervision is a form of monitoring. However, it is not simply a compliance type monitoring, but a fairly broad review of the activities of local government comprising both the fiscal activities that are originally entrusted to the sub-national governments and those that originally belonged to the central government, but that have been delegated to the sub-national governments.

1.4 Conclusion

Decentralisation has been a very popular move in many countries around the world, both developed and developing (transitional) throughout the 1990s. In many cases, it played an important part in introducing and/or strengthening accountability, whilst in others it was a fashionable, politically motivated move. In the West, strengthening local government capacity and ensuring accountability for shrinking public funds was the primary, if not the only, reason for decentralisation, whilst in the East (Europe) this was perceived as an important move in the process of democratisation of former socialist societies.

The socialist state was omnipotent and highly centralised, so the process of reforming the state required smaller units and fewer layers of government to ensure the effectiveness of reform. Reforming the highly centralised socialist state without some decentralisation was difficult, if not impossible. Therefore, decentralisation in CEECs was both the need and the fashion. Decentralisation ensures that democratic forms of governing are employed, and local people have their say in local matters and that local needs can be locally met, ostensibly in the best and most efficient and effective way. As a theoretical concept, it has worked rather well, but in practice there were some difficulties in empowering local citi-

zens and ensuring their active participation in governing local communities. The initial steps in decentralisation ensured the transfer of 'ownership' (in the widest possible sense— as final transfer of complex economic, political and public policy rights) from central government to sub-national level governments, primary local governments (cities and municipalities). Local governments have become primarily responsible for a number of public services and distribution of a wide set of public goods. Central governments opted for a number of responsibility-sharing solutions, which made delineation of responsibilities difficult and somewhat complicated. For instance, central government may accept the responsibility of funding salaries of teaching staff in primary schools (via the Ministry of Education), whilst local governments should cover salaries of technical and other non-teaching staff, and some material expenses. Of course, this example is still straightforward, as there are a number of more complex solutions in a number of countries, where certain costs in one case can be covered by the central government, and in another situation paid by the local government.

Unfortunately, political (democratic) decentralisation has been followed by very long delayed fiscal decentralisation. Local governments in a number of countries received more powers, but were forced to fight over the resources to fund the execution of their newly acquired rights. It took some years to secure steady revenues to fund their new functions, or to ensure the transfer of sufficient funds to ensure the execution of functions. However, one should make a clear difference here between delegated (entrusted) functions by the central government, and those original functions that local governments execute *per se*, as defined by law. In the former case, the central government will resort to transfer finance (grants), whilst in the latter case the local government should be fiscally capable of covering costs from local taxes and user fees and charges. The execution of delegated duties is always closely monitored, while the execution of original local government duties falls under general supervision exercised by the national government, as being ultimately responsible for the execution of the laws and well-being of the nation. Delegated functions can be revoked, often without any explanation, whilst central government intervention in the execution of original local government functions requires extraordinary intervention and usually assumes the organisational restructuring following the introduction of certain 'extraordinary measures' (suspension of local government bodies for a limited period of time, direct intervention of central government services in the execution of local functions, etc.).

Fiscal decentralisation in general assumes sharing funds. Central government can opt to collect all the funds centrally and allocate funds to local government following certain formula, or simply decide to go for a mixed system where certain collected revenues belong to central government, whilst others are original revenue streams of local government. Even when a legislator opts for the

latter, it may, at the bottom line, look like the renouncement of certain revenues by the central government, as some may see that fiscal component of sovereignty belonging exclusively to the central government as sovereign power over certain (national) territory. Whatever model is introduced, one has to be very careful with the choice of fiscal variables. Empirical estimation of ill-chosen variables may lead to deprivation of otherwise legally allocated funds, and create unnecessary social tensions in the country. The budgeting process in the public sector is a good example of a highly political bargaining game in which there are always winners and losers. The problem is that at the end, due, hopefully, to a properly introduced 'hard budget constraint' the final outcome has all the characteristics of the 'zero-sum game' result. Relative winners and relative losers may, in fact, be all losers if the scarce public sector resources are ill-distributed, and this wrongdoing initiates serious social conflict with high social costs.

Research reported in this volume deals with a number of current issues in different national jurisdictions. A number of case-country studies report on the existing and emerging legal (institutional) framework, different primarily nationally coloured solutions in revenue sharing arrangements in various CEECs, and analysed conflicting motives of sub-national level governments. It seems that, in certain countries, local governments prefer not to have original revenues, but to rely (heavily) on transfers from the central government. In such a system, the local population can blame the central government for underperformance, and the central government can always be called upon when allocated and transferred funds are not sufficient to meet the financial needs of good execution of local government functions. Although there is little empirical research conducted, one may claim with some certainty that over-reliance on grants and other 'transfer funds' may be a back-door for softening the supposedly introduced 'hard budget constraint'. If the central government can be blackmailed, it is most unlikely that local governments will build their overall capacity and be genuinely interested in improving their performance (primarily measured through the efficiency and effectiveness of the execution of entrusted functions). High fiscal centralisation or improperly introduced fiscal decentralisation (or in other words fiscal pseudo-decentralisation), accompanied by formally introduced political (democratic) decentralisation may lead to highly irresponsible governments and a blame game with the central government, especially if the national and local set of politicians come from different (competing) political parties or groupings.

Fiscally, poorly motivated local government may be a source of sabotage, as they may see obstructing central government fiscal efforts as supporting the interests of the local community (seen by politicians as a community of voters, rather than a community of socially responsible citizens), the foregoing supposedly existing 'national interests' as defined, by default, by the central government. Therefore, a fiscally engaging local government will think both of locally defined

interests and also of the interests of the larger community. In other words, if the affairs of the state are in good shape, there will be more room and scope for local governments to raise funds and perform better. The partnership, even in the form of competition between central and local governments, is better than passive, disinterested or constantly and continuously opposing local government. Financial (and/or fiscal) supervision, that should primarily ensure legality, should not be used as an instrument of political struggle between opposing central and local governments, but as a process of pointing out weaknesses in the system and therefore a source of useful information for definition of necessary corrective measures. Unfortunately, there are far too many examples where financial (fiscal) supervision exercised by the central government has been used for the elimination of political opponents in local governments and where politically opposing local governments were deprived (often irrationally, although maybe legally) of their share of revenues.

Reported research has shown that decentralisation in its classical form has been introduced with various levels of success in (almost) all CEE and CIS countries. However, fiscal decentralisation has been lagging behind and often it was pseudo-fiscal decentralisation, rather than real fiscal decentralisation. However, these findings have pointed out that it is a pre-requisite of successful decentralisation, or by some accompanying measure to work on fiscal and political capacity building of sub-national level governments. They may be in the game of governing, but it does not mean that they are ready for their supposed functions and this has been singled out as an important issue that has to be researched, following on from the research conducted and subsequently reported in this volume.

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2. Fiscal Decentralisation in the Czech Republic: Current Issues and Problems

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2.1 Introduction: Historical Background

The Czech economic and fiscal transitions to a market-oriented, decentralised economy and the country's progress towards local self-government (*samospráva*) have been noteworthy. They have placed the Czech Republic on the short list of countries aspiring to accede to the European Union. This is the second time the Czechs have approached membership as a modern democracy.

At the end of World War I, Bohemia and Moravia ceased to be part of the Austro-Hungarian Empire. Up until that time, they had enjoyed limited self-government and already launched their industrial development. When the Empire was broken up in 1918, Slovakia joined Bohemia and Moravia to form the Federal State of Czechoslovakia. That early and interim experiment in federalism gave the new federation the opportunity to experience democracy and begin a tradition of local self-government.

2.1.1 The Public Sector under Central Planning

The Nazi invasion and the Second World War disrupted the development of local self-government in Czechoslovakia. During the forty years of communist rule there was a strong nationalist sentiment in Slovakia and the principle of *samospráva* was in abeyance in both parts of the federation. During that period, the central planning of Marxist-Leninist socialism extended to the provision of local government services. These services were funded by grants from the central government and were generated by indirect taxation and transfers imposed on retail and industrial activities. Obviously, the assortment and quality of local services were controlled by the central government. Citizens of that era could hardly avoid being under the impression that the allocation of funds to local governments was influenced by political or party connections rather than by actual demands for public services. This approach to grants distribution generated a great deal of mistrust of the central government at the local level.

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2.1.2 Transformation change

The collapse of central planning in Czechoslovakia came two decades after the Prague Spring of 1968, which had culminated in the Warsaw Pact invasion of Prague. For a brief interlude following the December 1989 “Velvet Revolution”, the Czechs and Slovaks continued their partnership along the path of economic and political transformation. In their joint attempt to democratise, they inaugurated between 1990 and 1993 a number of common institutions, including a more western-style tax system. Then, pursuing long-latent, nationalist aspirations, the Slovaks had their accommodating neighbours dismantle the federation in the “velvet divorce” of 1993.

Although much had been undertaken since the withdrawal of Soviet troops from the region, reformers still faced numerous, complex problems. The ubiquitous, publicly owned and subsidised housing was in poor repair. Large, inefficient agricultural collectives dominated rural life and lands. The majority of retail trade was conducted in state-controlled stores. Industrial activity was a function of central ownership and planning. In short, there was no market to establish scarcity prices or to indicate the value of homes, farms and businesses.

The Czech Republic has successfully embarked on the path of transformation. It achieved relatively low inflation and unemployment and succeeded in avoiding significant budget deficits. Strong economic performance and rather effective macroeconomic policies were launched after the 1989 Velvet Revolution; prices were liberalised early, a far-ranging privatisation effort was implemented with fair success, and Czech export endeavours were reoriented towards the European Union.

There remains much to accomplish. The process of industrial restructuring has not been completed in the Czech Republic in spite of successes in the privatisation program. Important political forces sought to avoid transformation agonies through more gradual transition measures, intending to shield non-competitive firms from market shock. The Ministry of Finance and the banking system were not quick learners in a market environment that attaches importance to creditworthiness for loans. The finance ministry permitted the large, state-owned banks to keep less than profitable firms in business.

The Czech reputation for transformation success suffered in late 1997 when Vaclav Klaus was ousted as Prime Minister in a campaign finance scandal. The Czech government and its Finance Ministry had tended to ignore pressures to move ahead with the privatisation of the large banks. Since that time, progress has been steady, if not rapid. The banking sector, important because it will remain the primary source of investment funds in Eastern Europe for some time to come, is now approaching full privatisation.

The state of the banking sector has important implications for the development of the real estate market. Because scarce investment funds are vital for investment processes promoting development, relatively little money has been available for a home mortgage market. In part, the lagging development of a real estate market has reflected the reluctance of the Czech population to take on the obligation of long-term mortgages, thus constraining the development of demand in this market.

2.2 The Czech Property Tax and Fiscal Decentralisation

2.2.1 Multiplicity of Administrative Units.

Czech governmental and administrative systems, including the fiscal organisation, were composed until recently of only two tiers, the national centre and the municipalities. At the present moment, there are 6,234 independent municipalities in the Czech Republic, which is substantially more than were in existence in 1989. Directly after the Velvet Revolution, small communities were permitted to assert their independence, and they did so with enthusiasm. The problem with this large number of small municipalities is that it is very difficult to provide competent administration for them. Resource and personnel limitations are the common stumbling blocks in the effort to transform the municipalities of the former central planning countries into functioning, independent units of administration (Houerou and Rutkowski, 1996).

In the Czech Republic, this challenge seems to recommend either the administrative union of small groups of villages, and/or the establishment of an intermediate governmental tier to assist the municipalities with their administrative challenges. Czech authorities have recently addressed this problem by adopting 11 regional administrative units, the *Kraje*, to assume some of the functions of the centre and some of those of the municipalities.

2.2.2 Early Reform and the Legacy of Centralism

Another fundamental fiscal issue is how centralised the taxation system should be. In spite of the Czech Republic's post-revolutionary determination to achieve greater municipal independence, the Czech system has hardly emerged from the centralist era. Far too often, the central government in Prague still dominates intergovernmental relations; including the design and implementation of local fiscal policy matters by the Ministries of Finance and Interior. Nevertheless, the Czech fiscal system is changing.

The transition to markets required a more robust tax system than that of pre-revolutionary Czechoslovakia. For contemporary purposes, the ineffective, command-oriented fiscal systems required thorough revamping (Holzman, 1992). Preparations for a comprehensive tax reform were undertaken before the

1993 division of Czechoslovakia into two republics. Since the new system was modelled on the fiscal systems of Western Europe, it incorporated important elements of decentralisation. Although it was a clear improvement, the result was sometimes complex and distorted. It was particularly defective in failing to consider carefully the size of revenue flows required to satisfy national and local needs.

The Czech design aspired to achieve an acceptable balance between indirect and direct taxation. This is a particularly sensitive issue in the aftermath of the fiscal system of central planning, which had completely veiled taxation from the public view. It took considerable administrative courage to abandon indirect and invisible tax sources, increasing in a dramatic way the impacts of direct taxation on the sensitive citizenry. Direct taxes produce 46 per cent of the central government's revenues even today, while indirect taxes generate 54 per cent. The highly visible personal income tax, introduced in January, 1993, has rates ranging from 15 per cent on an annual tax base up to Kč 84,000 and up to 40 per cent on an annual base greater than Kč 756,000. The general corporate income tax rate is 39 per cent.¹

2.2.3 Property and Property Tax in the Czech Fiscal Reform

The property tax, of course, has the potential for being the most significant tax for local governments, especially for small ones. It is especially important for the autonomy of local governments. It provides for financial independence in both design and implementation. In the Czech Republic it has certainly not played its potential role, *i.e.*, providing a reliable source of revenues with minimal distortion of private allocation processes (Oates, 1996). The Ministry of Finance proposed changes in property tax laws that would enhance its role and result in substantially greater revenue yields, but the initiative was rejected by Parliament. They plan to make another attempt to increase the significance of the tax in 2003.

Admittedly, even if the Czech "real estate tax" was increased from its low, symbolic levels to play a more significant role in the financing of municipal services, other taxes would still be necessary to help fund the many essential municipal projects badly needed in the transition countries. Nevertheless, the property tax would give sub-national governments more meaningful control over local fiscal affairs, satisfying an important requirement of genuine self-government. The fiscal system of the Czech Republic has been described as one in which there are no local taxes, because all policy prerogatives belong to the centre (Kameníčková, 1998).

Early on in the transition process, the central government transferred significant numbers of (especially housing, but also some business) properties to the Czech Municipalities. In part, these could be sold off to secure needed

1 Czech Taxation in 1997 (Prague: Trade Links, February, 1997), p. 9.

revenues. Property sales are, of course, a non-recurring revenue source that will not indefinitely sustain an adequate cash flow. The municipalities were also able to generate revenues if they would incur some debt when faced with revenue shortfalls. As we will see below, the Finance Ministry of the Czech Republic has been understandably concerned about the growing prevalence of leveraged municipal activities.

A new tax law was proposed by the Ministry of Finance in 1996. The proposed, but never passed, legislation was to address the issue of the municipalities' unsatisfied revenue needs. The proposal suggested the possibility of more serious application of the property tax, targeting increased yields by as much as a factor of three. It also suggested that the "fees" charged for local government services are reclassified as "taxes", and that their levels be increased to generate greater revenues.

While the finance ministry was anxiously attempting to limit the amount of debt local governments were permitted to carry, the local governments were concerned about very meagre budgets. Deficits grew rapidly over the past few years for a number of the municipalities. It was proposed that the distribution of taxes from the central government be modified. The share currently accruing to the municipalities varies substantially by tax type, but sentiment grew for the provision by the centre of uniform revenue shares from all tax sources for the local governments.

2.2.4 Administration of the Property Tax and its Role in Decentralisation.

Important for the effectiveness of a property tax are the institutional questions: who establishes property tax policy and who administers the tax? Policy issues include such things as the types of property included in the tax base, the rate applied, and the revenue importance of the property. Questions of administration include the valuation of the property, record keeping, and the actual tax collection. The level of government responsible for each of these administrative and policy tasks is a matter usually determined more by central decision makers and tradition than by municipal or district governments. Exhibit 1 provides a topology illustrative of the tradeoffs countries face in establishing the participation of local governments with the nation.

Exhibit 1

Property Tax Policy and Administration

Central Government	Central Government	Sub-National Government
	Czech Republic France Sweden	Netherlands
Sub-National Government	Germany United Kingdom	United States Japan

Policy: (determining types of property included in the tax base, the tax rate, and revenue importance of the property record keeping, tax, etc.)

Administration: property valuation, collection, etc.

Source: William Dillinger, *Urban Property Taxation in Developing Countries. Embellishments by current authors.*

In the United States property taxation has been decentralised with respect both to policy and administrative issues. In other countries, like the United Kingdom, part of the process is centralised while others are not. In the Czech Republic, obviously influenced by the previous regime's centralist inclinations and traditions, both functions have been centralised. Fiscal decentralisation has not been an event following the end of the central planning regime, but a process of rediscovery. And it is unlikely that the process would have made as much progress as it has to this point, had the possibility of accession to the EU not changed perspectives and motivations to a very great extent.

The Czech property tax has not been affected by the influence of the EU as much as would seem desirable to the present authors. Policy is set at the national level and the administration of the tax is under the direction of the central government. Naturally, the four models in Exhibit 1 all have their advantages and their drawbacks. The major disadvantage of the decentralised approach is that local governments will not likely have the technical ability to administer the property tax. In the absence of district administration or government, the centralisation of administration is essential where such competence is lacking. Centralisation is also disadvantageous in that the central government does not benefit by any revenues from property tax collections, so that policy and administrative issues do not generate incentives that will prevent the centre from treating the property tax with indifference.

2.2.5 Strengths of the Property Tax for the Czech Republic.

Some rather thorny problems must be addressed when municipalities set about to operate a property tax system that is more than nominal in its scope. Obviously it is a highly visible tax, one that was kept nominal under the Marxist-Leninist regimes, since limited credibility of those regimes made it desirable to avoid public opposition on tax questions. But in spite of this legacy and the natural tendency

for the public to oppose property taxes, there is much to recommend them. A tax on real property might well “make good sense as part of the tax system as a whole” because “the property tax scores quite well in terms of both its efficiency and its equity aspects” (Kameníčková, 1998).

Can it be denied that successful fiscal decentralisation requires independent municipalities? Can such independence be achieved without access to independent revenue sources? If all revenue sources are derived from transfers from the centre, will such transfers be available without the accompanying influence of the centre? It is the view of the present authors that independent revenue sources are indispensable if the municipalities are to have a measure of policy independence in fiscal issues within their own jurisdiction. Anything less than this is likely to leave cities and towns dependent on the state, under-funded and incapable of meeting the demand for local services, or both.

Central and Eastern Europe’s countries in transition have perceived a fairly standard set of taxes and user fees to be well suited for their local governments. They have not generally felt the property tax should be increased from traditionally low, rather symbolic levels. Current levels, however, are not sufficient to provide genuine assistance in the delivery of municipal services or to perform the necessary administrative tasks.

We freely concede that revenue transfers from central governments would not become unnecessary in transitional countries, even if property taxes were significantly increased, unless the mix of taxes used by local governments were strongly enhanced, presumably by shifting other major kinds of taxation from central to local jurisdiction.

Nevertheless, a genuine form of self-government for regions and municipalities has not been achieved so long as the centre maintains complete control over their policy matters with regard to fiscal issues. This has particular bearing on the Czech Republic, for its tax system has been characterised as one in which “there are no local taxes”. The significant features of all of the various Czech taxes are determined by the central government or by the national parliament.² It is fair to say that all policy prerogatives belong to the centre in the Czech Republic, although with the establishment of the districts as a part of Czech regional policy, and with the announced determination that these districts will become independent (not merely endowed with the responsibility to perform tasks of “state administration”), change is certainly still possible.

2 Věra Kameníčková, “Jak jsou na tom obce v České republice?” Prague, Ministerstvo financí, Czech Republic, November 1996, p. 16. She writes “As a result of this, a discord occurs in local budgets between the authority and competence of the municipality on the expense side which is rather high, and the competence on the income side which is very limited.”

We will substantiate below the observation that if municipalities currently wish to enhance available revenues, they must seek opportunities from sources other than taxation. It is possible for them to sell off properties transferred to them by the central government. Likewise, they can incur debt should they encounter shortfalls in revenue. These sources are fraught with some potential peril, however, since the privatisation of property represents a non-recurring revenue source that cannot provide a cash flow that is sustainable and since loans must also be used with prudence.

2.2.6 The Base and Rate of the Czech Property Tax

The base and rate of the tax on real estate determine the tax yield. Czech tax legislation includes both land and buildings in the property tax base and the valuation of each is undertaken separately. National law prescribes the process by which the actual value of property is to be determined. Basically, the tax base reflects the floor space of buildings and the area of land plots. Tax rates, also centrally determined, differ for buildings and for land.

Local tax administrators can affect some modification of the basic principle that the property tax valuation of buildings and land is a derivative of their square-meter area as well as the size of the city and the type of the land or buildings in question. Admittedly, their leverage is not large, but local authorities do have some input in the final determination of tax revenues, which, of course, are not very large as an augmentation of total revenues available to the municipality.

Interestingly, it is the Czech taxpayer who actually performs the property valuation exercise and submits the form and payment to an office of the Ministry of Finance, making a personal calculation of the tax due. Self-determination of taxable value is even less common than the self-reporting of data which accompanies it. The level of this tax is such that (even when combined with the inconvenience of filling out the forms and determining the actual tax due), Czech taxpayers have not been sufficiently troubled to withhold compliance, or even to register serious complaints about it.

Czech taxpayers are provided with a manual that includes the property tax form and provides directions regarding the valuation of each type of building and parcel of property. When taxpayers pay their property taxes for a building, say, they start by using the following formula: the tax base of a building in terms of square meters is multiplied by a coefficient that accounts for the size of the city where the building is located. Consequently, the taxable value is primarily a function of the area of land or buildings in square meters, *i.e.*, valuation is *not* based on market prices. This non-market value system is unavoidable, given the lack of a functioning real estate market and of a corps of professional property tax administrators. Naturally, the system is also a reflection of a certain tradi-

tion; the property tax on private residences and farms is a legacy of forty years of communism.

Valuations of properties and buildings are adjusted by a coefficient for city size where they are located. The applicable coefficients follow the specific populations in parentheses: less than 300 citizens (0.3); 300 to 600 (0.6); 600 to 1,000 (1.0), 1,000 to 6,000 (1.4); 6,000 to 10,000 (1.6); 10,000 to 25,000 (2.0); 25,000 to 50,000 (2.5); 50,000 + (3.5); Prague (4.5). City tax administrators are permitted to adjust their municipality's coefficient up one level or down two. The city of Prague has the option of applying a coefficient of 5 to certain, well-located properties. For buildings with multiple levels, the number of square meters of each additional level is multiplied by a factor of 0.75 and added to the value of the ground floor base.

The final step in completing the tax form is the assessment of the amount due to the Ministry of Finance for the property. The taxpayers multiply their base by a suggested rate. It is stated in Czech crowns (KC) for buildings and ranges from one to ten crowns per square meter of floor space. The owner for each class of property then multiplies the base in square meters by both a rate and a coefficient for each class of property, including agricultural land, forests, fish ponds, yard and buildings plots, vacant plots, residential parcels, sites for garages and for summer cottages, as well as properties on which industrial, commercial and service institutions are located. The rate and coefficient reflect attributes of the land, *i.e.*, the location, the size of the parcel, and the use to which it is put, and they determine the amount of the self-assessed tax. The Czech Ministry of Agriculture estimates the productivity of land parcels and assigns an adjustment coefficient which is reported to local Cadastral Offices. The taxpayer calculates his taxes on the basis of the productivity coefficient he has obtained from the Cadastral Office.

After calculating the tax due, the taxpayer files the return and the payment at the District Offices of the finance ministry, which will enter data from the tax form into the Ministry's computer system. The computerisation of property tax records represents a significant accomplishment by the Ministry of Finance. As indicated earlier, the Ministry then transfers the property tax revenues back to the municipality of the taxpayer.

Although the burden of the property tax is relatively light in the Czech Republic, it falls more heavily on improvements to the land than on the land itself. Why improvements would be taxed at rates much higher than land is difficult to say, but it is probably a reflection of the political power of agriculture. In any case, it almost certainly also reflects a lack of appreciation of the potential benefits of taxing land at rates at least equal to those imposed on improvements.

Property tax exemptions that are standard in other countries are also granted in the Czech system. They are given separately for land and buildings. State-owned parcels, school plots, plots for military use, and plots for natural preserves are just some examples of lands qualifying for tax exemption. Forest land used for the transmission of natural gas and electricity is an interesting exemption, since in most countries the taxation of such lands represents a significant share of tax revenues raised on electric utilities and gas.

Finally, exemptions apply to buildings for state – and city-owned structures, churches, and schools. This exemption also affects publicly owned housing, which comprises about fifty percent of all housing in the Republic.

Czech property tax designers have attempted to encourage the construction of private residences by exempting new homes for a fifteen-year period. They have likewise attempted to smooth the transition to market ownership via privatisation. For older individuals restored through restitution to previously owned properties, a credible claim of insufficient income is honoured by a fifteen-year moratorium from the property tax. All exemptions must be applied for annually. It is worthy of note that in parts of larger cities, these exemptions granted by local authority represent a major portion of the potential tax revenues. This is not the only instance of taxation in transition countries where social welfare concerns have led to exemptions sufficiently large that tax revenue adequacy might be imperilled.³

2.2.7 The Property Tax Contribution to Czech Municipality Budgets

It is not the growth of Czech municipal budgets that represents a fiscal problem for Czech cities and towns. It is the level of funds made available by the centre. As Table 1 reveals, in 1993 the aggregate of local budgets represented just 25 per cent of the national budget. It grew rather continuously, although it stagnated at about thirty percent from 1997 through 1999, reaching a high of 32.6 per cent in the year 2000. The Czechs have continually improved the funding through tax-sharing and grants since the end of the central planning era, and are now probably approaching a level of funding for the municipalities that corresponds to fiscal balance characteristic of contemporary democratic, decentralised societies.

3 See Holzman, 1992, p. 242, which indicates that the Czech Republic also grants exemptions on the VAT for consumer goods “with detrimental consequences for tax revenue.”

Table 1
National and Local Budgets: Czech Republic, 1993 – 2000

	1993	1994	1995	1996	1997	1998	1999	2000
Public Budget TR*	422	472	536	585	562	595	626	651
National Budget*	358	390.5	440	482.8	479.6	509	538	557
Local Budgets*	91.1	111	129.1	161.72	145.3	157.2	187.7	181.8
Local Budget as % of National Budget	25.45	28.43	29.34	33.5	30.3	30.8	30.9	32.6
State Grants to Local Budgets*	27.03	29.25	33.28	59.44	35.87	37.39	41.43	46.05
Grants as % of Local Budgets	29.67	26.35	25.77	36.75	24.68	23.79	22.07	25.33
Total Local Revenues*	101	111	129	162	147	162	188	181
Local Budget Expenditures*	90.1	112.1	132.3	171.1	150.5	158	173	190
National Budget Tax Revenues*	224.6	230.1	255.4	283	466	495	524	544
Local Budget Tax Revenues*	35.97	53.243	70.679	72.67	76.093	83.32	87.01	95.81
Real Estate Tax*	3.021	3.808	3.799	4.018	3.943	4.108	4.248	4.437
RE Tax as % of Local Revs (%)	2.99	3.43	2.95	2.48	2.68	2.53	2.26	2.44
#Provisional								
*Billions sk, ck								

Source: Federal Ministry of Finance, Czech Republic, and own author's data

Grants provided by the national government have been more variable, viewed as a share of the local budgets such grants supplement. Table 1 indicates that grants have ranged from 22 per cent of total local budgets up to 37 per cent. Since 1993, grants as a share of local budgets have declined in five of the seven years and increased in two. So there has been a tendency to increase other forms of revenue transfer while grants have become marginally less significant.

Of great significance from our perspective is the relative insignificance of the property tax in the Czech Republic. Collected by the national government and returned to the municipalities, this tax certainly seems subject to moral hazard. The state is happy to keep this highly visible tax at minimal levels and receives little encouragement from the municipalities to make a serious effort to increase the property tax yield. The political leaders of the cities and towns are also content not to rock the boat by insisting the national government make a serious effort to identify properties and collect the tax. It is much easier to be satisfied with the revenue-sharing and grants the federal government provides. But this comfortable position does nothing for the political independence of the municipalities. With the state providing revenues for local, municipal projects, it is likely that they will have undue political influence on the determination of the nature of projects selected for funding. Municipal political independence, we believe, is not unrelated to the accessibility of independent financial sources.

As Table 1 shows, only in 1994 did property tax provide more than three percent of the total revenues available to local governments. In all other years from 1993 – 2000, its share was between two and three percent, increasing in three years, decreasing in four.

Other funds increase in volume and importance, while the real estate tax becomes less so, failing to increase rapidly enough to offset inflation.

2.3 Is the Czech Government's Relative Largesse a Substitute for Local Autonomy?

Many do not see the failure to implement a serious property tax as a problem for the Czech Republic. The municipalities have not really needed independent revenues, because the central government has supplied the sub-national governments with adequate funds. Compared to a number of transition countries, the Czech Republic has been fairly generous in supplying funds for the needs of the regions, districts, and municipalities of the republic. This fact is viewed by the European Union, it appears, as evidence for the proposition that the Czech Republic is developing satisfactorily as a modern democracy and should ultimately be admitted as a full member of the EU

It is the perception of the authors of this paper that this view is far too narrow. There are significant problems in the fiscal development of the Czech Republic's sub-national governments. The central government is quite slow in developing fiscally independent municipalities and regions (See: Bryson and Cornia, 2000); it is developing, rather, offices of what the Czechs term state administration. The centre too often establishes the policies, allocates the funds, and directs the local officers how to spend the money.

The local governments have had public housing (of poor quality and in need of major expenditures) turned over to them without the funds to maintain or repair them. Housing units may be privatised as a supplementary revenue source, but such activities are hardly the domain of local decision makers. Housing rents and tariffs on such public utilities as water and gas are still regulated by the central government, and they are held at levels below full cost recovery. Likewise, the salaries of local government employees are controlled by central government (Martinez-Vasquez and McNab, 1997).

Generally, municipalities have the responsibility to develop their own capital infrastructure. In the Czech Republic, local governments are still dependent upon the central government for the financing of capital expenditures, which is provided in the form of various grants and subsidised loans.

Currently, recently established regional governments are being phased in. They are to be funded for a transition period by transfers from the state budget. The regions have not yet been assigned clear expenditure responsibilities, but it is intended that they will inherit some of the state's responsibilities, *e.g.*, secondary education, regional planning and inter-city transport (Martinez-Vasquez and McNab, 1997, p. 6).

In numerous transitional governments, local governments have been constrained to become mere administrative agents as unfunded mandates have been assigned to them. The assignment of responsibilities without the corresponding resources keeps local governments dependent upon the state for transfers

in whatever form. In the years since the transition began, municipalities have become accustomed to having no independent operations based upon revenue sources that are significant and under their jurisdictional control. They have thus never broken free of their dependence on the state.

According to Oliveira and Martinez-Vazquez (2001) this situation is mitigated to some extent because the Czech Republic has generally avoided the imposition of substantial unfunded mandates on local governments. The central government has used specific grants to fund some activities left unfunded in other countries. Delegated functions usually obligate the central government to guarantee full funding and to transfer adequate resources for any new expenditures mandated to the municipalities. Nevertheless, there have been obvious exceptions to these rules. A recent transfer of the responsibility for issuing personal identification cards and passports to local governments was objected to when the funds were not transferred. A most famous case was the housing case referred to above, when funds were not transferred with responsibility. Then, when the state also retains control over the pricing of transferred service responsibilities (just another form of unfunded mandates), it adds insult to injury, which helps explain the soft budget constraint that develops for local government and the occasional need for bailouts. They cannot be expected to meet financial obligations if the responsibilities assigned to them have financial requirements in excess of available funds. The municipalities become hostage to their administrative directors in central government, but also avoid full financial responsibility.

2.4 Other Czech Taxes and Revenue Sharing

2.4.1. Introduction

VAT is the most significant of the Czech Republic's indirect taxes. Currently, it has separate rates for basic necessities (which are taxed at 5 per cent) and other commodities and services (22 per cent). The higher rate was for some time, at least, the second-highest among countries in transition (Oliveira and Martinez-Vasquez, 2001). Other indirect taxes are customs duties and the excise tax on gasoline, tobacco, and alcoholic beverages.

Czech personal and corporate income taxes are the most significant direct taxes. After tax revisions in 1996, 20 per cent of the corporate income tax yield is to return to the locality where it was collected. This windfall did not represent a net gain for the municipalities; the additional revenues had to replace 40 per cent of the wage tax yield thereafter transferred from cities and towns to the central budget. In any case, inter-jurisdictional revenue sharing is an established practice, as in other transitional countries. As observed above, it is based on the misdirect-

ing assumption that shared tax revenues should belong to the area that permitted their generation.⁴ The Czechs also have a road tax as one of their direct taxes.

In the Czech government's efforts to fund the cities and towns through other than the property tax, revenue sharing and financial grants are both very important. Table 2 provides data for an overview of these efforts. Let us begin by considering the aggregate of tax revenues accruing to the local governments as a percentage of the total of the Republic's consolidated government budgets.

Table 2
Czech National and Local Budget Revenues (Millions of Czech crowns)

	1994	1995	1996	1997	1998	1999	2000
Tax Revenues, State	349,027	391,228	439,186	464,087	495,232	524,765	544,142
Tax Revenues, Local	54,428	68,167	70,000	76,091	83,319	87,011	95,807
Consolidated budgets Total	401,503	457,022	506,202	592,474	575,836	608,585	636,618
Local Share in %	0.135561	0.149155	0.138285	0.128429	0.144692	0.142973	0.150494
Local PI Tax Revenues	48,716	60,096	50,818	54,503	58,581	60,078	63,501
National PI Tax Revenues	5,804	8,491	29,726	33,378	36,339	35,224	34,771
Total PI Tax Revenues	54,520	68,587	80,544	87,881	94,920	95,302	98,272
Local as % of Total	0.893544	0.876201	0.630935	0.620191	0.617162	0.630396	0.646176
Local CI Tax Revenues	128	3,145	14,139	13,361	16,232	18,773	23,470
State CI Tax Revenues	63,624	63,337	47,676	42,202	51,324	51,343	52,322
Total CI Tax Revenues	63,752	66,482	61,815	55,563	67,556	70,116	75,792
Local as % of Total	0.002008	0.047306	0.228731	0.240466	0.240275	0.267742	0.309663
Grants from National Government	30,980	34,803	61,504	35,839	37,355	41,374	45,939
Current	24,003	21,747	48,882	23,958	24,982	27,658	30,429
Capital	6,977	13,056	12,622	11,881	12,373	13,716	15,510
Local Rev & Grants Total	112,241	130,041	163,831	145,342	157,178	187,700	181,814
Consolidated Public Budgets	504,283	522,753	562,792	487,655	637,656	688,844	707,844
Local Share	0.222575	0.248762	0.291104	0.298043	0.246493	0.272485	0.256856

Source: Government Financial Statistics: Fiscal Data for the Czech Republic, Ministry of Finance, Czech Republic, and authors' calculations.

See the web site, <http://www.mfcr.cz/scripts/hpe/default.asp?VlfnSta>.

In 1994 local tax revenues were only 13.6 per cent of the consolidated budgets. Increasing to 15 per cent in 1995, the share then declined for three straight years, being lower at 12.8 per cent in 1997 than it had been in 1994. The next three years it increased again, reaching an all-time high in 2000 of 15 per cent.

4 Bird, Ebel, and Wallich (1995). They write of a "tendency for local governments to feel they have a primary claim on tax revenues generated within their jurisdiction", pointing out that such "Source-based taxation (also known as derivation-based) is unusual at the subnational level in market economies because of the inequities and inefficiencies that are likely to result from allowing subnational governments to keep large shares of the taxes levied on firms producing for a national or world market". (See p. 37.)

In fairness, it should be emphasised that the total resources available to Czech municipalities include far more than just the transfer of tax revenues and grants from the centre. The Czech national government, in transferring considerable properties in the form of housing and local enterprises to the municipalities, may have expected them to fund a good portion of their financial needs through the privatisation of these properties. In actual fact, some privatisation has actually occurred and revenues have been derived from such sales, but the total of such property sales has provided only a very small percentage, well under ten percent, of the total revenues accruing to the municipalities.

It is very interesting that in the early years of the Czech Republic, the centre turned over to the local governments a considerable share of the personal income tax revenues collected by the former. In 1994 the local governments received 89 per cent of such revenues and in the following year 87.6 per cent of total personal income tax revenues. In 1996 the share dropped to 63 per cent and remained at that level thereafter. Corporate income tax followed a contrasting pattern, with the centre initially transferring only a small portion to the municipalities. In 1994 only two tenths of one percent of corporate income taxes accrued to local budgets. Very soon, however, the amounts increased to the level of over twenty percent. From 1996 to 1999 it increased only gradually up to 26 per cent, and then it reached 31 per cent in the year 2000.

2.4.2 The Czech System of Inter-governmental Grants.

As mentioned earlier, grants from the federal government have been an important and increasing source of funding for the provision by the municipalities of the public goods and services they supply to their citizens. Since 1994, grants have represented around a quarter of the budgets of the local governments.

Grants from the federal government have been an important and increasing source of funding for the provision by the municipalities of the public goods and services they supply to their citizens. Since 1994, grants have represented around a quarter of the budgets of the local governments. They ranged from 22 per cent of total accessible funds in 1994 up to 29.8 per cent in 1997. From that point they declined to around a quarter of the total for the remainder of the decade, holding at 25.7 per cent in 2000.

Over the past decade, while the share of taxes transferred was increasing, the Czech national government was cutting back on transfers to local governments. The joint contribution of transfers and shared taxes stayed at roughly 70 per cent of local government revenues. It was, in a sense, a positive development that the municipalities became less dependent on state budget transfers, but it did not change the fact that a “meaningful degree of tax autonomy for local authorities was still missing” (Oliviera and Martinez-Vazquez, 2001). As compared to most other European countries, including other transition countries, the Czech Repub-

lic is rather unique in that it has no system of equalisation grants at the district or municipal level. Nor did the 2000 reforms make any provision for equalisation grants. There is, however, a complex system of conditional grants or subsidies transferring funds to the municipalities in pursuit of the central government's various policy objectives. The unifying feature of such grants is that they are targeted for specific purposes and that local governments must generally provide reports on the specific uses for which the funds were spent (Oliviera and Martinez-Vazquez, 2001). It should be emphasised, however, that the relative importance of earmarked subsidies continues to decline. These complex, earmarked subsidies provided only 24 percent of all sub-national government revenues in 1999.

Earmarked grants of two types fund current expenditure activities of local governments. The first type is for financing responsibilities legally delegated by the central government to the municipalities. These categorical grants must be spent on specific, well-defined programs and do not require any matching funds from the municipalities. Such transfers are generally distributed on a "per head" basis to cover outlays for social assistance and benefits, early education, hospital and assistance institutions, fire brigades, and the execution of general government services including registration and permits (Oliviera and Martinez-Vazquez, 2001).

Categorical transfers are used by central governments *inter alia* for redistributing fiscal resources, countering externalities, adjusting for vertical imbalances, and promoting local government expenditures in support of national programs. If unconditional grants were used rather than categorical transfers, central authority would demonstrate greater respect for the decision-making autonomy of local government officials. The nearly exclusive use of earmarked grants suggests the central authorities' belief that they have identified all local level priorities and that they simply possess better information on needs than local officers do.

A significant transfer of funds comes in the form of capital transfers from the central government general budget and from the State Environmental Fund. Normal capital transfers are designed for a variety of purposes, including *inter alia* including fire protection, natural gas distribution, schools, development of industrial zones, hospitals, water and sewerage treatment plants, and public transport. Matching funds are required of the municipalities for all centrally subsidised capital infrastructure projects except for the building of new social care institutions on properties the municipality has had to reconstitute to its original owners.

State Environmental Fund grants are for environmental purposes, *e.g.*, to fund water supply systems, to introduce gas, flood control, and energy conservation measures. Matching funds are required of the subnational governments at rates set by the state agency of at least 20 per cent. The State Environmental Fund total transfers in 2001 represented about 7 per cent of all transfers budgeted for that year.

The way specific transfers have been funded worked as a negative incentive for revenue generation by local governments, since the central government apparently reduces the level of discretionary transfers systematically as local governments increase their own revenues (Oliviera and Martinez-Vazquez, 2001).

To allocate grants conditionally and at the discretion of central authorities, as the Czech Republic does, tends to be less efficient and fair than through the use of objective formulas or well-publicised legislative procedures and criteria. Discretionary central systems can be distorted by pressures from lobbyists representing local governments or by parliamentary members defending or lobbying for local interests. Oliveira and Martinez-Vazquez (2001) suggest as an alternative to application processes on a project-by-project basis the evaluation of a comprehensive local government expenditure plan which then provides for funding according to the availability of funds.

2.5 Current Fiscal Issues

Some other issues that have been discussed in Prague have significant implications for the property tax, the potentially best source of financial independence for the municipalities of the republic. First, the central government has suggested that the cities and towns could reclassify the “fees” they charge for local public services to “taxes”, and expand their current range, assuring some increase in revenues. Second, the central government has decided to modify the distribution of taxes in its revenue sharing activity. The share accruing to the municipalities has varied substantially by tax type, and the government is now committed to the transfer of a uniform share of all tax revenues to local governments. This reflects the central government’s desire to reduce the disparities in the distribution of shares of the various kinds of tax transferred to local governments. Third, the centre has tried to impress upon the municipalities the hazards of irresponsible local government debt and have wanted to limit the amount local governments are permitted to carry. In the past few years in a number of municipalities, debt has grown quite rapidly.

The Czech Cadastral Office has also been working aggressively to modernise the cadastral system. Under the central planning system from 1948 to the early 1990s, the national cadastre was largely ignored. Records were not kept up to date and they were incomplete; real estate data submitted during the period were often left unrecorded. We were informed by cadastral officials that well into the post-Velvet period, as high as one-third of the parcels in the Czech Republic were not properly registered. In recognition of the essential information that should and will be available at the cadastre, the Ministry of Finance and cadastral officials are pursuing the goal of linking electronically the cadastral office and the Ministry of Finance. Modernisation of the national cadastre opens the possibility for the

implementation of a serious property tax, although Czech officials have not expressed any anticipation of or interest in doing so.

The issue of primary importance in Czech fiscal decentralisation is the flow of resources to the municipalities. There has been an ostensible willingness on the part of the Ministry of Finance to share fiscal responsibilities, especially for the provision of services, with the municipalities. It is less clear that there is equal willingness to share the revenues that those services require. It is only fair to say that the centre is facing its own considerable challenges in meeting the requirements of national finance. Although the national government is actually quite concerned with local resource requirements, and is quite prepared to discuss, to propose, and to respond positively to legislation that would improve the situation, the Ministry's financial constraints cannot be ignored regardless of any amount of good will. This reality does not make the financial situation of the municipalities any less difficult. In recent years they have been unable to depend on the centre for funds other than for current operations. Even those have too frequently been insufficient.

Property tax systems fall between the two extremes of non-market based arrangements on the one hand and systems with market-based tax valuations on the other. As a result of a privatisation process that has not yet generated a real estate market with scarcity prices, the present Czech system remains closer to the non-market type. As we saw earlier, those markets seem to be evolving very gradually, but many problems remain. In this housing market, social welfare concerns have left rents mostly regulated, especially for the large volume of dwellings that have not yet been privatised. Nor has the banking sector been healthy enough, given the other constraints, likewise of a social welfare nature, which have been placed on it, to finance a private housing market.

There is an intent to achieve a market-based system. But the government has not been able to move beyond the suggestion to adopt "market-driven coefficients" for all residential, agricultural, industrial and commercial land and buildings. The coefficients are being developed through cooperation between the finance ministry and the nascent Czech real estate industry. If this project is successfully completed, tax officials could estimate property values on the basis of the types and locations of homes and businesses. That hope leaves the Czechs still rather far from a market system, but it would certainly approximate market values more closely than is currently possible. It is hoped that this proposal could triple property tax revenues.⁵ This would clearly be a step in the right direction, but we won't have evidence demonstrating that for some time. Since the early discussions of this approach received a parliamentary blessing, fiscal and political crises of late 1997 and early 1998 caused the Ministry of Finance to turn its at-

5 Based on interviews with Ministry of Finance officials conducted in February, 1998.

tention to more pressing issues. Since that time the legislative proposals have not been given serious reconsideration.

Although Czech property tax revenues are modest, they represent some notable accomplishments. Their design and implementation have gradually developed a system that can be administered in the context of resources currently available to Czech public officials. Gradual movement in the direction of changing to a value-based property tax system has established a foundation that should contribute to the successful transformation of the property tax.

The choices for local governments have not been easy ones. The Czech national government has relied on the ability of municipalities to sell assets (*i.e.* to privatise the public housing and businesses that were transferred from the state) to supplement the meagre resources it was able to transfer. Unfortunately, the sale of such assets has had to occur at unfavourable prices because of the pressure on the municipalities to finance current operations. Moreover, when the centre transfers properties, it considers them to be an important asset for the newly enfranchised cities and towns, but at the same time such properties can represent a burden. Their deteriorated physical state suggests investments that the municipalities can scarcely afford. Too many local governments have been forced to supplement privatisation and transfer revenues by incurring debt.

Facing its own financial crises, the Czech government has tended both to reduce revenues flowing to the municipalities and to transfer to local governments service provision responsibilities heretofore managed centrally. Currently, the school system is an issue which may reflect this problem. The centre is currently considering the advantages of turning primary and secondary education over to local governments. That makes a lot of sense from the standpoint of local autonomy, but it is not clear whether the necessary funding would also be transferred, and the current property tax system does not come close to generating the financial resources that would be required.

We emphasise again that the funds available to the municipalities have been insufficient to meet current operations and to permit investments in the kinds of projects that will permit local governments to make the contribution that will be required for the balanced national development of a future member of the European Union. Currently, Czech municipal fiscal systems suffer a crisis culminating each year in the centre's budget announcement. When the state announces the transfer of funds to local governments, following an extended period of uncertainty in which the municipalities have been unable to complete their budgeting processes, its revelation that funds will be insufficient is no longer a surprise to local officials.

2.5.1 The EU and Ongoing Czech Centralisation

The institution which could easily place pressure on the Czech Republic to design and develop a fiscal system capable of delivering essential public services with acceptable quality in an environment providing genuine autonomy for sub-national governments. After the era of central planning, the Czech system retained its highly centralised character with local governments performing scarcely anything beyond central administration of delegated tasks. Moreover, the level of funding was low.

As reforms have been implemented, it is apparent that the Czech central government is willing to provide an acceptable level of transfers of funds and tax sharing so that the municipalities and the newly introduced regions are enabled to provide essential public services. The European Union, clearly on the basis of a continental tradition that is not overly concerned about a high degree of centralisation, apparently finds this an acceptable fiscal system for membership. It elects to ignore the lack of local or regional autonomy and the failure of recent reforms to address the problem.

According to the EU, membership requires that a country achieve:

- stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;
- the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;
- the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.

Clearly, it would be well within the rights of the EU to constrain more meaningful reforms on the Czech Republic, which could be expected to respond favourably to such demands, given its very strong aspirations for membership. Financial and budgetary institutions at the national level clearly do not guarantee the financial and political autonomy to local governments that democracy requires. Nor can it be said that the EU is really requiring fiscal decentralisation to which the EU pays lip service. In its initial report recommending the Czech Republic for ultimate accession to the EU, questions relating to the budgetary and finance systems were limited to the financial control system. Concern was expressed about the Supreme Audit Office created in 1993 and it was observed that the system of internal financial control of the Czech Republic did not correspond to EC provisions for member states. But the Czech government expressed its intention to improve budgetary control and the EC declared itself satisfied (Agenda 2000).

In the 2000 Regular Report by the Commission on the Czech Republic's Progress towards Accession,⁶ the Czech Republic:

- is commended for the strengthening of VAT controls by additional IT equipment;
- is enjoined to further efforts to strengthen administrative capacity in its financial control functions at all levels;
- is praised for the Act on Budgetary Rules, June, 2000, establishing the legal framework for managing budgetary relations with the EC;
- is censured for the Czech national government's poor management of EC pre-accession funds, having proved slow in formally requesting funds and in the implementation of funds granted;
- is castigated for ongoing weaknesses in the Finance Ministry in the areas of tax collections, and analysis of capital investment programs.

But the more serious, long-term problem of failure to provide for local autonomy is not mentioned as a subject of concern. The problems of unfunded mandates, the nature of financial transfers from the centre to local governments with extensive strings and controls attached, and disinterest in the property tax as a means of independent financial leverage are all testimony to the failure to take seriously the problem of local autonomy. The tradition of fiscal centralisation should now be celebrated as having a half-century tradition among the Czechs.

2.6 Conclusions

In the Czech Republic, the local tax initiative is both small and declining. Local revenues, including non-tax revenues generated by the provision of services and by their own tax collections, amounted to no more than 2.2 per cent of GDP from 1993–1996. Since then, it has fallen to 1.7 per cent. This compares poorly with member countries of the European Union such as Norway (12 per cent), Spain (5.9 per cent) Denmark and Sweden (17 per cent), Spain (5.9 per cent), France (4.4 per cent), and Hungary (3.8 per cent).

The Czech Republic's reformed fiscal system "has neither provided municipalities with additional meaningful sources of revenues nor introduced the necessary reforms of the real estate tax (or a broader concept of the property tax)". Municipalities must be assisted in acquiring the ability to make market assessments of urban properties, which will make the tax a meaningful source of local revenues. Institutions blocking the incentives and prerogatives of local government to secure and expand property tax revenues must be modified.

6 See EC 2000 Regular Report From the Commission on The Czech Republic's Progress towards Accession. See the website: http://www.europa.eu.int/comm/enlargement/report_11_00/pdf/en/cz_en.pdf.

Reforming the property tax would improve the level of both the autonomy and accountability of sub-national governments (Oliveira and Martinez-Vazquez, 2001). The reform of revenue assignments implemented in the year 2000 still leaves important, unresolved issues in the Czech Republic's system of inter-governmental fiscal relations. The Ministry of Finance retains the discretionary power to make fundamental budget changes through annual budget laws. To emphasise a point we have made previously and which is reinforced by the World Bank paper by Oliveira and Martinez-Vazquez, quoted extensively earlier, the 2000 reforms, previous reforms, and reforms currently under contemplation provide no effective incentive mechanism to mobilise local tax effort to overcome the dependence of local authorities on the centre and the tax-sharing revenues and transfers it provides. Thus, local authorities have an insignificant degree of autonomy over their own revenue sources, which invalidates their accountability to their constituencies. Moreover, as the new regional officers take up their fiscal responsibilities, they will find themselves likewise fully dependent upon the state budget, which nearly guarantees the rapid consolidation of regional subordination to central authority.

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3. Fiscal Decentralisation in Poland

Bartłomiej Gurba *

3.1 Introduction

This paper describes the two reforms of the intergovernmental fiscal system in Poland which took place during the last decade. The decentralisation reform of 1991 targeted self-governments at the local level, whilst the reform of 1998 targeted the regional and intermediate levels. The framework for this analysis is the definition of the concept of decentralisation and the classification of its three dimensions by Rondinelli (1981). The aim of the paper is to find out how deep fiscal decentralisation, i.e. the first dimension, is in Poland and whether it is soundly combined with the other two dimensions – political and administrative decentralisation.

According to Rondinelli, decentralisation is a transfer of authority and responsibilities for public functions from the central government to subordinate quasi-independent government organisations. Rondinelli makes the distinction between three different types of decentralisation: political decentralisation, administrative decentralisation and fiscal decentralisation.

Political decentralisation aims at giving citizens control over decision-making processes of local concern. In a politically decentralised system, these processes are executed by elected representatives dealing with local matters and informed about citizens' demands and preferences. Free and direct elections of sub-national governed bodies enable citizens to express their preferences and to vote representatives out of office when they do not keep their pre-election promises; hence such elections are the basic requirement for political decentralisation.

Administrative decentralisation transfers the responsibility for planning, financing and managing public services from the central government to its field units, regional or local governments. There are three major forms of institutional decentralisation: devolution, delegation and deconcentration. Ebel (1999) considers devolution as the most complete form of decentralisation. In this form, responsibilities for the delivery of services, finance planning and decision-making are given to independent sub-national governments. In the case of delegation, the sub-national governments are not fully independent. They are subject to supervision by the central government and/or financially dependent on it. Deconcentration takes place if the decision making process is transferred to local administrative offices of the central government.

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Fiscal decentralisation describes the system of local expenditures financed through local revenues, different types of intergovernmental transfers and borrowing. The share of each of these revenue categories in total revenues indicates the sub-national governments' dependence on the central government and hence the degree of fiscal decentralisation. The measure of this dependence is "vertical imbalance" and occurs when local expenditures are co-financed by transfers from the central government. This may happen because the central government wishes to internalise externalities¹ or achieve equity among local jurisdictions. The distribution of transfers among sub-national governments may differ by discretion. When transfers are distributed according to discretionary decisions of the central government and not automatically or according to predictable rules, the uncertainty and hence the dependence of local governments on the central government is higher. As a result, vertical imbalance is not a sufficient indicator for the dependence of local governments on discretionary transfers. This dependence can better be expressed by an index that considers the vertical imbalance and the institutional methods of transfer distribution.

The three types of decentralisation are closely connected with one another. Political decentralisation gives citizens control over the decision-making processes that work within the rules set by institutional decentralisation. At the same time, fiscal decentralisation results from decisions of elected politicians who act within a margin left by more or less decentralised institutions. What seems most important in this respect is the supplementary nature of political, fiscal and institutional dimensions. Parker (1995) recognises the impossibility of designing a single strategy for decentralisation and the importance of a sound combination of the three types of decentralisation – "like a soufflé that requires just the right combination of milk, eggs and heat to rise, so a successful program of decentralisation will need to include just the right combination of political, fiscal and institutional elements". In Poland, this right combination of political, institutional and fiscal elements is reached only at the local level. On the regional and particularly on the intermediate level, political decentralisation goes too far or – from another perspective – the institutional and fiscal decentralisation of revenues is not deep enough. The elected representatives of councils on intermediate and regional levels are responsible for fulfilling tasks that must be financed through revenues depending on discretionary decisions of the central government. The discretion of transfers index underlines that the intermediate level is most dependent on the central government.

This paper describes the three dimensions of the decentralisation process in Poland. Chapter 2 deals with the historical, economical and political circum-

1 Externalities emerge when the scope of provided services differs from the jurisdiction of a given sub-government. In this case services provided by a local government are used by citizens from other jurisdictions.

stances that influenced the decentralisation process after 1990. It explains the tradition of sub-national governments in Poland and the political motivations for initiating the two decentralisation reforms of 1991 and 1998. The depth of fiscal and administrative dimensions is then presented in chapters 3 and 4. The administrative decentralisation section contains many regulations that are important for describing fiscal decentralisation. These are presented in chapter 5.

3.2 Antecedents influencing the decentralisation process

Designing an efficient and clear system of intergovernmental relations seems to be one of the most important problems of the transition process in Poland. The reasons for this are of a political nature, particularly the different views on the final outcome of reforms, historical leftovers, and concerns about macroeconomic stabilisation due to the transformation process. It is these three factors that have influenced decentralisation in Poland since they were used by different political actors to change the course of the process in their direction.

3.2.1 Political circumstances

Political circumstances and developments divide the decentralisation process into three time periods: prior to 1991, from 1991 to 1998 and after 1998. 1991 is important as the date for establishing self-governments at the local level, while 1998 is important because of the decentralisation reform at intermediate and regional levels. The period during the communist era – until 1990 – will not be the subject of any detailed analysis, but the shortcomings of this and the preceding period will be briefly presented in order to gain a better understanding of the process.

At this point, it is important to characterise the main political powers in Poland and their orientation concerning the decentralisation process and inter-governmental fiscal relations.

The main parties in Poland are split into two “camps” which, until today, remain in strong opposition. “Post communist” forces include the Social Democratic Alliance (SLD), the heir to the Polish United Workers Party (PZPR) and the Polish Peasant Party (PSL), heir to the United Peasant Party (ZSL). “Post-Solidarity” includes parties that emerged from the 1980s’ opposition led by trade union “*Solidarnosc*” (Solidarity). The post-Solidarity camp had a majority during 1990–1994 in the Polish parliament and appointed governments. Under First Prime Minister Tadeusz Mazowiecki and Finance Minister Leszek Balcerowicz (Both from the Freedom Union), the camp introduced the first reforms and built the foundations for democracy and capitalism. Over the years, the camp began to split up into many small parties. These parties had very different programs and views, but can generally be divided into the more conservative and nationalistic group which became the AWS and the liberal and strong market and democratic-oriented party called the Freedom Union (former Democratic Union).

The conflicts within the post-solidarity camp and the high social costs of the first years of transformation, allowed the SLD to win the elections in 1994 and to form a coalition government with the PSL until 1998. Most internal reforms came to a halt during that time, but there was no tendency to move back to a communist regime. Both parties followed the free market and democracy principles and continued the western-oriented foreign policy of integration into the EU and NATO. The 5 per cent GDP growth rates and the agreement to continue the process of reforms by Polish citizens, allowed the AWS to win the 1998 elections and form a coalition of conservative parties under the leadership of the trade union *Solidarnosc*. The AWS and Freedom Union formed the government until the 2001 elections, which were again won by post-communist powers. The conflicts in AWS forced the Freedom Union to leave the government in 2000. AWS and the Freedom Union lost due to too many and badly implemented reforms and because of the large deficit of the last years of their government. Neither party has been represented in parliament since the 2001 elections. In general, the most decentralisation-friendly party remains the Freedom Union, not only forcing first reforms, but also having concerns about the macroeconomic stability of the country and therefore not allowing too much empowerment on the revenue side and imposing strong constraints regarding debt. The more nationalist-oriented parties focused on the unitary character of the country and were always afraid of possible separatism tendencies of the strong regions and of an uncontrolled selling of public property to foreigners. The post-solidarity parties also hoped that implementing self-governments would break the monopoly of post-communists in the province and activate local communities politically, allowing the build up of local structures. In the post-communist camp, PSL was constantly against decentralisation since they were afraid of the domination of the cities over rural areas at intermediate levels and of losing political influence at the regional and local levels.

3.2.2 Economical problems of the transition period

The most problematic leftovers and shortcomings are due to forty-five years of communist rule. Most problems in the early years of transition were due to old institutions and their hierarchical structure, to the influential communist party and powerful state enterprises, and due to the lack of a democratic system with local leaders, lack of local identity and lack of civil society. Moreover, the tax and allocations system based on bargaining was useless. At this point it is important to point out certain aspects of the transition process which directly influence the decentralisation processes.

During the 1980s, various political and economic reforms implemented to sustain the regime instead of prolonging its existence, created an environment conducive to the development of democracy and markets (Barbone and Hicks 1995). The reason for that was that market-oriented reforms cannot exist without destroying the centrally planned system. The unfinished reforms caused economic chaos and

hyperinflation, and finally resulted in the collapse of the communist system. The shock therapy in the early nineties, introduced to overcome the economic crisis, was necessary to establish a market economy. Price liberalisation eliminates government control over prices, whilst stabilisation imposes a harder budget constraint.

Privatisation deprives the government of direct control over enterprises and over all transactions and transfers which are managed by dividing the total output of the economy based on decisions made within a planning office. The necessary reforms destroyed the information sources of the centrally planned economy concerning the output and profits, eroded old tax bases because of a fall in production, increased the number of taxpayers and created new economy sectors which previously had not been taxed. This new reality brought about changes in the social services system and set new rules for former state activities. However, the shock therapy did not set out the role that the government and central fiscal agencies should play in the new economic world. At the same time, falling income, dislocation of employment or reduced or badly directed social transfers have led to increased poverty and inequality. Considering the reality of transition, constrained resources, limited access to non-inflationary finances and rising citizens' dissatisfaction, the Polish government passed budgetary adjustments with unrealistic assumptions about revenues. There are many examples of changes in the law by parliament and public administration because of problems with the redistribution of resources and cash-flow problems of state enterprises – consequences of the privatisation process. To exclude a large amount of state activities from the political cycles and parliament procedures, a large number of off-budget institutions were established which deal with public money. Major social and administration reforms took away from the state the legal responsibility for former activities, but at the same time, they did not ensure enough revenues sources for the newly created local governments. As a result, strong groups in the economy have formed and this has put pressure on the government. This means that fiscal reforms involve conflict over the allocation of the reform costs, the role of government and the correct economical way of reforms.

The crucial point concerning the role of government in the economy is the fact that achieving control over the budget is connected to the problem of reducing and restructuring state expenditure and changing the system of tax revenues. Despite high tax ratios, there is still a huge fiscal deficit in Poland and public spending still represents a large share of GDP (explained later). Expenditure policies were changed in order to have harmonisation with the reduction of public revenues. The solution for these problems appears to be the decentralisation of public finance. Most of the reformers recognised that governments have too much influence on far too many activities. Those governments should realise that as market-oriented economies, their capacity to sustain levels of expenditure typical of rich welfare states will be limited. But, on the other hand, new costs emerge because of necessary reforms requiring decentralisation, and there is only limited public acceptance for cutting expenditure.

Finally, most difficulties show the implementation of major reforms in areas provided by the state in former times, such as social services (pensions, medical care, and schooling) or in the decentralisation of public administration.

3.2.3 Historical determinations

The determinations of the past facing the Polish reformers responsible for the decentralisation process go back to the nineteenth century when Russia, Austria and Prussia shared Polish territories. This caused regional differences in development, destroyed regional identification and traditional horizontal and vertical government relations. The shifting of the Polish borders after World War II had a similar result. The migration of millions of Poles from the previous eastern to the new western territories and a need to rebuild and unite the country caused a natural dependence on central government. The shift of the borders, a lack of traditional regions and the implementation of the communist regime are the main reasons for the unitary character of Poland and the regional units' lack of autonomy.

In Polish history, there have been three kinds of administrative units. The voivodship (polish: *województwo*) is historically a regional unit. Voivodships were established in the 15th century, replacing princedoms in Poland and Lithuania. They were governed by a representative of the King called a *voivod* (polish: *wojewoda* – the one who leads to war). The intermediate units called powiat were also created in the 15th century. Their origin goes back to the formation of land courts for aristocracy, replacing prince courts in Poland and Lithuania. The gmina is the basic unit. The first of these was established by German immigrants to Poland in the 12th century.

Voivodships, powiats and gminas also existed in Poland before World War II. After the War, the communist regime established a three-tiered administration system within the new borders, consisting of 17 voivodships and 5 towns with voivodship status, 330 powiats and – at the local level – 704 towns and 2,993 gminas. In 1955, gminas were replaced by 8,790 gromada districts. Between 1955 and 1973 many gromadas ceased to exist and the powiat structure was re-established, so that at the end of 1972 Poland had 392 powiats (including 78 towns with powiat status) and 4,315 gromadas. Gromadas were replaced by 2,365 gminas, powiats were abolished and the number of voivodships was increased from 17 to 49 as a result of the reform between 1973 and 1975. The main changes during that time were the setting up of new administrative borders. Until 1989, there was a sort of deconcentrated system without democratic elections. The councils of lower units were hierarchically subordinated to councils of higher units. All those that were involved in the decision-making process were members of the communist party, which had full powers. Nevertheless, since 1975 voivodships have enjoyed substantial financial autonomy and gmina councils have had to accept the assigned mayor (Gorzelać 1999). However, all deconcentration reforms, even if they were accompanied by some devolution of power, only transferred authority within an integrated administrative system.

3.2.4 Decentralisation process

The decentralisation process began in 1990 after the collapse of the communist system, but it was soon running late due to the shortcomings previously mentioned. This resulted in the decision to introduce the decentralisation process gradually step by step, from the highly centralised communist country with some deconcentrated tasks at regional level (voivodships) through to decentralisation at local level (gmina) in 1991 to decentralisation at regional and intermediate levels in 1998. Decentralisation in these cases means delegation of power and establishing elected governments at sub-national levels. Nevertheless, Poland remained a unitary country, with a high level of influence from central government.

One of the main decisions of the first democratically elected government was to introduce local self-governments at the level of the former administration units (gminas) in 1991. The reason for this decision was political. The freely elected local councils equipped with rights to appoint local management were helpful in establishing democratic and pluralistic structures and in breaking down the communist party monopoly in the provinces. The 2,489 gminas are legally independent and enjoy property rights. The system gives local governments the responsibility for all public matters of local significance not legally reserved for other units. Gminas have their own administrative support units called *Solectwo*, with the responsibilities defined by Gmina councils. 49 Voivodships at regional and 254 *rejons* at intermediate level represented the central administration in the provinces. *Rejons*, as a new unit in the post-communist era, were established in July 1990 to support the general administrative work of Voivodships, especially with regard to rural Gminas. One *Rejon* usually provides services for three to twelve Gminas. This structure of public administration and local governments has existed since 1998. In 1992 the government created the Office of Public Administration Reform (OPAR) which was given the task of the preparation of reforms in the public administration sector. But, instead of focusing the discussion on the introduction of self-governments in voivodships, it concentrated on the creation of an intermediate tier called *powiats* (Levitas 1999). There were several reasons for their creation.

The solidarity-camp parties governing the country until 1994 had the authority to appoint the voivods and as supporters of unity of the Polish state, they were not interested in introducing self-governments at voivodship level. In the opinion of these parties and the OPAR office, the creation of *powiats* had to improve the quality and efficiency of services, particularly in secondary schools and hospitals and additionally broaden political influence in the province, as in the case of gminas. The PSL – the party of farmers – opposed the creation of *powiats* as they were afraid that the new units would be dominated by towns and cities. Finally the government introduced a Pilot *Powiat* Program for the 46 largest cities, allowing them to negotiate the assignment of several responsibilities going beyond gminas' tasks. The Pilot *Powiat* Program ran until 1998 as all cities of more than 100,000 people became separate

units, carrying out gminas and powiats tasks on their territory. During the period when the post-communist parties SLD and PSL governed the country (1994–1997), there was no progress made in the decentralisation process, the discussions concentrating on establishing powiats.

Period	Levels of government <i>(R – regional, I – intermediate, L-local)</i>
1945–55	R: 17 voivodships and 5 towns with voivodship status I: 330 powiats L: 704 towns and 2993 gminas – similar system before the war
1955–75	R: 17 voivodships and 5 towns with voivodship status I: 330 (392 in 1972) powiats L: 8790 (4315 in 1972) gromadas
1975–98 1990–98	R: 49 voivodships Additional rejons supporting administrative work of voivodships with regard to gminy L: 2365 gminas (self- government since local government reform in 1990).
1998–	R: 16 voivodships (self-government) I: 308 land and 65 towns of powiats rights (self-government) L: 2489 gminas (self-government)

The basis of the Polish decentralisation reform of 1998 was the Constitution of 1997 which set the conditions for the administrative system. The reform of the system in 1998 introduced self-governments to the 16 newly-created voivodships and more than 350 powiats. Free elections took place in voivodships, powiats and gminas that same year. These three kinds of units were given budgeting and acting autonomy, a step that established the conditions for efficient decentralisation. The significant aspects of the decentralisation reform are: splitting the system into central and local units, introducing budgeting processes, personal responsibilities for budgeting in local units and public services supplied by competitive market players (public and private). However, local governments have many expenditure responsibilities, but very modest revenues and borrowing possibilities. This results in the central government having a great influence and in practice, less autonomy than the laws and the Constitution allow. We observe on the one hand – because of economical circumstances – an extorted delegation or devolution of many responsibilities, but on the other hand, the central government tries to keep as much power and influence as possible.

3.3 Local Government at a glance

3.3.1 The depth of fiscal decentralisation

As a first step towards analysing the decentralisation process, I would like to show what the importance of central and local governance is and what the main indicators characterising the relations between them are. As table 1 shows, there is a slow decrease in public sector expenditure in relation to GDP. During the period from 1994 to 2001, this ratio decreased by 3.61 per cent. The public sector expenditures rose more slowly than GDP, both in nominal and in real terms. On the revenue side, the decrease in public sector income to GDP is much faster and remains at 12.31 per cent.

The processes of falling public sector expenditures and even faster falling revenues in relation to GDP are accompanied by a growing share of local government expenditures from 6.62 per cent in 1994 to 11.45 per cent (an increase of 42 per cent) and of a decrease in the share of central government expenditures to GDP (18.67 per cent.) Increasing the share of local governments to GDP is also seen on the revenue side. The central government revenues to GDP fell by about 32 per cent while the local governments' revenues rose by 40.3 per cent, from 6.58 per cent to 11.02 per cent. The most outstanding dynamic, both on the expenditure and revenue sides, is the jump in 1998 due to decentralisation reform.

The dynamics of revenues and expenditures are reflected in the development of deficits. The public sector deficit rose by about 60 per cent from 2.21 per cent to 5.5 per cent during the period of interest. Most of this deficit is due to central government behaviour. As local governments decide about 24.5 per cent of expenditures and receive 27 per cent of public sector revenues, their deficits are only 0.43 per cent while the central government's deficit is 5.12 per cent of GDP. The low deficits of local governments are due to the limitations set by the law. The rapid growth of local governments' deficits – 90 per cent – is mostly due to decentralisation reform, the growth of the number of sub-governments and vertical imbalances in powiats and voivodships which can be seen comparing deficits growth in gminas and cities. The same tendency can be seen as we look at the debt development. The data concerning the local governments are available from 1998, when the new debt limits were introduced. The public debt is 42.15 per cent of GDP. Only 1.7 per cent of this is local government debt and 40.45 per cent is central government debt. It is important to note that the growth rate of local debt is about 41 per cent while the central governments' fell from 43 per cent to 39 per cent and rose again to 40 per cent in 2001. Gminas and cities incurred most of the debt but powiats' and voivodships' debt growth rates are much higher – about 90 per cent compared to 30 per cent of gminas – which is again due to vertical imbalances, unfunded mandates and deficits which have to be covered.

Table 1
Expenditures, revenues, deficit and debt of local (LG) and central (CG) governments in relation to GDP.

	1994	1995	1996	1997	1998	1999	2000	2001	Growth
GDP in mln zł	225098	308104	387827	472350	553560	615115	685597	722341	
GDP	100	100	100	100	100	100	100	100	
Revenues									
(CG+LG)	45.74	44.77	45.23	44.89	43.91	43.25	41.78	40.73	-12.30
CG	39.16	38.28	37.25	36.52	35.58	32.70	31.19	29.71	-31.81
LG	6.58	6.49	7.98	8.37	8.33	10.55	10.59	11.02	40.30
Gmina			5.26	5.57	5.48	5.26	5.04	5.16	-1.99
City			2.72	2.80	2.85	3.15	3.17	3.28	17.07
Powiat						1.60	1.83	1.94	17.65
Voivodship						0.53	0.54	0.64	16.05
Expenditures									
(CG+LG)	47.95	46.79	47.58	47.41	46.04	45.93	45.48	46.28	-3.61
CG	41.33	40.35	39.46	38.83	37.46	35.23	34.53	34.83	-18.67
LG	6.62	6.44	8.12	8.58	8.58	10.70	10.95	11.45	42.19
Gmina			5.33	5.70	5.62	5.34	5.21	5.34	0.09
City			2.79	2.88	2.96	3.25	3.37	3.48	19.90
Powiat						1.59	1.83	1.98	19.61
Voivodship						0.53	0.55	0.66	19.07
Total Invest of LG	3.10	3.20	3.76	4.25	4.18	4.33	4.24	4.12	24.83
Deficits									
(CG+LG)	-2.21	-2.02	-2.36	-2.52	-2.13	-2.68	-3.69	-5.55	60.15
CG	-2.17	-2.07	-2.22	-2.31	-1.88	-2.53	-3.33	-5.12	57.59
LG	-0.04	0.05	-0.14	-0.21	-0.25	-0.16	-0.36	-0.43	90.20
Gmina			-0.07	-0.13	-0.14	-0.08	-0.17	-0.18	60.61
City			-0.07	-0.08	-0.11	-0.09	-0.19	-0.20	65.51
Powiat						0.01	0.01	-0.03	128.75
Voivodship						0.00	-0.01	-0.02	119.9
Nr of gminas with Deficits	1197 (2458)	917 (2484)	1380 (2484)	1426 (2488)	1485 (2493)	1334 (2425)	1694 (2425)	1415 (2425)	

Source: Main Statistic office, Gminas budgets 1994 – 1998 and Ministry of Finance, Statistics of self governments 1999– 2001

Analysing the deficits and debts, one must recognise that the situation in particular jurisdictions can be very different and that the figures presented show the sums of all units in the country. But in general, the number of units with deficits is constantly growing, as the example of gminas shows.

During the period from 1994 to 2001, the share of local governments' expenditures in relation to public sector expenditures (see table) rose from 13.81 per cent to 24.75 per cent, which is a growth of 44.21 per cent. At the same time, the

ratio of local government revenues compared to public sector revenues rose from 14.38 per cent to 27.05 per cent, which means an increase of 46.84 per cent.

Table 2
Debt of local (LG) and central (CG) governments in relation to GDP.

	1999	2000	2001	Growth
Debt				
LG+CG	44.372	40.892	42.153	-5.26
CG	43.366	39.525	40.455	-7.19
LG	1.006	1.368	1.698	40.77
Gmina	0.605	0.749	0.865	30.02
City	0.388	0.549	0.721	46.23
Powiat	0.009	0.055	0.074	87.82
Voivodship	0.004	0.015	0.038	90.12

Source: Ministry of Finance, Statistics of self governments 1999–2001

These figures emphasise the dimension of the decentralisation process in Poland within the last seven years on the expenditure and revenue sides and allow us to draw some conclusions. The shrinking expenditures on the central government side can be an effect of a decrease in revenues due to decentralisation. The fact is that the decrease of revenues and public sector and central government expenses is accompanied by an increase in local government revenues and expenditures. The smaller decrease of central government expenditures (18.67 per cent) in relation to revenues (31.81 per cent) ratios to GDP is conducted by a higher increase of local government expenditures (42.19 per cent) in relation to revenues (40.3 per cent) ratios to GDP. On the other hand, the local government revenues share in public revenues is higher and is growing faster than expenditure share. This means that the local governments increase the share of revenues and expenditures in the public sector but spend more in relation to GDP than they receive as revenues from central government.

The most important tier of local governments is the gmina. Even if gmina expenditures and revenues make up only 5 to 6 per cent in relation to GDP, it is the highest amount of all tiers. The revenues/GDP ratio decreased while the same ratio for expenditures increased slightly. In relation to public sector expenditures, gminas have a fairly constant share of about 11.5 per cent and about 12 per cent on the revenue side. As opposed to other tiers, gminas' expenditure and revenue shares remained constant even after the 1998 reform. Here, one can see an increase in expenditures and revenues share of cities similar to that of powiats and voivodships. At this time, powiats with about 4 per cent and particularly voivodships with about 1.5 per cent share in public sector expenditures, have much less status in the public

sector than gminas and cities. Voivodships' revenues, which are similar to revenues of powiats, are small and grow faster than those of other tiers of sub-governments.

Table 3

Expenditures and revenues of local governments (LG) in relation to public sector (LG+CG) expenditures and revenues.

	1994	1995	1996	1997	1998	1999	2000	2001	Growth
Expenditures									
LG+CG in mln zł (real growth)	107,943	144,150	184,546	223,935	254,865	282,530	311,800	334,317	309.72 (126.98)
LG+CG	100	100	100	100	100	100	100	100	
LG	13.81	13.76	17.07	18.09	18.64	23.31	24.08	24.75	44.21
Gmina			11.21	12.02	12.20	11.62	11.46	11.54	2.82
City			5.86	6.07	6.43	7.07	7.40	7.52	22.09
Powiat						3.46	4.01	4.28	18.99
Voivodship						1.16	1.20	1.42	18.45
Total Invest of LG	3.10	3.20	3.76	4.25	4.18	4.33	4.24	4.12	24.83
Revenues									
LG+CG in mln zł (real growth)	102,961	137,939	175,410	212,025	243,071	266,019	286,475	294,204	285.74 (117.15)
LG+CG	100	100	100	100	100	100	100	100	
LG	14.38	14.49	17.65	18.64	18.97	24.39	25.35	27.05	46.84
Gmina			11.64	12.40	12.48	12.16	12.07	12.67	8.16
City			6.01	6.24	6.50	7.29	7.60	8.04	25.32
Powiat						3.70	4.38	4.77	22.44
Voivodship						1.24	1.29	1.56	20.94

Source: Main Statistic office, Gminas budgets 1994 – 1998 and Ministry of Finance, Statistics of self governments 1999– 2001

3.3.2 Intergovernmental relations and the structure of governments

The legislation connected to the decentralisation process is very complex. There are many changes due to the transition process and due to the need to define the role of the state from the beginning. Establishing and empowering sub-national governments caused changes in every area of public life. Every act of Polish law has to be examined and readopted in line with the new division of competencies. In addition to that, many mistakes have been made by Polish legislators due to time pressure and a lack of experience in setting the law. The whole decentralisation process had to be linked to the ongoing transition process. Because of the lack of precedence in reforming the government system on such a scale, many solutions were accepted to find out how they would work. Many parts of them were good but many had to be changed and updated. These changes and updates

took place every year; therefore it is not possible to present the whole process in detail, but only the main laws and rules².

One can divide the legislature connected with decentralisation into constitutional laws describing the main rules of sharing public powers and assigning responsibilities, and into legislation directly connected with financial aspects such as revenues assignment and budgeting procedures. In these sections the rules of relations and the structure of governmental bodies will be considered. The main point is to identify the relations between local and central levels and the supervisory powers of central government. After that I will turn to other constitutional laws which describe the assignment of expenditures and responsibilities. The financial laws include revenue sources, borrowing restrictions and budgeting procedures which will be presented later on.

The first of the constitutional laws, the law describing the main tasks and responsibilities of local governments, is the 1990 Act 95 on Local Self-Government. This Act defines the bodies of local government, their tasks and duties and in general the responsibilities of individual gminas. It sets out a general framework which has not changed much since 1991. This law served as a framework for the 1998 Law on Powiats and the Law on Voivodships which were put together in the same way. The requirement for the setting up of these laws was the adoption of the new constitution. The 1997 Constitution set up the system of three tiers of self-government in Poland. It describes the importance of gminas as the basic unit where people's needs have to be met. The Act on Local Self-Government, the Law on Powiats and the Law on Voivodships dating from 1998 describe the division of powers within a certain unit. Because the Laws of 1998 are based on the 1991 law, they have the same responsibilities of institutions but with different names for the councils and executive presidents.

The councils of gminas (and cities equipped with powiat rights), powiat and voivodships:

- appoint the executive board
- decide on the salaries of its members as well as of the members of the executive board. The council members are not allowed to work for executive units, must not be voivod or parliament members, and must not be involved in any activities which would conflict with their interests as members of the council.
- appoint the executive board within three months after the elections, otherwise the council is dissolved

2 Considering further developments, it is important to note that there will be two changes in the near future. In constitutional laws, the change will result in direct elections of the presidents of executive bodies and empower those presidents with the competencies of today's Executive Board. On the side of financial laws, the Law on Revenues of Self-Government Units will be cancelled next year and all jurisdictions will be given new revenue sources. Now we turn to the structure of governments.

- make the overall decisions concerning financial policy,
- adopt the budget act prepared by the executive board
- set the limits for guarantees given and short-term credits and loans taken out by the executive board during the budget year.
- set taxes and fees according to financial laws
- set out the rules for emitting bonds and decides about long-term credits and loans
- adopt development plans
- constitute additional units and entities and decide on their responsibilities
- make decisions concerning international and national cooperation with other jurisdictions, units and bodies and – in the case of gminas – establishing unions
- decide on the jurisdiction's shares in companies and other commercial undertakings
- decide on the properties belonging to the jurisdictions.
- in order to supervise the actions of executive board and budget entities, appoint a revision committee.

The councils are elected every four years by direct, proportional and majority elections. Because the executive board is appointed by the council, one party or a group of parties must hold a majority in order to govern the jurisdiction³.

The general task of the executive board is to prepare law proposals, manage the properties of gminas and implement the budget and other laws set by the council. In detail, the executive boards make expenditures, emit bonds, take out loans, and decide on the reserves of the budget. Members of the executive board must not be Members of Parliament and must not work for central government administration (since September 2002). The executive board can be dissolved by a 3/5 majority of the council. Since September 2002 the presidents have taken over the responsibilities of the executive board.

With regard to the legality of acting, the Polish sub-governments are supervised by the voivods in the name of the Prime Minister and in financial matters by the regional audit offices. There are 17 voivods which represent the central government in voivodships. They report directly to the Prime Minister. The Executive boards present all laws enacted by councils, which are controlled by voivods in regard to their conformity with the existing laws. Voivods can stop the execution of a law in the case of illegality. Such a decision can be challenged in the administration court by the sub-government body.

In the case of breaking the constitution (for example concerning debt) or in the continuous breaking of the law by a sub-government, the Polish parliament

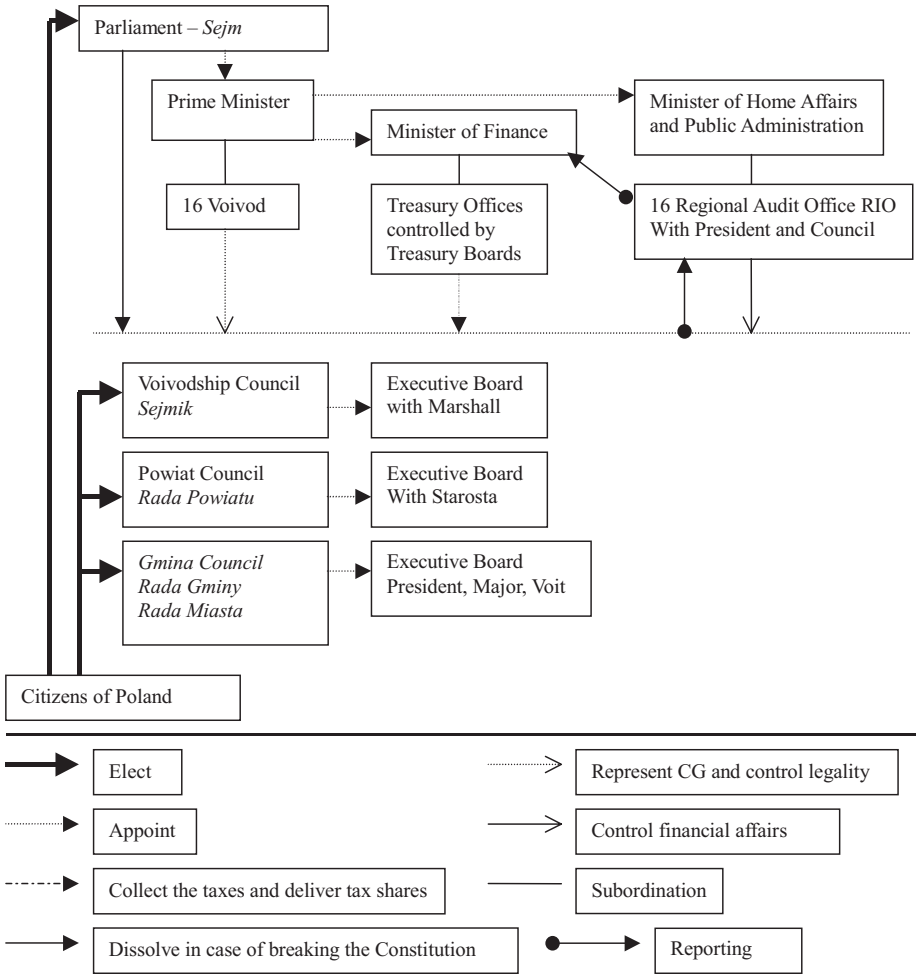
3 Since 2002 the presidents of executive boards are also elected directly. As experience shows in many local governments the presidents of executive boards are in the parties that don't have the majority in the council.

(Sejm) can dissolve the council or the executive board. In such a case, the Minister of Home Affairs appoints a person to fulfil the functions of sub-governments' bodies. Such a person can also be appointed in the case of local governments which do not fulfil their tasks correctly, for a maximum two years.

In order to ensure that local government units follow the financial rules described by the laws, the central government created Regional Account Offices (RIO) responsible to the Ministry of Home Affairs in 1992. The supervision of the legality of the jurisdiction's decisions and informing the borrowers of its credibility is one of the tasks of the RIO. RIO ensures the realisation of strict debt limitations established by the Polish government. It also approves all long-term debt resolutions adopted by jurisdictions. Borrowing increased beyond the limitations may end in restructuring procedures imposed by RIO and losing the autonomy of setting the budget by a jurisdiction. Any illegal decision made by local governments can be annulled by RIO which dictates the legal solution in such a case. The crucial point is that RIO can control the activity of local governments *ex post* but they cannot influence the decision making process. Nevertheless, RIO is quite powerful and independent.

The third central government body directly involved in the central-local relations is the Ministry of Finance and Treasury Offices subordinated to this Ministry. The rule of the Ministry of Finance is very important because of the budgeting process and local revenue system based on shares in direct taxes. The Personal Income Tax (PIT) and the Company Income Tax (CIT) are collected by Treasury Offices. The shares in these taxes should be delivered to the local jurisdictions by the 10th of the following month. In case of a delay, the local governments receive interest. Treasury Offices also collect other revenues of local governments such as inheritance taxes, which have to be delivered not later than 14 days after receiving a Treasury Office bank account. The Treasury Office informs local jurisdictions quarterly about the realisation of expected revenues.

There have been strict reporting rules since 1998, when the Ministry of Finance had to control the debt development of local governments. In general, the rules present a chain of reporting. The off-budget departments report quarterly to the executive boards on revenues, expenditures and debt and by not later than 10 days after the period expires. The executive boards give the same information quarterly (not later than 25 days after the period expires) to RIO and additionally report on deficits, while RIO also reports quarterly (not later than 40 days after the period expiration) to the Ministry of Finance. RIO must receive the report in the fourth quarter of a year by no later than February 28, and the Ministry of Finance by no later than March 15. In addition to these reports, cities have to report on powiats rights for the half year period and for the whole year. According to these rules, the Ministry receives the information on the financial conditions of self-governments entities up until March 15. After that date, the Ministry can react and adjust the budget plans for the next budget year.



3.4 Local government finance: An overview

3.4.1 Assignment of expenditures

As mentioned before, there are many circumstances and reasons for decentralisation of expenditures in Poland. The most important of these is to make expenditures more transparent, accountable and more controllable for local communities and as a result, make the system more efficient. This means the participation of the private sector in the delivery of services, privatisation and lowering the share of the public sector in the economy (GDP). On the other hand, there is a growing call for central government to take an active role in Poland. The most important reason for this is the need for significant investment into the old and mostly unusable infrastructure.

A problem is the rising inequality in income of local governments and ordinary people.

Until 1997, the basic law that described the responsibilities of local governments was the Local Self-government Act from 1990. It said that the public tasks not given to other jurisdictions have to be fulfilled by the basic units of local government (gminas). The tasks which have to satisfy the needs of the local community are “own tasks”. In addition, the central government may delegate mandated tasks based on agreements negotiated with local authorities.

These short rules are a repetition of the 1997 Polish Constitution, adding the fact that other levels of self-government can be established by the law. The assignments of the new jurisdictions should be, contrary to gminas’ responsibilities, explicitly specified. In such a way only gminas as a unit and gmina tasks to meet the people’s needs are anchored in the Constitution.

There is no special law dealing with tasks or institutions of cities equipped with powiat rights. These units have to fulfil the tasks both of gminas and powiats and get the corresponding revenues. Thus there is no need to describe the responsibilities of these units separately.

First there is a set of tasks that are carried out by gminas which are their “own tasks”. Most of them have not changed very much since 1991 and most of them are exclusive to gminas. All these functions are delegated, which means that the sub national governments are responsible for delivering services, but are subject to some supervision by the central government which provides some form of finance (Ebel 1999). Municipal services such as water belong to these services, as do heat and electricity supply, sanitation and the waste disposal system. Gminas and cities (as part of obligations as gminas) mobilise approximately 15 per cent of their spending for these services. That makes a share of 98 per cent in total expenses for this category. The situation in housing (4 per cent of gminas’ outgoings) is quite similar: here the share in the category is 97 per cent. Other own tasks are local environment protection, trading places cultivation, parks and cemeteries, running of libraries, promotion of gminas and cooperation with non-governmental organisations and local communities. Gminas also spend most of their expenditure on running cultural institutions as own tasks. Added to the cities’ expenditures, this amounts to 74 per cent of the expenses from all tiers in this category. The remainder is spent by voivodships, mostly for cultural institutions located in big cities, but which are important for a region, such as an opera house or a theatre. Advertising tourism and recreation also belongs to the gminas’ and cities’ own tasks, amounting to a share of 92 per cent spent on sport and 77 per cent on tourism. The mandated tasks which are fulfilled by gminas and financed by additional transfers are mostly in the area of social welfare. Both gminas and cities spend 10 per cent of their funds on this category. The 1998 Law on Powiats and the Law on Voivodships established self-governments at intermediate and regional levels. Together with the law on self-governments of 1990 mentioned

previously, they contain only the overall description of what each level has to do and represent the basis for detailed acts and solutions dealing with expenditure assignment. As a result, one has to look for detailed solutions in other laws dealing with the character and depth of decentralisation.

Powiat tasks are listed in the law on powiats according to the rule that powiats are organising and providing those services that extend beyond gminas' boundaries. Powiats are responsible for space planning, construction supervision, counteracting unemployment, running institutions and providing specialised social services for family and childcare. The assignment of responsibilities for secondary schools and hospitals which definitely goes beyond the basic needs and capabilities of many gminas was assigned to powiats in the 1998 reform. Establishing powiats caused political conflicts between left wing and right wing coalitions. One of the many arguments put forward – especially by the farmer party PSL, which was afraid of losing political influence in the provinces – was that establishing intermediate tiers of sub-governments would cause additional costs and inequalities. In such a situation the central government simply decided to replace existing administration office rejons by powiats governed by elected councils, but to give them, as financial resources, mostly grants of the rejons, which caused unfunded mandate problems.

The assignment of the tasks of voivodships – where a regional development strategy should be created – caused many conflicts between supporters of integrity and unitarity of the Polish state. The supporters forced the maintenance of the central government's control of development strategies. As a result, Sejmiks (regional parliaments) were given responsibilities for regional development, but only very limited resources, so they were not able to implement their plans and become independent counterparts of the European Union. Instead of getting the resources needed for providing regional policy, voivodships can place so-called “voivodship contracts” and multi-year investment programs with the central government. Apart from the tasks mentioned above, other tasks of voivodships include running cultural institutions, counteracting unemployment by utilising Voivodship Employment Centres, the modernisation of rural areas, the preservation of environment, water management and land amelioration.

The main tasks of the central government include fulfilling the basic functions of the state such as national defence, justice, public order (which is partly delegated to powiats) and central administration offices. An additional group of tasks is the development related tasks, for example, restructuring mining, the steel industry and export promotion programs. Part of the development related tasks are delegated to local governments, particularly education, roads and transport. Even if it seems that the decentralisation of expenditure responsibilities is quite deep, there are several areas in which the central government plays a significant role. In this context, it is important to note the fact that for many areas, the central government has defined and financed the functions provided by local

governments. Examples are subventions for education and roads, social services expenditures such as subventions to social insurance, public health, work funds, environment protection, agriculture and housing funds. Besides these categories, the central government decides on elastic expenditures, which include in particular, salaries and wages. Employees of public institutions also include employees of institutions that other levels of government are fully responsible for, e.g. teachers. Teachers have to be paid according to the amount set centrally but within the framework of the education subvention divided locally.

Unfortunately, the assignment of responsibilities for each tier of government is a mixture of mandated and own tasks. This fact has consequences for the assignment of revenues and allows for discretionary solutions on the central government side depending on negotiations with several units. This situation is mostly due to the fact that decentralisation has not been pursued; consequently, many tasks are assigned experimentally to lower levels of governments and there is still a demand for an active role from central government. Such a situation may lead to an overlap of competencies and a lack of a clear delimitation of tasks, overspending and government competition.

Agriculture, forestry and public order are good examples of a mixture of responsibilities. Gminas are running agriculture chambers, animals and plant protection. They spend about 54 per cent of all expenditures on agriculture, much more than voivodships (38 per cent), for which agriculture is important, although they spend only 15 per cent of their expenditures in this category. As regards mandated tasks, gminas spend more than 30 per cent of their total amount on forestry. It is the Powiats' task to supervise forestry, hence they spend 64 per cent of their total expenditure on this category. Another example of mandated tasks of significant importance given to powiats is public order and fire protection. Powiats spend 17 per cent of their expenditure on running police and fire stations while cities spend 8 per cent, as tasks based on agreements with central administration. These expenditures account for up to 96 per cent of the whole amount spent by local governments on public order. In addition to that, gminas are allowed to run their own municipal police and voluntary fire brigades, but this represents a small share in this category (4 per cent). In general, all examples presented here follow the subsidiary principle that the reformers tried to introduce, but this is more a result of bargaining between local and central governments than a clearly designed system.

The subsidiarity principle, in which the tasks are shared between all units of self-government and assigned to the lowest unit capable of providing it, is best represented in areas such as transport, education and health protection. In the transportation and communication categories, Gminas and cities are responsible for local public transport and local highways. Gminas spend only 6 per cent and cities 9 per cent on transport, but this amounts to a share of about 38 per cent for gminas and 34 per cent for cities of total expenditures made by all jurisdictions in this category. Responsibil-

ity for interurban, regional and national highways is shared between powiats, voivodships and the central government depending on the geographical scope of the roads. Transport is the most important expenditure for voivodships (21 per cent) and quite important for powiats (7 per cent), but the share in the total amount is quite low for these tiers (about 13 per cent and 14 per cent respectively). Kindergartens, primary and secondary schools are run by gminas and cities, while high schools, vacation and technical schools and schools for the disabled are run by powiats and cities equipped with powiat responsibilities. Universities are run by voivodships. The central government sets standards and the education policy accordingly. It develops a homogenous schedule of teaching programs and sets the minimum requirements for the equipment of schools and services for pupils. Education is the most important category for gminas and powiats (41 per cent each and 38 per cent for cities), while voivodships spend only 13 per cent on this category. Most of the total expenditure is carried out by gminas (52 per cent) and cities (30 per cent) because of the number of primary education facilities. Powiats have a share of about 17 per cent, which highlights the relatively small importance of high schools outside the cities. In this context, it is interesting to note that the highest amount paid for universities is by cities (and gminas) and not from voivodships as might be expected according to the law and according to theory, as the beneficiaries come from the whole region. Solutions in the public health system are comparable to the solutions found in education.

Gminas are responsible for public health policy within their borders. Basic public health and nursing services are also supplied by gminas, while hospitals and more specialised facilities are run and owned by cities, powiats and voivodships. The central government runs branch hospitals e.g. military hospitals and sets standards regarding the minimum requirements which have to be fulfilled by each medical facility. In the public health sector, most of the expenditures are spent by powiats (33 per cent) and cities (25 per cent), making them the tiers that were worst hit by the public health reform. The reason for that is the change of the owner of all facilities having formerly been in possession of the central government and having been managed mostly by *rejons*. Giving these tasks mostly to powiats resulted in the closure of too many of the large medical facilities.

In addition, the health care reform changed the system for financing public health. Health Funds (one in each voivodship) place contracts with institutions for medical care services only (about 60 per cent of hospitals' expenditures). All other expenses should be covered by powiats, which makes hospitals run into debt or forces them to privatise excess facilities due to a lack of funds. Powiats have no influence on Health Funds and cooperate only on a voluntary basis. Health Funds are controlled by voivodships which were also legally liable for any debts caused by Funds. These dependencies explain the relatively high share of public health in voivodships' expenditures (15 per cent) compared to other tiers (7 per cent for powiats and only 3 per cent for cities).

Table 4

Shares of LG in expenditure categories. Average over years 1999 and 2000

Category		Gmina	City	Powiat	Voivodship
Total	100	48.81	30.42	15.79	4.98
Agriculture	100	53.70	3.11	5.14	38.06
Forestry	100	29.61	5.71	63.69	0.99
Transport	100	38.45	33.95	14.39	13.21
Municipal Services	100	64.47	34.16	0.02	1.35
Housing	100	54.89	42.22	1.34	1.55
Education	100	51.61	29.90	16.77	1.73
Universities	100	25.88	70.80	1.42	1.89
Culture and art	100	44.85	28.51	2.92	23.72
Health protection	100	18.90	25.01	33.40	22.69
Social services	100	48.09	29.26	22.41	0.23
Sport	100	61.00	31.87	1.00	6.13
Tourism	100	48.38	28.60	13.95	9.07
Public administration	100	59.02	21.59	16.33	3.06
Public order	100	3.52	46.03	50.44	0.01

Source: Ministry of Finance, Statistics of self governments 1999– 2001

Table 5

Shares of expenditures categories in LG average expenditures over years 1999 and 2000.

Category	Gmina	City	Powiat	Voivodship
Agriculture	2.15	0.20	0.62	14.95
Forestry	0.03	0.01	0.18	0.01
Transport	6.19	8.76	7.16	20.81
Municipal Services	16.19	13.76	0.02	3.36
Housing	4.10	5.05	0.31	1.14
Education	40.82	37.91	41.07	13.37
Universities	0.01	0.06	0.00	0.01
Culture and art	2.95	3.01	0.59	15.27
Health protection	1.28	2.75	7.12	15.16
Social services	10.44	10.20	15.05	0.50
Sport	1.83	1.53	0.09	1.80
Tourism	0.08	0.08	0.07	0.15
Public administration	12.14	7.13	10.37	6.19
Public order	0.39	8.22	17.42	0.01
Other	0.69	0.52	0.00	0.16
Total	100	100	100	100

Source: Ministry of Finance, Statistics of self governments 1999– 2001

Table 6 shows the development of expenditure categories for all tiers of government, (1994–2000). Looking at this, it is possible to judge what the most important areas are for local governments and what the impacts of the 1998 reform on the expenditure side are. To arrive at the best conclusions on the impact of establishing two additional tiers of government on expenditures and on developments within gminas, it is necessary to look at these two categories simultaneously.

As previously emphasised, the category with the highest share in total expenditures is definitely education. The share grows constantly from 25.54 per cent to 40.5 per cent. The rapid growth is directly related to the taking over of primary schools by gminas and giving powiats responsibility for high schools and technical schools. The decentralisation reform did not change very much here because most of the high schools are located in bigger cities which took part in the Pilot Powiat Program and had been responsible for these schools. Municipal services, mostly supplied by gminas, decreased during the period. This could either be due to the privatisation process or due to a more efficient management. Expenditures for public administration have been constantly growing in gminas since 1997, which seems quite strange because gminas did not increase their expenditures within this period of time and did not receive many new responsibilities.

The share of health protection decreased dramatically after the health care system reform of 1998. As mentioned, this is directly correlated to financing these services by Health Funds. The problem is the discrepancy of a very large cut in overall expenditures (from 6 per cent to 4 per cent), which can cause problems with the fulfilment of tasks, especially with powiats and voivodships. Another significant change during this period is an increase in the expenditures for transport due to the change in the financing of road investments. An increase in expenditures for public order is directly related with mandated tasks fulfilled by powiats, while gmina expenditures in this category remain almost the same.

Accompanying the assignment of tasks and responsibilities, the central government previously transmitted the property rights of public institutions and state enterprises to local governments. All these facilities plus the sub-governments' possibility to act as the owners are essential to meet citizens' needs and for providing proper services. The problem was that most of them were under-invested and many jurisdictions were either not equipped with everything they needed or over-equipped with facilities that could not be maintained or properly used. To adjust the equipment to the local needs and goals, investments had to be carried out, new management and competition in providing of services had to be introduced and many facilities had to be privatised. For political reasons, there was no homogenous national plan or program to solve these problems.

Table 6

Dynamic of expenditure categories for all tiers of government, through the years 1994–2000

	1994	1995	1996	1997	1998	1999	2000
Total	100	100	100	100	100	100	100
Tourism	0.10	0.11	0.10	0.11	0.09	0.09	0.07
Public order	0.16	0.18	0.17	0.17	0.33	3.34	3.46
Sport	1.27	1.33	1.19	1.50	1.74	1.75	1.69
Transport	1.93	1.88	1.80	2.13	2.23	7.05	7.30
Agriculture	2.30	2.64	2.31	2.40	2.03	1.54	1.26
Culture and art	3.35	3.34	2.75	2.73	2.79	2.94	3.00
Housing	6.66	5.43	4.16	4.58	4.68	4.52	4.42
Health protection	8.69	7.62	6.06	6.11	6.10	1.88	1.82
Public administration	10.32	11.26	9.67	9.59	9.66	10.16	10.27
Social services	9.94	11.49	9.14	9.42	9.57	10.18	10.52
Municipal Services	26.83	25.60	22.30	21.89	22.23	15.71	14.80
Education	25.54	26.31	37.46	36.57	36.20	38.89	40.50

Source: Main Statistic office, Gminas budgets 1994–1998 and Ministry of Finance, Statistics of self governments 1999–2001

Table 7

Dynamic of expenditure categories for gminas, through the years 1994–2000

Gmina	1996	1997	1998	1999	2000
Public order	0.12	0.11	0.27	0.35	0.43
Tourism	0.12	0.12	0.10	0.09	0.07
Sport	1.18	1.57	1.89	1.93	1.73
Health protection	2.49	2.73	2.77	1.35	1.21
Transport	2.63	3.09	3.28	6.02	6.36
Culture and art	2.83	2.77	2.86	2.91	2.99
Agriculture	3.51	3.59	3.04	2.35	1.96
Housing	3.71	4.17	4.25	4.36	3.85
Social services	9.87	10.13	10.39	10.40	10.48
Public administration	11.27	10.96	11.16	12.09	12.18
Municipal Services	20.72	20.30	20.18	16.60	15.79
Education	38.21	37.36	37.42	39.56	42.08
Total	100	100	100	100	100

Source: Ministry of Finance, Statistics of self governments 1999–2001

Until 1994, it was optional for gminas to decide to privatise state enterprises, which provided urban services, or transform them into off-budget city departments. The services were then to be ordered by jurisdictions on free market

conditions. As a result, in all gminas there were some off-budget departments which fulfilled specific tasks such as public transport, electricity, heating, water and sewage for payment and in competition with private suppliers. Institutions such as schools and hospitals transferred to gminas since 1990 and to powiaty and voivodships in 1998 are budget departments of the given jurisdiction. All other privatised properties received an additional source of revenues for local governments.

Table 8
Investments done by LG in the years 1999 – 2001.

	1994	1999	2000	2001
Total invest		100	100	100
Gmina/Total		57.80	55.20	53.04
City/Total		28.91	29.59	28.59
Powiat/Total		5.04	7.04	8.93
Voivodship/Total		8.25	8.17	9.43
Total Invest of LG/GDP	1.49	1.99	1.93	1.91
Total invest/LG	22.57	19.08	17.74	17.01

Source: Main Statistic office, Gminas budgets 1994 – 1998 and Ministry of Finance, Statistics of self governments 1999– 2001

In that way all levels of government became fully responsible for the public infrastructure situated within the borders of their jurisdiction. The efficiency of such a solution requires autonomy in the operation and maintenance of the facilities. To do this and to fulfil other tasks, local governments have full responsibility for capital expenditures. The investments to GDP ratio rose from 1.49 per cent in 1994 to 1.91 per cent in 2001. This growth is very small and means a decrease in relation to local governments' expenditures from 22.5 per cent to 17.1 per cent.

Most of the investments are carried out by gminas and cities, but in this instance, gminas have also had a negative investment growth rate since 1999. Growth rates of voivodship and powiat investments are the complete opposite. These investments priorities reflect the tasks on which the tiers of governments concentrate most according to their responsibilities. Gminas invest the largest amount in municipal services (41 per cent) which is 68.62 per cent of all municipal investments. In practice this is sewage and purifying systems. Two other important areas which include maintaining schools and roads are education (18 per cent), with gminas being the biggest investor of all tiers (72.88 per cent), and transport (17 per cent), with gminas' expenditures making up 46.27 per cent of all investments in this category. Gminas are also monopolist, having the highest share in total investments, in categories such as forestry (80.95 per cent), tourism

(82.07 per cent), sports (65.28 per cent), housing (54.35 per cent), public administration (51.11 per cent) and transfer grants for economic tasks (82.54 per cent).

With cities, the same is true as with gminas: municipal services are in first place, but the share is lower (about 34.74 per cent in cities investments and 29.62 per cent in total investments for municipal services respectively). Cities invest 29.12 per cent of their expenditures in transport, having – like gminas – a very high share of 42.12 per cent in developing road and public transportation systems. About 11 per cent are used for housing (45.30 per cent in total investments for housing) and not much less in education (18.91 per cent). Similar to gminas, powiats invest in education (17 per cent) and transport (16 per cent) but the shares in these categories – 7.59 per cent and 5.11 per cent respectively – are much lower than gminas' and cities' shares. Another important powiat activity is investing in social services. Powiat investments of 11.23 per cent amount to a total share of 61.47 per cent in this category. Powiats are also leading investors in public order (38.50 per cent) even if this category is not high on the priority list (4.89 per cent). Most of the investments (40 per cent) concentrate on the sector of health protection, which means investments in hospitals and their equipment. Powiats with 34.59 per cent and voivodships with 42.29 per cent shares are the biggest investors in this category. Health protection investments are one of the priorities of Voivodships (37.98 per cent of voivodships' investments).

Similar shares are only found with agriculture (29.81 per cent), but only amount to 33.82 per cent in total agriculture investments while gmina investments make up 65.17 per cent. Because of the responsibility for regional roads, transport is another important share in voivodship investments, making up 6.5 per cent of the total amount for this category. Generally speaking, the investments statistics reflect the urgent needs within the responsibilities of different tiers of government. Due to the fact that figures show annual results, it is not possible to judge the scale of undertaken investment projects. Of course capital investments can and in most cases do exceed the yearly revenues of a local government unit. This is particularly true in cases where investments are equally urgently needed in all sectors in Poland. In order to avoid an inefficient increase in taxes due to high capital investment costs and in order to spread these costs over time and generations, it is reasonable to allow local governments to borrow. But as the former tables show, local governments avoid debt and deficits. The reasons for this are mostly the borrowing and debt restrictions established by the central government.

Table 9
Investments by categories. Average of the years 1999 and 2000

	Gmina	Powiat	City	Voivodship
Agriculture	8.24	0.15	0.22	29.81
Forestry	0	0.00	0.00	0.00
Transport	16.3	16.41	29.12	15.95
Municipal Services	40.9	0.19	34.74	7.17
Housing	6.49	0.27	10.59	0.08
Education	18.2	17.36	9.26	1.08
Universities	0.01	0.00	0.22	0.02
Culture and art	1.16	0.12	1.98	4.55
Health protection	0.78	42.95	4.34	37.98
Social services	0.24	11.23	0.98	0.03
Sport	4.13	0.01	3.61	2.34
Tourism	0.12	0.01	0.04	0.02
Public administration	2.56	6.08	3.27	0.93
Public order	0.35	4.89	0.93	0.02
Finance	0.07	0.00	0.09	0.00
Grants for economic tasks	0.04	0.00	0.02	0.00
Total	100	100	100	100

Source: Ministry of Finance, Statistics of self governments 1999 – 2001

Table 10
Shares of LG average investments over years 1999 and 2000 in investments categories.

		Gmina	City	Powiat	Voivodship
Total	100	56.83	28.96	6.04	8.17
Agriculture	100	65.17	0.87	0.14	33.82
Forestry	100	80.95	11.66	1.17	6.22
Transport	100	46.27	42.12	5.11	6.50
Municipal Services	100	68.62	29.62	0.03	1.72
Housing	100	54.35	45.30	0.26	0.09
Education	100	72.88	18.91	7.59	0.62
Universities	100	4.73	92.42	0.11	2.74
Culture and art	100	40.96	35.57	0.46	23.01
Health protection	100	6.04	17.07	34.59	42.29
Social services	100	12.33	25.97	61.47	0.22
Sport	100	65.28	29.34	0.02	5.36
Tourism	100	82.07	15.58	0.77	1.58
Public administration	100	51.11	33.26	12.97	2.66
Public order	100	25.82	35.43	38.50	0.25
Finance	100	61.19	38.58	0.23	0.00
Grants for economic tasks	100	82.54	17.46	0.00	0.00

Source: and Ministry of Finance, Statistics of self governments 1999– 2001

3.4.2 Assignment of revenues

As in many transition countries there is a rising burden from expenditures assignment of local governments. The difficult economic situation and rising public debt motivate the central government to suppress many tasks of allocation, distribution and stabilisation functions without discretionary powers on the revenue side allowing for efficient provision of goods. The difficulties in defining the state role in the market economy and the communist heritage of a very active and tutelary state are reasons for politicians not to give up their influence and not to allow too much autonomy of local governments. This has been reached by a modest revenue responsibilities assignment and financial dependence of self governments in Poland on central government transfers, leading to vertical and horizontal imbalances.

The Polish government decided to assign less revenue competencies in 1998 than the assigned goals and tasks postulated, and even less compared to the reform of 1990. This statement confirms the assignment of revenues for gminas carried out in 1991 and that of powiats and voivodships in 1998. It would appear there was a lack of political willpower to decide in favour of true decentralisation. So, even if the decentralisation of expenditure responsibilities seems to be quite widespread and the self-government autonomy is guaranteed by the constitution, there are a number of sectors in which the providing of services is delegated, while financing is centralised.

In particular, powiats suffer from a lack of resources to fulfil their own assignments and a growing number of mandated tasks. In most cases, delegation of tasks to powiats is followed by transfers of the same amount of money that the central government had been spending on a particular task. Such financing makes it impossible to reach the aims of decentralisation and conserves inefficient solutions. But in order to be able to judge all these problems in detail, it is first of all necessary to present the revenue side of the financial system.

Under Polish law, revenue rules are generally defined in constitutional laws and, in detail, in public finance laws. From 1991 to the end of 1998, general revenue sources for gminas were contained in the Law on Local Self-Government – the details were described in the Budget Law. After the passing of the Constitution and of new self-government levels, the Budget Law was also changed. Since then, the Constitution has divided the revenues of self-governments into “own revenues” and subsidies without any specifications. Further constitutional laws – the Law on Local Self-Government for gminas, the Law on Self-Government in Powiats and the Law on Self-Government in Voivodships – explain in detail what the definitions of own revenues and subsidies are. They also add grants as a third revenue source for tasks fulfilled on the basis of agreements with the central government. The detailed specification concerning the shares in central taxes, amounts of subsidies and transfers and the rules for their admission are included

in the Law on Public Finance (1998) and the Law on Revenues of Self-Government Units for the years 1999–2001 (1998).

In theory, local governments should receive as much of their own revenues as possible in order to exercise expenditure decisions, making them more efficient and independent from the central government which cannot properly estimate the needs of local communities. For equalisation and redistribution purposes, the central government may pay out some subventions which are accountable and based on formulas that do not change in the course of the business cycle. In addition, the central government may transfer some grants to fulfil important tasks for the country and to avoid spillover effects. In order to design a proper decentralised fiscal system it is important to find proper relations between the following three elements: own revenues, subsidies and grants. The right proportion should allow for an efficient supply of goods and enough flexibility for local governments to implement solutions which are favoured by voters. Designing a decentralised system in a transition country like Poland is a task which should be open to changes and implementing better solutions.

The problem is that in Poland, developments are not carried out consistently, and on the revenue side they went in the wrong direction. Analysing the dynamics of revenue categories, one can see that the share of own revenues has been constantly decreasing by 20 per cent since 1995: from 51.12 per cent to 40.84 per cent. This process started in 1995. Since that time the share of own revenues has fallen by one or two percent per year. Within this revenue group, shared taxes – whose definition as “own revenues” is disputable – have decreased by 30.28 per cent, mostly due to the decentralisation reform in 1998. At the same time local taxes have increased by 24.97 per cent and therefore turned from a less important revenue source (46.91 per cent) into a share of 68.50 per cent in own revenues. During this period, subsidy shares rose by 10 percent in 1996 and again by 10 percent in 1998 due to the increase in the number of jurisdictions. This means a rise of 147 per cent in the whole period from 1994 to 2001. The grants behave in a different manner. Their share decreases from 21.65 per cent in 1994 to 14.25 per cent in 1998. After the decentralisation reform, this share rises by 2.48 per cent to about 22 per cent due to the financing methods of powiats, which will be described later on.

The changes in the distribution of revenues, the increase of the share of subsidies and grants is mostly due to the decentralisation reform of 1998 and assignments of new tasks of local governments. This reform did not change the sources of income of gminas, which stayed quite independent in revenues, but added another two tiers which are completely dependent on transfers from the central government.

Table 11
Dynamic of revenues by categories in the years 1994 – 2001.

	1994	1995	1996	1997	1998	1999	2000	2001	Growth
	100	100	100	100	100	100	100	100	
Own revenues	51.12	51.40	48.30	47.73	46.55	43.67	41.72	40.84	-20.11
Shared Taxes	45.19	44.92	50.71	50.70	53.09	35.78	33.00	31.50	-30.28
Local Taxes	54.81	55.08	49.29	49.30	46.91	64.22	67.00	68.50	24.97
Grants	21.65	20.58	13.78	14.13	14.25	22.25	22.67	22.18	2.48
Subsidies	14.93	15.22	25.41	24.15	25.44	34.09	35.61	36.98	147.6

Source: Main Statistic office, *Gminas budgets 1994 – 1998* and Ministry of Finance, *Statistics of self governments 1999 – 2001*

Among the main sources of gmina revenues are “own revenues”. Their share decreased from 54.8 per cent to 52.1 per cent of the total revenues. The most important of the “own revenues” is the revenue of tax sharing, which is in fact a form of formula based transfer. In the case of gminas it amounts to 27.6 per cent (20.0 per cent until 1998) of PIT revenues collected from gmina inhabitants and to 5 per cent of CIT collected from legal budgetary and non-budgetary entities based in gminas. PIT with a share of 13.5 per cent in 2001 (16.3 per cent in 1999) is the more important of these two taxes, while CIT – which strongly depends on the business cycle – brought 1.4 per cent of revenues in 1999 and only 1.1 per cent in 2001, the year of economic slowdown. Gminas are the only ones of all levels that may set rates of some local taxes. These rates are limited by virtue of separate legislation. The rate of property and transport taxes is limited by a maximal amount. The property tax is an important income source and its share in gmina revenues grew from 11.7 per cent in 1999 to 14.8 per cent in 2001.

The rate of agriculture and forest taxes depends on the belonging of the particular gmina to certain tax districts. The tax districts were established to reflect the differences in forests and soil qualities. For the country, only the agriculture tax has a meaning – it yields about 2 per cent of revenues. The rates of inheritance tax (growth from 0.3 per cent in 1999 to 1.6 per cent in 2001) and tax on business activity of physical persons (decrease from 0.7 per cent to 0.4 per cent in the same period) paid in the form of a flat turnover tax does not come under gmina responsibilities. These incomes, which can be generated independently, are another significant source of revenues for gminas. These are revenues regularly obtained by gminas, like shares in enterprises, leasing or rental fees of gmina properties or privatisation of properties given by the state. All these revenues had a share of 7.8 per cent in 1999 and 4.8 per cent in 2001. Fees and user charges such as stamp duties, environmental utility charges, commodities, administration and trade fees are set autonomously and should cover the cost of services provided by gminas.

This source of revenues decreased dramatically from 4.3 per cent in 1999 to only 0.4 per cent in 2001.

Own revenues in the case of powiats and voivodships are much less significant than in the case of gminas. With powiats, the share grew from 6.2 per cent in 1999 to 8.6 per cent in 2001, while with voivodships, the share decreased from 18 per cent in 1999 to 13.4 per cent in 2001. This situation is understandable because own revenues of these two tiers consist for the most part of shared taxes which depend on the economic situation of the country. Powiats get a 1 per cent share of PIT decreasing from 1.9 per cent to 1.3 per cent in 2001 of revenues, while voivodships get 1.5 per cent of PIT (14 per cent in 1999 and 10.1 per cent in 2001) and 0.5 per cent of CIT revenues (2.4 per cent and 2.5 per cent in 1999 and 2000 respectively and only 1.3 per cent in 2001). These shares are very small so that revenues from properties are generating 2.2 per cent in 1999 and 1.2 per cent in 2001 in the case of powiats and an average 0.5 per cent in the case of voivodships.

As the cities equipped with powiat rights enjoy revenues from sources like gminas and powiats, the structure of own revenues contains that of gminas and that of powiats. In that way, own revenues have a share in cities of 47.6 per cent in 2001 (48.8 per cent in 1999). Cities enjoy the highest transfers of shared taxes (PIT 16 per cent and CIT 1.2 per cent in 2001) and additionally have the rights of gminas to set the local taxes – of which the most important one is the property tax, whose share increased from 11.2 per cent in 1999 to 12.6 per cent in 2001.

In sum, the system created to finance powiats and voivodships leaves them with little budgetary flexibility and modest own revenues. To cover the residual, to fulfil tasks with the same standard for the country as well as for equalisation purposes the central government delivers transfers. These transfers are divided into general subsidies and grants. General subsidies are payments to local governments which reflect the division of tasks between central and sub-national levels, while grants are payments made by a governmental unit to a third person to fulfil a given task. General subsidies consist of five parts: the equalisation part for powiats and voivodships, the per capita part for gminas called basic subsidies, the road part (in case of gminas “compensation part” because of the substitution of the road tax by subsidies), and of the education part for all levels of sub-government. Subsidies are most important for powiats, with a maximum of 47.7 per cent of their income in 2000 and with a minimum of 44.4 per cent in 1999. Subsidies are least important in the revenues structure of cities with a minimum of 29.5 per cent in 1999 and a maximum of 33.80 per cent in 2000.

The divisible pool of the equalisation part for powiats and voivodships is calculated on an ad hoc basis for all levels and allocated on a formula basis among units with PIT-share income lower than 85 per cent. Units with an income higher than 150 per cent of the average are the payers in this system. However,

the equalisation subvention distributed among units with a PIT share income lower than 85 per cent of average, causes no motivation among units, particularly powiats, to put themselves out to motivate citizens to gain more profit and to activate additional revenue sources. The equalisation part became an important revenue source for cities (from 0.5 per cent in 1999 to 3 per cent in 2001) and a decreasing source for powiats (from 3.2 per cent to 2.5 per cent) and voivodships (from 7.1 per cent to 5.6 per cent)

The basic subsidies also have an equalising function with a share of about 5 per cent in gmina revenues. The basic subsidies for all gminas are a minimum of 1 per cent of the central government revenues. The basic subsidies are divided into the equalisation part for gminas with a tax income lower than the given standard and the remaining part which is distributed among all gminas and calculated per capita. Gminas receive the basic subsidies monthly. The pool of road subsidies for powiats and voivodships is specified as a share of central budget revenues and divided among the units on a formula basis depending on quantities such as length and quality of roads, number of cars and accidents and in case of education.

The road subsidy is an important but decreasing revenue source for voivodships (about 20 per cent) and less important and also decreasing for powiats (from 8.3 per cent in 1999 to 7.8 per cent in 2001). Instead of receiving road subsidies, gminas receive a compensation subsidy which has to be a minimum 10.5 per cent of fuel tax income of central budget, but this subsidy has not been high (at maximum 3.9 per cent in 2001). The rules for these subsidies make them accountable for local governments and allow them to calculate fairly constant revenues. The education subsidies for all tiers of sub-governments depend on the kinds of schools and the number of pupils. These subsidies are very important for gminas (about 26 per cent), cities (arising from 23.9 per cent in 1999 to 27 per cent in 2001) and most important for powiats with 32 per cent in 1999 and 36 per cent in 2001 per cent.

The devisable pool for all grants is determined and then allocated on an ad hoc basis. There are four grant types: 1) grants from the state budget for implementation of delegated tasks, matching grants to co-finance self-government tasks, 2) grants for tasks implemented by self-governments on the basis of agreements with central government agencies such as grants from state budget funds for the removal of public safety and order tasks, 3) grants for agreements with other territorial self-government entities, and 4) grants for powiats and voivodships from special purpose funds. Budget classification distinguishes between sources for investments and for other purposes. The weight and importance of these ad hoc grants show the influence and the role of the central government in the system of intergovernmental fiscal relations. The successful fulfilment of many of the "own" and of course "mandated" tasks depends on these arbitrary allocated state transfers. The grants are the main revenue source for powiats (the share decreased from

49.4 per cent in 1999 to 45.1 per cent three years later) and voivodships where the share rose by 5 percent points to 52.2 per cent in 2001. In gminas, grants have a share of 11.7 per cent (with a short increase in 2000 when the share was 13.73 per cent) and are the most unimportant revenue source of all.

Cities receive about twice the amount that gminas do because of their right for powiats grants. The most important of all grants are the grants for delegated tasks. In 2001 powiats received about 28 per cent of their revenues via grants for delegated tasks. This shows how many additional tasks the central government gives to lower levels of government. The development of voivodships is even more characteristic. The share of grants for delegated tasks rose from 0.2 per cent to 23.5 per cent of total revenues in 2001. In addition to that, gminas received about 7 per cent and cities about 13.5 per cent of their revenues. In most cases, less than one percent is used for investments, which is quite characteristic as well.

The second most important revenue sources (the most important ones for voivodships in 1999 and 2000) are the grants for own revenues. The development in this category shows how many tasks given to sub-governments are out of finance and what shares of revenues important for own tasks are dependent on ad hoc decisions and bargaining. Again as gminas and cities stay at a constant share (3 to 4.5 per cent for gminas and 7 to 5 per cent for cities), grants for powiats and – as mentioned – for voivodships are much more volatile and much more important as revenue sources. In the case of powiats, grants for own tasks vary between 19 per cent and 16 per cent and in the case of voivodships they range from 30.2 per cent to 23.4 per cent.

One positive thing about these grants is that some parts of them are used for investments. In the case of voivodships this is between 13.4 to 15 per cent and in the case of powiats 3.6 to 4.5 per cent. Grants that are based on agreements with the central or with local governments are of much less importance than these two grants. The only significant figure is the 13.5 per cent income of powiats in 1999 mostly used for investments, given perhaps because of a flood. The grants transferred between local governments, even if small, are for the most part used for investments.

One of the factors that decide on the usefulness of revenue sources for local governments is computability of revenues planned in the budget law. It can be measured by the realisation of planned revenues. In Poland, the most computable are subsidies which are calculated on known and clear formulas which can not be influenced by the economic situation. As the table shows, there is nearly a 100 per cent realisation of subsidies at all levels and during all years.

Table 12
Dynamic of LG revenues by categories in years 1999 – 2000

	1999				2000				2001			
	G	C	P	V	G	C	P	V	G	C	P	V
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Own revenues	54.8	48.8	6.2	18.0	52.52	48.50	7.90	15.98	52.1	47.6	8.6	13.4
CIT	1.4	1.6		2.4	1.59	1.59	0.00	2.50	1.1	1.2		1.5
PIT	16.3	17.2	1.9	14.0	14.34	15.78	1.43	12.10	13.5	16.0	1.3	10.1
Agriculture tax	2.3	0.1			2.00	0.04			2.1	0.0		
Property tax	11.7	11.2			12.28	11.01			14.8	12.6		
Forest tax	0.3	0.0			0.28	0.00			0.3	0.0		
Means of transport tax	0.7	0.6			0.70	0.58			0.8	0.6		
Business tax	0.7	0.7			0.55	0.57			0.4	0.4		
Heritage tax	0.3	0.3			0.27	0.32			1.6	0.3		
Fees	4.3	3.4			3.76	3.19			0.4	1.0		
LG properties revenues	7.8	7.8	2.2	0.5	7.95	8.96	2.70	0.40	4.8	5.5	1.2	0.6
Other	8.9	5.9	2.1	1.1	8.70	6.44	3.78	1.01	10.4	8.2	6.1	1.2
Grants	11.6	21.7	49.4	47.3	13.73	20.33	44.40	46.22	11.7	19.3	45.1	52.2
For delegated tasks	7.1	14.0	28.5	0.2	7.23	13.35	24.47	9.55	7.0	13.6	28.0	23.5
Investments	0.0	0.1	0.3	0.0	0.10	0.10	0.34	6.74	0.1	0.1	0.2	4.0
Grants for own tasks	2.9	6.9	19.9	30.2	4.43	5.96	15.79	30.46	2.8	5.1	16.0	23.4
Investments	1.2	1.8	4.5	15.7	1.40	1.60	3.58	14.60	1.2	1.0	3.6	13.4
Grants for tasks based on agreements with CG	0.5	0.4	0.1	13.5	0.40	0.72	3.44	1.33	0.2	0.6	0.1	0.6
Investments	0.2	0.0	0.0	10.3	0.25	0.00	0.00	0.71	0.2	0.0	0.0	0.2
Grants for tasks based on agreements with LG	0.6	0.1	0.7	3.2	1.20	0.18	0.45	4.44	1.0	0.2	0.7	3.5
Investments	0.2	0.1	0.1	3.1	0.15	0.13	0.12	4.01	0.1	0.1	0.2	3.1
Grants from funds	0.5	0.3	0.2	0.2	0.53	0.14	0.24	0.43	0.7	0.2	0.3	1.2
Investments	0.4	0.1	0.2	0.1	0.38	0.10	0.18	0.33	0.6	0.1	0.3	0.8
Subsidies	33.6	29.5	44.4	34.7	33.80	31.24	47.70	37.80	36.2	33.1	46.3	34.4
Basic	4.4	0.1			5.10	0.00	0.00	0.00	4.9	0.1		
Education	26.1	23.9	32.9	7.2	25.09	25.63	37.35	11.46	27.4	27.0	36.0	9.8
Recompensation	3.2	2.0			3.55	2.36	0.00	0.00	3.9	2.6		
Road		3.0	8.3	20.4	0.00	0.46	7.70	20.20		0.4	7.8	19.0
Equalisation		0.5	3.2	7.1	0.00	2.70	2.66	6.10		3.0	2.5	5.6

Source: Ministry of Finance, Statistics of self governments 1999 – 2001

Own revenues achieved the second best results, which vary between a realisation of 94.3 per cent as the worst but mostly around 98 – 100 per cent in the period 1999 to 2001. It should be underlined that these realisation statistics are heavily influenced by shared taxes depending on business cycle and economic activity. The realisation of CIT for voivodships, for example, varies between 87.3

per cent in 2001 and 123.3 per cent in 2000. On the other hand there is a growing realisation (mostly over 100 per cent in year 2001) from year to year reflecting better administration work and activating local resources to be more independent from central transfers.

Table 13
Dynamic of LG revenues realisation by categories in years 1999 – 2000.

	1999				2000				2001			
	G	C	P	V	G	C	P	V	G	C	P	V
Total =100	100.1	98.7	99.6	95.6	97.93	98.38	99.40	94.84	97.5	98.2	99.1	94.3
Own revenues	100.8	98.6	105.2	98.6	96.77	97.26	103.2	96.44	96.0	97.0	99.8	96.7
CIT	103.6	94.0		93.1	115.0	113.9	0.00	123.3	91.0	101.1		87.3
PIT	99.5	99.0	98.2	97.8	90.08	90.83	89.66	90.50	94.1	95.4	91.0	96.9
Agriculture tax	92.1	93.0			93.36	91.88			93.7	97.1		
Property tax	98.3	97.2			98.84	99.46			100.8	101.7		
Forest tax	96.5	101.3			96.95	93.54			100.9	112.6		
Means of transport tax	98.2	98.7			98.83	100.0			100.5	101.8		
Business tax	93.3	86.6			93.58	93.52			91.0	90.5		
heritage tax	115.7	112.8			118.1	107.8			90.5	108.4		
Fees	117.8	99.0			100.1	102.1			96.8	91.3		
LG properties revenues	99.5	95.2	103.5	84.6	95.76	95.24	101.4	103.4	92.7	88.5	98.6	86.6
Other	103.1	108.0	114.4	137.8	103.1	108.3	110.9	125.6	98.3	101.3	102.1	117.2
Grants	97.0	97.4	98.6	91.6	96.92	98.53	97.90	90.50	96.2	97.9	97.9	90.3
For delegated tasks	98.3	98.8	99.2	96.1	98.03	98.33	99.30	98.01	98.5	98.3	99.1	94.8
Investments	97.6	91.2	95.0	100.0	73.45	62.34	96.92	97.89	77.1	83.3	91.0	95.5
Grants for own tasks	93.8	95.4	98.0	91.5	96.03	95.72	95.71	86.93	93.5	95.4	96.3	86.2
Investments	91.2	88.5	93.2	86.9	90.45	91.44	86.50	83.59	90.9	91.8	88.6	93.3
Grants for tasks based on agreements with CG	99.7	98.8	86.6	92.8	97.85	91.49	99.75	99.52	78.9	96.7	99.2	89.7
Investments	100.0	0.0	32.0	90.9	97.18	99.77	0.00	99.98	76.4	99.1	100.0	76.9
Grants for tasks based on agreements with LG	96.2	95.7	98.1	86.8	95.14	97.80	95.45	99.10	97.0	98.0	92.1	90.9
Investments	92.2	90.4	97.7	86.5	92.96	98.28	89.95	99.20	91.1	97.3	85.6	90.0
Grants from funds	95.1	81.3	94.3	98.2	93.05	93.77	85.68	92.89	90.2	89.6	91.1	86.1
Investments	93.5	99.5	94.5	100.0	91.47	98.81	82.77	98.72	89.6	89.4	89.9	82.4
Subsidies	100.0	99.9	100.0	100.0	100.2	100.0	100.2	100.0	100.0	100.0	100.0	100.0
Basic	99.8	100.0			100.0	100.0	0.00	0.00	100.0	99.9		
Education	100.1	100.0	100.0	100.0	100.2	100.0	100.2	100.0	100.0	100.0	100.0	100.0
Recompensation	99.8	98.9			100.2	100.5	0.00	0.00	100.2	100.0		
Road		100.0	100.0	100.0	0.00	100.0	100.0	100.0		100.0	100.0	100.0
Equalisation		100.1	100.0	100.0	0.00	100.0	100.0	100.0		100.0	100.0	100.0

Source: Ministry of Finance, Statistics of self governments 1999 – 2001

Grants have the worst realisation value. The figures underline the previous statement that grants are very bad sources of revenue for sub-governments. The overall realisation varies between 90.3 and 98.6 per cent, but there is nearly no realisation of 100 per cent. Instead there are situations, such as the investments part of grants for delegated tasks, where realisation for gminas and cities lies at 73.45 per cent and 62.34 per cent respectively in 2000 and at 32 per cent for powiats for investments of grants for tasks based on agreements with the central government. The fact that the realisation is shortened mostly for investments is also characteristic for grants. The influence of the central government and a lack of coordination are seen in transferring sources for grants based on agreements or for delegated tasks.

A positive aspect of this transfer system is the fact that all funding of local governments (except grants), financing of roads, funding for social insurance and other social expenditures are included in the Budget Act, so that the central government does not have a direct influence on the amounts or the use of the expenditures without a parliamentary procedure that makes the system more accountable. Apart from these categories, the central government decides on flexible expenditures, which include salaries and wages for public institution employees, including staff of institutions for which self-governments are fully responsible, e.g. teachers. On the one hand, these employees have to be paid according to centrally set figures, but on the other hand, within the limits of the locally divided education subvention.

As previously mentioned, there were many concerns about the macroeconomic stabilisation of the country when designing the intergovernmental system. In terms of stabilisation arguments, the central government in Poland controls nearly all taxes and this has strong stabilisation effects. Both income taxes are a highly disputable political topic because of contrary ideas of progressive and linear income taxes. One must emphasise this for stabilisation reasons, in a transition country, taxes which result in much profit – for instance excise tax or taxes on consumption – would not easily be given up by the central government.

The benefit principle of taxation requires financing the services by taxes based on direct benefits that are received by the taxpayer. This principle is partly met by the possibility to set fees and charges by the gminas. However, in the case of many costly services and in the case of many jurisdictions, this principle cannot be fulfilled because of the very high prices which have to be set for many services. Free local services and low prices, which never covered the costs of providing those services, are a heritage of communist times. A step forward has been taken through privatising or transforming the state providers into off-budget departments acting in a profit oriented way. Even if the tax autonomy given to gminas is modest, these jurisdictions run a lot of predatory horizontal competition. The possibility of lowering or making free some local taxes attracts compa-

nies to expand their production in Poland. The taxes used for this practice are property, agriculture and transportation. In relation to own revenues, the amount of whole reductions was 6.1 per cent and about 3 per cent in relation to total revenues. The reasons for tax competition are not only an expectation of additional sources, which can be significant for particular gminas even if CIT share is small, but also the task of ensuring local development and to undertake steps against unemployment. Moreover, tax competition is much easier for local jurisdictions – as in the case of gminas – when they know that they receive transfers for the basic tasks from the central government. Nevertheless horizontal competition is mostly found in the rich units. Rural gminas with poor citizens cannot fulfil the tasks with the existing system of own revenues and grants. Here lies the problem of horizontal imbalances and not horizontal competition. There are huge disparities between municipal and rural gminas on the one hand and between the east and the west of Poland on the other. One even speaks about Poland A and Poland B. These disparities are due to historical reasons which resulted in most new firms settling in the western part of the country and close to big cities.

A better infrastructure and better equipment in human and physical capital were the deciding factors. Equalising grants over the long term should decrease these disparities. But the system designed in Poland has opposing effects. The PIT and CIT shares have disparities which only serve to deepen the effects since only the jurisdictions with rich citizens and firms may expect higher sources. The disparities are so significant that, according to the existing system, out of all the powiats only Warsaw does not receive grants. The huge number of different grants and subventions motivates local governments to bargain and fix the ineffective redistributive system. As a result, many jurisdictions receive smaller amounts without using the gains of decentralisation.

According to theory, shared taxes, which are in fact transfers, can be considered as own revenues ensuring enough autonomy. Nevertheless, significant revenues from this source are assigned only to gminas. The lack of fiscal autonomy, particularly in the case of powiats and voivodships, leads to bargaining with central government and to vertical competition. This results in a lack of accountability and a lack of control by the citizens. Sharing taxes also has the tendency to widen the revenue differences, according to the rule that rich units receive more sources than those with a smaller number and poorer taxpayers. Small own revenues and a related lack of transparency are the reasons for the failure of the concepts of marginal and subsidiary taxation.

In summary, the system created in 1998 leaves local governments with little budgetary flexibility, modest own revenues, and transfers, which are insufficient to meet their needs and responsibilities. The best indicator for that is the small share of investments on the expenditure side which shows a lack of resources. The introduced reforms do not link sub-national expenditures with revenues which

have led to deficits, the highest of which are faced by gminas and cities. Most of them are financed by credits and loans, as one might expect. Still, an important amount for gminas comes from the surpluses from previous years. Throughout gminas and cities, deficits are also covered by issuing bonds. Privatisation does not play an important role in covering the deficits and that is an important message to be remembered.

Table 15
Debt of LG by categories in year 2001

		Gmina	Powiat	City	Voivodship
Deficit	0.705	0.344	0.058	0.277	0.027
Receipts	1.029	0.540	0.072	0.386	0.032
Credits and loans	0.622	0.321	0.038	0.247	0.015
Repayments of given loans	0.006	0.005	0.000	0.000	0.000
Surplus from previous years	0.121	0.083	0.015	0.020	0.002
Securities	0.007	0.000	0.001	0.006	0.000
Bonds	0.119	0.031	0.010	0.068	0.010
Privatisation	0.009	0.004	0.000	0.006	0.000
Other	0.146	0.095	0.008	0.039	0.004
Outgoings	0.324	0.196	0.014	0.109	0.005
Repayments of loans	0.260	0.152	0.012	0.093	0.004
Loans	0.009	0.004	0.002	0.002	0.002
Deposits	0.036	0.035	0.001	0.001	0.000
Redemption of securities	0.002	0.001	0.000	0.001	0.000
Redemption of bonds	0.016	0.003	0.000	0.013	0.000
Other	0.001	0.001	0.000	0.000	0.000

Source: Ministry of Finance, Statistics of self governments 1999 – 2001

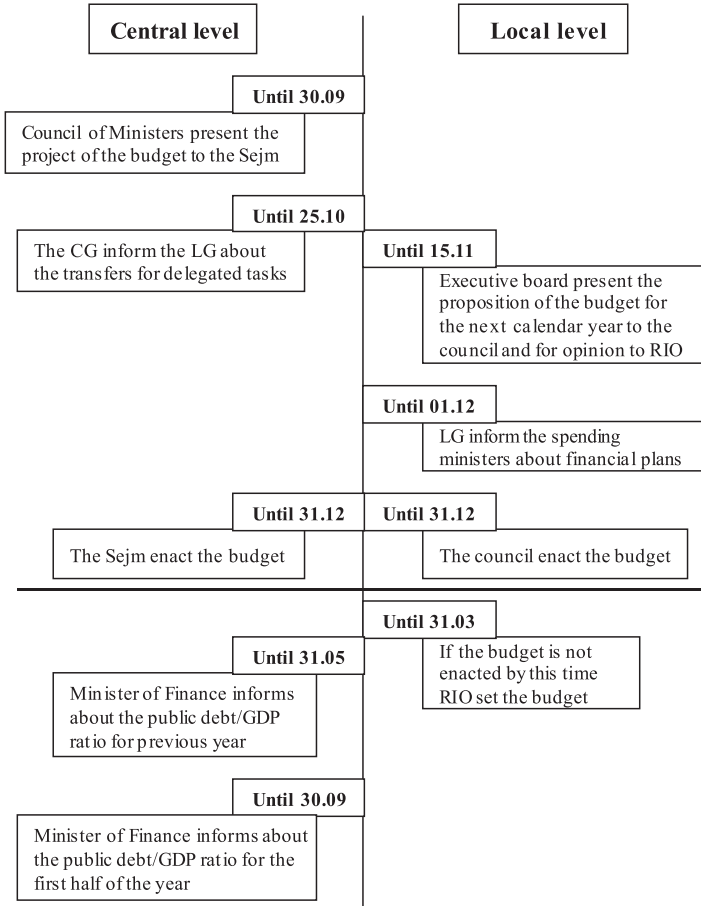
Local governments mostly rely on central taxes instead of being more independent. The realisation of property taxes shows that it could be an important revenue source. More autonomy in setting the base and the rates of local taxes is required. But the most dramatic situation is to be found in powiats. The number of transfers and grants has to be reduced and the rules have to be made more transparent to minimise the overall weight of all transfers in revenues.

3.5 The political economy of the local budgeting process

Two points have to be stressed concerning the budgeting procedures presented in the graph. The first one is the problem of deficit constraints which have to be held in case of an increase of public debt/GDP ratio over 50 per cent. To hold the constraints, local governments will have to adjust their deficits in the budget proposals for the following year. The relevant information for such a decision will

contain facts only for the first half of the current year (information given by the Ministry of Finance until September 30) and for the previous year (information given until May 31). Such a situation may lead to serious problems for many jurisdictions, particularly those involved in investment programs and paying back former credits. The second characteristic issue for the Polish system is the position of RIO and their prerogatives in the budgeting process.

The general role of RIO is the ex post control of the legality of the acting of local jurisdictions in financial issues. But the fact that the RIO ex post opinion on budget proposal is needed to enact the budget by the council allows an ex ante influence on the most important decision of the council. The involvement of RIO in such a way underlines the concerns of the central government of holding the debt concerns. In the case of where a council does not cooperate and as a result the budget is not be ready until 31 March, RIO may set their own budget. This is understandable for other reasons, namely to protect the local community from results of conflicts in the council. The rule that local governments have to inform the spending ministers (for example, the minister of education or public health) has a coordinating aspect between local and central governments. The ministers receiving information about the financial plans of local governments before the final enacting of the budgets may make some discretionary decisions concerning the expenditures of the ministers or grants for sub-governments. The discretionary changes concerning the grants and subsidies for local governments can also be made by ministers during the budget year, but only up until November 30. These solutions increase the field of acting for central government but because of a lack of accountability, aggravate the position of local governments.



3.6 Original revenue sources and local public borrowing

The process establishing borrowing restrictions for local governments can be divided into three periods. Since 1990, the restrictions change following each parliamentary election. In general, the Solidarity camp parties in 1991 and 1998 improved more restrictive solutions whilst between 1994 and 1998, the socialists made it much easier to borrow.

In the first period, in the years from 1990 to 1993, the limitations depended on the expenditure level. The short term loans and credits mostly used for covering deficits were to be paid in the same year and could not be higher than 12 per cent of the expenditures in the current year. Repayments could not be higher than 5 per cent of the planned expenditures. The amount of long term loans was to be defined in the budget of the jurisdictions. These regulations and limits

were changed by the law of financing the gminas of 1993. The repayments of short and long term loans were not allowed to be higher than 15 per cent of the planned revenues of the current year. The repayments also included, apart from covering the expenditures not covered by planned revenues, interest payments, potential guarantees and bonds ransom. The amount of repayments was diminished by loans and credits that were secured by gmina properties. This allowed unrestricted borrowing because in practice, any credit and loan could be secured by a property. Such a liberal position was introduced at a time of fast economic growth (5 per cent of GDP). The 1998 limitations for borrowing were set in the constitution and in the 1998 Public Finance law. The constitution allowed for a public debt – meaning the debt of all units – of not higher than 3/5ths of GDP. After reaching this benchmark, taking out new loans and credits is forbidden. It should be pointed out that the only restriction on borrowing for central government is in the Constitution.

The 1998 reform introduced limitations in cases where the consolidated public debt exceeds 50 per cent of GDP. There are three situations imaginable. In the case of 50 – 55 per cent of GDP, the central government sets the budget with deficit/revenue ratio not higher than the deficit/revenue ratio of the previous year. This d/r ratio is the maximum allowed for any local government. In a case where the central government debt exceeds 55 per cent of GDP, but is lower than 60 per cent, deficits of any local government should be lower than the central government deficit. If the public deficit to GDP ratio exceeds 60 per cent, then local government deficits are not allowed (unless there is a surplus from the previous years). In addition to these limits, there are a number of others. Repayment of obligations must not exceed 15 per cent of revenues and 12 per cent in the case where the national debt exceeds 55 per cent GDP.

The yearly debt of local government units must not exceed 60 per cent of revenues of this unit in the current budget year. Only this limitation is based on the Constitution. As in the previous periods, short term loans and credits to cover deficits have to be paid back in the same year. The new limitation is that they can be taken only from domestic banks and must be in Polish currency. Concerning long term loans, the operating costs have to be paid once a year, the interest must not be capitalised and the discount rate of emitted bonds must not be higher than 5 per cent. The nominal value of the loan has to be set on the day of the transaction. Additional local governments which plan to take a long term credit or issue bonds require a reference of creditworthiness. This reference can only be given by the RIO. In the case of bonds denominated in a foreign currency, the reference of a rating agency is required.

The idea of implementing such heavy restrictions was to impose fiscal discipline. These borrowing conditions were directly related to the Maastricht criteria which Poland wishes to meet. The Maastricht criterion concerning “state public

debt” was understood very strictly and includes the debt of local governments to the consolidated public debt. In the current situation in Poland, binding local debts to national debt leads to a vertical competition between local investment and national borrowing for operating expenses. The decision to introduce new limitations in 1998 is not based on any former debt developments at the gmina level. Strict borrowing conditions and existing budgeting procedures do not allow for the efficiency and flexibility needed to meet local needs and fulfil assigned responsibilities. They establish dependence on the central budget debt and lead to diminishing local governments’ capacity to borrow. On the other hand, central government may receive better conditions for borrowing than local governments and in that way financing of expenditures is cheaper. According to the figures, it is easy to see the relation of overall public debt and local government debt.

The fiscal discipline of sub-governments does not influence the debt level of the country. Passing the 50 per cent debt/GDP ratio depends on the policy of the central government. In such a situation it is very hard for many jurisdictions (particularly the poor ones) to borrow. Relying on borrowing as a significant source of revenue may be risky for local units, driving them into looking for other sources of income such as grants and transfers. All restrictions and the macroeconomic environment (growing public debt and slow down in GDP growth) lead to a very limited volume of borrowing activities of local governments. This situation does not correspond to the investment needs of public facilities in Poland.

Analysing the structure of debt of sub-national governments in 2001 in relation to GDP, the first observation is the small value mostly used for long term goals which, according to the deficit restrictions, can only be used for investments. Debt, mostly incurred on the domestic market, is financed by commercial banks and by about 1/3 by the public sector. The most important forms of indebtedness are long term loans and credits from commercial banks. The negative numbers in current liabilities means that sub-governments are creditors for the private and the public sector. The claim of local governments is roughly 1/3 of the gross debt. Foreign debt does not play a significant role, but some big cities such as Krakow enjoy high ratings and issue eurobonds abroad.

Table 14
Debt of LG by categories in year 2001

	Debt/GDP	Domestic		central bank	Foreign	
		total	public sector		commercial banks	total
Debt	1.060	1.022	0.371	0.030	0.995	0.038
Bonds	0.232	0.215	0.001	0.004	0.166	0.017
Long-term	0.221	0.204	0.001	0.004	0.158	0.017
Credits and loans	1.343	1.322	0.407	0.026	0.829	0.021
Long-term	1.263	1.241	0.386	0.023	0.770	0.021
Deposits	0.006	0.006	0.001	0.000	0.000	0.000
Current liabilities	-0.521	-0.521	-0.037	0.000	0.000	0.000
Supply of goods and services	-0.081	-0.081	-0.001	0.000	0.000	0.000

Source: Ministry of Finance, Statistics of self governments 1999 – 2001

Considering the fact that local debt has to be related to central debt, the timing of reporting and budget procedures plays an important role in the borrowing process. In Poland, budgets of local governments, such as the central one, have to be annual and unitary. This means that operating and capital budgets cannot be split and that the budget is legally binding only for one year. This solution is good for central, but not an optimal practice for local governments because of other functions and a need to implement multi-year investments. In fact, local governments act more like a firm concerned about their investments than a central government. Nevertheless local governments in Poland realise long term projects including them, each year, in the annual budgets.

3.7 Summary and conclusions

The description of the decentralisation process in Poland after 1990 shows differences in deepness among the political, the institutional and the fiscal dimensions of decentralisation as well as differences among the tiers of government with respect to the dependence on the central government's decisions.

The political dimension is the most advanced dimension. The councils of all three tiers of government are elected. Citizens use the same election rules – the tools of control and prising of politicians – in order to express their preferences concerning the local, intermediate and regional matters. But the decentralisation on the intermediate and regional levels in terms of institutional and fiscal dimension is less advanced than those of *gminas*. Hence it is questionable whether councils of *powiats* and *voivodships* should be elected if their representatives cannot be made responsible for revenues collection.

Gminas and cities focus the expenditures on education and municipal services. The *powiats*' main expenditures aside from education are social services and public order. *Voivodships*' priorities are transport, culture and art. Nevertheless

only *gminas* – thanks to institutional empowerment – can respond to local preferences and citizens' needs using local taxes and making spending decisions without being financed by the central government. Of course there are differences in the composition of *gmina* revenues and for many of them equalisation and internalisation transfers are inevitable, but *voivodships* and *powiats* do not have the possibility to levy taxes. In these two tiers the fulfilling of local preferences depends on cooperation with the central government and its ability to finance *powiat* and *voivodship* expenditures. Particularly *powiats* suffer under this solution because of the high discretion of the assignment of transfers. The consequence is an increase in borrowing that must cover budget deficits. *Powiats* have had the highest debt growth rate in the last three years of all tiers of government.

The central government tried to prevent fulfilling of local expenditures on the costs of fiscal discipline and limited the decision-making process through budgeting procedures, control and – since 1998 – through borrowing restrictions. The problem about these procedures is that they do not differentiate – the same as in the case of political decentralisation – between the different abilities of tiers of government to mobilise local revenues. As keeping borrowing restrictions depends mostly on the acting of the central government, not on *powiats* or *voivodships*, these will not be able to find new sources of revenues if borrowing is forbidden when the debt-to-GDP benchmarks are passed. They will heavily cut expenditures, while *gminas* would be able to increase taxes by shifting the responsibility of higher tax burdens to the central government.

In the system of sub-national governments in Poland, the sound composition of political, institutional and fiscal elements is reached only in the case of *gminas*. On the regional and particularly on the intermediate level, political decentralisation goes too far or – from another perspective – the institutional and fiscal decentralisation of revenues is not deep enough. Without ensuring *powiat* revenues that can be independently created, the fiscal discipline cannot be kept.

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4. Grant Transfers in Financing Local Governments in Poland

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4.1 Introduction¹

Local government reform has been one of the main priorities for the first post-communist government which was formed in September 1989. The 1990 reform introduced elected local government at the municipal (*gmina*) level only, while upper tiers of territorial divisions remained managed by the state administration. At the end of 1998, the government decided to change the territorial organisation of a state and to introduce new (upper) tiers of local government.

As a result of this process, currently there are three tiers of territorial governments: almost 2500 municipalities, 315 counties (plus 65 cities of a county status) and 16 regions. Both at a municipal and county level, self-government is the only form of public administration. On a regional level there is dual structure – on the one hand elected self-government, and on the other – a governor (*wojewoda*) nominated by the Prime Minister with his/her own administrative apparatus. However, functions of regional state and self-government administrations are clearly separated and there is no hierarchical subordination between them.

Presently (1999 data) local governments spend 10.5 percent of Polish GDP or 38 percent of total government expenditures. There has been a clear increase from 7.4 per cent of GDP and 16 per cent of total government expenditure by local government in 1991. The more precise data, including the historical development of the trends throughout the last decade, can be found in the Appendix. Almost 80 percent of self-government budgets are spent on a municipal level (including big cities which have a county status), 15 per cent by county level and only 5 per cent by regional self-government (Statistical Yearbook of Poland 2000, GUS, Warszawa).

Local governments are financed by a mixture of own revenues (mostly local taxes which are set – within limits defined by law – and collected by local governments), shares in revenues collected within local unit territory from central income taxes and grants transfers from central governments. The structure of local government revenues is illustrated in the Appendix.

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1 For more details on local government system in Poland see for example: Kowalczyk, 2000.

4.2 The Role and Purpose of Grants

There are several theoretical arguments which are frequently quoted to argue for the existence of state grants to sub-national governments (see for instance King, 1984, Bramley, 1990):

- horizontal equity– i.e. access to services of the same quality for the same price (tax effort);
- compensation for local governments who serve citizens living outside their boundaries, what happens when the catchment area is not identical to the geographical area of the government;
- securing a minimum standard of important services established at the central level;
- stimulation of expenditures for merit goods which are preferred by central government;
- reducing location inefficiencies which may be the result of tax competition.

It is very difficult to say which of these arguments have been the most important for the formation of the contemporary Polish grant system, since they have never been clearly defined by politicians. We can only try to guess from the general tone of discussions those which have been carried out during different stages of the decentralisation reforms.

Securing minimal standards of important services has probably been the most important purpose. This argument is sometimes closely connected with the horizontal equity argument. These considerations are definitely at the heart of such important elements of the Polish grant system, playing a role in education grants allocated to all tiers of self-government. The same thing applies, to a lesser extent, to the road grants and equalisation grants. Details of these elements of the grant system are described in the sections below.

Certainly the argument about the stimulation of spending for preferred merit goods is very popular with sector ministries of the central government and it has been instrumental in the quick development of the specific purpose grants (they were especially successful in reaching their goal in 1998 when the system of financing county and regional governments was formed). But such a goal has never been intentionally formulated by any of the government levels; it has rather been a side effect of the strength of central bureaucracy. The other arguments such as reduction of spillover effects and increasing location efficiency were rarely present in public discussions and could not be considered as significant for the Polish system.

There is one more important argument which is not found among theoretical features of the “ideal local financial system,” but which has been very important in the Polish environment. The revenue power of local government is not sufficient to cover expenses necessary to provide compulsory functions man-

dated to sub-national tiers. It is true not only for certain geographical areas (this is inevitable, since the tax base is always unevenly allocated across the country, regardless of which revenues are defined as local taxes), but also on an aggregate level. So-called “own revenues” are not sufficient to cover minimum needs related to performed functions even in relatively affluent local governments— there are very few exceptions to this rule. In such circumstances the role of grants is simply to support the local revenue base.

The latter function of the grant system has been more and more visible throughout the last decade. At the beginning of the 1990s there was a relative balance between the revenue power and the scope of functions of municipal governments. But several functions have been transferred to local governments since then. There was almost no parallel increase in the scope of local own revenues. Instead, new functions were financed through the grant system. The most powerful example of this phenomenon is a transfer of responsibility for primary schools (this process ended in 1996). This function, which in some local governments eats up more than half the total budget, is meant to be financed first and foremost by the general purpose grant. So, when schools were transferred to the municipal level, the amount of grant increased significantly and the share of own revenues in the total municipal budget decreased significantly. This process is illustrated by tables in the Appendix.

Moreover, the typical compensation for a loss of own revenue sources was also an increase in the general purpose grant (instead of finding alternative local tax revenues or of increasing the capacity to generate own revenues). The abolishing of tax on passenger cars is a good example of such a process. Similarly introduced by Parliament, exemptions to local taxes were usually compensated by the grant system. As we will see in the following sections, since 1999 there has been a separate part of the general purpose grant— a “compensating part”. Interestingly enough, in spite of official “own revenues” ideology, local governments and their national associations have usually not protested against such a change in the revenue structure, whenever the grant compensation was sufficient to cover the financial loss of own revenue power. From a political point of view, the highest dependence on inter-governmental transfers may sometimes be more convenient. It allows the avoidance of unpopular decisions (such as an increase in local tax) and possible reductions in local services can therefore more easily be blamed on the central government.

As may be seen from the discussion above, the actual role of the grant system is a result of both consciously formulated purposes and the spontaneous development of the financial system under the influence of various actors with specific interests.

In the general picture of the grant system’s funding of local governments, the most fundamental distinction is between general purpose (*subwencja*) and

specific grants (*dotacja*). According to the Act on Revenues of Territorial Self-Governments, general purpose grants are received by each local government. Details of the system will be discussed in the following sections.

Regarding specific grants, there is a real distinction between grants which “are” and which “can be” the source of local revenue. The former are received by each local government, while the latter are awarded only to specific governments. We will elaborate on specific grants in section 4.

Before going into detail on the description of individual grants, it is worthwhile to note that the vast majority of transfers in Poland is based on the principle of lump-sum transfers. It is definitely the case for the general purpose grant, which forms the largest part of inter-governmental transfers. However, some specific grants are also based on the lump-sum formula. The only significant element of the matching grant system can be found within the regulations on grants for capital investments. The own resources provided by local governments can (but not necessarily) be matched by the grant from central government, and the broad framework for the matching mechanism is described in the Act on Local Government Revenues.

One of the questions sometimes asked about the practical implementation of the grant system is to what extent imprecise allocation formulas allow for support of political allies of the parties governing at the central level (see Chandler 2001). Theoretically it is also possible that the detailed allocation formula (which does not allow for subjective decisions) is structured in such a way that it works in favour of a concrete political group.

To what extent might this be the case for Polish local governments? It seems unlikely, but to answer this question with a higher degree of certainty, we will try to undertake a more in-depth analysis including statistical tests of empirical data. First of all, it is unlikely to happen in the case of a general purpose grant based on clear and easily measurable criteria. Moreover, the allocation system has been stable enough for the last several years to make political bias of the formula unlikely. However, one may expect such decisions to be dictated by the partisan solidarity present in the allocation of some special purpose grants. It seems that grants for capital investments might be potentially the most vulnerable to such deformation. We have tried to check this hypothesis in several ways, using 2000 data on actual allocation.

First of all, it was verified whether the central decisions (made in parliament and government) are structured in such a way that they support regions governed by the parties ruling at the central level. If this hypothesis is confirmed, one might expect larger per capita investment grants to regional self-governments in regions governed by central government coalition parties. Moreover, one might expect that average per capita investment grants to municipal govern-

ments would be larger in the same regions, since the majority of local governments are dominated by the same parties. 2000 data suggest that neither of these hypotheses (concerning grants to regional and to municipal self-governments) is confirmed. There is no statistically significant relationship between the ruling regional party and the amount of capital grants. More surprisingly, there is also a lack of significant correlation between per capita investment grants and regional variations in GDP. This means that investment grants are not used as a tool of regional equalisation policy. We will come to this issue in section 4, in which we discuss the practical operation of capital investment grants.

Table 1

Per capita investment grants to regional and municipal governments depending on governing/opposition status of the party ruling on a regional level (2000)

Region	Per capita investment grants	
	- to the regional tier	to the municipal tier
Average – government	18.98	18.73
Average – opposition	22.29	19.85

Source: own calculations on the basis of Ministry of Finance data

But even if the central decisions on grants are not politically biased, one may expect this is more likely to happen at the regional level, where the governor (nominated by the Prime Minister) allocates support for individual municipalities’ investments. The full verification of this hypothesis would require much time and effort-consuming detailed studies and this is not possible in this paper. However, we are able to provide at least partial verification of the sample of 112 middle-size and small towns for which we have data on the political party of the local mayor.

Table 2

Per capita investment grants to municipal governments depending on governing/opposition status of the local mayor (2000, sample of 112 towns)

Towns governed by mayors belonging to:	Per capita investment grant
- governing coalition party	11.29
- opposition party	8.25

Source: own calculations on the basis of Ministry of Finance data

The data in Table 2 suggests there is a political dependence of the investment grant allocation. Statistical testing proved that the relationship is not significant, but one may still expect that such a relationship is more likely within individual regions, where one regional governor is making decisions concerning several local government investments. Again, to verify such a claim would re-

quire additional investigation. For the time being, we have been able to test such a hypothesis in three regions (which were the best represented in our 112 towns sample) and in one group of regions (four regions in Eastern Poland). Only one of these four tests demonstrated a correlation on the margin of statistical significance (at the 0.055 significance level). This happened in the region in which the majority of local governments were dominated by the opposition. Possibly, under these circumstances, government officials (the governor in this case) are more willing to support their political colleagues. However, the small size of the sample used does not allow us to treat this finding as anything other than a hypothesis. In summary, according to the available data, the thesis on the relatively high immunity of the Polish grants system from politically influenced decisions cannot be rejected.

4.3 General Purpose Grants

The current system of general grants has been in operation since 1 January 1999. It should be noted, however, that in the case of municipal governments, the system which operated in the earlier part of the 1990s was based on very similar principles. With some exceptions which are described below, grants are calculated and attributed to each of the three levels of local government separately.

4.3.1 Municipalities (*Gminas*)

The general grant for *gminas* consists of three parts: basic, educational and compensatory. Each of them is calculated and allocated according to the formula provided by the Act on Local Government Revenues. However, some details are relegated to the secondary legislation issued by individual ministries.

The **basic** part must represent not less than 1 per cent of the State budget's estimated revenues, increased by the payments of the richest *gminas*. It is divided into two pots: equalizing and proportional.

The equalizing sum falls by right to those *gminas* whose revenue-raising per capita capacity from local and shared taxes is lower than 85 per cent of the national average. The local government receives 90 per cent of the difference between 85 per cent of the national average and the *gmina's* index, multiplied by its population.

To calculate the tax capacity of each *gmina*, the maximum rates of local fees and taxes are taken into account. Therefore if a local council wants to favour its tax (fee) payers, it has to do so on its own "account". This rule does not refer to the most significant source of revenue, i.e. the property tax, when collected by local governments with less than 15 thousand inhabitants. For those *gminas* their actual tax-rates are taken into account in equalising grant calculation. Although this "solution" refers to all *gminas*, in practice it brings benefits mainly to the rural

ones. From among 1604 (in 1999), only 40 (just 2.5 per cent) numbered more than the threshold of 15,000 people. But there are also 78 municipalities of urban status (24.5 per cent of all cities) and 355 municipalities of mixed urban-rural status (62.5 per cent) which fall into this “privileged” category.

The residual is distributed among all *gminas* according to their weighted number of inhabitants. The weighting mechanism is as follows:

- for the *gminas* with fewer than 5,000 inhabitants the conversion number is 5,000,
- from 5,000 to 10,000 the two numbers are equal
- for *gminas* with 10–50,000 population the weight (on the “surplus” over 10,000) is 1.1
- for *gminas* with 50–300,000 citizens the weight is 1.2
- for *gminas* over 300,000 the weight is 1.25.

The progression is so flat that for the biggest *gmina*, Warszawa-Centrum, the eventual rate in 1998 was just 1.23. On the other hand, it favours small (and rural) *gminas*: 93 per cent of the 578 *gminas* which in 1999 had less than 5000 inhabitants, were rural. However, as shown in the appendix and in the following sections, the basic part in general and the proportional section of the general purpose grant in particular do not represent a large proportion of municipal revenues.

We mentioned that the basic amount to be allocated is increased by the payments of the most affluent local governments. Such a contribution is paid by *gminas* whose revenues from local and shared taxes exceed 150 per cent of the national average. The formula is as follows:

- 20 per cent of revenues between 150 and 200 per cent,
- 25 per cent of revenues between 200 and 300 per cent,
- 30 per cent of revenues over 300 per cent of national average.

For all units of the local government, the **education**² portion must represent not less than 12.8 per cent of the State’s budget estimated revenues and it is the largest part of the general purpose grant. Because the total amount of this grant is calculated for all tiers of local governments, resources may be moved between (for example) the municipal and county levels following demographic changes.

The precise distribution of this portion of the grant is the responsibility of the Minister of Education, although general rules are set down in the Act on Lo-

2 It should again be stressed that it is still a part of the general purpose grant, so it may be spent on many different purposes selected by the local council. The name is derived from the method of calculation. On another note most local governments consider the education grant insufficient and frequently subsidise the schools’ operations from their own revenues. But the opposite case (i.e. of local governments spending part of the education grant on other purposes), although not frequent, is also found. For example, in 1994, 17 per cent of the local governments running schools did this. In 2000, approximately 1 per cent used part of the education grant to finance other services (Swianiewicz, 1996; Ćwikła, 2001).

cal Government Revenues. The algorithm used for this has been the subject of changes almost every year. Since 1999, the basis has been the weighted number of pupils attending schools in a given locality (which is not necessarily equal to the number of pupils living there).

The number of weights used in the formula is quite high (in 2000 there were 14 weights for basic tasks in education and 7 for so-called non-school functions) but only some of them are really significant for most of the local governments. The most important weights include:

- 1.33 for pupils in rural *gmina* (the Ministry of Education admits that being a rural *gmina* does not necessarily imply higher costs. Authors of the formula agree that in the future a more precise analysis of variation in costs is necessary and that some other measures, perhaps including density of population, will be applied.). This weight is higher than it should be based on a comparison of spending needs in urban and rural areas, and has therefore an equalising effect on local revenues,
- 1.18 for pupils in small towns (up to 5,000 population). (The Ministry argues that although unit costs in small towns are not higher than in the larger cities, this weight is justified by the government priority for supporting the development of small towns)
- 1.50 for handicapped pupils in special schools and 1.25 for the handicapped in “regular” schools
- 1.20 for schools teaching national minorities languages,
- 1.30 for the number of pupils for whom local government arranges transport (usually school buses). This weight is called the “school network rationalisation bonus.” There is a belief that it will lead to the closing down of some very small schools in tiny villages and to the strengthening of larger (and providing better quality education) schools in the central village of each *gmina* (closure or organisation of the new school depends solely on the local government responsible for the service),
- 0.7 for schools for adults
- 0.6 for non-public schools for children and youth, 0.35 for non-public schools for adults³
- 1.15 for most vocational schools (for some the weight is even 2.00),
- 1.008 for methodological centres for teachers and pedagogical libraries

3 A brief explanation on non-public schools in Poland is perhaps necessary. Most of them are not private but they are run by not-for-profit entities (typically – foundations) established and managed with the strong participation of parents. At the beginning of the 1990s there was a wide-spread grass-root movement to establish such schools. For example, in Warsaw itself apart from approximately 300 public primary schools, there are also 30 “social primary schools” (led by foundations), 7 primary schools run by Church-related institutions and 22 private primary schools. Regarding comprehensive secondary schools, in Warsaw there are 114 public schools, 12 run by the Catholic Church or Church-related institutions, 29 “social secondary schools” (led by foundations or parent associations), and 23 private comprehensive secondary schools.

- 1.011 for special psychological counselling centres (the last two weightings relate to the number of pupils in *powiat* or voivodship depending on the area served by the centre).

Until 2000, local government was obliged to subsidise non-public schools with an amount not less than 50 per cent of the normative per pupil in public schools (the subsidy for non-public schools might be higher if the local council so chooses), but since 2001 the subsidy to non-public schools has been equalised with payments for schools run by local governments.

The **compensatory** part is a brand new solution in Polish public finance. It has operated since 1999. The compensatory part consists of two elements. The first one was introduced to compensate *gminas*' losses in revenues from the tax on vehicles, due to the severe reduction which began in 1998. This sum is fixed at not less than 10.5 per cent of planned revenue from the excise tax on petrol. It is allocated to the different *gminas* by the Ministry of Finance, basically in proportion to previous revenues from the tax on vehicles.

The second sum is to redeem *gminas* revenue losses resulting from the State's financial policy as determined by exemptions and reductions established through national legislation pertaining to: (i) the taxes on agriculture on forestry, (ii) the exemption of certain items from taxes in general (mainly from the property tax at the local level) and (iii) reductions by the State licence organs of the exploitation fee. The amount of this sum is fixed every year in the annual Budget Act.

4.3.2 Counties (Powiats)

The general grant for *powiats* consists of three parts: educational, road and equalising. The mechanism for the **educational** part has already been described.

The **road** part for both counties and regions is fixed at not less than 18 per cent of planned revenue from the excise tax on petrol. 10 per cent of this sum makes up a reserve for capital investments and the remainder is allocated according to the length of roads managed by a given authority (50 per cent of the formula), intensity of traffic on these roads (50 per cent in counties and 45 per cent in regions) and the intensity of traffic on border passes (5 per cent – in regions only). The Act on Local Government Revenues also refers to the rate of traffic accidents, but until now it has not been included in the actual formula prepared by the Government.

The **equalising** part is fixed every year in the Budget Act. It is allocated to all *powiats* – with one exception where the planned revenue from the 1 per cent share in the PIT paid by the *powiat's* citizens is the highest. All remaining *powiats* receive compensation at a rate of 85 per cent of the difference from the richest *powiat* per capita PIT shares revenues.

4.3.3 Regions (*Województwo*)

As in the case of *powiats*, the general grant for regions consists of the same three parts: education, roads and equalisation. The **equalising** part is fixed every year in the Budget Act. It is distributed amongst all regions, except to the one in which the planned revenues from shared taxes are the highest. The remaining regions receive 70 per cent of the difference between their own revenues and those of the richest region. Educational and road parts are defined in the same way as for county governments.

4.4 Special Purpose Grants

To talk about special purpose grants we need to distinguish between three basic types:

4.4.1 Grants for current spending on tasks delegated to local government administration.

The only relevant regulation in the Act on Local Government Revenues is that the amount of these grants should be calculated in the same way as the central government administration calculates its expenditures for the same purposes. Not surprisingly, this imprecise regulation was not sufficient to avoid bargaining and quarrels between the central and local governments. The local governments frequently complain that many functions delegated to them are underfunded and that grants received are hardly enough to cover even the salary costs of required personnel. Therefore delegation of new functions has sometimes been seen as a method to decentralise budget problems. Central government usually defends its position by saying that similar amounts were sufficient for the provision of services before passing them to local governments and that decentralisation should lead to some efficiency gains and related savings in necessary spending (actually the latter argument had been raised many times by local governments themselves but in case of quarrels over the amount of grants, it works against its authors). What central government fails to add is that the similar amount spent before by the central administration, was not sufficient to avoid arrears in payments. Sometimes government also cheated with inflation – for most of the last decade the inflation rate was under-estimated in official predictions, which also provided an occasion to “save” something on grants for delegated tasks.

As a consequence, it is quite common that local governments “subsidise” delegated functions using their own revenues or from general purpose grants which are supposed to support the provision of municipal functions. A good example is provided by data referring to the transfer of new functions to over 40 of the largest cities in 1994. For the first two years, these functions were treated as being delegated to local governments and they were officially funded by a relevant specific grant. In 1994, however, cities spent 13 per cent more on these functions than they received in grants (data of Supreme Chamber of Control, quoted after

Czekaj, 1999). Taking into account that these new functions consumed almost 20 per cent of total cities' budgets, the change in the scope of their activity led to quite considerable fiscal stress.

Grants on current spending related to delegated tasks are the most important in the revenue structure of *powiat* (county) governments, where they constitute over a quarter of total revenues. At the *gmina* (municipal) level their significance is somewhat more limited, although quite significant at the same time. In 2000 in cities of county status they constituted 14 per cent of total revenues. Historically, this share has fluctuated due to the changing status of some functions. The bulk of these grants is related to *powiat* tasks performed by big cities. In remaining municipal governments the share was about 7 per cent in 2000 and it has been undergoing a secular decline. Their significance is less for regional governments, where their contribution to the overall budget pot in 2000 was just under 4 per cent.

4.4.2 Grants related to current expenditures on “own functions” of local governments.

This category is probably the most difficult to describe, since regulations are extremely fragmented and unclear. Grants related to various functions (such as education, social protection, housing etc.) are regulated by several sectoral acts. Only in a minority of cases do regulations clearly indicate the amount of the grant and how it should be allocated amongst individual local governments. The grant to support housing benefits for poor tenants is a good example of a clear regulation, although even there we have not been able to avoid bargaining and discussions over methodology and the accuracy of government calculations. In most of the other cases, the central bureaucracy can make a decision at its own discretion and, not surprisingly, the final allocation is a result of the bargaining process between the central and local governments.

Early on in the decentralisation reforms, it was assumed that specific grants for core municipal functions would be the exception rather than the rule and that local governments should be financed mostly by their own revenues and general subsidies based on clear, transparent criteria. This was actually the case during the first few years of the last decade. In 1991 this category of grants provided just 0,3 per cent of total revenues and the share in 1994 was similar. But during the second half of the decade, the financing system has been gradually spoiled, and the share of specific grants for current spending in *gmina* (municipal) governments is now over 3 per cent of total revenue. It is characteristic that the change was not due to the change in official policy but rather the result of incremental changes and a series of small victories of the central sector bureaucracy, which would like to exert stricter control over the local government's spending structure. In terms of the expectations of the authors of the Polish decentralisation reforms, the share

of this category of revenues in county and regional budgets is disastrous at well over 10 per cent. Although current regulations on the revenues of these governments are considered provisional, this provisional period began in 1999 and will most probably continue throughout 2002 and possibly later.

4.4.3 Specific grants for local government investments

This type of grant is regulated in great detail in local government legislation, although its allocation criteria are still far from transparent. Grants for investments are distributed by the *wojewoda* (regional governor) after consultation with the elected regional council (*sejmik wojewodzki*). Allocation between *regions* and among wide sectors of budget classification is decided in the annual state budget. The criteria for allocation of this type of grant are neither stable nor clear. Normally, investment grants cannot exceed 50 per cent of the total investment cost, although there are some exceptions to this rule (e.g., if *gmina* revenues are lower than 60 per cent of national average or if the *gmina* is located in a region on a government list of regions affected by structural unemployment or if it inherited land used previously by the Soviet army. In these cases the investment grant may be up to 75 per cent of total investment cost). Since 2001 (in some cases from 2002), investment grants may only be allocated for investments specified in the regional development strategy and where they are related to goals formulated in the regional contract (signed between the regional self-government and the central government);

In spite of efforts to standardise and to clarify the criteria of allocation, much still depends on the individual decision of individual governors. There is not even a consensus as to the main criterion which should be used. To what extent should the allocation of capital grants be based on the historical and predicted effectiveness of individual local government investments? Should it be allocated first and foremost to localities with the poorest infrastructure, and the greatest investment needs? Or perhaps it should be distributed either on a per capita basis or by some other similar method? In such circumstances, as one might imagine, it is very difficult to find any clear pattern in the actual allocation. There is no significant correlation between received capital grants and the affluence of local communities and local governments, so the distribution has no equalisation effect. The only exception to this observation is that a narrow group of the richest local governments (10 per cent with the highest own revenues per capita) receive capital grants less frequently than others. Also lacking is a clear regional pattern, i.e. it is not that poor regions get more or fewer (per capita) capital grants, although even regional distribution is not equal. It appears rather chaotic and subject to fluctuations difficult to track through time). One may hardly expect to find that efficiency criteria are the most significant, since there is no agreed methodology to assess the economic consequences of past investments. Methods of cost-benefit

analysis (such as net present value and internal rate of return) are not commonly known and are rarely applied to the planned, future investments.

A study undertaken in 1998 (Marcou) described efforts to standardise criteria for grants for water and sewage investments (based mostly on the need criterion) and suggested that state grants for investments should concentrate mostly on sectors which do not receive separate, special support in the form of soft loans or sometimes even grants provided by the Environment Protection Fund or the National Housing Fund. Obtaining such subsidised loans has happened quite frequently and in 1997 and 1998 they were used by over 70 per cent of all municipal governments (see Swianiewicz and Dziemianowicz 1999). It was suggested, therefore, that central government capital grants should concentrate on sectors in which investments are financed only from local own revenues or commercial borrowing, such as for transportation systems and education (the largest local government sectors outside of the scope of activity of funds mentioned previously). However, this idea has never been implemented and no attempts at standardisation of criteria been successful.

At the beginning of the last decade, capital grants were much more important than grants for current expenditure and authors of the reform assumed it would be the main (and with limited exceptions, the only) type of specific grant, representing over 1 per cent of total municipal revenues in 1991 and over 3 per cent in 1994). Recent development challenged this assumption, however. During the last few years, capital grants to municipal governments decreased both in absolute and relative terms. In 2000 they were less than half of grants for current spending on own functions (see Appendix). The nature of regional governments' tasks and the regions' dependence on inter-governmental grants result in the high proportion of capital grants in regional revenues (over 20 per cent in 2000).

In the middle of the last decade, the share of central government capital grants in total municipal government investments was just below 20 per cent. Recently, however, it has fallen; in 2000 it was between 10 per cent (in urban local governments) and 12 per cent (in rural areas). They still remain the major source of the upper tiers' capital investments – more than half in the counties and over 80 per cent in regions.

4.5 The Equalising Role of Grants

The equalisation grant for local governments in Poland is an element of the general purpose grant system and has been described in section 3. It is funded to a large extent by the central budget, although in the case of municipal governments, there is also a modest contribution from the most affluent local authorities. In 1998 such an equalisation contribution was paid by 77 (3 per cent) local governments who paid a total of over 106 million Polish *zloty* (about 26.5 million dollars). In 2000, the number of contributing local governments decreased to 70

and the amount paid increased to 129 million zloty, which in constant prices represented an increase of 2 per cent. However this contribution constituted only 7 per cent of the basic part of the general purpose grant for *gmina* governments (as explained in section 3 the equalisation grant is a basic part of the general grant; available statistics do not allow a separation of the amount spent on equalisation and the remainder of the basic part).

In municipal governments, the basic and equalisations part of the general purpose grant constitutes between 0.5 per cent of total revenues in cities of a county status (these cities are usually relatively affluent, so their equalisation grant is very low) and 5.1 per cent of total revenues in the remaining municipalities (2000 data). Also, in the case of county and regional governments the share of equalisation grants in total revenues is not very high (2.7 per cent and 6.2 per cent respectively). It is low in spite of the very high degree of equalisation in the counties and regions, as described in section 3. This may be explained by a very low proportion of own and shared revenues in total county and regional governments' budgets.

There is no equalisation mechanism for shared revenues received by the sub-national governments in Poland. Shares of the personal and corporate income taxes are received by the localities of each territory where they have been collected and where there is no redistribution mechanism. Such a mechanism used to exist for municipal shares of the Personal Income Tax, but after some discussions and protests by rural communes (who were the main losers, since farmers in Poland are not PIT-taxed) it was abolished few years ago. It is worthy of note that at the beginning of the nineties this temporary PIT redistribution system was introduced not to support poorer localities, but (due to technical difficulties of the tax administration) to allocate revenue shares according to the taxpayers' place of residence. However, this technical solution unintentionally turned into a political mechanism which was very difficult to dispose of.

The equalisation system in Poland is first and foremost an equalisation of revenues. The equalisation grants formula includes data on revenues only, with no attempt to take into account variation in expenditure needs. However, there are some elements of expenditure needs elements in other parts of the grants system. The most direct one is in the portion of the basic grant to municipalities which is dependent on the population size. The number of inhabitants is given a different weight depending on the size category, as presented in section 3.

This weighting system is based on the assumption that large cities provide more services and therefore have greater expenditure needs. In addition, the system takes into account that the smallest local governments (in the Polish system, those with a population under 5,000) may have higher unit costs for many services. This system certainly reflects the real picture, but in a very crude fashion. First of all, weights are based on intuition rather than on precise data analysis. Second,

the real variation of needs normally depends more on the municipality's function and role in the settlement system than on the population size itself. For example, the spending needs of 60,000 towns located in the suburbs of Warsaw are definitely different from those of a city of similar size which is a regional capital. However, even more important are the cases where the solution described above has only symbolic meaning. The majority of the basic part of the general grant is distributed through the equalisation formula, and the amount which takes into account expenditure needs (thanks to the weighted population formula) is extremely small. It is well illustrated by the fact that in 2000 cities of county status (which do not receive equalisation grants) the basic part constituted just less than 1 per cent of the total amount of the general purpose grant. In the 12 largest cities (being members of the Union of Metropolitan Cities) this proportion was even smaller,– 0.4 per cent (Swianiewicz 2001). In fact, analysis conducted in various countries indicates several factors which imply higher expenditure needs in big cities. These factors include:

- **an increased number of service consumers**– some services are provided not only for inhabitants of cities, but also for suburbs and surrounding regions;
- **higher unit costs due to:**
 - higher costs of labour,
 - higher costs of property (for example higher costs of some infrastructural investments for which the city needs to buy plots of land),
- **greater externalities**– related to the high population density and the concentration of specific problems such as environment protection and transport;
- **concentration of problems (such as crime, drugs etc.) related to the sociological features of large cities** – this implies greater spending needs for services such as social welfare and public safety. Taking care of the homeless or security for big sports or cultural events (such as concerts) are examples of such greater needs.

These factors also apply to the large Polish cities, although they are not adequately reflected in the grant allocation formula.

The second example of taking spending needs into account is related to the formula of “road subsidy”, which is a part of the general purpose grant for county and regional governments. As emphasised above, this part of the grant is related to revenues from the excise tax on fuel and its allocation is related to the length of roads, the intensity of traffic and special needs related to traffic near national borders.

The third case in which there is an attempt to take into account variations in spending needs is the formula for the allocation of the education subsidy. The weights (discussed in detail in section 3) try to reflect variation in spending needs. The most important factor in the formula is the higher weight given to pupils in rural schools, which tries to reflect higher unit costs in smaller schools,

with smaller classes, the necessity of pupils' transportation to the school and a higher pupil/teacher ratio. This weight has been based on a careful statistical analysis of actual spending. The problem is that the weighting for rural local governments does not distinguish between rural schools in remote areas with low population density and schools in the suburbs of big cities, which are rural only formally (rather than by any characteristics of local community). There are plans to correct this drawback in the future. Also considerations of other factors (such as special weights for national minority schools, handicapped pupils, and special types of vocational education) are relatively successful attempts to reflect variation in needs, though indirectly they help to equalise not revenues but expenditure needs.

4.6 Payment of Grants

4.6.1 General grants

Because general grants account for quite a considerable part of local budgets, local government units need to know in advance how much they may expect in the coming year, so as to include that income into their budgets.

According to the law, each local government unit receives advance information on the amounts of each part of the general grant before 15 October of the previous year. The only exception is the compensating part of the general purpose grant information, which is sent within two weeks after the publication of the annual Budget Act.

Fixed amounts of individual parts of the general grant are transferred to local government units at different times and they are usually transferred in monthly instalments.

If any parts of the general grant are sent later than specified by the Law, the State has to pay interest on the outstanding tax.

4.6.2. Specific grants

As far as specific grants are concerned, the rules are the same for all tiers of the local government, i.e.:

- In most cases specific grants are sent to local governments by the regional governor (*wojewoda*), or in some exceptional cases, directly by the branch Ministry;
- If the amount of a grant for a delegated task or the time of its payment is a problem, a local government has the right to take the State to court.
- The above seems to provide a higher degree of security to local governments with respect to specific grants received. The Public Finance Act specifies, however, that the amount of a specific grant for current tasks may be changed (through the amendment to the annual budget law) up until 15 November

and in grants for own functions until 30 November. Moreover, the decision on the specific grant providing local revenues is not a sufficient basis for litigation when the sum has not been paid. Indeed, there are some known examples of local governments which received the promise of a capital investment grant but lost the cases in court when, not having received their funds, they tried to sue the central government.

4.7 Grants Mechanism Reassessed

Elements of our assessment of the grants system in Poland have been formulated above in our discussion of individual grant elements. In this section we will try to summarise the main arguments putting them into two groups: the strengths and the weaknesses of the present system. Reading this section it can be seen that the list of weaknesses is longer. However, this purely mathematical point of view might be misleading. We are convinced that the strengths which are enumerated below have greater weight and in spite of many specific critical comments and needs for improvements, the grants system which has been achieved during the decentralisation reform in Poland is quite well structured and includes several elements which are worthy of retention. These might also be interesting for countries which are currently struggling with local finance reform.

Strengths

- Allocation of the general purpose grant is based on a formula which depends on objective and easily measurable criteria. Therefore the system is influenced neither by subjective decisions of bureaucrats nor by political anachronisms. It helps to build a real and not simply a declarative autonomy of local policies.
- The overall amount of the general purpose grant “pie” to be divided is precisely defined by the Law on Local Government Revenues. Thanks to that, the general purpose grant is not a subject of political discussion during the preparation of and voting on the annual budget law. Central government cannot manipulate the size of the general purpose grant as a function of cyclical central budget problems.
- the basic formula allocation has been pretty stable over the last years. The changes introduced have had a somewhat marginal meaning. Together with the previous item, this provides stability to local finance and allows for long-term financial forecasts by local governments.

Weaknesses

- the relationship between the allocation formula and spending needs is not sufficiently close (although saying that it does not exist would not be a fair judgement). Practical disregard of spending needs in big cities is a good example of

this phenomenon. Even imperfect definition of “weighted population” taken into account in allocation of one (very small) part of the general purpose grant, is not applied consistently. There are no rational arguments why the same weighted population formula should not be applied to determine the right to an equalisation grant or to determine contributions of the most affluent local governments to the equalisation fund.

- The strengths described above are related to the general purpose grant, while most of its weaknesses may be identified with special purpose transfers. Their overall amount is not defined by the law, which makes them vulnerable to annual state budget bargain process.
- The criteria for special grants allocation are also much less clear (with some exceptions, such as support for housing benefits paid by local governments). Lack of clear criteria leads to subjective decisions and sometimes may reflect political clientelism. There is no doubt that adopting clear and sharp criteria in the case of specific grants (especially those related to capital investments) is much more difficult than in the case of general purpose grants. It is also difficult to find an example of a country where such an ideal system really exists. But it seems there is still much to be done in Poland to go towards the direction of a more transparent and fair system.
- the structure of local government revenues in general and of government grants in particular has been gradually worsening throughout the last decade. First, the proportion of own revenues in total budgets of municipal governments has been gradually decreasing (while the proportion of state transfers was increasing) and on a county and regional level it is extremely low. Second, the negative factor in the structure of transfers is the gradual increase of specific purpose grants. Contrary to the initial assumptions of reformers, specific purpose grants are less and less an instrument to support specific investment needs, and more and more an element of the financing of the current own tasks of local governments. It is extremely visible on a county level, but the negative trend can also be seen at the municipal level.

The description and evaluation of the grants system cannot be totally separated from the general picture of the local government finance system. In Poland there is a clear distinction between the way *gmina* (municipal) authorities are financed and the way those of county and regional governments are financed. The former may be characterised by a relatively high share of own revenues, having considerable fiscal autonomy and a significant role in public finance. Although the way *gmina* governments are financed would require some modifications (some of them, those related to the grant system, are discussed in the preceding sections), the main frame of the present system and also the main frame of the present grant system is worthy of retention. The latter (related to country and regional finance) is definitely underfunded, leaves almost no discretion in revenue-raising and is strongly dominated by grants. A large proportion of such grants are

specific and based on criteria that are not entirely clear. The system of county and regional finance is in great need of redesign; likewise, the grant system requires considerable, thoughtful change.

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Appendix

Table 1

The role of local government finance in the national economy– all local government spending or investment spending as per cent of

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total budget expenditures	16,3	15,2	16,7	18,9	19	24,6	25,3	27,9	38,0	39,8
GDP	5,5	5,6	6,2	7,1	6,9	8,1	8,6	8,6	10,5	11,0
Total investments	6,9	7,5	9,7	9,9	9,8	10,6	10,5	9,4	9,7	9,7
Total public investments	na	na	na	na	17,6	19,6	22,6	22,4	25,8	na
Total budget investments	42,6	43,6	49,9	52,0	53,5	53,7	55,5	53,3	62,5	64,0

Source: Ministry of Finance, *Statistic of self-governments, 1991 – 2000*

Table 2

Percentage structure of *gmina* (municipal) revenues– historical evolution

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Own revenues	45,52	47,31	46,49	40,32	40,07	34,80	35,27	33,46	32,80	33,20
-property tax	15,30	16,36	14,80	13,43	14,14	11,40	11,20	11,35	11,49	11,79
-agriculture tax	3,92	2,70	3,85	2,82	2,60	2,17	1,97	1,76	1,48	1,28
-stamp duty	4,61	5,27	5,04	4,02	3,74	3,39	3,28	3,35	3,99	3,54
Shares in central taxes	28,95	22,17	25,38	23,10	23,09	24,49	24,20	24,71	18,20	16,46
-PIT	na	19,59	21,76	20,63	20,74	22,67	22,42	23,02	16,68	14,88
-CIT	na	2,59	3,62	2,47	2,35	1,82	1,78	1,68	1,52	1,59
General subsidy	13,53	11,74	11,43	14,93	15,22	25,33	24,15	25,44	32,09	32,78
Specific grants	12,00	18,78	16,71	21,65	20,58	13,86	14,13	14,25	14,51	15,10
Other revenues	0,00	0,00	0,00	0,00	1,04	1,52	2,26	2,14	2,40	2,46

Source: Ministry of Finance, *Statistic of self-governments, 1991 – 2000*

Note: for 1999 and 2000 including cities of *powiat* (county) status

Table 3

Grants structure in municipal (gmina) governments (as per cent of total revenues)

	1991	1994	1998	2000
General Subsidy	13,53	14,93	25,44	32,78
- education part	?	11,2		25,3
- basic and equalisation part	?	3,73		3,32
- road part	0	0	0	1,07
- compensating part	0	0	0	3,09
Specific grants for current delegated tasks	10,5	17,9	7,7	9,8
Specific grants for current own tasks	0,3	0,4	3,3	3,7
Specific grants for capital investments	1,1	3,3	3,3	2,0
1A. Grants structure in cities of county status				
	1991	1994	1998	2000
General Subsidy	na	14,7	18,4	31,2
- education part	na	12,8		25,6
- basic and equalisation part	na	1,9		0,5
- road part	na	0	0	2,89
- compensating part	na	0	0	2,21
Specific grants for current delegated tasks	na	29,3	5,8	14
Specific grants for current own tasks	na	0,3	3,9	4,3
Specific grants for capital investments	na	2,2	3,4	1,9
1B. Grants structure in other municipal (gmina) governments				
	1991	1994	1998	2000
General Subsidy	na	15,2	28,5	33,7
- education part	na	10,5		25
- basic and equalisation part	na	4,7		5,1
- compensating part	na	0	0	3,6
Specific grants for current delegated tasks	na	11,9	8,7	7,1
Specific grants for current own tasks	na	0,4	3,1	3,3
Specific grants for capital investments	na	3,9	3,3	2,1

*Source: Ministry of Finance, Statistic of self-governments, 1991 – 2000***Table 4**

Grants structure in county and regional governments (as per cent of total revenues) in 2000

	Counties	Regions
General Subsidy	47,7	37,8
- education part	37,35	11,45
- basic and equalisation part	2,66	6,15
- road part	7,69	20,2
Specific grants for current delegated tasks	25,52	3,1
Specific grants for current own tasks	13,34	14,71
Specific grants for capital investments	4,84	23,54

*Source: Ministry of Finance, Statistic of self-governments, 1991 – 2000**Note: counties without cities of county status*

5. The Role of Municipal Bonds as a Repayable Source of Financing Territorial Self-government Units

Maria Jastrzębska *

At the end of the 1980s, shortly before the transition period began, two levels of public administration (local and regional) operated, but both were controlled by the State. The system was regarded as highly centralised and costly and neither efficient nor creative for local and regional representatives.

The process of political and economic transition that began in 1989 was a great challenge for the rebirth of local autonomy. One of the strategic aims of local government reform in the 1990's was the implementation of decentralisation of State power. To do this requires building the material and financial basis for the autonomy of territorial self-government units (TSU). It was expected that newly introduced territorial self-government units – communes (*gminy*) would reduce bureaucracy and lower the costs of public administration. Those involved in the process of delivering services to the local societies have been granted the right to influence that process.

The second round of territorial self-government reform in Poland was introduced in 1999, when an additional two levels of TSU were created. There are three types of territorial self-government units – the commune (*gmina*) at the basic level, district (*miasto na prawach powiatu* – a city with *powiat* status and *powiats*) as the intermediate level and voivodship (*województwo*) as the highest level of territorial self-government.

The division of TSU, according to the model presented above, results from the task-based criteria, which means that there is no subordination between TSUs (i.e. a commune is not subordinate to the district or voivodship and similarly, a district is not dependant on a voivodship). Communes and districts are units of local government and voivodships are units of regional government. In Poland, these units are also units of the new administrative division of the country. During the period 1999–2001 there were 2,425 communes, 373 districts (65 cities with *powiat* status and 308 *powiats*) and 16 voivodships. However, in 2002 there were new changes in territorial division which means there are now 2,425 communes, 380 districts (65 cities with *powiat* status, 315 *powiats*) and 16 voivodships.

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Table 1

The structure of revenues and expenditures of the public finance sector in Poland
During the period 1998 – 2001 in %

SPECIFICATION	PERCENTAGE SHARE IN TOTAL REVENUE OF PUBLIC FINANCE SECTOR				PERCENTAGE SHARE IN TOTAL EXPENDITURE OF PUBLIC FINANCE SECTOR			
	1998	1999	2000	2001	1998	1999	2000	2001
State budget	55.6	49.6	50.4	48.3	39.1	28.0	27.5	24.5
Local and regional budgets	12.2	11.7	11.8	11.2	15.5	20.6	22.4	22.7
Purposeful funds	25.9	26.8	25.8	24.5	38.6	37.8	36.9	36.3
Health Care Funds	---	6.7	7.0	8.2	---	7.7	7.6	7.9
Beyond budgetary economy – state level	2.7	1.7	1.6	1.8	2.3	1.3	1.3	1.3
Beyond budgetary economy – local and regional level	3.6	3.5	3.4	3.3	4.6	4.6	4.3	3.4
Other units of public finance sector	n/a	n/a	n/a	2.7	n/a	n/a	n/a	3.9

Source: Ministry of Finance of Poland.

The introduction in 1999 of additional levels of TSUs has not solved the problem of decentralisation of public finance, which still remains. During the period 1999 – 2001 we can see that the share of the State budget in the structure of total revenues of the public finance sector is still about 50 per cent and that means there is rather a high level of centralisation of public finance (see Table 1). Moreover, the purposeful funds and healthcare funds manage more than 30 per cent of those revenues. So, in fact, the central level gathers more than 80 per cent of the total revenue of the public finance sector. Accordingly, local and regional governments are only able to manage about 16 per cent of those revenues themselves. The situation is different in the case of expenditures of public sector finance. The state budget spends more than 25 per cent of total expenditures of public sector finance but local and regional budgets spend more than 20 per cent of those expenditures. So the percentage share of local governments in the structure of expenditures of the public finance sector is higher than the percentage share in the structure of revenues of the public finance sector. The reason for this is very simple – TSU finance their tasks using grants from the State budget. But in this way, they are very dependent on the central level. Moreover, there is insufficient money from the State level to fulfil all their tasks. It is worth noting that total transfers from the state budget to purposeful funds, depending on the amount, are almost the same as total transfers from the state budget to local and regional budgets.

Table 2
The percentage share of TSU average debt in total revenues
during the period 1999 – 2001

SPECIFICATION	1999	2000	2001
Gminas	11.5	14.8	15.4
Cities with powiat status	12.3	17.3	22.0
Powiats	0.6	3.0	3.7
Voivodships	0.7	2.8	6.4
Average – TSU	9.5	12.9	15.4

Source: Ministry of Finance of Poland.

Exercising the statutory tasks of TSU (current as well as investments), requires using replaceable financing sources such as loans, credits, issuing municipal bonds and bills. Therefore the money collected from repayable sources, according to Polish law, can be used to balance local and regional budgets. It can be seen that during the period 1999–2001, the index share of average debt of territorial self–government units in their total revenues rose from 9.5 per cent in 1999 to 15.4 per cent in 2001. The most remarkable increase took place in cities with powiat status (see Table 2). Those territorial self–government units spend more money on investments than other TSUs. The index of the share of expenditures for TSU`s investments decreased during the period 1999–2001 from 19 per cent to 17 per cent of total TSU expenditures. The share of expenditures for investments in the case of communes in the same period decreased from 22 per cent to 19 per cent of their total expenditures and in the cases of cities with powiat status– from 18 per cent to 16 per cent. The same situation exists in the voivodships – from 31 per cent to 28 per cent but in the case of powiats, we see an increase in expenditures on investments – from 6 per cent to 9 per cent. The increasing number of territorial self–government units with budget deficits during the period 1999–2001 is also confirmation that a very important part of self–government sector debts is connected to budget deficits and receiving money for balancing budgets from repayable sources of financing TSUs. Fortunately, the situation was better in 2001 because there was a decrease in all levels of TSUs with budget deficits (table 3).

Table 3

Number of TSUs with budget deficits, budget surpluses and balanced budgets
During the period 1999–2001

SPECIFICATION	1999				2000				2001			
	G	C	P	V	G	C	P	V	G	C	P	V
Number of TSUs with budget deficit	1332	43	43	14	1694	58	168	12	1415	49	94	11
Number of TSUs with budget surplus	1093	22	265	2	731	7	140	4	1010	16	214	5
Number of TSUs with balanced budget	0	0	0	0	0	0	0	0	0	0	0	0

Notice: G-gmina. C – city with powiat status. P – powiat. V – voivodship.

Source: Ministry of Finance of Poland.

According to the structure of TSUs with budget deficits, we can see that in the case of communes in 1999, 55 per cent of them closed their budgets with budget deficits; in 2000, 70 per cent, and in 2001– 58 per cent. In the case of cities with powiat status, the situation was much more serious. In 1999, 66 per cent of them closed their budgets with a deficit; in 2000 the figure was 89 per cent and in 2001, 75 per cent. In the case of powiats in 1999, 14 per cent of them closed their budgets with a deficit; in 2000 this figure was 55 per cent and in 2001, 70 per cent. In the case of voivodships, in 1999, 88 per cent of them closed their budgets with a deficit; in 2000, 80 per cent and in 2001, 70 per cent. According to the structure of liabilities of TSUs, we can see that in first place are the communes with over 50 per cent share of total liabilities of TSUs. Second place goes to cities with powiat status because their liabilities are equal to over 40 per cent of total liabilities of TSUs in Poland. In third place are the powiats (about 4 per cent) and in fourth place are the voivodships (about 2 per cent). The choice of repayable sources for financing TSUs is made with respect to their future financial solvency, their needs and the results of their spending. The local and regional self-government units may choose loans and credits – commercial and non-commercial– or to issue municipal bonds or municipal bills.

Table 4

The structure of gminas debt during the period 1995–1998 in %

SPECIFICATION	1995	1996	1997	1998
Non-commercial debt	67.3	58.2	57.7	36.0
Bonds	0.0	5.9	9.8	16.2
Bank credits	32.7	35.9	32.5	47.8

Source: Ministry of Finance of Poland.

During the period 1999–2001 we can see the increasing role of issuing securities, especially municipal bonds. However, this is still not the most important

source of money from repayable sources of financing TSUs considering the structure of TSU debts (see Tables 4 and 5). The figure is over 5–7 per cent for gminas of their total debt and 18–21 per cent for cities with powiat status. Some powiats started to issue securities in 2000 and some voivodships in 2001. The total debt figures went from 5 per cent in 2000 to 20 per cent in 2001 for powiats and for the voivodships it was around 20 per cent. Moreover, credits and loans are dominant within that structure with approximately 84–87 per cent for gminas, 75–76 per cent for cities with powiat status, 45–65 per cent for powiats and 70–75 per cent for voivodships of their total debt.

Table 5
The debt structure of TSUs during the period 1999–2001 in %

SPECIFICATION*	1999				2000				2001			
	G	C	P	V	G	C	P	V	G	C	P	V
Securities (including municipal bonds)	5.3	21.0	0.0	0.0	5.3	17.8	5.2	0.0	7.4	20.3	19.4	19.4
Credits and loans	87.1	74.9	64.0	73.3	83.4	75.6	44.7	74.4	84.9	75.6	66.4	69.7
Deposits	1.4	0.9	9.5	0.0	2.5	1.6	2.3	0.4	0.7	0.3	1.7	0.3
Liabilities**	6.2	3.2	26.5	26.7	8.8	5.0	47.8	25.2	7.0	3.8	12.5	10.6

Notice: *G-gmina. C – city with powiat status. P – powiat. V – voivodship.

**Liabilities: trade liabilities. obligatory fixed premiums for Social Insurance Fund and Work Fund.

Source: Ministry of Finance of Poland.

The role of non-commercial loans and credits decreased, so we can guess that the municipal bond market in Poland should expand. Confirmation of this is seen in the increasing number of municipal bonds issuers in 2001 (in 2000, 89 issuers and in 2001, 146). We can also see that the value of the issue of municipal bonds has increased (in 2001 compared to 2000 this figures was approximately 89.5 per cent) but we still cannot say that there is a real municipal bond market in Poland. This is because too few TSUs issued municipal bonds. They still do not have sufficient information to be sure that municipal bonds are a better financial instrument for them than credits or loans. The situation is not the same in every territorial self-government unit, but generally speaking, there exists several criteria to choose the right repayable source of financing TSUs. It is therefore very important to make a comparative analysis of the advantages and disadvantages of loans, credits, municipal bonds and bills. The share of municipal bonds in the debt securities market in Poland is about 10 per cent (see Table 6). Generally, the profitability of municipal bonds is higher than the profitability of treasury bills simply because the interest rate of municipal bonds (variable interest) is based on the profitability of 52-week treasury bills and this is increased with a premium

(bonus) if these securities are held for longer than a year. The territorial self-government units usually issue municipal bonds using the simplest and cheapest methods. This is a so-called closed issue referring to less than 300 investors (beyond the stock exchange and regulated secondary over-the-counter market in Poland – Central Table of Offers– CTO). That is why financial institutions are the most important investors in the municipal bond market (especially banks because they arrange and carry out the issue of municipal bonds). The level of liquidity of the municipal bond market is far from satisfactory. Moreover, these securities are issued for rather a short period of time, compared for instance, to the issuing period of the same securities in the US or in some EU countries. The average period of municipal bond issue is 5 years and only a few TSUs have issued bonds for longer periods – 8 or 10 years. The structure of issues during the period 1999–2001 referring to quantity of issues shows that rather small issues (up to 5m PLN) predominate and represent 42–48 per cent of the total issue of municipal bonds. With regard to the structure of the value of issue, they are equal to 5–8 per cent of the total issues value (see Table 7).

Table 6
Municipal bond market in Poland during the period 1997–2001

SPECIFICATION	1997	1998	1999	2000	2001
Value of municipal bond market in PLN	296.9	526.1	653.6	859.6	1628.6
Share of municipal bonds in debt securities market in %	8.7	7.0	7.1	5.8	9.8
Number of issuers	28	40	53	89	146
Increase of number of issuers in %	n/a	42.9	32.5	67.9	64.0
Increase of issues value of municipal bonds in %	n/a	77.2	24.2	31.5	89.5

Source: CERA S.A. *Central European Rating Agency*; at present– *Fitch Polska S.A.*

The second place in the structure takes issues from 10m to 100m PLN. Their share in the quantity structure is 30–26 per cent and they dominate the value structure 55–48 per cent. It should be noted that the share of that issue decreases from year to year. The stable part of issue quantitative structures represents issues of 5m to 10m PLN (23 per cent) and their share in the value structure is 7–9 per cent. The biggest issues – over 100m PLN play an important role in the value structure (30–35 per cent) but in the quantity structure, their share is only 4–3 per cent. From a territorial point of view, in first place for TSUs in Poland is WIELKOPOLSKIE voivodship with 30 issues with a value of 283,0m PLN. In second place is POMORSKIE voivodship with 14 issues of 276,5 mln PLN. The next (third place) is DOLNOSLASKIE voivodship – 21 issues of 160,6m PLN. Those local and regional units must realise new municipal investments since these areas of Poland are highly developed and therefore the investment attraction in these regions is very high. So, there are many needs which have to be fulfilled. But,

achieving the set goals of these territorial self-government units requires borrowing money and that also means issuing municipal bonds¹.

Table 7
Quantitative and value structure of municipal bonds issued in %

SPECIFICATION	TO 5 MLN PLN	FROM 5 TO 10MLN PLN	FROM10 TO 100 MLN PLN	FROM 100 MLN PLN
According to quantity of municipal bonds issued 1999	42.5	23.0	30.5	4.0
2000	47.0	22.5	28.0	2.5
2001	48.0	23.0	26	3.0
According to value of municipal bonds issued 1999	5.0	7.0	55.5	32.5
2000	7.0	8.5	55.0	29.5
2001	8.0	9.0	48.0	35.0

Source: CERA S.A. Central European Rating Agency; at present– Fitch Polska S.A.

The factors that restrict development of a municipal bond market in Poland are as follows:

1. a complicated procedure for the issue of municipal bonds and becoming part of the capital market,
2. a shortage of professional consulting agencies issuing municipal bonds– there is a small role for rating marks (see Table 8),
3. very few investors investing their money in municipal bonds and this is not good for primary and secondary capital markets in the concept of the development of a capital market in Poland and also for the municipal bond market,
4. a limited role of investment funds and pension funds as investors in the municipal bond market and there is little interest by local societies in the municipal bond market,
5. an ignorance of the benefits and costs of the issue of revenue bonds; the introduction of this type of securities should be very useful for the development of the municipal bond market, especially as issue of revenue bonds is not subject to legal regulations limiting the level of debt of TSUs and the level of expenditures for paying off the debt.

1 For instance in 2000, money from the issue of municipal bonds in Poland was spent on the following (for domains of tasks of local self-government units) – the structure in per cent: plumbing work – 32.1 per cent, education – 11.4 per cent, sewage system –10.5 per cent, public transport – 8.8 per cent, roads – 8.8 per cent, sports –7.9 per cent, sewage treatment plants – 6.5 per cent, social building – 5.2 per cent, other e.g.: recycling and storage of scrap materials, central heating plants, technical infrastructure of grounds – 8.8 per cent.

Table 8
Rating marks for cities with powiat status

CITY	RATING AGENCY	RATING MARK	RANGE OF RATING MARK
GDAŃSK	Standard & Poor` s	BBB	International
KRAKÓW	Standard & Poor` s	BBB	International
ŁÓDŹ	Standard & Poor` s	BBB	International
SZCZECIN	Standard & Poor` s FITCH IBCA	BBB	International
WROCLAW	Standard & Poor` s	BBB	International
OSTRÓW WIELKOPOLSKI	CERA	A-	Domestic
TYCHY	CERA	AA-	Domestic
ŻORY	CERA	BBB	Domestic

Source: CERA S.A. Central European Rating Agency; at present– Fitch Polska S.A.

The actions required to develop a municipal bond market in Poland (conditions of development of the municipal bond market) are as follows:

1. amend the law on revenues of territorial self-government units in order to stabilise its financial condition,
2. simplify the issues of municipal bonds to the stock exchange and the regular secondary over-the-counter market (CTO),
3. increase liquidity of the municipal bond market – in order to interest other investors in the capital market in Poland, not only banks, but also the inhabitants of TSUs issuing bonds, investment funds and pension funds,
4. change the type of TSU budgets from one-year to long-term (of many years standing),
5. separate operating budget from capital budget of TSUs,
6. search other methods for fixing interest paid on municipal bonds (not only based on the profitability of 52-week treasury bills),
7. introduce the issue of municipal bonds with interest capitalisation or with discount,
8. introduce within legal regulations the possibility to roll the debt of territorial self-government units,
9. begin the issue of revenue bonds by banks,
10. use securitisation to finance municipal undertakings (bonds are issued based on the assets of TSUs).

More than half of all municipal investments in Poland are financed from own revenues of the territorial self-government units. For this reason, these units do not often receive loans. Without loans and credits or issuing of municipal bonds they are unable to take that further step to make up for lost time and finance any future development (municipal investments). They also have another problem – how to choose an appropriate repayable source of money. For this reason, the territorial self-government units should take the following criteria into consideration. First of all, investment needs differ depending on the type of local or regional task and on their financial means.

The next criteria are the current and future financial condition of the TSU (budgetary solvency) and its ability to repay the debt. The flexibility of the repayable source for financing a TSU is also very important since it depends on when and how quickly the territorial self-government unit receives money and how often it will be in a position to pay instalments and interest. Another important criterion is the cost of collecting the capital. Due to the above, we can see that the issue of municipal bonds should become more popular with territorial self-government units in Poland because:

1. the cost of actually getting the money is lower compared to credit (lower commission and interest rate),
2. interest is normally paid once a year and in the case of credit – monthly or quarterly,
3. the issue of municipal bonds does not have to be protected,
4. the time it takes to get the money is short,
5. interest is paid up until the end of the last issued series and when the term of bond is up, (upwards one), the issuer pays back all money to the owner of the municipal bond according to the nominal bond value,
6. the flexibility of issuing a bond programme is adapted to the investment needs and credit ability of the issuer,
7. there is a promotion effect, especially in the case of issuing municipal bonds– i.e. public turnover (stock exchange and CTO),
8. there are also the social benefits – the inhabitants of a TSU, as the issuer, are really interested in the problems of their unit and are able to invest money in safe securities.

Summary and Conclusions

There is a high level of centralisation of public finance in Poland. The territorial self-government units are very dependant on the central level. Moreover, there is insufficient money from the state level to fulfil all their tasks. Exercising the statutory tasks of a TSU (current as well as investments), requires using replaceable financing sources such as loans, credits and issuing municipal bonds and bills. It can be seen that during the period 1999–2001, the share index of the average department of territorial self-government units, their total revenues rose from 9,5 per cent in 1999 to 15,4 per cent in 2001. The most notable increase took place in those cities with powiat status. The territorial self-government units are dependant on the capital market to collect funds for municipal investments and to keep financial liquidity and financial solvency (budgetary solvency). Both the Polish capital market and the way they use the financial instruments by local and regional self-government units are variable according to the changes in our economy. Furthermore, the reasons for borrowing money for the TSU's needs and the law regulations in the domain of local finance have also changed. The role of non-commercial loans and credits has decreased and therefore we can make the conjecture that the municipal bond market in Poland should expand. Confirmation of this can be seen in the increasing number of municipal bonds issuers and the increasing value of the issue of municipal bonds. Nonetheless, we still cannot say that there is a real municipal bond market in Poland.

6. Grant Transfers and Financial Supervision in Lithuania

*Mark Chandler**

6.1 Introduction

Lithuanian local government operates in a rapidly changing environment. The structure of Lithuanian local government finance is also continually being revised. Through the ten years of transition, changes have been made to the number of layers of local government, the number of municipalities, the taxes used to fund local government, and the types of grants paid by the state to municipalities. These changes continue up to the present day, with a fairly radical reorganisation of municipal funding in 2002.

Lithuania is a country of 3.5 million people, the approximate size of Ireland. Its current government is formed from a centre-left coalition of Social Democrats and Social Liberals, with the next parliamentary elections not due until 2004. All main parties in Lithuania are committed to the goals of EU and NATO membership.

Economic growth is a healthy 4–5 per cent, with inflation below 2 per cent. The Social Democrats and Social Liberals also received the highest number of seats in the spring 2000 municipal elections, totalling 546 from 2026.¹ Mayors of 25 local authorities are affiliated with governing parties². Other centrist parties control 17 mayorships, and the Peasants Party 11 mayorships.

Since reforms in 2000 there are 61 local authorities (LAs), an increase from 56 previously. Twelve municipalities are urban and there are 49 districts. Given an overall Lithuanian population of 3.5 million the average LA has 57 thousand residents. Some urban LAs are geographically submerged within a single district LA, leaving the district without a centre. Each LA is within one of 10 counties used as branch offices of the national government.

Local government has been seen mainly as performing an administrative role in Lithuania, despite being elected. It is not perceived to have much freedom of manoeuvre on policy but is judged on its capacity to provide value for money. Another traditional role for local government evident in Lithuania is as a training ground for politicians before entering national politics. In 2000, for example,

* EuroFaculty Vilnius Centre, Vilnius, Lithuania. Thanks are due to Artahses Gazaryan, Lina Domarkiene and Vytautas Sulija for helpful comments. All remaining errors are my own.

1 <http://www.lrs.lt/n/rinkimai/20000319/mlta.htm>

2 Own calculations from data provided at <http://www.lsa.lt/nariai> and <http://www.lrs.lt/n/rinkimai/20000319/asmp.htm>.

the mayor of Vilnius was appointed prime minister. The main services provided through local government are schools, social security and welfare, higher education, housing and residential services, and recreational and cultural services.

Almost all revenue sources for local government are controlled by the state and this weakens local government. The power of municipalities to make policy decisions over expenditure has oscillated since 1990. Overall there is a generally low opinion of local government in the general public according to regular opinion polls. Local government is often perceived to have low capacity to fulfil its responsibilities and this induces resistance to expanding their responsibilities any further. The main body responsible for fiscal and other relations between the LAs and central government is the Association of Local Authorities in Lithuania. The ALAL is also a key source of information on developments in the budget process. The most notable attempt to foster openness from local government is in Vilnius city where the mayor put a live view of his office on the Internet 24 hours a day.³

6.2 Local Government Legal Framework

There are two levels of government in Lithuania; national and local. The national government also maintains 10 county level offices with heads it appoints in political bargaining between the coalition partners alongside its ministerial appointments. Similarly some LAs divide their territory into neighbourhoods for administration of some services. Nevertheless the only levels of government elected by the citizenry are the national (president and one-chamber parliament) and the local authorities' councils.

Main legal acts:

1. Constitution
2. Law on Local Self-Government⁴

Constitution: Chapter 10 of the Constitution (articles 199-124) is devoted to "Local Government and Administration". Article 119 establishes that local administrative units have the right of local self – government and that their governing councils must be elected by the residents of each jurisdiction. The rest of the chapter provides for state support to the independent local authorities, discusses local fiscal policy, establishes the right of local authorities to appeal to court any violations of their rights, and the right of individuals to appeal to court against any infringements by the local authorities.

The Law on Local Self-Government provided more of the details needed for operation of local government such as the territorial division of the country, the

3 <http://www.vilnius.lt/new/vadovybe.php>

4 Council of Europe (1996): 5.

institutional structure and the organisational procedures. It was first passed on 7th July 1994 and has been amended several times since. The main decision-making body of local government is the local council. This is supplemented by the mayor, elected by the council, who is responsible for chairing council meetings, relations with other institutions, making proposals to the council and general supervision of the work of the LA. The structure of LAs also includes an executive board of the council, a head of administration accountable to the mayor, and a controller with legal personality responsible for supervision of funds. The LA's functions are in three groups by degree of independence from control by the national government; independent, limited independence, and state delegated.

The key channel for interaction with the national government is the Association of Local Authorities in Lithuania. This body is responsible for conducting budget negotiations with the national government on behalf of the LAs. The ALAL has also been involved in issues such as LA debt and supply of utilities. The ALAL represents Lithuanian LAs at the European Council. Another indirect channel of intergovernmental interaction is the courts. Occasionally LAs are found in contravention of health and safety or other laws and are forced to increase expenditure in a particular area in order to comply with the court decision. The county administrations of the national government employ government representatives whose role according to the Constitution is to evaluate the legality of LA actions.

Much power in local government affairs is vested in the Lithuanian Finance Ministry due to its control of the allocation of budgetary income to the LAs. Income is general and taxes are not assigned to any particular spending categories. This effectively removes one side of the budgetary process from local control. The more controversial question is how much control LAs have over their expenditure. The existence of expenditure norms, used by the Finance Ministry in calculating budget allocation may have considerable influence on LAs. LAs may be heavily politically constrained by these norms since spending less than a norm could be used as strong political ammunition against the ruling party on the local council. If no area receives less than the norm there is no flexibility to increase spending in any areas. Also, however, spending less than the norm could be self-defeating for an LA if the Finance Ministry reacts by reducing the allocation for the LA in that area the following fiscal year. Within the broad spending categories governed by norms, LAs may have more flexibility. Even here, though, they are constrained by decisions at the national level such as nationally determined teacher wages. One further constraint on the ability of the mayor or ruling party of an LA to make independent decisions is control from their national party. Although many commentators still argue that political parties are weak in Lithuania, LAs that are run by members of the same party as that in national government are less able to push for their own interests and more likely to follow the agenda of the government. Much, however, depends on the political strength of

individuals. An illustrative example is the mayor of Vilnius in 2000 who, despite being a member of the party of national government, withheld payment of social security taxes for city employees as a negotiating tactic with the national government. That the mayor and prime minister were of the same party may even have increased the ferocity of the battle as some commentators would see it as part of the war between these two figures for support within their party.

Experts of the European Congress of Local and Regional Government conducted a review of deficiencies in the legal structure of Lithuanian local government after a request from the ALAL. This led to 87 recommendations approved by the Congress on 30th May 2001. These included items urging the Lithuanian Government to ensure that financial control is carried out with proportional methods that would not harm local governments' independence. Another set of recommendations covered the need to ensure municipalities have recourse to courts to resolve conflicts with the state government.

6.3 Intergovernmental Financial Relationship

The financial relationship between state and local governments is complex and includes a matrix of impacts on both the revenue and expenditure side. There are formal obligations of one level of government to another, that have financial implications (e.g. grants from the state to local governments), and impacts that arise from political or other non-statutory considerations (e.g. the pressure on local governments to fund spending categories according to state guidelines). Furthermore there are effects from one layer of government to another that may be indirect consequences of their independent decision-making.

One of the main aims of the 2001 reforms to local government finance, then, was to improve the delimitation of local versus state responsibilities. In order to achieve this, functions administered by local governments were divided into three categories; state dependent, partially independent, and fully independent local function. Those functions deemed to be fully state responsibilities were henceforth funded by categorical grants with the municipalities clearly only playing the role of administrators of state policy. Those functions that were fully local responsibilities were to be funded from general revenue and the local councils would have policy control over these.

Before 2002 local government revenue in Lithuania was dominated by the personal income tax. This tax was used largely for the finance of local authorities although it is controlled by the national government. That dichotomy created problems for the efficient administration of the tax. It may be that part of the reason why revenues were so low from the personal income tax is that the institution in control of collection, the national government, had a significantly weakened incentive to improve collection since local authorities receive the vast majority of the revenues. The LAs could have become a strong interest group for

the improvement of efficiency of administration of the personal income tax. The LAs did not, however, take on this role, probably calculating that they would be unable to retain the benefits from such an improvement in collection.

The changes in the funding of state functions for 2002 implied a large increase in the amount of funding from categorical grants. To balance this there was a large fall in funding from general revenue, particularly the personal income tax. In the new system the state budget would take approximately 40 per cent of personal income tax revenue in each town, in addition to the 30 per cent taken by the compulsory health fund. For the first time the state government had a direct and clear interest in personal income tax collection and this may help to improve its efficiency.

The scale of the transformation is shown in the table below.

Table 1
LA Revenue by Source (000's. Lit)as

	2000		2002*	
	Amount	%	Amount	%
Personal Income Tax	2504272	76.5	1097804	32.0
Other Taxes	325556	9.9	295682	8.6
Non-tax	112521	3.4	69077	2.0
Grants from the state budget	315405	9.6	1963747	57.3
Transfers from other budgets	16515	0.5		
Total	3274269	100	3426310	100

*forecast

Sources: Statistics Lithuania (2001, p. 21-22), Ministry of Finance (2002).

Hence the new revenue structure has grants providing the majority of funding where the personal income tax did before. As shown in the table below for 2000, property taxes are the second most important category.

Table 2
Tax Revenues in 2000 (000's litas and percentage of total revenue)

	Personal income	Land	Land rent	Real estate	Estate, inheritance, Gift	Stamp	Market place
	2504272	20849	46019	189804	1831	60031	7022
%	76.5	0.6	1.4	5.8	0.1	1.8	0.2

Source: Statistics Lithuania (2001, p. 21).

Municipal revenue is almost totally controlled by the national government, as has been criticised by previous analysts.⁵ There is also a healthy debate among specialists within Lithuania on this issue. The ALAL proposed the establishment

5 See for example Martinez (1998, p. 77).

of local taxation but the national government has not been ready to accept this reform. Giedrius Lingis, ALAL Consultant on Finance and Economics, presented several arguments for the establishment of a local real estate tax [Lingis (2001)].

1. The European Charter of Local Authorities calls for local taxation with rates under the control of LAs.
2. The Law on Local Authorities (2000) provides that a part of LA revenue comes from taxes whose rates can be adjusted by LAs up to maximum levels set by law.
3. Local taxation would ensure healthy competition between LAs.
4. Increase in responsibility of LA councils and reduction in Government responsibility for increasing revenue in specific municipalities.
5. In other countries property taxes provide 30 – 40 per cent of LA revenue compared to only 8 per cent in Lithuania at present.
6. Real estate tax revenue is more stable and easier to forecast than other forms of taxation.
7. Income tax rates could be reduced, in accordance with the Government's "Tax System Concept".
8. It is more difficult to evade real estate tax, and this would enable tax rates to be reduced overall without reducing revenue.
9. Real estate taxes would be paid in the area of residence, where citizens actually use LA services, rather than in the jurisdiction where they work, as at present with the personal income tax.
10. There would be a reduction in the revenue inequality between municipalities.

To this list we might add the improvement in the incentive of LAs to develop the economy of their jurisdiction. The Ministry of Finance has disclosed that it is working on a proposal for local real estate taxation as part of a new Real Estate Tax Law.⁶ This may allow municipalities the flexibility to set their own tax rates between limits of ½ and 1 per cent. So far the full proposal has not been presented, however.

Every year the government must pass a law on the Confirmation of State and Local Authorities' Budgets' Financial Indicators. One of the issues that arises repeatedly is the accuracy of the government's forecast for tax revenue for the following year. An example of this is in the ALAL executive decision "On the Draft Law on the Confirmation of the 2002 State and Local Authorities' Budgets' Financial Indicators" (8th October 2001). This decision contains the claim that the 2002 revenue projection for the personal income tax is too high and so, to keep revenue the same in 2002 as it was in 2001, LAs overall would have to receive 45.77 per cent of personal income tax revenue rather than the 44.03 per

6 Private correspondence with Vytautas Sulija 10th January 2002.

cent given in the draft law. A more concrete example of failing revenues is in a table of forecast and actual revenue for the first 10 months of 2001 prepared by the Ministry of Finance (2001b). Here we see that overall LAs had received only 79 per cent of their forecast revenue for the year (compared to the 10/12 or 83.3 per cent they should have received). The situation varied significantly across LAs with 11 being on or ahead of schedule. The worst performer, Akmene district, had received only 72 per cent while two municipalities, Palanga city and Neringa, had already received over 100 per cent of their forecast revenue for the year by the end of October.

One possible explanation of why revenues continue to fall behind projections for most LAs is that governments deliberately overestimate future revenue so that they can better control the distribution of funds. When revenue turns out lower than projected, municipalities still receive what was projected due to later compensation for the shortfall. If revenue is higher than projected, however, the municipality keeps these extra funds and this implies a loss to the national government. So there is an incentive for the national government, having decided how much money it wants to distribute to each municipality, to give over-optimistic forecasts for revenue that enable it to set tax and grant parameters lower than necessary to ensure that revenue in reality, so that no LAs end up with more revenue than the government intended. This structure ensures that at the margin there is little incentive for most towns to improve revenue since their future compensation for their revenue shortfall will be reduced by exactly the amount that their revenue shortfall decreases by. The only advantage to the municipality would be from the time discount on future compensation.

The role of tax abatements by the municipalities in the overall state financial system is also fairly controversial. Bronis Rope, President of the ALAL, argues that these abatements are a method to encourage business and therefore ultimately increase revenues and reduce costs across government budgets [Rope (2001)]. He also uses the example of a government decision regarding granting exemptions to disabled persons to argue that such abatements are an integral part of national policy. Hence there is a case against the decision of the Finance Ministry to count revenue lost through abatements as having been received by the municipalities, although on balance it is better to allow municipalities to feel the cost of their decisions, even if prompted by governmental advice. The variety of abatements is quite striking; 5 municipalities gave none in the first 10 months of 2001 while in Neringa they amounted to 722,000 litas [Ministry of Finance].

Disagreements over the appropriate revenue for LAs arise from a number of sources. One of the most common is based on the provision of the Constitution that municipalities must be compensated by sufficient revenue to cover any increase in expenditures resulting from decisions of the national government. This gives a legal context for the Lithuanian version of the traditional intergov-

ernmental battles over unfunded mandates. A major financial development stemming from failing tax revenues and disagreements over legal revenue of LAs is the emergence of LA debt. This has an impact on the entire complexion of public finances since the state is implicitly the payer of last resort. The debt also forces LAs to be more assertive in pursuing their claims with the national government. The debt is thus a contributory factor in the initiation of court action against the national government by the ALAL. While allowing municipalities to engage in borrowing, the national government has also put maximum limits on the size of LA debt as a proportion of their annual revenue. In the Law on the Confirmation of the 2002 State and Local Authorities' Budgets' Financial Indicators the government increased this limit from 25 per cent to 35 per cent for all LAs except Vilnius city whose limit rose from 35 per cent to 50 per cent. There is also a limit of 20 per cent of their annual revenue for the LAs' borrowing in one year. The part of the debt that is owed to the national government becomes part of the financial negotiation as terms of repayment are traded for agreement on other aspects of the budget. An example of this is the agreement of the Finance Minister on the passage of the law on Confirmation of the 2002 State and Local Authorities' Budgets' Financial Indicators not to seek repayment of interest-free loans to the LAs due to their tax revenue shortfall in 2001.

6.4 The Grant System

6.4.1 Roles and Purposes of Grants

The system of grants applied in Lithuania can often seem ad hoc, despite the establishment of formulae and procedures in law. I will disentangle the separate decisions made on the different grants but also show where allocations in one category depend on those in another. The grant system is constantly evolving in Lithuania so I will attempt to give an up-to-date account of the newest revisions while also providing some context about the systems followed previously.

In Lithuanian legislation, grants are divided into compensation grants, specific grants and equalisation aid. Compensation grants are given to towns that received less income than was forecast for them. Grants became a much larger part of municipalities' incomes in 2002 as part of the general reorganisation of local government finance. The state and local authorities' budget law lists categorical grants for each municipality. These vary both in number and in size from year to year. The formulae for equalisation grants are established in the Lithuanian Local Authorities' Budget Income Method of Calculation Law. Prior to 2002 this law was supplemented by the Local Authority Budget Income and Equalisation variables law, which established the size of the formula coefficients that were fixed for three years. For 2002 this law was no longer required and all coefficients were set in the Lithuanian Local Authorities' Budget Income Method of Calculation Law.

6.4.2 General Purpose Grants

In the 2002 national budget, general-purpose grants to municipalities are only used to compensate for changes to overall projected revenue between 2001 and 2002 and for partial compensation of the revenue shortfall from 1997 – 2000. This contrasts with the 2001 budget, in which municipalities received general-purpose grants to compensate for the shortfall of tax revenue in the previous year and for functions newly delegated to them by the state government. This latter form of compensation is mandated by the Constitution. The new general-purpose grant in the 2002 budget⁷ is the general compensation grant given to ensure that municipalities in 2002 do not receive more than 1 per cent less than they were projected to receive in 2001. In addition, however, there is a general grant from LAs back to the state budget from those municipalities whose projected revenue in 2002 has risen more than 7 per cent from revenue projected for 2001.

(i) Compensation for reduction in revenue.

In previous years the Government has compensated municipalities directly with a grant for the shortfall of income tax revenue compared to that projected. In the 2002 budget, passed in December 2001, there was a provision for continuing compensation for shortfalls from 1997 – 2000 of 64,555 thousand litas but no compensation for 2001. A shortfall in revenue in 2001, however, is reflected in the revenue forecast for 2002 and so is compensated in LAs where overall revenue is projected lower than in 2001. To illustrate this point, consider the example of Birstonas given below.

Table 3

Birstonas 2001 in 000s litas	
Income tax revenue forecast net of Compulsory Health Fund:	2,054
Overall revenue shortfall in Jan-Oct:	268
Birstonas 2002 in 000s litas	
Income tax revenue forecast net of Compulsory Health Fund:	1,714

Hence there was a downward adjustment of the forecast income tax revenue associated with the overall revenue shortfall the previous year. That reduction in projected income tax revenue is reflected in a lower overall revenue forecast which triggers an increase in the compensation for reduced revenue. Revenue forecasts for the municipalities are thus significant determinants of the size of their general grant. In combination with the inevitable uncertainty associated with any forecast this means that they become controversial numbers in the budget negotiation process. Since the ALAL has complained about the lack of compensation for the

⁷ Other than the equalisation grants analysed separately in section 4.4.

shortfall of revenue in 2001 we may anticipate that this will be added to the budget by amendment during 2002 as the 2001 data becomes available.

An example of the sometimes rather ad hoc nature of the Lithuanian municipal grants system is provided by the phenomenon of interest-free loans that the Finance Ministry later does not require to be repaid. This happened in 2001 when interest free loans from the Finance Ministry were kept as grants by municipalities to cover revenue shortfalls from the personal income tax. This dispensation might be labelled grants for needy areas, those that received less than projected from the income tax, although they also form part of the equalisation system. The process then forms part of the story on the timing and mechanism of payment of revenue/grants to LAs. It becomes apparent with the operation of this compensation for revenue shortfalls that municipal income does not depend upon income tax collection in a given year, but only on the Finance Ministry's projection of what that revenue should be.

What is less clear is whether a decline in a municipalities tax revenue that is projected to continue for the following year leads to a decline in the funding of that municipality the following year or if the difference is made up completely by increases in other grants. This is similar to the question of whether any expenditure savings or revenue increases engineered by LAs will result in counterbalancing reductions in grants from the national government.⁸ It appears that there is enough flexibility in the municipal funding system for Parliament to adjust the various components of the budget to arrive at whatever final sum it wants to allocate to a municipality. This is an empirical question that could potentially be answered by careful econometric analysis. Unfortunately, in order to do this, we would first need a reliable model of the political decision-making in the Parliament regarding municipal budgets. Vote maximising by members of Parliament may be an inappropriate assumption in a transition country where gains from large-scale privatisations and other similar opportunities for politicians may outweigh re-election as a goal.

(ii) Compensation for newly delegated functions

Since there is a constitutional requirement to provide increased revenue to municipalities to cover newly delegated functions, governments have often felt it necessary to include this allocation as a separate budget item in the budget law. The 2001 budget law contained 3.3m litas in grants to the municipalities under this category, while in 2002 there is no such grant. Instead, however, this category of funding is likely to be partly subsumed under the new special grant to perform state functions. This is part of the effort to clarify municipal activities by dividing them between administration of state functions and independent local functions. The questions of under what circumstances the government is obliged to provide such funds, how it calculates

⁸ This was the claim, for example, in the interview with the Finance Minister in Lazdynas (2001a).

the amounts, and whether there is any mechanism to prevent the Government from removing these funds from another part of the LA budget thus become important.

6.4.3 Special purpose (categorical) grants

The number and type of categorical grants has varied through the transition period in Lithuania. They are established not only in the budget law passed before the year begins but also in amendments passed during the year itself. The only consistent grants have been for investment.

Table 4

Investment grants have followed the pattern depicted in the table below.

Year	Number of municipalities	Total (000's. litas)
1997	16	52,500
1998	18	61,333
2000		63,239 ^a
2002	30	64,731

Sources: Budget laws; a Statistics Lithuania (2001, p. 34).

Vilnius city also received special grants to renovate its Old Town of 15 million litas in 1998 and 1999 and 2 million litas in 2000 and 2001. Other grants were less stable as shown in the table below.

Table 5

Grants by type

Grant	Year	Number of municipalities	Total (000's litas)
Pay off debt	1997	7	31,142
Environment	1997	14	74,862
Environment	1998	19	81,702
Housing restitution	1998	44	18,700
Libraries	1998	56	2,000
Housing stock	1998	3	10,000
Children in state care	1999	54	53,053
National service	2001	59	2,714
Anti narcotics	2001	2	600

Source: Budget laws

In 2002 categorical grants became much more important in the structure due to the radical reorganisation of local government financing. Functions that are classified as state functions only delegated to local authorities for administration are now funded by categorical grants. They are of the following type and size:

Grant purpose in 000s litas	
State functions administered locally:	762,057
Pupil basket:	1,047,378
Special needs pupils:	1,046
Interest on loans for renovation of educational institutions:	5,590
State investment programme:	64,731
Total:	1,945,357

They made up 57 per cent of overall LA revenue. Most notable is the shift of education funding into a categorical grant called the pupil basket. The budget also contained partial compensation of the revenue shortfall from 1997–2000 as a categorical grant, although it is more accurate to consider it a general grant since there is no restriction on what these funds are used for. In practice they are likely to be used to repay debt but, at least at the margin, LAs can decide other uses.

6.4.4 Equalisation Grants

The equalisation system was reformed quite markedly in 2002, by amendment of the Method of Calculation of Local Government Revenue Law. The previous system⁹ was based on a state total equalisation grant for local governments, D, given by

$$D = A - B - C$$

where *A* = forecast level of expenditures for all municipalities

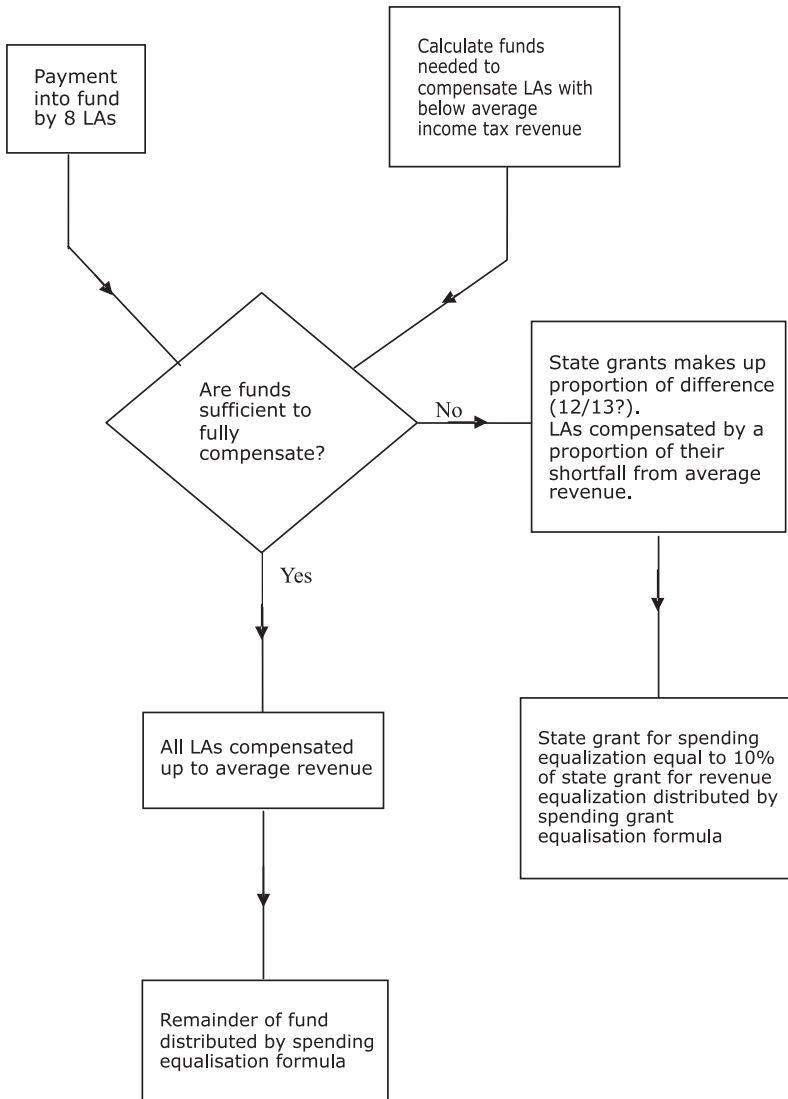
B = forecast revenues from tax and non-tax sources

C = total specific grants.

Hence the forecast of revenues had a direct impact on the state allocation for equalisation. This total grant was then divided between three sub funds. Revenue shortfall funds went to towns whose revenue was below what had been forecast. Revenue equalisation funds were for those towns whose per capita revenue was below the average. Expenditure need equalisation went to all towns whose indices of expenditure need were above the lowest. Expenditure need equalisation funds were supplemented by formula determined payments to the fund from LAs with above average tax revenue per capita. 20 municipalities in all paid into this fund. All funds were distributed to municipalities according to formulae that determined their share of funds for revenue shortfall, revenue equalisation, and expenditure need equalisation from their amounts of revenue shortfall, revenue poverty, and expenditure need, respectively, as proportions of the aggregate level. The formulae also contained scaling coefficients that ensured only a part of the relevant gap was considered for equalisation. Some coefficients for the formula were set for three years. Other variables were established annually in the national budget law.

⁹ See also the discussion of the first version of the previous system in Martinez (1998).

Several changes were made to the system in 2002. One of the main criticisms of the system of equalisation in 2001 was that it depended directly on revenue forecasts. Hence the new system was based instead on actual receipts. Another change was the removal of the formula for distributing funds for revenue shortfalls. The new system contains only equalisation for towns with below average revenue and equalisation of expenditure need. The formula for payment into the expenditure need equalisation fund was removed and replaced by payment of a specified proportion of tax revenue by a specified group of 8 municipalities. The structure of equalisation now looks as shown in the flowchart below.



The 8 LAs that pay into the equalisation fund are the five largest cities and three especially well-endowed municipalities.¹⁰ Hence the previous formula for determining payments was abandoned in favour of a simpler approach based on pre-set proportions and fewer payees. Their contributions are as in the table below. In the 2002 budget the proportion of income tax paid to the Compulsory Health Fund is 30 per cent and 57 per cent of the remainder goes to the state budget. Hence only 30 per cent of income tax collected in the municipalities remains to the local level of government and the proportion of overall tax collection that is paid into the equalisation fund is equal to this 30 per cent multiplied by the proportions given in the middle column of the table.

Table 6
Examples of equalisation grants

Municipality	% of income tax (net of Compulsory Health Fund and state budget payments) paid to the equalisation fund	% of overall income tax paid to the equalisation fund in 2002
Vilnius	60	18
Kaunas	26	8
Klaipeda	36	11
Siauliai	4	1
Panevezys	16	5
Ignalina	22	7
Mazeikai	45	14
Palanga	30	9

Since 34 per cent of all income tax in 2002 was projected to be paid in Vilnius, the contribution to the equalisation fund from this municipality alone represents 6 per cent of Lithuanian personal income tax revenue, or 20 per cent of the income tax revenue going to local government. Neringa municipality would appear to be one of the greatest beneficiaries from the new equalisation system; previously it kept only 1 per cent of its income tax revenue.

The second element of the equalisation system is the calculation of revenue equalisation grants to municipalities. LAs receive these payments each month that their personal income tax revenue per resident the previous month was less than the national average. The grant makes up 90 per cent of the difference i.e.

$$L_{ji} = 0.9 G_i (\bar{x}_f - x_{if})$$

where L_{ji} = revenue equalisation grant to the municipality i

G_i = population of municipality i

\bar{x}_f = average personal income tax revenue per resident in Lithuania the previous month

x_{if} = personal income tax revenue per resident in municipality i in the previous month.

¹⁰ Ignalina has a nuclear power facility, Mazeikai a large oil refinery, and Palanga is a major tourist resort.

This formula decides how much of the month's equalisation fund is paid out to each LA for revenue equalisation unless the payments to the fund are not sufficient. In that case an additional state grant for equalisation makes up some of the shortfall.

As long as the payments into the equalisation fund are sufficient to cover the grants paid out for revenue equalisation according to the above formula, the remainder is used for spending equalisation. If the payments to the fund are not sufficient, an additional state grant funds the spending equalisation. The size of this grant for all municipalities is set at 10 per cent of the total of the state grants for revenue equalisation. In either case the total funds for spending equalisation are divided among the municipalities according to a set formula. Only the 8 municipalities that pay into the equalisation fund are excluded from this process. They receive no grant for revenue equalisation and their cost indices are not included in the total index for all towns in the formula.

The formula for spending equalisation determines the share of the total spending equalisation funds paid to each municipality throughout the year as follows.

$$L_{2i} = L_2 \cdot \sum_n K_n \cdot E_{ni}$$

where L_{2i} spending equalisation grant to municipality i ;

K_n coefficient showing the influence of indicator n ($\sum_n K_n = 1$);

E_{ni} proportion of indicator n in municipality i given by the formula, $E_{ni} = \frac{R_{ni}}{\sum_i R_{ni}}$

where R_{ni} indicator n for municipality i .

This formula has been simplified by that used prior to 2002 in several respects. The previous formula contained three expenditure groups, each containing several indicators. The n indicators and their coefficients (K_n) for the new system were determined on the basis of recommendations by an independent organisation, the Lithuanian Regional Research Institute, as requested by the ALAL [Lionginas (2001)]. The table below gives the coefficients for each indicator.

Table 7
Coefficients for indicators

Indicator	Coefficient
Length of local roads	0.13
Area of municipality	0.17
Number of pension age residents	0.13
Number of children from 7 to 17 years of age	0.11
Number of children from 0 to 6 years of age	0.25
Area of land of educational institutions financed by the municipality	0.13
Area of mortgaged municipal land	0.04
Inverse of density for resorts	0.04

These indicators were found to be objective cost factors, beyond the control of the municipality. They imply that municipal costs depend on physical size factors as well as demographics. The previous system included 11 indicators so this has been reduced to 8.

6.4.5 Payment of Grants

Grant payment schedules can have a large impact on local authorities. One of the main reasons is the erosion of the real value of grants over time by inflation. In Lithuania, however, inflation has fallen to below 2 per cent and so this is of minor concern. Perhaps greater concern arises from the rate of interest paid on short-term borrowing to cover waiting periods. Categorical and equalisation grants appear to have been paid according to schedule since this issue has not been raised by the ALAL or individual municipalities. What has been a much larger problem is the receipt of compensation grants for shortfalls in tax revenue and for new mandates.

In 2001 the Government agreed that local authorities were still owed money to compensate for the shortfall in revenue from 1997–2000. The over-optimistic revenue forecasts of these years led to a large delay in payment of compensation. This led to large borrowing by municipalities while they waited to receive funds they were entitled to by law. When municipalities are then paid compensation grants for these shortfalls, the grants are added to their budget revenue in the year the grant is paid. These funds, however, cannot really be considered a part of current revenue. They are likely in practice to be used to pay off debt accumulated to cover the expense that was incurred previously. The funds are in fact simply a late payment of a previous year's revenue. Adding them to the later year's revenue gives a somewhat distorted picture of the balance between revenue and expenditure since the funds cannot be used to fund expenditure in the year they are received.

5.4.7 Grants Mechanism Reassessed

The grants system initiated in 2002 is a radical increase in the importance of grants in Lithuanian local government finance. This is especially true of categorical grants. It is now more evident which are the areas where local governments are administrators of funds received from the state explicitly for spending on certain national policy priorities. Hence categorical grants take a much bigger part of the overall grants picture now. Several simplifications to the equalisation aid formulae have resulted in a clearer system in which towns can more easily predict their contributions to the equalisation fund.

As with any major change to a fiscal system, there are potential winners and losers from the transition. These can be seen from the data provided by Ministry of Finance (2002) used to calculate compensatory grants for and from those towns whose losses or gains exceed the boundaries of 1 per cent and 7 per cent, respectively. Silutes forecast revenue, for example, rose from 50,787 thousand. litas

in 2001 to 60,579 thousand. litas in 2002 before capping, a rise of 19 per cent. This was largely thanks to a rise in its categorical grants from 0.1 per cent of its forecast revenue in 2001 to 78.8 per cent of the 2001 revenue in 2002. In Visaginas, however, categorical grants rose by only 39.2 per cent of 2001 revenue and hence this town lost 36 per cent of its revenue in the new system, all of which was recouped by the compensation grant. While the compensation grant system ensures that there are no substantial losers in 2002 this is only provided for three years in the law. Hence if the new financial system survived longer than three years, some towns would see substantial loses or gains. Given recent practice, however, it seems unlikely the new system will last that long before being revised.

6.5 Financial Supervision

Financial supervision of Lithuanian local governments is conducted by a number of different officials. Each municipality has a *controller* elected by a secret ballot of the council. The parliament ombudsman can investigate citizens' complaints. The State Control Office supervises all government institutions. The *government representative* works at the county level. Finally, the Parliament itself can impose direct rule on a municipality if the courts find it in violation of the law.

The municipality's controller supervises the execution of the budget and the use of property. They ensure that laws are not broken and also overview the effectiveness of the municipality's work. The controller is directly accountable to the municipal council, not its executive. Nevertheless Beksta and Petkevicius argue that there is a lack of independence and it would be better to have internal and external audits conducted by independent auditing companies. This has been disputed by Bronis Rope, President of the ALAL, who argues that the principal task of controllers should be to assist LAs with their financial control and therefore they do not need independence from the LAs.

The new Law on Local Authorities requires LAs to establish internal auditing [Vitkauskiene (2001)]. Currently LAs employ financial controllers whose role has not been developed to the point that it is possible to distinguish them completely from auditors. The new law raised many concerns among LA controllers due to the lack of specifics from the central authorities on methods and professional training. It is noteworthy to contrast the reaction from this group of professionals upon being given such leeway with the usual call from LAs for more independence from national government. The following data gives some indication of the workload of controllers.

Table 8
Workload of controllers

# of controllers	# of LAs
1	9
2	21
3	16
4	8
>5	6
Total	60

Number of institutions audited:4167
financed in LA budgets3067
institutions audited per auditor per year:20

Algimantas Demenius, Chairman of the Association of Local Authority Controllers of Lithuania (LSKA), contrasted this data with the claim that auditors can only effectively audit 7 institutions per year. EU standards of auditing are far from being reached by Lithuanian municipalities, in part because mayors often do not have the time or will to get involved in what they may perceive as a relatively technical issue. Other controllers present at the LSKA 2001 meeting argued that the Law on Internal Auditing has not been put into practice because it was adopted so hastily, without refinement, and that this is only compounded by absurdly unclear criticism from government institutions.

Rimas Kalkys, Senior Adviser of the parliamentary Committee on Local Authorities and Government Reform, commented that local government controllers will have to choose between two professions; financial control and internal audit as both of these two separate activities are needed in local government. Kaunas city LA has already made this separation. Darius Matusevicus, Acting Director of the newly formed Department of Financial Control Methodology in the Finance Ministry, pointed out that a Joint Committee coordinating the establishment of the auditing system in the state sector was formed in 2000.

The Parliament ombudsman can respond to citizen complaints regarding local government employees. These complaints may refer to corruption or to overly bureaucratic behaviour. The ombudsman does have the power to revoke local government decisions that are in conflict with the law. The State Control Office has similar oversight functions to the municipal controllers, and will sometimes control these controllers. Laima Sipkauskiene, chief of the State Control Office's Budget Control Department reported that state controllers found that audits conducted by LA controllers were superficial, often containing no more than descriptions of annual budget turnover.

Government representatives are responsible for checking that LAs are in compliance with the law and government decrees. They have had a somewhat tor-

tured existence in that they were abolished in 1997 only to be reinstated in 1998. If the government representative finds an LA to be in contravention of a statute they can require the municipality to make the necessary changes, although this may be challenged in court. There is in practice, however, considerable variety in the role played by these officials [Lazdynas (2001b)]. Sigitas Siupsinskas, ALAL Director, complained that what is required by LAs is an institution that would assist them with effective management of the functions delegated to them but that instead of this, the work of government representatives is akin to a bailiff.¹¹ He postulated that the best controller of the work of a municipality is the community itself. Government representatives claim that citizens, afraid of approaching courts, often turn to them to lodge their complaints about LAs. Petras Papovas, Chair of the Parliamentary Committee on State Administration and Local Authorities, argued that government representatives should leave investigation of the effectiveness of municipalities to LA controllers, and focus instead purely on the legality of LA statutes.

6.6 Conclusion

The reforms to local government finance appear to be a move in the right direction. There is now a clearer delimitation of which functions are under the control of municipalities and which are state functions only administered locally. The equalisation system was simplified in several respects. In a country with still limited capacity for public administration, particularly in fiscal areas, that is a significant gain. The sharing of personal income tax revenue with the state budget may also be a positive step if it leads to greater efforts from the state government to improve the efficacy of the tax. The Government has now proclaimed this a main priority.

The main problem of Lithuanian local government has still not been addressed. This is the issue of giving municipalities some control over their income. Lack of control over income inevitably leads to lack of independence in expenditure and administrative decisions. It also implies the absence of mechanisms to link decision-making over services to costs and benefits. The ALAL has called for municipalities to be given a true local tax. If the Government wants to start with a real estate tax with a maximum rate this should be encouraged as a first step. It is then to be hoped that the limit will be raised later to give towns the flexibility to provide extra services if desired by their constituents.

The equalisation system still contains two elements, revenue and expenditure need, that are somewhat contradictory. Some will object to equalisation in principle, although this seems less tenable in the Lithuanian system since it involves no distortion of taxing decisions. Equalisation in Lithuania can be seen as

11 This discussion took place at a meeting of government representatives organised by the Parliamentary Committee on State Administration and Local Authorities on 28th November 2001.

a government commitment to provide every municipality with the ability to provide the same level of service. With that objective expenditure needs equalisation is rational but revenue equalisation more difficult to justify. It seems counter-productive to bring all towns' per capita revenue to 90 per cent of the national average if some towns have less than 90 per cent of the expenditure need per capita.

Expenditure need equalisation is an imperfect art, however. We cannot be sure that the indices used to compute expenditure need give the true picture for all municipalities. This may be part of the justification for the compromise of including revenue equalisation. Expenditure need equalisation may also create some distorted incentives. While some of the indices, such as area of the municipality, are out of the control of the local council others, such as length of local roads, area of land of educational institutions, and even number of pensioners, may be influenced. Thus it is important not to give the councils too great an incentive to change these variables.

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Appendix 1: Revenues 1996 – 2002 (in 000s litas)

	1996	1999	2000	2001*	2002*
<i>Total Revenue</i>	2,657,043	3,207,977	3,274,269	3,209,851	3,426,310
Tax Revenue	1,998,865	2,904,116	2,829,828	2,889,251	1,393,486
Personal income	1,514,756	2,576,394	2,504,272	2,623,521	1,097,804
Corporate income	216,483				
Property taxes	177,430	246,606	258,503	258,060	288,082
Land		18,795	20,849	19,079	
Land rent		47,452	46,019	50,457	
Real estate		178,210	189,804	186,764	
Estate, inheritance, and gift		2,149	1,831	1,760	
Other	90,196				
Stamp duty		73,526	60,031		
Market place duty		7,590	7,022	7,600	7,600
Non-Tax Revenue	107,469	175,350	112,272	78,765	69,077
Grants and Transfers	550,617		331,920	241,835	1,963,747

*forecast

Sources: Martinez (1998, 96); Statistics Lithuania (2000, 23-38), Statistics Lithuania (2001, 21-22), Ministry of Finance (2001a), Ministry of Finance (2002).

Appendix 2: Expenditures 1996 – 2000 (in 000s litas)

	1996	1999	2000
<i>Total Expenditure</i>	2,654,525	3,295,167	3,265,886
Economy	416,282	453,031	387,941
Housing and community affairs	353,950		231,892
Fuel and energy affairs	61,715		80,614
Agriculture	617		49
Transport and communication			74,341
Other			1,045
Social Affairs	2,151,626	2,531,713	2,512,549
Education	1,117,107	1,903,867	1,871,815
Health care	645,013	17,919	13,266
Social security and welfare	290,009	445,124	478,300
Culture and recreation	99,497	164,804	149,168
Other Functions	86,617	310,422	365,396
General public services	86,617		155,231
Public order and safety			25,852
Other			184,313

Sources: Martinez (1998, 97); Statistics Lithuania (2000, 40); Statistics Lithuania (2001, 28).

7. Grant Transfers and Financial Supervision in Estonia

Annika Jaansoo * and *Eliko Pedastsaar* **

7.1 Introduction

Local governance values relied on the basis of the government system which was developed after Estonia's first independence in 1918 and most of them were rediscovered and restored (together with legal principles) on the eve of the post-communist transition. Local government (LG) reform began in Estonia when some radical politicians declared their vision of Estonia as a fully independent State. On August 8, 1989 the Supreme Council adopted the Local Government Reform Act and on November 10, the new Local Government Act was adopted. This was the first step that substantially undermined the old regime and hastened the development of democratic institutions in Estonia.

Today, Estonia has one tier LG with 247 LG units – 42 towns and 205 rural municipalities. The population in approximately 50 per cent of local authorities is less than 2000. In roughly 70 per cent of local authorities there are less than 3,000 inhabitants. Less than 20 per cent of the State's population live in these municipalities, which, however, account for approximately 70 per cent of the State's territory. So, the size and capacity of Estonian LG units are very different and to speak about universal practices, even in strictly regulated areas, is almost impossible. For instance the structure and policy style of local councils (that are much more regulated than government) are extremely different from those LGs which have a similar capacity.

Estonia has 15 county governments, which are the general administrative agencies representing the State interests at the regional level and supervising the actions of LG units.

Estonia has an autonomous (vs. integrative) system of LG. The State authority only has the right of supervision of the legality of LG actions. According to the law, an LG cannot delegate its functions prescribed by the law to the upper tier (county) of government. However, municipalities may delegate their functions to the sub-level and established municipal districts. Usually these sub-governments are established in larger cities (Tallinn) but larger municipalities with several centres also have sub-units to better represent the interests of the remote areas.

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Municipalities may set up voluntary associations with the aim of mutual co-operation in service delivery and to represent the interests of LGs both at the county and state level.

LGs are financed by a mixture of own revenues (mostly local taxes which are set by LGs and collected by the State), shares in revenues collected within a local unit territory from central income taxes and grant transfers from central government. The structure of LG revenues is illustrated in the Appendix.

7.2 Local Government Legal Framework

There are six general laws regulating LGs, including two laws that regulate LG finances. The reliance on the general laws usually makes the accountability more transparent and the system less controversial. All municipalities are governed by the same regulations despite the fact that their size and real capacity are different.

The main structure of the LG system is already presented in the Constitution and enumerates the financing and functions of sub-national governments as follows:

- 1) Only an Act of Parliament or an agreement with the local authority may impose compulsory tasks on an LG;
- 2) Expenditures related to the tasks of central government imposed by law on LGs must be financed from the State budget;
- 3) Local authorities may have independent budgets;
- 4) Local authorities have a right, according to the law, to levy and collect local taxes and to impose duties;
- 5) Local authorities have a right to form associations and joint agencies with other LGs.

Following this, five special acts on LGs were elaborated and adopted. There are two general acts and numerous sectorial acts which define the principles and regulate the details of municipalities' activities.

The European Local Government Charter was ratified by Parliament on the 28th of September 1994.

The Local Government Organisation Act (LGOA) (Adopted June 2, 1993) determines the functions, responsibilities and organisation of local authorities and relations of municipalities with each other and with central government. The act provides a basis for participation in economic activities, procedures for the formation of municipal districts, the general structure of the council, the principles for the formation of government, the competence of municipal agencies and other issues.

Through this Act, the **local government council** has sovereign authority to adopt the municipality statute, development plans and budget, establish local

taxes and tax exemptions, rules that administrate municipal property and appoint key people. It means that the council has full control over the final decisions concerning local finances.

Local government is autonomous in its adoption of decrees and orders in areas that are not listed as the sovereign competence of the council. The government can call the municipal council to revise its decrees or orders.

Members of the government are responsible for certain areas. In fact they are the political authority of the head of department or— where (as in small governments) the departments really do not exist— the latter are assistants to them. Members of the government can be part-time and may hold a position in the private or public sector. Vice-governors are usually responsible for budget and financial issues of the government. Municipal government may establish commissions and working groups in order to work out proposals with the participation of external experts. Usually this is a fiscal commission. The government is responsible for the elaboration of the draft budget.

According to the LGOA, LGs can establish LG associations. There are three i.e. the Estonian Association of Towns, the Association of Rural Local Municipalities and the Association of Estonian Association of Local Authorities, founded in 1993. These associations were set up to represent the joint interests of LGs before the central powers. As quasi-representative bodies, they are frequently a forum of settlement of controversies that emerge between LGs. One of the central functions of LG unions was the decision on distribution of investments. This function disappeared with the centralisation of decision-making on that issue. There is obvious rivalry between these associations that is mirrored in the life of the fourth body— the Co-operation Assembly of the Local Government Unions.

The problem with LGOA is that it does not make the decision on the definition of LG functions and accountability to render their implementation transparent. The functions of LGs that are prescribed unambiguously by the LGOA cannot be negotiated with State authorities. Also the LG cannot delegate its functions to the county government in case of failure to fulfil them. The only way to increase the capacity up to the minimal level is amalgamation.

At the moment there exists a very complicated and confused system of assignment and tasks.

Firstly, the Constitution declares that all local issues will be resolved and regulated by LGs operating independently in accordance with the laws. There has been no general definition on what the local issues are. They could be issues that are not regulated and implemented by the State. The list of functions should be supplemented by the criteria of differentiation of tasks

between local, regional and central levels. This cannot be found in the Estonian legislation.

Secondly, an LG is defined by the LGOA. Numerous special laws prescribe specific functions that can be observed and judged at the implementation level.

The same is true concerning the assignments of State functions to LGs. According to the Constitution, expenditures committed to the implementation of these functions should be funded from the State budget. The normative redistribution of central government support and the use of general grants might make the methods of compensation of expenditures by the government rather vague.

The other side of the coin is that the central government has no device to compel the LG to implement its functions. This has become a silent agreement between LG and the State. The government does not notice the failure on the part of LG units to implement their functions appropriately, because the government knows well that this is because the formula for the distribution of functions that would take into account the insufficient capacity on the part of LG units has not been worked out.

The Rural Municipality and City Budget Act (adopted on June 16, 1993) determines the procedure for the preparation, adoption and implementation of rural municipality and city budgets. The provisions concerning borrowing by a municipality are considered to be the most important amendments to this Act.

The Local Taxes Act (Adopted on September 21, 1994) enumerates local taxes and provides the procedure on how to impose and collect them. The Act largely follows the text of a similar act adopted in 1938 and does not take into account substantial changes that have occurred since that time.

The Territory of Estonia Administrative Division Act (adopted on February 22, 1995) determines the division of the territory of Estonia into counties, cities and rural municipalities and also regulates the procedures for the alteration of boundaries and the change in name of local authorities, etc.

The Local Government Council Election Act (adopted on May 29, 1996) regulates the procedure for local elections.

The Government of the Republic Act (adopted on December, 1995) regulates the activities of government agencies, including the function of county government in relation to the LG as well as the right of LG unions to influence the nomination of a county Governor.

7.3 Inter-Governmental Financial Relationships

According to the Rural Municipality and City Budget Act the budget revenues of LGs in Estonia can be the following:

- 1) revenues from State taxes,
- 2) revenues from local taxes,
- 3) revenues from assets and economic activities,
- 4) government grants and other financial contributions.

Since the beginning of 1994, LGs receive the principal part of their revenues from taxes. There are State taxes and local taxes.

State taxes are:

- 1) Personal income tax. This forms the largest proportion of LGs' revenues;
- 2) Land tax. Together with the local taxes, the land tax is the part of LGs' revenues over which they have sufficient autonomy. As the LG may set the tax rates and because 100 per cent of land tax is transferred back to LGs' budgets, this tax has all the prerequisites that the local tax must have. The absence of a tax collecting capacity as well as the immense possibilities of tax evasion could well be the reasons why this is still a State tax;
- 3) Gambling tax. Revenues from this are very small and this tax is mainly a revenue base for the large towns.

Local taxes are:

- 1) personal (income) tax (PIT),
- 2) sales tax,
- 3) boat tax,
- 4) advertising and announcement tax,
- 5) tax on closing the streets,
- 6) tax on motor vehicles,
- 7) tax on pets,
- 8) entertainment tax.

According to the LGOA, the municipal council may establish new taxes and change tax rates before the adoption of the local budget or before any change to it. Local taxes are imposed from the beginning of the budget year or from the change of budget.

The central government only sets maximum rates for some local taxes such as land tax and sales tax, to avoid harmful tax competition between LGs. The possibilities of tax competition are rather limited in Estonia due to the fact that in most municipalities, a substantial portion of inhabitants have low personal income to be taxed on and to the insignificant role of these taxes that might be rated differently. The enforcement of local taxes is restrained because the expense

in collecting them could be higher than the revenues gained and the possibilities of tax evasion are high.

Despite the low effectiveness of local taxes, the Ministry of Finance insists on their more intensive use. During the negotiations over the support fund, as well as investments from the central government, the absence of sufficient amounts of local tax revenues is sometimes used as an argument for refusal.

Revenue from local taxes represents only a small share of the local budget (ca 1 per cent) and several taxes (personal tax and entertainment tax) have not been imposed in any local authorities and thus remain theoretical. Some of the reasons for this are detailed below:

- 1) The financing system does not favour local taxes,
- 2) Local taxes are difficult to administer,
- 3) It is hard to organise the collection of local taxes because local authorities do not have their own tax authorities,
- 4) The revenue from local taxes is difficult to forecast,
- 5) Imposing local taxes is locally unpopular,
- 6) Municipalities prefer fees.

The State Tax Board manages the collection of all government taxes, both local and State. This is the first controversy in local budgeting. The real money from taxes comes to the accounts of the LG and is dependent on the capacity of the State Tax Board to organise repayments in time and on the smooth current cash flow in the State Treasury. Estonian local authorities have not faced substantial breakdowns in receiving their revenues, but substantial monthly fluctuations can occur. Hence, LGs cannot depend on a reliable schedule of tax revenues for financing current expenditures.

7.3.1 User charges

There are almost no services presented directly by the LG as an authority. The exceptions are certain legal services offered by the town secretary (business licenses, verification of documents etc.) and issuing of sales, hunting and fishing licenses. A major part of the services is provided by organisations subordinated to the local authorities.

A large portion of services at the local level are provided by the private sector: either by companies with LG shares, foundations, NGOs and private companies first of all, or by infrastructure and communal services.

LGs have contracts with organisations that provide public services. In these it is determined how the user charges are calculated. Usually, when the organisation wants to increase the user charge then it has to present the application and calculations to the LG. The LG then looks it over (sometimes demands further

calculations or an improvement in calculations) and approves or disapproves the increase according to the user charge.

7.3.2 Income from business and assets

One part of revenues of LG could theoretically come from dividends of *shares of companies* where an LG is a shareholder. As these companies are young and have made substantial investments, this is not yet an actual item of income.

The next specific source of revenue *is services that are provided to other LGs*, although officially these are considered as transfers. This has caused huge problems to the providers of these services. For towns, the delivery of services for the surrounding areas could be a substantial source of revenue because they may provide services that small rural communities are not able to and their services are, as a rule, of much higher quality (e.g. schools, kindergartens etc.).

7.3.3 Local government borrowing

The borrowing of Estonian LGs is regulated by the Charter of European Municipalities, the Local Government Organisation Act, the Law on Budget of Municipalities, the Law on the State Budget and the Law on Taking Foreign Loans for the Republic of Estonia and Ensuring State Guarantee to Foreign Contracts.

Municipalities can take out loans or issue obligations under the following conditions:

- 1) Total of all unpaid loans and issued bonds and other liabilities coming from those, together with loans to be taken and bonds to be issued may not exceed 75 per cent of planned budgetary revenues in any current year (conditional grants from central government are excluded);
- 2) Total of repayment costs of repayable loans and loan interests and bonds may not exceed, during any budget year, 20 per cent of planned budget revenue in case new loans and issuing of bonds are considered;
- 3) The municipality can also take short-term loans for covering current costs. These loans are not treated as loans mentioned in sections 1 and 2, i.e. these restrictions do not apply to short-term loans;
- 4) Restrictions in sections 1 and 2 are not relevant for loans that have a State guarantee. The State guarantee is given to those foreign loans where a creditor demands a State guarantee or requirement of State guarantee derived from the law. The State may give a guarantee in total of 15 per cent of budget income of the current year;
- 5) Loans will be taken or bonds issued for investments foreseen in a municipal development plan;
- 6) The municipality cannot give loans and cannot give guarantees for loans. Student loans are the exception.

- 7) Borrowing and taking other financial bonds is the exceptional right of the municipal council;
- 8) The government of the municipality has to present a copy of any loan contract or bond issue to the Ministry of Finance in the 30 days following the conclusion of the contract.

In the framework of existing restraints and procedures of approval by the Ministry of Finance LGs in Estonia are completely independent to enter the domestic and foreign credit markets.

7.4 The Grant System

The State Budget Act establishes general principles for appropriation of transfers to local budgets by the State. According to the Act, the following two types of allocations to the municipalities can be given:

- 1) allocations from the support fund and
- 2) conditional allocations.

In addition to governmental allocations, the LGs can receive resources from foreign aid programmes and loans.

In the 2002 budget, the revenues of LGs emanating from central government were divided into the following groups:

- 1) transfers from the State budget's support fund,
- 2) conditional transfers from the State,
- 3) investments to LGs (National Investment Program – NIP),
- 4) other various transfers.

In the 2001 municipalities' budgets, the State budget support fund transfers (52.3 per cent) formed the largest item. The second largest were the transfers for investments – NIP (29 per cent). The remaining grants formed a relatively small part.

Grants take up around 26.0 per cent (2001) of local budget revenue (the second source of revenue after taxes), and play a very important role in local finance in Estonia.

7.4.1 Roles and Purposes of Grants

It is very difficult to say what has been the most important purpose of the formation of the contemporary Estonian grant system, since it has never been clearly spelled out by politicians. We can only try to guess from the general tone of discussions, which have been carried out during different reforms.

Probably securing minimal standards of important services is one of the most important purposes of the grant system. For this reason a support fund that is a general grant was established.

Financing the duties established by the law can be also considered as most important. In Estonia, some special purpose grants are specified to pay for central government services delivered by LGs, for example, teachers' salaries.

Creation of the assumptions for development can also be considered as one purpose. LGs can apply for investment grants (usually with matching principles) in order to carry out different projects for the purpose of developing their region. All such projections are reflected in the National Investment Programme (NIP).

The grants also have a social role. For example, special purpose grants to the rural municipalities' and cities' budgets compensate the cost of trips for municipal schools and municipal universities' students, who are studying outside their hometowns. They also compensate the homeless. State grants are important for education development and social welfare.

Grants are also used for nationwide interests and for stimulating service delivery. The State can make certain actions and duties more attractive for LGs, for example, the Estonian government transfers grants for municipalities' expenditure connected with integration to the European Union. Consequently LGs are interested in the integration field.

7.4.2 General Purpose Grants

As mentioned, general purpose grants are grants that are not strictly defined on what the LG may use them for according to its needs.

In Estonia there are only two kinds of general purpose grant:

- 1) State Budget's Support Fund (equalisation grant) and
- 2) transfer to the LGs that are in extreme geographical or economical situations.

Those two grants are described below.

7.4.3 Equalisation grant

The rules for delivering the support fund (equalisation grant) are established by the State Budget Act. It states the principles of appropriations to local budgets by the State.

The equalisation grant is unconditional and is meant to finance the implementation of responsibilities set out by law and the creation of prerequisites for development.

The revenue equalisation system in Estonia is not self-financing, i.e. no revenue is redistributed from one LG to another. Central government has tried to transfer a certain amount of money from the richer LGs' budgets to the State budget at the beginning of 1990s, but did not achieve satisfying results.

The equalisation grant is calculated according to the following formula that has been valid, with minor changes, since 1995.

$$T_n = (m \cdot a_k - a_n) \cdot 0,9 \cdot c_n$$

Table 1
Elements of the formula

The elements of the formula	In year 2000	In year 2001
T_n	Amount of money transferred to the LG budget by the equalisation grant	Amount of money transferred to the LG budget by the equalisation grant
m	Coefficient of support level (the standardization coefficient)	Coefficient of support level (the standardization coefficient)
A_k	The average level of revenues (coming from State taxes and fees) per person that are received by the LG in the year 2000	The last two years' average income from the personal income tax and planned average level of income paid to LG budgets from land tax and fees of using mineral deposits per one inhabitant in Estonian kroons
A_n	The level of revenues (coming from State taxes and fees) per person that are received by the LG in the year 2000: the accounting of equalisation grant is based on planned revenues from personal income tax, land tax, fees for using mineral deposits and for special usage of water	The last two years' actual income from personal income tax and planned level of income paid to LG budgets from land tax and fees of using mineral deposits per one inhabitant in Estonian kroons
C_n	Number of inhabitants in the LG according to the data of Statistics Office in 1 st of January 2000	Number of inhabitants in the LG according to the data of Statistics Office in 1 st of January 2001

Since the beginning, the biggest problem has been the value of the standardisation coefficient. The coefficient depends on the amount of money that has been agreed upon, i.e. it depends on the total amount of support fund. Every year this coefficient is different. For example in 2001 it was 1.16 and in 2002 it was 1.13. The Co-operation Assembly of Local Governments Associations has tried to tie this coefficient with a certain indicator (the size of State budget, value-added tax, income tax, etc.) but so far they have not succeeded.

Previously, the average level of income was calculated as a presumed income of personal income tax per year per municipality. Now the formula takes into consideration the average amount of personal income tax paid to the local municipality during last two years.

This formula was changed because the estimation of personal income tax in each individual LG becomes more difficult every year. There are several reasons for this. Firstly, the transfer system of personal income tax is changed every year, because the tax exceptions are changed (amount of salary that is tax exempt, amount of child allowance that is not taxable etc.).

Secondly, the formula was changed to raise the initiative of LGs to develop the local economy. It means that they do not take into account the presumable increase of tax revenues so that the more developed LG gets more money than it would have had with the implementation of the old formula.

The application of this formula changed considerably the proportions of distribution of funds in comparison with those already in existence and those suffering most of all are the administrative units where the unemployment rate has risen and the income from income tax has decreased rapidly

Table 2
Transfers to the LGs according to the old and the new formula in 2001
(thousand EEK)

County	Amount of transfers according to the old formula	Amount of transfers according to the new formula
Harju	5,062	16,619
Tartu	81,187	95,288
Pärnu	75,564	82,129
Rapla	25,309	27,091
Saare	37,203	37,720
Lääne	26,518	26,821
Hiiu	5,250	5,912
Jõgeva	55,217	52,039
Järva	36,667	35,086
Lääne-Viru	71,686	70,663
Põlva	51,716	47,474
Valga	51,471	49,951
Viljandi	69,394	66,442
Võru	53,064	52,642
Ida-Viru	220,135	199,498
Total	865,443	865,375

Source of data: Ministry of Finance

Not all LGs receive allocations from the support fund. Every year there are around 17-18 LGs who receive no support. In these municipalities, the personal income tax per inhabitant is over 110–112 per cent compared to the Estonian average and one-third of the Estonian population live in those LGs. These types of LGs are mostly situated around the capital city, Tallinn, or in the east of Estonia where there are many mineral resources. Those LGs receive approximately 52 per cent of the income tax that is transferred back to the LGs' budgets.

The equalisation grant has one more feature – the LGs where the revenue per inhabitant is higher than average can also receive transfers from the support fund. By how much the revenue can be higher depends on the coefficient. In 2000, the limit was 3,225 kroons (206 EUR) per inhabitant, even though the average was 2,878 kroons (184 EUR) per inhabitant i.e. all LGs where the revenue per inhabitant was less than 112.06 per cent of the State average, received support. The amount of the support fund was 865.8 million kroons (55 million EUR).

The equalisation coefficient was calculated as follows:

$$m_{2000} = 1,1206; m \cdot a_k = 1,1206 \cdot 2878 = 3225.$$

All LGs where the revenue per inhabitant was less than 3 225 kroons (206 EUR) received support according to the formula: $3225 - a_n \cdot 0.9 \cdot$ number of inhabitants. If the result of $3225 - a_n$ became negative, the LG received no support.

The existing formula does not take into account the expenses and specific functions of LGs. It equalises only the differences in revenues compared to the State's average.

7.4.4 Special purpose grants

Special purpose grants in Estonia can be divided as follows:

Grants for current spending on tasks delegated to LG administration

The Estonian Constitution declares: expenditures related to the tasks of central government imposed by law on LGs (for example teachers' salaries) must be financed from the State budget, but the LGs complain that many functions which are delegated to them are under-funded and receive grants that are too small.

As a consequence, it is quite common that LGs "subsidise" delegated functions using their own revenues, which are supposed to support the provision of own municipal functions.

National Investment Program (NIP)

The NIP began in 1995 when the central government decided to give money to the LGs for investments from the State budget.

According to the system, LGs present their applications to the county governor who will prioritise the various requests. The counties present their lists of requests to the various ministries where it is decided what request will be added to the NIP list. The ministries present the list to the Ministry of Finance. The final total of the NIP is presented after the State's budget is approved.

This kind of system gives the possibility to lobby. There have been cases where the party in power at county government has not included in the list those requests presented by LGs which belong to the opposition party. Those cases

mainly occur in the east of Estonia. There have also been cases where the list of priorities presented not only consists of the requests presented by the Ministry of Finance, but also where Parliament has added others.

Allocations from the ministries

LGs also receive grants from the State budget through the budgets of ministries. These transfers partly cover the costs of LGs in implementing State functions or policies. In this case the transfers are expressed in the budget of the ministry. These grants are frequently conditional.

Table 3
Conditional grants by ministries (functional), 2002

	Function	role of exp. item in LG budget
1.	Education	1.7%
2.	Defence	0.0%
3.	Environment	0.3%
4.	Culture	1.1%
5.	Economy	0.2%
6.	Agriculture	0.0%
7.	Finance	0.0%
8.	Internal Affairs	0.0%
9.	Social	4.4%
10.	Transportation & Communication	0.2%
	Total	8.0%

As can be seen from the table, the Ministry of Social Affairs gave the largest portion of grants awarded by ministries. These are the resources for subsistence support for low-income persons and funds for supplementary social allowances. The remainder of the transfers are for other various social welfare needs: for social care programs, compensation to the handicapped for public transport, compensation for electricity to risk groups, government relief and compensation (support in case of funerals) and labour market services etc.

The Ministry of Environment gives resources mainly for investments (if the LG has applied), nationwide planning and pilot projects, forest security expenses and for the maintenance of institutions of environmental protection.

The role of the Ministry of Education is a modest one. The sums are targeted at the support of juvenile projects, at the organisation of general events at local level and also to support the learning of the Estonian language.

The Ministry of Defence gives resources to LGs for keeping a register of persons eligible and committed to the armed forces. The Ministry of Culture gives

resources for the maintenance of district libraries (salaries, social tax and administrative costs), for supporting various district cultural activities, children's sports schools, big sporting events, restoration of memorials and other expenses. The Ministry of Economic Affairs gives resources for energy-saving programs and for other investments that are connected with the ministry. The Ministry of Finance finances statistical works and the Ministry of Internal Affairs, the development of county government and the municipal rescue service.

The Ministry of Transport and Communications gives resources for keeping the ferry service running to and from small islands (the islands are a part of the municipality), subsidies to the local and regional bus services for municipalities in case the latter contract these services out to entrepreneurs, subsidies for buying buses and for maintaining the ferry harbours.

The amount of conditional grants and their disposal will be set down in the State budget. It is allowed to make the additional conditional transfers from the Government Reserve Fund during the budget year.

In 2002 the number of conditional transfers decreased. In distributing the conditional resources, the following are taken into account:

- 1) the number of inhabitants in LGs,
- 2) municipality's population aged between 7 and 15 years,
- 3) the previous year's income tax paid to the LGs' budgets and the prognosis of land tax and resource tax for the current year.

The transfer of sums from the State budget (from the budget of a ministry) for LG investments is made through the district Treasury. Over the last years, more and more money is transferred according to the invoices that are presented by LGs to the Treasury and this money is directly transferred to the contractor.

7.4.5 Payment of grants

The amount of equalisation grants in the State budget is determined by the contract made by the representatives of LGs, LG unions and central government during the negotiations. If there is no agreement, the amount of equalisation grants is determined by the central government. This type of formation of equalisation grants has existed since 1994. At the earlier stage, the planning of budget needs was no longer based on the expenditure standards per person (up to 1993). At the moment, negotiations seem to be the best way to solve the problem of the amount of the support fund. The alternative way would be to establish a self-financing support fund.

The negotiation process is long and sophisticated. It begins in February-March in the framework of the preparation of the following year's budgets. These meetings are irregular, but the following meetings are agreed upon during the previous meeting. The process is launched by the Minister of Regional affairs and

managed by his office. After the meeting, the detailed protocol is distributed to participants. Different opinions, as well as agreements achieved between partners, are included in the protocol.

There are also numerous shortcomings in the negotiation process. The main issues from the Government's point of view are:

- 1) Members of the Co-operation Assembly do not often come to a joint point of view, acceptable to the majority of LGs.
- 2) More emphasis is put on bargaining over the concrete amount of the support fund. Other issues of principle intergovernmental relations in the area of budgeting are rarely set as a priority;
- 3) Representatives of LGs are too focused on bargaining as opposed to the increase in revenues. The expenditure dimension is often ignored. LGs were unable themselves to make concrete proposals with argued financial analysis concerning the costs and procedures of delegation of functions to the LG.

Problems from the viewpoint of the Co-operation Assembly

- 1) Central government often cannot follow the agreements made. This is partly caused by a changing economic and political environment and partly because the agreement is not officially binding to both sides;
- 2) The Co-operation Assembly must recognise its inability to work out common positions that would be accepted by both rural municipalities and towns. The Assembly is not sufficiently prepared for negotiations.

At the end of negotiations, the final protocol is completed. Under the various items it contains all issues that were discussed whether they have been solved or not. Until recently, all protocols, including the final protocol, were not signed off as official documents. This has substantially decreased the normative force of this document. Where agreements were not reached, the Government's proposals were taken as the basis for State budget proportions. The settling of accounts is centralised and is carried out by the State Treasury. An exception is the transfer of tax revenues to the LGs by the Tax Board after the real tax revenues are received.

The Ministry of Finance and Ministry of Internal Affairs count, according to the data they have, the amounts of grants that will be received by the LGs. Those amounts are published in the journal *Riigi Teataja* (State's Communicator) where all legal acts are published. According to the sums published, the grant funds are transferred from the State budget to LGs' budgets quarterly.

For example, in 2002 transfers were made as follows:

I quarter	–	23 per cent of sums from grant fund,
II quarter	–	24 per cent of sums from grant fund,
III quarter	–	26 per cent of sums from grant fund,
IV quarter	–	27 per cent of sums from grant fund.

The transfers of support funds adversely affect many LGs. This is shown in the following.

The State's fiscal year and that of LGs begins on the 1st of January and ends on the 31st of December.

The preparation of the State budget is an autonomous process. There are only two connecting points: the Ministry of Finance sets the budget rules and economic forecasts that determine the general environment for the local budgeting and central government support grants are delivered after in-depth discussions which are carried out simultaneously, but separately, from the State budgeting process.

The following are prescriptions by the central legislation to the budgeting procedures:

- 1) The LG budget has to be approved by the LG council no later than 1st April or three months after the State budget is approved. Otherwise the council is dissolved.
- 2) The draft budget, approved budget, changes in budget and the report of the last year's budget must be published.

In addition to the centrally established laws on budgeting, LGs must adopt the Order of Budgeting that regulates the budgeting and financial actions in LG. That decree may be presented as a separate decree or as a part of an LG's statute. The other legal documents that define the content of the budget are the development plan and investment plan.

In practice, the budgeting process varies widely from LG to LG and those variations depend on the real experience of budgeting within the LG. The study of these variations could uncover the most reliable solutions to meet defined specific circumstances. Usually the LG budgeting starts in May when the budget target figures are set in municipal governments (these are set according to the last three years' budgets). The figures are then sent to LG organisations that will prepare their own budgets based on those figures.

In June, the sub-budgets are presented to the municipal government. The economic department then puts together a draft LG budget. This is then presented to the LG commissions at the beginning of August. After the council commissions have worked this draft budget through and made their improvements, the draft budget is presented to the municipal council for three readings.

Usually the budget is approved in the middle of December. The stages of the budgeting cycle described above are characteristic for most LGs. There are, however, LGs whose budget contains a large proportion (from 40 per cent onwards) of equalisation grants. These LGs can start the budgeting only after the amount of support funds is determined. Their budgeting cycle is as follows.

In November, the municipal council establishes the priorities and proportions of expenditures, which are presented to LG organisations and agencies. At the beginning of December, the LG agencies and organisations present their budgets. According to the sub-budgets, the municipal government prepares the LG draft budget. In January the first and second hearings of the LG draft budget are held in the municipal council.

In February, the donations from the central budget are announced and are then counted in the LG draft budget. Usually the third reading and approval of the budget are at the end of February, but if the central budget is not approved at the beginning of the budgeting year, then the LGs' budgets are approved later. There have been cases where the LG budgets have been approved in April.

According to Estonian legislation, as a legal act, the budget has the status of law. In the case of the LG it has decree status. Any deviation from the budget would be considered as a violation of the law or decree. The implementation of the State budget is managed by the Ministry of Finance. The banks where the State money is held are chosen through open contest. The budget expenditures are financed as soon as actual revenues are received and allocations planned.

7.4.6 Grants to needy authorities

In Estonia, there is only one grant to those authorities which are in need. This is the transfer to those LGs which are in an extreme geographical or economical situation. Those transfers are unconditional.

This grant is given mainly to the municipalities situated on islands or in border areas of Estonia. Every year there are 40-50 LGs receiving this type of grant. Mainly they are the same every year, but there may be some exceptions such as some sole-functional municipalities from where an enterprise has moved away or gone into bankruptcy and the unemployment rate has increased and incomes decreased dramatically.

7.4.7 Grants Mechanism Reassessed

The role of LGs as an analyst of the current situation, planner of regional development, collector of resources, advisor, informer etc. must expand. Today, it can be demanded only from the bigger municipalities. The central government is now planning the administrative-territorial reform in which LGs have to merge and form LGs with at least 3 500 inhabitants. Currently there are only 108 municipalities that have inhabitants over 3 500. After the administrative-territorial reform has been passed, proposals can then be put forward.

Because of the very big differences between LG revenues, negative support can result. This kind of support may be imposed on those LGs which do not receive transfers from the State support fund. This negative support will be trans-

ferred to the State budget or to the State budget's support fund. The coefficient 0.9 will ease the influence of positive and negative support. As a result of such negative support, the revenues of the capital, Tallinn, and the LGs around it will still be higher than in other LGs. The implementation of negative support depends on how much the State wants to equalise the revenues of LGs.

It must also be said that the implementation of negative support gives more equal revenues, but Tallinn, as our capital city and the biggest town, needs specific expenses (airport, ports etc). We could also see a self-financing support fund being imposed or the support fund may be a percentage from the State budget. The equalisation fund at the county level should be developed and the role of the general support fund proportionally reduced. Government support will thus be better targeted and justified via applications from LG. At the same time, financing from the central (ministerial) budget functions that are actually regional or even perhaps community functions, should be reduced. The delegation of the payment of teachers' salaries to the LGs in 2001 revealed that the administration of salaries had become much more flexible and simpler. The branch principle of distribution of the money is obviously more bureaucratic. Our opinion is that the role of regional institutions in financing local and regional development should be increased. This is obviously inevitable in the application for EU funds.

The amount of central government grants must become much more stable and determined over the next few years. Government must take more risks in ensuring the level of financing that relies on its forecasts. It helps avoid the so-called "last minute budgeting" in LGs. Also the banks will lend money more easily and with lower interest rates if they are assured that the LG will receive a certain amount of money during the loan period.

7.5 Financial/Fiscal Supervision: Rights and Duties

Supervision and control over economic and financial activities of LGs are basically regulated by 10 acts and are performed by:

- 1) County Governor (utilisation of funds and investments delivered by central government and European Union, grants and foreign aid);
- 2) Legal chancellor (correspondence of local regulations to laws);
- 3) State Audit (funds and investments delivered by the central government, also loans guaranteed by central government);
- 4) Audit Commission named by the LG council (utilisation of funds and investments drafted by central government and the European Union, grants and other foreign aid, use of municipal funds, correspondence of LG functions to the decisions and regulations, settlement of financial and accounting principles of LG institutions);
- 5) Internal control (only in certain LGs).

7.5.1 The Audit Commission

In LGs, the Council is the higher authority of control and evaluation of the work of LG organisations. The LG council forms an audit commission to control LG actions until the next elections. The commission must consist of at least three members. Only members of the LG council can be members of the audit commission.

The composition of the commission is political. Both the coalition and the opposition must be represented in the commission. Some of the LGs have started a tradition of electing the head of the audit commission from the opposition party.

According to the LGOA, the functions of the audit commission are to control:

- 1) The accordance of LG actions to legal acts and decrees;
- 2) The collection and registration of revenues at a fixed date;
- 3) The accordance of expenditures to the LG budget;
- 4) The accuracy of the accounting of the LGs' organisations, agencies and enterprises;
- 5) The purposeful utilisation of LG assets by LG organisations;
- 6) The implementation of contracts that are concluded by LGs.

A written report about the mistakes discovered, or shortcomings, must be presented to the municipal government with proposals for correcting these mistakes or shortcomings. The municipal government has to take a stand and present it to the LG council.

In some LGs, the audit commission works based on a schedule that is set up by them and confirmed by the LG council. This schedule normally covers a one-year period. That kind of working settlement has to ensure that an audit commission, as well as the LG council, will have a permanent overview of all LG organisations. Extraordinary controls are carried through according to the LG councils' order. In other LGs, the frequency and objects of controls are left to the audit commission to decide.

The biggest problem in the functioning of such commissions is the lack of competency of its members. The smaller the LG, the fewer members there are in the LG council– the circle of persons eligible to enter the audit commission is smaller. The members of the audit commission are not usually competent to control the accuracy of the accounting. Furthermore, the audit commission members are unable to be experts in many different areas, thus, cannot competently control these areas.

In many LGs, the audit commission does not work properly. Usually there is no systematic and regular control over LG organisations, agencies and enterprises. In many LGs, the audit commission has a right to nominate a person who will carry out the controls. This person has the authority to demand any information,

explanations and documents that relate to the issue. In practice the commission does not exercise that right, since it causes difficulties with the continued controls and professionalism.

The audit commission must report on its actions to the municipal council at least once a year. Usually this is only a list of issues discussed at commission meetings. According to the LGOA the audit commission has a right to audit the bookkeeping accounts of LG organisations and agencies, as well as business corporations and non-profit organisations, where the LG is a shareholder, founder or member. The commission can also decide and establish whether the assets and other investments from LG budgets are used according to the initial aims and purposes. At the national level there are no special regulations to audit these units. Actually, very few LG commissions have the competence to carry out both the audit of LG and its corporations. Usually the commission who sets the targets etc. for the auditing company, contracts out the audit. The audit is financed from local council expenditures, because council is primarily the representative of the owner of the assets.

Estonian legislation demands a follow-up control for local budgets. According to the LGOA, the audit commission has to give an overview on its work to the municipal council before budget authorisation. The commission also has to present its comments and proposals. According to this regulation the audit commission carries out the follow-up control. However, the external audit – the final step in the audit process – should be presented prior to the approval of the budget accounts for the previous year.

Obligation of *a priori* audit is not part of the Estonian legislation. At the same time, it does not exclude that possibility either. According to the LGOA, the audit commission will report to municipal government in written form on any shortcomings they have found and also make proposals for the elimination of these shortcomings. Municipal government will give its position ten days after the audit report is received and will present it, together with the file, to the municipal council.

7.5.2 Internal control of local government

The law does not impose any additional obligations for internal controls at the LG. An internal control unit or staff position exist only in some of the largest LGs. In most cases, an audit commission from the council carries out the internal controls.

The required qualifications of the internal control officer are normally:

- 1) at least a BA degree,
- 2) a knowledge of principles of public sector economics and budgeting,
- 3) a thorough knowledge of general standards of internal controls.

The responsibilities of internal control are similar to the audit commission's. Internal control has to:

- 1) Assess the reliability and accuracy of financial and administrative information of LG units and the structure of LG organisations and agencies;
- 2) Evaluate the effectiveness of operations inside LG organisations and between them;
- 3) Evaluate the implementation of budget and accuracy of the accounting service;
- 4) Control the feasibility, economic justification and implementation of contracts;
- 5) Control the accuracy of budgeting in the LG and its organisations;
- 6) Control the appropriate utilisation of budgetary and non-budgetary resources; etc.

Almost half of all internal control cases are carried out as the result of an *ad hoc* order. The control is organised in such a way that during 4–5 years, all organisations will be subject to control. Sometimes organisations are more frequently controlled when information about possible violations or mismanagement is received. The results of the control will be presented in the report to the LG. Sometimes the audit commission receives a copy of the report. Reports on the control activities and their results are attached to the report of the implementation of budget to the council.

The period between the present and previous control in the organisation is subject to analysis. Internal control does not usually analyse the reports of implementation of the budget. The internal control service does not restrict itself with the analysis of documents and data presented by the management of organisations controlled. Internal control collects part of the data themselves. There are special rules regulating the rights of access to the data. The effectiveness of internal control in various LGs is enormously different, depending on the people who staff the unit. The consistency of internal control depends on the existence of a correct plan. The law must introduce the composition of internal control plans in all LGs. To increase the competence, the external experts might be contracted out. There can be a mutual exchange of the most qualified internal control staff between LGs. For this reason, supplementary financial resources should be included in the budget. The contracts could be long-term and this makes the control more effective.

7.5.3 Legal supervision by the county governor

The county governor is a representative of central government at the municipal level. He/she has a duty and right to exert supervision over whether an LG has followed the legal norms in the implementation of its budget.

If the county governor finds out that the legal act adopted by an LG does not correspond to the superior legal act, he/she will make a proposal to abolish

the controversy within 15 days. If the LG refuses to obey, the county governor can then go to the administrative court. Usually the request of a county governor has a strong enough moral force to change the decision even in the case where the law is not formally violated. If the county governor establishes the illegal or inappropriate management of State assets, the county governor should apply to the State Audit and present all documents that he/she has on this case. From June 2000, a supplementary duty was assigned to the county governor: to supervise the utilisation of projects, aid or other resources received from the EU.

7.5.4 The Role of the State Audit

The State Audit Office is an independent budget organisation for the supervision of the appropriate utilisation and management of State assets. The State Audit Office can control the use of these assets and also of enterprises where the State owns more than half of the shares. The State Audit Office can also control the appropriate utilisation of central government grants and subsidies.

7.6 Conclusion

Issues arising from LG organisation in Estonia that were at the centre of discussions during the first part of the 1990s, were still at the centre of discussions at the end of the decade. The same applies to the controversies that the system contained. The prediction about the transitional nature of arrangements was confirmed.

The amalgamation of LG units is considered as the main tool of the reform of the LG system. Depending on the LG unit, the average size of a rural municipality must be 2,500; for municipalities close to the towns, 4,500 and towns with more than 10,000 inhabitants must be amalgamated with the surrounding areas. There are several exceptions that can be taken into account, e.g. in cases where the municipality had a sufficient capacity and development potential in the past. As a result, around 100 municipalities will remain instead of 247 currently. The minister of Regional Affairs proposed to form LG units on the basis of counties and give the 5 largest cities a special status. The Minister of Internal Affairs has also proposed the consolidation of up to 60 to 70 LG units.

Unfortunately, the other and more efficient tools to increase the capacity of LGs were not considered and developed:

- 1) differentiation of functions, dependent on capacity;
- 2) formation of a regional level of local administration;
- 3) possibility to delegate functions to the upper level;
- 4) to halt the implementation of functions in case of low standards;
- 5) the development of special districts; etc.

As stated, the balancing device of the autonomous model is local representative democracy and participation. Both were under-developed in Estonia during the 1990s despite intentional policy decisions. This was the cause and consequence of the development of corruption, parochial decisions and apathy from the majority of the population concerning local affairs. The current coalition government intends to introduce a rule whereby only those lists of candidates who are represented at the central level, could be put forward at the local level. There is a plan to link the budget subsidies to parties with electoral success at the local level.

A consequence of the above could be the incapacity of small LGs to carry out competitive elections and/or the erosion of ideological and social identities of the parties. This program statement would enable a better understanding of the real intentions of the government coalition: amalgamation of LGs would promote the shift of local councils towards the right end of the party spectrum. Presumably, in corporatist societies, the better way to promote democracy is to enhance the participation and transparency.

The idea of multi-year planning was very much supported by the financial officers of LGs. On the one hand, every official would like the stability that might bring about a reduction in workload. On the other hand, three-year planning (it was found optimal) could strengthen the role of the budget as a management tool, especially in the context of the introduction of elements of performance budgeting. Besides, experts of LGs as well as ministries would prefer to focus on the analytical and developmental activities instead of the annual marathon of budget procedures. Multi-annual budgeting would enable the political coalitions to better plan policy programs instead of routine distribution of existing money and investments that are frequently decided through political battles.

Long-term budgeting could also solve one of the central themes of controversies. It is not so easy to change the level of untaxed individual income, because this must be directly compensated. Also, the delegation of functions to the LGs without appropriate compensation of costs for their implementation becomes much more difficult. In other words, multi-year budgeting could make the inter-governmental financial relations more transparent and balanced.

The main problems the representatives of local and central governments have most debates on are:

- 1) an entire administrative reform, not only territorial but including regional democracy, regional management, i.e. the problems of regional co-operation, prescribing this in the law, the role of LGs' associations and the basis of their activities;
- 2) LGs' tax and revenue basis and its connection with administrative reform;
- 3) the new Local Government Act (already prepared by the Ministry of Internal Affairs);

- 4) participation in salary negotiations, including those of teachers;
- 5) taking over the subsistence allowances and their connection with revenue basis.

In order to develop the relationships between the local and central government and overcome at least some of the problems listed above, we propose the following:

- 1) integrate the LG fiscal objectives with central government's;
- 2) take the expenses and peculiarities of LGs into account by composing the formula of a support fund;
- 3) work out the specific criteria for evaluation of investment projects;
- 4) enhance the capabilities of LGs in applying for foreign aid;
- 5) also discuss taking loans into consideration during the annual negotiations on the support fund;
- 6) specify the role and tasks of county government.

The implementation of these suggestions would enable us to reduce the regional imbalance of income base and balance the income base with expenditure needs. It would also increase the financial autonomy of local authorities, create preconditions for sustainable development within the territory of the entire State and contribute to co-operation between local authorities and a more extensive involvement of the private sector in the production of public services.

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Appendix
Local governments' revenues and expenditures in Estonia, 1991 – 2001

Local governments (bill. kroons)	1991	1992 ^F	1993	1994 ^F	1995	1996 ^F	1997	1998	1999	2000	2001
	REVENUES										
Total revenue and grants	207,3	1 544,3	2 667,1	2 351,1	3 111,1	5 048,3	6 128,6	7 138,8	7 714,4	7 922,1	9 788,1
Total revenue	163,6	1 151,5	2 024,6	1 688,4	2 233,2	3 649,0	4 690,6	5 322,8	5 718,8	6 078,9	6 616,9
Current revenue	163,6	1 151,1	2 024,6	1 687,9	2 190,6	2 857,8	4 208,6	4 765,6	5 067,8	5 454,5	6 152,0
Tax revenue	158,1	1 113,6	1 866,4	1 509,1	1 976,2	2 262,9	3 246,1	3 833,5	4 036,5	4 116,2	4 022,3
Non-tax revenue	5,5	37,5	158,0	178,8	214,4	594,9	962,5	932,1	1 031,3	1 338,3	2 129,7
Capital revenue	-	0,4	0,2	0,5	42,6	791,2	482,0	557,2	651,0	624,4	464,9
Grants	43,7	392,8	642,5	662,7	877,9	3 399,2	1 437,9	1 815,9	1 995,7	1 843,0	3 171,1
EXPENDITURES											
Total expenditure by function	192,6	1 462,6	2 603,4	2 354,2	3 386,3	5 048,3	6 128,6	7 138,8	7 714,4	7 922,1	9 788,1
General public services	5,8	95,4	199,1	313,2	430,1	554,1	627,1	723,9	755,8	778,8	758,6
State defence and order	3,6	30,6	65,9	13,0	22,2	26,5	27,3	24,5	22,6	22,3	83,5
Social sphere	135,6	978,2	1 838,2	1 396,5	2 511,3	2 563,8	3 294,8	4 085,1	4 352,6	4 332,9	5 607,8
* education and science	47,7	537,6	777,0	1 106,5	1 498,5	1 886,7	2 159,5	2 565,3	2 749,8	2 699,2	3 821,8
* culture, art, sports and recreation	9,3	67,6	151,9	180,3	270,9	399,8	478,9	672,6	751,6	792,4	885,6
* housing and amenities	39,8	327,1	606,4	16,8	587,8						
* health care	32,9	13,8	109,0	22,6	37,3	80,6	82,7	108,7	104,6	102,3	112,3
* social care	5,9	32,1	193,9	70,3	116,8	196,5	573,7	738,5	746,6	739,0	788,1
Economy	12,7	115,3	196,6	563,0	166,3	1 235,3	1 262,4	1 420,3	1 714,8	1 656,3	1 891,1
Other expenditures	34,9	243,1	303,6	62,0	256,4	668,5	917,0	884,8	868,6	1 131,6	1 447,0

E – This symbol marks a break in the comparability of data; that is, data appearing after the symbol do not form a consistent series with those of earlier years.

Source: Government Finance Yearbook, 2001

Appendix

Transfers to the LGs in Estonia (bill. kroons), 1995 – 2001

Year	Transfers from the State support fund	NIP	Transfers for investments made from the budgets of ministries	Conditional transfers
1995	137.6		n/a	n/a
1996	689.5	128.7	n/a	25.3
1997	704.8	119.9	68.3	8.9
1998	695.7	282.0	71.0	59.5
1999	736.8	400.7	58.0	108.4
2000	866.5	218.2	30.3	3.0
2001	951.8	190.4	35.2	1,400.4

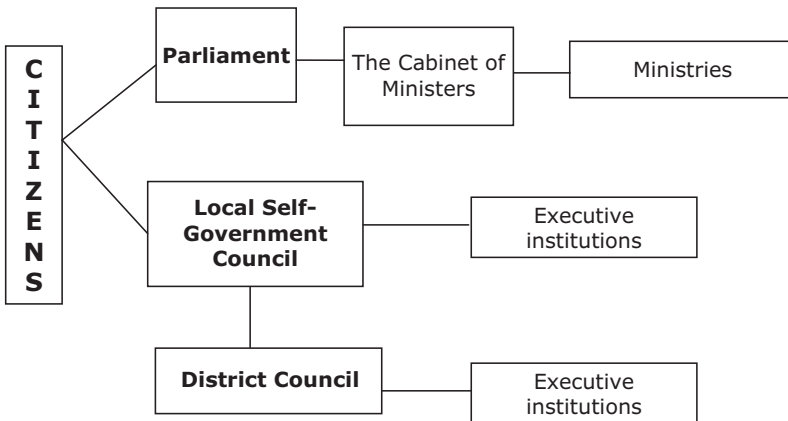
8. Grant Transfers and Supervision of Finances in Latvia

Mudite Priede and Solvita Klapare***

8.1 Introduction

The citizens of the Republic of Latvia implement state public power through the highest decision-making institution – its Parliament (Saeima), self-governments elected through direct elections and district councils formed by self-governments. According to the Constitution of the Republic of Latvia (Satversme), Parliament establishes the highest state executive power– approving the Cabinet of Ministers put forward by the Prime Minister and ministries.

Figure 1
Public Administration Scheme in Latvia



During the last 10 years, self-governments in Latvia have experienced fundamental changes. The process of these changes can be characterised by several stages, which are closely linked with the process of renewal of independent public administration in the country.

1990 – 1991 After the collapse of the USSR; the Republic of Latvia became a sovereign state. Keeping the structural principles of previous socialistic self-governments, the newly elected institutions of self-governments – councils– were established and strengthened.

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1991 – 1994 Self-governance reform. In 1991, the laws “On Rural Self-government” and “On Town Self-government” were passed in the Supreme Council. In addition, at the beginning of 1992, the law “On District Self-government” was adopted. The adoption of these laws has initiated a real development of self-governance in Latvia.

Prior to analysing the economic basis of self-governments of Latvia, it is necessary to briefly look into the overall economic situation and have a view of the economic course taken by the Government of Latvia. Since the renewal of Latvian state independence in 1991, irreversible processes have taken place. The consequent economic policy has permitted the establishment of a market economy basis and encouraging macroeconomic preconditions for the growth of Latvia’s economy in a relatively short time.

Transition to a new form of economy, as in other central and Eastern European countries, initially caused a sharp decline in manufacturing and living standards in Latvia. However, as early as mid-1993, this sharp decline in GDP stopped. Nonetheless, further growth of the economy has been delayed by the process of structural reforms, and the banking and financial crisis in 1995 directly affected these processes.

In the mid-1990s, the Government sped up privatisation and the process of arranging the legislative framework, strengthened supervision of the banking sector due to the banking crisis and strengthened state finances. It had a positive impact on the development of economy and since 1996, a GDP increase and improvements in the material situation of the residents has been seen in Latvia. Particularly successful progress has been observed from 1996 to mid-1998, when average growth of GDP was 6 per cent. This growth was basically assured by rapid developments in industry.

The economic crisis in Russia during the second half of 1998 and in 1999 has influenced the development rate of Latvia’s economy, in the same way it has affected economies of many other countries. Due to this crisis, Latvia’s exports decreased, several commercial banks appeared to be in a complicated situation, budgetary revenues did not come in as projected, and unemployment rose. However, it should be mentioned that the growth of activity in the construction and some service sectors has compensated the industrial and agricultural decline caused by the crisis. Production outputs continued to increase in the industry sectors, which focused mainly on western markets (wood and wood products, metal and clothing industries). Thus, GDP continued to increase, although growth rates in 1998 and 1999 were very insignificant – 3.9 per cent and 1.1 per cent, respectively.

Table 1
Latvia: Key Indicators of Economic Development

	1996	1997	1998	1999	2000	2001 p*
	(growth rates %)					
GDP	3.3	8.6	3.9	1.1	6.6	7.0
Private consumption	10.3	5.0	6.2	5.1	5.6	8.0
Public consumption	1.8	0.3	6.1	0	-2.9	0.5
Total fixed capital formation	22.3	20.7	44.0	-4.0	10.8	15.0
Consumer prices	17.6	8.4	4.7	2.4	2.6	2.5
	(% of GDP, unless indicated otherwise)					
General government budget fiscal balance (less privatisation revenues)	-1.4	0.6	-0.9	-4.2	-2.8	-1.8
Central government debt	14.4	12.0	10.4	13.1	13.2	13.4
Foreign trade balance	-15.6	-15.1	-18.5	-15.4	-14.9	-15.0
Current account balance	-5.5	-6.1	-10.6	-9.6	-6.8	-6.2
Foreign direct investment (flows)	7.4	9.3	5.8	5.2	5.7	5.0
Registered unemployment rate (% , end of period)	7.2	7.0	9.2	9.1	7.8	7.5
Share of job-seekers (% of economically active people)	19.4	14.8	14.0	13.5	13.2	13.0
Exchange rate of LVL against SDR (end of period)	0.7997	0.7997	0.7997	0.7997	0.7997	0.7997

*p – projection,

Source: Ministry of finance of Latvia

GDP in 2000 went up by 6.6 per cent, proving that Latvia has overcome the difficulties caused by external circumstances. 2001 also gives good reason to hope. The Gross Domestic Product in the first quarter of 2001 increased by 8.2 per cent. In the last two years, Latvia has shown the fastest growth in the Baltic States and in 2000, compared with the EU candidate countries too.

The precondition for an internally coordinated macroeconomic target scenario is a stable macroeconomic environment that can be achieved only if the initiated monetary and fiscal policies continue. The Ministry of Finance has prepared a concept note “Scenario on Macroeconomic Development and Fiscal Policy in 2001 – 2003” in 2000; the Ministry of Economy has prepared a long-term economic strategy, and various representatives of Latvian science and the government have prepared a concept note on sustainable development “Latvia– from Vision to Action”. Assessing the documents prepared, it can be concluded that development of self-governments has not been seen in a unified context with state development.

8.2 Legal Framework of Self-governance

The highest normative act of legal power in Latvia in respect to self-governance is the European Charter of Local Self-Government, ratified by Parliament on 22nd

February 1996. Twenty-nine of the thirty paragraphs of the Charter are binding for Latvia as a member country of the European Council (EC). That means that theoretically, Latvia has accepted the principles defined by the Charter.

Based on the law “On Self-governments”, adopted by Parliament in 1994, there are two forms of self-governments: local and district (regional) governments. Local self-government is the local executive authority – council – which acts as a representative body elected by the citizens. Through the Council’s established institutions and entities, it ensures the performance of functions assigned by the laws, as well as tasks assigned, based on the principles defined in this law, by the Cabinet of Ministers, and local self-government’s voluntary initiatives, taking into consideration the interests of the state and residents of the respective administrative territory.

Local self-governments are split into towns, pagasts (rural self-governments) and ‘novads’ self-governments (amalgamated territories), which have equal functions and rights. District self-governments have different functions from local governments. Governments of the Republican cities perform both the local and district government’s functions and have the rights granted to both.

Elections of self-governments and decision-making authorities of the Republican cities take place once every four years in Latvia – by equal, direct, closed and proportional elections. Since 1997, district governments’ decision-making authorities – the district councils– are no longer elected through direct elections, but are formed by the heads of towns, novads and pagasts governments.

When implementing local and district (regional) administration, local authorities within the framework of the Self-governance legislation are the subjects of public rights, whereas in the sphere of private rights, have rights of legal entity. Self-governments within their competences and the law act independently.

Since 1st January 2001, there are **578 self-governments** in Latvia:

- 473 ‘pagasts’ – rural self-governments,
- 7 ‘novads’ – amalgamated territories,
- 65 towns,
- 7 Republican cities,
- 26 district governments.

The law “On Self-governments” defines the general rules and the economic basis of self-governments in Latvia. The **economic basis of self-government operations** is the property that is currently under the management and use of the self-government, together with the financial sources formed by tax payments of legal entities and physical persons to the budget of the self-government; grants from the state budget and earmarked grants; loans, local fees and other payments; penalties transferred to the self-government’s budget; income from the management of self-government’s property and entrepreneurial activities of self-

government's entities and voluntary payments from legal and physical persons to achieve earmarked objectives, as well as other income.

Self-government property is separate from state property and from the property of other subjects of legal acts. Self-governments administer, use their property and manage it in accordance with the procedures defined by the law.

It is very important to understand the difference between decentralisation and local autonomy. Decentralisation is a necessary condition, but not sufficient for local autonomy. (A. Smith: "Level of autonomy which has been granted to local authority reveals political interests of the centre").

The model of Latvian local self-governance is the closest to the interaction model, which is characterised by influence and control from the central government, at the same time retaining high independence of local authorities. The model of district governments, in turn, corresponds most to the agency model, as the political authority is not elected through direct elections and there is no tax revenue basis.

As will be reflected in the further analysis of self-governments' functions and financial systems, there are a number of preconditions to improve the legal framework in order to adjust the model of Latvian self-governance to a relatively autonomous model.

When analysing the legal basis of self-governance in Latvia, it should be noted that there are certain barriers for effective and successful development of self-governments. In summary, there are three characterising legal features negatively impacting the stability and coordination of self-governments' budgets and finances, i.e.:

- frequent changes of normative acts;
- complicity and multiplicity of normative acts;
- insufficient consideration of hierarchy of normative acts in practice.

The principle of self-governance is not defined by the Constitution. Discussions, including a separate chapter on self-governments in the Constitution, have been going on for the past 10 years.

Competences of self-governments in the sphere of public rights are:

- 1) local and district administration and facilitation of socio-economic, as well as cultural and education functions defined by the law "On Self-governments", and which are performed by self-governments on a regular basis (out of which 19 functions are performed by district towns, 'novads' and pagasts self-governments and 4 district self-governments, whereas self-governments of the Republican cities perform all regular functions defined by the law "On Self-governments");
- 2) local and district administration and facilitation of social-economic, as well as cultural and education functions defined by the other laws, which self-governments perform for a certain period of time; performance of the state

- administration functions delegated to the respective self-governments in accordance with the procedures prescribed by the law “On Self-governments”;
- 3) functions within the competences of other self-governments, performance of which in accordance with the procedures prescribed by the law “On Self-governments” are delegated to the respective self-governments;
 - 4) single duties, which the state administration bodies have requested self-governments to perform in accordance with the procedures prescribed by the law “On Self-governments”;
 - 5) voluntary initiatives.

After regaining independence, Latvia began the process of delegating additional functions to self-governments, as well as decentralisation of tasks. Although the number of tasks to be fulfilled by self-governments was rising, the financial and technical capacity to perform these tasks has not been proportional. Such a capacity, however, has existed within the central government sector and respective ministries. As a result, decentralisation of government functions has not affected the ongoing centralisation of basic functions in the respective sector ministries.

Self-governments have the right to independently form and approve their budgets. Self-governments have the right to collect budget income in accordance with the legislation to ensure a regular and safe, macroeconomically stable, income basis.

The background of the financial system of self-governments is the basic document of self-governments’ operation – the budget. The budget is a tool for the implementation of state (self-governments) policy through financial methods. The law defines that budgets are split into the state budget and local governments’ budget which, in turn, consists of the basic budget and the special budget. The summary of state and self-governments budgets– the General budget (Consolidated general budget) of the Republic of Latvia is formed for informative purposes.

It is projected that the Income of the General budget in actual prices in 2001, compared to 1997 will increase by 32 per cent.

In the initial stage of composing the budget of self-governments, the Cabinet of Ministers, based on calculations, showing the share of self-governments’ budgets in the General budget of the Republic of Latvia and the need for the state budget grants, in relation to total assessment of the possibility of funding of the state budget and functions to be performed by self-governments, agrees with self-governments:

- on the total amount of the state budget grants for the projected economic year for the purpose of equalisation of finances,
- the total amount of the state budget for the projected economic year, and
- its distribution amongst the self-governments.

During the process, the Minister of Finance, or his authorised representative, represents the Cabinet of Ministers, but the self-governments' representative is the self-governments' public organisation, established in accordance with the requirements set out in clause 96 of the law "On Self-governments" (the Union of Local and Regional Governments of Latvia). The results of negotiations are formulated in the form of a protocol. A protocol of negotiations reflecting consensus or disagreements is attached to the draft project of the respective state budget, which then is submitted by the Cabinet of Ministers to the Parliament.

Latvia has been established as one of the most effective systems of inter-governmental negotiations in Europe.

The law "On Annual State Budget" defines self-governments' revenue (tax projections, amount of earmarked grants and grants to self-governments), as well as the total amount of self-governments' loans and guarantees. The calculation of the equalisation of self-governments' finance is incorporated in the explanatory notes of the state budget project.

8.3 Intergovernmental Financial Relationship

One of the objectives of the operation of the government of the Republic of Latvia is to ensure financial stability. It is essential to implement up-to-date and internationally recognised financial policies to achieve this objective. One of the most important objectives is the limitation of a fiscal deficit of the state budget. Fulfilment of the state fiscal policy directly influences self-governments' budget revenue.

It is advised in paragraph 9 of the Charter that the structure of funds of self-governments is broken up into two broader categories: own funds and funds, which they may freely operate with within the framework of their jurisdiction, and "transferred means" or financial transfers.

The dynamics of the Latvian self-governments' budget revenue during the period 1995 to 2001 are reflected in Appendix 1. The structure of self-governments' revenue is comparable from 1997, since until that time, income structure was radically changed every year. After regaining independence, self-governments received revenue from various taxes, agreeing on distribution every year during negotiations. Distribution of grants and earmarked grants has been very diverse and is unstable (Appendices 3 and 4). At the same time, several monetary reforms have been implemented – from the USSR rouble to the Latvian rouble, then to the Latvian Lat. The pace of inflation was sharp too. In 1991, subsidies and grants were allocated to district and town governments in thousands of roubles. Because of the sharp inflation in 1992, the budget was approved every six months. Self-governments received earmarked grants as well as donations for payments of allowances for the poor, because of the increased prices of energy resources.

In 1993, differential subtractions for self-governments from state taxes (profit tax, personal income tax and value added (turnover) tax) have been set, as well as donations for allowances for the poor. In 1994, for the first time, the equalisation of self-governments finance was introduced, which has since been changed every year. It was only in 1998 that the long-term law “On Equalisation of Self-governments Finance” was passed. In 1994, self-governments received reductions from personal income tax and grants from the equalisation fund, as well as earmarked grants for investments.

The law “On Taxes and Fees” stipulates forms of taxes and fees and describes the procedure for setting taxes, collection and enforcing, rights, duties and responsibilities of tax and fee payers and tax administration, as well as appeal procedures for tax and fees-related decisions adopted.

The tax and fee system is formed from the state taxes, state fees and self-government’s fees. Each tax must have its own separate tax law adopted and these laws should coincide with the general law. State taxes are paid into the state budget or, based on the prescribed distribution, split between the state budget and self-governments budgets, based on the respective tax law. *None of the taxes are stipulated as a self-government tax.*

Since 1997, local governments and Republican cities receive income from real estate tax in the amount of 100 per cent (there were two taxes until 1998 – land and property tax), 71.6 per cent of personal income tax, 20 per cent of the lottery and gambling tax, a share of the excise tax on oil products, and 60 per cent of the natural resource tax.¹

The State Revenue Service administers the personal income tax, except in three self-governments: Riga, Liepaja and Ventspils, which carry out individual administration functions. The tax revenue share transferred to self-governments’ budgets within the calendar year is determined based on the share of each self-government’s personal income tax revenue from total collected tax revenue in the state from the taxation year two years previously.

The existing situation whereby self-governments are not involved in the administration of personal income tax does not facilitate the interest of local authorities in the economic development of their territories. Self-governments have no access to the operative information about actually collected personal income tax amounts imposed on the revenue obtained by residents of their territories, which prevents self-governments from timely reaction to the changes of the economic situation in their territories.

Self-governments and the Union of Local and Regional Governments are sure that self-governments should be involved in personal income tax admin-

1 It was pointed out that it would be utterly wrong to classify personal income tax (PIT) as a local tax revenue, although numerous OECD and CoE popular publications do that.

istration since they have closer contacts with taxpayers. Ventspils, Liepaja and Riga authorities carry out separate personal income tax administration functions and experience shows that the involvement of self-governments in tax administration is effective. Self-governments have been considering the scope of personal income tax payers. Taxpayers with no intermediaries transfer the tax to the self-governments' budgets; timely payment of tax into the budget is controlled through reports submitted by the employers. It is possible to receive a report on tax payments received and tax debts at any time, as well as the tax payments of every single employer.

Paragraph 3 of Section 9 of the Charter also says that *at least a share of financial resources of local power has to be obtained through local taxes and fees, the rates of which they have the right to stipulate within the limits determined by the law*. Latvia has reached this point; however, none of the taxes are defined as a self-government tax in the Latvian legislation and self-governments have no right to change tax rates. Until 1995, however, self-governments were allowed to introduce local taxes.

As to the real estate tax, self-governments have the right to change the tax rate but only to decrease it. Several self-governments' chairmen think that it is necessary to also allow self-governments to increase it.

Since 1997, district governments do not have their own tax revenue and this does not favour their interest in economic development of their territory. At the moment, 90 per cent of district governments' incomes are made up of grants and earmarked grants.

Since 1997, self-governments' budgets are split into a base budget, which consists of tax and non-tax payments, transfers, and a special budget. Until 1997, financing of special budgets was formed as an additional budget. The revenue of self-governments' budgets has been increased and in 2001 is projected to be LVL 447.2 ml, compared to LVL 341.0 ml in 1997.

Earmarked grants and general grants form around 26.0 per cent of self-governments' revenue, out of which only approximately 7 per cent are general grants.

With respect to the share of self-governments' revenue in GDP, after 1996 self-governments' total income has remained relatively stable; in 1997 10.1 per cent; in 1999 dropping to 9.7 per cent and in 2001 – it is planned to reach 10.1 per cent again. The decrease in the 1999 indicator was mainly caused by the consequences of the economic crisis in Russia.

While revenue has been relatively stable, the number of self-governments' functions has been significantly increasing due to the recent laws and amendments to the existing legislation. Some of these functions are not performed at

all, due to lack of proper financing, and obtaining financing through loans is quite limited. Although not as sharply expressed, the fiscal imbalance still exists.

Revenue structure in various self-governments' groups differs and there is a significant difference between the revenues of various self-governments (horizontal imbalance). Tax revenue per capita in 2000 varied from LVL 17 in the poorest districts' governments to LVL 208 in the most advanced (richest). These differences, to some extent, are caused by the government's transfer system and, as a result, the structure of self-governments' revenue is uneven. Republican cities obtain the major share of their revenues in the form of taxes – 71 per cent in 1997, compared to 56 per cent in district governments and 47 per cent in rural self-governments. An analogous picture can be observed during the period 1998 – 2001. It should be re-emphasised that district governments do not have tax revenues.

The share of non-tax revenue in budgets of all self-governments' groups is modest: in Republican cities it is 2 per cent; district towns, 6 per cent and rural self-governments, 9 per cent. Non-tax revenue consists of revenue from entrepreneurship and property, fees, penalties and sanctions etc. Self-governments have the right to impose fees only on those activities stipulated by the law. Self-governments issue binding regulations when imposing every single fee, providing the following information: object imposed by the fee; fee rate; fee payers; period of payment and payment term; scope of persons released from the fee or to whom payment discounts are applied and lastly, a fee collection procedures and controls mechanism.

Paid services according to the budget revenue classification, correspond to non-tax revenue. However, when analysing the structure of revenue, they must be separated, as revenue is used to cover the expenditure of the provision of certain services. In Republican cities the figure is 7 per cent of revenue; district towns, 11 per cent and rural self-governments – 4 per cent.

To implement economic and social programmes which require investments, self-governments may take out long-term loans. A self-government's right to take out a loan and issue guarantees for self-governments' entities are set down in the law "On Self-governments Budgets". The Cabinet of Ministers' responsibility is to outline the procedure for taking out loans and issuing guarantees for self-governments.

The regulations of the Cabinet of Ministers state that self-governments may borrow by concluding a loan agreement with the State Treasury. The Minister of Finance, when considering a self-government's application for the implementation of a certain project may approve another lender if its loan terms are more favourable than those offered by the state budget. To implement the Latvian National Environment Action programs, self-governments may borrow and issue guarantees for loans from the Environment Investment Fund. This limits

self-governments' rights to free access to local and foreign capital markets, which contradicts Paragraph 8 of Section 9 of the Charter. This paragraph is the only one not accepted by the Latvian Parliament.

Self-governments' revenue is intended to cover expenditure of mandatory functions and voluntary initiatives stipulated by the law "On Self-governments". Decisions on the use of self-governments' revenue are made by self-governments independently, *except those on the use of earmarked grants*.

Similar to the development of total revenue, public expenditure as a share of GDP has remained relatively stable since 1997, at around 10 per cent of GDP. Comparing self-governments expenditure in Latvia to that in other economies, which have unitary intergovernmental systems, Latvia (10.6 per cent) is placed close to other transition countries in terms of its self-governments' expenditure as a share of the GDP. This is well below local expenditure rates of 20 per cent of GDP and more, that prevail in the neighbouring Nordic countries; the latter often being quoted as a model case for self-governance reform in Latvia.

Revenue of self-governments has to cover expenditures of mandatory functions and voluntary initiatives prescribed by the law "On Self-governments". Decisions on the use of self-governments' revenue are made independently, except with regard to the use of earmarked grants. Attachment 2 reflects self-governments' expenditure for 1995–2000. Since 1997, the scope of self-governments' functions has not radically changed. Until 1997, self-governments were responsible for health care. Since 1997 this has been a state function and self-governments should only ensure access to health care. The major share is spent on the education sector (40–55 per cent, depending on the self-government group). Other equally important sectors are the provision of communal services (on average 15 per cent) and social care (7–8 per cent).

8.4 The Grant System

8.4.1 Role and Purpose of Grants

The law "On Self-governments' Budget" stipulates that in order to strengthen the economic basis of regions and ensure the performance of state functions, the state budget may assign grants and earmarked grants for implementation of certain tasks. That means that self-governments in Latvia may receive only earmarked grants for financing of predefined assignments or general grants, which are used at the discretion of self-governments. There are two sources of financing donations: the state budget and equalisation fund of self-governments' finance, the revenue of which is formed by the state budget donation and payments from the "richest" self-governments. There are no mixed earmarked grants in Latvia, which may be freely utilised either for operational costs, or capital investments.

A special case is revenue from personal income tax. It is the biggest portion of self-governments' revenue. Based on the fiscal decentralisation theory, income from personal income tax in the amount of 71.6 per cent, is a transfer payment from the central government to self-governments, rather than self-governments' own revenue as this tax is administered by the central government, except in the three biggest municipalities. The state government sets the tax base and tax rate and self-governments do not have the right to impact it. But, as revenue from the above mentioned tax is the biggest portion, both self-governments and finance specialists in Latvia and abroad consider it to be self-governments' own revenue. In official publications one may come across different definitions of revenue from the tax in question. OECD publications consider this as a transfer payment or a share tax, and Latvia is characterised as a centralised state. On the other hand, the European Council, in its official publications, mentions this revenue as own revenue and Latvia is ranked with other highly decentralised countries.

The structure of earmarked grants since 1997 is relatively constant; the biggest share being formed by earmarked grants for provision of teachers' salaries in education institutions. One of the most important functions of self-governments is to take care of the education of residents – by providing certain rights in obtaining primary and general secondary education; providing pre-school and school-age children with places in educational institutions; organisational and financial assistance in interest education institutions and educational support institutions.

Each self-government must guarantee the opportunity to obtain pre-school and primary school education for children residing within its territory. Local self-governments must also ensure that youths obtain secondary education. Legislation stipulates that students have the right to choose between schools in the territory and other self-governments. This should be financed by the self-government after signing a mutual agreement with the other. It is the local authorities that sign and suspend work contracts with heads of educational institutions within their jurisdiction.

Grants from the state budget for the Equalisation Fund of Self-governments' Finance and performance of the Administrative Territorial law are projected annually. Grants for the capacity building of Regional Development Agencies are already assigned for the following year. In 1997 and 1998, grants were assigned for very specific and out-of-the-ordinary cases. The state base budget has allocated LVL 0.9 ml in 1997 and LVL 3.4 ml in 1998 for increasing self-governments' income basis for those self-governments with less revenue planned for the respective year, compared to the previous year. In 1998, self-governments received grants as a compensation for non-fulfilment of the prognosis of real estate tax revenue in the amount of LVL 4.5 ml, which was calculated as an uncollected amount of real estate tax due to circumstances which may not have been influ-

enced by the self-government. The Parliament adopted this decision after Riga City Council brought a Claim to 'Satversme Court' (highest legislative body) for unlawfully passed regulations by the Cabinet of Ministers envisaging a different compensation procedure.

8.4.2 General Purpose Grants

As was mentioned in the previous Section, self-governments receive the following general grants:

1. Grants from the Equalisation Fund of Self-governments Finance.
2. Grants for the fulfilment of the law "On Administrative Territorial Reform".
3. Grants to support the capacity building of Regional Development Agencies.

The state budget shares for the Equalisation Fund of Self-governments' Finance and amounts of grants assigned to self-governments from this Fund are defined in accordance with the law "On Equalisation of Self-governments Finance" and will be described more broadly in Section 4.4. This grant forms the major share of total self-governments' grants.

Grants for fulfilment of the law "On Administrative Territorial Reform".

Latvia has now passed a law "On Administrative Territorial Reform", which stipulates that self-governments may voluntarily amalgamate, or establish co-operation pacts by 2004. Based on the above law and the law "On the Annual State Budget", the regulations of the Cabinet of Ministers "On Assignment of Single Grants to Self-governments implementing Administrative Territorial Reform" were issued.

The regulations determine that a self-government has to submit to the Administration of Self-Governments Affairs the following information:

1. the decree of the self-government on amalgamation or cooperation;
2. the project of amalgamation of self-governments or co-operation agreement and project of this co-operation;
3. the performance review of the base budget of the self-government in the previous economic year;
4. the request for and the plan of projected use of funds.

The Administration of Self-governments' Affairs reviews the documentation and:

- in cases of self-governments' amalgamation, prepares the respective draft regulations of the Cabinet of Ministers, that, based on those regulations, fixes the amount of grant after the amalgamation of a newly established self-government;
- where a co-operation agreement has been signed between self-governments to perform common tasks, the Minister of Special Assignments in State Administration and Municipal Reforms, based on the decree issued by the

Administrative Territorial Reform Council and conclusion of the Ministry of Finance, prepares a draft order of the Cabinet of Ministers on the allocation of grants to self-governments in the amount determined in these regulations.

The Administration of Self-governments Affairs brings together the draft regulations and the order with the Administrative Territorial Reform Council.

If, after amalgamation has taken place, other self-governments join the newly established self-government, the grant is determined in the amount stipulated by these regulations, based on the previous economic year's base budget revenue of joining self-government, but excluding earmarked grants received from the state budget and loans (hereinafter, total amount of a self-government's annual budget).

If a cooperation agreement for performance of common tasks is signed repeatedly, the donation is not provided for those self-governments having already received a grant. Those self-governments signing a cooperation agreement for the performance of common tasks for the first time, receive a grant determined by these regulations in the amount based on the total budget amount of those self-governments.

The amount of grant assigned to self-governments amalgamating by 31 December 2001, if their total annual budget was below LVL 5 ml, is 5 per cent of the total amount of annual budget of respective self-governments. Self-governments amalgamating during the period 1 January 2001 to 31 December 2002 receive 4 per cent and self-governments amalgamating between 1 January 2003 to 31 December 2003– 3 per cent. The amount of grant to the self-governments with an annual budget above LVL 5 ml is 2 per cent of the total annual budget of the respective self-governments.

Self-governments signing a cooperation agreement for the performance of common tasks, qualify for a grant in the amount of 1 per cent of the total annual budget of respective self-governments.

It should be noted that the procedure of the receipt of an amalgamation grant is clear and transparent.

Grants to support capacity building of Regional Development Agencies.

One of the preconditions of the successful development of a region is ownership and participation of each self-government involved, as well as real actions to facilitate the processes of self-development of own territory. Therefore, on 4 April 2001, the Cabinet of Ministers adopted the decree stipulating the establishment of five Planning Regions by 1 January 2001. These regions are: Kurzeme, Latgale, Riga, Vidzeme and Zemgale. The formation of the Planning Regions took place democratically i.e., "from the bottom", as they were formed by self-governments (district governments and Republican cities). For the purposes of regional de-

velopment planning and policy implementation, Regional Agencies were established, and a grant from the state budget to strengthen them is projected in 2001 and in the draft state budget of 2002. The amount of the grant is modest, LVL 50,000 only for each agency. Funds from the state budget are transferred to the accounts of the self – government in which the agency is located and the agency may freely operate with the funds received.

In both cases the central government may control the use of grants through the general procedures (see Section 5), i.e., only the State Audit may assess on the appropriateness of the use of grants.

8.4.3 Special Purpose Grants

Earmarked grants may be broken up into 3 groups:

- for educational activities;
- for investments;
- for other purposes.

Around 90 per cent of all earmarked grants to self-governments are those for **educational activities**. The general structure of grants was reviewed in Section 4.1.

I. The main block is formed by *earmarked grants for institutions of basic, general secondary education, professional education, special education and partial payment of teachers' salaries of interests education programs, music and art schools and mandatory state social protection instalments.*

Earmarked grants are calculated based on the regulations of the Cabinet of Ministers "Regulations on the Salaries of Teachers". The regulations determine the detailed procedure and amount of salary payments, and scope of the workload. Earmarked grants are transferred to the budgets of districts and Republican cities' self-governments and the Educational Administration forwards these funds to the educational institutions.

Self-governments may not directly influence the amount of funds allocated for teachers' salary payments. However, they take decisions on breaking up the funds amongst the various educational institutions within the district. When so doing, they should, of course, take into consideration the regulations of the Cabinet of Ministers. Self-governments define the organisation of salary policy and priorities within the self-government by issuing a decree. Thus, self-governments decide on the amount of additional payments to stimulate the quality of work, and regulations stipulate that 10 per cent of salary funds of the respective educational institution may be allocated for this purpose.

The use of earmarked grants is very strictly controlled from the state side, and in cases of mis-use of these funds by self-governments (using it for other purposes), if this is discovered through a State Audit, then the self-governments

must reimburse the fund of the earmarked grants. The State Audit may also penalise them.

Both the state and self-governments ensure the financing of preschool educational institutions, basic education and general secondary education. The state finances teachers' salaries and state mandatory social security expenses (with the exception of preschool teachers) and the purchase of schoolbooks. Self-governments, in their turn, provide the financing for study materials, maintenance and repairs of school buildings, technical school personnel, student meals and communal services.

The structure of earmarked grants for education for 2002 is as follows:

- 1) for payments of teachers' salaries in basic and secondary education institutions,
- 2) additional payments for salaries of teachers who teach the Latvian language and other subjects in Latvian to minority schoolchildren,
- 3) salaries for teachers implementing a Christian and ethics educational program,
- 4) partial salaries for teachers of interests' education programs,
- 5) partial salaries for teachers of music and art schools,
- 6) salaries for teachers of special education institutions,
- 7) salaries for teachers of professional educational institutions,
- 8) for specialised preschool institutions, boarding schools and sanatorium-type boarding schools, special boarding schools for children with physical and mental disabilities,
- 9) salaries for teachers teaching 5 and 6-year old children, from 1st September 2002.

Earmarked grants for education make up around 90–95 per cent of total earmarked grants for self-governments annually. Each year, the state budget allocates earmarked grants for investments to self-governments within the framework of the Public Investment Program, as well as earmarked grants for the preparation of territorial plans and amalgamation projects, because of the administrative territorial reform implemented in the country. However, the share of these earmarked grants is inconsiderable.

II. Earmarked grants for district and republican cities' self-governments – for special preschool institutions, boarding schools and sanatorium-type boarding schools, special boarding schools for children with physical and mental disabilities.

The above mentioned institutions are entirely financed by the state budget, including teachers' salaries and operating expenditures. The General Education law stipulates that by 1 September 2004, operating expenditures of boarding schools within the jurisdiction of self-governments (except, specialised boarding schools) are financed from earmarked grants from the state budget. Starting from

1 September 2004, self-governments shall cover operating expenditures from their budgets. The Ministry of Education and Science recommends considering this fact, when calculating equalisation of self-governments' finance by introducing a new criteria.

III. Earmarked grants for preparation of Administrative Territorial Development Plans of Self-governments. The procedure for assigning earmarked grants is prescribed by the regulations of the Cabinet of Ministers.

The amount of grant for one pagasts, novads or town self-government does not exceed LVL 7 thous. within one budget year, whereas, for one district or Republican city self-government, the figure is LVL 15 thous. Also, it is stipulated that state grant recipients' co-financing should not be less than 20 per cent of the total cost of subsidised planning activities.

The Minister of Environment Protection and Regional Development has established the Commission of Assigning of State Earmarked Grants for Planning of Territory Development, based on the decision of which funds are granted. It is defined in the decision which activities and what amount of earmarked grant is allocated and advance paid, together with a timetable for report submission. The state grant may only be used for activities mentioned in the decision of the Commission. Decisions on assignment of the state grant are submitted to the respective self-government and the State Treasury.

To commence the planned activities, the state issues advance payment in the amount of 75 per cent of the total assigned grant to the grant recipient. The remaining share of assigned grant to self-government is paid through a single payment – after completion of all activities.

The State Treasury carries out finance operations related to the payments of earmarked grants. The Ministry of Finance submits the monthly payment plan of the approved state grant funds and advances. The State Treasury, not exceeding the approved by state grants' financing plan amount, and no later than two weeks after the receipt of the decision made by the Commission, assures the transfer of the state grant into the recipient's budget.

IV. Earmarked grants for investments.

Since 1995, earmarked grants for investments may be obtained through the Public Investment Program (PIP). The PIP is prepared by the Ministry of Economy for the next three years, taking into account priorities, financial strategy and the development directions of the economy, determined by the Government's Declaration for the period in question.

The following projects may be included in the PIP:

- investment projects of the ministries;
- investment projects of self-governments;
- national programs with long-term financing (more than one year);
- technical assistance programs, directly related to the public investment projects.

In accordance with the governing legislation, proposals of the investment projects of self-governments should be submitted to the respective sector ministries, which have a responsibility to define sector investment priorities and rank their projects next to self-governments projects. Proposals of ministries, incorporating both national and self-governments projects, are submitted to the Ministry of Economy by 1 April, which is responsible for reviewing proposals submitted and working out a draft working paper of the PIP, which is submitted to the Cabinet of Ministers. To prepare and submit the proposal, self-government should carefully follow the preparation methodology of investment project proposals, issued by the Ministry of Economy.

Nevertheless, the PIP is prepared every year for a three-year period; limits of funding are made known and are approved only for the coming economic year. During recent years, the state budget funds account for approximately one-quarter of the PIP funding – the remainder is made up of loans, foreign grants and other financial resources (including the co-financing share provided by self-governments).

Unfortunately, for several years now, there is a practice in Latvia, which in parallel to the PIP assigned earmarked investments, when adopting the current year's budget, the politicians assign "political investments", i.e., funding for various state institutions and self-governments. In many cases this has no proper project proposal.

8.4.4 Equalisation Grants

To ensure an equal development of self-governments, the Equalisation System of Finances plays a major role. The objective of the equalisation system of self-governments' finance is to provide similar opportunities for self-governments to perform the functions assigned by the law, as there are very rich self-governments resulting from their geographical and economic conditions, and there are territories, which are not able to perform their functions with only their own revenues in Latvia.

The equalisation system of self-governments' finance was introduced in Latvia in 1995. The system contains regulations on financial necessity or expenditure need, as well as revenue equalisation. The system is partially based on inter-municipal financing (horizontal equalisation) and partially on general state grants (vertical equalisation).

The Council of Europe has listed recommendations for the development of systems of grants and equalisation in its Recommendation No. 4 R (91) 4. The Council of Europe recommends equalisation of both expenditure and revenue. According to this recommendation, the expenditure equalisation system should cover as many activities as possible, and be based on objective criteria, over which the individual local authorities have no direct control (art. 6).

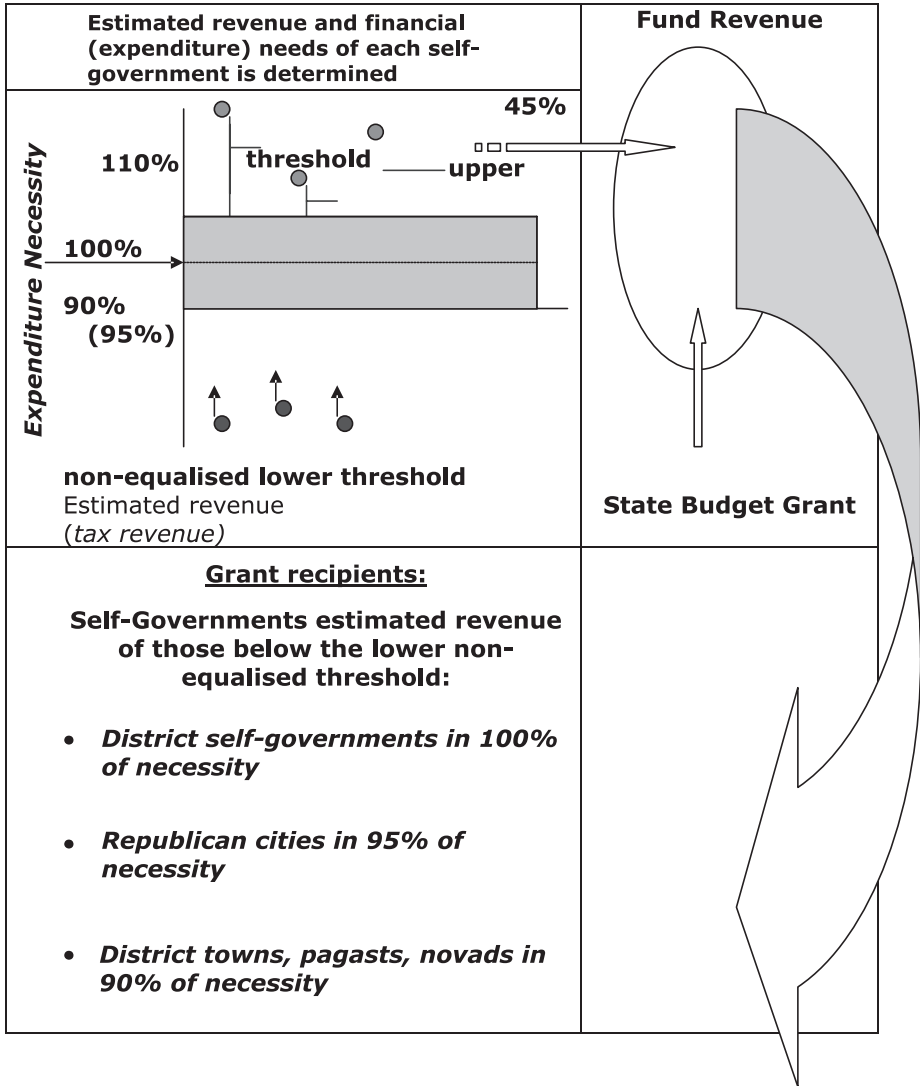
The equalisation of the self-governments' expenditure and revenue is carried out separately for the three types of self-governments (Republican cities, rural (town and pagasts, novads) governments and district governments).

The equalisation of the expenditure need and the revenues is carried out in an integrated way, where comparison of the expenditure needs with the revenue side in each of the 578 self-governments serves as a focal point. The self-governments with a revenue basis higher than 10 per cent of the calculated expenditure need, contribute to the system. These self-governments contribute 45 per cent of the aforementioned surplus. The self-governments with revenue below 100 per cent for the regions, 95 per cent for the Republican cities and 90 per cent for the towns/pagasts/novads of the expenditure need, receive grants from the Equalisation Fund to bring them up to 100 per cent, 95 per cent and 90 per cent coverage of their expenditure need, respectively.

The ceilings mean that self-governments between 100 per cent, 95 per cent and 90 per cent respectively, according to the type of the self-government and 110 per cent of the expenditure need covered by the revenues, do not contribute or receive grants from the system (a so-called *neutral zone* with no payments paid or received).

In 2001, 54 self-governments contributed to the Fund; 474 received grants from the Fund, and 50 were in the neutral zone.

Figure 2
 Equalisation System of Self-governments Finance



8.4.4.1 Equalisation of Expenditure

To carry out equalisation of self-governments finance, the first step is to determine the total financial (expenditure) necessity of self-governments in the country. The Union of Local and Regional Governments (ULRGL) and the Ministry of Finance do not have a common view on how to determine it.

The Ministry of Finance bases its calculation on Paragraph 8 of the law “On Equalisation of Self-governments Finance”, which stipulates that the “total minimum financial needs of self-governments in any economic year shall be calculated during the process of the preparation of the annual state budget law and shall be included in the annual negotiation protocol of the Cabinet of Ministers and the ULRGL, taking into account the following aspects:

- 1) total financial needs of self-governments planned during the budget preparation year;
- 2) the forecast of the state macroeconomic figures for the economic year;
- 3) re-division of functions between self-governments, as well as between self-governments and the government during the economic year;
- 4) priorities set for the economic year.

The experience of the last few years shows that the Ministry of Finance, in order to determine the total financial necessity of self – governments for the economic year, applies the inflation coefficient on the previous year’s financial needs only.

The ULRGL, however, when determining total financial necessity, uses Paragraph 13 of the Section 1 of the law “On Equalisation of Self-governments Finance”, as a base i.e., “total self-governments expenditure for carrying out those functions of self-governments, defined by the law “On Self-governments”, and which are not financed by earmarked grants.

Since the effectiveness of the current Equalisation Law (1998), the ULRGL and the Ministry of Finance have not found a consensus on the calculation of the total financial necessity of self-governments. Nevertheless, in 1998, a consensus on the methodology was reached. As a result of the economic crisis in Russia, the Ministry of Finance was forced to decrease the prognosis and the financial necessity for personal income tax, since it was impossible to increase the amount of state grant. In 2000, when determining financial requirements for 2001, both sides accepted methodology, but the government found it impossible to increase the state budget grant again.

8.4.4.2 Recent Developments: The methodology prepared by the Union of Local and Regional Governments and the Ministry of Finance

Financial necessity = self-government base budget expenditure – earmarked grants – income from paid services – capital investments + 20 per cent of investments + inflation.

The Ministry of Finance has determined the financial requirements for the year 2001 to be LVL 202.6 ml. The ULRGL– LVL 219.5 ml; however, the Cabinet of Ministers and Parliament approved LVL 211.3 ml as the amount of expenditure necessity.

Issuing the Cabinet of Ministers', regulations and teaching the methodology of calculating financial requirements, may possibly solve the aforementioned problems.

Based on the experience of European countries, the total financial requirements could be calculated by using the following method:

Total financial necessity = expenditure of self-government budget- earmarked grants – income from paid services – investments + 20 per cent of investments + inflation + loans for ensuring performance of self-government functions + expected salary increase + funding for new functions.

The system of equalisation of expenditure need is based on the following main criteria:

- 1) self-government group (Republican city self-governments; districts, district town self-governments, novads and rural self-governments);
- 2) the number of residents;
- 3) the number of children up to the age of 6;
- 4) the number of young residents in the age group 7 to 18;
- 5) the number of residents over working age;
- 6) the number of homes with children;
- 7) the number of dwellers in guesthouses and centres for the elderly.

The proportions of criteria (relative value) are calculated taking into account:

- 1) numbers of self-government budget performance for a two-year period, prior to the budget preparation year;
- 2) the state budget priorities for the economic year.

The proportions of criteria characterising expenditures are only used in cases when determining the self-government financial requirements and it should not be viewed as the norm for financing of self-government functions.

The first five criteria are real, "objective" criteria, i.e., those that self-governments cannot influence, whereas 6 and 7 are so-called "quasi objective" criteria, as these criteria are based on the number of children and the number of elderly people in centres for the elderly (who were there before January 1, 1998). The last two criteria were developed in order to adjust for the fact that some local authorities handle many of these children and elderly people due to special service centres from the past communist system of service provision.

8.4.4.3 *Equalisation of Revenues*

The Equalisation system is based on calculations of revenue from two taxes (personal income tax and real estate tax), prior to the commencement of the equalisation year. Self-governments pay or receive funds based on those calculations. If tax revenue appears larger or smaller than projected, corrections of grants and equalisation are not carried out afterwards.

It is interesting to note, that payments into the Fund are positively related to the per capita gross regional product– a measure of fiscal capacity. This is what is intended by the equalisation formula. Payments from the Fund do not go to those self-governments with lower fiscal capacity, but rather to those with higher expenditure needs, as determined by the percentage of population under and over the working age.

*Payments into the Fund are mainly fiscal capacity equalising, while payments from the Fund are needs equalising. For the three years (1997–1999), wealth has been the dominant determinant of payments **into** the Fund, while fiscal needs have been the dominant determinant of payments **from** the Fund.*

The current mechanism provides a high degree of equalisation and it addresses what otherwise could be a significant problem, given the large fiscal disparities that exist among self-governments in Latvia. Whether or not such a high degree of equalisation is needed or whether the degree of equalisation is excessive – these are difficult questions to answer. What degree of equalisation is desirable depends, to a large extent, on the level of national solidarity and societal norms. The current degree of equalisation may be considered excessive if wealthier communities are equalised below the average of poorer communities. Excessive equalisation may have the effect of reducing revenue mobilisation efforts by those communities that are brought up to a national average. It may also discourage revenue mobilisation by those self-governments that have to contribute to the Fund. An even harder question to answer is whether the high degree of equalisation may slow down an overall economic growth of the nation by diverting resources from areas with higher economic growth potential to the areas, where fewer growth opportunities exist.

8.4.4.4 The advantages of the present equalisation system

1. The law of 5 March 1998 was the first *general* law to lay down the main principles for equalisation, i.e., these principles do not have to be discussed every year.
2. The system provides for certain equal opportunities for service provision, although the system does not fully ensure this. The system links financial (expenditure) needs to revenue, i.e., the possibilities for financing the present self-government tasks.
3. The system is stable in terms of ensuring the major estimated revenue sources, i.e., state grants and personal income tax.
4. The administration of the system is stable, well organised and the transfers are made in a timely and regular manner.
5. The system is based on a sound principle, i.e. money follows the number of varying types of residents and not specific institutions.

Disadvantages of the present system:

1. There is no methodology for calculating the total financial needs.
2. The division of tasks and functions among different levels of government remains unclear.
3. Districts are almost 100 per cent financed by grants and earmarked grants in the present system of self-government finance. It reduces the link between the responsibility for the tasks and the responsibility for the finance.
4. The current system has some severe disincentives for some of the self-governments to develop business and economy within their area. If local authorities are below a certain revenue level, compared to their expenditure level, they will not receive extra revenue at all, even if they can strengthen the tax base within their area or support the tax collection, i.e., there is 100 per cent equalisation for the less wealthy self-governments. This problem will be aggravated in a situation where self-governments are involved and responsible for tax collection.

8.4.4.5 Proposals

A preliminary analysis of the system of grants and equalisation has shown that the current system is not in a state of emergency, but there are a number of areas requiring improvements in the short, medium and long-terms.

1. The current system of grants and equalisation and the reform hereof should be reviewed in the context of the upcoming administrative territorial reform and changes have to be introduced in parallel to this reform.
2. In the current Latvian situation, the funding of the system of equalisation should be shared between the central government and the richest local authorities.
3. The maximum percentage share of payment of revenue to the Equalisation Fund made by the “richest local authorities” should be increased and the highest percentage shares received by the “poorest local authorities” decreased, in order to ensure sufficient financing of the system, and at the same time, to ensure incentives for development.
4. The equalisation of the new regions should be carried out separately from other local authorities in order to ensure transparency and accountability.
5. New and additional criteria for equalisation of the financial needs (expenditure) should be developed, once the picture of the composition of expenditure across the various types of local authorities is clearer, based on ongoing analysis. These criteria should be objective and based on the functions and activities, which have a major impact on the expenditure level within each type of local authority. The main pillar of this should be demographic criteria.
6. The current, unclear division of tasks amongst the various government levels, adds to the problems in the existing system, and should be addressed in the future administrative territorial reform.

7. Financing of the districts (regions) should be fundamentally changed, in order to provide for own revenue sources.
8. Local authorities should be more directly involved in the development of a tax income prognosis.

8.4.5 Payment of Grants

At the initial stage of self-government budget formulation, the Cabinet of Ministers agree on the following with self-governments:

- the total amount of the national budget grants in the planned financial year for equalisation of self-government finances;
- the total amount of national budget in the planned financial year and its distribution amongst self-governments, based on calculations characterising self-government budget share in the consolidated budget of the Republic of Latvia; and
- the necessity of national budget grants in connection with the joint estimation of the possibility for national budget resources and functions to be performed by self-governments.

In the development and co-ordination process of the national budget, the Minister of Finance, or his/her authorised person, represents the Cabinet of Ministers through a public self-government organisation, which has been established according to the requirements of Article 96 of the law “On Self-governments”. The results of the negotiations will be incorporated into the protocol. The letter of agreement or disagreements shall be attached to the corresponding draft laws, which are sent to the *Saeima* by the Cabinet of Ministers.

As previously mentioned, Latvia has the most effective negotiations system in Europe. Self-governments, during the budget preparation process, are involved from the very beginning. Preparation of the following year’s budget commences as soon as February of the economic year, when sector ministries submit “base expenditure” calculations.

During the preparation of the budget process, the Union of Local and Regional Governments has monthly meetings with the Minister of Finance, at which discussions on self-governments’ revenue take place, namely, tax projections, amounts of earmarked grants, amount of state budget grants to be assigned to the Equalisation Fund of Self-governments Finance, together with the total limit of loans and guarantees of the self-governments.

The most sensitive issue during the negotiations is that of the calculation of the equalisation of self-governments’ finance.

The ULRGL carries out monthly Finance and Economy meetings, during which self-governments are informed about the status of negotiations and are shown the calculations used.

Budget projections are electronically transmitted to all self-governments, therefore it is a fact that self-governments obtain timely information on tax projections and the amounts of earmarked grants and grants.

Earmarked grants for educational activities are transferred into the self-governments' budgets by the 5th day of every month. Grants from the equalisation fund are paid by the State Treasury on a bi-monthly basis by deducting from the budgets of Republican cities, districts, towns, novads and pagasts 1/12th of total expenditure of the fund, but by no later than the 15th and 25th of the corresponding month. Transfers are made without delays.

There is another procedure for transferring earmarked grants for investments. Since 2000, the State Treasury transfers funds into the self-government's accounts only after it provides documentation confirming the completion of work.

The law "On Budget and Finance Management" stipulates that the State Treasury, every year on 31 December, closes all accounts opened within the current economic year. State base budget funding accounts are opened for state financed budget institutions in the following economic year based on the allocations assigned by the financing plans. Problems arise in the self-governments in those cases where self-governments have not been able to utilise assigned financing for investments within the year. The unused amount is non-transferable to the next year.

The Author's opinion is that this procedure should not be applied in respect of the investment grants, in the cases where self-governments have been unable to manage the financing due to circumstances outwith their control. Earmarked grants for investments should be transferable to the following year's budget.

8.4.6 Grants to Needy Authorities

There are no special grants for poor self-governments in Latvia. Equal opportunities to perform functions are guaranteed through the equalisation system of self-governments finance.

However, the state offers certain tools to help ensure an equal development of territories through implementation of various support forms for poor self-governments. The "Concept Note of Latvian Regional Development Policy" has been established in Latvia and the National Development Plan is currently at the preparation stage.

To support the poor regions, the law "On Regions in Need of Special Support" was adopted in 1997. Development processes of regions in need of special support is favoured through regional development means – state investments in infrastructure, special credit policy, investment grants, single payments to enterprises (businesses) and self-governments, activities in economic education and

the establishment of free (special) economic zones. It is important to note that only the regions, for which the number of residents does not exceed 15 per cent of the number of residents in the country, are considered for being granted the status of 'a region in need of special support'. The status, however, is reconsidered every three years.

The following statistical indicators are used to announce the status of 'a region in need of special support'.

- the GDP per capita;
- unemployment rate;
- personal income tax per capita;
- non-financial investments per capita;
- level of demographic load;
- number of economically active enterprises and business enterprises on 1000 residents;
- density of residents over 1 square km;
- variation in the number of regular residents.

The Cabinet of Ministers for the economic development of 'regions in need of special support' has established the Regional Fund, with the following funds being allocated:

- 1) funds assigned for the mentioned purpose within the state budget;
- 2) loans and grants issued by foreign and international assistance institutions;
- 3) earmarked payments and donations from legal and other persons;
- 4) other revenues.

As one form of assistance, self-governments may directly receive interest payments for earmarked loans from the mentioned Fund. Such a loan should be successfully used in accordance with the business plan.

In certain cases, based on the decision of the Regional Development Council, development of an infrastructure may be financed by the Regional Fund, together with the self-government's contribution.

8.4.7 Grant Mechanism reassessed

Self-governments in Latvia receive only earmarked grants for financing of certain tasks and general grants, and it is up to them how they use them. There are no mixed general subsidies in Latvia, which may be freely used for both operational and maintenance expenditure and for capital investments.

As already discussed, the main share of earmarked grants is for educational activities and more specifically the funding of salaries of teachers. The fact that earmarked grants form the largest share of the total amount of grants and earmarked grants is unreasonable from the fiscal decentralisation viewpoint. However, in the Latvia case, the heads of self-governments and directors of education

institutions regard this as a positive trend, that the state finances teachers' salaries whereas self-governments finance maintenance costs.

In respect to the earmarked grants for investments, the current governing procedure in which self-governments receive investment grants through the Public Investment Program is unsatisfactory.

The main shortfalls of the system are as follows:

- priorities are determined by the central level;
- self-governments' share is decreased by almost 40 per cent in 2002;
- financing is not transferable, i.e., should be acquired (used) within the economic year;
- "political" assignments of investments in Parliament.

Recommendations for system improvements:

- to split the quota for self-governments into two parts:
 - regional projects which are implemented jointly by several self-governments, by attracting EU pre-structural funds. Priorities for those projects may be defined by the central level;
 - local projects implemented within borders of one district, or separate self-government. This quota could be split amongst districts and self-governments which would themselves decide on priorities;
- to increase state and self-governments' share proportionally;
- to allow the use of investment grants during the following economic year as well.

In respect of the most critical grant for self-government – the grant from the Equalisation Fund of Self-governments Finance – it should be analysed as a part of the entire system of equalisation. As was mentioned in Sections 4.4 and 4.5, the system is stable and self-governments know in advance what amount they will receive. Transfers are timely and are of a predetermined amount.

8.5 Financial Supervision: Rights And Duties

Different terminology is being used in practice when talking about "management control" and "internal control". However, when further analysing those terms, they are the same as the term "audit" used in normative acts.

Based on the management theory, the functions of a manager are to plan, organise, control and motivate. The term "management control" is used more often to describe the third of these functions; the term "internal control" relates more to the revision of finances.

Internal control is the weakest link in the system of the Latvian self-governments management, since there is practically no such control.

Up until 2001, self-governments were required to form Revision Commissions, whereas nowadays they can choose whether to form such a commission or

not. On the other hand, we can consider the Revision Commissions as external control bodies.

Revision Commissions are elected proportionally to a number of elected members of each political organisation.

The Revision Commission, not less than once a year, in every self-government institution does the following:

- controls utilisation of self-governments funds in accordance with the approved budget and estimates;
- reviews lawfulness and usefulness of financial operations carried out by chairpersons and executive persons of self-governments' institutions and enterprises;
- controls that self-governments funds and property are managed in accordance with decrees of self-government and in the interests of residents.

If, when electing the Revision Commission, professional criteria are not considered, then the Commission is unable to ensure the performance of duties assigned to it. Performed revisions are more formal and do not bring real benefits. This was the main reason why the decision allowing the choice of whether to create such a commission or not, was made.

Regarding external audit, it is a fact that Latvia has one of *the strictest* systems of control in the world.

In 1993, an independent collegial institution – the State Audit (State Control) – was established, which revises the status of state and self-governments' property (including financial means) and operations related matters.

The task of the State Audit is to perform supervision so that collection and use, as well as operations related to the state and self-governments base and special budget means are lawful, **useful**, and correct.

It controls all state and self-governments' institutions, enterprises, business enterprises and physical persons that possess state or self-governments' properties, which are financed by the state or with self-governments funds, or which perform state of self-government (public) procurement.

The State Auditor is appointed by Parliament for a period of seven years. Members of the State Audit Board and Collegiates of Revision departments based on the recommendation made by the State Auditor are approved by Parliament, also for a period of seven years. Limitations on entrepreneurship, income, uniting job positions, and performing of works etc. the State Auditor, members of the State Audit Board and the Collegiate of State Control Revision departments, the State Audit Inspectors and the Assistants of Inspectors are all defined in the law "On Corruption Prevention".

The State Auditor, members of the State Audit Board, and Collegiate of State Control Revision departments may not be members of political organisations (parties).

The State Audit Inspectors and the Assistants of Inspectors are not allowed to hold positions in the elected institutions of political organisations (parties).

How does the control performed by the State Audit look in reality?

First of all, the State Audit may at any time, without prior warning, approach the self-government and carry out a full or partial revision.

Secondly, since 2001 the external audit system of self-governments has been generally changed and the law “On Self-governments” stipulates that local authorities ensure performance of financial revision in order to:

- 1) control the use of self-governments’ financial means in accordance with an approved budget and estimates;
- 2) review lawfulness and usefulness of financial operations carried out by chairpersons and executive persons of self-governments’ institutions and enterprises;
- 3) control, if self-governments fund, tangible property and real estate is managed in accordance with decrees of self-government’s council and the interests of residents.

For the performance of financial revision, the preparation of revision reports and offering opinions on the reports of a given economic year, local self-governments, not less than once a year, invite audit companies or sworn auditors, and pay fees specially assigned in the budget for this purpose.

After self-government has received the Audit Company’s opinion or sworn audit, it submits it together with a yearly report to the State Audit to receive their opinion. The Director of the Self-Governments’ Revision department of the State Audit, based on the sworn auditor’s opinion, issues his opinion and submits it to the self-government for submission to the State Treasury.

The Self-Governments’ Revision department of the State Audit, in accordance with the approved plan, performs up to 50 self-governments’ financial revisions annually, thus, also testing the work quality of the sworn auditors.

Thus, control over the self-governments activities is very strict. If a self-government has broken the law, for instance and has used earmarked grants for other than the designated purposes, the State Audit may ask for penalty payments.

In summary, the control system in Latvia may be considered as well grounded. However, the Authors’ opinion is that the State Audit should not control self-governments’ activities from the viewpoint of usefulness, as the self-government makes its decisions independently and carries the responsibility vis-à-vis its electorate.

To improve the relationship/link with the residents and to improve the sharing of information, beginning in 2002, self-governments are required to ensure the preparation of an annual public report and to publish a formal statement.

The annual public report of the self-governments contains the following information:

- 1) budget fulfilled during the last two years and the current years' approved budget, including the amount of liabilities and guarantees;
- 2) assessment of self-governments' real estate for the last two years;
- 3) self-government's capital share in enterprises and projected changes;
- 4) activities for implementation of the territorial development plan performed within the last two years as well as projected within the current year, including on:
 - a) public investments in infrastructure in the administrative territory of self-government;
 - b) private investments in the administrative territory of self-government;
 - c) participation of residents and enterprises in discussion and improving self-government's territorial development program and territorial planning;
- 5) opinion of a sworn auditor on the economic activities of self-governments, their institutions and enterprises, as well as an economic report on the self-governments' previous year;
- 6) local self-governments' council decree on the report of the last economic year;
- 7) the State Audit revision opinion and activities carried out by the local self-government to prevent the disclosed shortages;
- 8) self-governments' participation in cooperation projects, institutions and enterprises;
- 9) activities performed to perfect self-governments' institutions and enterprise management;
- 10) activities to facilitate the information level of residents on self-governments' operation and their opportunities to participate in the discussion of decisions.

The Authors would like to emphasise that a unified control system for self-governments, institutions and enterprises should be positively assessed.

8.6 Conclusion

After analysing intergovernmental fiscal relations in Latvia, it can be concluded that it is very complicated to issue a straightforward conclusion.

As mentioned in Section 4.1., the main self-governments' revenue source – personal income tax – is defined in several ways. The OECD's publications state that these are transfer payments or share tax and Latvia is characterised as a centralised state. On the other hand, the official publications of the European Council define the revenue in question as own revenue and Latvia is ranked amongst the most highly decentralised countries. The Latvian self-governance and finance specialists' opinion is that this revenue is self-government's own revenue.

In summary we would like to point out the positive aspects of the intergovernmental fiscal system:

1. Decentralisation of functions takes place in Latvia and many critical functions are delegated to self-governments.
2. Latvia has established one of the most effective central governments and self-governments' negotiations systems in Europe.
3. Personal income tax and real estate tax are a reasonable choice of main sources of self-governments' revenue.
4. Equalisation system of self-governments' finance is stable.
5. Latvia has established a strong, unified control system of self-governments, institutions and entities.

The negative aspects of the intergovernmental fiscal system

1. The assigned funding for the performance of functions is insufficient. Latvian self-governments perform almost exactly the same functions as the Northern European countries; however the share of Latvian self-governments' budget in the GDP is only half the share of the Northern European countries.
2. Self-governments have limited rights in defining tax rates.
3. District self-governments have no tax income.
4. Earmarked grants form the biggest portion in the total amount of grants and earmarked grants.
5. Latvian self-governments do not have the right to define types of fees.
6. Latvian self-governments have limited rights in attracting credit resources.

Recommendations

1. To involve self-governments in administration of personal income tax.
2. When delegating new functions to self-governments, provide funding for implementation of these functions.
3. Give rights to self-governments to determine rates of real estate tax.
4. Define the enterprise income tax as a regional self-government's tax.
5. Allow self-governments to determine types of fees.
6. After the implementation of regional reform, introduce a separate equalisation system for local self-governments and regional self-governments.
7. To ratify in Parliament section (8) of paragraph 9 of the Charter and allow self-governments to freely borrow in the local capital market.

In conclusion, analysing the role of earmarked grants and grants in the intergovernmental fiscal system – the biggest share of earmarked grants goes to educational activities. The current situation satisfies both – the state (the Ministry of Education and Science) and self-governments. As far as self-governments' major grant – the grant from the Equalisation Fund of Self-governments Finance – is concerned, it should be analysed jointly with the entire equalisation system.

Further considerable improvements would be necessary in the decentralisation of the tax system, i.e., by involving self-governments in the administration of personal income tax, as well as allowing self-governments to determine rates of real estate tax.

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Appendix 1

Self-government Revenue 1995 – 2001, LVL ml [State Treasury data]

Revenue Source	1995	1996	1997	1998	1999	2000	2001 plan
Tax Revenue	157.2	193.1	169.2	208.6	219.8	232.2	242.5
Personal Income tax	126.6	157.8	131.6	157.8	171.4	186.9	203.3
*Real Estate tax	25.7	31.1	37.2	48.3	47.3	34.3	38.0
Local (Internal) taxes for Services and Goods	4.9	4.2	0.5	0.7	1.1	1.2	1.2
Non-tax Revenue	5.9	6.9	28.2	19.8	19.4	18.1	20.2
Own Revenue	6.3	2.8	24.9	24.5	26.4	25.7	27.2
Transfers from Other Budgets	89.3	60.4	88.9	99.0	101.0	109.1	119.8
Grants from State Budget	55.8	9.5	76.4	10.6	9.1	7.1	7.7
Earmarked Grants	11.7	14.2	12.5	88.4	92.9	102.6	112.1
Self-governments Special Budget Revenue			30.4	45.4	46.9	56.5	40.5
Total self-government Budget Revenue	250.7	270.0	341.6	395.5	413.5	444.2	440.2

*until 1998 – land tax and property tax

P.S. 1. It is complicated to compare self-governments budgets from 1995 and 1996 because of the different tax income base and system of distribution of subsidies and earmarked grants;

2. It is impossible to fully compare self-governments budgets before 1995 due to monetary reforms, high inflation rate and annually changing income base.

Appendix 2

Self-government Expenditure 1995-2000, LVL ml (State Treasury data)

Expenditure	1995	1996	1997	1998	1999	2000
Administration	23,7	23,8	34,3	40,2	45,8	46,2
Defence	3,2	0,3	0,4	0,3	0,1	0,1
Public Safety		3,5	4,3	5,6	5,9	6,0
Education	55,0	62,8	144,9	170,4	182,8	201,1
Health Care	54,0	53,1	7,5	7,2	6,7	6,3
Social Security	28,2	26,6	27,0	30,4	32,4	34,2
Housing and Communal Services	35,0	36,2	47,2	63,6	62,1	67,3
Leisure, Sports, Culture	13,3	12,8	16,5	19,7	23,1	28,5
Fuel and Energy Services		2,8	5,7	4,8	2,4	1,7
Agriculture, Forestry, Fishing	0,2	0,2	0,5	0,4	0,4	0,5
Transport, Communication	2,3	3,7	4,4	8,0	11,4	10,8
Settlements with Self-governments Budgets	34,0	2,9	4,2	5,7	6,6	8,8
Payments to Equalisation Fund of Self-governments Finance		31,3	28,5	24,4	24,0	24,6
Other Expenditure	5,9	3,6	10,9	6,2	4,9	6,0
Total	254,8	263,6	336,3	386,9	408,6	442,1

Appendix 3
Structure of Grants 1995 – 2001, LVL ml (State Treasury data)

Grants and Earmarked Grants	1995	1996	1997	1998	1999	2000	2001 plan
Earmarked Grants, for:	11.7	14.2	*76.4	88.4	92.9	102.6	112.1
Investments	2.1	3.0	2.8	7.0	9.1	10.7	10.4
Educational Activities (payments of salaries and social security payments of teachers of basic, general secondary education institutions, institutions of professional education of self-governments and partial interest education institutions)		54.4	63.7		66.8	73.8	81.7
Educational Activities (special pre-school institutions, boarding schools and sanatorium-type boarding schools, special boarding schools for children with physical and mental disabilities)	6.6	7.6	13.3	16.4	16.3	17.5	19.2
Salaries of Leaders of Folks' Art Amateur Performance Collectives			0.2	0.2	0.2	0.2	0.2
Territorial Planning		0.6	1.0	1.0	0.4	0.4	0.4
Preparation of Amalgamation (Cooperation) Projects							0.2
Social Security Activities	3.0						
Ensuring the Operation of Psychoneurologic Pensions		3.0					
Salaries of Staff of Pre-school and Educational institutions			3.7				
Funding of Land Evaluation Works			1.0		0.1		
Other				0.1			
Grants from State Budget	55.8	9.5	*12.5	10.6	9.1	7.1	7.7
Grants for Equalisation Fund of Self-governments Finances	55.8	9.5		2.7	6.1	6.9	7.2
Implementation of Administrative Territorial Reform Law					0.2	0.2	0.3
Facilitation of Capacity of Regional Development Agencies							0.2
Increasing of Income Base				3.4			
Continuation of Attachment No.3							
Subsidies and Earmarked Subsidies	1995	1996	1997	1998	1999	2000	2001 plan
Non-fulfilment of Income of Real Estate tax Projection				4.5			
Compensation of Non-fulfilment of Personal Income tax Income Projection			12.5		2.8		
Grants from Equalisation of Self-governments Finance	65.5	46.7	28.8	27.1	30.2	31.5	34.4
Total	67.5	23.7		99.0	102.0	109.7	119.8

**In 1997 there was a grant allocated from the state budget for Equalisation Fund of Self-governments Finance in the amount of LVL 54.8 ml, which further from the Fund was distributed in a form of earmarked grant in the amount of LVL 55.4 ml and grants – LVL 28.8 ml. Total revenue of the Fund was LVL 84.2 ml (remaining share was formed by self-governments' instalments)*

Appendix 4

Brief description of the self-government finance system in 1989 – 1994

Until 4th May 1990, Latvia was a member of the Soviet Union and the budget of the Republic was linked to the budget of the USSR, thus, the distribution of funds was centralised. There were no self-governments as such. Executive bodies were established locally and within the districts. After regaining independence in 1990 the governance of the law “On the USSR State Budget for 1990” was stopped within the territory of Latvia, however the state budget still received instalments of the Union’s state taxes and revenue into the budget of the Republic of Latvia.

- In 1990 the pagasts, town/city and district self-governments were formed.
- In 1991 self-governments received subsidies and donations from the state budget.
- In 1992 the state budget was approved semi-annually.
- In 1994 budget was determined in LVL and self-governments received subsidies from the state local budgets’ equalisation fund and earmarked grants for investments.

Self-governments Grant Structure 1991 – 1994 (data collected by authors)

	1991 (thous. roubles)	1992 (thous. roubles)	1993 (thous. roubles)	1994 (lats)
Grants	478,545	970,428	n/a	5,809,520,361
Subsidies	39,018	n/a	n/a	n/a
Earmarked Subsidies, of which:	n/a	1,123,066 (for half a year)	234500	n/a
• State Investments	n/a	148,855	n/a	n/a
• Social Infrastructure Objects	n/a	100,000	n/a	n/a
• Capital Repairs and Construction of Rural Roads	n/a	45,000	n/a	n/a
• Education and Culture Activities	n/a	853,930	n/a	n/a
• Social Security Activities	n/a	75,281	n/a	n/a
Assignment to Payment of Allowance for Poor People	n/a	1,000	970	n/a

9. Grant Transfers and Financial Supervision in Bulgaria: Principles and Practice

Svetlana Alexandrova *

9.1 Introduction: Decentralisation Progress

The development of local democracy requires financial, legislative and territorial administrative preconditions. Transformation of the local and regional structure is a change in the local institutional structure, the administrators' behaviour and of the role of civil society.

One of the elements of local administration reform is the shift towards a greater participation by the public. Another is the decentralisation and improvement of links between central and local governments (many eastern European countries have launched local administration reforms before Bulgaria did and are far ahead in this field). Significant results have been achieved in the coordination of local, regional and national priorities during the last two years, one of the reasons for this being the necessity to come closer to EU membership standards; to decrease income differences; to improve the quality of social services and to improve living standards. The institutional background is crucial for designing an intergovernmental financial system and for the efficient allocation of resources at a local level.

Fiscal decentralisation in Bulgaria introduces a set of new rules and approaches regarding expenditure and revenue distribution and control. The autonomy of local authorities and decentralisation are the key factors in achieving balance between the optimal quantity of public services and the demand for them. Theoretically, fiscal and administrative decentralisations¹ differ from one another. Administrative centralisation exists in Bulgaria since central government delegates responsibilities in delivering public services, whilst all the funding is provided by the state.

Fiscal decentralisation means the transfer of the decision-making power to local governments for financial management and permitting those governments to allocate resources relevant to the population's benefit² and expectations.

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1 See Tanzi, 2000, Fiscal decentralisation exists when sub-national governments have the power delegated to them by the Constitution or by any particular law, to increase (some) taxes and carry out expenditure activities within clearly established legal criteria. Administrative decentralisation exists when much money is raised centrally but part of it is allocated to decentralised entities, which carry out their spending activities under close guidelines or controls imposed by the central government. p. 234.

2 Richard Musgrave's *The Theory of Public Finance* gives conceptual distribution of responsibilities between the government and second – tier governments.

Fiscal decentralisation aims at designing intergovernmental fiscal relations and setting a clear distribution of responsibilities amongst the different levels of government. Concerning the provision of public services, the question is how and what revenue should be distributed at a sub-national level. However, in Bulgaria, despite the progress achieved in self-government, municipalities lapsed into financial crises and faced the impossibility of delivering public services and improving social welfare.

The areas of local self-government competencies are defined and regulated by means of legislation that conforms to the European Charter of Local-Self Government. According to the Charter, the main principle of responsibilities and competencies distribution among different levels of government is the so-called “subsidiary principle”³. An efficient provision of government services requires that the needs and preferences of taxpayers be met as much as possible by the government.

9.2 Local Public Administration

At a regional level, the central executive body is the regions (districts). The Law on Regional Development was enacted in 1998 and aims at creating an institutional framework at a regional level. The new administrative division was enacted in January 1999. On the basis of regional planning and development, six regions were formed: the North West Region, the North Central Region, the North East Region, the South East Region, the South Central Region, the South West Region (see table 1 in Appendix). The number of districts has increased from 9 to 28 with 262 municipalities grouped into them. However, the above-mentioned law has not set out any rules concerning effective interaction between municipalities and districts.

The county/oblast is an executive body that coordinates regional planning activities. The counties are responsible for state policy implementation at a local level and coordination of national and local interests. The Council of Ministers appoints the regional governor, whilst the central government and the counties execute control on the legitimacy of all acts adopted by local authorities.

The Constitution of the Republic of Bulgaria protects the autonomy of local-self government. Article 136 defines local self-government as follows: “the municipality is the main administrative unit, which carries out an overall local self-government. Citizens participate in government through bodies elected by them. The Municipal Council represents a self-government body, elected by

3 The subsidiarity principle is essential for defining expenditure responsibilities. It is a leading principle in achieving successful local finance in the EU charter on local self-government. The efficient distribution of responsibilities follows the “subsidiary principle” of the EU charter on local self-government, according to which the needs and preferences of those who pay for public services are at best satisfied when there is a responsibility for providing any given public service delegated to the lowest level of government capable of doing it.

the population with a mandate of four years; it is a representative of the executive power. The responsibilities of the Municipal Council are the management of municipal assets, following the regulations of local finance management and elaboration and implementation of the local budget. The previous government intended to make some amendments to the Constitution aimed at increasing the power of municipalities in defining local taxes.

The mayor is elected by the population and also has executive power. During transitional periods, many problems emerge at the local level.⁴ The Municipal Council acts more as a central body of the local government. The main problems of municipalities are: high unemployment, poverty and low living standards resulting from the ongoing economic structural reform.

The Law on Local Self-Government and Local Administration (LLSGLA) decrees that a municipality is a self-governmental body possessing its own budget and property. Art. 9 of the LLSGLA established the National Association of Municipalities in the Republic of Bulgaria (NAMRB), of which all municipalities are members. It is the official voice of all the interests of local authorities. The Association plays an important role in discussions on budget issues and in solving problems that most of the municipalities face during expenditure engagements.

According to the LLSGLA each municipality is a legal entity and has the right to own property and have an independent municipal budget. Gradually NGOs⁵ took part in policy-making processes at the local level. Direct participants in the implementation of regional development policy at the local level are the mayors of municipalities and teams of experts from the business world and NGOs involved in local economic and social development, investment policy, municipal property management and the funding of municipal operations. Their involvement is oriented mainly towards the formulation of specific municipal initiatives and the development of project ideas based on priorities and towards recognition and involvement in regional development plans.

Improving the country's administrative capacity is the key factor in fostering the accession process to the EU and in implementing the priorities of regional plans in cooperation with business entities and NGOs. Six planning regions based on EU requirements (Objective 1 of the European Structural Funds) were created to promote regional development and regional planning. The funding, especially through EU grants, is based on economic and social priorities.

4 The chapter on Local Administration and Local Self Government of the Constitution delegates functions, organisational responsibilities and power to local authorities. (see Art. 135 Art.146)

5 The Foundation for Local Government Reform (FLGR) plays an active role in self-government and in the improvement of fiscal decentralisation process. FLGR helps the improvement of municipal management, enforcement of accountancy through involvement of civil society and citizens into decision – making processes.

The regional development plans are to identify the priorities of the districts that will promote further co-operation amongst regions, competitiveness of the regions, and financial support within pre-accession programs. The aims of the Law on Regional Development are to create regulations for the efficient allocation of resources and for the efficient use of state funds for regional development; to create conditions for accession to the EU, and to respond to EU requirements in the area of regional policy.

The new regional development policy aims at sustainable balanced regional development, reduction of inter-regional disparities, and the establishment of regional cross-border co-operation that facilitates the EU-integration process. The evolution of regional policy in Bulgaria (The Regional Development Plan and the Law on Regional Development) corresponds to Bulgaria's decision to join the European Union. On the other hand, the pre-accession program of the EU provides opportunities for funding different projects at a regional level. The Law on Regional Development is a regulative instrument for infrastructure development, creation of prerequisites for foreign investments at the regional and local levels and for the efficient allocation of resources.

9.3 Local Finance and Legislation

The main component of the decentralisation reform is the distribution of functional responsibilities and revenue sources. The Organisation of local finance in Bulgaria corresponds to the current legislation and regulations. The first step towards the transfer of powers to local governments for financial resources management was enacted in 1991 through the Constitution. According to the Constitution, all local taxes are defined by the law, which makes it difficult for local authorities to change the tax rates and tax base that are relevant to inflation, economic dynamics, and the welfare needs of the population.

The relationships between the state budget and the budgets of municipalities shall be implemented in compliance with Article 141, Paragraph (3) of the Constitution of the Republic of Bulgaria, Article 42 of the Structure of the State Budget Act, and Article 35, Paragraph (2) of the Municipal Budget Act. Most of the laws, which regulate intergovernmental relations, responsibilities and duties, were adopted by Parliament after 1997. The framework of fiscal decentralisation and local self-government was developed after 1993. There are several essential documents, which regulate local government and local administration: The Law on Local Self-Government (1991), amended in 1998; the Municipal Property Act (1996); The Law on Local Taxes and Charges (1996); Law on Administrative and Territorial Structure and Internal Division of Cities (1996), The Law on Regional Development (1998); The Municipal Budget Act (1998); The Act on the Structure of the Budget (1998). The procedures on developing and adopting the budget and on revenue and expenditure management refer to the following legal acts: The

Municipal Budget Act, the State Budget Act and additional instructions delivered by the Ministry of Finance.

The Municipal Budget Act (adopted in 1998, amended twice by 2001) sets out the responsibilities of local governments on the management and finance of public activities. Under the provision of this Act the central government continues to define mandatory levels of expenditures in sectors such as health, education, social services, environmental protection, and the salaries of local administrators. The Act specifies the distribution of revenues and expenditures to local governments and the fiscal powers of municipalities. This Act regulates the structure, implementation and procedures in the process of adopting the budget, and intergovernmental relations. The law determines in detail the procedures for absorbing revenues and the rules of budgeting, *e.g.*, efficiency, transparency, legitimacy, etc.

Under this law a crucial role of the Ministry of Finance is to determine the criteria for revenue allocation and the amount of general and target subsidies. The Municipality Budget Act specifies the types of revenue resources: (own revenues—local taxes and charges), transfers (shared taxes, subsidies, and subventions). The law sets down the transfers from local budgets to the state budget in the case of a surplus of revenue sharing. The State Budget Act reduces capital investments (up until 1999 it was 10 per cent of own revenues; in 2000 it decreased to 5 per cent). These restrictions reduced the municipal capacities for credits and access to the capital market. This limitation was intended to prevent municipalities from adverse selection and default risks, but it encourages municipalities not to invest in capital projects (thus spending budget revenues for operation purposes).

Municipalities have limited powers in developing and planning the revenue section of their budgets. They are obliged to approve not only the amount of the subsidy set by the Ministry of Finance, but also the tax revenues developed by the Ministry. Both Acts (The Municipal Budget Act and the State Budget Act) restrict the financial independence of local governments and their flexibility in local finance management. The Ministry of finance should approve the spending plans of the local budget. Financial sources, other than central transfers, are property tax and privatisation charges. The local taxation authority is responsible only for tax collection, and not for defining the tax rate.

The Law on Local Tax and Charges determines a variety of taxes and charges collected by the local government. Municipalities do not possess any powers in defining the tax base or rate. However, it is empowered to establish local charges, exemptions and administrative fees. Local taxes are collected by the Central Taxation Department and afterwards allocated to local authorities. The rate of the local tax is determined by the Municipal Council, but within the restrictions set down by the Ministry of Finance. It is important that local units be able to adjust the rate to correspond with local needs and conditions. The Ministry of Finance

administers local revenues. It has the power to collect local taxes and charges from municipal administrations. The distribution of powers on tax collection guarantees the sustainability of the process, although it appears not to be completely transparent in terms of information content. Municipalities have powers of property taxation, vehicle taxation, waste collection charges and surcharges. Municipal Councils establish rates according to the service quality and costs. In accordance with current regulations, municipalities can directly influence certain local budget items, *viz.*, local charges and the sale of municipal assets.

The Corporate Income Tax Act (CIT) and the Personal Income Tax Act (PIT) regulate the processes of tax sharing. The largest sources of municipal revenues are shared taxes (Personal Income Tax), which are unevenly distributed amongst all municipalities. The revenues from the PIT are allocated 50:50 between state and local budgets and are paid to local budgets according to the taxpayer's place of work. The law requires that tax revenues from CIT be credited to municipalities proportionately to the number of employees of tax-paying companies located in the relevant municipality and comprising not more than 10 per cent of the total Corporate Income Tax revenues. This approach requires accessible information about the Regional Taxation Units, which are generally more concerned with getting the correct tax revenue. In practice, municipal PIT revenues are often credited to municipalities where the relevant company has been registered. Since the municipalities do not have access to taxpayer's records, they have less power in monitoring the revenues of taxpayers on their territory. The collection and payment system corresponding to the place of work (not the residence) appears to be somehow unfair and can result in an inefficient use of public goods. This practice favours large municipalities with economic potential and at the same time is disadvantageous for small municipalities.

It is too difficult to develop a relatively sustainable local budget under these local taxation regulations and administrative practices, and therefore to establish an effective financial strategy. The State Budget Act reflects the central government's fiscal policy (decisions on subsidies and changes in grant transfers to local government, depending on variation in the government's deficit).

9.4 Assessment of Revenue Assignment Practices

Local governments in Bulgaria recognise the necessity of providing public services, but the existing legal framework and regulations still restrict the powers of local governments in setting revenues and making decisions on tax rates. Local authorities in Bulgaria have independent status, but the power to allocate resources still belongs almost exclusively to the central government.

One of the most important issues of fiscal decentralisation is the level at which functions and responsibilities are to be carried out. The central government assigns responsibilities for education, health care, and for certain unem-

ployment benefits and subsidies, but the expenditures for these activities usually turn out to be greater than the revenues. Strengthening local reform would be impossible without the establishment of an efficient system for funding needs at the local level.

Municipal bodies in Bulgaria are responsible for delivering public services corresponding to local needs, for accumulating their own resources and for elaborating the local strategy for economic and social development and growth. The imbalance between responsibilities and abilities to ensure revenues for the implementation of all these objectives is one of the most important problems for local governments. The nature of financial crises and budget deficits of the local governments in Bulgaria presents a budgetary structure, subordinate to central government's decisions. The own revenue share varies and is usually around 15 – 20 per cent (1993– 2000) but less than 20 per cent of the total revenues. The main reason for budgetary crises is the lack of power in expenditures management, which aims at responding to the needs for public services at the local level. Most expenditures are directed towards services assigned to local authorities by the central government and are spent on covering mandatory responsibilities.

The structural budget deficits of local governments, linked with the impossibility of fulfilling their mandatory responsibilities during the last two years were signals that the achieved fiscal decentralisation was fragile and unstable. Local taxes comprise a small share (15– 20 per cent) of municipal revenues. Approximately 80– 85 per cent of these revenues come from subsidies and shared taxes. The share of the subsidies and the shared taxes cover mainly the operational costs and most of the small and medium-sized municipalities were in public companies' debt. The problem has grown worse during the last two years because shared-tax revenues (mainly the Corporate Income Tax and the Personal Income Tax) have been reduced and local revenue sources are now extremely limited. Other reasons can be high unemployment and tight fiscal policy.

Due to their inability to raise local taxes and fees, the Bulgarian municipalities have attempted to cover their budget deficits through the sale of assets or privatisation. The low level of own local revenues makes the municipalities extremely dependent on shared taxes and subsidies from the central government. The mayors are currently fighting and lobbying to obtain high subsidies. This approach is contradictory to the free market model. The subsidy system is counter-productive to the initiatives of municipal management bodies in developing their human and financial capital, because most of them rely on state finances.

Local management requires clear definition of responsibilities in the allocation of resources and public services delivered at different levels (central and local). In practice we recognise two approaches: first, responsibilities are concentrated at the central level for the provision of public services. Local governments have no freedom in public sector management; all local government expenditures

and revenues are defined by the central government. The central government defines the allocation of resources, while the Ministry of Finance approves local budgets. In the second approach, the responsibility for expenditures is shifted to local governments. This supposes a high level of fiscal decentralisation and transfer minimisation from the central to the sub-national levels.

Bulgarian practice is close to the first approach, based on sharing responsibilities in public services between central and local government, where the most significant portion of the revenues is defined by the central government. Public services are provided both by the central and local governments in Bulgaria. Shared responsibility weakens the operational effectiveness through divided management control (over salaries, staff patterns, facilities, etc.) between the central government and the municipalities. One of the main reasons for municipalities not to take into consideration the priorities set down appears to be the lack of sufficient resources.

A basic element of the local finances is the budget, the main form of local finance organisation. The municipal budget is a separate, but important section of the consolidated budget. Municipal budgets are confirmed by Parliament as part of the consolidated budget. Subsidies and payments of local governments to the state budget are approved by Parliament. The budget consists of sections addressing both expenditures and revenues. Budget resources are distributed according to a range of priorities – salaries, social contribution payments, drugs, social aids, etc. If priorities have not been followed, the subsidies can be cut. If the target subsidies have not been used, they can be transferred to another municipality by the Ministry of Finance. Revenue of local units can be divided into tax, non-tax, capital and grant subsidies. Table 2 indicates the share of revenues in local budgets. Local governments rely on shared taxes, while local taxes do not play a major role in their budgets.

The State Budget Act determines revenue sharing. The shared tax is a decentralised form of vertical revenue sharing. The central government decides the amount of transfers and sets up the budget on the basis of the previous year's budget. The revenues from shared taxes come from Personal Income Tax. The regulations for revenue distribution have been changed very often. The highest percentage of revenues is for salaries in the fields of education, health, social and health insurance and social aids. The average expenditures for labour remunerations are approximately 55– 57 per cent of the total local expenditures.

The gap between revenues and the costs of delivering obligatory services induces local governments to use grant transfers to cover operational costs and current needs, with no heed to either the priorities of the budget or the local strategy for economic and social development.

Municipalities are interested in developing the capacity of local administrations thus facilitating the process of taxation. However, in Bulgaria central government taxation departments, located in the municipalities, implement collection activities, but they still do not pursue the interests of municipal governments. Simplification of local taxes and charges and delegating the collection responsibility to local governments would cut administrative costs and ensure reliability of revenue information. The taxation system needs improving, including the establishment of a computerised central information system.

The central government's general practice is to collect taxes and then allocate revenues to local governments in the form of transfers. A survey, carried out by experts, has shown that municipalities control from 15 to 18 per cent of their revenues and 20 per cent of their expenditures.⁶ Subsidies or grants make up the remainder of municipal revenues. Subsidies fund financially weak local communities and are normally used to establish fiscal equalisation.

9.5 Expenditure distribution

Assigning expenditure responsibilities determines at what level of government services are delivered. The role of local governments in the process of determining the quality, quantity and variety of services has become greater with the ongoing decentralisation reform.

Most public services provide important benefits for local communities and for the nation as a whole. Activities such as education, health care, social insurance and environmental protection are often provided not only by the central government, but also by municipal governments. The central government may set the policy, regulations, and standards, while the lower levels of government are mostly responsible for actual service delivery. Assigning expenditure responsibilities to each level of government is the first step in the improvement of the system of municipal and intergovernmental finances⁷. Defining the relevance between public service competencies (expenditure responsibilities) and different levels of government is the first step towards a decentralised fiscal system of government. Clearly defined expenditure responsibilities enhance system accountability.

Expenditures at the local level are mainly allocated to schools (primary and secondary), the health care system, social care, security payments, housing, public goods, infrastructure, and cultural and economic activities. As a share of total budgets, expenditures for education and health have not changed, and salaries are the largest component of those expenditures. Due to the new health care ar-

6 See the Report on Fiscal Decentralisation – Local Government Initiative – Sofia (USAID)

7 For more information see the paper “The Assignment of Revenues and Expenditures in Intergovernmental Fiscal Relations” – by Jorge Martinez, World Bank Institute www.worldbank.org/decentralisation.

rangements in Bulgaria, certain hospitals that formerly served just one municipality can now deliver their services to other adjacent municipalities. The health reform decreased the divergence in expenditures because most of the health establishments are under reconstruction and will be privatised. Health expenditure responsibilities create great divergence, because of the location of the health entities. The burden of social payment varies from municipality to municipality. As a result of unemployment and minority populations, small municipalities have greater social assistance burdens than the remaining municipalities. The differences between local governments still remain, due to the diverse population structure, production volume and level of unemployment.

Complications arise when the benefit area exceeds the area of the jurisdiction providing the service, when economies-of-scale make it significantly less costly for a larger jurisdiction to provide the service, or simply when a given activity is more easily administered over a wider area. In such cases, central government involvement can ensure that the benefits are provided in a sufficiently large area. Bulgarian practice shows that the assignment of expenditures can be determined by the central government on the basis of delegated activities. The centralised financing and the increase in the number of “delegated” activities would ultimately weaken local autonomy. Any centralisation of remunerations for locally provided services would similarly reduce local autonomy.

9.6 Assessment of Intergovernmental Relations

The milestone issues discussed over the last years in Bulgaria were in the nature of financial relationships between the various levels of government; what taxes should be allocated to what level of government; how the central government redistributes resources amongst local governments and what impact, grant transfers have on local development.

The first step in designing decentralisation is to establish clear and transparent intergovernmental fiscal relations. Grant transfers are the main component of intergovernmental relations, but this corresponds to the principle of decentralisation. Grants have two main functions: to compensate the lack of financial resources and to equalise the financial capability of municipalities. Effective budget management supposes a clear distribution of responsibilities and duties between different levels of government. The grant transfer is set on the basis of the revenue capacity and responsibility assignments. Intergovernmental grants are especially needed where major public services, such as education, health care, social care and culture, are provided by municipalities. The intergovernmental fiscal system consists of municipal revenues such as shared taxes, subsidies and grant transfers. The allocation of subsidies for fiscal equalisation depends largely on the calculation of the fiscal capacities of local units. Fiscal capacity is an indicator of the ability of a local unit to collect revenues and finance expenditures.

As mentioned previously, the State Budget Act establishes the financial relations between central and local governments. This Act determines the amount of grant transfers and subsidies distributed to sub-national governments and the payments of municipalities to the state budget. There is no attempt to measure the fiscal capacity of municipalities in Bulgaria and doing this would decrease the financial imbalance. (Practice shows that bigger municipalities have the potential to finance their needs, whilst smaller ones have certain difficulties with this activity). Financing municipalities according to their fiscal capacity would enhance the transparency of intergovernmental relations. Subsidies are a tool for dividing powers between central and local governments in service delivery. Transfers– shared taxes and subsidies– are used to balance inequality between the municipalities.

The criteria for the efficiency of intergovernmental relations are:

- **Adequacy** of revenues: the revenues transferred to sub-national bodies have to be sufficient to cover the expenditure distribution;
- **Equity**: transfers must be relevant to objective indicators, which measure the financial needs and are proportional to the tax potential of the municipalities.
- **Stability and prognostics**: transfers to local units should be predictable and stable;
- **Transparency and objectivity**: there must be clear and visible information on the rules of grant transfers.
- **Economic efficiency**: intergovernmental relations should provide incentives for mobilising revenues and providing efficiency for other recipients.

The above-mentioned criteria are not established methodology for the determination of transfers to local governments. However, with the present practice, the distributed revenues are not sufficient to fulfil the mandatory obligations of most of the municipalities in Bulgaria, especially those of low economic and industrial potential. Transfer calculation on the basis of a formula appears to be unclear, not transparent and subjective. For this reason, certain municipalities find themselves in more favourable financial conditions than others where financing does not correspond to the needs and tax potentials of communities.

Municipalities in Bulgaria receive additional subsidies at the end of the year. Although the distribution appears to be subjective and unequal (some of them receive 45 per cent and others only 10 per cent, or less, in additional subsidies). The shared tax base of transfers to local authorities is fixed on the basis of registered companies, but does not usually correspond to the real number of companies and their actual taxable earnings for the municipality. It is common practice for some companies to be registered in one place whilst functioning in another. This creates an unfair and inefficient determination of the size of the shared tax transfer.

As a result of economic restructuring, the income disequilibrium has increased in Bulgaria. There are many municipalities (small and medium-sized) where most of the population is jobless for a long period of time, but the demand of services is similar to that of other economically developed regions. Income disparities among regions are great, and grant transfers are the most appropriate way to overcome this situation. The grants decrease inequities between regions arising from disparate taxation capacities, contributions to the state budget and the provision of services of similar standards. The contribution of municipalities to the central budget differs and depends on population, gross product and level of employment.

The practice of distribution of grant transfers is based on an indicator presenting the diverse impact of the grant transfers on the local budgets. The value of the indicator is relevant to a division of municipalities into three groups. Criteria for this division are size, population, and the level of unemployment and production growth. The first group involves small municipalities of well-functioning and developed industry, and somewhat larger municipalities. The second group includes medium-sized municipalities with lower production growth. And the third group involves middle and small-sized municipalities with economic and social problems (a high level of unemployment and low production levels). This classification is useful in obtaining precise information on needs and expenditures.

The Grant transfer mechanism has the effect of equalising revenues for all municipalities. Through equalisation transfers, ambiguity among different levels of government is reduced, thus increasing the accountability of local governments towards residents. The existing mechanism of finance distribution by the central government sets municipalities in an unequal position. Small local governments depend on general transfers; about 50 per cent of their current revenues are generated by the central government. The largest municipalities receive larger proportions of their revenues from shared taxes (over 50 per cent, and 70 per cent in Sofia) and have a much greater basis on which to collect their own local taxes and charges. The responsibilities of local governments in social assistance cause a big problem in municipalities with minority population and a high level of unemployment.

9.7 Equalisation

In the context of economic theory, subsidies and grant transfers are tools for the equalisation of incomes and economic divergences. Pigovian concepts explain the use of grants and subsidies: they are tools for the optimal allocation of resources targeting the reduction of externalities. Justification of subsidies and the income per capita present another taxation capacity for municipalities. Subsidies and grant transfers ensure equal access to public services. There are two types of fiscal equalisation– horizontal and vertical. The main instrument of vertical equalisa-

tion is tax sharing, and the main tools of horizontal equalisation are subsidies and grants. Equalisation leads to the achievement of vertical balance (adequacies between mandate responsibilities and revenues), and the equal allocation of resources aims at reaching the same benefits of public service delivery.

The divergence of incomes and taxation capacity across local governments is large. It can render access to public goods and services unequal. Therefore, equalisation is justification for intergovernmental transfers. Regional disparities have increased in Bulgaria in recent years. The disparity is a result of the structural reform, high levels of unemployment and low incomes. The grant transfer is used to decrease the discrepancy in income and economic development among regions. It reflects the transfer of money from regions with a high level of income and taxation capacity to the poorer regions. The transfer system has developed in two directions: vertical revenue distribution from central to local governments, and horizontal allocation in the form of transfers among recipients.

Vertical equalisation addresses the correspondence between expenditure and revenue arrangements at the local level. Vertical balance is a tool to balance the expenditure and revenue responsibilities of sub-national governments. Vertical equalisation in Bulgaria can be achieved by increasing local revenues or transfer grants from central to local levels, because local governments have no capacity to ensure an adequate level of public services and their expected benefits.

9.7.1 Variety of vertical approaches

Subsidies distributed at the sub-national level determine to what extent transfers achieve vertical balance. They are calculated in different ways: as a share of governmental revenues, on an ad-hoc basis, and through a tax sharing methodology.

Shared taxation. This is a system where central government determines the distribution of taxes shared with the sub-national levels. The sub-national governments receive fixed fractions of revenues from particular national taxes (the central government and local units in Bulgaria share the Corporate Income Tax and Personal Income Tax). The shared taxes are sensitive to economic growth and the overall production rate. This approach severely restricts fiscal autonomy with respect to how given revenues are spent. This does not affect, however, the power to alter the amount of revenues received from the shared taxes. Wealthier governments have more stable tax bases and better collection administration. In Bulgaria the implication of the shared tax in circumstances of inefficient tax administration leads to a wide disparity of taxation capacity among rich and poor regions.

Ad hoc Subsidies. This is a centralised approach that contradicts the fiscal decentralisation of management and is based on state governmental control of sub-national budgets. During the last year ad hoc subsidies were typically used to fill gaps in local government budgets. This approach is not transparent and it

could also be used for political purposes. This creates uncertainty of revenues and decreases the capacity of local governments to control expenditure distribution. The advantage of this approach is that it allows flexibility in case of budget deficits and of tight fiscal policy. The downside of it is the lack of transparency and the impossibility of forecasting money flows at the local level.

Fiscal decentralisation in Bulgaria requires that all municipalities have revenue-raising powers in order to finance local decisions concerning provision of a range of services, to increase economic and social welfare. The disadvantage is the subjective aspect of defining the revenues available to local governments and their real needs. Local governments face a budget constraint since most of the funds come from the Ministry of Finance and usually they determine a lower level of services.

The distribution of subsidies is based on a special formula mentioned in the State Budget Act. Equalisation relates to the formula, used to allocate funds to local governments. The idea of the formula is to include the objective criteria that reflect local government commitment. Fiscal transfers and own revenues determine budgetary constraints. Subsidies are the main part of revenues, and they aim at equalising the differences amongst municipalities. Local governments receive general subsidies without preliminarily fixed expenditure directions.

Bulgaria, as with other countries, implements the subsidiary principle as an approach to provide financial support for local governments. The Ministry of Finance defines the amount of subsidies for each municipality (using the relevant methodology), and this amount should be later approved by Parliament, together with the State Budget Act. The formula for the allocation of general operational subsidies among municipalities is too complicated, thus making it difficult to forecast future revenues. Certain problems that have occurred in the system of fiscal equalisation are the result of continually changing the formula. These criteria are not realistic enough for the allocation of subsidies. Since its introduction in 1993, it has been changed every year, becoming more and more complicated. During the last years, the percentage of grants allocated under the objective criteria was relatively high and it has varied from 35 to 45 per cent. The number of objective criteria has increased from 5 to 27 in an attempt to reflect all expenditure needs of local governments. The number of indicators has gradually been changing: 1998– 27, 1999– 23, 2000– 27, 2001– 15. Changes in indicators do not allow any prognosis on amounts transferred. There are certain cases of ignoring the criteria as a result of intervention on the part of mayors and other politicians. The objective criteria included are quantitative indicators, which reflect the revenue needs in the public sector. The methodology was not accepted by the local governments, because of changes in the number of the criteria. The grant formula was insufficient with respect to transparency, flexibility and the principles of intergovernmental relations.

The calculation methodology comprises the following components:

- A/ The basic subsidy (percentage of the general subsidy from the previous year). The purpose here is to have less general subsidies than a year ago. Own funds of the mandatory budget can be calculated if from the sum of the mandatory budget (salaries, social security payments) and social assistance we subtract the amount of the expected own revenues (non-tax revenues and charges);
- B/ Subsidies related to objective indicators – number of pupils, inhabitants, settlements, the area, number of patients attending hospitals, number of individuals who received social assistance and the number of community culture centres. These subsidies are formed as follows: the difference between real revenues and the coefficient of marginal revenues is multiplied by the number of population earning less than 50 per cent of average income;
- C/ Target subsidies are formed in accordance with priorities in the context of the local government development and social assistance;
- D/ Capital subsidies allocated for the implementation of capital investment projects.

These are subsidies directed mainly to capital expenditure that are designed for special purposes. They are allocated from the Republican budget for the implementation of governmental investment programs, infrastructure development and the implementation of regional programs of specific purposes.

The calculation of subsidies is unclear, the variables and their value in the model are subjectively determined. Subsidies distributed under a formula do not encourage sub-national autonomy and provide no incentive for own resources and capital accumulation. Ideally, overall municipal revenues would match municipal expenditures. However, municipal revenues are usually less than municipal need expenditures.

The mechanism of formula distribution reduces the lack of resources and inequalities. The analysis of the formula approach shows that municipalities with low revenues per capita receive larger subsidies. The formula does not reflect all duties delegated to municipalities by certain line ministries. The experts in local finance suggest that shared taxes be distributed according to the number of citizens rather than the number of registered companies. The system of shared taxes is not the most perfect and does not guarantee sustainability and efficiency of the distribution of shared taxes amongst local authorities. Nevertheless, the changes in shared tax transfer indicators do not affect income and economic divergences.

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complicated tool, for each year it requires updates and contradicts the devolved decentralisation approach. The intergovernmental transfer system in Bulgaria is not transparent and is subject to political interests, which lead to uncertainties for the sub-national governments.

Horizontal Equalisation addresses fiscal imbalances between regions and local governments. Horizontal fiscal disparity stems from different taxation capacities and income levels. Taxes in Bulgaria that are reasonably assigned to sub-national governments are not sufficient to finance the provision of services and they result in horizontal fiscal disparities. Sub-national governments of strong taxation capacity and a high-income level have the opportunity to generate high revenues from local taxes. They are thus empowered to provide the level of required public services, compared to small and low-income level local governments. The applied practice of allocation is not an efficient approach for achieving horizontal equalisation among the recipient units (municipalities).

9.8 Financial Supervision and Auditing

Supervision involves activities assessment and the availability of conformity with the legislation and the specific budgetary objectives. Municipalities submit the budget to the Ministry of Finance for approval and endorsement. The Ministry of Finance together with the National Audit Institute, within the frameworks of the Auditing Act and the Internal State Financial Control Act, delegate responsibilities to control local finances and budgets. There are several levels of control: at the local level, the financial department monitors how the revenues are spent and how they relate to the distribution of responsibilities (expenditure distribution); at a national level, monitoring is undertaken by the Ministry of Finance's Municipal Budgets Department. The main objective of local financial departments is to strictly observe the cash flow and make the allocation of resources transparent.

The Municipal Council adopts the annual report of budget implementation and the expenditure and revenue balance. The mayor and a specialised financial department currently monitor the process of budgeting. Municipalities are obliged to submit a report on expenditures and revenues quarterly to the Ministry of Finance. The National Auditing Institute monitors and controls budget implementation and submits a final auditing report to the Ministry of Finance.

Municipalities have restricted powers related to budget planning. The Ministry of Finance defines municipal revenues based on assessments carried out by the central taxation administration. The Audit Office controls the performance of local governments in the allocation of expenditures and the use of grant transfers. The Institute imposes penalties when local governments have not used their funds according to public sector priorities.

The control on the budgetary performance of local governments by the Ministry of finance is relevantly low because of the lack of an information system. The State Budget Act and the Municipal Budget Act restrict effective financial management at the local level. The procedures for budget control are incomprehensive and unclear and auditing is usually performed according to accounting acts and regulations. The Internal State Financial Control Act (art.19) establishes a system of financial management and control at the local level. Each municipality is responsible for setting and implementing rules for the efficient monitoring of revenues accumulation and spending under the provisions of the Municipal Budget Act. The mayor accepts the rules of financial control, while the administrators are responsible for its implementation. Larger municipalities have the capacity to create a modern financial system.

An obstacle to the effective functioning of a financial system is the lack of well-structured information based on contemporary information-technology products. Despite the insignificant role of the central authorities in service provision, the increase of local autonomy also requires strengthened monitoring of local fiscal performance and enhanced evaluation of service delivery outcomes on behalf of the central government. Good central monitoring and evaluation paves the way towards local autonomy in the future, as municipalities demonstrate a growing capacity to manage expenditure (and revenue) responsibilities.

9.9 Conclusions and Recommendations

Budget constraints under the currency board regime, the ongoing economic structural reform and the continuous fiscal decentralisation process cause Bulgarian local governments to experience various problems related to the distribution of responsibilities and the limited flow of revenues.

The unfavourable financial status of Bulgarian municipalities is a consequence of the centralised approach to transfer redistribution from central to local governments and the restrictions of current legislation, which do not allow local governments to set up taxes and charges. As a whole, municipalities have no freedom in determining their revenue and expenditure policy. Their powers are limited by the existing legislation and centralised approach to the distribution of financial resources from the Ministry of Finance to municipalities. At present, municipalities have no tax autonomy. According to the Local Taxes and Charges Act, municipalities have limited powers in setting the local tax base and tax rates. The subsidy distribution to local governments depends on a decision taken by the central government in Bulgaria. Municipalities also have fewer powers to plan the revenue section of their budgets. All taxes, including local taxes, are collected by the tax administration and transferred back to municipalities. The disadvantage of this approach is that there are no incentives for improving tax collection and achieving transparency of the whole process. They are supposed to approve

not only the amount of the subsidy, set by the Ministry of Finance, but also the tax revenues, drafted by the Ministry. Such actions encourage a lack of budget discipline and at the same time do not enhance the beneficial use of budget resources. Additional allocation of grants and interest free loans granted ad hoc to municipalities contradict the heavy budget constraints. All these restrictions are the reason for the low creditworthiness of the municipalities.

The main reason for budgetary deficits is that municipalities are assigned more responsibilities than the available local revenues will fund. In order to bring balance between revenues and expenditures, the Ministry of Finance allocates additional grants and interest-free loans to municipalities. The more municipalities share revenues, the less independent they are in the decision-making processes. The existing transfer approach imposes restrictions on the expenditure policy and does not guarantee the improvement of the quality of services. Municipalities can provide effective local services in cases where they set the level of taxes. Compared to other countries in transition, Bulgaria's local government has less authority to regulate its own revenues.

Finally, improvement and further strengthening of intergovernmental transfers requires:

- proper assignment of expenditure and revenue responsibilities – public service competencies and revenue-raising authority – to each level of government;
- the development of an intergovernmental fiscal system leading to an overall balance between revenues and expenditures at each level of government;
- the introduction of horizontal equalisation;
- the sustainability and transparency of subsidies allocation;
- taxation independence, so that local governments have more power in defining local taxes and tax bases within the context of fiscal decentralisation;
- increased power for local governments in revenue distribution that would positively affect local accountability.

Fiscal decentralisation is a process that involves powers in increasing the revenues and in delegating responsibilities concerning the effective provision of public services. That means municipalities should have their own resources in order to ensure their capacity to meet their responsibilities.

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Appendix

Table 1
Planning regions, districts and municipalities in Bulgaria

Planning regions	% territory	% population	Number of districts	Number of municipalities
North-West Region	9.6	7.1%	3	33
North- Central	16.2	15	5	40
North -East	18	16.4	6	49
South-East	13.2	10.1	3	22
South Central	24.8	25.3	6	66
South-West	18.3	26.2	5	52
Bulgaria	100	100	28	262

Table 2
Share of Local Revenues in the State Revenues

Revenues	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Tax revenue	73.8	55.6	47.84	35.00	45.0	47.00	53.7	54.5	46.7	45.2
Shared revenues	62.0	44.4	46.6	34.6	35.6	48.4	55.1	46.5	41.7	39.5
Grants	26	37.9	45.2	46.7	42.7	33.8	34.3	38.3	39.6	42.6
Capital revenue	n.a.	n.a.	1.1	1.4	1.4	1.1	1.6	1.0	1.0	1.2
Non-tax revenue	1.9	6.1	6.1	8.5	13.0	11.4	6.3	6.0	12.3	11.9
Property tax	1.3	1.2	2.3	3.5	3.2	3.7	1.6	7.7	4.8	4.5
Charges	1.3	2.4	3.8	6.2	6.1	7.1	4.2	8.6	8,5	8.2

Table 3
Share of the Local Expenditures in Local Budgets

Expenditures	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
General public services	3.3	2.6	4.7	4.7	5.3	6.1	6.8	6.9	7.1	7.4
Education	32.8	32.5	35.0	32.4	32.9	31.4	32.8	29.1	30.4	30.98
Health care	27.8	29.4	33.4	30.86	30.50	29.17	31.6	27.7	25.5	20.4
Culture	2.82	2.3	2.8	2.8	3.1	2.8	2.9	3.3	3.5	2.7
Social Welfare	7.1	8.1	10.45	9.6	9.3	8.6	8.9	9.1	12.8	15.5
Housing Communal Service	16.7	17.4	9.5	16.6	16.8	15.9	12.9	14.3	15.2	14.7
Local Admin	4.2	3.8	3.2	2.0	2.4	6.0	5.8	6.1	6.5	7.2.

Table 4
Composition of revenue sources

Own tax	The tax base and rate are under state control. They are determined by the legislation and the Ministry of Finance (except waste collection tax and administrative charges).
Non-tax revenues	Fees and charges, the local government specifies the base and provision of methodology for their calculation.
Shared tax	The legislative acts fix the ratio of tax revenues allocated to sub-national governments. This approach is centralized and not enough relevant to the free market concept.
Subsidies	Central government decides the amount of subsidies on the basis of a formula - objective criteria for distribution.
Specific grants-capital grants	The Ministry of Finance, depending on the priorities specified in capital and infrastructural programs, determines the absolute amount of the grant.

10. Grant Transfers and Financial Supervision in Romania: A Focus on Major Reforms Introduced by the Law on Local Public Finance

Clare Romanik* and Francis Conway**

10.1 Introduction

10.1.1 Overview of the system of local government

The basic structure of local government in Romania is defined by the Constitution under which local public administration is to be carried out “...in territorial-administrative units... based on the principle of local autonomy and decentralisation of public services.”¹ Each administrative unit is constituted as a legal person, having all the rights, duties and obligations assigned to that status by Romanian law. The two tiers of local government in Romania are county councils and local councils, with the latter divided into municipalities, towns and communes. There is no real or presumed hierarchical relationship between these two tiers of local government. Bucharest municipality has a special status and functions as both a municipality and a county.

Table 1
Structure and Population of Local Government Administration

	Number	% of total	Population (millions)	% of total	Average Population (thousands)
County Councils	41	–	22.5	–	549.6
All Local Councils	2,951	100%	22.5	–	7.6
Bucharest	1	–	2.0	9%	2,027.5
Municipalities	83	3%	8.0	36%	96.8
Towns	179	6%	2.3	10%	13.0
Communes	2,688	91%	10.2	45%	3.7

As the basic units of local government in Romania, municipalities, towns and communes perform both a legislative and an executive function, the legislative function is performed by local councils whose members are elected for four-year terms through direct popular election. Once constituted, local councils elect a chair for each meeting by majority vote and meet monthly in an ordinary

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1 Ch. V, Sec. 2, and Art. 119, Constitution of Romania (1991).

session. The executive operation of local government is carried out by a mayor and a vice mayor. Mayors are elected by the population and vice mayors are appointed by majority vote of the council. The mayor serves as the principal executive officer of the local government and is accountable to the local council for the efficient operation of the local government.

At the county level, council members are also elected for four-year terms through direct popular election. County councils meet in ordinary sessions on a bi-monthly basis. The Council Chair serves as the county's chief executive officer. As is the case with the mayor of local councils, council chairs are given broad executive powers to fulfil the legal mandates of the county councils and carry out the county's day to day operations.²

10.1.2 Recent political and economic developments

After three years of negative growth, the Romanian economy began growing again in 2000 and is projected to continue to grow in 2001. The recent economic recovery can be partially attributed to the previous government of the centre-right coalition, Democratic Convention of Romania (CDR). In mid-1999, it embarked on serious macroeconomic reform, which helped stabilise the country's economy by late 2000. However, it was too late for CDR to benefit in the November 2000 elections. The CDR did not even obtain enough votes to pass the threshold for obtaining parliamentary seats. A minority government led by the centre-left Romanian Party of Social Democracy (PDSR) instead now rules the country. Despite harsh criticism of CDR policies during the campaign, the PDSR has promised to continue the CDR policy of pursuing European integration and appears to support the stabilisation and reform measures advocated by the international finance organisations.³

Many of the population believe that international finance organisations make the country's economic policy. This is a result of the strict conditions placed on the Romanian government by the IMF, World Bank and the European Union to pursue macroeconomic stabilisation and economic reform and the Romanian government not wanting to be responsible for the harsh consequences of these policies (Stolojan, 1999).

The decline of the Romanian economy and the measures taken to address its fiscal implications, have had a profound effect on local finances. This decline reduced the tax base and, presumably, increased the propensity for tax evasion. The low fiscal and non-fiscal revenues, in conjunction with the need to have a low

2 See Law on Local Public Administration, No. 69, November 26, 1991, as amended by Law No. 24/96 and M. Belcher, et al (1997) Romania: Municipal Creditworthiness and Local Government Decentralisation, Washington, DC: Urban Institute Project 06610-804.

3 Political News and Forecast. Bucharest, Romania: Romanian Academic Society and the Center for Urban Sociology (November 2000).

budget deficit, forced policy-makers to cut expenditures drastically either when constructing the budget, or via rectification. The reduction in expenditure had a negative effect on public investment and material expenses. The strained budget also explains the reluctance of policy-makers to provide more resources to the discretion of local authorities.

Table 2
Trends in the Economy and Public Finances – 1996 to 2001

	1997	1998	1999	2000	2001 ^a
Macroeconomic indicators					
Real GDP (Annual change)	-6.1	-5.4	-3.2	1.6	4.5
Fiscal balance (Percent of GDP) ^b	-5.3	-5.5	-3.8	-4.0	-3.5
Unemployment Rate	8.9	10.4	11.8	10.5	8.6
Fiscal indicators (%)					
CG expenditures/GDP	20.9	21.1	20.5	19.2	N/A
LG expenditures/GDP	4.1	3.6	4.1	4.2	
LG Expenditures/General Government	12.1	10.2	11.4	11.7	
LG expenditures/CG expenditures	19.6	17.2	20.2	22.0	
Fiscal Transfers/GDP	3.3	2.7	0.9	0.8	
Transfers to LG/CG Expenditures ^c	15.9	13.0	4.2	4.3	

Source: Table prepared for this report. Data on GDP, fiscal balance and unemployment from the IMF (Press release No. 01/43 dated October 31, 2001). Public expenditure ratios calculated for this report based on data from the Ministry of Finance of Romania.

Notes: a. Based on IMF estimates per the approved program for Romania.

b. Represents overall balance of general government

c. Transfers do not include revenue sharing, which was introduced with the Law on Local Public Finance in 1999.

10.2 Local Government Legal Framework

The following set of laws governs the functioning of local governments and their finances:

- Romanian Constitution (1991);
- Law on Local Public Administration (1991 as amended in 2001);
- Law on Local Public Finance (1998 as amended in 2001);
- Annual State Budget Law;
- Law on Local Taxes and Fees (1994 as amended in 1997 and 1998);
- Law on Public Patrimony and its Legal Regime (1998);
- Law on the Regime of Concessions (1998);
- Law on Local Public Services (2001);
- Law on the Transformation of Regii Autonomies (publicutilities) (1997);
- Law on Regional Development (1998);

- Law on Establishing Revenues in the Budgetary System and Salaries of the Official Staff (1998).

Until 1998, local finances were subordinated to the national budget process. Three key legislative reforms dramatically changed the nature and structure of local government finances. The Law on Local Public Finances,⁴ adopted in 1998, puts local finances and the local budget process on an equal footing with those of the national government. This law abrogates and replaces Chapter III of the Law on Public Finances that had governed the local budget process in the past. It defines the structure of local revenues and expenditures, reinforces local control over the budget and clarifies and simplifies the rules for access by local governments to the credit markets. The amendments to the Law on Local Taxes and Fees authorised in 1997 and 1998 greatly expand local control over their own revenues and authorise local governments to administer their own taxes. The Law on Public Patrimony, also adopted in 1998, created the basis for ownership by local governments of property associated with the functions they perform.

10.3 Inter-Governmental Financial Relationship

10.3.1 Assignment of Responsibilities

The assignment of responsibilities is generally based on the principle of correspondence and responsibilities of basic level local governments (municipalities, towns and communes) differ considerably from those of the counties. The counties generally are responsible for child protection and the care of handicapped children, county public services and county roads, as well as county cultural institutions (museums, libraries, etc.). Municipalities, towns and communes carry out more direct service provision (urban transport, sanitation, public utilities); maintain roads, sidewalks, parks, and green areas; and are responsible for education, other social assistance (such as benefits transfers), local culture and sports services, local economic development and markets.

During the period from 1991 to 2000, there were major changes in the spending levels of most of the six key functional areas: local administration; education; health; social assistance; public works and housing; and transport and communication. (See Table I.2: Local Expenditures by Function in Annex I.) These changes are either a direct result of national policy shifts or an indirect impact of these changes. Beginning from 1993, local governments were given expenditure responsibility for health care – which became 12 to 15 percent of their budgets – but this responsibility (and concomitant spending) ended in 1998 with the introduction of a new health insurance system. In the meantime, education responsibilities were given to the local level in 1995. Education accounted for 10 to 11 percent of total expenditures in 1995 – 1997, but has now declined to about

⁴ Law on Local Public Finances, No. 189 of 1998.

8 to 9 percent, due to the addition of other functions. As a result of new and changing responsibilities in other areas, the ability of local governments to spend on public works and transport has varied considerably during this period.

The variability in spending levels of key functional areas reflects the fact that the current system lacks a clear assignment of local expenditure responsibilities. Although the Law on Local Public Administration lists the “tasks” of the local governments, these tasks are not functional competencies. The functional responsibilities (services provided by the local self-governments) are in fact determined each year through an annex to the Annual Budget Law. This annual determination and modification of local expenditure responsibilities reflects the lack of an overall consensus or “vision” of the role of local government in Romania.

10.3.2 Financing of Local Governments from Local Sources

With the implementation of new or amended local finance legislation in 1999, revenues from local sources have become increasingly important in the overall composition of the sources of financing for local governments. (See Table I.1: Local Revenues by Source in Annex I.) The Law on Local Public Finance, adopted in 1998 and implemented in the budget year 1999, introduced tax revenue sharing in Romania and had a profound impact on the structure of revenues of local governments. Under the new arrangements, the county and local councils receive a share of the income taxes collected from taxpayers in their geographic area of jurisdiction. Amendments to the Law on Local Taxes and Fees authorised in 1997 and 1998 greatly expanded local control over their own revenues and authorised local councils to administer their own taxes. Implementation of these legislative changes also redistributed revenues by level of local government, by regions and by individual local governments (Romanik, et al., 1999).

10.3.3 Local Taxes

A previous major source of revenues – taxes on non-wage income (rental income, royalties, and self-employed professionals) – has now become part of the income tax and are no longer local taxes. In the process, local councils have grown increasingly dependent on personal and corporate property taxes. They now represent over 80 percent of total revenues from local taxes and fees. The growth in revenues from the property tax reflects largely the impact of the revaluation of the tax base by 270 percent in 1999 in an amendment to the Law on Local Taxes and Fees. This same amendment also authorised each local council to increase the tax base by the rate of inflation once each year. This is an important provision that should protect this important source of revenues from the effects of inflation.

The principal local taxes in Romania are:

- Personal property tax (land and building taxes are separately imposed);
- Corporate property tax (land and building taxes are separately imposed);
- Personal vehicle tax;
- Corporate vehicle tax;
- Resort or tourism tax.

10.3.4 Tax Collection and Administration

Both the amended Law on Local Taxes and Fees and the Law on Local Public Finances shift responsibility for the administration of local taxes and fees to the local governments. This was to be mandatory from January 1, 1999. Neither the local governments nor the Ministry of Finance had prepared adequately for this event. At the request of both parties the laws were amended to change the deadline for mandatory conversion to January 1, 2000. Since then, all local jurisdictions have assumed responsibility for administering their own taxes and fees. The evidence from larger cities and towns suggests that the change has produced an overall increase in collections of revenues from local taxes and fees. There is no information on the impact of the change on smaller jurisdictions, particularly those in rural areas.

10.3.5 Fees and User Charges

The Law on Local Taxes and Fees specifies the amount that local governments may charge for certain local fees. This includes fees for construction and for advertising. As with the local taxes, local governments may adjust the amount of the fee set in the law annually to reflect the impact of inflation. In addition, special fees have grown in importance. The Law on Local Public Finance provides broad authority to local governments to approve special fees. The revenues from such fees may be used only to pay for specific expenditures. For example, a local government might adopt a fee for parking in central city locations as a source of financing for maintenance and improvements of those areas. Each local government adopts those special fees it deems necessary so there is no unique list of such fees.

User charges are an important source of financing for local expenditures. For example, the amount that households pay to utilities for basic public services, such as water or heating, can be many times greater than what the same households pay to the local government in taxes and fees. This means decisions made by the local government (subject to approval by the national government) on user charges for basic public services may have a greater impact on the typical household budget than its decisions on local taxes and fees.

User charges, by and large, are assessed and collected by off budget organisations. These may be public institutions or public utilities. These organisations

have their own management, operate under their own budget and maintain separate accounts from those of the local government. The local government appoints the manager and approves the budget and financial accounts of the organisations. In a simplified way, the public institutions are like off-budget departments and operate on the same financial principles as any other government department. Typical examples of public institutions are local museums, libraries or specialised schools. The public utilities have their own legal personality, are more independent of the local government and operate on commercial terms.

10.3.6 Other Local Sources of Financing

Local governments obtain financing for operating and capital expenditures from other sources as well. These include the rental or sale of property, as well as the proceeds of the sale of certain confiscated property. They may receive donations from local or external sources. They also receive a share of the profit generated by local public utilities. In effect, these are like dividends paid to shareholders of a company.

10.3.7 Debt and Borrowing Issues

Until the passage of the Local Public Finance Law, there were no rules or specific authorisation for local governments to borrow. This law authorises local governments to borrow in the domestic capital markets on their own initiative, without requiring approval by the national government. The same law indicates, however, that any local borrowing in the international capital markets must be authorised first by a special commission chaired by the Ministry of Finance. According to the Law on Public Debt (No. 81/1999), loans contracted by the local governments are part of the public debt of Romania, but do not represent the debts and responsibilities of the Government. Debt servicing repayments are to be made exclusively out of the revenues with which the local authority secured the loan. The Law on Local Public Finance sets an upper limit on the debt obligations of local and county councils, such that debt service payments may not exceed 20 per cent of current revenues. For purposes of debt limitations, the law uses as a base revenues from local taxes and fees, shared tax revenues and other sources of financing for operating expenditure.

Given the weak state of the banking system, high inflation, and the general economic situation in Romania, the borrowing option has not been widely available to local governments. Domestic borrowing consists essentially of short-term cash-flow loans from the State Treasury. Long-term loans are at present only available from the international financial institutions, such as the EBRD, and from some domestic banks. The overall volume of financing through debt at the local level is still small.

10.3.8 Local budget process

The local budget process begins roughly in June or July of the preceding year with a draft budget that includes estimates of revenues from local taxes and fees and shared tax revenues and a proposal for expenditures for the next year. The individual budget of each local council is consolidated in a single county-level budget that also includes the draft budget of the county council. The budget is forwarded to the Ministry of Finance. After reviewing all budgets of local and county councils, the Ministry gives each county and local council a spending limit that they use in finalising the draft budget for the next year. If at the beginning of the fiscal year the State budget still has not been approved, the local governments receive authorisation from the Ministry of Finance to spend each month one-twelfth of their total actual expenditures for the previous year on a line-item basis.

After the approval of the State budget, often as late as May or June of a fiscal year (from January to December), each local government can adopt its own budget for the year. First, however, they must adjust their draft budget in accordance with the rules set forth in the current State budget law. In each year since 1991 this has included changes in the expenditure responsibilities of both local and county councils. It also has included variations in the volume and type of transfers, both general and earmarked. In addition, the local councils must wait for the county council to allocate to each of them their corresponding share of the equalisation grants received by the county council from the State budget. This allocation process has followed different rules in each of the 41 counties. The usual practice involves some quantitative criteria, but the process is far from being based purely on a formula. No local council knows for sure what amount they will receive from the county council. The process typically involves significant individual communication between the local councils and the county council.

The budget process is a major obstacle to any attempt by the local and county councils to manage their finances on a sound basis consistent with local needs and priorities. There is no hard budget constraint that compels them to make difficult spending priority decisions within a given level of revenues. Until the State budget has been adopted by Parliament and the equalisation grants allocated by the county councils, they do not know with any certainty the full extent of their revenues or of their expenditure responsibilities. Often, this information becomes available after a third to a half of the budget year has elapsed. The adverse impact is greater in the case of the communes. On average, they are far more dependent on the transfers from the State budget than the towns and municipalities or the county councils. As a result, the communes are much more at the mercy of the changes adopted in the State budget and of the decisions of the county councils on the allocation of equalisation grants.

In this context, it is not surprising that many local elected officials – the mayors and the members of the local councils – have adopted largely a passive attitude regarding the budget process. Their most important skill is the ability to negotiate with

the county council and the ministries to secure the highest possible grant allocations. It is difficult to ask the mayors and local council members to engage the local community in a dialog on their needs and priorities, when these elected officials feel that they lack the authority to actually implement the spending priorities of their community.

10.4 The Grant System

10.4.1 Roles and Purposes of Grants

Besides revenue sharing, there are both special purpose grants and equalisation grants in the Romanian intergovernmental fiscal system. The revenue sharing of the income tax (this was the wage tax before 2000) addresses the issue of vertical equity between the central, county and local levels of government. Before the introduction of revenue sharing in 1999, there were general purpose grants and special purpose grants that filled this role. In an effort to increase local government autonomy, general purpose grants increased and special purpose grants decreased from 1991 to 1997. (See Annex II – Grants Structure.) However, the real achievements in local revenue autonomy came in 1999 with the introduction of the revenue sharing system. Revenue sharing represented approximately one-third of all local government revenues in 1999 and 2000.

Although the Law on Local Public Finance envisioned almost an elimination of special purpose grants, they have persisted. Most notably, there remain special purpose grants for investments, both those financed through external loans and those deemed a priority by line ministries. The special purpose grants dictated by the line ministries are a countervailing force to increasing autonomy in local government spending decisions. There are also several special purpose grants for the support of social assistance responsibilities transferred to local governments. Special purpose grants fell from their dominant position of 84 per cent of all local government revenues in 1992 to 17 and 18 percent of local government revenues in 1999 and 2000.

The Law on Local Public Finance also introduced equalisation grants. The purpose of the equalisation grant is to reduce horizontal inequity among local governments (both at the county and sub-county level). In 1999 and 2000 equalisation grants represented 11 and 10 per cent of all local government revenues.

10.4.2 General Purpose Grants

The revenue sharing of the personal income tax can be thought of as Romania's general purpose grant. According to the Law on Local Public Finance, 40 per cent of the tax was to be distributed to the local council and 10 percent to the county council. Distribution is based solely on the origin of the tax revenues, and not on any allocation formula. By some analyses, this has increased the disparity of revenues among counties and local governments.

Although the purpose of the law was to establish a predictable source of revenues, the allocation shares were already changed by the first year of the law's implementation. In 1999, 35 per cent of the tax revenues were distributed to the local council and 15 per cent to the county council. Beginning in 2001, local councils will receive 40 per cent of the income tax revenues to compensate for the fact that taxes on non-wage personal income, previously local taxes, have been incorporated into the national income tax.

By establishing a revenue sharing system and reducing earmarked transfers, the Law on Local Public Finance has granted local governments considerable more financial autonomy. However, the discretionary spending power of local governments has been seriously curtailed by the national government's continued imposition of unfunded expenditure mandates to address pressing social needs. By mandates, we mean those cases in which the national government establishes the level of spending but does not provide funding to cover the corresponding expenditures. For example, in the case of means tested income transfers, the eligibility criteria and the level of the benefits are set nationally. Yet, local governments must fund the cost of the benefits from their own resources.

Evidence from individual local governments in 1999 and 2000 suggests that while earmarks have indeed gone down, the mandates now account for over 50 per cent of the operating expenditures of larger, urban local governments. The problem of the mandates is not unique to large urban areas.

(Unfunded) Mandates:

- Child protection services;⁵
- Means-tested income support payments (*ajutor social*);
- Payroll of persons assisting the handicapped;
- Payment per child in institutionalised care (starting in 2001);
- Payroll of the staff of the veterinary stations;
- Payroll of pre-university education teachers and staff (starting in 2001).

The way local governments cope with the mandates is by not funding the full obligation. For example, a report prepared for the World Bank in 1999⁶ looked in detail at income transfer payments and assistance for groups with special needs managed by local governments in specific localities in five counties of Romania. An Urban Institute report looked at funding for child protection services in each of the 41 counties in Romania (Conway, et al., 2000). Both found evidence that local governments have not funded the full cost of the social services assigned to them. The problem appears to be particularly acute in delivering means-tested cash benefits.

5 This is not a proper mandate as counties are free to determine the budget for these services. However, the degree of attention that child protection receives from the European Union and certain donors, and the expectations they have regarding increased funding for these services, create many of the characteristics of a mandated expenditure.

6 Romania Local Social Services Delivery, Washington, DC: World Bank (report still in draft).

10.4.3 Special Purpose Grants

The special purpose grants from the State budget provided to local governments until 1998 were of two types. The first were subsidies paid by the local governments to the local heating companies to compensate for national price caps and to the public transport companies to compensate for free transportation they must provide by law to certain categories of persons (disabled, veterans). The second were subsidies to finance local investments. This amount was given to the counties based on a negotiated, *ad hoc* transfer system and then allocated among the local councils in the county. The (State) Annual Budget Law identified priority investment categories for which the investment grants could be used. Specific investment projects needed to be approved by the Investment Evaluation Office in the Ministry of Finance, by the local Ministry of Finance Budget Office, and by the county.

Table 3
Special Purpose Grants for Investment (1996 to 2000)
Million current Romanian lei

	1996	1997	1998	1999	2000
Total special purpose investment grants	1,161,666	2,079,687	2,834,072	2,061,025	2,617,551
Grants for local investments (through 1998)	1,154,919	1,894,588	2,185,545		
Grants for investments financed by external loans	6,747	81,798	255,033	632,747	811,619
Road fund (part transferred for investment)		103,331	82,785	146,150	75,000
Communal road and water works			310,738	321,924	717,084
Housing fund				918,995	930,655
Other				41,209	83,193
Special purpose grants as % of local of investments	85%	79%	83%	43%	39%

Source: Francis Conway, et al. *Romania Local Public Expenditure Report*, Washington, DC: Urban Institute Project 07147-000-00 (2001): 65.

The Law on Local Public Finance only prescribed special purpose grants for investments financed by external loans. However, practice has differed from the law. Special purpose investment grants managed by the line Ministries continue to direct funds to their sector priorities, such as roads, water works, and housing. There are no transparent formula for determining who gets the funds and how much. Table 3 (above) shows that special purpose investment grants represent a decreasing share of total local investments, even as the number of specialised national investment funds has increased.

10.4.4 Equalisation Grants

The Law on Local Public Finance formalised the distribution of state revenues for the purpose of equalising revenues among counties and local councils. Equalisation grants and revenue sharing both come from the same revenue source, the personal income tax. However, the equalisation grants are distributed based on a formula, while revenue sharing is based on origin of the tax. Article 10 (1) of the Law on Local Public Finance states that:

“In order to create a budgetary balance among certain territorial-administrative units, the budget law can provide for the amounts of the shared funds from certain revenues of the state budget as well as for distribution criteria of the latter to territorial administrative units.”

The Ministry of Finance develops a formula for distribution of the equalisation grant among counties. This formula is published in the Annual Budget Law along with the specified maximum amount to be retained by each of the county councils and the corresponding minimum amount to be distributed to local councils. The Ministry of Finance’s distribution criteria have been proxies for fiscal capacity and operating expenditures.

The intent of the Law on Local Public Finance is that each county council in turn should develop their own formula for distributing the equalisation grants among the local councils within its area of jurisdiction. However, the county councils disregarded this in 1999, so in the 2000 Annual Budget Law, the Ministry of Finance directed the county councils to follow an allocation formula based on fiscal capacity. A review of a sample of eight county councils, however, shows that even in 2000 about half of the county councils resisted the use of any formula. The county councils gave the following reasons for not following the directions of the Ministry of Finance:

- They suspected that local councils were not doing enough to raise revenues through their own taxes and fees, thus increasing their reliance on equalisation grants.
- They believed that some local councils may have lost revenues due to factors outside their control, such as the relocation of the headquarters of a major company.
- Most felt it was too difficult to allocate funds for investments using a formula. In part, this reflects the lumpiness of investments, that is, investments represent an increase in the level of expenditures (and hence revenues) that may last one or two years as a large project is under construction, then tailor off when the project is completed.
- Many believed that a formula could not resolve the case of unique expenditure needs of a few local councils, such as institutions that care for the elderly or the handicapped.

- Finally, they wanted to help those local councils with problems such as accumulated unpaid debts for energy or urgent repairs needed for a school or other such critical facility.

Such complications will arise in every attempt to implement a formula-based allocation process. There are ways to account for many of these factors in a formula-based allocation process, but for the moment not much is being done in this regard in Romania.

10.4.5 Payment of Grants

Final grant allocation cannot take place before the state budget is approved, and this can happen as late as May or June of a fiscal year that runs from January to December. Before the Law on Local Public Finance, the late payment of grants was an onerous burden on local government budgets. This problem has been minimised by the new revenue sharing arrangement by which the local governments receive a pro rata distribution of the income tax directly deposited to their accounts as the taxpayers make their payment.

Both the overall pool of funds and the allocation criteria for equalisation grants, however, are still victim to the drawn-out budget process of the national and county governments. To account for the fact that the final distribution of equalisation grants may occur late during the budget year, in the interim, local governments receive on a monthly basis one-twelfth their previous year's share. After the final distribution is decided, a local government may have to pay back funds if this year's share is less than the previous year's share. Not only do local governments not know how they will compare to other local governments based on the equalisation criteria, there is also much uncertainty surrounding the overall pool of funds. As mentioned above, this is a more serious problem for communes because equalisation grants play a larger role in their budgets.

Special purpose grants are published in the annex to the state budget, as are the equalisation grants. Therefore, the receiving local governments are uncertain of their allocation until late in the fiscal year. Although the larger local governments have greater own revenues, they also often have greater investment needs, such as degraded district heating systems. Given that long-term debt financing is not feasible for most local governments, the allocation (and the delay in the process) of special purpose investment grants is a great issue. As mentioned above, the special purpose investment grants are supposed to promote specific sector priority financing, but there are no transparent criteria for the allocation process that would demonstrate how these priorities are being implemented.

10.4.6 Grants to Needy Authorities

There are no systematic grants to needy authorities in Romania. However, the government has instituted favourable policies and other types of assistance for

some depressed regions, most notably the mining area Jiu Valley. The previous CDR government took steps to restructure the mining sector, which resulted in a loss of nearly 20,000 jobs within 2 years only in the Jiu Valley. In the largest municipality in the Valley the unemployment rate in July 2001 was 43 percent.

Assistance programs include: designating it a special industrial zone with preferential tax treatment, projects implemented by the Regional Development Agency-West, the National Development Agency, the Agency for Rebuilding the Mining Areas, and revolving funds for micro-credits. The Valley also benefits from EU grants of about 10 million Euros. The EU/Phare programs fund updating infrastructure, active labour-market measures, and loans and grants for small and medium enterprises. Despite these efforts by the national government and donor agencies, the Valley's economic future remains bleak.

10.5 Financial/Fiscal Supervision: Rights and Duties

10.5.1 Deconcentrated Offices of the National Government

10.5.1.1 Prefect

Prefects are appointed by a decision of the Government and function as “the representatives of the Government at the local level and shall direct any decentralised public services of the Ministries and other central agencies in the territorial administrative units.” Amongst other things, prefects supervise the activity of the local and county councils and of the mayors to ensure that they are carried out according to the law. In exercising his authority the prefect may challenge the acts of local governments in the Court of Administrative Contestations. In such cases, the challenged act of the local government is suspended until a ruling on its legality can be obtained. In practice, however, the role of the prefect appears to be less invasive than might be suggested by the law. In effect, the prefect monitors, but does not supervise or exercise direct control over the activity of elected local government officials. There is no relation of subordination between the prefect and local elected officials.

10.5.1.2 Court of Accounts

The Court of Accounts was established in 1992 with local branches at the county level. As a stand-alone system, the Courts of Accounts are subject only to parliamentary control. The COA “... exercises control over the formation, administration and use of the financial resources of the state, the public sector and administrative-territorial units.” Essentially, the COA performs a financial audit and control function over all expenditures of state funds and the use of state property. The COA's jurisdiction includes oversight and audit responsibility for monitoring: budget preparation and execution of local governments as well as financial transfers among them; creation, use and administration of special funds and treasury

funds; and the application of budget allocation for investments, subsidies, transfers and other forms of financial support for local government.

10.5.1.3 County Offices of the National Ministries

Generally, each of the line ministries of the national governments is represented at the county level through a 'deconcentrated' office. These offices tend to have very little autonomy from the national ministry to which they belong. Largely, they carry out the instructions of the ministry within limited budget resources.

The Ministry of Finance is represented in each county by the Directorate General of Public Finance and State Financial Control (DGPF). The DGPF in turn is composed of a Directorate General of State Control, a Local Treasury Office (LTO), a Department of Taxes, Fees and Budget (DTFB) and a Tax Inspectorate. The DTFB is concerned primarily with coordinating and assisting local governments in the budget preparation process. LTOs carry out treasury operations and tax administration and collection operations at the local level. The Tax Inspectorate performs a tax enforcement function for the county.

The county office of the State Treasury is involved in all funds received and paid to the county or local councils. By law, these local government institutions must keep all their funds in the State Treasury. All funds received by the county and local councils are kept in their individual accounts with the State Treasury. Upon written instructions by the county and local councils, the State Treasury makes all payments on their behalf. This may be the office that has the most frequent continuous contact with the county councils and all local councils.

10.6 Accounting and Financial Reporting

Although a single, uniform, national system of classification for all public financial data in Romania facilitates the financial and fiscal supervision of local governments in aggregate, the current system does not meet all the current financial accounting and reporting needs of individual local governments. A major drawback is that cash-basis accounting does not produce vital information on outstanding liabilities, such as unpaid heating subsidies. In this case, the accounting system records only the payments made (actual cash disbursed) to the heating company by the local government. There is no record of the amounts owed for heating subsidies but not paid.

Another problem is that local governments do not report combined financial results for all of their subordinated public institutions. Each public institution is treated as an independent reporting entity, even when various institutions are subject to the authority of the same public officials. As a result, there is no readily available report that provides comprehensive financial data necessary to reflect the full financial accountability of these public officials. Without a combined

report, public officials can “hide” certain expenditures in a subordinated public institution.

There are no general purpose external financial reports. All the financial reports that exist are prepared for internal use, that is, for government managers and elected officials. In fact, the very notion of a general purpose external financial report does not exist. Such reports provide essential information needed by all interested parties for a fair assessment of the finances of a government entity. The criteria to determine what is essential for the fair presentation of a government’s finances are known as generally accepted accounting principles (GAAP).

These limitations in the rules and practices of financial accounting and reporting represent a serious constraint to the continued development of the system of local government in Romania. Local governments cannot show that their actions have complied with the public decisions on how to raise and spend public funds – financial accountability. They also cannot show that they are providing services efficiently and effectively – operational accountability.

10.7 Conclusion

Although Romania states its desire to move towards decentralisation, in practice, local government is often treated as an extension of the national government. For example, contrary to the Law on Local Public Finance, grants are used as instruments of public policy. The state budget laws in 1999 and 2000 reintroduced special purpose grants for roads, housing and child protection and divided the equalisation grant in two parts, one general and one solely to compensate for the cost of residential heating subsidies. Another example is the two amendments on the rules on revenue sharing since the Law on Local Public Finance was passed in 1998. Should Romania want to move towards real decentralisation, then there will be a need for significant reforms.

- *Establish clear, stable expenditure assignment by law*

Local government legislation will have to be amended to define clearly the areas of local expenditure responsibility. In anticipation of such new or amended legislation, it would be important to conduct a national dialog on the functions of local government so that the legislation reflects as much as possible a consensus among stakeholders on the subject. This, in turn, will contribute to the stability of the local expenditure assignment.

- *Assign authority commensurate with level of responsibility*

It is not sufficient to define the areas of local expenditure responsibility clearly. The legislation must also assign clear authority to local governments to perform their assigned functions. The level of authority must match the level of responsibility. The definition of local authority must distinguish between own

and delegated functions. Own functions would be those where local governments have broad authority and discretion to determine the service policy and methodology and to decide on service quantity, quality and cost. Delegated functions are those governmental activities that the national government may assign to a local government for performance in a manner and to a degree which is determined by the central government.

- *Limit earmarked funding and discontinue unfunded mandates*

Unfunded mandates in general are a bad practice that should be discontinued. Earmarked funding is not appropriate in the case of own functions. The use of earmarked funding is perfectly acceptable as long as it is limited to delegated functions, such as those in the area of social assistance discussed above.

- *Provide greater transparency and predictability in the allocation of grants*

The intent of the new legislation is that each county council in turn should distribute the equalisation grants to the local councils within its area of jurisdiction using a formula to determine the amount allocated to each individual unit of local government. To the extent feasible, before preparing their budget the local councils must be able to estimate what level of equalisation grants to expect in the coming year. The variation from these estimates should be a function in the size of the overall pool of funds for equalisation authorised in the State budget for the specific county, not in the relative share of the pool allocated to each local council.

- *Strengthen the local budget process*

The national and county governments can take specific practical steps to create a framework consistent with sound and prudent management by local governments of their finances. Local and county councils should be required to develop a draft balanced budget based on their own estimates of the equalisation grant they will receive by formula. The Ministry of Finance should limit its review of draft local budgets to confirming these estimates of the equalisation grants. This will create a hard budget constraint that will oblige the local council to focus on setting spending priorities rather than on negotiating additional revenues. The local council will be autonomous in developing and approving its own budget. It will also be clearly accountable to the local community for the spending priorities included in that budget.

Until the State budget has been adopted by Parliament, local governments may incur expenditures equivalent to one-twelfth of the actual prior year expenditures *by line item* on a month-by-month basis. A more reasonable approach would limit the amount that local governments may include as revenues from grants and transfers to one-twelfth of the amount in the previous year but to allow local governments to spend these revenues based on current needs and pri-

orities. Of course, spending of revenues from special purpose grants might have to wait for the adoption of the State budget.

- *Improve local financial accounting and reporting*

In the longer term, Romania will have to consider a comprehensive reform of local public financial accounting and reporting standards and practices consistent with EU directives on the subject. This probably cannot occur without being part of an overall reform of public sector financial reporting and accounting in the country.

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11. The Byelorussian Public Sector Finance System: Problems of Over-centralisation

Leonida Pliskevich * and *Željko Šević* **

11.1 Introduction

The Republic of Belarus is still a highly centralised state, despite the fact that some forms of fiscal decentralisation have been promoted since 1997. To a large extent, the central government holds everything in its hands and pulls almost all the strings in society. The country has a very strong presidential regime of a modified ‘Executive President’ model, where the president is the formal Head of State and the head of executive power. The Republic of Belarus is a so-called ‘presidential state’ in which the President has the predominant executive power, besides being formally the Head of State. The state power in the Republic of Belarus is executed on the basis of a Montesquieuan division into legislative, executive and judiciary branches. *De jure*, state bodies within the limits of each power are independent, but they are to interact, control and balance each other’s prerogatives. However, due to the current state of public policy practice, the executive power is predominant, and to a large extent the other two branches assist the executive to perform the functions and achieve the desired policy outcomes.

The government is there to support the president and implement presidential policies. If one takes into account the fact that the country has very isolated relations with other countries (external isolation), whilst there is no strong opposition in the country (internal isolation), one can understand the reasons for over-centralisation. There is a necessity to make the regime survive any eventual challenge, either from abroad or from within the country.

However, despite these ‘political challenges’ the state has initiated some steps towards decentralisation.

11.2 Public Sector Organisation in Belarus

The sovereignty of the Byelorussian Republic, as an independent state, was proclaimed on July 27th 1990, when the Supreme Soviet of the Republic adopted the “Declaration of State Sovereignty of the Republic of Belarus.

The Law on Ensuring Political and Economic Independence of the Byelorussian Soviet Socialist Republic was enacted on 27th August 1991. According to this Law, all enterprises, organisations and institutions of the Soviet Union that were situated on the territory of Belarus were transferred to the property fund of the

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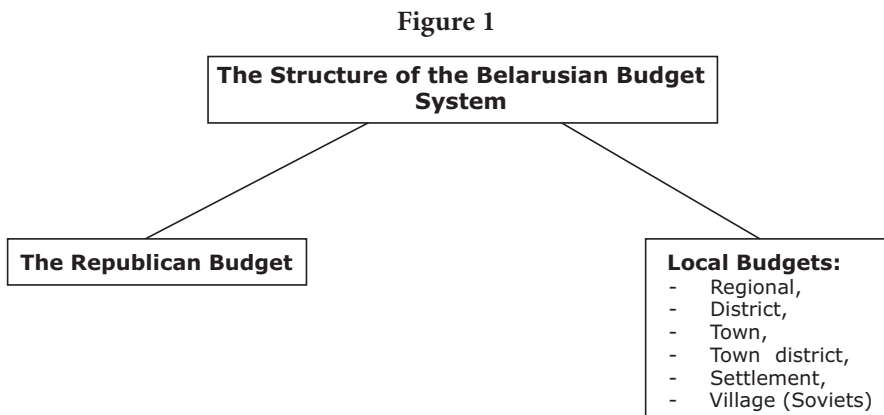
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Byelorussian Soviet Socialist Republic. Only on September 26th, 1991 did the Supreme Soviet adopt the Law changing the new name of the Byelorussian Soviet Socialist Republic into the Republic of Belarus. However, they needed almost four more years to agree on the national symbols. On May 14th, 1995 new state symbols were introduced – a new State Coat of Arms and the Flag.

The Byelorussian Constitution of March 15th, 1994 laid formal and firm foundations for the development of a modern legal system. Following the promulgation of a new constitution, presidential elections were called. Alexander Lukashenko was elected the first President of the Byelorussian Republic, with an overwhelming, but widely disputed, majority. Following the success at the elections, President Lukashenko put forward the idea of calling a republican referendum to amend the (newly adopted) Constitution. Constitutional changes that followed the referendum, declared the Republic of Belarus a unitary, democratic, social state, based on an overriding principle of the rule of law.

11.3 Byelorussian Public Finance System

From the declaration of independence in 1990 until 1993, the Byelorussian fiscal system operated based on old Soviet legislation. Only in 1993 did the Supreme Soviet of the Republic of Belarus promulgate the Law on the Budget System of the Republic of Belarus and State Extra Budget Funds. It was expected that a number of by-laws would be enacted, but unfortunately until now, this remains the only source of law in this important area of social life. The Budget System of Belarus is underlined by the administrative and territorial division of the Republic, as can be seen in the following graph.



The State Budget serves as the main financial plan of the Republic. It comprises all revenues and expenditures, not only at central government level, but also for lower level appointed governments. It also serves as a master budget and

comprises both the central government budget and budgets of all lower level governments in the Republic.

The budgetary process itself looks fairly transparent and easy to grasp. Namely, a draft of the State Budget is formally prepared by the Council of Ministers and enacted by Parliament. Drafts of local budgets are formally prepared by a Soviet Executive Committee and promulgated by a respective local Soviet of Deputies. According to the Budget Law, the main function of the Republican Budget is the following: to provide monetary resources for the Republic to discharge its duties. As the duties are also carried out by the regional and local governments, it is necessary to provide them with sufficient resources to successfully discharge their statutory functions. Grant transfers are the main source of revenue for sub-national governments. They generally use block grants, which by their very nature take into account the economic strength and needs of sub-national jurisdictions, including the City of Minsk as a special administrative region, being a nation's capital.

Revenues and expenditures of the Republican and sub-national budgets are defined by the Parliament (formerly the Supreme Soviet) of the Republic of Belarus and observing the Law on Local Self-Government and Local Economy in the Republic of Belarus. The budget law stipulates that the revenues of the Republican budget come from a range of sources, such as: 1) republican taxes and revenues (minus the part of the resources transferred to the local budgets of regions and Minsk at the rate stated by the Supreme Soviet of the Republic of Belarus); 2) corporate tax, with a notable exception of enterprises and organisations, whose tax is treated as a revenue of local budgets (mainly local enterprises); 3) export and import taxes; 4) custom duties, 5) revenues from international economic activities; 6) transfers received from other states in accordance with signed international treaties; 7) revenues from operations with securities by the republican bodies, and 8) any other revenues according to the legislation of the Republic of Belarus.

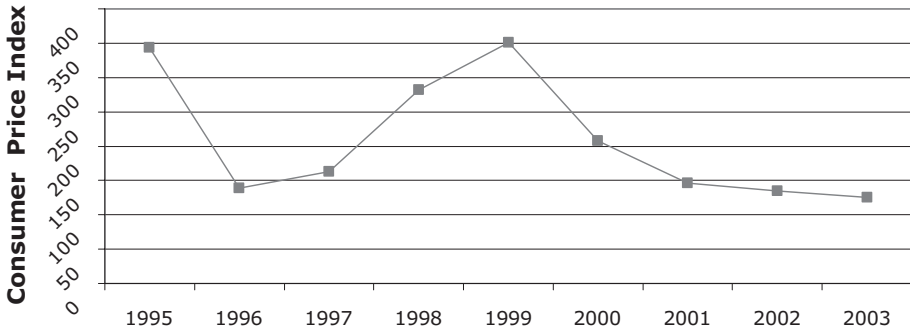
In order to perform its constitutional and legal functions, the Republic must incur certain expenses. The budgetary legislation is pretty detailed on how public funds are to be allocated to final uses and on what functions. The public funds from the Republican budget may be spent on: 1) capital expenditures in acquisition of property into the republican hands or maintaining the value of republican property; 2) environmental protection and preservation of natural reserves; 3) eradication of the consequences of the Chernobyl catastrophe; 4) social programmes of Republican importance; 5) expenditures associated with international economic activities; 6) financing institutions and organisations in education and sport subordinated to the respective republican bodies (i.e. the institutions of republican importance), 7) maintenance of the required level of public reserves; 8) financing of judiciary and other law enforcement agencies; 9) national defence, border guard and custom service; 10) interest payment on

national debt and other credit repayment; 11) maintaining the reserve fund of the Council of Ministers of the Republic of Belarus, reserve fund of the Ministry of Finance and the other (statutory) reserve funds; 12) transfers of grants, subventions and subsidies to enterprises, organisations and sub-national (regional and local) government bodies; 13) for other activities financed from the Republican Budget in accordance with the positive legislation.

However, the Byelorussian Republic Budget shows many specifics, if not anomalies, of the Byelorussian system of public finance. For instance, when referring to interest payments on public debt, the Law explicitly mentioned repayment to the National Bank, although formally the National Bank was independent in conducting monetary policy and providing price (monetary) stability. However, although obtaining exact data on the public debt financed by the National Bank is difficult, if not entirely impossible, it is obvious from daily life that monetisation of the public debt is practised (despite the fairly well-suppressed, for the time-being, inflation). Inflation has been a big problem for Belarus. From the moment it gained its independence and the liberalisation to some extent of the state sector, Belarus was faced with the problems of persistent and systemic inflation, if not hyper-inflation.

Local budgets are formally perceived as a financial basis of local governments (Soviets of Deputies). Local budgets are fairly diverse, ranging from noticeable (in their size) regional budgets to small village budgets. Soviets of deputies in all forms of sub-national government (regions, districts, towns, town districts, settlements and villages) formally promulgate local budgets, but in a highly centralised state (like Belarus) they are put in a direct dependency relationship with the Republican government. It seems that, to a large extent, a local budget is more the result of central government's 'grace' and will to assist a particular local government, than a result of blind application of the letter of law. As a consequence, local governments often cannot meet their dues and perform their legally stipulated duties. This kind of intergovernmental relationship maintains the *status quo* and empowers the central government to be not only dominant, but also almost the only player in the public policy processes (although without the presence of the accountability variable). Local governments are neither allowed to spur new, nor support the existing, entrepreneurial initiatives. Many activities are prevented or slowed down significantly as the central government is in charge of providing the necessary permission and licenses.

Figure 2
 Consumer price index for Belarus, 1995 – 2003



Source: Statistical Office of the Republic of Belarus

According to the current Belarus legislation, the main function of a local budget is financing of economic, social, cultural and other programmes of local and inter-district importance, organised and executed by the local government bodies. Revenues of local budgets at every level are defined in accordance with the tax legislation of the Republic of Belarus, and more specifically the Law on Local Self-government and Local Economy in the Republic of Belarus. Grants, subsidies and subventions may be transferred to the local governments from the hierarchically higher body. However, all the local budgets are, *de jure*, independent and consequently there is no requirement for the preparation of a consolidated budget. However, it seems that in practice, the Ministry of Finance is the sole owner and main controller of the use of financial resources in the Republic.

Local Soviets of Deputies define the local expenditures independently, with the exception of resources transferred from a hierarchically higher body for particular purposes (so-called ‘specific grants’). They also have to provide for reserves and other expenditures for particular activities as defined by the local Soviet of Deputies. Local Soviets of Deputies are allowed to invest unspent revenues on economic activities, bonds and securities, grant loans to enterprises and other legal entities. It is interesting to note that the law allows local governments to practise an active treasury function. However, it is most unlikely that a financially exhausted and stranded local government would have unallocated resources to invest. This regulation has adversarial behavioural effects. Namely, local governments are not encouraged to play a pro-active role and try to make the most of the resources that are shifted their way. However, in truth, they would have problems investing uncommitted resources as there is no active financial market with enough depth, and the only option left for a local government may be (and in practice is) to engage directly in economic activity. There is still a major problem with the overall understanding of the provision of public and private goods. Namely, many traditionally private goods were perceived

as public goods during socialist times, and this view still prevails today. People expect the government to provide heating, water and sewage services – directly. This is contrary to all transitional efforts to remove government (regardless of what level) from economic activities and instead promote its wider regulatory role.

The amount of revenues is defined by the Republican Parliament which always endorses the government, i.e. the Ministry of Finance's proposal. However, all sub-national level governments are free to define how they will spend their respective budgets following the main guidelines as laid down by the Law. The Ministry of Finance is then the final judge on the utilisation of resources by the local government, and if it is perceived that resources were not utilised in the desired manner, fines will be imposed, and as a rule, local government officials replaced.

The following information base of state finance statistics is formed using the reports on the execution of consolidated, republican and local budgets submitted by the Ministry of Finance in dynamics for several years.

Table 1
Consolidated budget of the Republic of Belarus
(Current prices; bln. roubles)

	1999	2000*	2001	1999 per cent of total	2000 per cent of total	2001 per cent of total
Revenues – total of which:	1,054,907	3,181	5,747	100	100	100
Direct income and profit taxes of which:	235,750	717	1,316	22.3	22.5	22.9
income tax	89,288	277	534	8.5	8.7	9.3
profit tax	141,694	395	637	13.4	12.4	11.1
Domestic taxes on goods and services of which:	424,419	1,336	2,284	40.2	42.0	39.7
value added tax	261,993	818	1,447	24.8	25.7	25.2
excise tax	99,687	254	442	9.4	8.0	7.7
Property taxes	18,051	93	237	1.7	2.9	4.1
Receipts from foreign trade and foreign economic transactions	58,011	142	300	5.5	4.5	5.2
Revenues of state off-budget funds and target budgetary funds	89,754**	590	1,033	8.5	18.5	18.0
Expenditures – total of which:	1,142,843	3,233	6,023	100	100	100
Industry, power engineering and construction complex	20,410	35	57	1.8	1.1	0.9
Agriculture	37,254	87	146	3.3	2.7	2.4
Transport, road maintenance and communications	33,257	100	156	2.9	3.1	2.6

Housing and communal services	81,388	249	450	7.1	7.7	7.5
Prevention of extreme situations and natural calamities, liquidation of their after – effects	48,611	111	229	4.3	3.4	3.8
General and local government	29,823	88	168	2.6	2.7	2.8
Science	13,522	36	68	1.2	1.1	1.1
Social and cultural measures of which:	396,382	1,187	2,351	34.7	36.7	39.0
education	185,708	562	1,110	16.2	17.4	18.4
culture and art, cinematography	13,866	45	88	1.2	1.4	1.5
public health and physical culture	150,841	455	873	132	14.1	14.5
Expenditures of state off-budget funds and target budgetary funds	161,736	558	996	14.2	17.2	16.5
Deficit	87,936	55	276	-	-	-

Source: Various government departments

**In terms of the new denomination (1 new rouble is equivalent to 1,000 old roubles).*

***Revenues of state special purpose budgetary funds.*

11.4 Looking at the Transfer Finance and Financial Supervision

Transfer finance issues arise in every jurisdiction where there is more than one government, assuming that the principle of sovereignty prevents the existence of two competing governments on the same level, over the same territory. Theoretically, the superior, central government can either decentralise, giving the revenue raising powers to sub-national governments, or decide to transfer some centrally gathered resources, or go for a combination of the two. As a rule, in a centralised country the central/national government resorts to financial transfers as the main, if not the only mode of financing the sub-national governments. In decentralised countries the latter two models are the rule.

Being a highly centralised country, the financing of sub-national government is primarily based on the transfer from the central government. The general budgetary rule applied in the budgetary process is that the budget must be balanced (effective revenues must be equal actual expenditures). However, throughout the year there are a few “re-balancing” exercises when the ‘low and controlled inflation’ is taken into account and budgetary items adjusted. Of course, the speed with which certain budget items are realised is not known. For instance, it is possible to spend the entire planned sum of money for a particular purpose before the ‘re-balancing’ exercise takes place, and the adjusted figure immediately after, which in high (or hyper-) inflationary conditions makes a lot of difference.

The central government budget should provide for both horizontal and vertical equalisation, ostensibly applying the principles of justice and openness of

the budgetary system. Theoretically, it should serve as an instrument for stimulating local governments to mobilise the existing resources in the best possible ways and minimise expenditures (covered by the principle of 'budget effectiveness'), ensuring something called 'value for money'. In order to (supposedly) exercise this, the Republican budget uses three forms of transfers to sub-national governments: transfers, subventions and subsidies.

Transfers are perceived as financial support coming from the Fund of Financial Support of Regions in the situations where all current revenues are insufficient for the balancing of the lower level government budget. Transfers as such were introduced as late as 1997. The Fund for Financial Support of Administrative-Territorial Units is presented as an item in the main Republic budget. The main source of revenue for the Fund is a fixed proportion of collected Turnover and corporate tax revenues. The execution of the Fund's expenditure plan is the duty of the Ministry of Finance, as is the case of the entire Republican budget.

Subventions (in Belarus) are special grants used for maintaining housing, providing communal services, and social, educational and cultural functions of the Local Soviets. Usually each of these functions and the property associated with the execution of these functions are in the hands of local Soviets. Subventions as such, must be spent for planned purposes and cannot be rolled-over to cover general local expenditures. In practice, local government has often to find some additional resources if they are to perform their statutory functions well.

The third form is subsidies, which are in fact grants-in-need, demonstrate regularity in payments. They are transferred to lower level budgets in order to equalise the level of social and economic development of a respective administrative and territorial unit. In practice, subsidies are transferred to local budgets for the purpose of building, additional housing, or in support of a failed local economy, still largely in state hands (either under central or local government control). For this reason, subsidies in Belarus can theoretically be classified as a transitional form between grants-in-need and special grants.

The local public finance system in Belarus clearly demonstrates a number of significant shortfalls. The main problem is that the development of a local public finance model is at a standstill. But, despite all these problems, which are mainly of a political nature, the local budgets have succeeded in truly depicting the existing tasks of local governments. All the main local government functions are covered, with varying levels of success. Local governments are given an opportunity to plan their activities knowing more or less, what their entire revenue will be for the next fiscal year, although, the opposite may have been expected. The Republican budget followed the agreed revenue sharing agreement and as tax revenues demonstrated a relatively high level of stability recently, they were able to provide local government with a stable source of revenues. The full application of all transfer instruments enabled better horizontal and vertical equalisation.

However, despite this logical claim, in practice there is a widening gap between the capital (Minsk) and the rest of the country. Cities and settlements inland often demonstrated less than the minimum level of public services provided, irrespective of which level of government might be responsible. Certainly, practice shows that the results are not as glorious as the central government would like them to be.

As with all transitional economies which have fallen behind in their transition to a more democratic society, there is a significant problem found in Belarus with regard to law enforcement. At first sight, the legal system is sound and well-defined. There are decently written laws that observe the basic criteria of Continental European legal thought. However, in practice, this is something totally different. For instance, the Parliament of the Republic of Belarus, the State Control (i.e. the Committee of State Control) of the Republic of Belarus and the Council of Ministers *de jure* control the execution of the Republican Budget. The Ministry of Finance, financial bodies and state tax inspections control the revenue and their effective expenditure. Throughout the year, the execution of the Republican Budget is continuously reviewed by the Parliamentary Finance Committee and the State Control. If required, the Committee reports to Parliament during a full session, recommending the necessary actions to be taken. At the end of a fiscal year, the Government (Council of Ministers) prepares Annual Accounts and a full report on the execution of the budget, which are discussed by the Parliament, following a detailed procedure. But, in practice, only the Ministry of Finance has an effective control over resources, as it sits on the entire financial resources of the country. Even the Ministry cannot contradict the President, who can at any moment, directly order the Ministry to redeploy resources in contravention to the promulgated state budget.

As inherited from the old Soviet system, *de jure* financial supervision over the Local Budgets is performed by the Soviet of Deputies, through its executive committees and by the Control Chamber of the Republic of Belarus. At first sight it looks as if there is a clear delineation in power between the central government and local governments, but... The Ministry of Finance supervises the execution of sub-national budgets— that part financed by intergovernmental transfers— and it is the only body which can undertake measures to correct any mistakes it finds. In practice, special focus is directed towards subventions and subsidies as some kind of special purpose grants. Also, various inspections control the collection of revenues (tax collection administration, etc), but their activity is outside the scope of our current interest. Again, the strong political factor should not be neglected. If one region or city is in the President's favour, more resources will be shifted their way and again if they fall out of favour, they will be penalised and will not receive the resources which were earmarked for them in the Republican budget.

11.5 Economic Performance and Corporate-Tax Base

According to the data provided by the Ministry of Statistics 4,411 Byelorussian enterprises recorded losses on 1st of November, 2002, which is approximately 37.5 per cent of the overall number of registered enterprises, which is a slight increase compared to 2001. Compared to 1999, this figure has more than doubled. It is very difficult to say why there is a constant increase in the number of loss-making enterprises. One plausible explanation is that plant and company managers are trying to reduce the value of the enterprises they manage in order to facilitate their sale in the process of privatisation, probably attempting to buy their own company. However, their plans may be thwarted if central government opts to sell state enterprises to foreign strategic partners, who are not from Russia. It is to be expected that some kind of a deal can be struck with Russian buyers.

The increase in numbers of loss-making enterprises seriously affects the corporate tax-base in Belarus. It is very difficult to speculate on the influence of this continuous underperformance on the part of the economy in Belarus on the revenue-raising capacities of the State Budget. Also, it is not clear at the moment what government policy will be with regard to the privatisation of state enterprises. Until now, a relatively small number of enterprises were privatised through directly arranged sales, mainly with Russian partners. This was to be expected, taking into account the general political orientation of Belarus to align with Russia.

Table 2
Share of loss-making enterprises and organisations
by branches of the economy (per cent of total number of enterprises)

	1991	1995	1996	1997	1998	1999	2000	2001
Total of which:	5.2	17.9	18.4	12.3	16.2	16.9	22.3	34.2
Industry	2.8	11.6	17.6	11.8	10.5	8.8	18.8	29.7
Agriculture	1.2	13.2	15.2	11.0	33.3	39.2	41.8	54.2
Transport	3.3	9.0	11.9	9.7	12.9	15.0	14.5	31.6
Construction	3.3	10.2	14.3	7.9	8.0	5.2	7.7	19.2
trade and catering	3.2	40.5	25.7	12.6	6.6	8.8	19.1	31.7
material supply and sales	9.7	9.0	7.4	2.8	6.9	6.2	11.2	27.7
housing and communal services	80.6	43.7	29.8	27.7	25.0	21.2	28.1	33.1
non-industrial personal services	34.3	41.4	34.9	33.1	27.0	26.6	13.6	18.6

Source: Various government departments

The process of denationalisation in Belarus is defined as a partial or complete transfer of the functions of direct control over economic entities (mainly through privatisation) by the state, to natural persons and legal entities. How-

ever, the Byelorussian definition of privatisation would not really fit into any Western understanding of denationalisation. It seems that denationalisation in Belarus does not entail the return of the property seized by the Communists to their rightful owners. As in some other countries (such as Croatia, for instance) pre-communist owners may decide to purchase their own property as it may be a quicker way to lay hands on their inheritance, rather than waiting a long time for restitution and bribing their way through the process. As privatisation in Belarus is still a novelty, despite the fact that the first privatisations were recorded in 1995, it is difficult to make any conclusions. However, based on numbers, it seems that privatisation is slowing down, as the smaller economics units were privatised and only those larger ones remain in state hands. One of the legs of power for President Lukashenko is a large state sector. He can buy-in supporters by appointing them directors in state enterprises, and they in return have to display high levels of loyalty, which ensures the stability of Lukashenko's regime. In highly centralised, authoritarian-style countries, privatisation is usually seen as a toppling of the regime. State assets are sold only if there are huge discrepancies in the State Budget, and there is an urgent need to fill the cracks in the state finance system (payment of pensions, grants to students, or any payments on the eve of 'democratic' elections). It may be interesting to look at the trends in privatisation in Belarus, with little comment.

Table 3

Privatisation and denationalisation of state-owned enterprises (projects)

	1995	1996	1997	1998	1999	2000	2001	1991-2001***
Total number of enterprises (projects) reformed and alienated	465	527	574	805	915	577	471	5,476
Total number of enterprises (projects) reformed by way of privatization:								
Transformation of state-owned enterprises into economic partnerships (stock companies)	257	222	178	89	184	130	63	1,417
Redemption of leased property by lease holding enterprises	36	58	76	53	49	13	9	722
Sales of auctions	172	208	223	187	74	34	22	1,334

Source: Ministry of Economy of the Republic of Belarus

*** Since beginning of privatization

11.6 Conclusion

The disintegration of the USSR and the loss of economic relations between the former Union republics created considerable financial difficulties for Belarus. The vertical integration with geographical dispersion practised in the USSR severely affected this country. For instance, a textile factory in a Byelorussian city was exclusively dependent on the supply of (cheap) cotton as a main raw material from a Central Asian Republic and energy from the Russian Federation, etc. When the USSR disintegrated, suddenly the supply stopped as market prices were introduced and previously heavily subsidised intra-republican transport became expensive international transport, etc. As a result, the factory, although it has not formally closed or gone bankrupt, does not work and the factory yard looks like a dumping ground. One can see, however, that it was well-maintained some twenty years ago. This is not a unique story in Belarus, once the most industrially developed republic in the USSR.

As a direct consequence of this systematic economic failure, for a number of years all budgets recorded a deficit despite, *de jure*, an applied principle of balanced budget. The government was forced to resort to different forms of raising finances. Unfortunately, credits from the National Bank were the easiest option, but the price has been rather high (high rising inflation). The National Bank was also constantly 'asked' to purchase government securities, but despite this irresponsible behaviour, the macroeconomic conditions have been deteriorating slowly. As the budget recorded a deficit, the government showed growing interest in other para-fiscal funds (health, social security, etc.). The government tried to attract funds from abroad, but besides a few credits by international organisations, not much has been done. Ideas to finance deficits by issuing securities abroad was hampered by the very low country rating of Belarus, mainly because of delayed *political* and economic reforms. In short, the main source of revenue for the central government for a number of years has been massive monetisation exercised by the central bank, which in an autarchic economy somehow succeeds to keep inflation within high, but still relatively reasonable levels (not more than 40 per cent which is still regarded as a manageable level).

Besides well-tested monetisation, Belarus resorted on and off to international loans. For instance, in 1993–1994 the dominating source of financing of the deficit was external loans. The credits were given by the Russian Federation and International Monetary Fund. However, the Republic demonstrated a high level of inability to service its foreign debts. Then in 1995 Lukashenko was elected, and the problems with the international community intensified. With the deterioration of international relations with the West, the flow of loans dried up, and monetisation became the most important source of revenue. It also seems that Russia is giving some assistance in kind, although it is not recorded in the state budget.

It is difficult to believe that the situation will improve significantly, unless there is a change in economic structure and political regime. The National Bank must become really independent of daily politics and ensure long-term monetary stability, forcing the central government to resort to healthy sources of public finance. This would require fast development of a market for government securities followed by the development of capital markets so that shares of privatised companies can be traded on. This should certainly create an inducive environment for the creation of a healthy public finance system, so necessary for Belarus. However, the current developments do not give hope that this will happen in the foreseeable future.

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12. Intergovernmental Fiscal Relations in Armenia

David Tumanyan *

12.1 Introduction

In transition countries it is very important to find an acceptable model of government. After the definition of the governments' levels, the next question is the clarification of intergovernmental relations. The latter has different aspects, among which fiscal relations have a special place. Each country forms its own kind of intergovernmental fiscal relations but in general, they eliminate regional differences and provide sustainable development.

Intergovernmental fiscal relations in Armenia are not complicated. They are not connected with the simple governmental structure, as Armenia is a unitary country. The law on the budgetary system and decisions of the Government of Armenia define intergovernmental fiscal relations.

12.2 Local Self-government in the Public Administration System of Armenia

As in all post-Soviet countries, Armenia, after the proclamation of independence (September 1991), began the process of state building. The democratisation of the society was and still is, one of the basic goals of the state. It implemented the decentralisation process and the formation of a local self-government system. Decentralisation reforms can be divided into the following three stages.

Table 1
Chronology of Decentralisation in Armenia

1995 - 1996	Legislative, institutional and structural changes, the creation of a new public administration system.
1997 - 2001	Additions to and strengthening of the legislative bases, the formation of a local self-government system.
2002 -	Widening of local governments' responsibilities.

Source: Author

During the first stage, the new system of public administration (state government and local self-government) was formed. Institutional and structural changes took place on the basis of the new Constitution and new laws. The second stage was characterised by the formation of a local self-government. Operation mechanisms of local self-government were set out and used, capacity building processes took place and new laws and legislative acts were applied. The

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beginning of the third stage is connected to the adoption of a new law on local self-government on May 7, 2002 by the National Assembly. This new law designs the widening of local self-government bodies' rights and the development of political and fiscal decentralisation.

For new independent states, the foundation of the local self-government system is an important part of state building. Local self-government reforms do, in fact, mean the redistribution of powers between the state and local self-government bodies. This definition of the reform's purpose is very simple, though widely held. The main goal of the local self-government reforms is the consolidation of democracy and civic society, meaning the approach to local self-government reforms must be serious and systematic.

The constitution, which was adopted on 5 July 1995, became the legal foundation for local self-government reforms in Armenia. It must be said that the reforms were greeted with little readiness on the part of the country... There had not previously been a clear ideology of state building. The absence of a clear strategy reduced the effectiveness of the reforms. The lack of readiness was reflected, not only in state authorities' activities, but also in the local authorities themselves, particularly in their deep-rooted disposition of dependency. In initiating local self-government reforms, the state should give sufficient independence to local governments to solve local matters. The state must form local self-governments, on the one hand, and defend them from the state on the other.

There is a two-tier governance system in Armenia. Armenia is a unitary country and this is reflected in its administrative structure. Most of the administrative powers belong to the Government. Territorial administrative units are 'Marzes', which are branches of the central government administrative structure and are not a separate tier of the public administration system. A marz is an administrative subdivision of the State, which has some characteristics of a local government, but is not classified as such because there are no elected marz officials or bodies by the marz inhabitants, nor does it have its own budget.

A *marz* is governed by the *marzpet*, which implements the territorial policy of the Government in the marz.

The bodies of local self-government are: community elders (council) and the head of the community (the city mayor, village head or district head). Both are elected by the community for a three-year period through general, equal and direct elections by secret ballot. In Armenia, local self-government bodies are political subdivisions of the State and are created by the State. The head of a community performs double functions, both as an autonomous government body and as a representative of the State authority in place. All Armenian communities lie within the boundaries of a *marz*.

At first sight, it appears that the legislation gives broad powers to local self-government bodies. But in actual fact, it is ambiguous. One law defines the powers of local self-government bodies and the other limits them. It is no secret that power without finance is not real power. Existing community budget revenues do not allow the local self-government bodies to realise all their powers. Current legislation partially regulates the relationship between local self-government and the Central Government.

The Government may dismiss a head of a community from office upon the submission of the *Marzpet* of the respective region or (if in Yerevan) upon the submission of the Mayor of Yerevan. These can be put forward to the Government only when the head of a community defies the Constitution or community elders' decisions or breaks the law. Until the newly elected head of the community accepts his appointment, the Government appoints a substitute head of the community. The new judicial system is currently being defined in Armenia. There are a few cases where mayors have appealed to the courts in defence of their rights and have won. Community elders may demand and receive from State authorities and officers any information regarding the goals of the community that are not specified by the law as being confidential. Such demands are mandatory for the State authorities and officers. The decisions and actions of local self-government bodies can be appealed through the court by the respective Regional *Marzpet*, or if in Yerevan, by the Mayor of Yerevan.

However, in practice the rights set down by the law are not a reality. The traditionally powerful nature of the *Marzpet* under the former system of government (at that time the Governor appointed the Regional Secretary of the Communist Party) reinforces the perception among citizens and local government officials of a centralised and authoritarian government, rather than that of a local democracy with powers to affect change and deliver public services.

The *Marzpet* often uses administrative methods in its relations with the local self-government bodies. In some cases, the relations between the central and local governments are that of a partnership. The State provides health care, primary, secondary and higher education, social services, pension and unemployment security. The law enables the local self-government bodies to provide similar services on a voluntary basis, providing they have the required financial resources. Though the financial capacity of local self-government bodies is very limited, they try to utilise these voluntary powers.

The law regulates relations between the central government, local authorities and private sector organisations. The land, trading organisations, public catering and servicing as well as small and medium sized industrial enterprises are mostly privatised. Certain industrial enterprises do not work as a result of the country's economic situation, whilst others function normally.

The local politico-administrative system in Armenia typifies the mayor-council form of governance particularly the “strong-mayor” variety. The council (community elders) has legislative functions, but not a chairman. The mayor presides over council sessions and has a deliberative vote, which has a significant impact on council decision-making.

The Head of a community is part of the executive body of that community. He or she implements power on the principle of individual leadership and carries out his/her responsibilities through his or her staff, enterprises and organisations that are subordinate to the community. No later than one month after acceptance of office, the Head must submit a staff structure to the community elders for approval. A community is a legal entity and has a seal bearing the State Emblem of the Republic of Armenia, or of the community, or its name. It is composed of the Deputy Head of a community, the Secretary of the staff and its divisions. The number of employees of the community Head’s staff is defined by the community elders.

The Head of a community may not simultaneously occupy any other State post or perform any other paid work, except for creative, scientific or pedagogical activities. The Head of a community has mandatory and delegated powers in the following spheres: finance, protection of citizens’ rights, protection of public security, defence, planning, building, construction and land use, public utilities and the provision of amenities, transport, trade and services, education and culture, public health, physical culture and sport, agriculture, nature and environment protection. Though the legislation gives certain powers to local governments, in practice they are rarely fully utilised.

12.3 Legal Local Government Powers

Local governments’ powers are characterised by the allocation of government functions. The decentralisation process defines a framework of powers and responsibilities for each level of government. It should be mentioned that the implementation of each function requires certain material, financial and labour resources. Nowadays, the existence of financial resources is very important. In many cases the lack of sufficient finance does not permit the fulfilment of that function.

Local governments have the following responsibilities:

- operation of the water supply, sewage, irrigation, gas supply and central heating systems etc.
- improving the community;
- determine the use and maintenance of non-privatised residential buildings and non-residential premises, dormitories, administrative buildings and other structures owned by the community;

- ensuring the proper maintenance of cemeteries (this service is not exercised by the Head of the district community);
- construction, reconstruction and operation of roads, bridges and other engineering structures under the community's jurisdiction;
- construction, maintenance and operation of sanitation facilities (this service is not carried out by the Head of the district community);
- regulating the operation of public transport in the community (this service is not carried out by the Head of the district community);
- construction, reconstruction and operation of the community's irrigation systems;
- collection of and disposal of waste;
- land and property taxes collection.

The management and operation of kindergartens is a mandatory responsibility of the local self-government bodies. The cost of operating and maintaining kindergartens is covered jointly by the parents and by the community budget. The amount of fees paid by the parents is set by the community elders, and varies in different communities. Community elders also define the social groups of residents whose children may attend kindergartens free of charge or with a discount. A number of kindergartens have closed, mainly because the number of children attending kindergartens has decreased.

Local self-government bodies provide specialised education, which includes music and fine arts schools, athletic schools and centres for enhancing the technical and creative potential of children. Community elders set the fees for each service and determine the number of students that are entitled to these services free of charge. Part of the costs is covered by the community budget. In most small communities, such services are not offered and children of these communities are taken to neighbourhood communities. The fees for these services vary and are primarily based on the demand for a given service. Some communities provide these services free of charge.

The maintenance costs of libraries and museums are covered entirely by community budgets. Houses of culture charge fees for their services but these fees are not sufficient to cover their maintenance and the deficit is covered by the community budget. The economic role of the local authorities is small. It is a voluntary responsibility and because of the absence of financial resources, many local authorities do not directly examine economic issues.

Table 2
Community Budget Revenues in Armenia

Type of Revenue	1997		1998		1999		2000		2001	
	amount (Mln. AMD)	%	amount (Mln. AMD)	%	amount (Mln. AMD)	%	amount (Mln. AMD)	%	amount (Mln. AMD)	%
Taxes	4,302.3	43.3	6,056.6	49.1	6,689.2	57.2	6690.3	48.3	5,221.2	34.1
Income Tax	-	-	1,754.0	14.2	1,298.2	11.1	1410.6	10.2	28.3	0.2
Land Tax	2,109.3	21.2	1,161.9	9.4	1,436.0	12.3	1454.2	10.5	1,667.8	10.9
Property Tax	735.5	7.4	1,567.6	12.7	2,407.0	20.6	2601.2	18.8	2,811.4	18.4
State Duties	1,457.5	14.7	1,573.1	12.8	1,263.9	10.8	880.2	6.3	3,744.4	2.4
Local Duties	-	-	-	-	282.4	2.4	330.6	2.4	3,19.5	2.1
Other Tax revenues	-	-	-	-	1.7	0	13.5	0.1	19.8	0.1
Non Tax revenues	1,773.7	17.8	2,085.7	16.9	1766.3	15.1	1782.1	12.9	2,073.0	13.6
Land Rental Payments	746.2	7.5	785.4	6.4	695.0	5.9	824.0	5.9	775.2	5.1
Property Rental Payments	-	-	-	-	120.1	1.0	88.9	0.6	88.5	0.6
Local Fees	-	-	-	-	108.9	1.0	184.7	1.3	124.6	0.8
Other Non Tax Revenues	1,027.5	10.3	1,300.3	10.5	842.3	7.2	684.5	5.1	1,084.7	7.1
Total Income	6,076.0	61.1	8,142.3	66.0	8,455.5	72.3	8472.4	61.2	7,294.2	47.7
Residual Revenue to Cover Expenses	91.3	0.9	341.5	2.8	994.2	8.5	180.2	1.3	1,120.7	7.4
Transfers and Subsidies	3,774.6	38.0	3,845.3	31.2	2,252.4	19.2	5202.0	37.5	6,866.3	44.9
Subsidies from State Budget	3,753.0	37.8	3,690.3	29.9	2,192.4	18.7	5194.3	37.5	6,801.9	44.5
Transfers from Other Community Budgets	7.0	0	0	0	60.0	0.5	1.9	0	10.4	0.1
Short-time Loans	14.6	0.2	15.0	0.1	0	0	0	0	-	-
Other transfers	0	0	0	0	0	0	5.8	0	54.0	0.3
Subventions	0	0	140.0	1.2	0	0	0	0	-	-
Total	9,941.9	100	12,329.1	100	11,702.1	100	13,854.6	100	15,281.2	100

Source: Ministry of Finance and Economy of Armenia

12.4 Local Budget Revenues

As with most countries, Armenia's local self-governments have more assigned expenditures than revenue sources to finance them. The result of this vertical imbalance is that localities generally depend on transfers from the State. A problem of local finance is that not all local governments are the same: there are medium sized and small cities and urban and rural communities. Providing local services fairly and efficiently in the absence of a well-designed revenue and transfer system gives rise to a horizontal imbalance. Another problem is the low degree of local budgets implementation. For example, local budgets were implemented 53.2 per cent of the time in 2000 and 56.9 per cent in 2001.

The main sources of community budget revenue are:

- Centrally established taxes and duties;
- Subsidies from the State budget;
- Local duties and fees;
- Land rent and property rent payments;
- Revenue on community property sales.

Revenues from the capital budget are minimal. Capital budgets are non-existent in many communities.

12.5 Introduction Of the Tax-sharing Model in Budgetary System of Armenia

Tax sharing is widely practised amongst developing and transition economies. Two questions arise in designing a tax sharing model: 1) which tax is to be shared? and 2) what is the percentage of tax to be shared? In this case, the central government allocates a share of national collections of certain taxes to the provincial/local government sector. Each country decides the type and percentage of taxes to be shared.

As Table 3 demonstrates, the number of shared taxes is immense. Concerning the percentage of the tax to be shared, countries vary widely in their choices. In many countries, the percentage is defined each year. For example, in Hungary the local share of the personal income tax has decreased from 50 per cent to 15 per cent over the years. China and Russia allocate about 25 per cent of VAT collections to sub-national governments whereas Estonia allocates 56 per cent of personal income tax to sub-national governments.

Table 3
Tax sharing in different countries

Countries	Taxes							
	VAT	Property tax	Sales tax	Payroll tax	Motor Fuel taxes	Personnel income tax	Corporate profit tax	Motor vehicle tax
Russia	+						+	
China	+							
Indonesia		+						
Dominican Rep.		+						
Peru			+					
Mexico				+				
Brazil					+			
Estonia						+		
Lithuania						+	+	
Poland						+	+	
Hungary						+		+

Source: *Experiments and Reforms*, Horvath, Budapest, 2000.

Note: Readers should be aware that this table has been produced here primarily for illustrative purposes. Most, if not all the countries listed in the table have fairly diverse fiscal system and centre-periphery relationship. Some countries are federal while the others are united with two-tier local governments, etc. (Editorial comment).

There are two methods of tax sharing between central and local governments. The first is the origin method, where each local government receives a fixed share of the tax collected within its borders. The second method is formula based, where a fixed share of the national yield is divided between local governments on a formula basis. The first method is the simplest.

The laws on the Budgetary System and Local Self-government provide an opportunity for the use of tax-sharing models in Armenia's budgetary system. In the first year (1997) of the new local self-government system, the centrally established taxes paid to community budgets were the land and property taxes. Income tax was added later (see table 4), but only 15 per cent was paid to community budgets. In Armenia at that time, all taxes were collected by the State Tax Agency. The principle of sharing was established in order to increase the State Tax Agency's incentive to collect taxes. However, the amount of income tax is very small or is non-existent in rural communities, which is why, since 2000, all income tax revenue goes to the State Budget and the amount of subsidies from the State Budget to the community budgets was increased. Land and property taxes have remained as the only community budget tax revenue and are fully paid to the community budget. The origin method was used in 1998 and 1999.

The tax-sharing model must not only serve as a source of budget revenue, but also stimulate economic activity in the communities. Local governments can

directly or indirectly impact the development of economic activity. The main aim of any tax-sharing model must be community economic development. This is a vital goal, as it will give local authorities an incentive to support the development of small and medium-sized enterprises.

Table 4
Share of Centrally Established Taxes Paid to Community Budgets in Armenia,
1997 – 2000 (%)

Year	Income Tax	Land Tax	Property Tax
1997	-	100	100
1998	15	95	95
1999	15	95	95
2000	-	100	100
2001	-	100	100
2002	-	100	100

Source: Ministry of Finance and Economy of Armenia and Author

The use of tax sharing in Armenia will strengthen the fiscal position of local governments and provide the necessary finance for fulfilment of their functional responsibilities. At the same time, it may support development of local economic activity. If a tax-sharing model is used, the next issue to be decided upon is which taxes are to be shared. According to the new law on local self-government (2002) the land and property taxes collection responsibilities are given to the local self-government bodies. The tax sharing model on income tax and profit tax will be used from 2003. This means that local budget revenues will be increased. The share between the state budget and local budgets will be decided by the annual state budget law.

12.6 Mechanisms of Transfers from the State Budget to Local Budgets

Intergovernmental transfers are an indivisible part of every local government's financial system in every country. For example, in Sweden and Denmark, the major part of local governments' revenue comes from local sources, while in countries such as Great Britain and Bulgaria, most of their revenue comes from state transfers. In Armenia, state transfers are an important part of communities' financial means. They form the major part of many communities' budgets and are used for the maintenance of inventory and buildings, fulfilment of main community services and their development.

The total amount of equalisation subsidies in the state budget has its own budget line and is paid immediately upon adoption by the National Assembly. This means that irrespective of the level of state budgets' implementation, the

Table 5
Local Budgets Revenues With and Without any Subsidies from the State in Armenia (*Thousand AMD*)

	1997		1998		1999		2000		2001	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Local Budgets with no subsidies from the State	6,188,920.2	62.25	8,498,763.5	68.9	9,509,740.8	81.3	8,660,320.2	62.5	8,479,264.9	55.5
Subsidies from the State budget to the local budgets.	3,753,048.3	37.75	3,830,314.1	31.1	2,192,421.0	18.7	5,194,318.9	37.5	6,801,926.2	44.5
Local Budgets including the subsidies from the State	9,941,968.5	100.0	12,329,077.6	100.0	11,702,161.8	100.0	13,854,639.1	100	15,281,191.1	100

Source: Ministry of Finance and Economy of Armenia

subsidies transferred to communities are defended and considered to be mandatory payments. The Ministry of Finance and Economy, according to the law on “Financial Equalisation”, distributes the amount of subsidies defined in the state budget amongst the communities. The aggregate amount of subsidies planned for the communities is equal to the total amount of subsidies defined in the state budget. At the beginning of the fiscal year, the Ministry of Finance and Economy pays one quarter of the subsidies and gives this to the Treasury to make the payments. All communities foresee a proportional quarter distribution. In the case of a normal collection of state budget revenues, subsidies are transferred to the communities in accordance with these 25 per cent amounts.

This mechanism is partly defined by the law and partly by the Ministry of Economy and Finance. In reality, the situation is far from ideal with some communities receiving subsidies early and others late. The equalisation subsidies are given to the communities irregularly and with systematic delays throughout the entire year. Most of the subsidies are transferred at the end of the current year, mainly during the last ten days of December.

The selection mechanism used for those communities that receive the subsidies earlier and more completely is unknown.

The state transfers share among the community budget revenues varies (See Table 5). It was less in 1999 because the State budget did not perform its duties. It had been decided to allocate AMD 4388.7 million subsidies in financial equalisation and an AMD 86.1 million subvention to community budgets. But in reality, only AMD 2192.4 million subsidies were allocated. The remainder was drawn up as debt and transferred in 2000. In 2000, not only was the debt not paid but it also increased. At the end of 2000, the total debt to the community budgets was AMD 3397.1 million. However, at the beginning of 2002, the debt was reduced to AMD 2586.7 million.

Another problem is that sometimes the subsidies are given for distinct purposes; for example, the subsidies given if the head of the community agrees to pay water, heating or electricity debts from these subsidies.

In order to improve the mechanism of state transfers, first of all it is necessary to make amendments to the existing legislation. The total amount of each community’s subsidy must be distributed into quarters and months. The law must define that in the case of the non-implementation of the state budget, communities should receive subsidies in proportional amounts. There should not be preferential and non-preferential communities. The allocation of subsidies to the communities should not depend on the will of a public official. The legislation does not regulate the mechanism of subventions’ allocation. Clear criteria should be set down to define the allocation of subventions. Each community which satisfies these conditions can apply to the Ministry of Finance and Economy. The

selection of communities will take place on the basis of competition. Winning communities are chosen according to the total amount of subventions defined in the State budget.

12.7 Financial Equalisation System

Equalisation has an important place in intergovernmental fiscal relations. The different varieties of intergovernmental transfers include grants, shared taxes, subventions and subsidies. Whilst all of these types of transfers are used to implement equalisation, subsidies and grants are the most common financial instruments.

Each country is characterised by wide fiscal disparities amongst the regions. The average income in the richest places is many times greater than that of the poorest places. If countries are to equalise their regional financial capacity differences, inter-governmental transfers must be used. As a rule, equalisation payments are unconditional. Recipient local governments are free to spend the funds on local public services according to their own priorities.

In most countries, equalisation subsidies come in the form of transfers from central government to local governments (Canada, Australia, United Kingdom, Japan, Korea, Hungary, Latvia, etc.). In countries such as Germany and Sweden, the equalisation transfer is made from states with above-average fiscal capacities to states with below-average fiscal capacities. In other countries, equalisation subsidies take the form of a general revenue sharing.

There are three ways (See: Wallich, 1994) that governments approach regional demands for special treatment. The first is individually negotiated payments between the central and regional governments. The second is special fiscal regimes that grant special rights to certain regions for taxation and expenditures. The third is a formula-based system, normally designed with equalisation objectives. Although most countries use some kind of formula distribution to address regional issues, only a few include components in their formulas for dealing with demands made by a specific region. A formula subsidy uses certain objectives and quantitative criteria to allocate the pool of revenues to the eligible local government units. What are the objectives that might drive the design of a formula subsidy? The most common reason why governments move to formula based distribution is to gain transparency and certainty in the distribution of subsidies. This creates a sense of fairness in that, everyone knows the exact criteria through which distributions are made; that there is flexibility in those distributions, and that they may be changed as the needs for public expenditures change. In short, formulas are meant to remove judgment.

The following questions may be raised in regard to equalisation:

- What are the limits of equalisation? How much of the gap between the rich and poor communities should be eliminated.
- What services do local governments deliver and what is the degree of their fulfilment?
- What distribution formula is used to allocate finances amongst local governments?
- What is the mechanism for equalisation?
- How will equalisation be monitored? What index of equalisation will be chosen to measure the effectiveness of the system?

The main components of the equalisation formula are the elements of the formula, the data necessary to implement the formula and the conditions of the formula. All three components are important considerations in equalisation subsidies design. The design of the formula is arguably the most difficult issue, because it raises the question about the goals of the equalisation program. The formula should reflect its objectives. In general, a formula might reflect four objectives, as is mentioned in different literature.

The first objective is to allocate the subsidies in a manner that reflects regional differences in expenditure needs. Different countries have used different indicators of expenditure needs including:

- Population, i.e., a straight per capita distribution.
- Indicators of physical factors that may lead to greater costs of service provision, e.g., land area, population density, and urbanisation.
- Measures to reflect the concentration of high cost population in the local government areas, for example, the percentage of families living below the poverty line, the percentage of people on pensions, and the percentage of school-aged children, etc.
- Indicators of infrastructure needs, such as miles of paved highways, percentage of households with access to an adequate water supply and infrastructure needs to support economic development, etc.

The second objective is the equalisation of income or fiscal capacity. In this case, the formula subsidy attempts to provide more money to those jurisdictions that have a weaker capacity to raise taxes. The problem comes in trying to find an indicator that will enable us to allocate funds to those places with an inherently weaker fiscal capacity. There seem to be two general approaches:

- Allocate funds according to the level of average income in the local area, or according to the level of some indicator of the size of the tax base.
- Calculate the amount of money that could be raised if all appropriate tax bases were subjected to “normal” rates.

The third objective is to include a tax effort provision directly in the formula. The goal here would be to provide local governments with some positive incentives to increase the overall level of revenue mobilisation. One option is to introduce a measure of tax effort directly into the formula. The second is the use of such an index. This approach has been used in the past in India. Another approach is to require maintenance of some level of revenue mobilisation as a condition for receiving the subsidy.

The fourth objective is that the subsidy formula reflects the balance between revenue raising capacity and expenditure needs. Many countries use variants of this approach. Some countries define a standard level of expenditures according to a formula, based on physical indicators of desired levels of service. This is related to a “normal” level of revenue mobilisation based on the size of the tax base. Korea has, in the past, been part of this tradition. Some school aid in the US is defined by a formula that links minimum expenditure requirements with property tax revenues if a specified level of property tax effort is exerted. Some of the transition countries (Russia and China) have defined the required level of expenditures as equivalent to some amount from the past year, inflated to the present. The level of revenue needed to guarantee this expenditure level is the amount of the transfer.

A major constraint to designing a formula subsidy system is finding the data to implement and update the system. There are some problems here. Some data are simply not available. Many other forms of data are available, but limited in terms of timeliness. For example, some data are available only during the census year and must be used in the interim period without adjustment. Some data are limited in terms of geographic coverage. There are some problems concerning the reliability of the data itself. The accuracy of the data is often questioned, even if it has been gathered by official bodies.

Formula subsidy systems must be monitored on a regular basis. Monitoring includes formula elements and the actual subsidy distributions, as well as the financial outcomes of each local government. The existing equalisation system in Armenia is based on a formula subsidy system. The amount of equalisation subsidies is calculated separately:

1. The communities, which have more than 300 inhabitants;
2. The communities, which have not more than 300 inhabitants.

The amount of the subsidies for the budgets of the communities with more than 300 inhabitants is determined by the following factors defining their economic situation:

- a) Local community per capita land tax and property tax revenues (factor “a”);
- b) Population of the community (factor “b”).

The total estimated amount of the subsidies destined for the budgets of the communities with no more than 300 inhabitants and upon factor “A” must not be

less than 25 per cent of the total income tax, land tax and property tax actually collected during the previous fiscal year and upon factor “B” it must not be less than 10 per cent of income tax collected during the previous fiscal year. Factor “A” subsidy is destined for the budgets of those communities with more than 300 inhabitants, where per capita land tax and property tax revenues level is lower than the average revenue marginal level of per capita of the Republic land tax, property tax and total amount of subsidy upon factor “A”. According to this principle the amount of subsidy destined for each community is determined by the following formula:

$$A = (M - H) \times B \times G$$

Where *A* = amount of the subsidy allocated to community upon factor “a”;

M = average revenue marginal level of per capita of the Republic (besides the communities with no more than 300 inhabitants) land tax, property tax and total amount of subsidies upon factor “A”, which itself determines by the following formula:

$$M = [D + \Sigma (T + P)] : (\Sigma B)$$

Where *D* = total amount of subsidies allocated to communities based on factor “A”;

T = the calculated indicator of the community’s budget land tax for the calculation of every fiscal year’s subsidy;

P = the calculated indicator of the community’s budget property tax for the calculation of every fiscal year’s subsidy;

B = community’s population;

H = revenue level of community per capita land tax and property tax, which is lower than average revenue marginal level of per capita of the Republic land tax, property tax and total amount of subsidies upon factor “A” and itself determined by the following formula:

$$H = (T + P) : B$$

G = average regulating coefficient, which is determined by the following formula:

$$G = D : \Sigma [(M - H) \times B]$$

Factor “B” is used to provide a subsidy to all communities (apart from those with no more than 300 inhabitants) by multiplying the number of community population by the subsidy amount per capita. The latter is determined by the ratio of the total subsidy amount under the “B” factor to the whole population of the Republic (apart from those with no more than 300 inhabitants).

The amount of subsidies for the budgets of communities with no more than 300 inhabitants is calculated evenly. There are 172 communities, which have no more than 300 inhabitants.

As can be seen from the above, the equalisation subsidies are given to the communities in 3 ways. Equalisation subsidies given to the communities, with no more than 300 inhabitants and factor “B”, are rather close to each other. In the first case, all communities receive equal subsidies. In the second case, subsidies depend on the number of community inhabitants. The first one has no serious basis, because there is no real indicator of subsidy size’s definition. With the third

way, subsidies are given to the communities with factor “A” and are the same as Formula B subsidies. It means communities’ financial needs are not taken into consideration– only the equalisation of fiscal capacities is considered.

We would like to suggest a new equalisation model for Armenia. Normative expenditures for the implementation of local government’s functions are the basis of the model. They are calculated by the Ministry of Finance and Economy.

The equalisation formula is as follows:

$$STR_i = (SSA - ABR_i) \cdot \frac{\sum STR_i}{\sum (SSA - ABR_i)} \cdot K$$

Where STR_i – Subsidy transfer from the centre to the i -th community,

SSA – Standard Spending Assessment,

ABR_i – Previous year’ administrative budget revenues of i -th community,

$\sum STR_i$ – Transfers from the the centre to all communities,

$\sum ABR_i$ – Previous year’s administrative budgets revenues (without subsidies) of those communities, which have revenues less than SSA ,

Where ATR_i – i -th community budget previous year actual tax revenues,

CTR_i – i -th community budget previous year calculated tax revenues.

Those communities can receive subsidies from the state budget, whose previous year’s administrative budget revenues (without subsidies) are less than SSA . According to the existing Armenian legislation, SSA should be calculated in the following fields:

- Local governments,
- Kindergartens,
- Specialised schools,
- Cultural organisations,
- Current repair and operation of roads, streets, bridges and other engineering structures under the community’s jurisdiction,
- Waste collection and disposal,
- Planting and improvement of the community,
- Current repair of housing stock owned by the community,
- Sanitary cleaning,
- Public transport,
- Heating.

If local governments’ responsibilities are widened, then this framework will be enlarged. The Government will calculate SSA each year, considering the Government’s social-economic strategy, inflation rate, any delegation of responsibilities to local governments and foreseen average wages level in public sector.

The use of coefficient K will support an increase in tax revenue collection. The higher the degree of tax collection, the greater the subsidy will be.

The best equalisation result will be in the cases of $\sum STR_i = \sum (SSA - ABR_i)$ and $k=1$. This means that those communities whose administrative budget revenues

are less than SSA, will receive the missing portion from the state budget for complete fulfilment of their functions. Communities should receive subventions from the state budget for capital expenditures' performance.

12.8 Conclusion

The new local self-government system has operated in Armenia since the end of 1996. Roughly 6 years' experience shows that there are many problems, the solutions to which are necessary for further development of the local self-government system, civic society and democracy.

One of the main problems is the implementation of fiscal decentralisation and the development of an intergovernmental fiscal relations regulation. Armenia assigns more expenditure functions to local self-government than can be financed from the revenue sources directly allocated to these governments. This means that an acceptable variant of fiscal decentralisation has not yet been found.

As a result the following recommendations are offered:

1. Use of a tax-sharing model in Armenia's budgetary system will strengthen the fiscal position of local governments, provide them with the necessary finance for fulfilment of their responsibilities and will support development of their economic activity. Personal income tax, corporate profit tax and VAT will be shared.
2. Clear mechanisms should be defined for the location of state transfers by law. The total amount of each community's subsidy must be distributed into quarters and months. The receipt of subventions by the communities will take place on the basis of competition.
3. A new equalisation model is offered for Armenia which is based on the fiscal needs of local governments and normative expenditures for the implementation of their functions.

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13. Grant Transfers and Financial Supervision in Kyrgyzstan

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13.1 Introduction

The government of the Kyrgyz Republic has progressed immensely in the stabilisation of the economy and sector reforms. With the support of the World Bank, it has adopted a Public Sector Resources Management Adjustment Program (PSR-MAC) and with the budget of 1997, the first steps to implement several elements of reforms were undertaken.

The implementation of the reform strategy had been supported by a Preferential Program Credit at the rate of SDR 30 million (approximately \$43 million) and was provided by the International Development Association of the World Bank Group. The project lasted two years and was designed to prepare a budget that was an efficient instrument of government economic policy and provide conditions for sustainable economic growth. The main weaknesses of the budget system were the absence of intergovernmental mechanisms for the budget system. Therefore, the Reform Programme within PSRMAC was aimed at public sector resources management. The objectives were to ensure that resources were allocated to priority programmes providing for more effective allocation of government funds and maintaining service delivery costs at the lowest possible level. The proposed programme was aimed at raising the effectiveness of the budget process and rendering conditions for the development of improved expenditure programmes more acceptable in scope and content. This made fiscal stabilisation more sustainable.

The Reform Programme envisaged transformation in the area of intergovernmental finance. This necessitated the implementation of an improved system of financial relations between different government levels, namely between Republican and local budgets.

13.2 Local Government Legal Framework

13.2.1 History of Local Self-Government

Upon gaining independence in 1991, Kyrgyzstan was faced with the challenge of developing new government principles and methods which, unlike those of the former strictly centralised totalitarian Soviet system, would expand the sphere of democracy and promote political and business activity, initiative and self-reliance of the local population.

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By that time the Law on “Local Self-Government in the Republic of Kyrgyzstan” had already been passed. Its main principles were in line with the ideals of our young republic, which are committed to the path of democratic development. It was decided, therefore, to carry on local self-government development within the existing legal framework.

Thus, the issue of local self-government became one of the most important and urgent challenges to be addressed by the newly independent state from its first days of independence. More than ten years have passed since then. The process of local self-government development has passed through a number of different stages and by the end of 2001 it had reached the “final sprint”, opening up bright prospects for the future. What are the features of these stages and what determined them?

13.2.1.1 Stage One: Self-Government by Councils of Peoples’ Deputies

In accordance with the Law on “Local Self-Government in the Republic of Kyrgyzstan”, adopted by the Jogorku Kenesh on April 19, 1991, authority at the local level was delegated to the Local Councils of Peoples’ Deputies, which was transformed overnight from former representative bodies of Soviet state power into “the main element of local self-government in the Republic of Kyrgyzstan”.

During the first months following the adoption of the law, local councils were still operating under the control of the Communist Party. However, after the dissolution of the territorial Communist Party bodies in August 1991, authority was held entirely by the local councils. All the regional administrative structures in the Republic, without exception, switched to local self-government by order of Parliament. It seemed that the time had come for the inevitable victory of self-government and its dissemination throughout the country.

However, things turned out differently. The transfer of authority to the Councils of Peoples’ Deputies coincided with the collapse of the USSR and the breakdown of established economic relations with the other republics. The impending crisis required local councils to take urgent and exceptional steps to mobilise internal resources and develop the economy at the local level; to introduce market mechanisms and establish new economic relations; to strengthen state discipline and public order and resolve numerous other issues at the local level.

Contrary to expectations, the local Councils of Peoples’ Deputies with their monopoly of authority, performed poorly with respect to socio-economic management in their respective territories.

One of the main reasons was that the Councils and their Presidium, functioning according to the principle of collective decision-making, turned out to be incapable of taking flexible and decisive actions. “Mini-Parliament” debates frequently flared up at the local councils’ sessions on any pretext and had a nega-

tive effect on discussions and on the quality and terms of implementation of the decisions made.

The capacity of the local councils to maintain a balance between local and central government interests was also doubtful. While considering such issues, priority was often given to local interests, i.e. to their own interests at the expense of the national interest, and this negatively affected the overall situation in the Republic.

Contrary to expectations, the local Councils of Peoples' Deputies which were supposed to be "the main element of local self-government" according to the law, were unable to even take the lead in implementing the principles of local self-government in communities, creating the necessary conditions for territorial public management institutions and involving the local population in the management of local affairs. The basic principles of self-government such as self-financing, self-sufficiency and self-education were left unconsidered.

As a result, the sublime idea of democratic self-government was gradually transformed into collectively organised anarchy and became a hotbed of tribalism and parochialism. The economy of the territories slumped rapidly and the welfare and social protection system deteriorated dramatically as the self-government system proved unable to govern efficiently and to act independently without control and instructions from the upper levels of authority.

It became clear that despite the democratic character of the transition of authority at the local level to the representatives of the local population, the empowerment of the councils did not meet one of the major requirements of a democratic system: a mechanism of checks and balances to prevent uncontrolled and arbitrary actions.

It was therefore becoming exceedingly dangerous to continue the experiment with the empowerment of the councils, which transformed the very idea of local self-government into a farce. The reality proved that transition from the totalitarian management system to a democratic one needed an intermediate form of local government that would combine democratic and administrative principles with an effective mechanism of checks and balances.

Thus, the idea and practice of the transfer of administrative bodies to complete self-government, and the empowerment of local representative self-government bodies in the form of the Councils of Peoples' Deputies at the local level failed.

13.2.1.2 Reform of Local Administration and Self-Government

Despite this failure and other difficulties, the most progressive and democratically minded politicians, under the leadership of the President, having firmly decided to establish a state based on the rule of law, did not abandon the idea of

local self-government. In view of the fact that there was no ready-made recipe for democratic local government and self-government management, it was decided to change the strategy and tactics for implementing local self-government reforms of the existing system of local government.

The need for reform and for the establishment of a new national system of local government combining both democratic and administrative principles during the difficult transition period had been established. Thus, the President of the KR submitted to Parliament, for its consideration, the draft law on “Local Self-Government and Local Administration in the KR”, which was adopted on March 4th 1992.

In order to reform local government, the law introduced the dual principle of organisation of local authority, consisting of:

1. Local self-government including local *keneshes*, bodies of local self-government, as well as local referendums, citizens’ meetings and other forms of direct democracy;
2. Local state administrative bodies representing the executive power of the Kyrgyz Republic in a particular territory.

The new system of local authority was based on the principles of strict division of functions and mandates of local bodies of representative and executive power in the territory. These included the unified authority of the head of local administration, the combination of central and local interests and the self-reliance, independence and responsibility of local *keneshes* and local state administrations for resolution of issues at the local level.

As a result of the reform, the executive and distributive functions were removed from local *keneshes* (the representative bodies of local self-government). Also removed was the responsibility for coordination of the activities of local self-government and state government and for the approval of candidacies for management positions in government bodies.

Under the new law, local *keneshes* were declared “the representative bodies of local self-government” and given the exclusive power to approve local socio-economic development programmes and budgets and to monitor their execution. At the same time, they were empowered to approve the appointment of the head of the local state administration as well as expressing their lack of confidence in him. This permitted the democratisation of the procedure of appointing heads of local state administrations and control of their performance and ensured a reasonable balance between the state administration and local self-government.

The inclusion in the Constitution of the Kyrgyz Republic of the people’s right to self-government was clear and convincing evidence of the determination of the young democratic state and its head to continue to develop local self-government. The Constitution provided a complete legal basis for the structure

of local authority and relationships between local state administration and local self-government. Article 91 of the Basic Law of the country states that “issues relating to the population of villages, towns, cities, districts and *oblasts* holding local status are to be resolved according to the principles of local self-government, now coexisting with state power”. The constitutional right of the population to local self-government becomes the political and legal basis for the development of local self-government in the Kyrgyz Republic.

13.2.1.3 The Initial Stage of Development of the Local Government Concept

The Presidential Decree of August 18th 1994 “On the Reform of Local Self-Government in the Kyrgyz Republic” identified two stages of reform. It was also the starting point for the official development of the concept of local self-government.

The first stage was to embrace the reform of local self-government at the level of *ayilas* (villages), towns and cities that were permanent places of residence and the basis for the formation of local communities. The second stage considered the possibility of introducing the system of local self-government in districts (*rayons*) and provinces (*oblasts*) in their capacity as systems of primary-level local communities, taking into account their demographic, natural, historical, cultural and other features.

The Commission on Local Self-Government Reform, the composition of which was approved by Presidential Decree of 22nd August 1994, promoted further local self-government. After painstaking and fruitful work, it soon managed to draft the provisions “On the Basic Elements of Local Self-Government Organisation in the Kyrgyz Republic”, approved by Presidential Decree on September 22nd 1994.

In these provisions the political, legal, organisational, financial and economic bases of local self-government in the Republic were placed on a solid theoretical and practical basis and their future form delineated. Definitions were given of “local community and its members”, as well as some principles of the organisation and system of local government, the rights of the local community to own communal property and carry out external trade operations, and the bases for economic, financial and social activities.

The practical implementation of local self-government reform began with the establishment of one of the major democratic institutions, elective representative bodies of local communities– the cornerstones of self-government. On October 22nd 1994, for the first time in the history of the country, free democratic elections of deputies of local *keneshes* were conducted countrywide.

After the elections of heads of village, town and city *keneshes*, the first conference of local government leaders was held at which the President of the Kyrgyz Republic, Mr. Akaev, delivered a significant paper.

This paper discussed the historical bases and theoretical provisions for local self-government and its practical value. It also defined the essence of the local government reform conducted in the Republic and the priorities for its development. The conference posed the task of building a national model of local self-government that would embrace all that was valuable and useful both in global experience and that of the Kyrgyz people's own history.

Forming representative local government bodies ended with the election of *rayon* and *oblast kenesh* deputies in February 1995. They were completely different from the previous local Councils of Peoples' Deputies both in size and quality. All in all, some 6,921 deputies were elected to the local *keneshes* at all levels for the first time on the new basis. This was only one-third of the number during the Soviet era.

The introduction of local self-government in the capital of the Kyrgyz Republic, Bishkek, was one of the most important events, not only in the history of our country, but of all the Central Asian Republics. For the first time in the history of the region, the mayor was elected on the new basis by the population. By Presidential Decree of July 4th 1995 "On Urgent Measures for Organising the Self-Government of the City of Bishkek", the Temporary Provisions for Basic Principles of Self-Government Organisation were confirmed. At the same time, the list of the state functions and mandates delegated to the mayor was compiled, the structure of the city management was changed, and the state commission to transfer appropriate entities to the municipalities was established.

After the establishment of the first municipality in Central Asia created according to international standards, work on the further development of the concept came to a halt. The reason for this was that some of the principles of local government organisation set out in the Constitution and the Law on Local Self-Government and Local State Administration turned out to be non-viable. That constrained further development of the theory and practice of local government.

Thus, Article 7 of the Constitution stipulated that state power in the Kyrgyz Republic was based on the principle of "division of state power and local self-government".

At the local level of management there were numerous issues pertaining to local state authority and local self-government which made it impossible to differentiate between the state issues and the local issues. The main reason for this was the absence of communal property to be managed by local self-government. The Constitution made no mention of municipal property, something that is

recognised all over the world. As a result, the local state administrations actually ran everything at the local level, leaving the elected local government bodies with almost nothing to do. This demonstrated the need to introduce specific changes and amendments to the Constitution to provide opportunities for further development of local government.

13.2.1.4 Changing the Constitutional Base for Local Self-Government and Reform of Self-Government in Rural Areas

By the end of 1995, due to a number of successful achievements in the development of democracy, decentralisation progress demanded growing efficiency of the state authority. The local communities needed as much freedom as possible in managing their affairs. Taking this into account, some amendments and additions were made to the draft law “On Amendments and Changes to the Constitution of the Kyrgyz Republic” and were put to public vote by the President in February 1996. These legal amendments and additions were designed to promote the further development of local government. They were approved by referendum and became part of the Constitution, providing a wide range of opportunities for local government reform.

Article 7 of the new edition of the Constitution identified the relations between the state power and local self-government, not on the basis of the principle of separation, which prevented them from co-operating, but on the basis of differentiation of functions. The strict separation of functions became impossible because Article 94 of the Constitution had been completely changed and a new clause added, according to which local government bodies “could be assigned some state functions... and with respect to the delegated responsibilities they are accountable to the state bodies”. As a result of this modification, local government bodies were entitled to manage and resolve those issues that were within the scope of local administration responsibilities within the limits set by the laws and by presidential and government decrees.

Article 92 of the Constitution, in its new edition, has begun to play a vital role for further development of local government. It states clearly and precisely “Local self-Government bodies can own, use and have at their disposal communal property”.

These new constitutional provisions became the basis for the renewal and further development of the concept of local government reform. On March 20th 1997 the President issued the decree “On Measures to Strengthen the Role and Responsibility of the Local State Administration and Local Self-Government Heads”, in which local government bodies, represented by the local *keneshes* were, for the first time, entitled to carry out state functions and mandates to register land and social and cultural infrastructure; to mobilise the population for com-

munity works; to ensure public order and create non-budget funds to fulfil urgent tasks at the local level.

It should be noted that this decree was crucial to the resolution of problems in rural areas, where more than 60 percent of the country's population live. It is also significant because it regulates administrative relations at the level of *ayil* (village) *keneshes*, which are the primary local government units in the Kyrgyz Republic. The establishment of qualitatively new executive bodies – village governments (*ayil okmotu*) – made it possible to eliminate the system of multiple authority in rural areas, making village governments responsible for local and state affairs. The provisions for *ayil okmoty*, approved by the Government decree on April 24th 1996, became the legal basis for the new unit of local government.

The new local government bodies very soon managed to take over the reigns of government and take concrete measures to develop communal industry, improve the social sector and strengthen public order in the rural areas, gaining the approval of the rural population. Local *keneshes* at all levels made the decision to form communal (municipal) property and proposals were made to give local government real rights to develop local budgets, implement them independently and utilise the funds to tackle all matters not requiring government involvement at the local level.

This local government initiative was highly praised by the President at the second national conference of local government leaders, which took place on October 4th 1996. President Akaev analysed the pace of local government reform and formulated the strategy and tactics for further development of the principle of democracy in the country. The Association of Local Government Bodies of the Kyrgyz Republic was founded, the first of its kind in Central Asia. 51 people were elected to its Central Council.

Based on the recommendations of the national conference, the President issued the decree “On Measures for Further Local Self-Government Development in the Kyrgyz Republic”, which provided a wide range of opportunities for development of local democracy. This decree approved the Exemplary Charter of the local communities of *ayil keneshes*, the provisions for rural *kurultay* (joint meetings) as well as the Charter of the Association of Local Government Bodies of the Kyrgyz Republic.

These legal documents, for which there were no analogous laws in the CIS countries, became the tools for teaching the rural population the principles and rules of local self-government, and promoted the development of democratic principles in rural areas. This can be seen from the fact that from December 1996 to February 15th 1997 *kurultays* were held in all rural communities of the Republic. Some 69,000 delegates, or 94 per cent of all delegates elected by members of local communities, participated.

President Akaev then decreed in 1998 that 7 rayon-subordinate cities were to become local self-governing, which led to the establishment of new city administrations subordinate to local councils. Subsequent decrees rounded up the number of cities to 12.

In May 2001, President Akaev decreed that oblast-subordinate cities become local self-governing, but during the interim period, mayors would still be significantly accountable to the national government.

13.2.2 Legal background of Central Government

Following the constitutional amendments of February 1996, the government of Kyrgyzstan has been organised on the principle of Presidential rule *sui generis*. The President of the Kyrgyz Republic has broad powers and a considerable part of the Constitution (articles 42-52) determines the President's mandate and responsibilities. The President is the head of the executive power in the Kyrgyz Republic, representing the country, symbolising its unity and harmonising the functioning of the state machinery. He appoints, upon approval of Parliament, the *Jogorku Kenesh*– the Prime Minister– and appoints the members of the cabinet in consultation with the Prime Minister. He also appoints, in co-operation with local councils at the corresponding level, provincial governors (*gubernators*) and district heads. The President decides on the establishment and reorganisation of government organs that are outside the Cabinet's mandate and jurisdiction. In consultation with the Prime Minister, he decides on a unified (standardised) system for recruitment, salaries and training of public servants. He also decides on the legal validity of statutory and executive instruments– the rules and regulations adopted by central executive organs.

The Kyrgyz Government is led by the Prime Minister who is appointed by the President with Parliament's approval. His cabinet is in charge, *inter alia*, of budget preparation and implementation, financial, credit and tax policy, management of public property, and the implementation of all laws, rules and regulations adopted by the president and parliament. The cabinet guarantees the observance of constitutionality and it invalidates legal instruments adopted by any public agency not in accordance with the legal system of the country based on the constitution.

The Kyrgyz legal system defines the relationship between the President's office and the government, emphasising the defining role of policy and the controlling role of the President's office. It also establishes the co-ordinating, monitoring, supervisory and hierarchical role of the central government. It is a top-heavy structure with responsibilities concentrated in the higher echelons of government.

Central government plays a dominant role in all regulatory, development and investment activities in Kyrgyzstan. It formulates public policy, manages and

implements the budget and monitors the operations of local government and public sector enterprises.

13.3 Local Government

The constitution provides for a double-tiered system of local government. In paragraphs 76-78 it provides for decentralised government that implements laws and regulations. In paragraphs 91-95, local government is empowered to act on behalf of the state and solve local problems, subject to the provision of earmarked financial resources. Recent legislation further elaborated the constitutional background for local government.

Kyrgyzstan divides its sub-national government institutions into two types of local state administrations and local self-government bodies. At present, local state administrations exist in provinces (*oblasts*) and districts (*rayons*) headed respectively by governors and akims appointed by the president. The central government delegates their powers to locally organized bodies that are in fact extension of the central government.

Oblasts and *rayons* are now, according to the constitution, major, though regulated actors in achieving national integration and economic development. They also have locally elected councils (*keneshes*), which are considered a body of local self-government. *Rayon*-subordinate cities and villages have *keneshes* and have an executive body that is legally subordinate to these *keneshes*. Both the *keneshes* and local executive are considered to be bodies of local self-government. *Oblast*-subordinate cities were given local self-government status in May 2001.

It is now clear that government policy is to promote decentralisation. However, the central administration has retained fairly tight control over provinces and districts.

13.4 Intergovernmental Financial Relationship Intergovernmental Finance

All countries with national and sub-national levels of government have, to some extent, developed a system of intergovernmental finance that determines the fiscal interaction between the authorities of various levels.

The previous system of financial relations between the different levels of government was ineffective and characterised by considerable amounts of transfers, and “soft” budget constraints in using financial resources. The Tax Share mechanism created conflicts between the “centre” and “local governments”, did not stimulate local governments to increase tax collection, and facilitated “parasitic” dependency. Local governments are responsible for the bulk of local social services and their total budget expenditures constitute a significant part of all consolidated budget expenditures.

Reform of the budget expenditure side includes the division of responsibilities and improvements to the system of transfers between different government levels. Division of responsibilities between different government levels involves the definition of responsibilities at each government level for specified expenditures. At present, the Ministry of Finance has defined and clearly divided functions between expenditure commitments of the central government and local budgets, including mixed budget expenditures.

Table 1
Local Budget Revenues Structure, %

Revenues	1997	1998	1999	2000	2001
Total Revenues	100	100	100	100	100
General Revenues excluding Transfers	48,9	52,5	49,9	51,3	46.9
Current Revenues	48,9	52,5	49,9	51,2	46.9
Tax Revenues	34,1	40,8	37,3	38,5	35.8
Non-tax Revenues	14,8	11,7	12,6	12,7	11.1
Capital Revenues	0,3	0,03	0,02	0,1	0.0
Received Transfers*	50,8	47,5	50,1	48,7	53.1

* Include Grants and other Transfers

Source: Ministry of Finance

Improvement of the transfers system between different government levels requires the introduction of categorical grants for local budgets, which ensure timely payment of salaries in socially significant sectors, such as education and health care and pensions and benefits. It should be emphasised that in the future, grants will be aimed at ensuring the minimum level of expenditures in these sectors and a certain formula is required to calculate them. Instead of the traditional quantitative methodology (based on the number of personnel and institutions), which was used to define the amount of allocated transfers, qualitative indicators are now used. They relate the number of people to a weighted-average and correspond to the delivery costs in towns, villages and mountainous and remote country districts. The formulae used to calculate these grants multiply weighted-average quantities by minimal expenditure sums, calculated per capita. These qualitative indicators include the number of pupils per school, sickness rate, and number of people living in the local area. This calculation method brings revenues collected in these *oblasts* into line with expenditures required to ensure the minimum level of services and enables the development of local government initiatives for the optimal allocation of resources, provided from the republic's budget.

13.4.1 Revenue sharing

The system of financial relationships between different government levels should also be based on the appropriate division of commitments, not only for budget

expenditures, but also for revenues. The share of tax revenues is the most important component in this system. Availability of stable and fixed norms of deductions from overall government tax and other revenues, which are common for all regions, will enable local governments to implement effective budget planning based on the scientific methodology of forecasting revenues. It will also increase the collection of taxes and other payments both at the national and local levels, and create incentives to find additional sources of revenue. In 1997, non-specific subventions to local budgets were abolished. Stable, fixed levels of tax-sharing were established for local budgets for several years ahead. For all regions they were fixed at a rate of 35 per cent for all taxes with the exception of VAT.

13.4.2 Other revenues

In order to equalise regional revenues, a system of equalisation grants has been introduced. In addition, local government rights to establish local taxes and payments are being increased.

13.5 The Law on “Basic Principles of the Budget”

The legislation on State Budget Management, Law on Budget Principles of January 1994, did not meet the existing economic requirements. Therefore, the revised version defines all basic principles for the preparation and execution of central and local budgets. The law was approved by the Legislative Chamber on 20 March 1998, and adopted by the Peoples’ Representatives Chamber on 8 March 1998 and signed by the President of the Kyrgyz Republic on 11 June 1998.

The intergovernmental finance arrangements of the Kyrgyz Republic are based on the following preconditions:

1. The structure of public administration determined by the Constitution of the Kyrgyz Republic assumes the division of the Republic into administrative territorial units. The level of social and economic development, and, therefore tax potential, varies enormously. The specialisation of regions in terms of agricultural production also influences the level of local budget revenues.
2. According to the Basic Principles of Budget Law in the Kyrgyz Republic (article 37), the authority for budgeting is allocated according to three levels:
 - Central government functions. These are the expenditure obligations to fund functions of national importance.
 - Local functions. These are expenditures for activities under the responsibility of local governments on which the general level of education, health and welfare of the regions’ population depend.
 - Mixed functions. These cover expenditures for activities under the responsibility of both central and local governments, where their realisation is more effective, for various reasons, by local levels of public administration.

Whilst government functions are wholly financed from the Republican budget and local functions from the local budget, mixed functions are financed from both Republic and local budgets (local budgets own resources and the Republican central budget grants).

3. The above mentioned law also determines the structure of the budget revenue of the Kyrgyz Republic. According to articles 31-33, revenues of the state are subdivided into:
 - Overall state taxes and other revenues;
 - The revenues of the Republican budget;
 - The revenues of the local budgets.

The overall state taxes can go into the Republic as well as local budgets, and the Annual Budget Law establishes the allocations between these two levels.

It should be noted that the initial factor of intergovernmental relations is the economic distinction in regional development. The other two factors are the result of the first and are components of the intergovernmental finance system.

The Law requires the establishment of a Government Budget Commission to make the budget formulation and execution processes public and open. The Budget Commission consists of representatives of the Government, key ministries and agencies, as well as governors of Oblast Administrations. The responsibilities of this commission include control over budget execution and current adjustment (when necessary) of the budget revenue and expenditure indicators. It should be emphasised that changes to the approved annual budget parameters remain the responsibility of the *Jogorku Kenesh* of the Kyrgyz Republic.

13.6 The Grant System

13.6.1 Roles and Purposes of Grants

The mechanisms of redistribution vary from country to country and include various components. In general, the transfer system includes the following basic types of transfers (grants):

- Categorical grants. This type of transfer is allocated by central government to subordinate administrations to perform strictly defined functions.
- Equalisation grants. As a rule, the purpose of these is to equalise various opportunities of regions with respect to tax collection and non-budget revenues of the regions.
- Stimulating (shared) grants. This type of transfer is established by central government to co-finance various kinds of local activities according to their priorities. The final objective of this transfer is to stimulate local authorities to increase regions' potential in the collection of budgetary and extra budgetary revenues

In fact, the system of budget transfers in the Kyrgyz Republic currently is represented by two types of grants– categorical and equalisation. The Annual Law on the Republican central budget determines the targeted use of categorical grants. It is recognised that improvements in the public health and education sectors are priorities in the Republic. Therefore, the Ministry of Finance has allocated categorical grants to oblasts to finance the education and health care agencies in the oblasts.

In the case of equalisation grants, the ways in which they are used are currently determined directly by the local administrations according to their own decisions and priorities.

The transfer system in the Kyrgyz Republic was introduced into the budget in 1997 and was based on the basic principles of acknowledged global practices for each component of the system of intergovernmental finance. The principles are:

- Transparency
- Objectivity
- Stability
- Non-agreement basis.

Currently, the models for the computation of categorical and equalisation grants have been developed and are used successfully. The models represent progress from a situation whereby the discrepancies in revenues varied from region to region and discrepancies were eliminated by state subventions or other transfers. In the 1998 budget, a grants calculation model was based on statistical and socio-economic factors.

Table 2
Grants and Local Budget Revenues Structure, %

	1997	1998	1999	2000	2001
Total Revenues	100	100	100	100	100
Grants	46,2	45,6	47,5	34,3	37,8
Categorical Grants	41,1	36,0	35,7	28,5	33,8
Equalisation grants	5,1	9,6	11,8	5,8	3,8

Source: Ministry of Finance

According to the “Republican Budget Law of the Kyrgyz Republic for 2001” the categorical grants are allocated for the financing of priority areas in the education and public health sectors. The Ministry of Finance recommended to the local governments that they allocate the categorical grants primarily to budget protected economic items (salary, deductions to the social fund, grants, medication and food).

In 1997 categorical grants supplied 87.5 per cent of the local budget expenditure on salaries; in 1998 the figure was 83.6 per cent and in 2001, 68.9 per cent was allocated.

13.6.2 Grants as an additional source of revenue for local budgets

13.6.2.1 Role of grants in local budgets

In many countries, grants are connected to government policy, for example to increase living standards of poor regions or to increase regional development etc. The ideal is that the grant share in the regional budget should be small. However, in the Kyrgyz Republic the share of categorical and equalisation grants in the regional budgets is about half of the total *oblast* revenue.

13.6.3 Allocation principles of intergovernmental transfers

Categorical grants, as a component of intergovernmental finance, between state authorities are intended to finance priority areas in education and public health sectors and also to maintain minimum standards for these services. Categorical grants are financial resources allocated from the Republican budget to cover expenses in the social sphere (education and public health sectors).

In 1998, in the Law on the Republican Central budget, it was recommended that local administrations use financial resources from categorical grants financing the priority directions in education and public health sectors. The pool for the categorical grants is determined from the forecast of the republic's budget, which remains available to Government; and priorities for education and other public expenses. Currently, the process of grant allocation for each *oblast*, according to the formula, has provided objectivity and transparency of the system. As the most objective parameter for the formulae determining the size of the grant for both the education and health sectors, it was decided to take the population size of each region. For categorical grants, for education, the number of pupils in secondary schools and boarding schools is applied, together with the following criteria:

- Age break-down (this takes into account that the education services for junior schools costs less than for senior schools);
- Location of establishments (in villages, maintaining schools is more expensive than in urban areas because of the distance factor, also, in high-mountain areas maintaining schools is more expensive than in flat, valley areas because of the increments to wages in high-mountain areas).

For each age group, there is a special coefficient, the value of which depends on the cost factor. The number of pupils is multiplied by a coefficient, the result of which is a weighted number of pupils in each region. The size of the pool for categorical grants for education is determined by the Ministry of Finance. Allocation of the pool is based on the weighted number of pupils in each region.

To define the size of the grant for financing health sector expenditures at the local level, the total number of inhabitants must be taken into account. In this case, the degree of differentiation is larger than in the education sector.

First, because the population of each region is divided into 19 age groups, each of which is given a coefficient dependent on the cost of public health services for that group. The most «expensive» from this point of view are those aged 60 years and over and children less than one year-old. The coefficient is determined by a methodology developed by the Ministry of Health and the “Manas” group. These two institutions are reforming the public health sector in our Republic. A similar approach (per-head allocation) is currently used to identify the amount of funds to finance the Family Group Practices (reps) that are operating in the majority of areas in the country. The second factor is the distribution by place of residence (urban, village, high-mountain population) to which coefficients are also applied.

Multiplication of the number in the individual age groups by a coefficient yields the weighted population of each region. This weighted population number is the basis for the calculation of categorical grants for the health sector. It should be noted that, under this approach, the *oblasts* with approximately the same number of people, but with a different age structure, have completely different values for the weighted population. Therefore, the size of grants varies. At the same time, an equal amount of financial resources is allocated from the central budget for each person in the weighted population.

13.6.4 Grant allocation in the education sector

The principles of the categorical grants calculation for education, in contrast to the public health sector, is based on the number of registered pupils, and on weighted factors used for various age groups, for the determination of appropriate expenses for education. The most important factor in categorical grants calculation for education is the number of senior age group pupils, as their education takes the greatest share of total expenses and they have more expensive educational materials.

13.6.5 Grant allocation in the health sector

The method is based on population with weighted factors used for various age groups to determine the appropriate expenses on public health services. One of the primary factors in the formula is the number of new-born children and senior citizens living in the various regions of the Republic because the largest portion of medical expenses is spent on these vulnerable groups.

Advantages of the categorical grant calculations through the formula are:

1. The Republican resources to finance priorities in public health and education are allocated on an objective and transparent basis. Although, as mentioned above, the Law on the Republican Budget recommends that local administrations use the categorical grants to finance their priorities for the health and education sectors, the local levels use the grants to finance protected items,

namely wages and social fund contributions. This is firstly because of insufficient local budget revenues, which fail to cover all current expenses. Secondly, it is because of commitments by the local administrations to meet the conditions of protected items financing. Thus, the technique of categorical grant calculation conflicts with the actual use of them.

In previous times, when the above mentioned expenses of the *oblast* administrations had been funded from the Republican budget in the form of subventions, the calculations of the amount of transfers did not present any difficulties and did not require the use of a formula. The situation has changed in two respects: (i) reduction of central budget resources because of the increase in obligatory payments (debt service and other) and (ii) changes in budgetary policy (the reorientation of directions of expenditure not by items of economic classification, but by government priorities). Therefore, the need for the development of a new methodology for transfers for *oblasts* has arisen. The total amount of financial resources allocated for categorical grants does not cover the needs of the *oblasts* to fund the protected economic items. Therefore, an objective criterion is necessary to allocate resources to the regions. The population factor used in the budget practice in the Kyrgyz Republic meets the criteria of objectivity and transparency in the allocation process.

2. Local financial departments, with the data of the medium-term financial forecast (total sum of means allocated for categorical grants in a medium-term prospect) can calculate a forecast of grants for the regions.
3. This technique of grant calculation is a first step in the transition towards demand-side budgeting, instead of supply-side budgeting. Under traditional budgeting, the first step is to identify the number of establishments located in the region and the number of employees to be paid from the budget and other charges. In this case the resources to cover these expenses depend on standards and norms. This means that the size of the required funds is calculated on the quantitative parameters of existing establishments such as the amount of beds in hospitals and number of classrooms etc. The qualitative parameters (such as efficiency in the use of resources and whether there is a demand for the number of establishments with their capacities) are not taken into account. The technique of categorical grants calculation enables more effective financial resources allocation based on the valid needs of regions for education and public health sector services, in terms of the number in certain categories of the population requiring such services. The population needs for specific services should basically define the volumes of financing directed towards the provision of these services. Certainly, the needs for services are not expressed only as a parameter of population, but as already mentioned, are a first step in the change of the budgeting technique. Also, local authorities can already allocate the received resources according to the specific needs of the region.

A further positive factor in the technique of grant calculation is the following. The technique meets the requirements of the reforms currently being implemented, in particular in the public health sector. The health sector is in the process of rationalisation of medical establishments. This will be carried out on the basis of an analysis of the number of people in the region and its needs for specific kinds of services, the number of establishments in the region delivering these services and the efficiency of the use of their capacities. Similar work has begun in the Ministry of Education within the framework of the development of the education sector project. The technique of categorical grants is oriented on rationalisation and increased efficiency of public service institutions, as categorical grants cover about 90 per cent of local budget expenditure for education and health. The new technique of grant calculation will ensure an increase in the efforts of local authorities in the optimisation of the structure of institutions and increase the efficiency of the use of limited financial resources.

It should be noted that the principles of categorical grants allocation on the basis of formulae are used only between *the Republican budget* and *oblast* levels. The oblast financial departments allocate resources on the basis of their own needs and priorities. At the same time, the dissemination of the practice of grant allocation on the basis of formulae could have positive effects. This will enable the *rayon* financial departments to plan resources to fund the social sector.

13.6.6 Existing problems

13.6.6.1 *The statistical factor in the use of the grant calculation model*

The main problem with the existing grant calculation model is the use of official data received from the Statistical Committee on population numbers and their ages and residences in the oblasts and the capital. Today the only source of information accessible to us is official information, which is not always reliable. About one million people, for example, currently live in Bishkek. Official data for the population of Bishkek city as of January 1st, 2001 is only 708.3 thousand.

13.6.6.2 *Delayed grants transfer from the Republican budget*

As a result of the difficult financial and economic situation of the Republic, the Ministry of Finance during 1998–1999 did not fully finance the categorical grants. The reason for this was the deficit in budget revenue.

13.6.6.3 *Non-purpose use of grants*

The Accountancy Palace inspects the correctness of categorical and equalisation grants use, in institutions of the education and public health sectors. The results of inspections in these institutions reveal cases of delayed and incomplete grant allocation for the salaries of teachers and doctors and also their incorrect use.

The facts revealed that the grants had been used on travel, transport and miscellaneous costs.

13.6.6.4 Delayed reallocation of grants at the local level

The cases of unreasonable delays in categorical grants allocation were admitted. The reasons for the delays in grants allocation to budget institutions are connected to the unavailability of cash in the banks.

This analysis can be related to only one type of transfer– the categorical grants. In the case of equalisation grants, the size of each region was determined by the difference between planned expenditures and revenues in the region.

13.6.7 Equalisation Grants

13.6.7.1 The purpose of equalisation grants for local budgets.

Equalisation grants are intended for the horizontal alignment of revenues between local budgets. They are introduced for local government stability in financing services, which are important for the region's population. These services involve social sphere expenditures and maintenance of social and economic and other services, which are not covered by categorical grants.

13.6.7.2 Equalisation grants allocation in oblasts

The *oblasts* have divergent capacities for tax collection and expenditure requirements. Those in more favourable situations will receive limited or negative equalisation grants and the poor oblasts will receive a large part of the grant pool.

The equalisation grants for 1997 were calculated as the balancing budget revenue item necessary for oblasts to cover their planned expenditure. Therefore, the higher the *oblast's* own revenue collection from tax revenues and categorical grants allocation, the lower the required financial equalisation. In 1997, only three oblasts had equalisation grants, while the other four oblasts had to deduct from their own resources to remit to the central budget. As a result, the central government transferred sums from taxes and categorical grants allocation to four oblasts, which, in turn, transferred back to the central government a certain amount. The ideal is that the size of tax and categorical grant allocation should be calculated so that there is not a negative equalisation grant.

In the 2001 budget, the equalisation grants were planned to reach 194.3m, some reaching 5.7 per cent of total local budget expenditures. This is because local budget expenditure continues to grow faster than revenues.

The most serious disadvantages of this mechanism are that the local authorities rely on this Republican budget source to cover their deficits. This results in reduced initiative from the regions to increase the local budgets' own revenues (or reduce budget expenditures by increasing the efficiency of public service institutions). In

many countries, equalisation grants are calculated on the basis of the difference in the tax burden per head, the difference in living costs and the difference in income per head. These factors are objective derivatives of the social and economic development of regions, and financial resources allocated to local governments by central government have to equalise these differences. It is probable that the international practice of application of the above mentioned or similar parameters in grant calculation will be acceptable in the Kyrgyz Republic budgetary process.

The development of the formula to calculate equalisation grants is currently important because there will be a tendency for discretionary resources to decrease in the Republican budget over the medium-term time frame. This will decrease the size of the pool for equalisation grants. In this case, the government's needs for additional funds to cover their budget "deficits" will exceed the available funds from the central budget. To increase the objectivity and transparency of the allocation, it is necessary to use objective factors to calculate and allocate budgetary resources under the equalisation grants. The use of parameters related to the living standards in the regions would approximate more closely to the ideology of equalisation grants. The development of a formula for equalisation grant calculation, on the basis of factors related to standards, instead of the need to maintain service-providing institutions, will help develop the local administrations to implement measures to rationalise these institutions, the numbers and other relevant expenses.

Other important disadvantages of equalisation grants, as they currently function, include the existence of "negative" equalisation grants. The *oblasts* which receive more revenue than required to cover budget expenditures as a result of the activity of enterprises and categorical grants, transfer the surplus to the central budget. Thus, for these *oblasts* there is a counter flow of financial resources: from the Republican budget to the local budget and vice versa. This unnecessarily complicates the process of flows of financial resources. Secondly, it creates a significant level of uncertainty for the Republican budget, because in most cases, it is difficult to obtain these "surpluses" from *oblasts*.

In most cases, the main source, which the *oblasts* use to accumulate financial resources to transfer to the Republican budget, is the land tax, which has the following features. The first is the seasonal tax collection and the second is the unpredictability of planned tax collection. One of the ways to solve this problem is to introduce for such *oblasts* an adjusting coefficient (in part of reduction) for categorical grant allocation. In this case, the *oblast* does not receive equalisation grants, but all revenues collected in the *oblast* (minus Republican budget shared taxes) are used for the needs of *oblast* budget organisations. This practice is already applied in the Republic and it has reduced the number of regions having negative equalisation grants from 4 in 1997 to 1– Chui *oblast*– in 1998. The second way to solve the problem is not in a framework of transfer relations but an

individual approach to identify the share of shared taxes, at least for oblasts with “negative” equalisation grants.

13.6.8 Monitoring the use of grants from the republican budget

13.6.8.1 *The control of timely transfer and receipt of categorical and equalisation grants*

The functions of the financial control departments of the Ministry of Finance are directed at timely, categorical and equalisation grants allocation. Since the introduction in 1997 of the grant system, the Ministry of Finance finances the salary payments in the education and public health sectors through the local financial departments, based on monthly revenue receipts. According to the procedure, the Budget Division gives the order to the Treasury on grant transfers to the regional branches of the Treasury.

13.6.8.2 *The control of categorical and equalisation grants use*

The oblasts financial departments submit reports to the Treasury monthly on the allocation and use of *categorical and equalisation grants*. The results of an inspection of grants allocation and use in local budgets in 2000 are shown below.

Non-purpose use – total – 5 per cent;

Non-purpose use – *categorical* – 6 per cent;

Non-purpose use – *equalisation grants* – 0 per cent.

Another element of the intergovernmental finance system, the main objective of which is to stimulate initiatives by local administrations to develop their regions and increase the revenue mobilisation, is stimulating grants.

These grants are included in the Basic Principles of Budget Law of the Kyrgyz Republic. Under the Law, the matching grants are financial funds from the Republican budget allocated to stimulate the efficient use of budget resources, to increase local revenues and to mobilise local sources of revenues. The objective is to support the initiatives of local authorities to develop activities in the area of capital investments, or other measures that strengthen and expand the oblasts’ fiscal base. The Republican budget can partially finance these activities. The share of the Republican budget in financing such expenditures can be determined on the basis of the following factors:

- The degree of necessity to perform the given measure in the region;
- Expected efficiency of the measure (from the point of view of its influence on the budget revenues);
- The level of regional development.

The introduction of these transfers in the practice of the Republican budget is blocked by the availability of budgetary resources, which have been limited over the past few years. Nevertheless, an analogy of such transfers nowadays is several

Public Investment Programme projects based on the communal approach. The essence of such projects is that they are developed in a certain region under conditions of both its expediency and efficiency, and the local authorities project co-financing. With co-financing of less than 10 per cent of the general expenditure, it is less than the prospective benefits from the project for the population of the region in social and economic aspects. The negative side in this kind of stimulation of local government initiatives to mobilise their own resources and expand the revenue base, is as follows. Although the Public Investment Programme includes projects for the development of national priorities and terms of the loan are soft, the investment credits represent a large debt burden for the Government. This requires strict efficiency criteria in project selection. Financing the priority projects from internal sources of the Republican budget can increase the efficiency of the measures performed. Therefore, the issue of establishing a fund for matching grants allocation could be based on the availability of domestic resources. One of the variants for matching grants allocation could be the reallocation of the equalisation grants pool into the matching grants pool. However, this decision should be approved only on the following basis: (i) analysis of the situation in the regions; (ii) a study of all the possibilities for expenditure optimisation; and (in) a financial analysis of the project's efficiency, offered by local authorities and aimed at expanding the revenue base of the regions or improving the social and economic situation in the regions.

13.7 Financial / Fiscal Supervision: Rights and Duties

13.7.1 Budget Expenditures Control

A Debit Slip System had been implemented in order to strengthen financial control over the spending of budget funds and to eliminate the misuse of budget funds, and make civil servants more responsible for the distribution of financial resources. This system is based on allocating budget appropriations to ministries, administrative agencies, government commissions and committees, and other organisations and institutions financed from the state budget, in accordance with approved marginal expenditures (limits) defined for ministries and agencies by the budget. The system has been implemented in all organisations and institutions financed from the budget at the beginning of the 1998 financial year. However, in September 1998, because of the crises in Russia, the operation of this system was suspended. The Ministry of Finance intends to make it operational in the near future.

13.7.2 Improvement of the Government Audit System

The implementation of the "Government Audit" component included the following:

- Identification of the measures necessary to improve the accounting system and financial management of the government audit of the Kyrgyz Republic (legal framework, organisational structure, staff, effectiveness in improving the accounting system and financial management).

- The specification of the Chamber of Accounts and State Financial Inspectorate mandates, in order to provide the government audit with an appropriate legal framework, and to minimise functional duplication (provide recommendations on the division of the state audit mandate between the Chamber of Accounts, the State Financial Inspectorate, and the Internal Audit Division of the Ministry of Finance).

At the moment, there is only one governmental financial control organisation– the Chamber of Accounts. It has extensive legal power and financial budget support to strengthen the control function of the government.

13.8 Conclusion

13.8.1 Recommendations

The existing model of grant calculation should be modified in the following ways:

- To calculate the cost of expenses in the education and public health sectors for types of programmes and options for programmes covered by categorical grants.
- To disseminate the practice of categorical grant calculation on the basis of population and pupil numbers to the level “oblast-rayon” based on initial principles of allocation. The categorical grant allocation on a basis of “per-head” meets the requirements of public health sector reform which is carried out at all levels.
- To expand the model of the intergovernmental expenditure financing to the rayon level. To define bases of tax allocation between central and local governments based on the formula.

The equalisation grants calculation should be made according to specific criteria.

Those *oblasts* whose expenditures exceed total revenues need to develop progressive directions on budget expenditure reduction. Ideally, the sizes of tax allocations and categorical grants should be calculated so that in no oblast is there a negative equalisation grant.

It is important to analyse the necessity of the equalisation grant formula, which equalises “income per-head” of the region’s population.

To assure a gradual reduction categorical grants allocation to local budgets:

- Develop a model of matching grants allocated to increase local government initiatives in capital investments and expansion of revenue sources.

The grants have a negative effect on the economic growth of a region. Therefore it is important to:

- give independence to local governments to mobilise their own sources of financing.
- increase the interest of local budget holders in revenue collection.
- provide ad hoc incentive grants as a stimulus for local governments to increase local revenue collection.

14. Decentralisation and Structural Adjustment in Hungary

*József Hegedüs**

14.1 Introduction

Hungary has gone through a radical structural change after the fall of the socialist block in Central and Eastern Europe. Two basic processes dominated the transition: privatisation and decentralisation. The Hungarian experience has demonstrated that political decentralisation of the state sector can have a substantial contribution to an efficient economic adjustment in a transitional recession. Local governments under fiscal pressure, enjoying broad expenditure autonomy, have chosen the level and the form of public service provision which resulted in huge advantages both at macro and micro level. However, the Hungarian experience shows that political, fiscal and administrative decentralisation is a process with conflicts between different stakeholders. The sector ministries, the local government associations, different types of local governments (small towns, big cities, the capital Budapest), and sector business groups (such as service providers) have different interests in intergovernmental relations. The process of decentralisation has not been completed and in certain areas, a move towards centralisation can even be detected.

The process of Hungarian decentralisation has been burdened with several conflicts related to the usual weak areas and sensitive points of intergovernmental relations: fragmentation, unfunded mandates, unclear expenditure assignments, moral hazards, incentives and deficit grants, equity issues and equalisation grants, etc. Badly designed instruments (grants, laws, etc) have incurred a social cost on transition, but this has not outweighed the benefits of decentralisation.

The three key elements of the process are: 1. the democratic election of the local self-government; 2. substantial expenditure responsibility and autonomy; and, 3. hard-budget constraints on the independent local budgets.

In Hungary, from 1990, the law has provided these key elements of successful decentralisation. Local government's expenditures have been reduced by 10 per cent in real terms between 1991 and 2000, while the level and the scope of services provided has not been decreased. However, the country missed important elements of a well functioning system, including a trained central and local administration, a modern accounting system, a tradition of public participation, a well developed statistical system, institutions of objective auditing, local budgetary and financial management practices, etc. Hungary has learned a lot in the

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past 10–12 years, and it is time to start a modernisation of intergovernmental fiscal relations based on the experiences and the expectations of the EU accession.

14.2 Decentralisation: The Local Government System in Hungary

14.2.1 Legal and political framework

The development of local public administration in East-Central European countries started out from the soviet “council” system. Behind the formal, very centralised structure of the councils, the real power lay in the hands of the communist party, which had the same regional administrative structure as the council system. The formally (not in a democratic way) elected bodies did not have real power over the executive organs.

The reform of the Hungarian local government system began in the middle of the 80’s. Before 1986, the distribution of investment funds to councils was not based on an objective evaluation of local needs and capacities. Instead, negotiation and political influence at the central, county and district¹ levels determined the revenues and expenditures allotted to each council. Many principles of financing municipalities were established in the second half of the 80’s. However, the reforms of the 1980’s took place in an institutional and political environment which did not allow moving towards political decentralisation (political accountability of the elected bodies to their constituency) and thus an economically more efficient system.

The 1990 Local Government Act reflected the political collapse of the former system; a new democratic system was introduced which gave the right to every settlement, even to the smallest, to set up a municipal government to manage its own affairs. The new system is a unitary government with a two-tier sub-national structure, where the municipal government provides services at settlement level, and the county government does so at the regional level. County governments have no authority over municipalities; they are self-governing units with different responsibilities. The basic rights and power of local governments are exercised by an elected council. The council establishes committees with special rights. The directly elected mayor is the head of the office with two functions: execution of council decisions and performance of delegated state tasks. Major administrative functions are managed by the chief administrator (notary). The Local Government Act decrees that towns, cities, the capital and its districts, as well as counties, have equal rights as local governments.

Since 1990 the number of local governments has doubled to 3,154 (1999) from 1,523, as many of the local councils broke themselves up into discreet units.

1 Districts (*járás* in Hungarian term) were abolished in 1974.

This was a political reaction to the forced amalgamation policy of the 70s. The 19 counties, the middle tier, which used to be one of the strongest power centres, still exist, but their responsibilities have been scaled down. The counties are now parallel authorities and unrelated to the localities. The local governments in Hungary have an average of 3,482 inhabitants, quite far from the average of 10,000 considered to be “optimal”.

Budapest, as the capital of Hungary, has 19 per cent of the country’s population, and accounts for one-third both of GDP and capital investment. This role has been recognised in the law, which has defined special procedures for revenue allocation. The local governments of Budapest dispose of joint revenues which have to be allocated between the Municipality and the districts according to expenditure needs. The central government established a general guideline for revenue division among these local governments, but passed on the responsibility to the Municipality of Budapest to set up a revenue allocation system in the Capital. (Balás-Hegedüs, 1999).

The government is currently discussing the future of the regions. Today there are seven statistical regions, and seven Regional Development Councils with limited authority. There is a four-year program for regional reform, which would lead to the creation of seven regions with elected councils. One option would be to create a regional structure which would be a new tier of the government (locally elected level of government). One of the purposes for creating regions is to be able to channel EU structural funds. However, in the case of the creation of regions, there is the question of the continued existence and role of the counties.

14.2.2 Expenditure assignment

The size of the overall public sector is large in Hungary, compared with other European countries. General government expenditures (including social security) were about 51 per cent of the GDP in 1995 (10 percentage points lower than in the early 1990s), and 43 per cent in 2000. The plan is to reduce it to 40 per cent by 2003. Local government expenditures have decreased from 16.5 per cent of GDP to 12.8 per cent in the period 1993–2000. In real terms, their expenditures have decreased by 20 per cent.

The Local Government Act of 1990 transferred a number of important public functions to lower tiers of government. Some tasks are defined as **mandatory**: provision of safe drinking water, kindergarten education, primary school education, provision of basic health and social welfare needs, public lighting, maintenance of local public roads and public cemeteries and the enforcement of the rights of national and ethnic minorities. The law defines the tasks of the local governments in a fairly vague way. They are basically shared responsibilities because both the legal and financial aspects of these services are highly influenced

by the central government. The services can be classified according to the level of revenue and expenditure autonomy of the local self-governments.

The largest expenditure category is education, where local governments, as the service providers, have a wide range of expenditure responsibility, including the possibility to cease providing services. Educational expenditures account for one-third of the total expenditures. Primary education is mandatory for all localities. Secondary, technical, and vocational schools, while not mandatory, are typically financed by county governments or larger towns. The second biggest item is the health sector (one fifth of the total expenditures), but LGs act as agents of the National Health Insurance Fund in providing health services, including hospitalisation— in the larger towns. Services are determined by the national government, and local governments are reimbursed for the cost of providing services and medicine. Investment outlays are also a local responsibility, although financial support is available from central investment grants. With the transfer of communal housing and other assets to localities, maintenance of housing and properties has become a local responsibility. Considerable responsibility for administrating social welfare and several forms of social assistance has also been delegated to localities through the Law on Local Self-Government and the more recent Law on Social Assistance (1993). Responsibilities include the management of long-term social care facilities, such as homes for the elderly and for the handicapped.

There is a good deal of flexibility in service delivery. The law has not defined either the minimum service delivery requirement, or how local services are provided. There are different institutional options for service delivery. The local government non-budgetary institutions have a significant role in the local government finance system. The various other forms include local government owned public companies, limited liability or shareholder companies, NGO's founded by local governments, and private companies owned partly or regulated by local governments. They generate off-budget expenditures and revenues as well. The size of the off-budget revenues is estimated at 10–30 per cent of the total local government budget. (Hegedüs, 1999). According to a recent study, local government owned enterprises have a net turnover of 40 per cent of the local government total expenditures. (Hertelendi-Koppányi, 2000)

The definition of tasks in the Law on Local Self-Government gives wide scope for local governments to define the quantity and the quality of the services, as well as the way to organise them (contracting out, privatisation, public-private partnership). This feature of the law and the flexible revenue structure make possible, adjustments by the local government. There are some exceptions to this, e.g. health care, and fire protection services.

The freedom of expenditure decisions, which is not always welcomed by the representatives of the central government, is influenced by the sectoral legislation and the supporting grants system. The sector laws redefine the local government

tasks. The interest of the sector policy makers to increase their share in the budget plays an important role in proposing modifications to the sector laws. For example, the “Water Lobby” fights to redefine the waste water service as a mandatory task, which – probably– would mean that the central budget should finance the investments in the waste water treatment plants under the supervision of the sector ministry. This is an example where the sector ministry cooperates with the local governments to achieve its particular interest against the other sectors.

The mandatory and optional tasks of local governments were defined in the Act on Local Governments but they are continually being modified by the latest laws and regulations: Act on the Budget, Bankruptcy Act, Social Act, Housing Act (arrangements for required investments), Act on Public Education, etc. A “quiet” reform is taking place in public finance.

Sector laws could redefine the local government tasks in other ways. For example, the proposal for the Law on Waste Management (to be discussed by Parliament in 2003) intends to take the waste management for business units out of the hands of local governments. This could cause a financial problem for local governments as they would lose the advantages of “economics of scale” and the possibility of cross subsidy.

Table 1
Expenditure responsibility (1999)

	Share in the local expenditures
General Public Services	14%
Defence	0%
Public Order and Safety	1%
Education	33%
Health	19%
Social Security and Welfare	16%
Housing and Common. Amenities	9%
Recr. Cultr. Relig. Affairs	5%
Fuel and Energy	0%
Agric. Forestry. Fishing. Hunt	1%
Mineral Resource	0%
Transportation & Communication	1%
Other Economic Affairs & Services	1%
Other Expenditures	1%
Total	100%

Source: OECD Hungary, 2001

Housing is another example. In developing the new housing policy in 1999, the central government wanted to give more responsibility to local governments to manage the housing subsidy program. The proposal would have given a matching block grant to local governments for support in the local housing sector. During budget negotiations, the local governments rejected this proposal arguing that they did not have own resources to supplement the central grant.

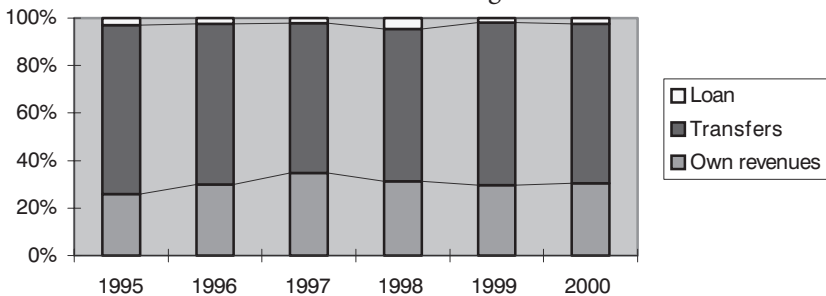
In 1995 the central government (which sets general policies in the area of social expenditures) decided to reform the health delivery system and to reduce hospital capacity to around 10,000 beds, as a first step towards rationalisation of the supply of curative health service. However, the local governments are the owners of several hospitals, therefore, on constitutional grounds, they are the only ones who ultimately have to approve the reduction in the number of beds in their own territory. The local governments and management of the hospitals have resisted the closure of hospital beds, creating a delay in the reduction in hospital capacity (Lutz, et al, 1997, p 164). However, the real reason for that behaviour was the lack of incentives, as the local governments had a very limited expenditure autonomy in the hospitals and the “political cost” of cost reduction could not lead to a financial benefit.

14.2.3 Revenue assignment

The Local Self-Government Act provides for a range of revenue sources to finance local government functions. The **local revenues** (accounting for 26–35 per cent of total revenues in the last 5 years) include: five *local taxes* (tax on business, tax on plots, tax on buildings, tax for communal services, and a tax on tourism), *user charges*, and revenues from entrepreneurial activities, from the disposition of rental and commercial properties, and from assets.

The **central government fiscal transfer** (accounted for 63–71 per cent of total revenues) includes normative grants, and several targeted matching and non-matching grants for investments.

Table 2
The revenues of the local governments



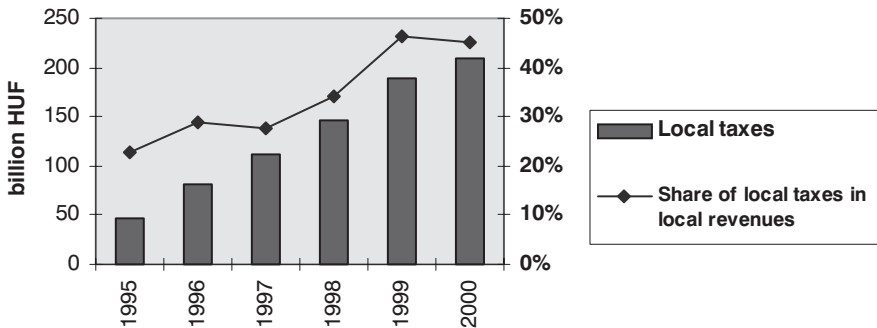
Source: Ministry of Finance

The local government can **borrow** to finance investments and to meet overdrafts or budgetary shortfalls. Its share has not become substantial. The structure of revenues (share of own revenues, transfers, and loans) proved to be quite stable in the last 5 years, while the whole intergovernmental fiscal system – as we will show – has been modified frequently.

14.2.3.1. Local taxes

The Act on Local Taxes defines the municipal taxes. The 1990 Act assigns five taxes to local government: i) the business tax; ii) the communal tax (i.e., a poll tax and/or payroll tax); iii) the urban land tax; iv) the property tax on buildings; and v) the tourism tax. In practice, local governments must decide, at their discretion and by resolution of their respective councils, which of these taxes they want to levy in their jurisdictions. The respective tax bases and the ranges for tax rates are established by the central government (CG).

Table 3
Local taxes in own revenues



Source: Ministry of Finance

The number of municipalities that levy at least one of the local taxes has increased each year. In 2000, 94 per cent of municipalities levy at least one tax, compared to 73 per cent in 1996. The two taxes which are most commonly levied are the business tax (2,226 municipalities) and the communal tax on private persons (more than 1,800 municipalities).

Table 4
Local taxes collected by Hungarian local governments, 2000

Tax type	Number of local	tax revenue	
	governments	amount (billion HUF)	proportion (%)
Property tax housing	296		
non-housing	687	21995	9,9%
Land tax	380	3 001	1,4%
Communal tax private	1 858	4 423	2,0%
corporate	764	1 175	0,5%
Tourism tax	541	2 717	1,2%
Business tax	2 226	188 623	85,0%
Total	2 970	221 934	100,0%

Source: *egovernmnet.hu*

Note: * The two types of taxes on structures taken together

Business tax: The business tax is a gross turnover tax levied on manufacturers. Retail sales are not covered by this tax. The maximum rate is set by the CG. The business tax may be levied on all enterprises, public and private, on gross sales revenue net of the VAT and other consumption taxes. **Communal Tax** can be levied on household dwellings (owned or rented) and on businesses. The **land tax** applies to urban land only and is levied on the property owners of idle (unimproved) lots. Its maximum tax rate is Ft. 200 per m², or 3 per cent on the “corrected value” of the plot. The corrected value is equal to 50 per cent of the “assessed value”, as determined by the local government. The assessed value is supposed to reflect the actual market value of land. Local governments can legally levy **property taxes on privately owned buildings**, such as flats, single family houses, summer cottages, garages, storehouses, workshops, and other residential housing. They can also levy taxes on commercial and industrial property. The tax may be levied on area size (m²), or on the assessed value of the property. The maximum tax rates as established by the Central Government are HUF 900 per m², or 3 per cent of the “corrected value”. The corrected value is defined in the same way as that which applied to the land tax, as described above. The current **tax on tourism** includes rents, guest nights, and summer cottages. The maximum rates as established by the CG are HUF 300 per night for guests, 4 per cent on the rental fee, and HUF 900 per m² for cottages.

The total local tax revenues are quite low, not more than **7.5 per cent of the central government tax revenues** (VAT, PIT, corporate tax and consumer tax) in 1999, 90 per cent of Hungarian LGs levied taxes in 2000, but the majority – that is 85 per cent – of the local tax revenues comes from the business tax. Generally local governments do not tax households, 6–8 billion HUF local tax is paid by

the household sector, which equals the amount the household sector pays for cigarettes (7.5 billion in 1998).

14.2.3.2 User charges, fees

User charges and fees are collected by local government institutions and public utilities, such as fees for meals in schools and nursery schools, fees for use of a public place, parking fees; however, the main revenues come from rents, user charges for garbage collection, gas and water supply. From the point of view of local government revenue structure, user charges and fees collected outside the mayor's office and the budgetary institutions are off-budget revenues and are not shown in the LG budget. (In this case there is only one budget item, a subsidy – if it exists at all – that relates to the charges.) So, for example, parking fees could be part of the LG revenues, if they are collected by the budgetary institution, or could be off budget revenues if collected by an enterprise owned by the local government and responsible for parking services. The organisational structure of service delivery defines how these data are accounted for.

Local governments have the autonomy to set their own user charges and fees for public services such as water, sewage, housing, district heating, and garbage collection. However, they have no discretion over setting fees in education, social and health services. User charges (for water, garbage etc.) are generally agreed upon by the board of directors of the different companies, public enterprises, or mixed enterprises, where the local government is the main owner or shareholder. In the case of services given in concession to the private sector, adjustments in charges follow a procedure set by law and are agreed with the local government. Therefore, in principle, local governments may recover the full cost of service provision.

14.2.3.4 Revenues from sales of local government assets

On the basis of Asset Transfer Law (1991), from the beginning of 1990 and through 1995, considerable assets were transferred to the local governments (LG):

- (i) primary assets necessary for the functioning of the local administration, basic education, health and social services, which may only be sold in a limited way;
- (ii) assets related to the provision of network and infrastructure public services;
- (iii) publicly-owned housing;
- (iv) other assets to compensate municipalities for original ownership stakes of former council companies.

It is not easy to evaluate the effect of the property transfer on intergovernmental fiscal relations. The assets transferred could be managed by off-budget institutions (limited liability companies, foundations, etc.), which could generate revenues spent on services outside the LG budget. For example, property managed by an LG owned company could generate revenue which could be used outside the control of the local government.

Table 5
LG revenue from assets in million HUF, 1995 – 2000

	1995	1996	1997	1998	1999	2000
Sale of physical assets	43,699	42,968	51,242	51,404	53,000	47,100
as % of total revenue from assets	63.0%	47.5%	36.1%	72.4%	75.7%	85.5%
Sale of shares	19,757	27,332	81,251	15,665	12,000	7,000
as % of total revenue from assets	28.5%	30.2%	57.3%	22.1%	17.1%	12.7%
From privatisation	5,938	20,064	9,258	3,969	5,000	1,000
as % of total revenue from assets	8.6%	22.2%	6.5%	5.6%	7.1%	1.8%
Total revenue from assets	69,394	90,364	141,751	71,038	70,000	55,100
as a % of the total own revenue	34.0%	32.2%	35.2%	16.7%	17.0%	11.9%
Total own revenue	203,946	280,706	402,218	424,718	410,693	461,850

Sources: Budget Laws

Revenues from local government property, as a share of total LG own revenues are substantial– 32-35 per cent– in 1995–97, however, with a decrease in 1998, showing that this was a “one time revenue”.

14.3 Intergovernmental transfers

Intergovernmental transfers provide about 65–70 per cent of the total LG revenues in the last ten years. The transfers are categorised in the budget as shared revenues, normative grants, earmarked grants (grants for theatres), special grants (deficit grants), etc. From the analytic point of view we can differentiate between the derivation based tax sharing and the different grants (which can be earmarked or not, allocated on a formula basis or ad hoc).

14.3.1 Shared taxes

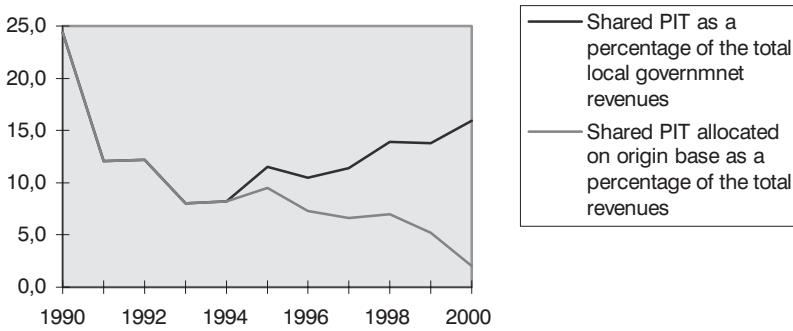
In establishing municipal revenue sources, two national taxes were designated for sharing: the personal income tax (PIT), the motor vehicle tax, and the tax on land rents. (From the analytical point of view, even the Duty tax can be classified as shared tax.)².

The PIT is shared, based on the locality of residence of the taxpayer, but is distributed with a delay of two years. The percentage share of PIT allotted to municipalities, and the rules for distribution are modified annually in the State Budget Law. In 1990, 100 per cent of PIT was allocated to municipalities; since then this share has been reduced to 40 per cent. Up to 1994, the full share of PIT

2 Duty fee was close to 40 billion HUF in 1998. The revenues were allocated to finance the county local government and the municipal government of Budapest.

was allocated directly on the basis of residence. Since 1995, the PIT has gradually evolved toward an additional form of normative grant and equalisation grant, with ever more complicated rules for its distribution and an additional share allocated to counties.

Table 6



Source: Ministry of Finance

Change of the significance of the Shared PIT in the LG revenues

The figure shows that PIT used to play a significant role in LG revenues, but its share decreased from 24 per cent to 2 per cent, which means that basically this type of transfer has been eliminated. In 2000, only 30 billion HUF was budgeted for shared PIT.

The reason for this change was – according to the official view– that PIT increased the horizontal inequity. But this seems not to be the whole explanation. The total expenditures of the LG sector have decreased by 10 per cent between 1991 and 2000 in real terms. To force LGs to adjust their expenditures, local governments which had more room for manoeuvring should have resources taken away. Transfers with derivation origin give less opportunity for central government to exercise fiscal pressure, and this was the main reason why the significance of the shared tax has been decreased.

The shared PIT always contained an equalisation part. Local governments having PIT revenue less than the minimum stated in the Budget Law received a **PIT supplement**. As this minimum was set quite high, most of the small local governments were eligible for this grant, which means that this is a *per capita grant for most of the local governments*. PIT supplement is given to the local government where the per capita value of PIT is less than 90 per cent of the average per capita. The amount of the equalisation supplement equals the difference between the local government per capita shared PIT and 90 per cent of the average per capita PIT multiplied by the population of the local government. The source

of this supplement was paid for out of central budget from the shared PIT until 1996. *The local governments above this ceiling are not equalised downward.*

The motor vehicle tax, which is, according to the tax law a shared tax, had a “piggy back” element. Local governments, at their discretion, can add a charge on top of the minimum level set by the central government, up to a limit. One-quarter of local governments use this option, representing more than 50 per cent of the population. The total revenue from this tax was 20.8 billion HUF in 2000.

14.3.2 Grants

The intergovernmental transfers consist of different types of grants. The grants vary according to allocation principles (formula or ad hoc), matching rules, whether they are earmarked or not, etc. In the budget under one heading different types of grants are included, which in itself is an indication of one of the weak points of the Hungarian grant structure.

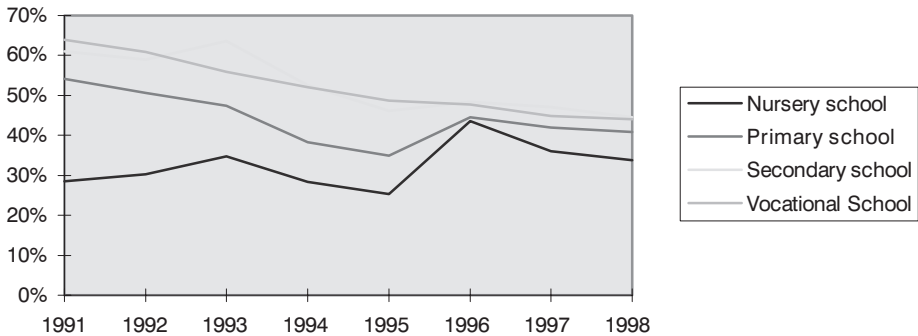
14.3.2.1 Normatives

The largest transfer from the central government to municipalities is the **normative subsidy**. The real value of the normative subsidy has declined over the period, as well as its share in local government budgets, from 42 per cent to 28 per cent of current revenues between 1993 and 1998. There are currently four types of normatives included within the normative subsidy: (a) per capita grants based on population, which are a proxy for service needs; (b) grants for core services, based on the number of beneficiaries; (c) capacity normative, such as based on the number of beds in homeless shelters; (d) matching grant for tourist tax.

The largest amount (two-thirds in 1998) of the normatives is distributed based on education criteria and the second largest for social welfare tasks. The criteria and types of normatives have been subject to annual adjustments. There was an attempt to simplify and reduce the number of normatives in 1995–96, but subsequent modifications have only further complicated the system. The calculation has become less transparent, with some elements of previous normatives currently distributed separately under the shared personal income tax.

Revenues of the normative grant are not earmarked in principle. But in the case of beneficiaries’ grants where the grant/cost ratio is lower than 1, the grant is earmarked. This is the case, for example, with the grant tied to education. Table 7 shows that the grant/cost ratio has been around 40–50 per cent. The normative grant system is calculated on the basis of estimated indicators of local needs mostly for the sectors of education and social welfare. Their value has come to represent less and less the cost of providing the services on which their calculation is based. Municipalities are required to make up the difference from other revenue sources, which ultimately reduces funds available for other priorities, and especially investment.

Table 7
Grant/cost ratio in education between 1991 – 1998



Source: Miklós Balogh (2000)

14.3.2.2 Earmarked transfers from central government

The amount of other transfers from the central government and the State budget has increased considerably over the period. Their share in total revenues has been within a range of 20 – 24 percent, and in current revenues, from 25 to 29 percent. The largest of these transfers is the **social security transfer** for health care, which is sent directly to the health care institutions.

The other earmarked transfers are a collection of a number of disparate grants, including the theatre subsidy, the municipal fire department subsidy, supplementary grants for education, the earmarked decentralisation fund, the deficit grant and centralised allocations.

Centralised allocations are an additional type of normative, earmarked subsidy which finances a number of specific tasks. These include ad hoc grants and matching grants, and the funds distributed in this manner are quite significant, 30 – 50 billion HUF. The targets are determined by central government or Parliamentary priorities for local government actions.

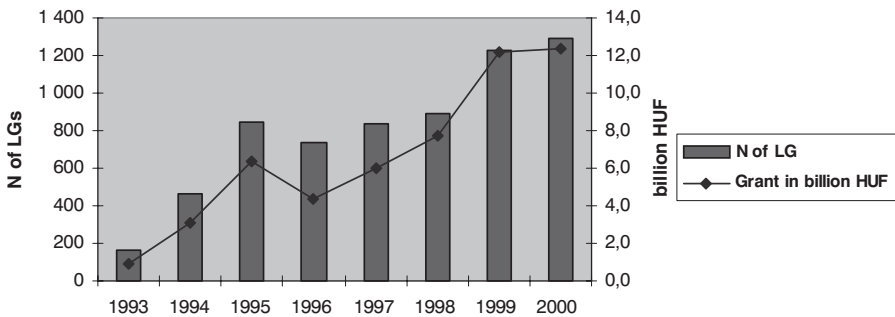
14.3.2.3 Equalisation grants

Horizontal equalisation is an important issue in the intergovernmental finance system. There is no standardised budgetary scheme to equalise the fiscal capacity and the expenditure needs of the local governments. However, there are several intergovernmental grants which have an equalisation effect more on an ad hoc basis. For example, PIT supplement (discussed above) from the beginning has been revenue equalising, while the normative based on general needs criteria or formula using fiscal capacity variable (as the social policy normative) – equalises the expenditure needs. In the case of the capital investment grants the equalisation is as important as in the case of expenditure finance. A specific equalisation

grant was used between 1991 and 1996 by the Ministry of Regional Development, but in 1996 it was gradually decentralised to the County Development Agencies.

In 1999 a new grant was introduced, “**grant to equalise fiscal capacity**”, which amounts to 38 billion HUF (1999) and 44 billion (in 2000). This grant basically works in the same way as the PIT supplement, that is, equalises the *revenue capacity* from the local business tax. It calculates the tax capacity of the local government and supplements up to a normative level. The norms were different according to the type of the settlements (villages 12,500 HUF, cities 16,500 HUF, county seats 17,700 HUF and capital (with its districts) 20,000 HUF). This grant basically neutralises the effect of the local business tax using a grant which is 22 per cent of total revenues.

Table 8
Number of local governments and cost of “deficit grant” program



Source: Ministry of Finance

Deficit grant is for “local authorities incurring deficits through no fault of their own”. The number of beneficiaries has increased rapidly over the period. In 1997 approximately 840 local governments (including a number of counties) received close to 6 billion HUF, compared to 1,289 local governments which in 2000 received twice as much as before, that is, 12.4 billion HUF. The distribution of this grant is based on revenue and expenditure estimates of the municipality, and its functioning both discourages additional effort to raise own local revenues, and rewards inefficient expenditures. The deficit grant in principle is a normative grant with objective criteria for allocation (not discretionary). But in practice the rate of acceptance is changing (both in terms of the number of applicants and the sum they asked for). In 1998, 50 per cent of the amount requested was transferred to the local governments.

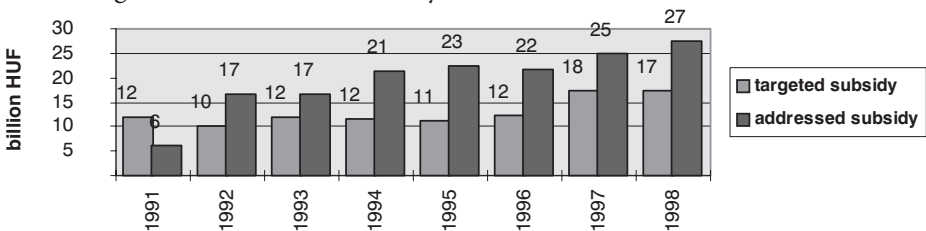
Budapest has more than two million inhabitants representing one fifth of the total population of Hungary. There are 23 districts and municipal governments with special revenue sharing procedures. The law on the capital (1991) and its amend-

ment (1995) regulates a quite **radical revenues sharing procedure**. (Ebel. – Simon, 1995) The Municipal Government and the district government with regard to their municipal rights are equal. The capital municipality is responsible for performing duties which concern the whole city (urban transportation, urban planning, public works and housing policy). The municipal government, however, has neither a regulatory nor supervisory role over how districts perform their own duties. The Act on the Capital defines the revenue sources which have to be distributed among the Municipality and the districts: 1. PIT; 2. normative grants based on the total population; and, 3. local business tax. The fiscal need is measured by the service level and its normative cost estimates, and the revenues as user charges, central grants tied to the services. In 2000, the total revenue redistributed is 52 per cent of the total operating costs in the case of districts, and 46 per cent in the case of the Municipality. (Balás-Hegedüs, 2000) The effectiveness of resource reallocation is put into question by the uneven distribution of the property stock (the latter is not subject to redistribution, although a version of the capital act would have ordered the redistribution of the yield of properties), and the strikingly uneven geographical distribution of capital investment, which is not part of the equalisation procedures.

14.3.2.4 *Investment grants*

Addressed and targeted subsidies increased to 52.3 billion HUF in 2000. These subsidies support municipal investments in priority areas, identified by Parliament annually (clean drinking water, sewage, education and health care), though in very different forms. In case of targeted subsidies the share of subsidy – as a percentage of total investment costs – is set in each specific target area while addressed subsidies are discretionary decisions and often provide nearly 100 per cent financing. Addressed subsidies were originally introduced to finance the continuation or completion of huge regional developments (hospitals, waste water plants) that had begun before the new decentralised municipal system. These objectives seem, however, to have been modified and addressed subsidies have been granted for new investments too, making the program economically unjustified. The volume of the two kinds of subsidies is defined by the annual budget law.

Table 9
Targeted and addressed subsidy in billion HUF between 1991 – 1998

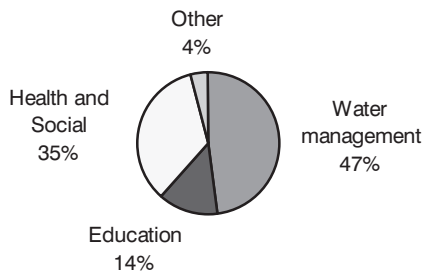


Source: Ministry of Finance

The targeted subsidy is a matching grant, where the matching rates are determined in the Law of Targeted and Addressed Subsidy approved by the Parliament. The supported programs and the matching rates have changed in the last years. In 1999–2000 the priorities are building waste treatment plant and sewage network (50 per cent matching rate), investing into solid waste landfill (40 per cent matching rate), buying special medical equipment (40 per cent matching rate), and reconstructing educational buildings (50 per cent matching rate). During the last years the water sector was the most important area for the targeted and addressed subsidy; 47 per cent of the grants were used in this sector.

Table 10

Distribution of targeted and addressed subsidy among sectors from 1991–1998



Source: Ministry of Finance

Separate funds of the sector Ministries are another source of investment financing. Since mid–1996, the **grants for regional development** are distributed through the County Regional Development Councils (CDC). Three types of grants are available to municipalities through the CDC's: regional equalisation grant, development subsidy and earmarked decentralisation fund. Local investment priorities are set by each development council.

14.4 Borrowing

14.4.1 Local government capital investments

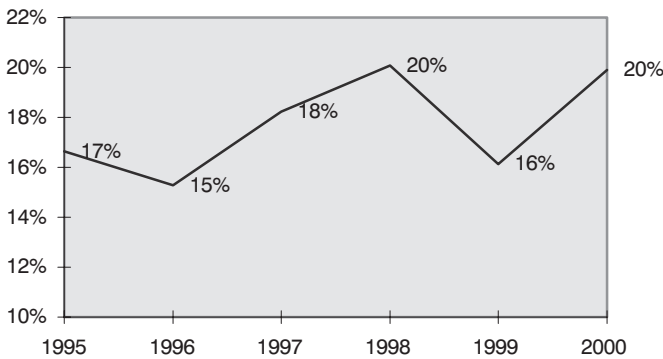
In 1990, local governments in Hungary became responsible for the investments in the areas they are responsible for according to the expenditure assignments. These represented huge investment needs in the areas of infrastructure and environment, especially with respect to EU accession. However, local governments had to make up for deferment in capital investment. Local government investments have remained quite stable over the last years, between 15–20 per cent of the total expenditures.³

³ In 1996, the lower level of investments can be explained by the “Bokros package” (austerity program), and the higher figure for year 1998 is explained by the election.

But because the local government share in the GDP has decreased, their investment share has decreased as a percentage of GDP, as well.

We have to note that “off-budget” local government investments are not included in Table 11. While local governments have spent 2.2–2.5 per cent of GDP annually on infrastructure investments, municipal public service enterprises have carried out investments of an additional 1.5 per cent of GDP. In basic activities, municipal companies’ investments accounted for 30 per cent of the total sector investment. In the Supplementary service sectors this proportion equalled 20 per cent. Companies in which municipalities have shares carried out investments in an amount of more than HUF 400 billion (nearly 5 per cent of GDP). Out of these investments 31 per cent was undertaken by gas and electricity companies and 38 percent by companies operating in other business services. Basic and supplementary public service companies invested nearly HUF 130 billion in 1997 (1.5 per cent of GDP). Within supplementary services, telecommunication accounts for more than half of the investments. In the case of basic service companies, the distribution of investments is more even within the various sectors. District heating, sewage and waste treatment take up on average 12–13 per cent respectively, water management and local transport account for 25–29 per cent of the total basic service investment. (Hertelendy and Kopányi, 2000)

Table 11
Local government investments as a percentage of total expenditure from 1995–2000



Source: Ministry of Finance

The main source of financing local government investments is revenues from property (sale of assets), the grant from central government, loans and “operating surplus”. Table 12 shows how the role of different financing sources has changed.⁴ Revenues from local government asset sales were the main source

⁴ The data do not show exactly the financing source for investment because some part of the revenues could be used for operating expenditures. But it shows the main trends.

during the years 1995 – 1997, accounting for 60 – 80 per cent of total investments. From 1997 its share has decreased. The second most important source is the capital grant, which accounts for 16 – 25 per cent of total investment. The data show some of the distortion in financing local government investments. First, property sales cannot be a long-term source, and as it was distributed unevenly among local governments, it contributed to the growing disparity among the different settlement types. Loans have a very limited role, which shows that the municipal credit market has not played the role expected.

Table 12

The financial source of the local government capital investment in 1995 – 2000

	1995		1996		1997		1998		1999		2000	
	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %	in b. HUF	in %
Capital investment	136,1	100,0	143,7	100,0	216,9	100,0	279,7	100,0	237,0	100,0	314,4	100,0
Revenue from property	80,3	59,0	107,1	74,6	175,2	80,7	105,1	37,6	50,7	21,4	94,9	30,2
Loan	19,7	14,5	14,3	10,0	17,6	8,1	43,4	15,5	12,0	5,1	21,3	6,8
Capital grant	24,2	17,8	24,0	16,7	38,1	17,6	50,6	18,1	55,6	23,4	70,1	22,3
„Operating surplus“	11,9	8,8	-1,7	-	-13,9	-	80,7	28,8	118,7	50,1	128,2	40,8

Sources: own calculation based on budget tables

14.4.2 Local government and the capital market

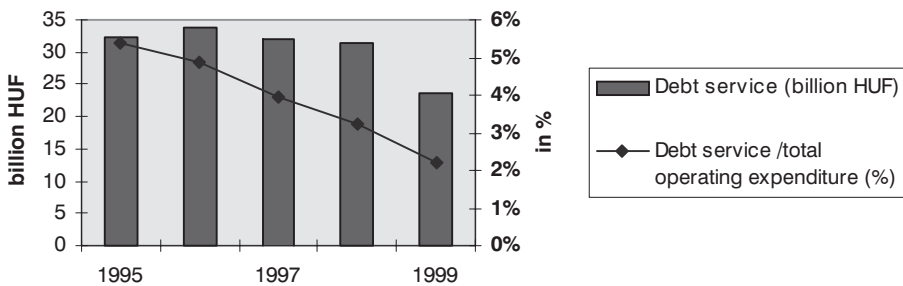
According to the LG Law of 1990 local governments are, in principle, free to finance their budget deficit through the capital market. Evolution of the municipal credit framework in Hungary may be divided into two general phases. In the first phase, from 1990 to 1995, there were no formal central rules which constrained local government borrowing– no debt service limits, no reporting requirements, no separate specifications for the issuance of municipal bonds. The controls on sub national borrowing essentially operated (or did not) based on market discipline.

The possibility of credit has not been utilised by the local governments, the main reason for which is not the supply side regulation, but much more constraints on the demand side. Local government financing choices for investments were determined by two other factors. The first was the availability of a large number and amount of central government grants, targeted by sector and type of equipment. This has led most municipalities to engage in “grant-maximisation” behaviour. The second factor was the large share of revenues generated from the sale and privatisation of municipal assets.

Outstanding loans to the LG sector have not increased; indeed, the local government sector is a net depositor. In 2000 (January 1) total financial liabilities were 142 billion HUF, and financial assets were 417 billion HUF.

To measure the role of the credit market in terms of debt service, the conclusion is the same. The debt service reached 5 per cent of total expenditure in 1995, but decreased to 2 per cent by 1999. One of the reasons was that the revenue from asset sales was used to repay outstanding loans.

Table 13
Local government debt service in 1995 – 1999



Source: Ministry of Finance

Regulation of local government borrowing and the eventual consequences of municipal default were implemented through three measures: (1) a debt service limit for local governments was introduced in 1996; (2) the Municipal Debt Adjustment Act (1997) and (3) the Securities Act includes rules on issuance of municipal bonds (1997).

14.4.2.1 Debt service limit

Debt of the local government is defined to include loans, bonds, guarantees issued on behalf of third parties and lease agreements. The annual debt service is limited to 70 per cent of corrected own current revenues. Own current revenues are defined to include local taxes, duties, interest revenues, environmental fines and other own revenues. This definition excludes revenue of institutions (rent, user fees) although these are also included in local government budget tables as part of “own local revenues”. Own local revenues are “corrected” by subtracting the amount of short-term liabilities, (not including cash flow credits which are used to ensure funding of local government operations). Data on the current status of local government debt service indicate that for 1997, local governments reached over 20 per cent of their available debt service limit and close to 30 per cent in 1998. This data does not include guarantees and leases, so the level of available borrowing capacity is even lower than can be directly estimated (Pigey, 1999).

The centrepiece of the new municipal borrowing framework is the Municipal Debt Adjustment Act, Law XXV of 1996, in effect from about mid-1996. The law defines a debt adjustment process, whose objective is to allow local governments to regain their financial health while at the same time protecting the rights

of creditors. The provisions of the Municipal Debt Adjustment Act are quite sophisticated and impose a definite financial and moral cost on local governments who default on debt or other payments.

14.5 Impact of decentralisation: Conflict and solutions

Decentralisation is a process where the changes take place as a consequence of the negotiations and conflicts of the stakeholder institutions. In the next part of the paper the most important areas of the conflicts will be described.

14.5.1 Privatisation game: assets of the local governments

Municipalities received considerable equity through municipal and related acts, so that they could perform their tasks, primarily public services. Two questions of key importance are the value of this equity and the most effective way of making use of it.⁵ Assets could be a dynamic source of new revenue for local governments. But there is no useful information about the distribution of local assets, which means that this has become an important factor for regional inequality. (The book value information is not appropriate as a basis for an equalising grant system.)

The most important assets were housing and non-residential properties (offices, land) and public works. There was a debate whether these constituted liabilities for the local government or real assets. In the beginning, most of the municipal companies (public works) were loss-making organisations because their fee structure did not make cost recovery possible, but in the long run – as a result of the adjustment process– increased user charges changed this situation. However, the arrears issue (contingent liability) is an issue even today.

The conflicts between the two levels (central and local) of government were particularly sharpened by the political cleavage in 1990–94. But even after the 1994 election when this cleavage disappeared, the fight over the privatisation revenue became an important political issue. According to the Property Transfer Law (1990), the land the state companies own belongs to the local governments, which they were to receive as shares in the privatisation process. The SPA (State Property Agency) has been blamed for systematically undervaluing the real estate part of the companies they have sold. The Law was not very specific and offered a wide range for interpretation. (1) The SPA deducts from the land market value, the value of infrastructure (network of the pipes), which is highly criticised by the local governments. (2) The debt of the company should be deducted from the

5 The “windfall” gain through the asset revenue is very important. One example is Győr, the fourth largest city in Hungary, which realized a 3.5 billion revenue from selling its cable television company, which is 20 per cent of its budget in year 2000. Budapest estimated the wealth of the Municipal Government to 1,000 billion HUF, which is around 4 times of the budget (500 billion shares in public works, and 400 billion in budgetary institutions).

value of the company's assets including land value. One of the most significant political scandals of 1996 was connected to this dispute. Both LGs and SPA paid substantial fees to private consultant companies to make a compromise. The fee was 10–15 per cent, which made a “fortune” for the selected companies. According to some estimates, the unpaid share for LGs is around 60 billion HUF.

The privatisation revenue from the Public Gas Companies and Electric Companies had to be shared between the local government sector and the central government. In 1996 the LG was to be given shares from the Public Gas Company with a book value of 18.6 billion. Local governments sued the SPA in 1996, and the Constitutional Court made a decision in September 1998 in favour of the LG sector. As a consequence, SPA has to pay net 50–60 billion HUF to the sector in 2000. This is equal to 20 per cent of the sector's one-year investments. According to an estimate, the total value of assets under suit by local governments accounted for 700 billion HUF, which is 3.5 times the investment made by LG in 1998.

14.5.2 Accountability and the role of own revenues

The standard criticism against the Hungarian intergovernmental fiscal system is the low share of own revenues. However, in Hungary, education, social welfare, health, etc., have a dominant role in local government tasks, which explains the importance of the transfers providing horizontal equity. Access to these services should not depend on the revenue capacity of the local governments. Therefore it seems to be an illusion to radically increase the share of own revenues.

The structure of the own revenues is much more problematic. The role of revenue from asset sales raises some concerns. First of all, this is not a long-term source as was shown above. Secondly, assets have been distributed very unevenly among localities, which forced the CG to increase the effect of the equalisation grant, and intervene in the transfers system. The problem was not just the inequality, but more so that no information was available about the size of the distortion caused by this element. The third problem with this revenue source is the lack of accountability to the voters. The LG managers consider this revenue as their own success, which does not need public control in the same way as tax revenues.

Increase in own local revenues implies encouraging municipalities to levy local taxes. The most frequently implemented local tax is the business tax, which is very unevenly distributed among municipalities. Encouraging greater local revenue raising could work against another objective, that of equalisation. Equalisation concerns have come to the fore in Hungary due to the unequal distribution of the personal income tax (discussed earlier). Two-thirds of the revenue from this tax is raised in Budapest.

The *business tax* comprises 85 per cent of total local taxes, which although not a long-term solution to municipal revenue requirements, has increased the

accountability of local governments to the taxpayer, and has thus begun involving them in the decision-making process. However, this has been limited to a narrow group of potential taxpayers, i.e. entrepreneurs, businesses, and industry. Another disadvantage of the business tax is that taxing business too heavily may discourage investors. Therefore there is pressure to increase exemptions, which, in turn, leads to inequity across the tax base. It must also be noted that while the business tax is often portrayed as being a way of avoiding taxing households directly, in fact, the cost is ultimately borne by the consumer. Hence, it is usually a regressive tax (Garzon, 1999).

The central government is trying to centralise the local business tax revenues or a part of it. According to a proposal, the local business tax (which is 202 billion HUF in year 2000) would be collected by the state tax administration and would be redistributed to local governments partly on the origin bases. There are strong counter arguments against this attempt as it punishes local government which used this tax as a part of long term development strategy, giving exemption for new business development. Furthermore, it is really a “badly designed” tax causing a lot of distortions.

Also, it is evident that there is a need for modernisation of local taxes. For instance, the property tax (PT) is based on the physical *size* of the properties rather than their *market value*. In addition, the property tax is primarily levied (if at all) on non-residential property. Clearly, there is a need to expand the PT tax base to residential property, among other things, through the elimination of tax exemptions, particularly those that refer to “living-space” and newly built flats. Furthermore, the vehicle tax, which is a national tax shared with local governments, is based on the weight of the vehicles rather than their market value.

However, the uneven distribution is further compounded by the choice of the municipality to levy the business tax as the preferred local tax source. Business tax capacity is likewise concentrated in the same municipalities and regions with above average PIT payments. As the business tax is not mandatory, using this revenue in an equalising mechanism could discourage municipalities from levying the tax.

14.6 Service delivery: local structural adjustment

In response to a fiscal squeeze, local governments adopted **three main cost reduction approaches**. First, in reaction to the changes in the grant allocation system, they increased the provision of services where the grant-to-cost ratios were high and cut on both quantity and quality of services where they were low. Second, they restructured and rationalised services by introducing more efficient management and institutional structures. Finally, they took full advantage of different contracting out techniques and privatisation opportunities as well.

14.6.1 Grant structure and service provision

While the 1990 Local Government Act and the subsequent legislation on decentralisation gave local governments ample flexibility to adjust their expenditures, they also imposed hard budgetary constraints. The majority of local governments prefer to rely on central resources and pursue a policy of minimum local taxation and not borrowing. The main objective of these municipalities is to obtain necessary resources to finance the provision of local services without overburdening local taxpayers and taking unjustified political risks. In many respects, complying with the eligibility criteria for central grants became an important local financial strategy. Many municipalities design their financial plans around the grant allocation process and have special staff responsible for tracking available grants and submitting the applications.

In the current intergovernmental transfer system, grants are negotiated annually. The grant structure, depending on the type of grant, in one way or another, affects the economic behaviour of local governments. As local governments try to maximise the amount of grants they receive from the central government, the grant allocation process may distort their financial decisions resulting in a situation where local user preferences have little or no effect on the provision of services. The response of local governments to the grant allocation system can be described as optimal when they discontinue or minimise the provision of services with low grant-to-cost ratios and of low local priority. The grant-to-cost ratios can be low, not because of insufficient grant financing, but due to high costs related to over-capacity or bad management. An example of this type of behaviour was the closing of nursery schools in the early 1990s due to the lack of grant financing and partly because of the decreased number of eligible children.

Only in cases when municipalities discontinued the provision of services which were badly needed by the community, but received insufficient grant financing, can their economic behaviour be considered distorted. An extension of this type of distorted behaviour is when municipalities reduce the scale or quality of important local services, typically by neglecting adequate maintenance or renovation work, or by scaling back on the level of services. Another form of municipal response to low grant-to-cost ratios for certain local services has been to transfer the responsibility for their delivery to the county level.

Nevertheless, while sector transfers are generally earmarked for certain services, the pressure on local governments to provide services differs across the sectors owing to the rigidity of sector regulations and their enforcement. As a result, in practice, local governments frequently draw resources from less rigidly regulated sectors such as social services or housing to cross-subsidize the provision of politically more important and more tightly regulated services such as education.

As part of cost cutting measures, local governments were involved in active privatisation of municipal assets, which was made possible by the Privatisation Law. Between 1991 and 1995, more than 500,000 apartments were sold, resulting in substantial savings on housing maintenance for municipal budgets. Housing privatisation resulted in savings around 25 – 30 billion HUF (calculated for 1998), which account for 2.5 – 3 per cent of total local government expenditures.

14.6.2 Reorganisations

The 1990 Law gave local governments an opportunity to choose the set of local services and the organisational forms of service delivery that are most suitable for the local conditions. However, the inertia of the existing tasks and responsibilities embedded in institutional structure frequently prevailed, resulting in little or no changes in the traditional organisational structure of municipal service providers. Nevertheless, in the mid 1990s, changes in the organisational forms of local service provision started taking place under the influence of (a) sector laws which introduced new local service responsibilities; (b) tax incentives for private service providers; and (c) local lobbies advocating the alternative forms of service delivery.

The Hungarian local governments were quite innovative in introducing alternative ways of service delivery, and a spectrum developed from the direct provision of services by municipalities to full service privatisation. A wide range of institutional arrangements is used to provide local services. Most frequently, however, the service delivery responsibilities are vested either with (1) Mayor's office, (2) municipally owned organisations or foundations; (3) joint ventures, or (4) privately owned service providers.

While the improved cost efficiency and better quality of services are usually the main rationale for experimenting with different institutional vehicles, in some cases other objectives are no less important. Usually local governments try to avoid compliance with certain government regulations, which can be achieved by changing the institutional structure of the service provider. For instance, while municipally owned service providers are subject to government cash-accounting rules and cannot obtain refunds of the VAT, a service provider structured as an independent company can be refunded the VAT and in general can receive more favourable tax treatment.

The provision of services through the local government institutions is also quite common. It has become standard practice for cities to create one or more municipally owned companies which are responsible for park, road maintenance, snow clearing, refuse collection, and cemetery services. In turn, some of these services are subcontracted out to private firms. Operating as internal units of the local government, such entities usually enjoy a significant degree of independence in terms of planning and budgeting procedures.

The local government institutions have their own personnel policy, have the right to subcontract and the right to use municipal assets under their management the way they see fit. They can also seek external funding and can even start some entrepreneurial activities. While the director for such institutions is appointed by the elected body, the operational control is in the hands of local administration. In general, local government institutions account for 60–70 per cent of total local government spending, which means that the efficiency of local governments very much depends upon the right incentives given to these institutions.

14.6.3 Contracting out and privatisation.

In their efforts to reduce the costs of local service provision, local governments also took full advantage of various contracting out opportunities presented by the new Hungarian legislation on procurement standards, modelled after the standards set out in the EU procurement directives. The general experience is that contracting out results in a more cost efficient delivery of local services as private firms can employ labour far more cheaply than public entities. In addition, private companies may obtain refunds of their VAT payments, while government entities cannot. This tax adds about 25 per cent to the cost of local public service providers.

The contracting out strategy led to a more efficient provision of services. In addition, as municipally owned service providers were aware of the contracting out arrangements, the efficiency of their operations has improved too. In 1997 alone, the Hungarian municipalities awarded 135 billion HUF in contracts through tenders, which amounts to almost 15 per cent of their gross expenditures. In addition to that there were tenders awarded by public service providers in the amount of HUF 81 billion (Baar, 1998).

14.7 Local financial management

The Treasury began functioning in Hungary on January 1, 1996 with the intention of having more effective cash management and further structural budget reform. It was expected to save the GOH, at 1996 prices, 35–40 billion HUF annually, or over one half percent of GDP. Among others, the treasury provided a net salary payment system whereby state employees receive only their net pay (i.e. after taxes and social security contributions have been deducted). The plan was that the accounts of local governments and budgetary institutions would be handled by the treasury from 1998. It was not approved because of the resistance of the local government interest groups, and the National Savings Bank, which has a financial interest in servicing local government accounts.

The creation of independent financial treasuries in Hungary has been a product of economic pressure rather than public demand. Following a change in the government fiscal policies, large cost reductions had to be made at the local

level to meet the increasing service requirements with only modest financial resources available. The local treasury aimed to control the budgetary institutions.

Improvements in financial management at the local level were achieved through rationalisation of the budget execution process. The ability of municipalities to organise efficient cash management, introduce cost controls, monitor expenditures, and generate adequate financial reporting were key to a successful fiscal adjustment at the local level. To perform these functions, many municipal governments created local treasuries.

Historically, the main reason for setting up local treasury operations was to increase local interest revenues through consolidation of cash balances in municipal institutions. Closer monitoring of the accounts of local budgetary institutions resulted in a better financial discipline and improved their financial management. In contrast, earlier on, the local institutions paid little or no attention to whether their revenues had been collected as it was the local government which financed all their expenses. Though institutions recognise the benefits of a municipal treasury, there is a widely spread perception that this represents an encroachment on their institutional autonomy.

14.8 Conclusion and recommendation

The Hungarian reform of public finance was one of the most radical moves made towards decentralisation. In a ten-year perspective, we can conclude that the early start had some drawbacks on intergovernmental fiscal relations, especially as the types of central grants, as well as local taxes proved to be less efficient in the system. It is far from us to idealise the system, but it has not lost its three basic features: 1. elected councils accountable to their constituency; 2. “hard budget constraints”, which set limits to the moral hazard behaviour; and, 3. substantial expenditure responsibility and autonomy.

The comparative analyses of the intergovernmental fiscal systems over-emphasise technical issues and neglect the fact that the transition from the centrally planned socialist economy to a democratic market economy requires continuous structural changes which modify the position of the different tiers of government. For example, the expectation of a predictable revenues structure is an illusion in the time of radical changes, while hard budget constraints and autonomy are the key elements of an efficient adjustment.

In Hungary the case of the hospitals is a good example of how the lack of incentive has led to a series of bankruptcies. As we discussed earlier, local governments do not have substantial expenditure and revenue control over the health services. As the management of the hospitals realised that the budget constraints had been “softened” by the central level on the basis of the political pressures, almost each of them went into deficit. There is no final solution to this problem,

but one suggestion was to give more responsibility to the local government or re-centralise the task.

The rule of law is one of the key questions in the region. Countries under “pressure” of the donor agencies are willing to adopt laws (as a condition of support programs), which they do not want, or cannot implement. Hungary does not belong to this circle of countries, but the rule of law is a problematic area. Hungary established a system where local governments are no longer agents of the central governments. The power of central government and the parliament are exercised through different laws. The ministries have no direct control over the local governments, and the enforcement of the laws and guidelines given to the local government is critical. The lack of “co-ordination” among the ministries has led to situations where the sector law transfers tasks and responsibilities to local governments without sufficient financial support (unfunded mandates). It is not rare that local governments are unable to provide services prescribed by the law.

Although Hungarian local governments are not agents of central politics, politics have always tried to intervene in the local issues. The centralist tendencies exist in the government based on the view that “local governments have more freedom than is necessary”. In the intergovernmental fiscal system, the grant allocation based on discretionary decisions gives room for political interventions. There is always room for intervention, but the key issue is that these interventions should be marginal, and should not dominate the behaviour of the central and local government. The hard budget constraints mean exactly that ultimately the transfers are not entirely negotiable. There are elements in the intergovernmental system which are negotiable *within certain limits*, not just for political, but sometimes for technical reasons. The deficit grant in Hungary is a good example of that, which has been misunderstood by several experts. Another example is the capital city, which is in almost every country a special, politically dominated issue.

The Hungarian intergovernmental finance system has gone through a series of continuous reforms and it has been over-regulated with the partial, uncoordinated modifications. The reform steps attempted to solve the most urgent short-term problems with the aim of optimising the position of the central government. It was basically successful, but started to ruin the framework of the efficient adjustment process. There is a need for a coherent reform program in the area of intergovernmental finance.

The Hungarian experiences of decentralisation showed that one of the weakest points in the system is the **low level of local taxes, in a real sense**. In the case of local taxes the local governments should have a reasonable discretion over tax revenue, and they should have the political responsibility to introduce the tax burden on the constituency. The reason for this is that the political “cost” of the

local tax has not been compensated by the political benefits. This needs cooperation between the central and local government to give additional incentives to the introduction local taxes.

One of the most important elements in the reform is the grant structure. The **grant structure** for the expenditure for the service delivery should be radically restructured. More simple– formula-based – grants should be introduced, where the interest of the sectors will be provided through a block grant design. (This was proposed by Davey-Péteri, 1999) The grant design should be based on the local own revenue capacity (not just local tax) and the expenditure needs. In this system the role of deficit grant will be more important, as it is the only way to compensate the special cases. Disincentives should be built in to avoid moral hazard behaviour.

The reform should include the **revision of sector strategies**. The government has to revise sector strategies in view of decentralisation, making clear task assignments and estimates of the real investment need and its financial sources. Parallel with these steps, it is very important to make decisions about the nature of the second tier.

Local governments, despite the fiscal squeeze, managed to maintain acceptable local service delivery, but localities had to adjust to the changing financial environment. One of the most important factors in the efficient adjustment process was the *wide scope of expenditure decisions* transferred to local governments. It is true that there were several cases when this freedom led to mismanagement of public resources but the overall effect was a more efficient public sector. The other factor which explains why the net decrease of LG sector revenue did not lead to a more critical situation was the “reserves” the old system accumulated in inefficiency. (See Six City Report, MRI/UI 1999).

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15. Unanticipated Budgetary Consequences of Devolution: The General and the Specific

*Herrington J. Bryce**

Many areas in Eastern Europe have moved rapidly toward privatisation and local self-government. Today, the formal transition is nearly complete in many areas, but problems of adjustment to the new economic order are of concern.¹ Essentially, the common problem faced by local public administrators throughout Eastern Europe is how to make these concepts work.

15.1 Introduction

As a result of the devolution of power, a substantial number of implementation problems fall on the local public sector and the capacity of administrators at these local levels to administer a constantly growing body of laws and policies in the context of a dynamic environment in which previous laws and experience may be irrelevant, give wrong signals, or may be non-existent.

In addition, fiscal problems plague not only the national governments but also their localities. These problems are marked by a mismatch between actual and potential revenue sources and growing expenditure requirements. Thus, throughout Eastern Europe we find only variations of the following challenges facing local public administrators: How do we meet the challenges of decentralisation (increased local responsibility, pressures and accountability) when revenue requirements cannot be met but the demands of citizens rise both in terms of delivery and accountability?

Unlike other approaches to addressing this dilemma, this paper compares the devolution of powers in Russia, using a specific case study with the powers of comparable local governments in the United States and the associated budgetary impacts. By so doing, it is hoped to place the plight and privileges of these governments in an international context for better appreciation and in search for probable solutions.

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1 The process is complete in the sense that there are local charters creating local democratic governments that are functioning and there is a private market economy fully institutionalized and, by law, protected against state interference. As in any dynamic, democratic society, however, there is a constant process of change and readjustment. For some impressionistic and thoughtful views of how these processes have gone in Russia as a whole, see Nikiforov, 1994, Sukhotin, 1994 and Bim, 1994.

This paper draws very heavily and directly from an earlier published paper.² Its distinction is that this current document broadens the scope of the discussion beyond one single local government and beyond one period 1992, the date the original study was done. It also expands on probable recommended public policy considerations. Hence, numerical data in this study are used not to depict current events, but to illustrate the magnitude of the problem at the earliest recorded period in the transition.

15.2 The Devolution of Infrastructure Responsibilities

Changes in the number and size of local government units are not new in Eastern Europe. Sulev Maltese's (*Local Self-Governments in Estonia-Future Trends*, mimeographed 1992) traces such changes, for example, in Estonia from 1950 to 1992 when devolution was widespread in Eastern Europe. A common administrative unit used throughout the devolution process in Eastern Europe is the *raion*. This is an administrative, budgetary, economic and political unit which is similar to a county in the United States. Every state, as every oblast (the Eastern European analogy to a state in the United States federal system), contains several counties. Each county (and each *raion*) is composed of both incorporated and non-incorporated rural and urban areas.

Devolution involves the shifting of responsibilities and accountability from the federal to the state and ultimately to the *raion* (county) and to its composite units. This paper focuses on the impact of devolution on the *raion*, its newly acquired responsibilities and the legal and budgetary constraints which define its ability to conduct these responsibilities.

In Russia, as elsewhere, the current infrastructure of the *raion* including roads, schools, boilers, water and sewer and hospitals for which the government is responsible were acquired since 1991 when privatisation was launched by turning all of the state farms and processing enterprises into privately owned businesses and then assigning all of the social assets (housing, boilers, water and sewer, roads, schools, etc) which were owned and operated by the state farms (individually or as a group) to the local governments.

Consequently, the local budgets quickly became responsible for a variety of social assets, many requiring maintenance and replacement because of years of deferred maintenance and dis-investment under the Soviet rule. Accordingly, an unintended consequence of decentralisation and devolution is to increase the size of the local government bureaucracy, to enlarge the scope of local government responsibilities to take care of the newly acquired infrastructure, to respond to the unleashed pent-up demands of local citizens, and to increase the subsequent

² This paper draws heavily and directly from Bryce, 2000.

need for locally generated revenues at the same time that economic enterprises (being privatised) were removed as potential revenue sources.

This unplanned and sudden transfer of social assets without off-setting productive revenue sources and within an un-chartered political environment is at the foundation of the problems facing local public administrators. The basic challenge for the local budgets therefore is how to absorb newly devolved powers and responsibilities within tightening budget constraints and increasing demand.

15.3 Local Government Powers and Responsibilities

Local government within a federal context is best understood not only by looking at the government itself, but looking on its relationship with those units (federal and state) that are higher up in the hierarchy. The Federal Law on the General Principles of Self-Administration in the Russian Federation 1995 says that local self-government is an expression of the power of the people and is fundamental to the Russian constitutional system. It declares that local self-determination is recognised and guaranteed to all citizens of the federation and must be guaranteed by all levels of government.³

Rebuking the old Soviet model, the 1995 law gives previously unheard of discretion to local authorities to develop their own budgets, to determine sources of revenues, to determine expenditure patterns and promises that the oblast (the state-level government) and the federal government will guarantee local financial independence specifically through:⁴

1. The assignment of specific revenue sources to the local government so that it can meet minimum expenditure requirements.⁵
2. The guarantee that if the minimum local expenditures cannot be met by the assigned revenues sources, both the federal and oblast governments will transfer revenues from their own budgets or the budgets of other subject governments.
3. The guarantee that in making up fiscal gaps, no importance will be given to the fact that in prior years the local government may have had a surplus. Past surpluses cannot be seized or encumbered by the federal or oblast governments or used to reduce payments.
4. A promise that in addition to assigning revenue sources, the federal or oblast government may reduce their share of revenues from taxes collected by the local government.

3 Chapter 1, "General Provisions", Clause 2, Federal Law on General Principles of Self-Administration in the Russian Federation, 1995.

4 Ibid. See Chapter III, "Financial and Economic Foundation of the Local Self-Administration," Clauses 35-39, for the points being enumerated here.

5 The guarantee is specifically to meet the social minimum requirements (i.e., minimum standard of living). We shall describe these later in the paper.

5. A requirement that local governments must be compensated for any federal or oblast mandates that increase local expenditures.
6. An acceptance that local governments are only responsible for implementing mandates of higher levels of government to the extent of compensation received.

It is noteworthy that such strong guarantees from the federal government have no precedence in Russia and no counterpart even in the United States although in 1996, the U.S. Congress passed a law applying only to the federal government that is similar to Item 5.

But the 1995 Russian federal Law also retains strong powers in the federal government. These retained powers include:⁶

1. The right of the federal government to establish minimal social standards for all citizens and to assure that local budgets provide for them. These standards cover health, food, nutrition, education, and so on.⁷
2. The right to adopt regional economic development programs for local governments.
3. The right to coordinate and approve local government budgets partly to assure conformity with federal laws, and
4. The right to transfer some federal functions to local governments (with compensation) and to monitor and control compliance.

These are powerful guarantees. Yet, these expressly retained powers lead to a constant approval-seeking deference to the federal government by local public administrators and policy makers that often lead to (but not always warranted) a dampening of budgetary initiatives and an attitude of why-bother. As one local official stated: "What can autonomy mean if you are always afraid of annoying your creator, benefactor and guarantor?"

15.3.1 The Oblast as Designator and Guarantor

In Russia, the *oblast* (or state) is both a designator of responsibilities and, at least on paper, a guarantor of fiscal resources to meet these responsibilities. Unfortunately, the reality is otherwise.

In the United States, local governments are creatures of the state and their powers are derived from state law⁸. The federal government does not guarantee the existence of or the financing of the local government. This is not the case in democratic Russia.

6 Ibid., See Chapter, "Federal Bodies Powers in Local Self-Administration," Clauses 4-8, for the points being enumerated here.

7 State Minimum Social Standards for Defining Norms for State and Local Budgets, July 3, 1996. These norms are easily verifiable.

8 This is the familiar Dillon Rule.

The Oblast of Volgoda, for example, fully respecting federal law, guarantees home rule to the citizens of its *raions*. For example, it requires local citizens to adopt charters describing the structure and procedures of government they wish, the forms of guaranteeing citizen participation in voting and in policy-making, the openness of government, the equality of all citizens, and in determining the status and removal of locally elected officials. Federal law specifies that the only reason that an oblast can reject a local charter is that it is in violation of the laws of the federation or of the oblast.⁹

With these powers, a *raion* is analogous to a home-rule county in the United States. Its powers, budgetary and otherwise, are broad and unrestricted by size, income or other method of classification.¹⁰ In the *raion*, the citizens are guaranteed the right to form any kind of government they think best, given their needs, ethnic, historic, geographic and other characteristics as long as they do not violate certain principles--generally of civil rights, openness, universal suffrage, and accountability.¹¹

But the *raion* is specifically assigned responsibilities for financing and managing social assets. These include roads, schools, boilers, hospitals, housing, police, utilities, water and sewers. Financing of these must be incorporated in the local budgets.

At the same time, local fiscal independence is guaranteed by the oblast:¹²

1. The local government can independently set up, approve, and implement its budget and reallocate resources as it sees fit.
2. The oblast may not attach or discount surpluses or additional revenues resulting from local tax increases.
3. The local government is guaranteed a sufficient level of assigned revenue sources, revenue sharing or monetary transfers to balance its budget.

But what do these (particularly 1 and 3 above) mean within the current context? Local public administrators explain that under the Soviet system, the central government always provided enough money to cover all local expenditures all of which were authorised and mandated by the central authority. There simply

9 Ibid., Chapter I, "General Provisions," Clause 8.

10 In the United States, each state decides the type of charter to issue. Some charters are general meaning that the state may issue a prototype which individual jurisdictions may adopt; a state may also issue a specific charter which applies only to a specific jurisdiction; it may issue different types of charters for different types of localities according to some variable which is usually population size; and, finally, it may issue a broad charter call home rule to very large and special cities; i.e., New York City.

11 Charter of the Volgoda Oblast, Chapter 11, "Foundations of Local Self-Administration," Clause 83 and Clause 88.

12 Ibid., Clauses 82-103, especially Clauses 86, 91, 92 and 100.

was no budgetary discretion at the local level even when the mandated and fully funded expenditures were obviously not socially optimal--even wasteful.

Today, the local public administrator has discretion over programs, projects and revenues with the guarantee of funding from the oblast and the federal governments coming only over those expenditures mandated by them. The problem is that even dedicated revenue sources are not sufficiently productive--never yielding enough revenues to cover either discretionary or mandated expenditures.

Furthermore, there is little confidence in the guaranteed federal or oblast payments since both of these levels of government are now in arrears in payments of key benefits to the military, local veterans, teachers, and families to whom child care benefits are due. As one official put it, "now we have discretion but no money to exercise it."

15.3.2 Local Charters: Conflicts between Efficiency and Accountability

In order to guarantee self-determination at the lowest level of organisation, the aspiration for full and local accountability may conflict with the need for economic efficiency. The *Cherepovetz raion* for example, is divided into 26 geographic rural administrations. Each of these is headed by an administrator previously elected by village leaders, but who will, under the newly proposed charter, be appointed by the chief administrator of the *raion* with the approval of the village population.

The rural administrator operates as an ombudsman between the *raion* government and the village population and as a *raion* extension agent in furthering the educational, business and recreational interest of the local population. In addition, each administrator can impose special taxes and receives 100 percent of the income tax revenues the *raion* collects in his or her area. The *raion* has no revenue equalisation powers.

Furthermore, the rural administrator is free to allocate these funds as deemed best for the local population. While the concept of zoning is not encoded, the rural administrator may also zone within his or her area and distribute land (at no cost); i.e., for the building of *Dachas*.

In 1992, 73 percent of these areas had less than 2,000 residents. Just under half have no more than 1,000 and none has 10,000 persons. Most of these areas are too small for efficiencies in most public services. Thus, to local public administrators, the micro-structure is politically advantageous because it brings local self-government to a micro level, but it may be very inefficient from a budgetary perspective since many have their own small inefficient assets such as boilers. (Maltese, cited earlier, gives similar breakdowns for Estonia and compares it with other countries such as Finland and Sweden).

The federal, oblast, and raion laws do provide for mergers and consolidation of areas. Further, these areas may be natural bases for economic zones. They are different in natural endowments, in population size, in wealth, in proximity to the central city, and in the nature of their development capabilities. Currently, there is a strong emphasis, among local government officials surveyed, to treat all these places “equally” – consistent with the Soviet model.

This may be fiscally inefficient as the net marginal social benefits per dollar spent on similar investments cannot be the same in each region given their different endowments and the possibilities of economies of scale suggesting that the concentration and sharing of certain social infrastructure assets may be a more efficient path.

15.4 The Local Budget

Until now we have discussed specific federal, oblast and local laws related to the devolution of responsibilities, decentralisation of powers and their budgetary importance to local public administrators. What are the major issues in trying to implement a local budget now that this is now in the scope of responsibilities of the local public administration?

The budget of a *raion*, for example *Cherepovetz*, is a unified capital-operating budget. It is not required by any level of law to be balanced. A deficit is projected for the current year. Unlike the Soviet model, both the expenditure and revenue sides of the local budgets are determined locally within the constraints and guarantees discussed earlier in this paper. Note that in the United States, most local operating budgets are required by law to be balanced, although this is not true of capital budgets and the separation of these two budgets is common.

The principal source of revenues (34 per cent) is the profit tax and the principal expenditure (20 per cent) is for housing and utilities followed by education (19 per cent). About 8 per cent of all expenditures go to various forms of agricultural subsidies. Business subsidies are generally in the form of loans for which the interest rate is set by local law at 25 per cent of the central bank rate. At current levels, the subsidised rate would be between 40 – 50 per cent.

15.5 The Deficit

The most recent budget passed by the Legislative Assembly of the *raion* shows expected revenues at 95,300,700,000 roubles¹³ and expected expenditures at 75,371,100,000 thus expected expenditures could exceed revenues by 13 per cent. Deficits are the usual budgetary expectation.

13 At the time of original writing the exchange rate was 5,355 rubles for one U.S. dollar.

In the past, projected shortfalls have been met by (a) cutting capital expenditures, in particular, a hospital and a day care centre, (b) reducing hours at facilities such as clubs, (c) some assistance from other levels of government, (d) paying current wages out of reserves for teacher vacation pay, and (e) primarily by delaying payment of current liabilities including wages of other *raion* workers. Wages can be 4–6 months behind. What options are there for dealing with a projected deficit now and in the future?¹⁴

15.5.1 The Compliance-Enforcement Nexus as Cause of Deficit

There is near unanimous agreement among local administrators that the basic problem in causing shortfalls and in implementing a local budget is that many people do not pay taxes and user fees. Revenue sources may be dedicated, but they yield little because people do not pay. Tax and fee evasion, or avoidance, plague even the national government (See: McKay, 1996, p. A14). A discussion of specific reasons follows.

15.5.2 Reasons for Non-payments and Their Economic Consequences

Let us begin with the non-payments by households. In some Western countries there is a tradition, “a game” of escaping or minimising tax payments. Under the current system in Eastern Europe, there are free-rider problems generally associated with the pricing of public goods and the inability to exclude users. To illustrate, because heat is centrally provided and there are no individual meters, it is impossible to cut-off (individual households) or to know how much heat each unit uses. When the central heating system is on, everybody gets heat; when it is off nobody gets heat.

To approximate the amount of heat consumption by each household in order to determine a fee, an “average” household usage is calculated by the Russian Academy of Science. This is multiplied by an average cost of production for all 25 boilers in the *raion*. But by law, only 30 per cent of this amount can be charged and this 30 per cent must not exceed 15 per cent of the earnings of any family.

Thus, it appears that because there is virtually no technical capacity to cut-off non-payers (there is no individual unit control) a “free-rider” phenomenon exists. In addition, because of a legal guarantee of heat, there is no incentive to pay. And because user fees are not based upon actual use, there is no incentive to economise.

14 A study of 1300 U.S. cities, roughly the size of Cherepovetz, and their adjustment to economic crisis shows the importance of cutting back capital expenditures (67 percent) and cutting back in services (32 percent). Only 25 percent of the cities chose to postpone wage increases. Holding wages in arrears is not a common option. See Bryce, 1979, pp. 105-120.

In short, the provision of a social minimum heat for all may well lead to a cost well above that which is socially optimal. Non-payment of user fees— especially for utilities— is “encouraged” by the legal restriction on local government to enforce payments when this means increasing hardship. The law prohibits eviction by the government. Furthermore, user fees are set by current federal law to net less than 100 percent of total costs. Therefore, even if user fees were collected, they would cover less than full costs, requiring a subsidy.

As far as payroll taxes are concerned, individual households are generally in arrears because their employers, including the local government are in arrears in paying both the employee’s salary and in withholding and transmitting amounts due the government. Most large firms are currently operating at a loss and have limited cash flow, so they postpone payment of wages; and, they are allowed to postpone withholding until salaries are paid.¹⁵ Also many of these businesses are operating at a loss and have no profits to tax. Taxes are not on gross, but net revenues.

Further, many of these firms need significant increases in investment if they are to be competitive in foreign markets and in domestic markets against imports. Yet, greater investments increase depreciation allowances and thereby reduce tax liabilities over a long time. In addition, many sidewalk, mobile enterprises, and underground operators are able to elude tax collectors altogether.

Non-compliance by major firms often reflects strong bargaining positions. The major firms assume that seizure for failure to pay is unlikely under current law because should seizure take place, the government will find that there are no potential private buyers for the firm’s outdated equipment and plant; and, government ownership after a seizure would be a return to the status *quo anti* which is undesirable by all.

In addition, politically, these firms do disguise unemployment keeping the official rate of unemployment low and the population active; moreover, since these firms are often employee-owned, a closure or a seizure hurts resident voters who have guaranteed suffrage and to whom the elected officials, by virtue of law, are accountable.

Furthermore, a seizure without a pre-packaged sale is most likely to have the effect of increasing the cash flow problems of the local government. It would temporarily, at least, have to operate plants and equipment that require upkeep and

15 This argument was made more than once. But, administratively, the inability to pay an employee can be made unrelated to the firms’ withholding taxes. The firm could be required to calculate the withholding and transmit it on a timely basis even though the employee has not yet received cash. The firm would then be in debt for payment only to the employee. It may well be that given a cash flow problem and a choice between paying the government and paying the employees, paying the later is preferred by all parties including the *raion*. Therefore, paying the government payroll taxes when the payroll cannot be met is not done.

replacement and that are now operating at a loss. It will have to meet employee wages and benefits during its tenure of operation and have only the proceeds of the sale to look forward to since the profitability of many of these firms are, by their own accounting records, negative.

15.5.3 Limitations on Increasing Taxes and Fees

Under ordinary circumstances, one way to reduce a deficit is to increase taxes and fees--a weak remedy. Given current levels of non-compliance, increasing taxes and fees cannot be hugely productive and would only penalise those who now comply. Indeed, the reverse is more probable. A reduction in taxes and fees may yield greater compliance if rates are realistically tied to taxpayer ability to pay or to benefits received.

Indeed, rampant non-compliance may be a clue that the tax system is out of whack.¹⁶ It is commonly held, at least in developed countries, that the higher the rates, the higher the incentive to avoid taxes. Moreover, because incomes are so low, higher rates take the risk of violating Russian laws concerning the norms which limit taxes and fees to about 30 percent of income.

Increasing user fees so that there is 100 per cent cost recovery is an option. Two questions need to be asked. First, 100 per cent of what? Soon most of the boilers and other equipment used to provide utilities will be in need of replacement. Therefore, recovery should be 100 per cent of replacement cost if the objective is to make the system self-financing – which would be considerably higher than current capital costs measures.

Second, will this latter amount (the replacement plus operating costs) be within the financial capacity of users? Given current incomes and non-payments, the most probable answer is no. Therefore, the subsidising of utility use may be required for some time.

15.5.4 Limitations on Debt Financing

The charters of local jurisdictions may not provide for the issuing of long-term debt in the form of bonds or short-term debt in the form of tax anticipation notes--a power which counties have in the United States. In Cherepovetz the charter only provides for borrowing specifically from banks. With interest rates ranging from 120 – 200 per cent, even bank borrowing is ruled out. Furthermore, given its deficit, delays in payments and in receipts, the credit-rating (if there were

16 There are two parts to this question. The first is whether the appropriate levels and types of taxes and user fees in lieu of transfer are being applied at the local level. See Richard Bird, "Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralisation," .. and Richard M. Bird, Caroline L. Freund, and Christine I. Wallich, "Decentralizing Fiscal Systems in Transition Economies," *Finance & Development*, September 1995, pp.31-34. The other issue is whether the rates are too high given the ability to pay and the desire to promote reinvestment.

one as there is for counties in the United States) would likely be very low, making the cost of borrowing prohibitive. For all practical purposes, therefore, these jurisdictions are shut out of the debt market.

15.5.5 Limitations on Reducing Expenditures

In spite of the budgetary independence referred to earlier, there is substantial limit on local discretionary spending. In Russia, Federal, oblast and *raion* laws require the budgets of *raions* to cover certain minimum norms. These include numerical norms for food, nutrition, health care, libraries, ambulances, orthopaedic services, clubs, social help centres, transportation and wheel chairs for invalids, rehabilitation centres, clinics, clothing, orphanages, schools and defined for specific populations' characteristics such as age, sex and type of handicap.¹⁷

Fortunately, as discussed earlier in this paper, the federal and oblast laws also provide that absent the ability of the *raion* to meet these social minimums, the federal, or oblast government will do so from their own budgets or through releasing revenue sources to the locality. Roughly 85 percent of the expenditures in the Cherepovetz budget fall into the social norm category.¹⁸

Discretion is also limited by the local assembly. It has approved a list of four categories of protected expenditures--but with no revenue sources earmarked to finance these expenditures. These, in order, are wages and salaries of the *raion's* employees, medicine and medical supplies; meals, relief and benefits required by federal and oblast laws; and, finally, electricity, security, and heat.¹⁹ The items in the two preceding paragraphs cover approximately 85 percent of the planned expenditures in the *raion*.

What is evident is the conflict between the Soviet model of setting minimum social standards which translate to the local government as budgetary constraints but with no assured revenue-yielding ways of financing them. With limited revenues, the bulk of the budgetary decisions on the local level is about meeting these standards. The effect is to reduce, if not nullify, the practical meaning of budgetary discretion.

17 In the long-run, the impact of these costs may be escalating throughout Russia see, James Alm and David L. Sjoquist, "Social Services and the Fiscal Burden in Russia," *Comparative Economic Studies*, Vol. 37, No. 4, Winter 1995, pp. 19-30.

18 I got this figure by summing all social-type line items and dividing by total expenditures. This figure is not unreasonable or new. See Beth Mitchneck, "An Assessment of the Growing Local Economic Development Function of Local Authorities in Russia," *Economic Geography*, vol 71, no 2., April 1995, pp. 150-21. She notes that most local expenditures went to social assets and economic development expenditures depended upon higher level governments and how they perceived the local government in their gestalt.

19 Resolution of Borrowing, passed by the Legislative Assembly, Cherepovetz, Raion, February 14, 1996.

15.5.6 Need for Introducing Budgetary Control Measures

But greater operational efficiency is always possible and should be encouraged, even though for many administrators, this may seem without purpose or even too abstruse. As this author demonstrated in a seminar of about 40 local public administrators in Cherepovetz, Russia, and an equal number in several cities in Estonia, the use of the basic concepts (without the technicalities) of zero-based and performance budgeting would encourage periodic program review for efficiency, modification and elimination of projects.

A simple zero-based budgeting exercise without the complexities would allow each agency to assess what it is doing now, its priority, and to gauge the extent to which it ought to be done in government and by which agency. A performance budget would allow them to assess what is needed, what is attainable, how it will be funded and what obstacles exist in meeting specific, often quantifiable, objectives over what period of time.

A simple cost analysis would allow them to begin identifying fixed from variable costs and cost centres—ways of beginning to determine which costs can be controlled and how. To keep expenditures within bounds, a system of regularly calculating variances between budgeted (appropriated), obligated, and actual expenditures by and within agencies would be helpful. Currently, the budget director in Cherepovetz prepares an overhaul variance, but agencies and perhaps even program managers, need to do the same.

One final word should be said about increasing efficiencies in the way described. Local administrators find themselves in a position not unlike firms in a competitive market. There is little they can do to increase prices per unit because the price is basically dictated by the market— they are price takers. Consequently, much of their efforts are concentrated on increasing efficiency and reducing costs. With large enough margins that can be retained, they are able to expand. The general principle is the same, even though the specifics are obviously different.

15.6 Recommendations

The truth of the matter is that for many local jurisdictions in Eastern Europe the deficit reduction choices are grim. But this does not mean that there is no future. As firms go through the process of bankruptcy, government reorganization, as corporate reorganization, should be considered for their potential economic impact.

The recommendations that follow relate to two problems identified in this manuscript and corroborated by over 100 hours of in-depth interviews of public officials as described in an earlier paper. Because recommendations have limited applicability if they fly in the face of what is constitutionally possible, it is always wise, as did this author, to check to be sure that they are acceptable within the current legal framework.

The recommendations that follow rest on the observation that the revenue-generating limits faced by these jurisdictions are real, as discussed earlier, and that there is a conflict between achieving accountability and uniformity by having a number of small administrative units each trying to provide a common set of public services. Many of these units are too small to finance certain infrastructure functions or to efficiently operate them.

Accordingly, one of the recommendations of this paper is the consideration of administrative re-alignments according to functions. Examples are the creation of water districts, sewage districts, health districts and the like, which cut across jurisdictions and are administered through intergovernmental agreements and shared governance and fiscal responsibilities. Such arrangements reduce costs, increase administrative efficiency by drawing the best of resources such as personnel from a wider pool, by increasing specialisation and concentration, and by reducing average costs per person (thus making it more likely to fall within their fiscal ability) by spreading costs over a larger population and by widening choices for physically locating plants and other capital structures. Local autonomy and control is reduced, but not denied since each jurisdiction, retaining its political structure, will have representation in the governing bodies of these service districts.

A second recommendation is the consideration of public authorities. Public authorities are non-profit organisations formed by government to carry out highly specialised (usually infrastructure) functions within a service district that may cross-jurisdictional lines. They are financed primarily through the issue of debt, the charging of fees, and the earmarking of tax revenues. In general, however, the two principal sources are debt and fees.

Authorities, being independent, relieve the local budgets, reduce the impact of political and budgetary infighting and compromises, allow the bypassing of many rules that bind government operations, and provide for a level of operating flexibility unimaginable in government agencies.

Here, too, some accountability is lost, but much is retained by the ability of elected officials to design, appoint, evaluate and to approve many of the actions, including budgetary ones, of the authorities. For example, the authority may have the power to issue bonds, but the terms of these bonds and the actual issuing and negotiating with the underwriters may be done by a government body. Furthermore, this initial power to issue the bonds is one granted by locally elected officials and, presumably can be denied or amended by them.

With respect to accountability, there is an appropriate set of questions derived from agency theory that should be raised. This theory implies that the authority would be an agent from the political jurisdictions that form it, which in turn are agents of the citizens that make up the jurisdictions. Agency breaks down when the agent fails begins to act principally on its own behalf rather than

for the benefit of its principle. The ultimate of this is that the agent may seek survival even after its usefulness has waned or even when such a survival conflicts with the good of the principle. Therefore, any attempt to consider the recommendations made above must also provide for evaluation and monitoring.²⁰

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²⁰ See Herrington J. Bryce, "The Authority as a Mechanism for Public Enterprise" *International Review of Public Administration*, (Ian Thynne and Roger Wittenhall, special editors), Vol. 6, #1, June 2001, pp. 11-20 for a development of this theme with respect to privatization and my *Financial and Strategic Management for Nonprofit Organization*, 3rd edition, Jossey Bass 2000, pp 119-121 for a fuller description of the authority as a nonprofit organization. They should also refer to the origin of this paper for specific references to Cherepovetz. Please see Herrington J. Bryce, "Unintended Budgetary Consequences of Devolution and Decentralisation: The Case of Cherepovetz Raion, Russia, *Public Administration Quarterly*, Spring, 2000, pp. 25-45.



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