

LOCAL GOVERNMENT FINANCIAL CAPACITY BUILDING IN TRANSITION COUNTRIES: SELECTED COUNTRY STUDIES

Edited by
Željko Šević



NISPAcee

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

NISPAcee

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

Local Government Financial Capacity Building
in Transition Countries:
Selected Country Studies

Edited by

Željko Šević, University of Greenwich, United Kingdom

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NISPAcee is an international association focused on public administration. Its mission is to foster the development of public administration disciplines and training programmes in post-communist countries, increase the quality of instruction and research and assist the development of its member institutions at both international and national levels.

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Prologue: Building the Capacity (to Govern Financially)

I

The term “rogue states” has recently been adopted in political theory to describe certain countries which have unstable systems and which cannot be trusted (either easily or at all) by the remainder of the international community. The states grouped into this category are those which are involved in nuclear arms proliferation and in the development of weapons of mass destruction and which have a total disregard for human rights and the generally accepted values held dear by other members of international communities. This term may be seen by some as being highly ideological and as being a result of a particular point in time in international relations [or balance of power(s)], but in fact, it is merely an extreme case of failed states.

The state should perform a number of duties, one of the most important being to ensure the welfare of its citizens (in whatever manner this may be defined in a particular society), enforce law and order, respect the internationally endorsed code of conduct in international relations and support economic growth and development etc. In order to do so, the states must have a well-functioning *apparatus* (or bureaucracy) and must have an institutional setting in place that enables the achievement of these tasks. However, not all states in the modern world can boast performing bureaucracies and their ability to deliver those functions that are usually associated with the state. This has been recognised by international financial institutions and following the Washington consensus, (the World Bank Group, the Inter-American Development Bank and the International Monetary Fund) the focus of the World Bank has included public administration (in new jargon “good government” or “good governance”) and its reform, in order to ensure the efficiency and effectiveness of bureaucracy and in order to promote economic growth and development and long-term elevation of poverty around the World (see: Edwards, 1997, etc.).

Nevertheless, the existence of competent, performing and capable central (national) government does not directly imply that sub-national government level(s) will also be able to boast an exemplary existence. In fact, even some developed countries are highly centralised and their sub-national governments may not really be highly performing. Decentralisation was the fashion of the 1990s, primarily due to the transformation of the former socialist countries, which in their very essence, were highly centralised. Democratisation processes in former communist countries unavoidably encompassed the nation-wide decentralisation exercise. The dismantling (or reform) of socialism was impossible without wide decentralisation and full empowerment of sub-national government levels,

especially in the municipalities and local communities (the latter, particularly in rural areas). Similarly, developed countries have been seeking a model that would empower a grassroots democracy, put the citizen (voter) in the centre of the local public policy process and ensure that the deliverers of public services were as close as possible to the benefactors. The European Union (EU) has adopted the principle of '*subsidiarity*', meaning that there is a general presumption in favour of sub-national/local government when it comes to delivery of services and, only in exceptional cases which are fully justified, can the delivery be entrusted to the central/national/federal government.

General political agreement that decentralisation is good for the country does not ensure that decentralisation will deliver in practice. The decentralisation of functions from the central to any sub-national (regional and/or local) levels must be accompanied or followed by the decentralisation of the resources necessary to perform the delegated functions. Decentralisation itself may take several forms. The weakest one, which in fact does not deliver very much, is (administrative) *deconcentration*, where duties are moved from the central ministerial offices to the field offices based in the regional seats. The provider of services is still the central government body, but the process itself brings it closer to the final recipient. This 'decentralisation' does not usually require any change in the way the central government accounts for resources. Civil servants in regional seats will still probably be on the pay-roll of the respective ministry and will simply be considered as working outside the ministry's headquarters.

In contrast, *delegation* really requires a change in the way services are delivered. The central government body will still be responsible for the delivery, but the process will be entrusted to a sub-national government body, which will perform the functions on behalf of the central government body. This arrangement requires financial resources to be channelled to the regional/local governments in order to enable them to deliver the entrusted functions. As the central ministry is still ultimately responsible for the delivery, they may revoke the delegation order at any point in time and resume direct delivery. In most cases, the central government will not even be required to justify the decision to revoke. Finally, *devolution* represents 'real decentralisation' as the functions are transferred to the bodies of sub-national governments, where central government may, or may not, resume the functions of inspection and control. The sub-national government bodies, under this arrangement, are ultimately responsible for delivery and only in very exceptional cases, (total failure to deliver, gross mismanagement, embezzlement of public purse *et similiaire*) can the central government resort to the direct delivery of service, thereby suspending the sub-national body. However, if the suspension order is issued, the central government must explain and justify its decision and as a rule, the sub-national government body can challenge the decision in court. In the case of devolution, new arrangements must be made, as

the financial resources have to be secured for a sub-national government to be able to fund the delivery now within its formal jurisdiction.

II

As the central government must possess the necessary capacity to deliver at national level, sub-national governments have to be able to do the same at their level of responsibility. As the World Bank rightly points out “Good government is not a luxury – it is a vital necessity for development”. (World Bank, 1997, p. 15) There is no universal consensus on how to enhance state capacity. Usually, there are examples of good governance, but what good government generally entails is not the subject of general consensus. Often the capacity is linked with internally or externally initiated government (administrative) reforms with the aim to “rewrite the contract between elected politicians and bureaucratic officials” (Haggard, 1995, p. 12). Reforms are also initiated by increasing international pressures and the development of many alternative markets, which require re-thinking the manner in which traditional public services have been delivered. So, any change in the public sector now has to entice a reduction in transaction (or even total social) costs; the introduction of greater (democratic) transparency; better communication with all societal stake-holders (civil society, i.e. the third sector) and prevention of anti-market or market-distorting behaviour. International pressures should not be neglected either, especially in countries which are regular customers of international financial institutions (primarily the World Bank).

Market-orientated reforms have reduced and redefined core functions of the state, so the central government has to reinvent itself (see: Osborne and Gaebler, 1993). The World Bank, as a prominent international player, promotes three mechanisms for enhancing the state capacity/capabilities 1) rules and restraints, 2) competitive pressures and 3) voice and partnership (World Bank, 1997, p. 7-11). Generally, all three aspects can be pursued simultaneously and there are relatively few obstacles in achieving results (*Ibid.*). Modern government has to be less expensive and therefore is on the lookout for savings, constant efficiency gains and innovative cheaper forms of service delivery. Democratisation of public policy processes assumes that citizens will be involved in the decision-making process, either through different civic organisations or individually. Widening consultation processes require all involved to be more critical, more innovative and more engaged. However, these different forms of engagements require the commitment of resources, which again opens up the question of affordability, despite the political desirability.

In bringing the government closer to the people, the issue of taxes, especially local taxes, emerges more than ever. Newly empowered sub-national governments (either regional or local) have to ensure that they have sufficient resources to discharge their functions, either those that are original or those delegated by

the central government bodies. In the case of original duties, the local tax base must be sufficient to fund the duties entrusted by law to the local government. If the tax base is insufficient, either the central government will have to support the financing of the activities, or it will be necessary to re-examine delivery arrangements. Good local (sub-national) taxes are 1) those that are (relatively) easy to administer; 2) that are imposed solely (or mainly) on local residents and 3) that do not raise problems of 'harmonisation' and 'competition' between various sub-national governments or between the sub-national national level governments and the central/national government (see: Musgrave, 1983; Oates, 1998; McLure, 1999, etc.). Often, only the property tax meets all the criteria and, to some extent, some secondary income taxation. Alternatively, the sub-national governments are encouraged to charge for their services and therefore, user charges and fees are theoretically a significant source of revenue, although in practice, fees and charges do not usually contribute to more than 5 per cent of aggregate revenues of sub-national governments. Still, the main source of revenue for sub-national governments is grant transfer, or in some countries, the tax share arrangements. However, the latter are increasingly replaced by various grant transfer arrangements.

But, it is not only about defining the sources of revenue. It is of the utmost importance to ensure that the respective levels of government can collect and process revenues in an effective and efficient manner. In many countries, despite the high level of decentralisation, all revenues are collected by the central government Tax Office on behalf of local governments. Often, the regional governments are left without their original revenues and are entirely dependent on grant transfers from the central/national government. Even if the local tax base is properly assessed, in the vast majority of cases, the collected revenues will not be sufficient to fund the activities for which sub-national government is charged. So, again there is dependence on central government funding. Despite the current sub-national government's curse of chronic insufficient funds, it is generally agreed that there is a need to build the fiscal capacity of sub-national, especially local governments, in the fiscal sphere, which should allow them long-term self-sustainability and provide an incentive framework for local government to develop their own tax base and deal with the local community in a more innovative manner.

III

The papers presented in this book explore the issues of capacity building in general and fiscal capacity building at sub-national level in particular. The book presents a series of case studies that follow the same research protocol. They deal with particular issues that face each of the countries presented and try to provide an accurate picture of the institutional (legal) framework and positive practices in developing sustainable local finance in those countries. We have taken care to

ensure that the papers depict the current situation correctly. The authors have tried to follow the common methodology and, to a large extent, this has been respected, but due to the vast differences amongst national solutions, on occasions it was not possible to do so.

The book is the result of both individual and collective efforts of the members of the NISPAcee Working Group on Public Sector Finance and Accounting. This is the second book in the series and following the success of the previous title (*Financial Decentralization and Grant Transfers: A Critical Perspective*) we hope that this one will be welcomed by both academics and professionals dealing with administrative reforms, especially fiscal reforms, at both national and sub-national levels. The work presented in this volume should be contributed to the authors and not to the organisations for which they work. The editor assumes overall responsibility for the volume and any eventual criticism should be addressed to him.

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Elena Žáková is a Programme Manager in the NISPAcee Secretariat, charged with supporting the Group. She has done her best to support both the Group Convenor and the Group itself. Often that was not easy, but she has endured the entire test put before her. *Ludmila Gajdošová*, NISPAcee Executive Director, has been a staunch supporter of the group from the very outset and has shown continuous interest in its work. Certainly, she is one of the prominent Group supporters who merited being mentioned and to whom all the authors have to say a big “Thank you”.

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Željko Šević

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1. Institutional Capacity Building in CEEC's and FSU: A Perspective

Željko Šević

1.1 Introduction

Institutional capacity is traditionally primarily understood to be the ability of an institution to perform according to an implicitly or explicitly agreed standard. Traditional public law theory has assumed that performance capacity is inherent to any public (state) body, as it was perceived that sovereignty cannot be limited in any way and is, in fact, self-limiting. The recently established international tribunals (for the former Yugoslavia, Rwanda and the International Criminal Tribunal) have proved that sovereignty can be limited and that the highest government office holders can be called upon to answer to international institutions for their actions which, *stricto lege*, were in accordance with nationally promulgated laws and regulations. Moratoria on debt repayment, often resorted to by highly indebted countries, have also proved that states can be close to bankruptcy and ultimately probably perceived as bankrupt, despite what the national law may say about this. Institutions in developed countries (primarily industrial democracies) are usually used as an example of good performance, whilst institutions in developing and transitional countries are classified amongst those that have problems in meeting the expectations and delivery of their tasks. However, this firm claim on their performance does not mean that the Western world institutions are still frozen in time and do not require their periodical 'reinvention' (see: Šević, 2004). In fact, quite the opposite is true, as numerous reform attempts in primarily Anglo-Saxon countries have demonstrated in the last 20-odd years (see: Lane, 1997).

'Capacity building has been recognised as an effective approach to achieving sustainable social, cultural and economic outcomes in the long term' is a definition often underlined by the Australian Commonwealth Government for the purpose of initiating socially inclusive programmes. As some papers in this volume (primarily Tumanyan) specify, capacity building has three dimensions: human resource development, organisational development and institutional and legal framework development. Often (and it has been demonstrated in this volume), authors and policy-makers focus on the latter – presenting and studying development of an institutional framework, assuming that a good institutional and legal framework would ensure effective and efficient building of (societal) capacity. However, this may be seen just as one dimension of capacity building, that does not necessarily ensure any expected social well-being. However, in the transition countries, the main focus (rightly or wrongly – only time will tell) has

been on institutional capacity building and endorsement of new processes and procedures associated with the newly emerged intuitions.

1.2 Rethinking Institutional Capacity

When institutional capacity is seen from an institutional building perspective, it may mean the increasing ability of organisations to absorb responsibilities, operate more efficiently and enhance accountability. While the traditional definition focuses more on the outcomes (or often outputs), the 'building' perspective is more process-oriented in a sense that the institutions are subjected to an 'improving' process that would lead to enhanced outcomes in their overall performance. Not only the democratic changes in the former communist countries in the former Central and Eastern Europe (CEE), but also the increased complexity of post-modern (post-industrial) Western society, requires a solidification of the institutions improving the components, activities and 'energy' that make them up (see: Amin and Thrift, 1994; Kaufman, 1985). Institutions are usually behind the times and this is why their adjustments are often rather erratic (see: Savitch, 1994). Institutions are open systems and therefore they interact with and are open to influences by the environment, where there are sets of external dynamics that are often not completely understood or appropriately regarded. This is why institutions cannot remain isolated and have to respond effectively to constantly changing settings. This brings us again to the point of departure where we claimed that institutions are behind the times. As they require formalisation, the process of which takes time, when this does eventually happen, it again requires a significant effort to initiate a new formalisation process. We often refer to this fact as tradition, although it could just as easily be labelled *conservativism*.

The democratic processes initiate different social interactions and new forms of informal, semi-formal or even emerging formal organisation of citizens (voters). The new informal form requires a change in the existing institutional framework and consequently, there is a need for change in existing institutions. The 'spontaneous forms of organisation' may have found new channels and forms of information retrieval, which will make them an important social player and they will, in turn, be able to initiate changes quicker and the very processes of change will not be very easy to plan and/or predict (forecast). Theory would state that smaller and more adaptable organisations will do much better than those that are larger in size and limited by their own experience and history. Empirical and theoretical research has clearly shown that smaller organisations are better equipped to define people's needs and to meet them (see: Coleman, 1988; Putnam, 1993). Also, very important in the study of institutions, is the realisation that they are not simply social tools, but rather a social framework, that creates rules, transmits values and creates a particular social climate. Institutions are rooted in history and experience that define the rules, the norms, identities

and beliefs (see: March and Olsen, 1989). Collective behaviour will not only be affected by the institutions, but also pro-active modern institutions will be affected by created and practised social behaviour.

Modern society commands a large set of institutions, which together develop a better, more effective and hopefully, more efficient society. The 1990s were marked by (still on-going) the search for a cheaper but more effective social framework. Society connects in a matrix structure way. In the social playing field, there are government(s), private firms, mass organisations, non-profit organisations and quasi-government organisations, mass-media, etc. All these players influence the national playing field and define how policy processes will be conducted. Of course, for the effectiveness of the process, there is a need for a richer set of institutions and their interactions. In a matrix structure, organisations have vertical, horizontal, collateral and other relationships (such as coalitional) and through their interactions, one obtains social outcomes. In a well-defined setting, the outcomes are usually the desired ones, whilst in a weak intuitional setting, the outcomes may not be those that policy players expected and bargained for.

The communist experience has shown that it is not the number and mere existence of institutions that matter, but their interactions. What is referred to as institutional thickness not only looks at the institutional structure (the formal existence of institutions) but at its interactions, where both static and dynamic elements create an institutional system. We also look at the issue of trust, since this is a core requirement for the successful performance of institutions. Trust is perceived as a voluntary relationship (see: Fukuyama, 1995), built through common patterns of social interaction and voluntary acceptance of institutions and everything that comes hand-in-hand with these (rules, identities, beliefs). Basically, trust can be defined as 'regular, honest and co-operative behaviour, based on commonly shared norms' as Fukuyama (1995) put it. Modern society requires a higher level of trust, as information is more easily accessible and social players are more knowledgeable. Modern societal governance faces, much more frequently than in the past, the emergence of ad hoc created social networks which contribute more to the social order (see: Ostrom and Ostrom, 1993; Parks and Oakerson, 1999). Development of community-based organisations may lead to a better devolution of power and to the creation of a community support network for actions undertaken by the major players (usually and almost exclusive the government) for the benefit of citizens. Building capacity from the grass-roots can be interesting, especially if there is a presence of 'spontaneous sociability' (Fukuyama, 1995).

1.3 (Managing) Institutional Building from the Bottom Up

Modern institutional building adheres to the support of grass-root organisations and initiatives, consultation with grass-root organisations, deregulation of the playing field for grass-root organisations and allows the flexibility of governance and

management of grass-root initiatives as long as they do not contradict the spirit of the law. Whatever organisational form the institution may take, it is led by the elite and followed (or empowered) by the masses. The elite will generally be able to allocate resources, but the good governance model ensures that the allocation has benefited all, not only the leaders. The importance of good governance models is that they design incentives for leaders to converge their actions on the interests of the wider membership (the masses). Some organisations are driven by economic interests, whilst others are driven more by some sorts of civic virtues. The relative perceived social importance of an institution will certainly affect both the manner and substance of participation.

The change, including social change is a long and painstaking process. Although everyone is publicly pro-change, when it comes down to implementation, a very small number of people actually subscribe to it and the number of institutions that are champions of change, are even smaller. The role of public sector change is to create a positive societal climate that will support change in an institutional framework and at the same time induce the public to enlist and participate in the process of change. But, even wide public participation does not guarantee success in reform/change implementation. Most research has established a direct link between institutions and behaviour, where the interaction is mutual (March and Olsen, 1989; Savitch, 1994). Institutions allocate functions, distribute power, define relationships and in the process of doing so, influence behaviour. The ultimate application of legal sanctions is a guarantee of the efficiency of the institutional setting. The rule of law is a result of good institutional setting and also, to a large extent, a prerequisite for a stable institutional framework. Institutions may fail to change behaviour immediately, but in the long run they have a substantial impact on societal behaviour. The messages institutions send are very important for shaping individual and collective actions in society. They may not be able to create the desired level of trust in a society, but they certainly emphasise the issue (*cf.* Putnam, 1993).

Building institutional capacity goes together with a profound value change process in society. Institutions are capable of influencing value as they offer the means, incentive and opportunity for people. Means are often perceived as education and training; incentives are, for instance, job availability and social improvement/mobility, whilst opportunities are the resources available for social/community mobilisation (see: Savitch, 1994). Institutions may also be seen as a desired collective action. The promotion of community-based actions is a way of promoting collective actions amongst different players. Modern governance trends are in favour of small, grass-root organisations that support local communities. But, is there a possibility that a large or even uncontrolled growth in small organisations will, in fact, create a situation of institutional hyperinflation? This may be the case, but it has constantly been reiterated that citizens (and voters)

prefer the smaller organisations and/or institutions to larger ones (see: Gallup Organization, 1996).

Giving a number of mushrooming small organisations some kind of authority raises the overall level of risk. However, as with all risks, it is possible to turn them into a calculated risk, where one can see the costs and benefits of a particular model chosen. Smaller organisations, if well designed, have the advantage of eliminating rent-seeking behaviour through strong peer-pressure and the introduction of better oversight practices (see: Olson, 1965). Also, it is known that hyper pluralism can hamper an organisation (see: Lawrence and Lorsch, 1969). However, the more developed the organisational specialisation, the greater the fragmentation will be and the more difficult it will be to integrate newly emerged organisations. This presents a challenge for modern government. It is not an argument for total dissolution of modern, current government (and the model that it represents), but rather to redefine that same government model, which has to take into account new players and learn to play a better intermediate role. This is additional capacity building which is required as a process of change in modern public governance. Informal governance settings may be useful in formulating the perceptions and views of people, but certainly an informal model will not be able, in the foreseeable future, to replace the formal model of public governance.

1.4 Securing the Roles for the Traditional Governance Players: Reconsidering the British Experience

Conventional, traditional government has to hold on to its formal supervisory powers and, if necessary, intervene and stop the application and the existence of other more alternative models of societal governance. The formal responsibility for national well-being must rest with formally elected representatives and therefore parliaments, as the highest and most widely elected representative bodies, should resume ultimate responsibility for the state of the nation. In fact, shifting ultimate responsibility to parliament rather than the government (of the day), is another step towards promoting democratisation of the accountability process. Most of the US authors¹ would say that the ultimate responsibility rests with governments (federal and/or state), but we see that democratisation requires a shift from the executive branch to the legislature as the most widely elected public body.

The executive branch is traditionally dominated by appointees (both political and career), whilst the parliament (or its equivalent) is filled with the people's elected representatives. One should not overlook the fact that the forms of governance that accommodate institutions are normally subject to higher level oversight, which generally permits expansion, shrinkage or adjustment. Accountability mechanisms are used to ensure the constant flow of information between

¹ A reader can choose almost any of the US authors listed in the bibliography section at the end of this essay, to see the point for her/himself.

interested parties and to ensure that the ultimate institution can evaluate the performance of other players in the process and facilitate their progression. Benchmarking might prove an important tool in doing that, although it is very difficult to benchmark emerging institutions in emerging and new fields of societal life.

Institutional capacity building can be perceived as the provision of technical or material assistance designed to strengthen one or more elements of organisational effectiveness. Those elements that can be addressed through the process of institutional capacity building can be governance, management capacity, human resources, financial resources, services delivery, external relations and sustainability. The main idea of building institutions is to ensure long-term sustainability in three main aspects of operations: managerial sustainability, technical sustainability and resource sustainability (often referred to as financial sustainability). Organisational effectiveness is to ensure that there is a good governance framework, management practices, human resource capacity, financial resources and financial resources to implement desired policy actions. Development will take place in phases, beginning with a nascent stage when the initial framework emerges, but there are no clear signs as to what can be expected. In the emerging stage, there are basic structures of governance, but they are not capable of meeting expectations and performing their functions properly. In the consolidation stage, institutions are capable of fully delivering their tasks and can cope with emergencies and other sudden changes and challenges.

However, institutions may also reach the maturity phase where they have no inclination to change institutional frameworks, and this consequently leads to them having a problem to manage citizens' expectations. If the maturity phase is indeed reached, then instructions have to be issued prior to entering the process of self-examination to try to accommodate the changing expectations of the public. However, this is not a simple task because when institutions achieve their necessary stability and equilibrium, they tend to maintain the *status quo*, if at all possible. Over time, challenges mount and there is societal pressure to change, initially to adapt to the new environment and later on to move to a new equilibrium. Often, changes and shifts within the institutions are initiated by an important ideological paradigm that often marks the age of change. In the 80's in the UK, the Conservative Party was the major driver of change and innovation. They subscribed, with astonishing zeal, to the policy and practice of new public management (NPM). The government was to reinvent itself and still be able to cope with a changing environment. Despite the popular rhetoric, the move was largely initiated by the lack of funding and need to literally get by. The Conservatives and Baroness Thatcher certainly changed the political and institutional landscape in Britain forever.

We are primarily interested in the financial aspects of institutional change in the UK. A Financial Management Initiative (FMI), launched in 1982, is one of the early attempts to introduce a wide range of changes in the British Civil Service.

Before FMI, the British tried to improve the quality of its Civil Service through the Fulton Report in 1968 and 'Efficiency Scrutinies' in 1982. The Financial Management Initiative was further followed by the 'Next Steps Initiative' (1988) and the Citizen's Charter in 1991, etc. Since the launch of FMI in 1982, the British Civil Service has been subject to a continuous process of change and improvement, to a large extent mirroring the changes experienced outside the Public Sector, not only in the UK, but also overseas. Although the goals were outreaching and mainly non-financial (cost consciousness, better value for money, 'downsizing', 'de-layering', decentralisation and devolution, etc.), the financial logic played a very important role in the process of the implementation of changes. The British Civil Service has been reduced by one-third since 1976 and has significantly improved its resource management, as more power was given to line managers.

The aim of FMI was to improve management of the Civil Service by ensuring that all managers knew what their objectives were and how their achievements would be assessed; had well-defined responsibilities for making the best use of their resources and the necessary information, training and advice to exercise their responsibilities effectively. This was primarily carried out through the delegation of budget expenditure decision-making to managers, but accompanied by careful measurement of the outputs whenever it was possible and the principle of cost-effectiveness. The reforms resulted in making Civil Servants more responsible and accountable for their work. Each department works within a limit for its total running costs. This was followed by the Next Steps Initiative that emphasised the need to look critically at functions of the Government and the ways in which government functions are discharged. Decentralisation meant that a central government department would be more responsible for strategic planning, while the day-to-day control would be carried out by lower level units. This also assumed that all non-pure (non-core) government functions should be discharged by executive agencies, headed by a chief executive, usually coming from outside the civil service. Managers were encouraged to use their full managerial freedom and there were incentives in place to inspire such behaviour. The introduction of strategic planning (although this term was not used explicitly in the related documents) assumed that the agencies and departments were expected to set the goals, aims and objectives of their expected outputs and outcomes, with more or less explicit performance indicators.

In financial terms, FMI had three main elements: 1) delegated budgets, giving individuals at lower levels of management control of resources to match their responsibilities, 2) better information systems that assumed that people on lower levels would know what they had to do and how to do it (demonstrated through the costs incurred) and 3) setting clear objectives and performance indicators for individual civil servants. FMI led to the accelerated implementation of advanced, computer-based accounting systems and related efficiencies. The objectives-based

management initiatives, together with the delegated budgets, raised some fundamental questions about the management culture of the Civil Service, *per se*.

Overall, the UK experience has proven that managers in the Civil Service performed better when they had a clear view of their objectives, measurable outputs or performance in relation to those objectives and a well-defined responsibility to make the best use of their resources, including the delivery of outputs and 'value for money'. 'Inputs' are perceived as resources (salaries, accommodation, equipment, etc.), while 'outputs' are the goods and services 'produced' by a particular government unit (department), such as the provision of policy advice, the administration (enforcement) or regulation, etc. Finally, outcomes are the effects on the community of an output or a set of outputs.

The UK's and similar experiences (New Zealand, Sweden, etc.) have proven that organisational restriction is just a first step, while it is expected that the Civil Service would try to implement related 'best practices' developed outside of the Public Sector. Focus on customer satisfaction, business processes, quality and external comparisons and indicators can certainly help to improve the work of the government and to simultaneously deliver 'value for money'. The measuring performance of an effective government is an inseparable process embedded in strategic planning. The Citizen's Charter strengthens the importance of citizens' perceptions of the Civil Service and its effectiveness. An effective Civil Service will be able to satisfy the expectations of the citizens and certainly this may reflect on the chances of the government remaining in power for another term in office. The development of a 'best practices' guide/manual also enables the Civil Service as an organisation to learn quicker and certainly disseminate good practices across a large number of government units in a more effective manner. However, development of best practices requires not only profound knowledge of performance measurement practices, but also familiarity with the specifics of the particular national Civil Service system. Failure to recognise the specific national characteristics can be very expensive especially when it comes to the process and costs of implementation of reform in the Public Sector.

The introduction of administrative reform usually requires a strong political sponsorship. At least, the British experience has shown the importance of a project that is well regarded by the key political players in the country. The agreement of all political factors would certainly support the speed of the reform, but usually is not a prerequisite. In the former socialist countries, public sector reform has generally been connected with institutional capacity building and as yet, very little has been done on the introduction of new policy initiatives. Often the terms 'institutional capacity', 'institution building', 'institutional strengthening', 'organisation capacity' and 'organisational development' are used interchangeably, but refer to the same thing – the ability of an entire organisation to provide quality and effective services, while being viable as an institution.

The organisation as such, must be *programmatically, organisationally sustainable* and have *sufficient resources* to achieve its main goals, aims and objectives. It is also assumed that the organisation will have support from its immediate and wider environment (political, economic and social) for the discharge of its functions. An organisation can be perceived as a system of related components that work together to achieve an *a priori* defined mission. In order to discharge its functions, the organisation must have well-set administrative procedures and management systems, financial management practices, human resource management and management of other resources. All these together provide a sustainable and successful organisation, capable of realising itself through achieving an agreed-upon mission. When the organisation is organised in a way to meet its function, then it assumes the duty of continuous improvement and this is the way reform in well-performing organisations is embedded in the process of permanent improvement and is not a one-off action. This is why it is only when the process of continuous improvement is in operation that the organisation is really performing well and can be regarded as effective and with an appropriate level of capacity abilities.

The British experience has certainly demonstrated the importance of adaptability of institutions and the need for change. In fact the propensity to change is an important feature of good and well-performing institutions. They are fully aware of the limits and the need to carefully reconsider all the important issues and to reconcile the interests of different pressure groups that have their own political agendas. Another country with a formidable ability to accommodate and implement changes, especially after major social challenges, is the US, where traditionally, both the government and the wider society were able to implement major social reforms with little social friction. This may be due to a particular historical experience and people mix but we see this more as an impact of well-designed and performing social institutions, capable of sustaining the change. It might be an ideal in institutional development where intuitions achieve institutional maturity and at the same time have high (formidable) change absorption capacity and the ability to sustain change. This may also be an ideal for transition and developing countries.

1.5 Instead of Conclusions: Looking ('Critically') at Institutional Capacity

The government, especially local government, has to reinvent itself in a very volatile environment. For instance, the Soviet-type public administration was established to serve the purposes of the party state and it was of the utmost importance that the party's requests were served without any question. In fact, the party apparatus usually had more resources and abilities to perform the duties of public administration than the public administration itself. This dichotomy ensured that party

supremacy was not challenged. However, with the dismantling of the party state, the existing public administration system lost orientation. This may be the reason why the state became very ineffective in handling growing social problems and corruption practices found a very fertile ground on which to develop. In contrast to other former socialist countries, Yugoslavia kept many pre-World War II traditions and preserved a noticeable level of professionalism in the Civil Service. Organisations of the Communist Party (in fact the Union of the Communists) were present in all central and local government units, but were not of paramount importance. Only in a few cases did the senior party officials hold ministerial posts (defence, internal affairs, foreign affairs, *et sim.*). The role of the party was to guide, rather than to manage, after the changes introduced in the mid-1950s, with the implementation of the *social self-management*. The decentralised administrative model theoretically should have enabled the Yugoslav civil service to develop itself along the lines suited to performance management, but unfortunately all the processes remained within the classical framework of bureaucratic hierarchical periodic reporting, where budgeting control was the major (if not only) method of control.

The papers in this volume deal with a particularly narrow aspect of institutional capacity. They predominantly look at the resource/financial capacity of local government in a number of countries in Central and Eastern Europe. The papers give a fair overview of developments and changes that have taken place over the last ten-odd years. It is certain that central and eastern European countries (CEECs) have come a long way from highly centralised, communist countries to become countries that are either members of the EU, or are close to membership of a single Europe. The initial focus in the reform was on the economic institutions building and promotion of private ownership, which is believed to be more efficient than publicly owned. The narrative of legislative changes and the implementation of new legislation in CEEC's is, in fact, maybe somewhat legalistic, but is a fair story of institutional change in the region and shows how those countries dealt with the challenges of transition and with the changing public sector in the process of the overall social transition.

The public finance institutions in CEEC's are now going from the emerging to the consolidation stage (some of them have already been in the consolidation stage for some time). Decentralisation, as the main activity promoted by the World Bank and its affiliations in the early stages of public sector transition, has generally been achieved in a number of CEE countries. There are still problems with ensuring the existence of original local government revenues to sustain real decentralisation over time. In a number of countries, fiscal decentralisation is in fact to a large extent, quasi-decentralisation and creates significant frictions and hampers local government's capacity to deal with all the issues entrusted to them by law or by central government regulations. It seems that due to the general perception that supporting and strengthening central government is really an exercise in nation-state building, local governments will still have to wait some

time before real fiscal decentralisation is implemented. Central government still believes that fiscal/financial leverage is an important instrument in keeping local governments obedient and subservient. On the other hand, there are also local governments that are not particularly keen to be fully financially independent, as the central government can serve as the culprit on the many occasions when there are serious shortcomings in local government performance.

Financial decentralisation has remained an issue and will remain a specific issue in institution building in transitional and developing economies, especially due to an (unnecessarily) high tension political context. This book certainly has filled in the gap in research, but it has by no means covered all the facets of the problem. In fact, it has merely opened an issue and initiated a long research journey which lies ahead of all students of (transitional) public finance in Europe in general and in Central and Eastern Europe in particular.

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**PART ONE – EXPLORING
CAPACITY BUILDING**

2. Revenue Raising and Accountability of Local Governments in Lithuania

Mark Chandler

2.1 Introduction

Lithuania is a highly centralised state with local authorities caught in a “fiscal straightjacket” [World Bank (2002)]. Hence there are no truly autonomous local taxes in Lithuania. All taxation is either controlled, or at least heavily regulated, by the national government. This study investigates the potential for increasing the accountability of Lithuanian local government by introducing a true local tax.

There are only two levels of democratically elected government in Lithuania – national and local. The national government contains only one elected chamber of parliament, but also has a directly elected president. There are 60 local authorities whose councils are elected by party list proportional representation. There was a major reform of local authority finance, beginning with the 2002 budget.

Giving local authorities (LAs) more control over their revenue could potentially increase local fiscal accountability. LAs should be given the right to increase their revenue through taxation, even though this conflicts with the efficiency of the location of people and businesses. Entangled with this issue is also the question of the appropriate tax base for local government. That in turn depends on the services provided by local government. At present, the main role of Lithuanian municipalities is to administer schooling, but funding of this function is centralised. It is therefore necessary to consider the decentralisation of schooling in order to address decentralisation of revenue-raising. By giving LAs control of their revenue, we would effectively give them control over important decisions of resource allocation for public services. However, if we are reluctant to decentralise this control due to considerations of efficient location or equity, then local revenue control will be less attractive. A subjective counter argument to the location efficiency critique of decentralisation is that a community of people in a geographical area is just as valid a part of its environment as other “natural” features. Hence, to preclude the interplay of the communities’ preferences on resource allocation would constrain these preferences unnecessarily, leading to an important efficiency loss.

Turning more to methodological individualism, there is a trade-off between the efficiency loss from the political externality of a centralised resource allocation decision and that from the distortion of location decisions from differing local tax rates. The only way to avoid the latter while, decentralising taxation, is to tax the fixed factor, land, at a unit rate. This may, in the short run, lead to an

increase in the supply of land for rent, if poor landowners are forced to rent out some of their land to cover the tax. That would cause a further rise in allocative efficiency, a benefit possibly outweighed by the distributional consequences. In the absence of specific land taxes, there will be a distortion of location decisions. Land is an insufficient tax base to finance modern local government, however. This is clearly observable since the total rent obtainable from all Lithuanian land is lower than the expenditure of Lithuanian municipalities.

The primary justification for local taxation must be a local public good that is to be financed. Local expenditures are dominated by provision of schooling but it is questionable whether this is a true public good. Many argue that education is a private good since it is excludable and rival (or non-joint) in consumption. Few, however, would deny that there are positive externalities associated with education and hence it could rationally be subsidised. Moreover, there may be certain features of the education of children, e.g. group learning, that do exhibit, at a minimum, the features of club goods, i.e. excludable but locally non-congestible. Public goods are often associated with defence, against violence or disease and hence there may also be a public good in the defence against ignorance. The establishment of a society where illiteracy is reduced to a minimum would appear to be a commonly desired public good of this type. Hence a minimum of education is a fairly global public good. Certain communities may desire to provide higher levels of education to the attendees of schools in their district. They may be dissatisfied with the level agreed by national parliaments, or may simply prefer to concentrate more resources on educating children in their immediate vicinity than on those outside.

However, the true good may not be the provision of education itself, but the aspects of the environment actually consumed by individuals. Individuals consume an environment that contains traces of ignorance or knowledge, in addition to information about the conditions of others. To the extent that the former dominates an individual's preferences, they may be expected to prefer higher levels of education of those in their immediate surroundings. The more mobile the individual, the less this consideration will lead to focus on a local area and the more they will support education over a wider geographical area.

The foregoing argument implies that local taxation may be a mechanism for concentrating the resources that one is pooling for community projects on expenditures in the local vicinity, rather than over the whole nation. This may be problematic for equity since it implies that less is invested in the human capital of children in some districts. It may, from this view, be preferable to force concerned parents to raise the general level of expenditures than to allow them to focus on their own community, probably leading to a lower level of expenditure in the nation in the political equilibrium. However, this view implicitly assumes that the raising of such expenditure is the correct policy and superior to alternative paths.

In essence, the discussion of decentralisation of taxation consists of a series of questions about the use of a local tax to fund a particular service, e.g. schooling. Should schooling be funded by a local tax? Yes, if there is community preference for providing a minimum level of schooling locally that is higher than the national minimum. There may be some municipalities whose provision will lie on the threshold and not want any additional local funding. In that case, local taxation will be zero and the town will revert to being purely an administrator of a nationally funded school. With this logic, it appears that the appropriate step for Lithuania is to set a national subsidy for schools to the minimum required standard and allow towns to raise further funds for their schools from local revenues. There is also the question of whether schooling provision, rather than finance, need be in the public sector. The community building nature of local schools should not be forgotten here, as it may form a significant part of the public good nature of municipal schools.

Summarising this discussion, the following considerations are key in determining the relevance of treating schooling as a local public good:

1. Is education received as a non-rival and non-excludable good?
2. Is the educational content of the environment consumed as a non-rival and non-excludable good?
3. Is there congestion in the consumption of the education environment?

Some aspects of education may be non-rival and non-excludable since knowledge itself is not depleted by sharing it with another person and people cannot be very cheaply prevented from sharing knowledge that is not quite highly specialised. However, the key service provided by schools – teacher contact – is rival and easily excludable. This means that both private tutoring and private schools survive in the market. The educational environment consumed by individuals may be both non-rival and non-excludable. As individuals become more mobile, their environment extends over a larger area and hence, their preferences for a good environment include a larger area. Congestion in the consumption of the education *environment* in contrast to the congestion that exists in receiving education services is complicated by the fact that all the individuals are part of the environment and so the consumers are part of what they are consuming. Looking purely at the aspect of the environment that includes the education of the younger generation, however, this is not congested by adding more consumers from the older generation (i.e. voting taxpayers). Once an environment of educated individuals has been created, extra consumers of that environment do not deplete it or change the probability of meeting ignorance in that environment. In that sense, investments in the environment by educating the next generation are global public goods and should be provided at the higher level of government. This contrasts with the practice that education of children receives more attention from local governments than education of adults.

Hence, the cost and benefits of a global community may result in some education for a particular Lithuanian town, say, for example, funded by the UNDP. This

means that everyone now experiences an increase in the educational level of that Lithuanian town. However, there is another good which individuals consume – their *immediate* environment. They may have higher preferences for the quality of their immediate environment. Looking from the global perspective, this good is clearly a rival. Investments into the immediate environment utilise the resources that could otherwise be used for investment into the immediate environment of another distant individual. A teacher cannot simultaneously teach in two distant towns any more than an apple can be eaten by two people. It is also excludable, as education can be given to one town without being given to another. It is not rival or excludable among individuals within the immediate environment, however.

Moving to a more continuous formulation, we can say that an individual may care less about a child's education that he is unlikely to meet. This implies that the individual's marginal benefit from a particular child declines with the distance that exists between them.

An alternative is to accept that improving the education level of a particular town is a global public good but the question must be asked "how do we reach an efficient level of provision?" The most obvious way in democracy is to have each taxpayer pay their marginal benefit. Since the marginal benefit of those outside the town is likely to be much lower than the marginal benefit of those inside the town, it is an efficient approximation to have the good financed only by the latter. If those outside the town have no tax liability, they cannot participate in any decision-making as their choice will not take costs into account. So, local financing of improvements in the local environment may be seen as an approximation to a more efficient decision-making process for a public good.

Hence the local public good is the immediate living environment, which includes the level and distribution of education in the town. The main local public goods for which local tax autonomy is relevant are environmental: road quality, refuse collection, management of public land, socio-cultural projects and policing.

2.2 An Overview of Local Government

a. Local government at a glance

Lithuanian government expenditure has fluctuated between 31 per cent and 38 per cent of GDP in the last five years. Municipal expenditure was estimated at 7 – 8 per cent of GDP between 1996 and 2000 [World Bank (2002), 3]. The budget law is passed each year with forecast allocations for each municipality, based on projected revenues from each of the taxes, specific grants and the results of the equalisation formulae. The main specific grant is for schools and hence the financing of this function is largely controlled by the national government. Towns are then free to reduce their revenue by offering tax abatements to businesses and individuals. Towns must form their own budget for expenditures in accordance with

a large set of regulations regarding salaries, number of employees and other aspects set by the national government. These restrictions severely restrict the room for local authorities' manoeuvre on the expenditure side. Hence, local authorities are largely reduced to the role of administrators of a budget that is preset for them by the national government.

b. Local government finance

A large reform of local government finance took place in 2002. The table below shows the scale of the shift, by comparing the breakdown of revenue by source projected for 2002 with that realised in 2000. The main change is the switch from personal income tax to specific grants as the main source of municipal revenue.

Table 1
Revenues 1994 – 2002 (thousand litas)

	1994	1998	2000	2001	2002**	2002 in %
Total Revenue	1,927,461	3,719,954	3,274,269	3,233,895	3,527,222	100
Tax Revenue	1,301,313	2,739,550	2,829,828	2,803,503	1,494,876	42
Personal income	626,550	2,421,738	2,504,272	2,511,614	1,115,346	32
Corporate income	213,660	285	–	–	43,744	1
Property taxes	38,220	235,014	258,503	284,409	328,274	9
Land	6,876	15,046	20,849	23,065		
Land rent	31,344	50,070	46,019	47,266		
Real estate	–	169,199	189,804	211,826		
Estate, inheritance, and gift	–	699	1,831	2,252		
Other	110,130	82,513	67,053	7,480	7,512	0
Stamp duty	106,861	75,726	60,031	–	–	
Market place duty	3,269	6,787	7,022	7,480	7,512	0
Non-Tax Revenue	77,602	198,338	112,272	117,226	68,599	2
Grants, Loans and Transfers	547,928	781,775	331,920	302,932	1963747*	56
Grants from the state budget	357,392	760,816	315,405			
Loans from the state budget	15,376	–	–			
Loan from the World bank	–	–	–			
Transfers from other budgets	175,160	20,959	16,515			
Sales of fixed capital assets	618	291	249	10,234		

* Forecast

** Not ultimate data

Sources: Lietuvos Respublikos valstybinio valdymo įstaigų ir finansinių įmonių finansai 1994. V.: Lietuvos statistikos departamentas prie Lietuvos Respublikos Vyriausybės, 1995; Valstybės ir savivaldybės institucijų finansai 1998. V.: Lietuvos statistikos departamentas prie Lietuvos Respublikos Vyriausybės, 1999; Lietuvos apskritys 2001. V.: Lietuvos statistikos departamentas prie Lietuvos Respublikos Vyriausybės, 2002; www.finmin.lt.

c. Original Revenue Sources and Local Public Borrowing

Lithuanian municipalities have accumulated significant debts to banks for short-term and long-term loans. The government seeks to control this through a system of controls, but this has proved insufficient. Local authorities have run deficits, as a group, totalling as much as 7 per cent of revenues in 1999 – the worst of the last 5 years [World Bank (2002), 11]. There was also a growing stock of arrears equal to 13 per cent of revenues by October 2001. Overall the stock of arrears and short-term and long-term debt was approximately 30 per cent of annual revenue by October 2001.

This situation led the 2002 World Bank report to recommend that the system requires both greater municipal control over their own revenues and expenditures and concurrently that the national government should toughen the budget constraint faced by municipalities by refraining from ad hoc bailouts. The existence of such large stocks of arrears and debt indicate the strain already placed on local authorities. Hence, it may indicate a lack of capacity to manage the additional administrative burden of a local tax, whilst also suggesting the need for a local tax, so that local authorities can at least prevent their debt burden from growing.

2.3 The Political Economy of the Local Government Budgeting Process

To analyse the political element of budget allocation takes a detailed analysis of the allocations to each municipality. However, changes from year to year are more readily apparent. The reforms in 2002 gave the biggest increase in revenue to Šilute, hence we can ask whether this municipality had increased its lobbying power compared to previous years [Data provided by the Ministry of Finance, *www.finmin.lt*]. This contrasts with the situation for Visaginas, which although protected from actually losing revenue in 2002 by grandfathering, would otherwise have lost 36 per cent of its revenue. A more complete table of the main winners and losers from the 2002 reform is as follows:

Table 2
Winners in the 2002 Reform

Municipality	Excess revenue (thsd\$ litas)	Excess revenue (% of total)	Municipality type
Šilute	5,097	9	Western medium sized rural weak poor
Palanga City	4,556	18	Western small urban poor
Panevezys	1,881	4	Northern medium sized rural (weak) poor
Jonava	1,586	3	Central medium sized rural weak

Table 3
Losers in the 2002 Reform

Municipality	Grandfathered revenue (thsd\$ litas)	Grandfathered revenue (% of budget)	Municipality type
Visaginas	12,489	36	Eastern medium sized urban poor
Birstonas City	4,291	33	Southern small urban
Svencionys	2,609	8	Eastern medium sized rural weak poor
Sirvintos	2,390	10	Eastern small rural poor
Pakruojas	2,206	7	Northern medium sized rural poor

These tables show that both the winners and losers tended to be small or medium-sized poor towns with weak economies. None of Lithuania's larger cities appear. We may conjecture that this is due to the political barrier to making reforms that would affect any larger city in a dramatic way. The clearest difference between the winners and losers is geographical. The winners are concentrated in the West and North of Lithuania, whilst the losers are in the East and South. Therefore, we might ask if there has been a shift of political/economic power in Lithuania, particularly away from the East.

Let us now turn to the political economy of introducing true local taxation. Having agreed that there is local public good in making investments into the local environment, the next question is how to achieve a provision that is responsive to the will of the community about these services. In order to answer that question we should:

1. Enumerate the factors desired by community members.
2. Find a way to evaluate the relative importance of these factors.
3. Deal with issues of timing and uncertainty.
4. Compare the effect of various systems on the overall evaluation.

This seems to be an impossible task. Hence this paper will seek only to evaluate one possible shift – adding local taxation to the current Lithuanian system.

1. What elements of service provision are desired by residents?
 - overall expenditure level (quantity of provision)
 - distribution of the service
 - content mix in the service
 - employment policy
2. Evaluating the relative importance of the above factors requires the use of a social welfare function and therefore, may be impossible. Lithuania's democratic institutions may provide a rough approximation of a social welfare function for Lithuania. Hence the question becomes; would local taxation make Lithuanian local government more responsive to the outcomes of decision-making by Lithuanian institutions? This question is cannibalistic, however, since local government decisions are automatically the resolution of those

institutions, whatever the mechanism. Hence the question would have to be reduced to comparing the actions of Lithuanian local governments to a subset of institutions, such as the election results. This does not give a clear means to distinguish a result, however, since there are no polls of elected representatives other than council votes. Hence, the main index of local opinion is the voting patterns of the local government council. Giving towns a local tax would enable Lithuanian councils to vote on increasing revenue. This would mean that local government actions were more accountable to local preferences.

We must conclude that there is no way to evaluate the relative importance of the factors so as to correspond logically to an aggregation of individual preferences without making some simplifying assumptions. The assumptions may enable us to look at the effect on certain mechanisms of practical democracy, by assuming that a positive effect on a certain mechanism will result in a positive effect on accountability. Examples of the types of mechanism we might consider are:

1. the ability of the council to affect resource allocation
2. the control of local residents over their local council.

Disadvantages of local autonomy

Another way to look at this question is to ask a given community that has a majority desire to supplement nationally-provided services by taxing itself, or a majority desire to shift spending on public services to private income by reducing taxes “why would you want to prevent this”?

1. Reduction of equity – especially for the environment of minors and increasing uncertainty and fragmentation in the nation
2. Inefficiency of local taxation – mobility incentives
3. Reduction of minimum expenditure levels
4. Redistribution away from poorer communities – leaves them with poorer local environments and worse schools.

This has to be set against the potential advantages of allowing richer communities greater freedom to increase their taxation, which may be partly linked through an equalisation system to aid poorer communities. However, if your objective is maximum (based on the current minimum standards being too low), practical experience indicates that centralisation is the best policy. This conclusion, though, may be quite separate to the question of how tax autonomy impacts accountability. This centralisation removes local decision-making power and hence would need to be complemented by an increase in the power of citizens over their national government. This could be implemented through taxpayer funding for lobbying of school parent-teacher organisations to members of the national parliament and to the Education Ministry.

2.4 Reconsidering the “Original” Local Government Revenue Sources

Local government “own” revenue sources include the real estate tax on commercial buildings, stamp duties, land lease charges, land tax and market place duties. They may only partially be classified as original local sources, however, since national law places limits on the rates. Municipalities may not raise tax rates above the legal maximum but are free to abate these taxes and reduce the rates at a direct cost to the municipality’s budget. The other feature that distinguishes them from income tax is that only the local government receives revenue from these taxes. Similar to the income tax, the revenue they receive is that collected from within their jurisdiction. These taxes provided approximately one-tenth of local government revenue in 2002, as shown in Table 1. The real estate tax has dominated, providing 75 per cent of the revenue, among this group of taxes.

General features of “original” local government revenue sources in Lithuania

Several aspects are common to all the above taxes in the Lithuanian system.

1. There is a maximum rate set by national law.
2. Municipalities receive the revenue collected from their jurisdiction.
3. Collection is administered by a regional tax collection agency.
4. Municipalities can abate or completely relieve the tax burden on a taxpayer or group of taxpayers, at the cost of reducing its own revenue.

Hence, these taxes are essentially imposed by the national government but the tax base may be adjusted directly and indirectly by the municipalities.

The real estate tax

The real estate tax was established by the 1994 law on “The real estate taxes of business entities and organisations”. The key features of this tax, mandated by law, are:

1. It is not levied on land.
2. It is only levied on real estate owned by legal persons. Private persons’ real estate is untaxed, apart from land (taxed by the separate land tax).
3. The taxable value of the property is based on the current cost of construction.
4. There is a reduction in value for depreciation since it was built.
5. The value is also adjusted for regional variation.
6. The maximum tax rate is 1 per cent.
7. A variety of governmental, public service and agricultural entities are exempt from paying the tax.

Municipal tax abatement

This is the key area of tax autonomy currently exercised by Lithuanian local authorities. It is thus important to understand how much autonomy municipalities currently exercise over the level of abatement of these taxes. The main question

that arises is “are towns that currently abate taxes making a deliberate decision to sacrifice public services for increased private income or are they mainly abating taxes in order to support long run development and revenue?” There are at least 3 possible explanations of municipal tax abatements.

- (i) Towns are trading off present collective consumption for current private consumption.
- (ii) Towns sacrifice present collective consumption as an investment in future business.
- (iii) Towns’ abatements do not sacrifice any current collective consumption as the abated taxes would not have been paid even if demanded.

The first of these implies traditional tax decision-making power allowing the local community to decide how much of its private income it would like to allocate for collective use. If abatement is only of the second variety, there is a particular type of tax autonomy that allows towns to act only when there is a pressing case for avoiding loss of business in the community. The last of the explanations for tax abatement implies no tax autonomy for the town, only a decision about whether to decriminalise non-payment in particular cases.

56 out of the 60 municipalities offered some tax abatement in 2000; this number dropped to 55 in 2001¹. Total abatements were 8.75 m. LTL, approximately 1 per cent of municipal revenue. In 2000, abated revenue was dominated by abatements of the land rent charge, land tax and real estate tax which made up 38 per cent, 29 per cent and 24 per cent of total abatements, respectively.

Hence tax autonomy was not effective for at least 5 municipalities in 2001, since they engaged in no abatement. In order to assess the degree of autonomy exercised by the remainder, we need to know more about the motives for abatements in those towns. A first step is to classify towns by which of the three motives above was dominant in their decision-making. I conducted a survey of municipalities in autumn 2002 in order to obtain some answers to these questions. From the 60 municipalities surveyed, answers were received from 44. They came from a variety of units in the municipalities, including mayors’ offices, departments of finance and budget and administrators’ offices. The most common reasons given for tax abatement, mentioned by over a third of respondents, were support of local employment and the difficult financial position of firms. This puts abatement into the second category, with some autonomous trade-off made between current spending and other goals. If the financial position of firms is critical, however, it may imply the third case with municipalities deciding to allow a company to continue operations despite its inability to pay its local taxes.

Another aspect of the abatement decisions is their tendency to be granted to individual cases rather than a general reduction of taxation. If a community de-

1 Data provided by the Ministry of Finance

cided to reduce collective expenditure to increase private income, exercising true control over its level of collective action, we might expect to see a general abatement of a tax for all taxpayers. This would be equivalent to a reduction in the tax rate. It would also imply that from that point, a community had the power to increase or decrease its level of collective provision at the margin. This would be a powerful indication of tax autonomy and therefore it would leave the municipality effectively unconstrained by national law. In practice, there have been only a few municipalities that have passed council decisions to make general reductions in abatements. This situation may change with the increase in the legally allowed maximum tax rate on land in 2002. Nevertheless, it is important to note that allowing municipalities to receive more revenue from the land tax would enable them to increase revenue from only a narrow tax base. Increasing taxation in this way could put acute financial pressure on a relatively small group of land-owners, who would bear the entire incidence of the tax. The significant and unexpected loss might cause such an action to be perceived as an unjust appropriation of property by the government. Landowners could be expected to resist strongly.

2.5 Enhancing Local Fiscal Capacity and Democratic Accountability

In Lithuania, the step towards tax autonomy which is being seriously discussed is the introduction of a real estate tax for natural persons, giving local authorities control over the rates. Hence, pressure on the government for increasing tax autonomy is most likely to speed up the introduction of this reform. It is likely to include, at first, some upper limit on the tax rates. If towns choose rates below the upper limit, they will still have effective tax autonomy at the margin. This would increase the statutory ability of local councils to affect resource allocation.

A framework for analysis

Whether the above change translates into practical autonomy depends, to a large extent, on the capacity of the local governments to use that power. The effect on residents' control of the council is equally unclear. So the two key determinants of whether tax autonomy leads to greater accountability are

- (i) what is the capacity of local government to make use of tax autonomy?
- (ii) how much control will residents have over their local governments that have been given tax autonomy?

I will comment on each of these in turn for the Lithuanian local government system.

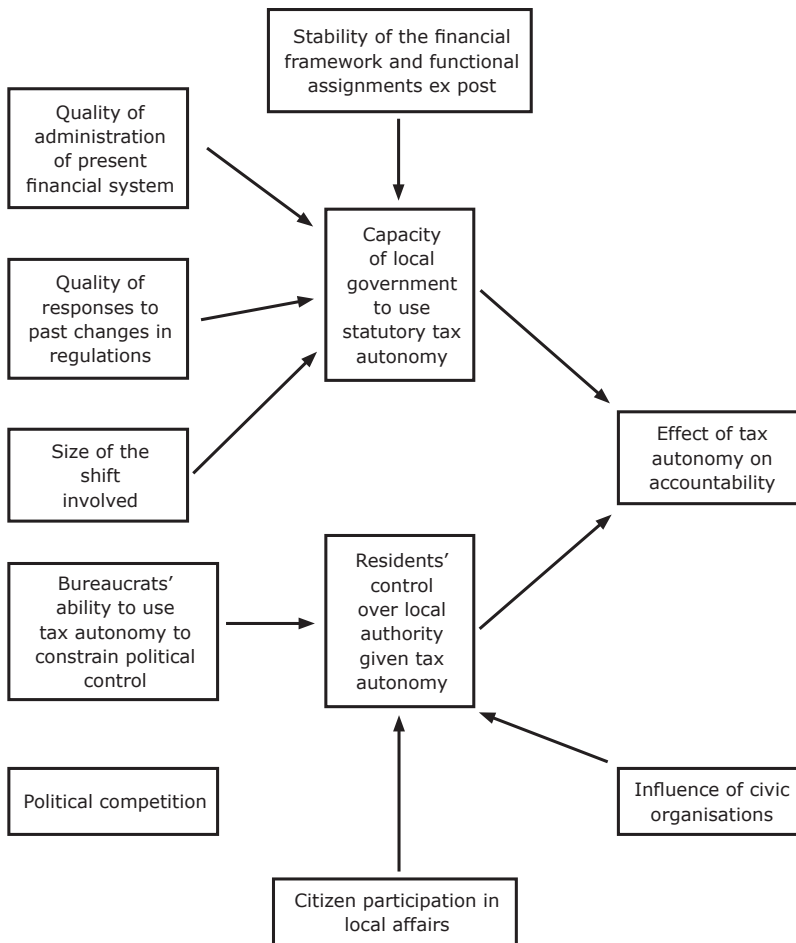
(i) The capacity of local government to make use of tax autonomy

In order to determine the capacity of local government to make use of tax autonomy there are a few guidelines. First, there is the capacity already demonstrated

by Lithuanian local government in their administration of the present system. Second, there are examples of Lithuanian municipalities' reactions to previous changes in their responsibilities, particularly in financing regulations. Third is the size of the shift, i.e. how great of an adjustment will it be for local authorities to implement true local taxation? Fourth is the likely impact of any further shifts in the financial structure and functional assignments. These measures are likely to reveal unequal capacity across municipalities and thus it is reasonable to expect unequal use of the power granted to them by statutory tax autonomy. To make an overall evaluation, it would be useful to compare with other countries, particularly those which have moved to decentralisation of taxation. Thus a system of benchmarking and ranking could be used.

Figure 1

A framework for analysis of the impact of tax autonomy on accountability



Hence, one way to evaluate the capacity of Lithuanian local authorities is to evaluate their administration of the present financial system. This may be done with measures of outputs produced by the LAs, as proxies for effectiveness. A less direct alternative is to use measures of inputs such as the qualifications or turnover of staff.

Quality of administration of the present system

a) Problems:

One of the most prominent features of the Lithuanian local government finance system in recent years has been the conflict between the municipalities and the national government. This is an output feature, thus it impinges directly on the capacity of Lithuanian local authorities. The Lithuanian Association of Local Authorities long contended that the national government had not followed the law in providing local authorities with adequate compensation for new mandates and low tax revenue. Eventually, the Association took the national government to court over the issue and won its case. The fact that co-operation between the levels of government broke down so completely as to require court action, may be a sign of low institutional capacity to manage finance. Alternatively, local governments may be commended for having the capacity to stand up to national government and strike an historical legal victory that laid down an important marker in the evolution of the rule of law in Lithuania. Perhaps most directly what these events demonstrate is the difficulty of the present intergovernmental financial system, that this may be improved by giving fiscal autonomy to local authorities. Fiscal autonomy would reduce the municipalities' dependence on national government and hence reduce the scope for conflict.

Another problem, related to the first, has been the growing indebtedness of the local authorities. Some of them have taken on markedly higher loans than others, putting them in a precarious financial position.

b) Successes:

Perhaps the most outstanding successes of Lithuanian local government have been its ability to work with international agencies, primarily the EU PHARE program, to facilitate investments that improve the standard of living of the population.

Quality of responses to past changes in regulations

Local government finance continues to be in transition in Lithuania and there are frequent changes to the budget system. Local authorities have shown considerable flexibility in dealing with these changes overall, despite problems in some municipalities. Instability of the financial system and functional assignments harm local authorities by providing continuous extra administrative burden in adjusting to

new frameworks, preventing the accumulation of learning on the administration of a framework and necessitating disruptive reallocations of resources. In Lithuania, however, reforms such as the introduction of the “pupil basket” categorical school grant in 2002 seem to have taken place fairly smoothly.

Size of the shift involved

This factor depends on what reform of local taxation is considered. Since the current situation only gives revenue control to local authorities through tax abatement, we may judge the shift to be quite large. If, however, we take the option most discussed in Lithuania, the introduction of a real estate tax for natural persons with some control over the rate in the hands of local authorities, we can evaluate the size of this shift. The shift would be significant because it would be levied on an entirely new tax base. It would be likely to yield considerably more revenue than the land tax and, in time, could become a significant part of the municipalities’ revenue. Hence the shift would be one of the largest reforms undertaken in Lithuanian local government finance in recent years and perhaps even more of a challenge for the municipalities than the introduction of equalisation grants several years ago.

Stability of the financial framework and functional assignments ex post

There are two prominent aspects to this question. The first aspect is that the changes in the financial framework have shown no sign of slowing down in Lithuania in recent years. Hence we might anticipate continued changes for some years to come. The second aspect is that the introduction of local taxation is likely to be a catalyst for further changes in the financial framework and possibly also in the assignment of functions. Since a local tax gives municipalities more flexibility over their revenue, it also introduces flexibility over expenditure. Both of these benefits are likely to be expropriated by the national government to some extent, through rearrangements of the financial and functional structure. This is especially true for local taxation introduced via a new tax base, such as the real estate of natural persons. The continuing shifts in the framework will hinder the abilities of Lithuanian municipalities to take advantage of their new local tax. It is likely that this will be disproportionately problematic for the smaller and economically weaker local authorities.

Taking these factors together, governing the capacity of Lithuanian local authorities to administer local taxation, what overall assessment can we make? It would seem that Lithuanian authorities have demonstrated a strong flexibility to adjust to changes in their framework, but not without some strain on their capacity to manage operations and the introduction of a new local tax would be a larger shift than most previous changes experienced by Lithuanian local government since the mid-1990s. The reform would also be likely to lead to further after-

shocks in the evolution of the system of local government, which would increase the challenge for municipalities to quickly manage the new revenue source.

(ii) Resident control over the tax autonomy of local authorities

This aspect of the increase in accountability depends, to a large extent, on the degree of political accountability of the local councils. As noted by Wright (2000), not only administrative, but also political and civic development is important for decentralisation. Hence it is important to question the degree of political competition for local council control and the possibility for residents' influence over local government between elections through civic organisations. Both of these aspects are connected to the degree of the population's participation in local affairs. A fourth factor here is the power of the local bureaucracy to interfere in the political control of the population, which is a familiar type of principal-agent problem.

A positive factor for Lithuanian residents' involvement in local affairs is their low mobility compared to populations in other European countries. However, trust in local government is low in Lithuania. Lithuanian municipalities are among the largest in Europe, hence residents may also feel quite distant from their municipal government compared to countries where average municipal units have less than a tenth of the population of the average Lithuanian municipality. Residents' ability to lobby local government between elections depends on the formation of interest groups and NGOs. There has been steady development of the NGO sector but it is largely confined to the capital and the larger cities. Political competition in Lithuanian municipal elections is completely within the framework of parties; there is an absence of independent councillors. This fits with the regional trend of greater party involvement in larger municipalities. Local government election results have not exactly paralleled national elections, however, with a different mix of party strengths emerging. Hence political competition may be said to be active. Another measure of the political competitiveness is that in the 2000 elections, only 8 of the 60 municipalities, (13 per cent), have town councils with a single party majority. Hence 87 per cent of councils rely on cross-party agreement to pass resolutions, making them more susceptible to residents' pressure.

Whether the municipal bureaucracies significantly reduce political control over revenue from a local tax is perhaps the most difficult aspect to predict. The bureaucracies will have a natural tendency to try to reduce competition among them by increasing regulation. For this reason, they are likely opponents of the whole project of decentralisation. Once tax decentralisation is inevitable, the local bureaucracies may nevertheless seek to institute national regulation that ameliorates inter-authority differences and hence reduces the power of residents to make local choices. In order to know how successful the bureaucracy may be in this endeavour, we can ask whether the necessary institutions exist and

how successful the Lithuanian municipal bureaucracies have been in past similar cases. The existence of the Association of Local Authorities of Lithuania (ALAL) for several years now and its incorporation even into the law for the allocation of budget funds, suggests that there is an institutional basis for municipal bureaucracies to lobby for their interests. Although the ALAL operates as a political association of municipal mayors, it also has the bureaucratic structure that might enable pressure on behalf of the local bureaucracies. It is difficult to find evidence of bureaucratic behaviour in an environment where the structure is continually changing. However, one might speculate that the tendency of Lithuanian municipalities to follow central government guidelines without deviation, although partly driven by asymmetric political preferences with respect to local reductions and increases from the guideline levels, may be reinforced by the bureaucratic desire for uniformity. Hence it would seem important that any local tax, even if introduced with an allowed range of tax rates, should not be accompanied by a guideline rate, or the local bureaucracies may be similarly successful in leveraging a uniformity that contradicts the objective of allowing local control.

2.6 Conclusion

The consequences for accountability of an increase in local autonomy depend on two major factors. The first is the technical capacity of the municipality to cope with the introduction of a local tax and the second is the amount of control residents have over their municipality. The introduction of a true local tax would be a major administrative challenge for Lithuanian local authorities in an environment where the continuing flow of institutional changes put significant pressure on their management capabilities. This may be combined with weak participation of residents in local affairs, particularly outside the major cities and established channels of bureaucratic influence to ameliorate the ability of local authorities to make independent policy choices with the new revenue source. This will be especially true if the national government does not refrain from forming a guideline tax rate for the local tax.

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3. Building Fiscal Capacities in the Czech Republic

Robert Jahoda, Jitka Pekova and Jan Selesovsky

3.1 Introduction

The Czech Republic is one of two independent states formed in 1993 by the division of the former Czechoslovakia. The Republic's administrative structure has been set out in its Constitution, which specifies three levels of government with separate budgets. The top level is the Central Government, which directs the Regional Governments. The Municipal Governments (Councils) are at the bottom level.

Until 1998, the Constitution was not fully implemented with regard to this administrative structure. The Government failed to create a regional administrative level and the only functioning administrative levels included Central Government and Municipal Councils. In addition, there were still territorial state administrative units – districts – dating back to the year 1950. The district administrative offices were mere elements of central administration, lacking the features of self-government. The directors of districts were appointed, dismissed by and reported to the central government (i.e., to the Minister of the Interior). The task of the district offices was to implement central state policy at the local level and to provide legal supervision of municipal political activities in the area of delegated powers.

In 1998, the newly elected government declared that it would prepare and implement a Reform of State Administration, which is still in progress. The core element of the Reform was the creation of an intermediate level of government – the regional governments. A team of experts was established in the Ministry of Interior to prepare the Concept of Public Administration Reform. The Concept was submitted to Parliament for discussion in 1999. It defined three basic variants of public administration. The Parliament later decided on the *combined model* (combining “delegated” responsibilities and “own” responsibilities at the regional as well as the municipal level¹). The 2000 Administrative Act (no. 129/2000 Coll.) established 14 self-governing regions. Towards the end of the same year, the first election to regional governments was held. Regional governments have effectively functioned since 2001. The district offices, not considered in the accepted model, were closed at the end of 2002 (see Table 1).

¹ at a municipal level, the combined model has been exercised since 1990

Table 1
Numbers of Government Entities

Year	Central	Regions	Districts	Municipalities		
				Total	Delegated	With extended powers
1993	1	-	76	6,191	-	-
1996	1	-	77	6,228	383	-
2000	1	-	77	6,246	383	-
2001	1	14	77	6,241	383	-
2002	1	14	77	n.a.	383	-
2003	1	14	-	n.a.	381	205

Municipalities have been the basic, local administrative unit from the beginning of the independent Czech state. Citizens elect municipal representatives and the municipal representatives indirectly elect members of the Municipal Council, which is the executive element of the self-government system. The mayor, selected from among members of the Council, heads the municipal offices. Intergovernmental expenditure assignments in the Czech Republic conform to conventional general principles, especially the principle of subsidiarity. Municipalities are responsible for expenses within “own” and “delegated” responsibility. The scope of “own” responsibility is specified in the Municipality Act (no. 128/2000 Coll.). Pursuant to this act, the municipalities control the operation of nursery and elementary schools, culture and recreation, safety and order, sanitary services, street lighting, water distribution and sewage systems, site planning etc. Delegated responsibilities include activities pertaining to the civil registry (birth, marriage, and death), building codes, regulation and enforcement of laws pertaining to the environment, transportation, sanitation and so on. Prior to 2000, the widest range of delegated responsibilities was performed by 383 selected municipalities, with authorised district offices governing the remaining municipalities. Responsibilities of the closed district offices were taken over by the extended power municipalities (205 selected towns). Since 2003, these selected towns (sometimes called “designated” municipalities) have performed the greatest portion of state administrative tasks, such as the issue of identity cards, passports, trading certificates, crisis management acts, social work etc.

3.2 Local Government at a Glance

Tables 2 and 3 indicate the share of local finance in GDP and in total public expenditures. The share of expenses in GDP has been stabilised at 7.4 – 8.0 per cent recently, with the exception of the years 2000 – 2002. Those years represented increased expenses as a consequence of increased capital income going back to the years 1998 – 2000 (see Table 4). The increased share of expenditures is only temporary and will terminate as soon as the reserves are used up. Other reasons

for increased municipal expenses are the ongoing reform of public administration and the related transfer of responsibilities of district offices to municipal councils.

The comparability of local finance data is partly biased by varied interpretations of the district office budgets of the state line of public administration of the Czech Republic. Prior to 2000, these budgets were not part of the state budget and were included in local finance together with municipal budgets. From 2001 until the closing of the district councils, their budgets were part of the state budget.

Table 2
Public Sector Expenditure and its Components in bln. CZK

	1994	1995	1996	1997	1998	1999	2000	2001	2002 ^a	2003 ^b
GDP	1,183	1,381	1,567	1,680	1,839	1,902	1,985	2,157.8	2,268	2,400
Public Sector Exp.	518.8	593.9	660.5	700.8	752.7	796.4	867.9	963.9	1,084.5	1,127
State Budget	374.3	431.8	466.8	503.5	546.8	580.6	626.9	671.2	714.1	788
District offices	19.5	20.8	21.6	20.9	19.4	19.8	20.3			
Regional offices								14.4	38.2	91.3
Municipalities	92.6	110.3	122.8	129.2	136.3	147.1	164	195.5	206.9	192.7

Note a: Components of Public Sector Expenditures are not fully consolidated.

Note b: Health Care Expenditures and expenditures of other (central) state purpose funds are not contained in the table.

Note: Exchange rate is stable for the entire period (around 33 CZK (\pm 10 per cent) for 1 €).

Source: State Final Account for 1993-2001, State Budget 2003, Macroeconomic prediction CR (February 2003)

In 2001, the Regional Councils took over the responsibilities of the closed district offices, including certain responsibilities transferred to the new regional governments from the central state administration (such as secondary school management, apprentice schools, 2nd and 3rd class roads, hospitals, social institutes etc.). The last three years have seen soaring expenditures by the regional councils; in 2003 they represented half of the regional budgets. Most of the expenses are derived from the areas of delegated responsibility, e.g. secondary schools, representing in 2003 almost 70 per cent of all expenditures. Regional governments are currently financed from earmarked subsidies – in 2003 forming 85 per cent of the overall income of the regions, the remaining 15 per cent consisting of tax revenues (13 per cent) and non-tax revenues (2 per cent). Allocations of tax revenues take the form of general subsidies serving as provisional solutions. Since 2004, a legislative change is to be implemented reversing the ratio of subsidies and tax revenues in favour of tax revenues.

Table 3
Distribution of Expenditures Between the Levels of Government

	1994	1995	1996	1997	1998	1999	2000	2001	2002 ^a	2003 ^b
As a percentage of GDP										
Public Sector	43.9	43.0	42.2	41.7	40.9	41.9	43.7	44.7	47.8	47.0
State Budget	31.6	31.3	29.8	30.0	29.7	30.5	31.6	31.1	31.5	32.8
District offices	1.6	1.5	1.4	1.2	1.1	1.0	1.0			
Regional offices								0.7	1.7	3.8
Municipalities	7.8	8.0	7.8	7.7	7.4	7.9	8.3	9.1	9.1	8.0
As a percentage of total PSE										
Public Sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State Budget	72.1	72.7	70.7	71.8	72.6	72.9	72.2	69.6	65.8	69.9
District offices	3.8	3.5	3.3	3.0	2.6	2.5	2.3			
Regional offices								1.5	3.5	8.1
Municipalities	17.8	18.6	18.6	18.4	18.1	18.8	18.9	20.3	19.1	17.1

See Notes and Sources to the table 2.

3.3 Local Government Finance: An Overview

For the income and expenses of municipalities, see Table 4 below. It shows that the share of expenses in GDP have been relatively stable, with the volume of income corresponding to the volume of expenses. Economies of municipalities are in deficit, but the balances are relatively low. The overall indebtedness of municipalities shows a moderately increasing trend. For more details regarding the deficit and local indebtedness, see the section below.

Table 4
Consolidated balance LG's budgets [in per cent GDP]

	Ø 1994-96	1997	1998	1999	2000	2001	2002 ^{budget}	2003 ^{budget}
I. Tax revenues	3.9	3.9	3.9	4.0	4.2	4.2	4.4	4.5
II. Non-tax revenues	1.3	1.3	1.3	1.3	1.2	1.1	1.0	1.0
III. Capital revenues	0.4	0.6	0.7	1.9	0.8	0.5	0.5	0.4
Own revenues	5.6	5.7	5.9	7.2	6.3	5.7	5.9	5.8
IV. Transfers	1.7	1.6	1.4	1.7	1.9	2.9	2.7	1.6
Other	0.3				0.2	0.4	0.2	0.2
Revenues	7.6	7.3	7.3	8.9	8.2	8.5	8.9	7.7
V. Current expenditures	4.7	4.8	4.8	5.2	5.4	6.0		
VI. Capital expenditures	3.2	2.9	2.6	2.7	2.8	3.0		
Expenditures	7.9	7.7	7.4	7.9	8.3	9.1	9.1	8.0
Balance	- 0.3	- 0.4	- 0.1	+ 1.0	- 0.1	- 0.5	- 0.3	- 0.3
Debt	1.8% (1996)	2.0	2.1	2.1	2.1	2.2	n.a.	n.a.

Source: State Final Account for 1993-2001, State Budget 2003

Note the remarkable fact that capital expenses represent more than one-third of total municipal expenses. This is the result of the low level of investment prior to 1989 and the consequent necessity of repairs of existing municipal property (buildings, infrastructure, public spaces etc.). Capital expenses were, to a certain extent, affected by capital income. Since a substantial decline in capital income is expected in the coming years, a corresponding reduction in capital expenses may reasonably be assumed. The volume of capital expenses is further affected by sources provided by the central government to finance infrastructure, housing or environmental policy. The government provides earmarked subsidies and loans at favourable rates, which tends to create a dependency of the municipalities on these sources. Thus, the purpose of the loans tends to limit the level of independent decision-making on the part of the municipalities.

One particular question of interest is whether smaller municipalities are disadvantaged because of their inability to realise economies of scale in the production and delivery of services. This should be particularly evident with regard to administrative costs. For example, in 1995, municipalities with less than 200 inhabitants spent 35 per cent of their funds on internal administration. This declined to 25 per cent for slightly larger municipalities (those with 500 to 1,000 inhabitants) and continued to decline with the size of the municipality. For those municipalities with populations of over 500,000, internal administration represented 11 per cent of total expenditures. This argument, together with the shortage of economic and legal experts in small municipalities, has led Central Government to attempt to consolidate a number of small municipalities in the Czech Republic. This effort currently manifests itself in the allocation of tax revenues to individual municipalities. For more details concerning this issue, see the following chapter.

The volume of tax revenues has been relatively stable since 1993, with certain increases in the years 2002 (preliminary information), and 2003 (estimate of the Ministry of Finance). While tax revenues show a slightly growing trend, non-tax revenues continue to experience moderate reductions. This does not encourage the transfer of responsibility to the municipalities. These two incomes together, however, represent a relatively stable source. Capital income is expected to drop in the coming years, but as it grew significantly towards the end of the 1990s (as a consequence of the sales of shares allocated to the municipalities in the period of privatisation), some municipalities then created substantial reserves, which gradually dissolved into capital investment.

More than one-fifth of all municipal revenues in the Czech Republic come from state budget subsidies, from state funds and from other programmes, such as EU financing programmes (via the National Fund). Certain transfers are also received from regional budgets.

Subsidies in the Czech Republic are classified on the basis of various criteria, such as current and capital subsidies (for investment activities). Particular events are

subsidised by specific subsidies, conditioned by the principles of the state's policies on subsidies. The funds allocated in this way may be used exclusively for a given purpose; that purpose and a detailed breakdown of expenses must be reported to the state budget. Unused resources must be returned to the state budget. This applies to both investment and non-investment subsidies. General (global) subsidies defined as non-specific subsidies are allocated without specification of the purpose of their application. Within limits, municipalities may use them at their own discretion. General subsidies include, for example, contributions for the performance of state administration.

Another classification of subsidies refers to the specified functions for which funds will be used. These are eligible and non-eligible subsidies. Eligible subsidies are related to specified public functions performed by municipalities. This type of subsidy is granted automatically under certain predefined terms and conditions. Non-eligible subsidies must be applied for. Their allocation depends on a wide range of conditions to be met by the municipality in order to qualify for this particular type of subsidy.

The new resources recently made available for the Czech Republic and applicable at the communal level, include pre-structural funds of the EU. These funds complement the system of subsidies, grants and projects implemented in the Czech Republic. The available funds include the PHARE project, established by the European Union, in favour of the transforming countries. The PHARE programme includes, for example, the Small Project Fund, the Small Infrastructural Project Fund and the Cross-Border Co-operation Program etc. Towns and municipalities (or voluntary groups of municipalities) may participate in some of these programmes, on the condition that they are able to prepare corresponding projects in compliance with the programme requirements.

Since 2000, pre-structural PHARE funds have been supplemented by the EU – ISPA and SAPARD funds are now also available to the Czech Republic. EUR 23.7 M of the SAPARD Fund, oriented towards pre-accession assistance to agriculture and country development, was allocated to the Czech Republic in 2002. Following the flood in 2002, many EU programmes were modified to incorporate preferential assistance to support programmes for the flood-stricken municipalities. At the same time the newly established Solidarity Fund allocated EUR 129 M to alleviate the consequences of the floods, including assistance to municipalities.

3.4 Tax Revenues as Own Revenues?

Table 4 shows that the volume of tax revenues of municipalities in the last 10 years has moderately increased from 3.9 per cent to 4.5 per cent of GDP. The level of municipal authority in the area of taxation, however, is very low, as most taxes allocated to the municipalities can affect neither the tax base nor the tax rate. Limited prerogatives are allowed in the area of real estate tax and local fees. Some indirect effects on PIT (personal income tax) revenue reflected municipal support for business activities, but these were lost to municipal authorities in

2000 by the RUD (tax sharing system) Act, discussed below. For tax revenue history see Table 5.

Table 5
Tax Revenue of local governments in bln. CZK

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
PIT	38.2	48.0	41.1	44.0	47.4	48.8	51.4	26.1	30.0	33.0
from wages	25.1	33.2	25.3	28.2	30.7	31.9	34.7	16.3	19.4	21.6
from self-employment	13.1	14.8	15.8	15.8	16.7	16.9	16.7	8.2	9.3	10.2
from other incomes.								1.6	1.3	1.2
CIT	0.6	3.2	14.1	13.3	16.2	18.8	23.5	23.5	26.7	28.8
non-municipality			11.8	10.3	11.9	13.6	12.9	17.3	20.5	22.1
municipality ¹	0.6	3.2	2.3	3.0	4.3	5.2	10.6	6.2	6.2	6.7
Property Tax	3.8	3.8	4.0	3.9	4.1	4.3	4.4	4.5	4.5	4.5
Administrative and local fees (tax)	3.1	3.2	3.3	3.4	3.6	3.2	3.6	3.8	3.7	4.0
VAT								31.3	30.8	32.7
Other Taxes	0.1	0.3	0.2	0.8	0.8	0.6	0.7	0.7	3.8	3.9
Total	45.8	58.5	62.8	65.4	72.1	75.7	83.6	89.9	99.5	106.9

¹ Municipalities retain all CIT paid by their "own commercial activities"

Source: State Final Account for 1993 – 2001, State Budget 2003

Tax revenues of municipalities can be divided into local tax revenues (property tax, administrative and local fees), transferred tax revenues (legal entity income taxes paid by municipalities owning the respective legal entities) and shared tax revenues. The principles of sharing between the state and the municipalities have changed. In the past there were two substantially different sets of rules applied to the allocation of revenues to municipalities. These include the rules applicable during the period 1993 – 2000 and those applicable since 2001 (see Table 5).

Prior to 2000, tax revenue transfers were based on the principle of the allocation of district-generated tax revenues to municipal budgets². This system later came into conflict with certain principles of ideal resource allocation. Moreover,

2 The characteristic features of the period 1993-95 included the fact that tax revenue from the PIT represented the largest source of tax revenue of municipalities. Municipalities and districts shared tax revenues from wages within the territory of the district. Municipalities shared 40 per cent (1993), 50 per cent (1994) and 55 per cent (1995) of the revenue, allocated among the individual municipalities of the district, depending on the population, the remainder staying with the district office. 100 per cent of income tax revenues from self-employment remained with the municipality in which the taxpayer registered the main office. These rules were partly amended towards the end of 1995, mainly for the reason of different elasticity of the various tax revenues. While the PIT grew rapidly, the CIT (corporate income tax), allocated to the state budget, stagnated. This meant quicker development of municipal funds and slower growth of state funds. The reform in 1995 took away from municipalities' part of the revenue from the wages tax, replacing it with part of the PIT. During the years 1996-2000, wage tax revenues were shared between municipalities (30 per cent), district offices (30 per cent) and the state (40 per cent). For increased motivation of municipalities in tax revenues and for the support of local business activities, 10 per cent of the tax revenues were allocated to the place where the taxpayer paid his tax and the remaining 20 per cent were allocated on the basis of the population of the municipalities of the district allocating the revenues. There were municipalities where the 10 per cent revenue was higher than the 20 per cent revenue share. To compensate for the relocated portion of PIT, 20

the funding of (providing tax revenues for) the newly established regions became an important issue. Leaving aside the necessary changes following on from the Public Administration Reform, the following were the major objections against the previously applied allocation rules:

- the existence of unjustifiable differences between the revenues of individual municipalities within districts and between the revenues of the individual districts themselves;
- concentration of tax payers in big cities and the consequent transfer of tax revenues to the cities;
- speculative self-employment moves which result in tax revenue transfers);
- as a consequence of extensive fragmentation of the municipalities in the Czech Republic (6245 municipalities in 2000), ineffective use of finances by certain municipalities (especially the smallest villages);
- different dynamics of tax revenues into state and municipal budgets.

The above facts are mutually correlated. The progress of information technologies and the consistent pressure towards cost reduction were forcing companies to amalgamate their wage accounting departments, e.g. a company with five branches would base its accounting department at its headquarters. These taxpaying departments moved from small municipalities to centres, such as the district capitals. As a result, the employee tax revenues of district capitals were increasing, whilst the same revenues of smaller towns and villages were declining correspondingly.

Another fact affecting the system of tax revenue allocation was the varied employment structures in individual municipalities and districts. Some regions were affected more by structural unemployment than others. Regions with a higher percentage of structural unemployment enjoyed lower numbers of tax payers. This reduced the average wage in the district, which meant reduced tax payment, given the progressive tax policy applied in the country. To sum up: regions with higher unemployment had fewer employed tax payers and they paid lower taxes, which meant lower revenues from the wage tax in those regions. Practical experience has clearly demonstrated this correlation between the level of unemployment and the PIT revenues in these regions. In 1999, personal income tax revenues of municipalities varied from CZK 500 to CZK 50,000 per capita. One wonders whether this difference was not too high, considering the identical level of services required from the individual municipalities.

Prior to 2001, self-employment also fluctuated widely. Municipalities competed by “stealing” income tax payers from each other. The reason was that tax revenues from the self-employed were transferred to the municipality in which the entrepreneur had permanent residence. Some municipalities there-

per cent of the CIT was allocated to municipalities on the basis of the ratio of municipal to total state population.

fore promised refunding of part of the paid tax (which was allowed by the legislation supporting private business.). This trend was in direct contradiction to the objective of stable tax revenue and tax equity (i.e. tax should be paid by taxpayers using public municipal assets such as technical infrastructure, security, lighting, etc.

The government reacted to these trends by developing new rules for allocating tax revenues to individual municipalities. The new system was based on the assumption that similar municipalities provide a similar range of public services and that their tax revenues should therefore be similar. The Government classified similarity between municipalities in terms of their population size. This criterion, very simple and transparent, has both advantages and disadvantages.

The last factor significantly affecting the revised rules of tax revenue allocation was the high number of small villages. Their existence was an expression of their inhabitants' desire to govern their affairs independently, which made the villages very active in settling their own issues and strongly motivated their political representatives. On the other hand, however, third decentralisation produced high administrative costs which consumed the lion's share of municipal income. This raised the question of the effectiveness of municipal spending. The limited financial resources led to part of the municipal population unwilling to participate in municipal politics. These municipalities often came under the rule of other, larger municipalities, effectively losing their independence. In 2000, the Czech Republic had 584 municipalities with populations under 100 and 1163 municipalities with populations between 100 and 200. With such a large number of municipalities, it was also difficult to achieve good coordination between state and self-administration.

The result was the new, state-imposed Tax Allocation Act (no. 243/2000 Coll.) in effect since 1st January 2001, which substantially changed the principle of tax sharing between the central and local governments³. The new system combined sharing of overall revenues from three main tax sources (PIT, CIT and VAT), allocating the revenues to municipalities on the basis of their population, subject to modifying coefficients⁴. The new system thus attempted to create conditions for voluntary mergers of small municipalities (see Table 6).

3 Proportion between state and local government tax revenue remains the same and at the same time, reform significantly changes the allocation principle for municipalities.

4 This act is often criticised for the complete absence of factors motivating municipalities to increase tax revenues. In reaction to criticism, Parliament, in 2001 passed a tax revenue incentive for municipalities. We believe, however, that the less than CZM 1 billion motivation factor was insignificant for the municipalities.

Table 6
Impact of the new tax sharing system act [in CZK]

Size of municipality		Old rule – 2000				New rule – 2001		
From	to	number of	number of municip.	mean tax revenue per inhabit.	dispersion	average tax rev. per inhabit.	dispersion	coefficient
0	100	41,286	584	6,498	33,633	5,135	6,703	0.4213
101	200	173,411	1,163	4,947	5,456	5,424	4,371	0.537
201	300	214,772	876	5,304	10,177	5,442	3,286	0.563
301	1,500	1,828,622	2,785	4,797	2,434	5,403	1,775	0.5881
1,501	5,000	1,467,776	572	5,193	2,368	5,453	808	0.5977
5,001	10,000	928,534	133	5,905	3,214	5,840	777	0.615
10,001	20,000	937,508	67	6,370	1,620	6,956	1,241	0.7016
20,001	30,000	697,378	28	5,878	1,100	6,602	620	0.7102
30,001	40,000	349,267	10	6,464	1,778	7,343	1,338	0.7449
40,001	50,000	227,765	5	8,091	3,221	8,368	1,099	0.8142
50,001	100,000	1,247,257	17	6,916	1,510	7,793	981	0.8487
100,001	150,000	103,015	1	7,220	0	9,170	0	1.0393
150,001	1,000,000	872,366	3	12,995	1,611	13,152	131	1.6715
Praha		1,186,855	1	20,693	0	21,566	0	2.7611

Source: Own calculation

The process of Czech fiscal decentralisation was initiated in the context of the public administration reform. The process was implemented in several stages. Changes in the tax revenue transfer system eliminated most of the difficulties of the previous system. The new system also exerted pressure on the smallest municipalities to merge (up to 100 inhabitants). The positive outcomes of the reform certainly include the fact that the amount of tax revenues is today much less affected by economic conditions in the municipalities. Moreover, differences in tax revenues have been significantly reduced for municipalities of similar size (see Table 6). On the other hand, the tax revenues of the municipalities are affected only by changes in the size of their populations. In certain respects *tax revenues are becoming more and more non-specific subsidies*.

3.5 Local Government Borrowing

Self-administrative units of the Czech Republic usually use refundable resources for funding communal public investments. Small municipalities with small budgets may get into a difficult financial situation at the beginning of the year, since they have no reserves from previous periods and are forced to borrow, often for provisional financing of operational costs.

Local governments may make use of:

- *refundable financial assistance and loans*. These might be from the state budget or from state funds, from the budget of another municipality, or

from the regional budget, either interest-free or in the form of low interest bearing loans;

- *short-term credit loans*, refundable after one year, or by the end of the current budget year;
- *medium-term credit loans*, refundable in four (or sometimes five) years, and
- *long-term credit loans*, refundable in ten (sometimes fifteen) years, or
- under certain conditions, the municipality may issue securities (this variant involves the additional costs of issuing bonds, reducing the net revenue from the issue of them).

Municipal indebtedness through bank loans must be approved by the municipal authority. Loans are provided on the basis of an agreement concluded with a bank and an approved payment schedule and repayment of the principle and interest will come from the municipal budget. The banks provide loans to municipalities against collateral (capital, future income, or securities).

After 1990, a number of municipalities were unable to make realistic estimates of an acceptable level of annual debt service and the impact of indebtedness on their economies in the future. They lacked experience in long-term budget planning, under the changing conditions of municipal economy – rules for tax revenue allocation, rules of subsidy provisions from the state budget etc. Comprehending the history of the municipality’s budgeting was easy. What was much more difficult, or nearly impossible under the existing conditions, was producing a prognosis of the medium- or long-term economic impacts of their debts.

Municipal authorities should borrow up to the amount where annual debt service is equal to the lowest assumed current budget surplus (i.e. the difference between regular income and regular expenses) for the duration of the repayment period. The need for realistic planning is apparent and it represents a problem, especially for smaller municipalities.

Not all municipalities have always been able to realistically assess the purpose of the investment motivating the borrowing, especially in cases of financing so-called profit investments. Often the planned profits intended to be used for repayment have not reached the levels initially assumed. This was particularly the case for certain small villages such as Rokytnice nad Jizerou⁵. Municipalities have often underestimated the business risks of their undertakings.

⁵ The town of Rokytnice nad Jizerou is a prime example of failure to properly manage debt. In addition to a loan for the municipal wastewater treatment plant (CZK 70 Mil.) and issue of communal bonds (CZK 120 Mil.), the town provided funds for the construction of a funicular (CZK 145 Mil.). The investment in the funicular was not as profitable as expected and the debt of the town increased and Rokytnice nad Jizerou was unable to repay it. A Consolidation Agency took over the debt and ordered the first forced auction of municipal property in the Czech Republic (2002). The auction was to serve as a warning to other municipalities that the state would not take over the role of the “last-minute guarantor”. There are more municipalities, however, reported in the press to be approaching this sad state of affairs.

Local business credit loans have also had a negative impact on municipal debts. when the business risks assumed were not recognised by municipalities. When businessmen have failed to repay a loan, the municipality as the guarantor has had to assume that responsibility.

According to legislation, the Czech state takes no responsibility for the liabilities of local governments. During the past ten years, the state has either failed to regulate the use of municipal indebtedness or has paid insufficient attention to the regulation⁶. Indirect regulation of municipal indebtedness by the state takes the form of a 15 per cent maximum debt service share in regular municipal income, when municipalities wish to apply for non-specific subsidies from the state budget. The State regulation on communal bond issues first took the form of granting (or refusing) approval for municipal issues by the Ministry of Finance. Then in the late 1990s, approval was granted or refused by the Securities Commission.

The positive aspects include the fact that municipalities generally borrowed with a repayment deadline which could exceed one year for the financing of the capital costs of an investment in the local public sector. Such borrowing was permitted because of the poor technical infrastructure in towns and villages. In the latter half of the 1990s, municipal budget deficits increased dramatically in the Czech Republic (see Tables 4 and 7). The rate only dropped after 1997. Towards the end of the 1990s, however, small municipalities began to increase their debts. Debt service represents a significant burden for the indebted municipalities.

Table 7
Development of the municipal debt (in bln. CZK)

Debt Item	1993	1994	1995	1996	1997	1998	1999	2000	2001
Loans	2.5	4.9	8.7	11.6	13.5	18.0	17.6	18.4	22.6
Bonds	0	7.6	8.5	11.9	13.2	11.9	10.9	10.1	13.3
Others	0.9	1.8	3.1	4.8	7.7	9.1	11.5	12.5	12.4
Total	3.4	14.3	20.3	28.3	34.4	39.0	40.0	41.0	48.3

Source: State Final Account for 1993 – 2001

It is assumed that municipal debt in 2002 will reach over CZK 53 billion, which on average, represents nearly one-quarter of the municipal budget. The image of municipal indebtedness is somewhat distorted by the debts of big cities (Prague, Brno, Ostrava and Plzeň). Indebtedness excluding these cities is shown in Table 8.

⁶ Last year, Parliament passed an Act regulating municipal indebtedness – however, counter-proposals raised in Parliament caused ambiguity of the selected indicator and resulted in the subsequent cancellation of the regulation by amendment to the Act. Therefore the state no longer regulates municipal indebtedness.

Table 8

Development of the municipal debt without four the biggest cities (in bln. CZK)

Debt Item	1994	1995	1996	1997	1998	1999	2000	2001
Loans	3.8	6.3	9.9	12.7	14.4	12.9	13.4	14.3
Bonds	0.3	0.9	1.6	1.6	1.4	0.9	0.5	0.0
Others	1.4	2.7	4.2	6.5	7.6	9.8	10.2	9.8
Total	5.5	9.9	15.7	20.8	23.6	23.6	24.1	24.1

Source: State Final Account for 1993-2001

3.6 Enhancing Local Capacity and Democratic Accountability

Local administration in the Czech Republic is accountable for the local tax rate applied, as well as the utility use rate for mixed local and regional public goods. The prices of mixed goods are not subject to traditional market pricing, but are set solely by local authorities. For example, the local administrative authority sets the price of public transport tickets, even when the service is provided by a private transport company. The decision-making of elected authorities is strongly affected, not only by their voters – the users of public utilities – but also by political parties, frequently including vested interest groups and public bureaucracy.

Collective decision-making of local administrative authorities often undermines individual responsibility for effective provision of mandated public goods. In actual fact, citizens could not exert much pressure on their elected representatives, even if they were inclined to do so.

3.6.1 Revenue from Net Public Goods – Tax Price

Net local or regional public goods' costs should be funded from tax revenues, for individual shares of each citizen's consumption cannot be accurately determined. This is known as the tax price. Following the assumption that citizens of individual municipalities should contribute with their local or regional taxes to the financing of local public goods, as the consumption of the goods is limited to them, the obvious conclusion is that revenues from local and regional taxes should be sufficient to cover the costs, which may vary by region. This at the same time implies that municipalities or regions should be able to impose taxes or be able to affect the imposed tax rates to achieve equality between revenues and production costs. On the other hand, extensive taxation powers reduce pressure to reduce the costs of production of public goods. At the same time, the high number of municipalities in the Czech Republic (over 6,000) disables effective implementation of tax competitiveness in a period when tax bases are becoming increasingly mobile.

Municipalities in the Czech Republic are allowed to charge local fees (taxes), most of them of a tax nature. As for construction of these local fees, the taxation powers of the municipalities are very low. Although no serious research has been

done, it can be assumed that these local taxes, whose contribution to the budget is perennially low, cannot cover the costs incurred for provision of public goods⁷. Thus the costs have to be subsidised from other incomes.

Municipalities make decisions on the introduction of local taxes, although the implementation of local taxes is limited to those specified in the relevant (centralist) legislation. Unlike income and other taxes, unified across the Czech Republic, the local tax rates – within the legislatively specified local tax types and rate limits – may vary significantly by municipality, for the municipality may or may not apply the maximum rate applicable to the relevant tax type.

Local taxes must be announced in the form of a generally binding public notice and are administered directly by the municipality itself, unlike income and other taxes administered by the Financial Office, where the municipalities only receive the specified percentages of the revenues. Currently, Czech municipalities may therefore charge local fees of the following types⁸: dog owner tax, recreation tax, spa tax, public space usage tax, admission tax, accommodation tax, motor car access tax, gambling machine operation tax, waste collection, transport, sorting, recycling and disposal tax⁹.

Furthermore, budgeting does not usually include purpose-specific links between specific types of income and specific types of cost. This makes comparisons of local and regional tax revenues and utility costs for matching extremely difficult.

3.6.2 Revenues from Mixed Public Utility Service – User Fees

Mixed public goods, especially those representing facultative consumption, are provided to citizens for a user fee, representing a modified price for unit consumption. Application of user fees to use of mixed public goods assumes the possibility of an accurate measurement of consumption of the public good in question. In such cases, user fees are non-tax revenues. If a particular good's consumption cannot be accurately measured, or is not measured because of the extremely high transaction costs involved, the lump user fee is *de facto* a tax (see for example the Czech communal waste disposal fee-tax).

7 Research has indicated that administrative costs of local tax collection are in many cases higher than the revenues themselves

8 Act no 565/1990 Coll., on local taxes.

9 In addition to local taxes, the municipalities collect administrative fees in the context of delegated responsibility, without the ability to affect the rates, which are specified by law. Even these fees, however, represent municipal revenue. The class of communal taxes also includes environmental tax. Environmental tax is close to administrative fees and the revenue resulting from its collection is usually distributed between the State Environmental Fund and the respective collecting municipality. This tax comprises the fee for air pollution, and exemptions from agricultural or forest land. Fees for mining areas and revenues from mined materials are shared between the state and the respective municipality.

The effectiveness approach would welcome user fees and taxes covering 100 per cent of the calculated costs of production of mixed public goods. These costs will be subject to geographical differences, for both objective and subjective reasons (lying especially in the area of management quality). Therefore the mixed good consumption fee rates vary by municipality, or by region.

User fees need not necessarily go directly into the municipal budget. In some cases they do, if the municipality is the direct provider of the service to the citizens. As other subjects also provide these services, the revenues usually go directly to the providers. Nevertheless, the municipality invariably decides the rates. In addition, municipalities collect “rents” on housing and charge tariffs on water and other utilities owned by them. However, the prices (“rents” and “tariffs”) are still regulated by the central government. This has had a significant impact on local budgets, especially in the case of rents on housing.

Consider the construction of a user fee for mixed public goods provided by the communal entity itself. Generally speaking, the unit costs of a mixed public good – and thus the user fee rate (for a presumed 100 per cent cost coverage) depends on the number of users, i.e. on the use of capacities reflected in the overall costs of production in the form of fixed expenses. A fixed cost flow is different from other cost flows. If a municipality attempts maximal use of the capacity of a device producing a mixed public good, for example, by joining a neighbouring municipality and providing the good to the inhabitants of both, in that instance, fixed costs per unit may be reduced radically, which may either allow reduction of the user fee or prevent its increase (despite inflationary pressures), or generate a profit.

3.6.3 Municipal Property Management in the Czech Republic

Municipal property in the Czech Republic consists of real estate (land and buildings), movables (furniture, motor cars, computers, machinery, devices etc.), intellectual property (industrial rights, registered trade marks etc.), also including property rights (claims), securities and monies. Property ownership is one of the basic attributes of self-government and is therefore accentuated in the Constitution of the Czech Republic as well as in Municipal Act¹⁰. Self-administration units, such as autonomous legal corporations, may dispose of their property independently of state intervention within the limits of powers and responsibilities specified by the Constitution and other applicable legislation.

Municipal properties were returned after 1989 by transfer from state property¹¹. The property included historic property and property of the former na-

10 See Act no. 1/1993 Coll., Constitution of the Czech Republic, section 7, and Act no. 128/2000 Coll., on municipalities and municipal administration).

11 See Act no. 172/1991 Coll., on transfer of specific property by the Czech Republic onto municipalities.

tional committees, including forests, agricultural land, building plots, buildings and the residential fund, etc. By transfer from the closed district offices, municipalities also acquired other properties.

A special part of property acquired by municipalities from the state was represented by securities. Municipalities acquired those by free transfer in the context of the privatisation process. The securities included shares of infrastructure producers and distributors of power, heat, water and sewerage. Municipalities thus acquired 34 per cent of the shares of gas and power companies and 80 – 90 per cent of the shares of water management companies.

The scope and structure of property returned or transferred to municipalities did not always correspond to their needs. That is why, in many cases, municipal property needed restructuring. In the first half of the 1990s, significant municipal property sales took place, especially including real estate. In the late 1990s, many municipalities “got rid of” shares, thus acquiring substantial one-off incomes supporting their budgets.

It is difficult to make objective comments on the real estate and security sales outside the context of the role of municipalities and their newly acquired property. It is certainly impossible to positively view sales increasing regular budget revenues and thus consumed in the course of the year. Many municipalities, however, took over real estate property with maintenance costs largely exceeding revenues from the ownership, which was one of the frequent and logical motives for the sales (see the previous section – user fee – and problem of rents on municipal houses).

As for security sales, the criticism may be sharper, for the original intention was to use the transfer of shares in power network service providers to municipalities to achieve municipal control over the respective branches of industry, especially to prevent natural monopolies. Acquisition of securities by municipalities, therefore, was a political decision. Their holding by municipalities was to become an expression of public control and a potential instrument of economic control exercised by local authorities. However, most municipalities, pushed by the limited disposable income and the necessity to provide the services required by the citizens, needed quick financial means for construction and modernisation of communal infrastructure. The revenues from security sales were generally used for capital investment.

One of the main features of a “healthy” economy is maintenance and extension of property. What follows from this is that the principal criterion of good economics for a self-administration unit is not only a balanced budget, but also an extended property base. Municipal authorities must develop a clear investment strategy, outspoken priorities supported by knowledge of citizens’ preferences. The order of implementation of individual investments should generally be in-

cluded in the accepted development strategy. This means that consensus should be reached between the authorities and political parties on whether the highest preference should be given to construction of a public water supply system, a sewerage branch, a sports stadium or a swimming pool. This is the only way to maintain budget stability, for demanding project implementation may exceed one term of office. Under normal circumstances, unless an emergency occurs (floods, etc.) the priorities cannot be changed overnight and construction projects cannot be discontinued without negative impact on the budget, as well as on the life of the municipality.

Most municipalities and their authorities are thoughtful about their property management, giving preference to leases over sales and expanding municipal property by their activities. Municipalities have mainly invested in long-term material assets, such as the construction of new infrastructure including, *inter alia*, water pipelines, sewerage and wastewater treatment plants.

3.7 Conclusion

The first stage of creating a municipal financial system in the Czech Republic appears to be complete. For almost ten years municipalities have been operating with their own property. They have extensive expenditure authority and adequate incomes. In the case of large investments, when revenues are insufficient to cover planned expenditures, municipalities have the right to borrow on the capital market or take out bank loans.

An important challenge municipalities currently face, is the insignificant degree of autonomy over their own revenue sources. This adversely affects efficiency and accountability. Aside from subsidies, most of their income is in the form of non-purpose transfers. The reform of tax revenue transfers of 2000 stipulates that these shared tax revenues are allocated to municipalities according to the number of inhabitants. Municipalities have only a few possibilities to affect the size of their revenues (whether tax or non-tax). We therefore suggest that current reforms and future changes be made with the intention of boosting the autonomy of municipal revenues. This will improve budgetary predictability and the accountability of local authorities. We offer the following suggestions in the field of revenue assignments for consideration:

- the adopted adjustment coefficient for the tax-sharing distribution should be revised in order to give it a clear economic rationale;
- the deregulation of some public goods prices should be completed so that local governments can set user fees corresponding to the costs of providing such services;
- more local autonomy should be provided and tax-effort incentives should be restored by reassigning the personal income tax (PIT). The municipalities should have the right to impose their own flat-rate (proportional) PIT local

surcharge (piggybacking on the national adjusted progressive PIT rate) within a scale of rates;

- the predictability of local budgets should be increased, giving municipalities liberal powers to define local tax law (e.g. scale of local tax rates, local tax base and exceptions);
- the impact of property (buildings) tax should be increased by permitting municipalities to implement a value-based tax rather than an area-based tax. The administration of this tax could be transferred to the municipalities;
- obligatory certified educational modules for local officials and administrators should be introduced to upgrade their skills. Such courses should cover the basics of public finance, performance budgeting and European structural policy, etc.

At the same time, we have identified several arguments, which could work against the process of increasing the fiscal autonomy of the LG's or at least reduce political willingness to implement the proposed changes:

- the as yet unfinished process of decentralisation and de-concentration of competencies in the public sector (to individual stages of territorial administration) prohibits the strengthening of municipal "own revenues." At the same time, it leads to increasing subsidies (the full dependence of the new regional administration on the state budget);
- the preparation of the first step of the Public Finance Reform prevents adequate anticipation of reform steps, both with respect to the fiscal capacity of local governments and to the tools of budgetary policy available at the municipal and regional levels;
- the non-professional decision of elective bodies and executive management causes, especially in the small municipalities, the ineffective expenditure of scarce budgetary resources. The approximately 60,000 municipal authorities determine 9 per cent of GDP, but they are rarely economically educated;
- the high number of municipalities – over 6,000, with fully independent villages of less than 50 inhabitants means the transfer of some tax competencies to the municipalities could result in chaos;
- the difficulties in improving the effectiveness of the local and regional public sectors makes it necessary to introduce norms, indexes and standards to public services. The enhancing of fiscal competencies should be followed by greater effectiveness in spending;
- the low quality of monitoring budgetary activity, both by experts and the lay public – citizens do not play an active role in public affairs management and feedback is required.

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4. Enhancing Local Government Revenue Raising Capacity: A Way of Reaching More Accountable Local Government: The Case Study of Kazakhstan

Lyubov Chapurina

4.1 Introduction

With its territory of some 2.7 million square kilometres, Kazakhstan is the second largest country in the CIS. It shares borders with Russia in the north and west, China in the east and Kyrgyzstan, Uzbekistan and Turkmenistan in the South. The population of Kazakhstan is 14.9 million, of which 56.4 per cent live in urban areas. The average population density is low, 6 persons per square kilometre (compared to a European average of 67 per sq. km). Kazakhstan is a unitary state with a presidential form of government. Since its independence in 1991, Kazakhstan has made some progress in implementing complex political and socio-economic reforms to establish a democratic state with a socially oriented market economy. The goals of these reforms were to create conditions enabling the development of the country's potential, the promotion of long-term economic growth, and the improvement of citizens' quality of life. Kazakhstan has entered a new stage of development and has become aware of its place and role in the contemporary world.

A centralised governance system during the early period of independence of Kazakhstan was justified by the strategic objectives of that period, which included the establishment of an independent state and the strengthening of sovereignty, securing territorial integrity. An effective and accountable local government is an important condition for the implementation of a national development strategy, given the territorial dimension and regional diversity of the country. As was indicated in the strategic plan of development of the Republic of Kazakhstan up until 2010, it is necessary to develop a gradual country strategy of decentralisation, taking into account global experience of decentralisation and the realities and traditions of Kazakhstan. To date in Kazakhstan, there are 14 oblasts/regions, 84 cities, 160 rayons/districts, 2036 okrugs, 200 settlements and 7684 rural populated areas. In this context, decentralisation and empowerment of local governments is an important element of the overall public administration process. For this reason, the State Commission on Differentiation of Functions between public administration levels and improvement of inter-budgetary relations was established in 2001. The major task of this Commission is to define and differentiate the various functions of governance bodies. For local bodies to be efficient it is necessary to provide them with real authority in relation to their budgets; each level of administration should be assigned its own source of revenues and should enjoy the right to independently determine the allocation of expenditures.

As a complementary activity, the UNDP country office in Kazakhstan assisted the Administration of the President in conducting a situational analysis of regional development and local governance. The goal of this effort was to improve policy making process at local levels. The donor community in Kazakhstan, as well as the regional UNDP programs, conducted several activities for a mixed group of decision makers from the Presidency, Parliament and Government to familiarise them with the various aspects of decentralisation such as fiscal, administrative and political. However, the structure of local authorities has not yet undergone any substantial changes; there are three descending hierarchical levels: regions (oblasts), districts (rayons) and towns (villages). There are weak vertical and horizontal linkages between these levels of government that lead to duplication of functions of the authorities at the local level.

Overall, the following primary objectives of decentralisation have been defined in the strategic plan of the country up to 2010:

- Divide spheres of activity, functions and responsibilities between different levels of authority;
- Create conditions for effective functioning of local state bodies; and
- Introduce local self-governance as the basis of a democratic state.

4.2 Local Government at a Glance

Financial crises in South East Asia and Russia in 1997 – 1998 have shown that the economy of Kazakhstan has the potential to withstand external shocks. Kazakhstan was able to overcome these crises with minimum loss in economic growth and was able to secure GDP in the first six months. Real GDP growth during the last five years was 26 per cent. In 2001, the banks gave credits worth 460 billion tenge (over 3 billion USD). The refinancing rate of the National Bank was reduced from 340 per cent in August 1994 to 9 per cent in 2001.

Description	1995	1996	1997	1998	1999	2000 forecast
Actual growth of GDP, % to previous year	-9.2	0.5	1.7	-1.9	1.7	3
Inflation: By the end of period, %	60.3	28.7	11.2	1.9	17.8	9.5
Average for year, %	176.2	39.3	17.4	7.1	8.3	13.6
Exchange rate of tenge to US Dollar.						
By the end of period	63.95	73.3	75.55	83.7	138.2	154.8
Average for year	60.95	67.3	75.44	78.3	119.53	146.5
Monetary aggregates in % to GDP	11.4	9.5	10.3	8.6	14.4	15.6
Refinancing range of National Bank, %	52.5	35	18.5	25	18	12
Revenues of state budget, in % to GDP	19.5	16.9	24.4	21.8	21.1	22.4
Including fiscal revenues in % to GDP	15.5	12.5	19.7	16.6	17.4	17.4
State budget deficit, in % to GDP	-1.4	-2.8	-3.8	-4.1	-3.5	-2.9
Expenditures for state debt and debt of local executive bodies, in % to GDP	0.6	0.2	0.6	0.8	1.0	2.2
Export turnover, million US dollars	5,440	6,291.7	6,899.2	5,870.6	5,988.5	6,300
Import turnover, million US Dollars.	5,325.9	6,626.7	7,175.6	6,671.5	5,644.8	6,070
Net export, mln dollars	114.1	-335.1	-276.5	-800.9	343.8	230
Investment growth to capital, % to previous year	-42.4	-40.3	12.6	13.1	15.0	15.0

Source: Agency of Statistics, National Bank, Ministry of Finance

According to the accounting data for 1999, the state budget revenues have made 19.8 per cent of GDP, the costs and crediting were 23.2 per cent of GDP. The deficiency of the state budget has made 3.5 per cent of GDP and has decreased by 0.7 per cent in comparison with 1988. In 2000, according to accounting data (without the accounting period), the state budget reached made 32.1 per cent of GDP, the costs and crediting 23.0 per cent of GDP with an insignificant proficiency of the state budget of approximately 0.1 per cent of GDP. The exchange rate of the national currency, tenge, remained stable. In 2000, the decrease of the tenge exchange rate versus the USD was 5.2 per cent. The relative stability of the tenge exchange rate, together with the significant growth in production has pre-conditioned twofold a decrease in inflation during the year from 17.8 per cent to 9.8 per cent.

The development of Republican and local budgets is regulated by the following acts¹:

The budgetary system in Kazakhstan consists of the state, Republican and local budgets. Local budgets are a consolidation of the oblast budgets and rayon budgets². However, the assignment of revenues between oblast budgets and rayon budgets is not defined by law. This allows an oblast to assign its expenditures and revenues. Each year, a draft of the law “On Republican Budget” is prepared for the following fiscal year. It is then approved by Parliament and subsequently signed by the President of the Republic of Kazakhstan. The approved plan of the Republican budget can be revised throughout the year by the Republican Budget Commission. At the local level, representative bodies known as Maslikhats, approve the drafts of the local budgets. In accordance with the Law “On Budgetary System” the volume of revenues in the local budgets shared between Republican and local budgets are approved by local representative bodies under the proposal of local executive bodies of an amount agreed with the Ministry of Finance of the Republic of Kazakhstan. During the course of the year, approved local budgets can be revised by Maslikhats at the suggestion of the budget commission at the appropriate level. Mid-year revisions entail an increase in revenues for local budgets.

Administration of expenditures and approval of budget spending priorities is mostly conducted at the central level. The Republican Budget Commission resolves disagreements between Republican and local budgets during their development and approves the main priorities for public spending. The central gov-

1 Law of the Republic of Kazakhstan “On Budgetary System” of April 1, 1999 N 357-1, Law of the Republic of Kazakhstan “On Public and Publicly Guaranteed Borrowing and Debt” of August 2, 1999, N464-1, Law “On Taxes and Other Mandatory Payments in the Budget” of June 12, 2001, N 209, Decree of the President of the Republic of Kazakhstan of January 29, 2001, N543 “On Some Issues of National Fund of the Republic of Kazakhstan”, Decree of the President of the Republic of Kazakhstan “On Budget Commission on Formation of the Draft of Republican Budget in Appropriate Fiscal Year”, April 25, 2001, N589, Decree of the President of the Republic of Kazakhstan “On Creation of Special Economic Zone, Astana is a new city”, June 29, 2001, N645.

2 The Law “On the Budgetary System” defines the division of revenues and aggregated expenditures between the Republican and local budgets.

ernment establishes the norms and procedures for developing Republican and local budgets. The Oblast Budget Commissions are key to developing the budget at the oblast level, with the rayon budget dependent directly on the Oblast Budget Commission. In 1999, a set of measures on reforming Kazakhstan's budgetary system, including the development of inter-budget fiscal relations, was developed. It included the introduction of balancing mechanisms between the Republican and local budgets by means of subventions and withdrawals. Implementation of these measures signalled the beginning of new fiscal relations between the budgets at various levels. By implementing these measures, the following results have been achieved:

- Legislative division of revenues and other mandatory payments to the state budget between central and local budgets, based on unified norms for all local budgets (instead of the old system of balancing between central and local budgets individually by each region);
- Development and performance of the state budget's expenditures together with classification of three types: financing administrative expenditures of central and local government bodies, maintaining budget institutions and assignments for the public sector to provide public services;
- Legislative determination of the main principles and phases of budget planning. The number of state organisations financed from the Republican budget has been reduced, as have the number of civil servants at the central level;
- Consolidation of all extra budgetary funds with the state budget and a unified body, a national tax service, has been established which is responsible for the performance of revenues;
- Further development of civil service reform that improved fiscal capacity of local bodies and improved accountability, transparency and efficiency of interaction between state and local entities; and
- Implementation of budgets at all levels through the Treasury at the Ministry of Finance, which has improved monitoring of the use of public funds.

4.3 Local Government Finance: An Overview

Instability of the fiscal relations between central and local budgets makes the local budget development and performance dependent on the decisions of the central bodies. It also means that the process of state budget formation becomes an annual process of negotiation between the Ministry of Finance and local bodies. The oblast and rayon budget commissions are formed by local authorities at the appropriate level. The general tasks of local budget commissions include; 1) determination of expenditure limits under the current budget programs and development programs; 2) consideration and approval of budget applications from the administrators of the budget programs and 3) resolution of difficulties with subordinate budgets. The present mechanism for determining subventions and withdrawals thus takes into consideration the total volume of expenditures financed by the

local budgets and its own means and subventions, including current budget programs and programs for development budgets. However, it is important to measure inter-regional proportions related to the implementation of particular investment projects which are multi-year projects that pass from one year's budget into subsequent years' budgets. Furthermore, each region's need for additional investment should depend on social and industrial infrastructure and on the geographical conditions of the oblast. Analysis of inter-regional equality under the development budget should take into account the availability of fixed assets per capita; this includes the physical infrastructure of the region such as schools, hospitals and other structures of a social character. Estimation of real demand of the oblast can serve as the basis for building the development budget amounts.

The administrators of the local budget programs are state bodies financed from the local budget, responsible for financial substantiation and realisation of the local budget programs³. The primary objectives of the administrators of local budget programs are:

- 1) Preparation of the report on implementation of budget programs for the previous year in accordance with the description of budget programs to the local authorities;
- 2) Elaboration of proposals for the list of expenditures' priorities of the local budgets (oblast or rayon);
- 3) Elaboration of proposals for the list of local budget programs which are not subjected to sequestering during the forecast year; and
- 4) Formulation of budget applications within the expenditure limits for the current budget programs and development programs, list of investment projects to be financed from local budgets, taking into account budget arrears and budget descriptions.

Expenditures of local budgets are divided into capital expenditures and operational expenditures. Capital expenditures provide innovative and investment activities and other expenditures associated with cost of production. Operational expenditures provide operational support to state administration bodies and local administration bodies as well as local self administration and other expenditures that are not included in capital expenditures in accordance with the budget classification of the Republic of Kazakhstan.

Expenditures financed from local budgets:

- Public services of representative, executive and other entities that perform general functions of public administration;
- Public services of entities that perform financial activities;
- Public services of entities that are engaged in activities of military service campaigns and organise work in extraordinary situations;

3 *Law on Budgetary System*, of April 1, 1999, N357-1

- Public services of entities that perform law enforcement activities, exploitation of the equipment and means to regulate road traffic in settlements;
- Public services of entities that carry out state functions on education, health-care, social welfare and social assistance for population, cultural development, sport and tourism and information network;
- Public services on the development of agriculture, water resources, fishery and forestry and environmental protection;
- Public services of entities that provide development of communal utilities and housing, as well as roads financed from the local budget;
- Public services for development of transport and communications; and
- Other public services.

The introduction of a precise distribution of all types of taxes and expenditures between central and local bodies and the gradual transition to stable sums of subventions and withdrawals was supposed to last for three to five years. Subventions are transfers from the Republican budget to local budgets in which the revenue capacity is less than the demand for expenditures; withdrawals are transfers from local budgets to the Republican budget if there is an excess of revenue capacity over the need for expenditures. It is important that the volume of local budget expenditures during the transitional period reaches an average Republican level of the local expenditures per capita. This would create equal conditions for all local budgets at the end of the transitional period. As at the end of the transitional period, the performance of revenues and expenditures of local budgets would be more independent of the performance of the Republican budget, as the sums of subventions and withdrawals would be fixed by the appropriate law with a long-term perspective. It would strengthen the capacity of local budgets if additional revenues become available. However, the proposal to fix subvention and withdrawal sums was rejected during budget deliberations in the Parliament of Kazakhstan in 1999. One of the major reasons for rejection was the inability of local authorities to use the allocated budget funds appropriately, in accordance with the Law on Budgetary System due to the absence of instructions and procedures and due to a lack of training of staff involved in the budgetary process in the regions. Regional peculiarities and distant regions were not taken into account and it created additional difficulties to have a clear picture for subventions and withdrawals. The Ministry of Economy and Budget Planning RK will develop the draft Budget Code to be submitted for discussion in Parliament RK in May 2003, whereby clear instructions for local authorities will be elaborated upon.

In the long term, the following steps have been identified to achieve budget decentralisation for the following five to seven years as has been stipulated in the strategy 2010:

- Creation of an effective system of inter-budgetary relations by giving a maximum independence to the local budgets;

- Achievement of an accurate legislative differentiation of spending authorities and respective accountability;
- Development and adoption of the Budget Code of the Republic of Kazakhstan that will ensure a single legal provision for the development, approval and execution of budgets;
- Assignment of taxes and tax collection to defined levels of the state budget;
- Creation of an effective system of transfers; and
- Provision of regions with independence in defining priorities of social and economic development within the framework of the state development strategy and spending of budgetary funds in compliance with these priorities.

4.4 The Political Economy of the Local Budgeting Process

The performance and control of both Republican and local budgets is also regulated by law⁴. Control over the execution of budgets is an important component of the budgetary system. It includes the processes of monitoring, analysis and evaluation of the quality of budget execution, as well as budgetary efficiency and applied methodology in the budgetary process. The following state entities are participants of budget control in Kazakhstan: the President, Parliament, Accounting Control Committee, Committee of Financial Control at the Ministry of Finance, National Bank and the Treasury, as well as other central executive and representative bodies. At the local level, the Maslikhats and territorial and administrative units and executive bodies also participate. The Ministry of Finance and local executive bodies exercise control over approval of expenditures of state institutions financed out of local budgets, as well as controlling the utilisation of budgetary allocations. Revision commissions of representative bodies such as the Maslikhats together with the Ministry of Finance and its territorial bodies, perform controls for the development and execution of local budgets. The Ministry of Finance and local representative bodies determine the procedure and sequence for conducting revisions and checks of the utilisation of funds of Republican and local budgets in accordance with legislation. Three types of financial controls exercised by these entities are:

- *Preliminary Control* which is carried out during discussions of the draft law on budget and other budgetary and fiscal legislation;
- *Current control* which is exercised when some issues of budget execution are discussed during working meetings with commissions and representative bodies;
- *Post fact control* which is carried out during the consideration and approval of reports on budget execution.

4 Law of the Republic of Kazakhstan “On Public Procurement” of May 16, 2002 N321 and Law of the Republic of Kazakhstan “On performance of Republican and local budget control” of January 29, 2002 N286.

The review of the budgetary system and financial controls, followed by conducting a functional analysis, was carried out in Kazakhstan with the support of the World Bank and the UNDP. Functional analysis⁵ allowed the state bodies to look at the deficiencies in budgetary policies and also to look at the efficiency of state institutions and to make the budgetary process more transparent. The functional analysis involved the program of Actions of the Republic of Kazakhstan government during 1998-2000, which was endorsed by the Decree of the Republic of Kazakhstan to the reform of the budget program. A budget commission was created at the Republican level by order of the Prime Minister to summarise the findings of the public sector financial analysis, to reach decisions on limits for funding, to perform a functional review of the national budget in 1999 and to plan actions to organise public finance. The commission outlined the results of work carried out with the focus on specialisation of a grouping of state functions, the distribution of functions between central and regional authorities and the transfer of functions of review from one level of authority to another level of authority. Prior to commencing the 1999 budget elaboration, the administration of the Ministry of Finance commissioned a group of ministry workers to implement the following actions of budget programming:

- To work out precise criteria for the evaluation of activities and methods of analysis, permitting evaluation of whether public institutions were fit to carry out their activities or whether privatisation of all or some of their functions might better serve the citizens;
- To collect and validate information relating to the types of activities of public bodies, to compile a list of organisations performing state functions, the status and the sources of funding thereof;
- To evaluate the functions of establishments funded from the national budget under conditions of a market economy and to distribute functions among different levels of power;
- To analyse the functions of executive bodies to define what functions and institutions would not be funded from the national budget, and how they would be carried out.

As a result of the analysis, the following recommendations were submitted to address budget transparency:

- Control of the use of the budgetary funds shall be increased for the purpose of evaluation of budgetary funds efficiency;
- Monitoring of expenditures shall be carried out under a rigid and improved system;

5 The functional analysis in Kazakhstan was conducted by the Ministry of Finance as part of the execution of the Decree of the Republic of Kazakhstan government, known as "On the Program of Further Reforms of the Public Service in the Republic of Kazakhstan and the Government's Plan of Measures to Implement it".

- Work will be continued on the improvement of the legislative base for development of internal and external audits of the state sector;
- The role of the Accounting Control Committee and its regional departments will be strengthened; and
- Information on public finance issues at the central and regional level will be published in the mass media.

As is mentioned in the strategic plan of the development of Kazakhstan up to 2010, financial transparency must become the guiding principle in development of preventive measures against corruption in public finance.

4.5 Reconsidering the Original Local Government Revenue Sources.

The adoption of the newly developed Tax Code in 2002 brought about a redistribution of taxes between levels of the budgetary system and this is carried out in accordance with the Law on Budgetary System. The new Tax Code was adopted; however, much room was left for its further improvement, due to difficulties with its implementation at the local level.

Revenues of local budgets⁶

Taxes, fees and other obligatory payments:

- Income tax from legal entities;
- Excise duty on all types of alcohol (50 per cent), vodka (50 per cent), liqueur (50 per cent), wine (50 per cent), and cognac (50 per cent),
- Income tax from individuals;
- Social tax paid by individuals engaged in entrepreneurship activities;
- Land tax;
- Unanimous land tax;
- Transport tax;
- Share of the state in the division of production on concluded contracts in the part related to revenues of local budgets;
- Fees for registration of individuals engaged in entrepreneurship activities;
- License fees for the right to be engaged in separate types of activities;
- Fees for state registration of juridical persons;
- Fees for sales from auction;
- Fees for the right to sell goods at market;
- Fees for utilisation of the symbols of Almaty city in trade marks in accordance with the legislation;
- Fees for payment of road tolls of local importance;
- Fees for water; and
- Fees for use of forests.

6 Law "On Taxes and Other Mandatory Payments to Budget," (Tax Code), 2002

Non fiscal revenues:

- Non fiscal revenues from individuals and financial institutions;
- Administrative fees;
- State fees;
- Penalties and sanctions; and
- Other non fiscal revenues.

The division of property on Republican and local (communal) land began in 1999. The government has approved the list of state shares in limited liability companies within Republican property and those transferred to communal property. State shares of nationally owned companies, as well as other important objects of the economy are transferred to Republican property. Local social service infrastructure is transferred to communal property, for example schools, kindergartens, hospitals, libraries, sports complexes and theatres and all infrastructures including gas, energy and heating suppliers. At the local level, only oblast akyms and akyms of Astana and Almaty cities have communal property and can sell it or lease it through auction.

Revenues from operations with capital:

- Revenues from privatisation of communal property objects;
- Revenues from the sale of grain production, procured for self sustainability of regions; and
- Revenues from sale of parcels and from right of permanent use.

The new Tax Code was enacted on January 1, 2002 and all types of taxes and their collection mechanisms have been set⁷. The new Tax Code is focused on the creation of a favourable environment for the optimum combination of interests of the state and taxpayers and grouping of regulatory norms under the framework of one legislative act⁸. This Act addresses corporate income tax, individual income tax, value added tax, excise taxes, taxes and special payments from users of natural resources, social tax, land tax, transportation means tax, and property tax.

All fees and payments are listed in the Tax Code Articles 61 and 62 as well as in the State Fee Article 63 and Customs Fees Article 64. Responsibility for tax collection is held by the Tax Committee and its territorial entities at the Ministry of Finance. The tax bodies are subordinate to the highest tax body in a vertical line and do not refer to local executive bodies as is stipulated in Article 15 of the Tax Code. Redistribution of taxes between central and local budgets is carried out by the Treasury, in accordance with norms adopted by regional representative bodies and by the National Parliament. Kazakhstan was one of the first states in CIS countries that achieved a duly targeted financing of budget programs through the

7 The Tax Code draft was published in the mass media and underwent wide discussion at all levels in 2001. It was then approved by Parliament.

8 In Section 11 of the Tax Code, all major taxes are indicated as well as other obligatory payments to the budget; the following taxes have been defined in Article 60

Treasury system. The rates of value added tax and social tax were reduced to 16 per cent and 21 per cent respectively in the year 2001, in order to decrease the tax load. The structure of local revenues is given in Table 1. One can see that the share of tax revenues in local budgets increased from 64.6 per cent in 1998 to 83.5 per cent in 2001. In 1999, there was a significant introduction of the social tax and by 2001 its share constituted one-third of local budgets' revenues. Another important share of local revenue comes from the income tax on individuals, which has been growing steadily.

Table 1
Structure of Local Budgets in Kazakhstan in per cent to overall amount

Description	1998	1999	2000	2001
Revenues	100.0	100.0	100.0	100.0
Revenues total	73.3	85.2	86.1	87.6
Tax revenues	64.6	80.2	82.9	83.5
Income tax from legal entities	13.5	12.6	26.3	20.3
Income tax from individuals	16.4	16.0	16.0	17.8
Social tax	0.0	31.4	25.3	32.2
Property tax	14.7	10.9	8.3	8.6
VAT	7.6	3.8	3.8	2.4
Excise	7.8	1.8	1.3	1.1
Revenues for utilisation of natural resources	0.9	0.2	0.3	0.2
Fees for entrepreneurial activities	2.9	1.8	1.3	1.0
Taxes for international trade and external transactions	0.2	0.1	0.1	0.0
Non fiscal revenues	8.7	5.0	3.2	3.4
Revenues from entrepreneurial activities and property	3.3	1.8	1.0	1.0
Administrative fees and payments, revenues	2.1	1.7	1.5	1.3
Revenues of penalties and sanctions	1.5	1.0	0.6	0.5
Revenues from operations with capital	0.1	0.0	0.0	0.7
Transfers	26.4	14.7	13.8	12.4

Source: Ministry of Finance

The share of income tax from legal entities has increased from 13.5 per cent in 1998 to 26.3 per cent in 2000. However, in 2001 its share decreased to 20.3 per cent due to the establishment of the National Fund of the Republic of Kazakhstan. The revenues from this line item since 2002 are allocated to the Republican budget.

The revenues from the VAT are from Astana city and are allocated to the Republican budget. Overall, expenditures for education, health and social welfare dominate the expenditure structure of local budgets; almost 70 per cent of local budget allocations have been for these line items in 1999 and 60 per cent of local budget allocations in 2000. The mechanism for budget subventions and withdrawals has been used since 1999; in those regions where revenues exceed expenditures, the surplus is delivered as subventions to the regions where revenues do

not cover all budget needs. There is a tendency for the size of withdrawals to exceed the size of subventions. As a result, in 2001 84,155 million tenge were withdrawn and subventions totalled 35,504 mln tenge. This system of subventions and withdrawals would require further improvement, as both recipient regions and donor regions are dissatisfied with this system.

Table 2
Subventions (+) and withdrawals (-) in 1999 – 2001 in million tenge

Regions	1999		2000		2001*(without taking into account accounting cycle)	
	+	-	+	-	+	-
Akmolinskaya	+3,928		+4,153		+4,391	
Aktubinskaya		-1,646		-1,830		-3,626
Almatinskaya	+5,891		+6,055		+8,298	
Atyrauskaya		-6,766		-13,227		-28,790
Eastern Kazakhstan	+275			-1,279		-2,460
Zhambylskaya	+2,286	+3,158			+4,866	
Karagandinskaya		-3,939		-5,820		-9,856
Kyzylordinskaya	+3,169		+2,403		+1,262	
Kostanaiskaya		-363		-337	+841	
Mangistauskay		-4,844		-4,262		-10,629
Pavlodarskaya		-3,539		-1,590		-2,106
Northern Kazakhstan	+2,791		+3,192		+3,732	
South Kazakhstan	+5,959		+7,902		+12,115	
Almaty City		-16,162		-21,867		-25,801
Astana City	+5,103		+2,200		+4,646	
Total	24,814	37,259	27,118	50,251	35,504	84,155

As was mentioned in the previous sections, in spite of the achievements made, the following problems can be identified in the Kazakh public finance system:

- Incomplete decentralisation of the budgetary system still remains a critical problem of inter-budgetary relations;
- There is disproportion between the decentralisation of the budget reserves and centralisation of the budget authorities;
- Serious inter-regional disparities undermine the purported advantages of budget system decentralisation;
- Own source revenues are not fixed at rayon and oblast levels;
- Over execution of local budget revenues, partly through partial entry of the revenues to the Republican budget, often generates free funds of the state budget;
- The local executive and representative bodies face the problem of the impossibility to increase the plan of revenues on these sources and reallocate the funds on additional expenditures. The spare funds could be involved in a

timely turnover and directed to solving serious social and economic problems at the local level;

- Over-estimation or under-estimation of different sources of revenues occurs frequently. This destabilises the budget performance at different levels;
- Legislative procedures of defining long-term budget withdrawals and subventions are insufficiently implemented;
- The expenditure part of local budgets is mainly focused on current expenses; there is uncertainty in capital costs estimation;
- The current mechanism of transfers does not contain any substantial criteria for evaluation of the status of the regions; it lacks transparency and needs to be constantly updated by the central government;
- Insufficient transparency in the performance of state and local budgets results in poor control of state expenditures; and
- There is no efficiency monitoring system for budgetary expenditures.

As has been emphasised, proposals to consider the above mentioned problems will be put forward in the new concept of the budgetary process to be presented in May 2003 by the Government.

4.6 Original Revenue Sources and Local Public Borrowing

The process of public borrowing, as well as local borrowing, is regulated by the central government⁹. Borrowing by local governments is limited by the following parameters:

- Approved limits of borrowing in local budget and debt of the local executive body;
- Volume of local funds assigned to paying debts of local executive bodies; and
- Borrowing of local executive bodies is carried out in:
 - The form of loan agreements;
 - In the form of securities issuance by local executive bodies.

In order to determine the size and direction of borrowing, local executive bodies are required to:

- Develop regional investment programs, which are subjected to priority implementations out of loan proceeds. The decision to attract loans is carried out within the limits of borrowing and debt of local executive bodies and
- Prepare necessary feasibility documentation and justification to be sent to local representative bodies for their consideration;

⁹ Law of Kazakhstan on August 2, 1999 "On State and Guaranteed Borrowing and Debt", by provision of the Government of June 8, 2000 "On Set of Rules to Implement Government Borrowing and Borrowing of Local Executive Bodies of the Republic of Kazakhstan" and by other normative acts of the Republic of Kazakhstan.

In order to finance regional investment programs by the Government of Kazakhstan, local executive bodies are required to:

- Carry out a search of potential creditors;
- Conduct preliminary negotiations on schemes and conditions of loan provision;
- Prepare drafts of loan agreements to issue securities by local executive bodies in accordance with rules and procedures; and
- Obtain financial expertise from the Ministry of Finance and legal expertise from the Ministry of Justice. The drafts of procedures of issuance, circulation, repayment and service of securities are also sent for consideration to the National Commission of the Republic of Kazakhstan on Securities.

Furthermore, finalised borrowing agreements, together with other attachments, are sent to the Ministry of Finance where their compliance is checked against established conditions and the agreement is registered. The local executive body receives it later. The local executive body is required to organise and carry out registration, monitoring, management and repayment of debt as a result of borrowing. Local budgets are allowed to have a deficit. However, local representative and executive bodies are responsible for maintaining budget balance. Any budget deficit will be covered by borrowing. As has been indicated above, the Ministry of Finance, upon the request of akyms of the regions and Almaty and Astana cities, can allocate budget credits from the Republican budget. Overall, local executive bodies have the right to borrow, in accordance with current legislation, from the following sources:

- From legal entities and individuals to finance a regional investment program in coordination with the Government;
- From the Republican budget from the special reserve within the reserve of the Government for the following financial year; or
- From the Republican budget to finance investment programs approved in the law on the Republican budget for the following financial year.

Borrowing of local executive bodies is carried out in the form of loan agreements or by issuing of securities by local executive bodies. The government determines the procedure for issuance of securities and loan agreements for local executive bodies¹⁰. The debt service for a local executive body should not exceed 10 per cent of its budget revenues for the following year. There is no specific law that regulates local borrowing. Therefore, the Government issues various provisions and normative acts to regulate the issuance of securities. Table 3 shows the volume of local loans in relation to GDP.

¹⁰ In the Law “On state and Guaranteed State Borrowing and Debt” it is stipulated that the limit of local borrowing should not exceed 1 per cent of local budget revenues for the following year and the limit of the debt of the local executive body should not exceed 25 per cent of local budget revenues.

Table 3
Volume of local loans in relation to GDP in Kazakhstan

Description	1999	2000	2001
Volume of local loans, mln US dollars	7.824	4.555	38.666
GDP in million US dollars	16,854.4	18,264.7	21,873.5
Share of loans to GDP in %	0.0005	0.0003	0.0018
Exchange rate	119.64	142.14	150.2

The major holders of securities of local executive bodies are banks and pension funds. Regions that issue securities were able to obtain a credit rating from leading international companies such as Fitch and Monday's Investors Services starting in 2000-2001. In spite of the progress made by local executive bodies in issuance of securities, some problems remain which may undermine the service of local government debt payments such as:

- A lack of systematic and reliable budget planning and forecasting at the local level due to subsequent changes of state policy related to import, export and taxation etc;
- Frequent changes of fiscal legislation related to tax collection and distribution between Republican and local budgets;

Overall, local budget revenues remain unstable and the Government intends to impose more restrictions on local authorities in the form of procedures for local government borrowing.

4.7 Enhancing Local Capacity and Democratic Accountability

As mentioned previously, the structure of local authorities has not yet undergone any substantial changes; it has three descending hierarchical levels – regions (oblasts), districts (rayons) and towns (villages) – with weak vertical and horizontal linkages that lead to duplication of functions of the authorities at local level. Gradual transition to a system of horizontal accountability of akims, through election, is foreseen for 2000-2007. A pilot election for a rural district akim was held in Almaty oblast and is expected to be replicated at rayon, city and oblast level in all regions by 2007. However, before entrusting local administrations with expanded responsibilities and resources, much work needs to be done to ensure that proposed intergovernmental rules will balance the national level interests of a stable economy with a minimum level of social safety for all and local interests in specific public services. Regional disparities and abuse of delegated power is also a problem. By joint collaborative efforts of a UN system and donor organisations in Kazakhstan, as well as through regional UNDP programs, several sub-regional activities were conducted for a mixed group of decision-makers from the Presidency, Parliament and Government to familiarise them with various aspects of decentralisation such as fiscal, administrative and political decentralisation. UNDP contributed to programming for the study tour

of a group of agency heads and akims to the US in 1999. UNICEF in Kazakhstan has undertaken a recent initiative “Quality of Life for All Approach” in collaboration with the Government of Kazakhstan. The purpose of this project is to provide a quantitative framework that will serve as a basis for local government in situation analysis, planning, implementation, monitoring and evaluation. This initiative aims to enhance national capacity in monitoring sub-national development, strengthen administrative leadership in social development concerns and develop greater responsibility, authority and accountability of local government in monitoring and improving the quality of life of all their constituents. The above mentioned activities, conducted in coordination with international organisations, led to a number of lessons learned, such as:

- Plans for decentralisation should be strategic rather than predefined. There should be a clear implementation design with defined roles for the various management levels and linkages between them;
- Broad participation is needed for the decentralisation process to be successful. Not all government functions should be decentralised. While decentralisation is primarily a political process, it will not be successful unless adequate provision is made to finance the developed or decentralised responsibilities; and
- More capacity and technical expertise needs to be provided in the areas of local revenue generation and financial assistance from the centre.

It has been stipulated in the strategic plan of development 2010 to undertake the following step by step measures, such as:

- Dividing spheres of activity, functions, and responsibilities between different levels of authority;
- Creating conditions for effective functioning of local state bodies; and
- Introducing local self-governance as a basis of democratic state.

4.8 Summary and Conclusion

Having studied the issues related to the fiscal capacities of local governments, the budget system at local level in Kazakhstan can be characterised by:

- Established and developed fiscal and budgetary legislation at Republican and local levels;
- Established standards for reporting systems;
- Established intergovernmental commissions on the distinction of functions between centre and regions; and
- Planned programs of capital investment at Republican and local levels.

However, the following problems can be identified:

- Budget imbalance (budget deficit and surplus);
- Ineffective use of budget expenditures at local level; and
- Disparities in per capita social expenditures among regions.

The following issues should be taken into account and thoroughly investigated in order to enhance the financial viability and capacity of local governments:

- strengthening of the capacity of local bodies, at all levels of power, with clear differentiation of responsibilities in relation to revenues;
- removal of functions from the local level that duplicate those of the central government;
- establishment of conditions for participation of citizens in decision making process;
- making the process of budget deliberations at the local level transparent and open to the public;
- introduction of public budget hearings at the local level;
- improvement of the local fiscal system to make it adaptable to reality;
- establishment of a transparent and accountable budget system at local level; and
- further strengthening of the capacity of executive and representative bodies as well as civil society institutions at the local level.

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5. Fiscal Capacity Building in the Armenian Local Government System

David Tumanyan

5.1 Introduction

Implementation of local governments' responsibilities depends on the existence and correct use of financial resources, which in turn requires fiscal capacity building. This is an important part of the integrated capacity building strategy.

Overall, capacity building means the integrated development of an appropriate system or framework conditions, organisational aspects and individual capacity requirements to support the performance of local government's responsibilities and provision for sustainability.

- System or framework capacities generally include the design of the overall structure and policies that guide local government, the coordination of different types of organisations (public, private and civil society) as well as the allocation and management of development resources.
- Organisational capacities focus on the structures, processes and management systems that enable specific organisations to function smoothly and adapt to changing circumstances. They include the human, physical and knowledge resources of an organisation, as well as the processes employed to transform these resources into services or products.
- Individual capacities include improvement in the ability of local government leaders and officials to perform their work functions, together with related changes in attitude and behaviour. It also includes the community's ability to engage productively with the system through improved access to services and greater influence over resource management.

Capacity building is closely connected to the decentralisation process. When receiving certain responsibilities from the central government by law, local governments under the requirements of the laws and reality "are forced to build" capacity.

Decentralisation reforms in Armenia may be divided into three phases:

- 1995 – 1996 – legislative, institutional and structural changes which include the formation of the new system of public administration.
- 1997 – 2001 – strengthening and amendments of the legislative bases, including the creation of the new local self-government system.
- 2002 – widening of powers of local self-government bodies (LSGBs).

The success of decentralisation reforms greatly depends on the effective division of the responsibilities among the governance tiers, the solution of fis-

cal decentralisation issues and fiscal capacity building of local governments. The public administration system in Armenia is divided into two levels: central government and local self-government. The territorial-administrative units are: regions (*marz*) and communities (*hamaink*). State government is implemented in the regions and local self-government in the communities.

International organisations take an active part in the capacity building process. They provide technical assistance, advice, training, etc. The UNDP, World Bank, GTZ, DFID, Urban Institute, ICMA are among these organisations.

Taking into consideration the above mentioned structures, the following issues are analysed and discussed in this paper in the context of Armenia:

- Local government's capacity building process,
- Decentralisation and local revenue creation capacity,
- The new Law on local self-government and fiscal capacity building,
- Public participation in community management and accountability,
- Capacity building problems,
- Future prospects.

5.2 Local Governments' Capacity Building Process

It is very important to have a comprehensive and systematic approach for the institutional reforms. Physical, human and financial resources must be provided to undertake the reforms. A necessary component is also supportive political, economic, social and psychological conditions. The role of capacity building is very important. It must be the main component of the reforms. If the capacity building process is not provided, then the reforms are at risk. Transition countries, especially the new independent states (NIS), have many difficulties to face during the implementation of reform. This is mainly related to the lack of capacity.

Institutional reforms, decentralisation and local self-government system creation, which began after the adoption of the Constitution in 1995, took place in Armenia with a lack of or an unsatisfactory level of supportive resources and conditions. The election of local self-government bodies first took place in November 1996. There was insufficient literature, methodical materials, and explanatory work available to inform these initiatives. Central government bodies provided few methodical materials (norms, budgeting, etc.). Training centres or universities providing in-service training did not exist at that time. The formation of the society's sectors (public, private and voluntary) was in its preliminary phase. Newly elected heads of communities began the formation of his/her staff and implementation of responsibilities in this difficult situation.

Community heads and elders (councillors) have neither been technically prepared for the performance of their functions, nor have they received any orientation regarding the principles and values underlying democratisation and the decentralisa-

tion of government. In particular, the rural areas communities lacked the knowledge on which roles and functions are to be performed and especially regarding how to carry them out. This applies to the internal organisation as well as to its relationship to the communities and their position and rights within the entire system of governance. In general, their perception of decentralisation was rather negative as they saw themselves with only little chance and prospects to deal with the difficult socio-economic situation that they were facing within their communities.

Training, especially in-service training, has a crucial role to play in the capacity building process. Since 1997, some international organisations have provided local governments officials in-service training.

Training initially began with *International City Management Association (ICMA)*, which implemented the project Modernisation of Communities Financial Management from 1997 to 2000, with the Armenian School of Public Administration (ASPA). The project was very successful. However, officials from only about 20 communities were involved in the training. The topics included budgeting, financial management and public participation, etc.

Since 1997 ASPA has organised 2 or 3 workshops a year for local government officials. Twenty to thirty officials participated in each workshop, which is a very small number. ASPA has implemented 2 local government projects, funded by the Eurasia Foundation. Projects included the preparation and publication of training-method materials, textbooks, training of the LSGBs leaders and officials. One of the main outputs of the projects is the publication of 5 books, which are distributed among local governments and widely used in training processes.

Over the past few years, the Armenian reform process has received increasing support by bi- and multilateral development agencies. Some programs with capacity building components have been identified, which do not only focus on similar thematic issues, but also are, or will be, working in the same geographical area as the Integrated Food Security Project, South Armenia (IFSP-SA). In order to avoid duplication of interventions and to provide harmonised approaches towards the targeted clients, it is recommended to establish a regular exchange of conceptual issues and modes of operation.

The minimal experience with strengthening participatory approaches to development and capacity building for Local Governments in Armenia is reflected in the very limited availability of documentation, background information and capacity building material, particularly in the Armenian language. In order to limit the translation of standard documents into Armenian, the development of training material will build on field-tested approaches. wherever possible.

UNDP

From March 1998 to June 1999, UNDP implemented a project on “Integrated support to sustainable human development” in four regions of Armenia. Com-

plementary to the promotion of agricultural development, forestry rehabilitation, disaster prevention and social services in the education and health sectors, the project comprised a particular *Governance Component* seeking to build the capacity of local and regional governing bodies.

Training interventions focused on aspects of “*Management and Leadership*” targeted at the offices of the regional Governors and Community Heads. The training program was implemented in the Lori, Shirak, Siunik and Tavush Regions. 246 regional and local self-government employees have been trained. The offices of the regional governors and the offices of the Mayors of 17 towns were included. Due to the fact that the interventions were held before the elections of Local Government officials, the majority of mayors and a number of staff have since been replaced. Thematical areas comprised a range of issues that were also addressed under the IFSP’S capacity building scheme; strategic thinking and planning, aspects relating to the internal organisation such as facilitation and communication skills, conflict resolution and conducting meetings etc.

Under the second “*Local Governance*” training scheme, communities have been assisted in the preparation of the community annual budgets and triennial socio-economic development plans. Based on the provision of general information relating to the legal and institutional aspects of the reform process in Armenia, the mayors, councillors and staff training aspects included the analysis and formulation of development strategies and objectives. It also had to reflect both the community development plans and budgets.

The programme was operated through local trainers who received a comprehensive package of “*Training of Trainers*”, including adult learning facilitation and moderation skills.

The UNDP is currently co-operating with the Minister of Territorial Administration in the implementation of the Community Typology Project that will rank communities according to their development, resources and potential.

USAID

Under USAID’s Local Government Programme, which assists Local Governments to become more effective and responsive to its citizens, nine pilot cities were selected. The implementing agency is the Urban Institute. Major intervention areas comprise support to the promotion of public participation and strengthening of the development planning and financial management capacities of the targeted municipalities. In addition, seven of these towns and 12 Yerevan district communities were equipped and supported in the operation of Public Information-Analytic Centres (PIAC). The programme’s approach provides for tailor-made advisory services to each of the municipalities. A baseline study assessing the progress of local government reform in Armenia and basic consultation to some of the target municipalities in, for example, asset management, were undertaken.

The Eurasia Foundation funded the formation of PIAC in more than 20 communities and the training of its staff. Save the Children and the Communities Finance Officers Association (CFOA) have cooperated in the programme's training and capacity building activities.

The GTZ has supported the Minister of Territorial Administration within the framework of a programme on the Promotion of Local Authorities. This programme focused on the support of the legal framework, IT support to local authorities and the improvement of local utilities. The GTZ has also been active in supporting the creation of Inter-Community Unions in the Syunik region (as part of its Integrated Food Security Programme in Southern Armenia), to develop local governance capacities and collaboration and it is currently expanding these activities to other regions in the country.

Save the Children has extensive experience in managing humanitarian assistance programmes in Armenia and Southern Caucasus. It also has considerable experience in fund management and awarding funds to other organisations. It has produced a Sub-Grant Management Manual to guide fund managers and staff. Save the Children has also helped to carry out participatory urban appraisals as part of the Urban Institute/USAID's Local Government Programme. Through its Community Development Programme in Armenia, which has been ongoing since 1995, STC has worked successfully to promote community development and empowerment in one-third of Armenia's 930 communities. The programme's methodologies and approaches are now being replicated by other NGOs and co-operation agencies. STC's experience in working with communities and establishing Civic Action Groups will form a vital part of the LGP programme.

DFID provided a direct assistance programme that initially concentrated on the governance, finance and agricultural sectors. More recent activities have included assistance to the Ministry of State Revenue and capacity building in the Prime Minister's and President's offices. DFID is currently providing capacity building support to the World Bank Armenian Social Investment Fund II and it is in the process of launching a major governance and community development programme in the *marzes* of Tavush and Gegharkunik.

The World Bank has been involved in a range of economic and infrastructure development programmes, and in particular, the provision of a USD 20 million credit for the second phase of the Armenian Social Investment Fund (ASIF). In addition to funding local infrastructure projects in all regions of the country, the second phase of ASIF will also have an important training and capacity building programme for community heads and finance officers, school principals and accountants, civil society organisations and implementing agencies. This component, which is co-funded by DFID, provides training in management and leadership skills, budgeting and fundraising. Participation in such

training courses will be a precondition for accessing the fund. The project began in 2002 and continued in 2003. Training sessions have taken place in the regions.

The World Bank has also signed a USD 16 million credit with the GoA for a project to improve the management of natural resources and reduce poverty in Armenia. The project will target the two marzes of Tavush and Gegharkunik.

TACIS has supported programmes in the area of institutional, legal and administrative reform. During 2000-01, TACIS carried out a programme on Strengthening Regional Capacity in Lori Marz. Project staff and marz administration members prepared a regional plan (the first marz in the country to do so), established a regional administrative computer network and information centre and devised and introduced new budgeting formats. At its conclusion, the programme left behind a number of local experts who moved from the programme into a newly created Regional Development Unit in the marz.

It will be important to learn from the above programmes and to collaborate with those programs that are currently operating, particularly in the areas of training and capacity building.

5.3 Decentralisation and Local Revenue Creation Capacity

A constraint on effective governance at the local level was the lack of sufficient financial resources. The total budgeted revenue for local government in 2001 was AMD15.3 billion or USD 27.8 million at current exchange rates¹. Based on a population of 3.8 million, this constitutes a per capita spending on local government of USD 7.3 (the corresponding per capita figure for spending by the national government was over USD 100 per capita). This compares unfavourably to per capita spending on local government in most of the neighbouring CIS countries, let alone the more advanced western democracies². Such low levels of spending make it difficult for LSGBs in Armenia to provide a meaningful level of local public services. As the USAID/Urban Institute baseline study points out (Doane et al, 2000:8), “unless this circumstance is dramatically changed, local government spending in Armenia is unlikely to ever be significant enough to necessitate citizen participation in local democracy – simply because there is virtually nothing at stake.”

1 This represented an increase over previous years. Total local government revenue (in AMD) was 9.9 billion in 1997, 12.3 billion in 1998, 11,7 billion in 1999, and 13.8 billion in 2000 (Tumanyan, D, 2001).

2 The per capita spending figures (in USD) for other selected countries are Georgia (27), Azerbaijan (37), Lithuania (235), Russia (137), the UK (2,518) and the United States (2,776) (Barents Group, 2002:22).

Table 1
Community Budget Revenues in Armenia, 1997 – 2001 (per cent)

Type of Revenue	1997	1998	1999	2000	2001
Taxes	43.3	49.1	57.2	48.3	34.1
Income Tax		14.2	11.1	10.2	0.2
Land Tax	21.2	9.4	12.3	10.5	10.9
Property Tax	7.4	12.7	20.6	18.8	18.4
State Duties	14.7	12.8	10.8	6.3	2.4
Local Duties			2.4	2.4	2.1
Other Tax revenues			0	0.1	0.1
Non Tax revenues	17.8	16.9	15.1	12.9	14.2
Land Rent Payment	7.5	6.4	5.9	5.9	5.1
Property Rent Payment			1.0	0.6	0.6
Local Fees			1.0	1.3	0.8
Other Non Tax Revenues	2.8	10.5	7.2	5.1	7.7
Total Income	61.1	66.0	72.3	61.2	48.3
Residual Revenue to Cover Expenses	0.9	2.8	8.5	1.3	7.1
Transfers and Subsidies	40.0	31.2	19.2	37.5	44.6
Subsidies from State Budget	37.8	29.9	18.7	37.5	44.5
Subventions		1.2		-	0.01
Transfers from Other Community Budgets			0.5	-	0.1
Short-time Loans	0.2	0.1		-	-
Total	100	100	100	100	100

Local government revenue in Armenia is comprised of two main sources: (i) own source revenue; and (ii) official transfers (subsidies and subventions) from the state. Own revenue consists of a share of centrally established taxes and duties, as well as local duties and fees, land and property rents and revenue from the sale of property. All taxes in Armenia are collected by the State Tax Agency. However, local governments are assigned a role in tax collection. Initially, the centrally established taxes paid to community budgets were land and property tax (since 2000 LSGBs have received 100 per cent of these taxes), but later they included fifteen per cent of the income tax collected. Since the latter taxes are low or non-existent in rural communities, the government decided in 2000 to designate income tax as state budget revenue. To replace the local share of income tax collected, the government intended to increase the subsidy, but so far has failed to act accordingly. LSGBs also receive revenues from some state duties (essentially duties for registering births, marriages and deaths, as well as for notary services). Locally determined and collected revenues include land and property rents, revenue from the sale of property and local duties (largely for various types of licenses) and fees (including user fees for local services, as well as fees for technical services provided by the LSGB). Details regarding the community budget revenues for the period 1997-2001 are provided in Table 1 above.

Collection rates for these various taxes, duties and fees are very low in Armenia, currently averaging between 40 per cent and 50 per cent (Barents Group, 2002:19). As the Barents Group and others have pointed out, the reasons for this include:

- The state tax agencies have little incentive to collect land and property tax because these revenues go to the local budgets.
- LSGBs generally lack the tools (computers, databases or even hard-copy tax rolls) to show the amounts due and collected from individual taxpayers.
- The high rates of poverty in Armenia result in many citizens lacking the means to pay.
- The low level of services provided by many LSGBs means that citizens have little incentive to pay these taxes, even if they have the means to do so³.
- There are no effective enforcement mechanisms in place.

Under the Law on Financial Equalisation, a proportion of the community budgets are funded by transfers (subsidies) from the central government⁴. The total amount of such transfers is quite low, however, and, as Table 1 shows, they fluctuate significantly from year to year (partly as a result of fluctuations in property and land tax payments for which the subsidy attempts to compensate). Late payment of subsidies serves to compound the situation.

Another problem with subsidies has resulted from the government's decision to introduce a programme of offsetting the cost of supplying water to individuals, via the community distribution systems, against the subsidies due to communities. Basically this means that amounts accruing from unpaid water bills are deducted from the subsidy, leaving the LSGBs to shoulder the burden.

In addition to subsidies, the central government also provides subventions to LSGBs to be used for the purpose of capital investments. These go into a separate fund component of the community budget. Table 1 shows that such subventions form an extremely low proportion of total community revenues.

These constraints emphasise the desperate fiscal situation in most Armenian local governments. Own-source revenues are low, transfers from the state budget are insufficient, staff salaries are often not paid for months at a time, many local public services are simply not provided, and there are few, if any, resources available for capital investment.

Property and land tax collection responsibility is given to the LSGBs by the new law on Local Self-government. At the beginning of 2003, the State Tax Agen-

3 This, of course, leads to a vicious circle – citizens do not pay their taxes, so LSGBs cannot afford to provide decent services, so citizens have no incentive to pay.

4 The Law contains a formula (based on size in the case of very small communities and on a combination of population and previous years' land and property tax revenue in the case of the remainder) designed to ensure that the subsidy addresses financial differences and imbalances between the different communities.

cy began transferring taxes databases to the local authorities. Taxes databases are not in a satisfactory situation. It is necessary to undertake a significant amount of work for the clarification of databases. Implementation of this responsibility, of course, will strengthen LSGBs fiscal capacity, but only by providing local self-government employees with the appropriate training.

5.4 The New Law on Local Self-Government and Fiscal Capacity Building

Although the New Law on Local Self-Government (May, 2002) is not as radical as some observers had hoped, it does try to address some of the limitations and deficiencies of the old law of 1996. Some of the most important changes introduced by the new law include:

- The community is now given recognition as a legal entity.
- The new law applies to the whole territory of Armenia (under the previous law, some areas were considered as state property).
- Land and property (assets), which are considered state property and situated in the administrative territory of the community, are transferred to the communities without compensation (unless such assets are necessary for the State to implement its authorities).
- The Heads of Community are required to have specialised secondary or higher education. Community Heads can be elected to a maximum of two consecutive terms.
- Heads of Community now have the responsibility for the organisation of land and property tax collection and control; registry and civil acts services; maintaining the urban, environmental, agricultural and other cadastres and the initiation of economic activities.
- Community councillors (elders) also have a number of new responsibilities, including approval of the community development programme; the establishment of local public user charges; approval of the number of employees, personnel list and salaries of the community head's staff and budget agencies; decision-making powers with regard to the establishment, reorganisation and liquidation of community budgetary institutions and commercial and non-commercial organisations with community participation and approval of the composition of the boards and supervisory bodies of such organisations.
- Community councillors now have the right to appeal the actions of community heads or the council in court.
- Sessions of the Community Council must now be open.
- Financial resources from the alienation of community property shall be transferred to the fund part of the community budget.
- One of the conditions for tenders for local service provision shall be the highest rate of payment for the services provided.

- The State shall not increase the scope of powers of the community or decrease the revenues without relevant financial compensation.
- LSGBs will now receive a share of income tax, profit tax, and nature protection fees. The share of these taxes and fees will be defined in the State annual budget Law.
- Clarification of the position regarding the removal a head of a community from office by the Government upon the request of the *marzpet*⁵.
- Clarification of State monitoring and control local governments. The National Assembly (through its Supervisory Chamber) will once a year perform the supervision of the targeted utilisation of financial resources provided to communities from the State budget. In addition, the Government, through the relevant state authorised body, or the regional governor's office, will carry out an annual financial inspection of communities.

In some workshops and presentations, central government officials explained that the objectives of the new Law includes (i) the setting of a clearer legal framework for local governance, consistent with the Constitution; (ii) the establishment of a clearer division of powers and responsibilities between the State and LSGBs and the different powers of local government bodies (mandatory, delegated and voluntary); (iii) bringing together into a single law, as many as possible of local government regulations and requirements, thus reducing the possibility of conflict with other legislation affecting local governance; (iv) providing clearer powers to community councils to enable them to organise their activities in a more accountable and independent way, according to rules adopted by themselves; and (v) enabling community councils to be less dependent on the heads of community. They also mentioned that the Government has decided to refrain from introducing radical change mechanisms at this time, preferring instead to allow developments to take place on a voluntary basis and to test these before making fundamental changes to the existing legislation.

But in reality, the new Law on Local Self-government was not followed by amendments to other laws, which raised many ambiguities among them. On top of that, at the end of 2002, Parliament adopted amendments to the Law on Local Self-government, which further complicated the situation.

One of the key changes in the new law is that the total amount of subsidies provided from the state budget to the community budgets would not be less than 4 per cent of the sum of revenue actually received by the consolidated budget of the RA during the preceding year (Article 58 of the New Law). It would be a difficult financial task for the Government to honour this commitment, given its current fiscal position.

5 The removal of a head of community may only take place when s/he breaks the Constitution, Laws or the decisions of the community council. The Government's decision on the removal of a head of community may be appealed in court by the head of the community council. The head of community continues in office until the decision of the court is made known.

5.5 Public Participation in Community Management and Accountability to the Public

Armenian legislation does not address public participation in the decision-making process in detail. According to the 1996 Law on Local Self-Government, community residents may submit draft resolutions to the community council and attend council sessions with the permission of the local council. Under the new Law of 2002, residents will no longer require permission to attend council meetings. Article 14 of the new Law states that “sessions of community councils shall be open”, unless decided otherwise by a two-thirds majority vote of the councillors present at the meeting. To date, however, the level of public participation in council meetings and local government affairs, in general, has been very low. Most citizens are poorly informed about local authorities and their responsibilities, as well as local government procedures. Although the Constitution provides for forms of direct democracy, such as referenda, public hearings and meetings, they have been rarely used at the local government level.

Different surveys were carried out among citizens in Armenia to determine their level of knowledge of, interest in and satisfaction with, local government. Its main findings were:

- Citizens’ understanding of and participation in, local government, is in general very low.
- Citizens are generally dissatisfied with the quantity and quality of local service delivery, but do not believe that they or the local governments themselves can do anything to improve the status quo.
- Few opportunities exist for effective civic participation in local government activities.
- Citizens perceive that LSGBs lack the resources to have meaningful programmes, so there is no reason for them to take an interest in local government matters.
- Citizens who are interested in local government activities and operations have great difficulty in gaining access to information.
- There is very little coverage of local government activities in any of the media. Reporters have considerable difficulty in gaining access to credible and reliable information about local governments.
- Condominium associations potentially provide an effective vehicle for developing cooperative relationships between LSGBs and citizen groups, especially in urban areas, but this potential has not, as yet, been realised.
- Residents of villages have a stronger sense of their community and are comparatively better informed on local government activities than their urban counterparts. However, residents of villages also lack understanding of how community revenues are generated and what the spending objectives are of local governments.

- In many localities and especially the smaller rural ones, there are insufficient numbers of organised business interests, workers groups, citizens associations, NGOs and other interest groups to constitute a healthy and pluralistic democracy at the community level.
- Local government bodies in their present state are not effective institutions of democracy.

However, these surveys should not necessarily lead to the conclusion that no potential whatsoever exists for improved collaboration at the local level between LSGBs and civil society. For a country of its size and with its particular history, Armenia has a relatively large number of NGOs and other civil society organisations (CSOs). Over 3,000 NGOs are currently registered with the Ministry of Justice. Admittedly, many of these are based in the urban rather than rural areas, quite a number are non-operational (though still registered) and few of them are actively involved with local governments. But there is still potential for collaboration, providing greater incentives, some resources and a greater willingness by both sides (LSGBs and civil society) to co-operate together.

Even in the rural areas, evidence of this potential is illustrated by the work of organisations such as Save the Children and NGOs such as Shen. Through its Community Action Programme, STC has assisted communities to form Civic Action Groups in one-third of Armenia's 930 communities. The CAGs have engaged their communities in over 370 small-scale investment projects. Many CAGs have transformed themselves into viable and active NGOs, community associations and cooperatives. CAG members have been elected to local community councils or as community heads, as a result of their CAG leadership. Since its establishment in 1988, Shen has facilitated similar forms of community mobilisation and empowerment, leading to many successful small-scale investment projects in areas such as irrigation, drinking water and road rehabilitation and construction. Again, some of the community members who played a leading role in such activities have subsequently been elected as councillors and community heads (UN National Human development Report, 2001:53). What clearly needs to be done is to link these forms of community mobilisation and empowerment more effectively to the activities of LSGBs, in ways, which are mutually beneficial to both partners and the communities they serve. To date, many of the community development programmes sponsored by NGOs and international organisations have by-passed the local authorities.

There are currently three major local government associations operating in Armenia. These are the Community Union of Armenia (CUA), to which 530 of Armenia's 930 communities are affiliated; the Union of Armenian Elders (UAE), which has close to 80 members and the Community Finance Officers Association (CFOA), which has over 80 members, mostly from LSGBs. The CUA was established in 1997 and the UAE and CFOA in 1998. The main purpose of these

associations is to support their members (through advice, training, workshops etc.), and to advocate on their behalf for changes and improvements in the policy and legislative framework for local government.

All three associations have engaged in a number of useful activities. The CUA has drawn up a draft concept of public policy in the sphere of local self-government and submitted this to the Government. The UAE has submitted amendments on local government laws to the National Assembly, and has organised training workshops for Yerevan district councillors (elders). The CFOA has, in many ways, been the most proactive organisation to date. In partnership with various donors, it has participated in the drafting of the new Law on Local Self-Government (with particular reference to the finance sections), carried out training, organised seminars and workshops, drafted plans for the joint financing of inter-community projects, and established and operated community information centres. With support from the Eurasia Foundation, the CFOA has also developed a computerised software package on budgeting for use by LSGBs. In 2002-2003, the CFOA with the support of Urban Institute organised workshops for the preparation of representatives from civil society and local governments in local budgets public hearings. Budget hearings took place in 9 cities each year.

However, all the associations have experienced problems in collecting membership dues, and only the CUA is able to employ full-time paid staff. Because of this, and the short time that such organisations have been in existence, to date, they have not been fully influential as change agents. Nevertheless, the potential is clearly there and it will be important for the donor organisations to work closely with such bodies.

The tradition of accountability to the public has only begun in Armenia. Local self-government leaders and officials do not find it necessary. On the other hand, there is no demand from the public. While legislation, particularly the law on Legislative Act (April, 2002), requires the government to publish local governments' legislative acts. This requirement is very difficult to implement in rural communities.

5.6 Capacity Building Problems

Underlying the various problems is a serious lack of capacity and resources in many LSGBs. This applies to human and physical capacity, as well as to financial capacity issues. Although capacity constraints affect all local authorities, they are particularly pronounced in the large number of small rural communities. Many of the 59 urban communities have administrative, financial and service departments staffed with trained specialists, as well as the necessary equipment to carry out their functions, including IT equipment in an increasing number of

urban LSGBs⁶. However, such resources are seriously lacking in the rural areas. Most rural authorities lack the funds to hire qualified specialists in management and budgeting. It is hardly surprising, therefore, that many of these authorities struggle to properly estimate the cost of the various services the communities must provide. There are 930 communities in Armenia, among which 54.4 per cent has less than 1000 inhabitants. It is very difficult in these communities, to have trained and skilled officials.

Training and capacity building needs to exist in all or most LSGBs, especially in areas such as management and leadership, strategic planning and strategic thinking, participatory planning project management, budgeting and financial management, fundraising, human rights and gender awareness. Training programmes are also needed in the area of change management, to expose local government leaders and officials to attitudinal change and new ways of thinking, in order to help them move away from the current rule-bound and dependent culture (“you can’t do anything unless the law says so”) towards more innovative, entrepreneurial and problem-solving approaches to their work.

Training is mainly organised through international organisations, such as the International City/Country Management Association (ICMA), the UNDP and the Urban Institute, also by NGOs with support of donor organisations. Despite such interventions, a more comprehensive training system for local government employees is urgently needed.

Only the Law on Local Self-government regulates (if it may be called a regulation) the civil service in the local self-government system. Unfortunately, the Law on Civil Service has not included the local level, which makes it difficult for the implementation within the civil service broad principles of public administration, as well as in the local self-government systems. The Law on Municipal Service has not yet been adopted. It means that the framework of the civil service is not clarified. It raises many negative consequences: instability of personnel, defencelessness of civil servants, casual labour appointment to high posts, etc. As a result, a professional and stable “corps” of civil servants is not available. After each election of local self-government bodies, newly elected community leaders dismiss a significant number of municipal employees. The recruitment, promotion, mobility, evaluation and training of staff are not regulated by any normative acts. In the absence of a coherent national policy, each local government addresses such issues in its own manner.

6 The staff of the larger urban LSGBs will normally include the Mayor, Deputy Mayor, Secretary of the Local Administration and the Head and support staff of a number of departments, both service departments (such as public utilities, trade, housing, education, culture and sport) and support departments (such as administration, finance and budgeting, legal, architecture and urban development, public relations). In the smaller rural LSGBs, there will be at best a Head of Community, a Deputy, a Secretary of Local Administration, a Community Accountant and perhaps a small number of support staff. Computer equipment is generally lacking in most of the smaller LSGBs.

As the framework for the civil service is not clarified, the official statistics include only the total number of municipal employees. This was 6425 (without the heads of communities) in 1999: rural communities' employees – 77.7 per cent, urban communities' employees – 12.6 per cent and district communities' employees – 9.7 per cent.

The low salaries paid to most of the country's local government officials and workers, has resulted, in many cases, in low motivation and productivity and high rates of staff turnover and absenteeism. This has often compounded capacity problems. Most employees, especially of small rural LSGBs, earn less than USD 10 a month, and are often paid irregularly. In order to survive, many of them are forced to engage in multifarious commercial and other activities. They may even be tempted to accept illicit payments for offering their services (UNDP, UNDESA, SALA, 2000:7). Another factor that affects morale and performance is the fact that local government staff has no security of tenure. When a new head of community is elected, he/she can replace existing staff with new staff. It is clearly very difficult to develop a professional service ethos in such circumstances.

Table 2
The Number of Local Self-governments Employees

	Total	Of which		%	
	Persons	Male	Female	Male	Female
City Mayors	47	0	47	0	100
Deputy City Mayors	49	2	47	4	96
City Mayors Staff	764	290	474	38	62
Heads of Yerevan District Communities	12	0	12	0	100
Deputy Heads of Yerevan District Communities	12	0	12	0	100
Yerevan District Communities Heads Staff	606	228	378	38	62
Heads of Village Communities	871	20	851	2	98
Deputy Heads of Village Communities	871	38	833	4	96
Village Communities Heads Staff	4123	1623	2500	39	61
Total	7355	2201	5154	30	70

5.7 Future Perspective of Capacity Building

More than six years experience of local self-government systems shows that for its further development it is necessary to prepare a decentralisation strategy and implement it. The strategy must clearly define the spheres for transfers to the local governments' new responsibilities, terms, phases, mechanisms, evaluation indicators and criteria.

The decentralisation strategy must include the following items:

- Communities enlargement,
- New responsibilities delegation to the LSGBs,
- Legislative bases development in time,

- Strengthening of local governments capacity,
- Allocation of financial resources accordance to the local governments' responsibilities.

It is necessary to take into account that a logical connection exists between these items. It is not possible to provide for local government development without the inter-relationship and implementation of these actions simultaneously. Also, the expansion of the local governments' responsibilities and definition of corresponding amenities will support their strengthening and development.

The development of a decentralisation strategy is a central government issue. Implementation will require participation by the central government, local governments, the civic and private sectors.

Simply giving powers and responsibilities to the local governments by law is not sufficient for the implementation of fiscal decentralisation. It is necessary to adopt the law on Municipal Service, which will define the municipal service framework, service requirements, the rights and responsibilities of municipal servants, jobs description, the matter of servants retraining, attestation and defence and their social guaranties, etc. At the same time, it is very important to establish training centres for local governments. Municipal staff must have mandatory in-service training. In-service training expenses should be included in the local budgets and transferred to the training centres to pay for the required programs. Donor organisations have an important role to play in this initiative. They must be interested in the foundation and development of training centres because it is a base for sustainable development.

International organisations also must envisage supporting programs that provide assistance in the areas of financial management, including budget preparation and administration and the strengthening of the capacities of civil society organisations as non-governmental and community-based organisations. Efforts to harmonise approaches, however, have to be undertaken in relation to common activities concerning public participation in local governance issues, planning of development projects, support in the delineation of functions between the regional and local government bodies and enhancing co-operation between municipalities, as envisaged by the ISFP via the support to the formation of Council associations.

5.8 Conclusion

Local government capacity is one of the weaknesses of the local self-government system in Armenia. There is no clearly defined central government strategy in this regard. Legislation does not provide all the necessary conditions for capacity building and strengthening local governments. The *Law on Municipal Service* is currently not adopted. Sustainable functioning training centres have not been

established. Many international and donor organisations have organised and implemented different capacity building, including training projects. However, it is not satisfactory for sustainable development. Only the solution of the above mentioned problems will permit the development of a capacity building process.

The strategic goals and objectives of a community's development, including capacity building must be at the centre of central and local governments' attention and implemented in close co-operation with other relevant sectors of the society.

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6. Enhancing The Capacities Of Regional And Local Governments To Provide More Authority In Public Finance

Araksya Margaryan

6.1 Introduction

Decentralisation and formulation of democratic local government systems are parts of broader reforms in CIS countries. As part of the former Soviet Union, the three Caucasus countries – Armenia, Azerbaijan and Georgia – have experienced the pros and cons of a planned economy with a highly centralised unitary system, where issues of intergovernmental fiscal relations were handled and controlled by a central government with indisputable authority regarding resource collection and fund allocation.

The political and fiscal decentralisation processes taking place in Caucasus are linked. The Government's complete structural reforms include the distribution of power at the local level, and the necessity for enlarging and providing more public finance authority.

The main characteristic of the local self-government system in Caucasus countries is the formation of the system as a result of governance decentralisation. Each country defines its own framework and politico-administrative models for local self-governance.

Armenia has a two-tier governance system with most of the administrative powers belonging to the government. The branches of the central government administrative structure are known as territorial administrative units – “*Marzes*” – which are not a separate tier of the public administrative system. There are no elected marz officials and it does not have its own budget. All Armenian communities lie within the boundaries of a marz. The members of the community elect the community elders and the head of the community for a three-year period through general, equal and direct elections by secret ballot. There are a total of 930 communities, of which 465 have 1,000 inhabitants or less.

Currently, Georgia has established a four-level government model including a three-level regional government model. They are: a) Central level; b) Autonomous republics' and regions' level, where the status of political autonomy is defined by the constitutional law on state-territorial arrangement and c) Local government representative level made up of rayons. There are six cities which are not incorporated into the rayons; d) local self-government level comprising villages, settlements, towns and cities incorporated into the rayons.

There are 966 Villages and cities at the first level – 60 rayons/districts and 9 regions in Georgia.

The importance of the legal and institutional framework rests with its function of establishing rules, incentives and constraints on public officials in the Caucasus region. Institutions create opportunities for public financial officials to make choices and thereby exercise autonomy. They also constitute a framework of regulations and other enforcement mechanisms that together provide the means to hold public officials accountable for their choices as they affect fiscal and economic performance. There is a critical interdependence between accountability and autonomy and both rely on the strength of supporting institutions. Key institutional features for supporting autonomy and accountability include:

- Political and civil liberties, including democratic elections, freedom of expression, opportunities to form civic organisations,
- Integrity of public officials, low level of corruption,
- Effective processes for fiscal control, including budgeting and financial reporting
- Secure and well-defined property rights

6.2 Functional Responsibilities of Local Government

The concept of decentralisation and local governance, as well as the legal framework for its functioning, was introduced in Armenia only six years ago. After Armenia joined the Council of Europe in January 2001, the government was obliged to carry out legislative amendments to expedite the decentralisation process. Since then, the Government of Armenia has relinquished some of its powers to local officials. The Law on Local Self-Government has since been drafted and updated. The latest version was adopted by the National Assembly in May 2002. The new Law on Local Self Government, in accordance with the Council of Europe Charter, is the first step to establishing a sound legal framework for local governments to operate.

The Municipal reform in Georgia assumed a determined position from 1997, when the Presidential Decree “The State program for Municipal development” was approved. The second stage of the decentralisation reforms began through the Presidential Decree #94 of March 13, 2000 “On the Second Stage of Municipal Development in Georgia”, which determined major trends in decentralisation and local self-governance for the short-term (2000-2001) and the mid-term (up to 2005). Three major draft laws have been prepared within the framework of this program: the Organic Law on Self-Governance adopted in 1997 and extended in 2001 (which regulates the activities and responsibilities of local government and self-governments); the Draft Law on Local Budgets; and the Draft Law on Municipal Property. Only the first has been adopted. The remainder will be presented to Parliament in 2003.

Following the July 1999 “Law on Municipal elections” and “On Status of Municipalities” in Azerbaijan, municipalities were formed. On 12th December the first elections of municipal bodies were held. The process of decentralisation and enlargement of authorities has continued over the past few years, based on the legal legislative framework.

The context in which the requirements for decentralisation of authority and fiscal responsibility to sub-national units are recognised depends on what the functions or purposes of the sub-national units are.

Table 1
Analysis of Decentralisation in Armenia, Azerbaijan and Georgia

CRITERIA	EVALUATION		
Conditions required for efficient decentralisation:	Armenia	Azerbaijan	Georgia
Elected local government council	xxx	xxx	xxx
Chief local officers are appointed directly or indirectly by the elected local council	xx	xx	x
Local governments must have some taxing powers	xx	x	xx
Local governments must have some significant expenditure responsibility	xx	xx	x
Local governments must have some significant responsibility determining service levels	x	xx	xx
Local government must have adequate tax administration capacity to collect those revenue sources that are assigned to it	xx	x	xx

CRITERIA	EVALUATION		
Roles of different levels of government			
Allocation	Local	Local	Local
Stabilisation	Central + Local	Central	Central
Distribution	Central + Local	Central+Local	Central+Local
Privatisation	Central + Local	Central	Central+Local
Nation Building	Undefined		Central+Local
Models of decentralisation			
Devolution	xxx	xxx	xx
De-concentration	xxx	xx	xx
Delegation	x	xx	x

xxx the criterion is present and corresponds to the definition

xx the criterion is present, however does not fully correspond to the definition

x poor presence of the criterion

In all three countries, the primary level of local government (city, town or village) has the responsibility for a range of infrastructures and utility services including local roads, waste management, water supply and sanitation, public transport, energy supply, heating, social housing, cemeteries and parks. However, exercising this responsibility is constrained by a number of factors. Responsibility

for the social services differs between the three countries: in Armenia pre-school, primary and secondary education, social services and health care are state responsibilities, which local governments may supplement on a voluntary basis. In Georgia, draft legislation assigned these services to the cities with rayon status. Many of the institutions through which these services are delivered have catchment areas which exceed the boundaries of towns and villages. In spite of the Armenian Law on Local self-government, which clearly defined the roles of local self-governments and local governments, in the Organic Law of Georgia, there are many incompatibilities with other laws and also a lack of symmetry between the articles contained in this law. Because of this, several competency issues of local governments and self-government bodies have overlapped, sometimes allowing both to fulfil particular responsibilities “through mutual agreement” (Article 8.2).

As can be seen from Table 1 above, Armenia, Georgia and Azerbaijan have made significant steps towards reaching an efficiently decentralised fiscal system. However, there are many areas and issues that need further improvement, reformation and revision.

The main problem in all countries regarding decentralisation stems from the fact that local governments do not have clearly defined functions and this creates an authority problem. Representatives of all three countries have mentioned that the main reason for this was that decentralisation had been carried out in an *ad-hoc* manner, which in turn complicates management. Often, very good laws on Local governance cannot regulate the public service and intergovernmental relationships, which in turn creates confusion at the different levels of governance.

The competencies of Local Governments in Armenia, Azerbaijan and Georgia can be found in Table 2.

6.3 Local Government Finance

The problem of finding the right fiscal relationship between central and local governments plagues the countries in transition.

The budgetary system of the Republic of Armenia consists of three units: the state Government budget, local government budgets and the Social Insurance State Fund (SISF). The main part of consolidated fiscal transactions of the Republic is concentrated within the state Government budget. It is a requirement of the law that local governments run balanced budgets. Therefore, since local governments have limited revenue capacity, the share of local governments’ expenditure in the structure of consolidated expenditure is very small.

To prepare the outline of the budget (Table 3), the Administrator instructs the managers of state enterprises and the relevant staff members of the district government to present forecasts of revenues and expenditures. Based on this data, he then writes the draft budget and a letter of decision for the Council of

Table 2
Competencies of Local Governments

Functions (Maintaining, development, hire the staff, financing in another way)	All municipalities (Alone or commonly, esp. in associations)			Central or state territorial administration		
	Arm	Az	Geo	Arm	Az	Geo
Education						
1. Pre-school	X	X	X		X	
2. Primary		X	X	X	X	X
3. Secondary		X		X	X	X
4. Technical				X	X	X
5. Higher				X	X	X
6. Specialized	X		X		X	X
Social welfare						
1. Nurseries	X	X	X		X	X
2. Kindergartens	X	X			X	X
3. Welfare homes				X		
4. Personal services for elderly and handicapped	X			X	X	X
5. Special services (for homeless, families in crisis, etc.)				X		
6. Social housing	X					X
Health services						
1. Primary health care	X	X		X	X	X
2. Health protection				X		
3. Hospitals				X	X	X
4. Public health	X	X		X	X	X
Culture, leisure, sports						
1. Theatres	X			X	X	
2. Museums	X			X	X	
3. Libraries	X			X	X	
4. Parks	X	X	X		X	X
5. Sports, leisure	X					
6. Maintaining buildings for cultural events	X				X	X
Economic services						
1. Water supply	X	X	X		X	X
2. Sewage	X	X				
3. Electricity	X			X	X	X
4. Gas		X		X	X	X
5. District heating	X		X		X	
Environment, public sanitation						
1. Refuse collection	X	X	X			
2. Refuse disposal	X	X	X			
3. Street cleansing	X	X	X			
4. Cemeteries	X		X	X		
5. Environmental protection	X	X		X	X	
Traffic, transport						
1. Roads	X		X	X		X
2. Public lighting	X		X	X		X
3. Public transport	X		X	X		X
Urban development						
3. Town planning	X	X				X
4. Regional/spatial planning				X		X

Elders. On the contrary, in Georgia, representative bodies have the authority to supervise the implementation of set parameters and apply changes, if necessary, without increasing the deficit in budget revenues and expenditures. If revenues exceed expenditures during the budget implementation process, then the excess amount remains in the respective executive and government bodies and may be used according to the views of the government bodies.

Table 3
Locally Approved Budget

Armenia	Azerbaijan	Georgia
Local or district budgets are approved by local Councils of Elders. The District budget is drafted by the District administrator based on a quarterly development report, which presents analysis of financial needs and resources.	In accordance with "The Law on Financial Bases of Municipalities" Municipalities create the project of the Local Budget, taking into account grants from the State Budget. The local budget is not part of the State Budget.	The Organic Law defines the responsibilities of the Gamgeoba / mayor's office/ in the process of the formation and implementation of the local budget. It grants the local government the right to make decisions freely in the approval of the local budget.

Source: *Law on Self- government of Armenia,*
The Law on Financial Bases of Municipalities, Azerbaijan
The Organic Law, Georgia

According to the Law on the Budget System and Budgetary Regulation of Georgia, if the budget is not approved at the beginning of the fiscal year, then all levels of government are entitled to have monthly expenditures of up to one-twelfth of the factual expenditures of the previous year. Because local government and self-government depend on transfers from the state budget, adoption of their budgets was also delayed.

In Armenia, based on the relevant documentation presented to the Council of Elders for discussion either before, or within a one-month period from the date of the approval of the state budget, the council of Elders either approves the draft immediately or suggests amendments to it, which should be made by the Administrator within three days. If the Council does not approve the budget, then the Administrator must resign. After Council's approval of the district budget, this is presented to the Governor. The Governor checks whether the budget corresponds to the law and follows the principles set out in the relevant legislative statutes.

6.4 Revenue and Expenditure Assignment

In the analysis of Georgia's local government finances, revenues should be grouped into two main categories: shared and local (see Table 4). The Armenian law on Local Self-government sets the following local revenue sources: land tax, property tax, proportion of other taxes stipulated by law, duties and other mandatory payments, subventions and subsidies and other sources not published by law. Currently, there are no shared taxes with local governments in Armenia. Sub-na-

tional governments in Armenia lack independent sources of revenue. As a result, they have a low level of fiscal autonomy, which results in a wholly public service management in local communities. Tax sharing is encouraged and welcomed by communities, as it promotes economic activity and public service. This increases efficiency because local governments are better informed than central government on the needs and wills of community members. Unlike Armenia, the shared tax exists in Georgia (28.5 per cent).

Table 4
Local Government Revenue, 2001/per cent of total/

Revenue	Armenia	Georgia
State taxes	60.5	15.1
VAT	39.3	9.4
Excise	17.1	2.1
Customs	4.1	3.6
Shared taxes	-	28.5
Profit	-	10.0
Withholding tax	-	18.5
Taxes assigned to LG	8.3	23.8
Land	0.1	7.5
Consumption of Natural resources	1.4	1.6
Environmental pollution	1.5	5.7
Property tax	5.1	8.5
Property transfer tax	0.2	0.5
Local taxes	3.5	5.6
Fee and other non-tax revenue	1.3	2.8
Rev. from state owned property privatisation	5.1	10.2
Special funds	1.1	2.4
Total tax and non-tax	79.8	88.4

*Source: Ministry of Finance, Georgia
Ministry of Finance and Economy, Armenia*

Georgia's and Armenia's local budget revenues are made up of the following: taxes and fees, which are imposed at the local level by local governments within the framework set by the state and national taxes which are completely attached to the local government.

Searching for ways to finance service delivery, local governments in economies in transition may revert to coping mechanisms that may allow services to be delivered, but at a cost of many important national objectives. Efficiency depends on three conditions being satisfied. First, taxes can be adjusted up (or down) by the local self-government according to shifts in public spending. Second, regional and local self-governments must have some control over the tax rate or base and the burden of taxes must fall on local residents. Third, spending responsibility must be clearly assigned and local government must be able to deliver efficiently the chosen level of expenditures.

Local revenue autonomy requires access to a productive tax base, independent authority over user charges and an administrative capacity to collect local revenues. In the region, they have been slow to develop the most obvious local tax base – commercial and residential property. In Armenia, property tax, paid by both enterprises and individuals, is turned over to the local governments. The only share of property tax that goes to the state budget is the tax paid on property that is state-owned. Depending on the country in question, this reflects a combination of institutional weaknesses, including slow progress on privatisation, immature property markets and inadequate administrative capacity for assessing and collecting revenues. Other options for generating more substantial local tax revenue, such as local sales taxes or surcharges on national income taxes, are just beginning to emerge in the various transition countries. With regard to user charges, the main obstacles appear to be a lack of administrative capacity and the persistence of central government regulations concerning pricing for various locally-provided services, such as transportation and utilities. Pricing regulations constrain local efforts in achieving greater cost recovery. A subsequent section looks in great detail at the current status and recent developments regarding local revenues. However, with respect to issues of autonomy and accountability, local revenues remain an area of particular weakness throughout the region.

Another important source of local government revenue in Armenia is transfers from the state Government budget. The Law on Financial Equalisation regulates this type of inter-governmental fiscal relations. The concept of Financial Equalisation is to secure harmonious development of local self-governments through minimisation of the differences in their financial means and resources. Financial equalisation transfers from the state budget to district budgets constituted 5.19 billion Armenian drams (AMD) in 2000 and 6.12 billion AMD in 2002 (*Armenia Economic Trends Quarterly Issue: October-December 2002*. TACIS).

The development of a legal framework for regional and local self-government will improve the basis for sub-national fiscal autonomy and accountability. Autonomy requires that local and self-governments have the opportunity to mobilise their own sources of revenue and independence, in deciding how to allocate financial resources across the different types of spending. This presumes a well-defined assignment of expenditure functions across different types of activities and services.

Expenditure assignment is clearly defined for self-governments in Armenia. Financial resources are directed to financing of current expenditures and provision of district services. Local governments are obliged to render services in the spheres of water and sewage, utilities, garbage collection, transportation, communication, agriculture, health, education, culture, sports and social security etc. Responsibilities and obligations of local government in the provision of services are defined in the Law on Self-Governments.

Local elections in October, 2002 addressed the most basic civil concerns – garbage collection, care of green zones and cemeteries, local tax administration, rental decision of local assets and assets procurement. However, the broader and more active involvement of municipalities in the development of the community is rather limited. A current failure in urban service delivery in Armenia is the reflection of legal and financial constraints upon the cities and communities, most of which have inadequate budgets for the demands for services. The local government budget in Armenia constitutes 8 per cent of the total State budget. “The 8 per cent is further reduced to 4 per cent because the central government typically transfers only 50 per cent of the planned subsidies to local government budgets,” said a leading advisor of the Government of Armenia on local government issues. (By comparison, European countries allocate up to 40 per cent of their national budgets to local government.) The new law on Local Self-Government increased the budget allocation for local governments. More specifically, apart from property and land tax, the communities will also receive some portion of income and revenue taxes, the percentage of which will be determined annually. According to estimates, the additional revenue sources might bring an extra 9.6 billion drams (about 17 million USD) to the local government budgets – which would effectively double them. Specialists in municipal management say that the devolution of powers should be a well-thought out and timely process to ensure that the central government does not give too much functional responsibility too rapidly without the appropriate capacity-building support.

While the big cities demonstrate a willingness and general capacity to manage greater powers, it is not a given that the remaining cities and villages of the country will be able to undertake additional functions. The Central Government, experts say, should be identifying resources to provide training, technical equipment and facilities for communities adjusting to the transfer of power.

A limited sample of country-specific data on expenditure assignments and shares by functional category of spending, confirms in most cases, a broad correspondence between actual assignments in the former socialist states and that implied by commonly accepted principles regarding the distribution of functions across levels of government. However, there are exceptions, the most important of which concerns sub-national financing of redistribution of social welfare policies. There is also evidence that in transition countries, vague and unstable expenditure assignments create undesirable opportunities for one level of government to shift responsibilities unilaterally to another level in response to political or fiscal pressures. Another concern arises from central government mandates affecting a range of sub-national expenditure responsibilities. Typically lacking adequate funding from the centre, these mandates constrain sub-national budgetary autonomy. Together, these persistent shortcomings continue to undermine sub-na-

tional fiscal accountability and autonomy. As such, further actions are required to remove these obstacles to effective intergovernmental fiscal relations.

In all three countries, the studies refer to the problem of “unfunded mandates”, which are duties imposed on local governments that exceed their financial capacity. Local governments suffer from a lack of sound intergovernmental financial arrangements. While fiscal decentralisation of local governments should be encouraged, it is vitally important that local governments be assured of adequate financial and human resources before they are given responsibilities that may be too difficult for them to manage.

Autonomy must also extend to expenditure decisions. If local authorities lack control over the allocation of public spending, then there is no basis on which to hold them accountable for the quality, quantity or mix of public services. In fact, local authorities in the region have substantially increased their formal authority over spending decisions. However, there are also clear examples where the independence of sub-national budgets is violated by central mandates in areas such as education and health spending, wage rates, control over hiring and firing, or by the unilateral transfer of expenditure responsibilities from central to local budgets, as in the case of social protection spending. Compared to the more region-wide failure to establish adequate revenue autonomy, there is greater distinction among Caucasus countries as regards the independence of local budget expenditures (Table 5).

Table 5
Total revenues and expenditures of Local Governments as a Percentage of the Consolidated Budget and GDP (in Mil. USD)

Title	Armenia 2001	Georgia 2001
Gross Domestic Product (GDP)	2,367	2,900
REVENUES		
State Budget	362.2	320.1
State as GDP %	15.2	11.1
Local	33.8	160.4
Local as consolidated %	9.2	33
Local as GDP's %		5.61
EXPENDITURE		
State Budget	459	450.4
State as GDP %	19.4	15.8
Local	31.5	158.2
Local as consolidated %	7	25
Local as GDP's %	1.3	5.5

*Source: Ministry of Finance and Economy, Armenia
Ministry of Finance, Georgia*

In summary, many of the institutional conditions relating to public sector accountability, which underlie the standard argument in favour of fiscal decentralisation, fail to be met in most former socialist countries. In Armenia and Georgia, local governmental institutions remain relatively weak. They, in particular, are characterised by the following: single-channel, bilateral arrangements between the national government and individual sub-national jurisdictions, intended to satisfy the political demands of regional elites and contain cessionary pressures; proliferation of non-transparent financial and barter mechanisms undermining public sector accountability at all levels of government; failure by both national and sub-national authorities to comply with the terms of budgetary agreements covering inter-governmental transfers, expenditure assignments and revenue sharing.

6.5 Case study: The Reform of the Armenian Tax System and Tax Administration

Reforms of tax administrations are already priority tasks for the government of Armenia. With the municipal reform issued in 1996, Armenia introduced an important step towards the following: the reconstruction of the political and administrative system; the decentralisation of state functions and the construction of a municipal autonomy. However, in spite of a number of already introduced legal and institutional reforms, the communities are not yet able to execute their tasks adequately. The foreign and local projects aim to support municipal institutions in fulfilling these tasks. The consultation and training of the Association of Treasurers in questions of local finance management; the consultation and support of the Association of Treasurers in improving software for local finance management and its dissemination and the development of a system to monitor community development with regard to economic and financial aspects.

These are being undertaken with a view to balance the need for public revenue and promote community development. Related reforms in accounting, such as adopting International Accounting Standards which is already underway, will not only improve tax administration in Armenia, but will also increase transparency and might also develop financial markets.

Analysis has shown that the State Tax Agency does not co-operate with communities' tax inspectorates in the process of tax collection, revealing that the primary interested party is the local government. Based on statistics supplied by the Department of Tax Improvement at the Ministry of Finance and Economy, the level of tax collection in 2002 decreased, compared with the previous year, by 7.3 per cent. This is a result of the way the tax administrations in rural communities work and the methods used, as well as a lack of elaboration upon and operation of a uniform organisational system. Local governments can significantly increase the collection rate because they have a greater interest in the collections,

would know more about their residents and would administer some taxes more efficiently than the central government.

Up until March 2000, tax sources of revenues for district governments included 15 per cent of Personal Income Tax (PIT), 95 per cent of property tax and 95 per cent of land tax, as well as local fees and rents. However, in March 2000, the President of RA ratified amendments to the Law on the Budgetary System whereby revenues from PIT were to be transferred in full to the state Government budget, while land and property taxes would be transferred to the local budgets' revenue. Local governments have the power to levy local fees and rents. The Law on Local Fees and Rents defines these. With respect to the rate of local fees, although it is up to the Council of Elders to decide on the size, the Law defines the minimum and maximum margins for those rates. However, the Council of Elders has the power to decide on the size of local rents. The amounts of rates for local fees and rents cannot be changed within a given fiscal year. Local fees and rents are charged on an equal rate for all district residents and legal entities.

For implementation of their legislative responsibilities, district governments are provided with adequate capacity. However, there is a poor collection of taxes, fees, rents and other revenues. This is explained, not by the inability of local self-governments to implement their revenue duties, but by the poor social-economic state of the population and poor assistance from Central government. The situation is devastating in rural areas, where unemployment is high and income level is extremely low. There are many problems concerning the tax collection process. One of these problems is that collection costs for Property and Land tax are high: one tax inspectorate reported that 15 per cent of operating costs was spent on collecting 2 per cent of taxes.

During the Congress of Communities Association of Armenia in 2002, the mayors of Ijevan and Gyumri mentioned the current poor state of local revenues, reporting the difficulties encountered with the collection of income tax. The new law on local self government has now devolved the local tax collection powers to local governments beginning in January. However, as many experts mentioned, the central government has so far failed to share its database with the local governments to assist with the new powers.

The importance of strong local communities as a basis for national economic development was pointed out by other mayors who introduced the current state of their cities, the progress made and problems they face. Some of the critical issues local government currently deal with, with tax collecting bodies, do not prioritise local tax collection.

Local self-governments require an incentive to increase revenue mobilisation. Under the present system in Armenia, this could happen in two ways: Local governments might strengthen tax enforcement. They do have some influence

with local State Tax Service offices all over Armenia and there is a close relationship between local governments and the state enterprises that make up the largest part of the tax base. Sub-national governments might also help increase the profitability of their public enterprises.

Assuming that local self-governments achieve an appropriate degree of autonomy with regard to revenues and spending, it is certainly important to have in place, the mechanisms necessary, to hold decision-makers accountable, both to their constituents and possibly other levels of government. Accountability requires access to information. Mechanisms to ensure access to information include public statements of short and medium-term fiscal objectives, a transparent and inclusive budget process, accurate and comprehensive financial reporting on outcomes and an independent media to assist in the public dissemination of the information.

7. Enhancing Local Government Revenue Capacity in Byelorussia

Leonida Pliskevich

7.1 Introduction

The process of restoring local self-management in Byelorussia began after the election of the people's deputies to local councils in the Spring of 1990. For the first time, elections were competitive and all candidates were forced to address the real problems of the voters, in order to win the mandate of trust. The characteristic inadequacies of local authorities at the beginning of the 1990s included:

- excessive stress on politics in the representative bodies, which produced pretentious decisions and a duplication of the work of the national parliament;
- the absence of quality legal regulations;
- a too-frequent low level of professionalism on the part of deputies, which was an obstacle to the formulation and implementation of reforms of local organisation and municipal services.

A basic element of the reform of local authorities was the Law «On local self-management and the local economies in the Byelorussian Soviet Socialist State» on 20th February 1991. Following this, the role of the local authorities, the Councils of People's Deputies, increased.

In 1991 – 1992 in Byelorussia the first edition of the Law on local self-management and local economies came into effect. According to the constitutional mandate, authority was concentrated in the system of Councils. The Supreme Soviet formed the government, including the Council of Ministers and other republican state bodies. The legal basis for forthcoming constitutional changes was accepted on the 27th July, 1990. On 25th August, 1991, the declaration on state sovereignty by the Supreme Soviet, gave the status of constitutional law greater validity in relation to the Constitution.

The changes directed to strengthening the power of executive committees and promoting a centralisation of authority were mandated by the 1993 Law on local self-management and the local economies. Executive committees were given the right to approve staffs independently, to appoint heads of departments accountable to the Council and to establish municipal properties.

The material precondition of centralisation of authority was the prevalence in Byelorussia of state ownership. Under the dominance of state ownership, permitting an excessive autonomy of the regions was a mistake. The Law on local self-management restored the government's influence on regional policy and was subordinate to Councils on the principle of “democratic centralism”.

The problem of local self-management appeared so complex that it did not receive the appropriate sanction of the constitutional process over a four-year period. At various stages of this period, as different projects were pursued, the topic of local self-management was most confusing and constitutional experts could not determine the place and role of local self-management in the system of state institutions. That is why the section on local self-management was the weakest part of all the projects pursued and seemed to be continually in conflict with the constitution.

The most recent history of self-management was initiated with the issuance of the Decree of the President of Byelorussia on 19th September 1995 (№ 383) «On the implementation of the reform of Local management and self-management bodies» according to which, regional Councils of deputies in cities and their bodies were finally abolished. In the municipalities, administrations were formed with legal persons as local governments. The higher executive committee comprises the heads of local administration and their assistants.

One of the main questions in the analysis of self-management remains: What should Local government be? The Byelorussia legislature has, for a long time, searched for the formula of a meaningful and successful local self-management. Unfortunately, legislation has answered this question. Article 2 of the Law «On local management and self-management in Byelorussia» contains the instruction that through local self-management, citizens should operate directly or through elected bodies to resolve local problems. This legislation mandates the creation of local Councils of deputies and bodies of territorial public self-management, the implementation of local referenda guaranteeing the free assembly of citizens and the use of other forms of direct participation of the citizenry in state and public affairs. Councils are said to be the basis of local self-management, coordinating the activity of bodies of territorial self-management. Local self-management is to be implemented within both administrative and territorial units. The basic powers regarding questions of administrative-territorial organisation belong to the President of Byelorussia as stated in Chapter 2 of the Law of 5th July 1998 « On administrative-territorial division and the decision of administrative-territorial questions in Byelorussia ». The President of Byelorussia forms and abolishes areas, establishes and transfers administrative centres and establishes and changes area borders. The regional Councils of Deputies are concerned only with the formation, abolition and transformation of Village Soviets.

The law of Byelorussia of January 10, 2000, «On local management and self-management in Byelorussia,» “approves local self-management in Byelorussia – the form of organisation and the activity of citizens to make independent decisions are managed directly or through bodies elected by them”. This Law de-

termines the legal status of bodies of local management. In current legislation, there is also no precise definition of the bodies of local management, although it would seem that such bodies form a uniform system of regional, municipal, settlement and rural executive committees and local administration.

History shows that economic forces are of great importance in achieving genuine self-management. An independent system of public authority can develop on the basis of its own property and financial resources. The expansion of self-management means a reduction in the scale of central government. This process can occur through the privatisation of public authority or transferring part of its prerogatives to local self-management. In market societies there is also a social basis of local self-management – those social groups demonstrating initiative and accepting responsibility accrue greater influence.

Consolidation of local self-management is the most important way to increase the efficiency of the government when it is released from petty trustee functions that it should not have undertaken in the first place. Only then can it concentrate on any significant decisions, appropriate to the national government.

7.2 Local government at a glance

In Byelorussia, *representative bodies* and the basic systems of local self-management are the Councils of Deputies. These bodies are selected for a period of four years. The constitution of Byelorussia calls for representative bodies of local self-management at the municipal level. This includes:

- The formulation of programs of economic and social development;
- The formulation of local budgets and reports on their implementation;
- Definition of the limits established by the law, about managing municipal property; and
- Arranging for local referenda.

According to the Law «On local management and self-management in Byelorussia» presidiums are created in the City of Minsk, the regions and in the cities of regional Councils for the organisation of their work. In other Councils these functions are carried out by a chairman. Participants of the presidium are:

- The Chairman of the Council;
- The vice-president; and
- The Chairmen of the standing commissions of the Council.

These posts, together with the representative body itself, are weakened by the position of the Chairmen of the Standing Commissions. All of the deputies, including the Chairmen of the Standing Commissions, execute duties including those of the basic service or industrial activities. In the first legislative acts on

local self-management, the Presidium was considered a permanent working body of the Council.

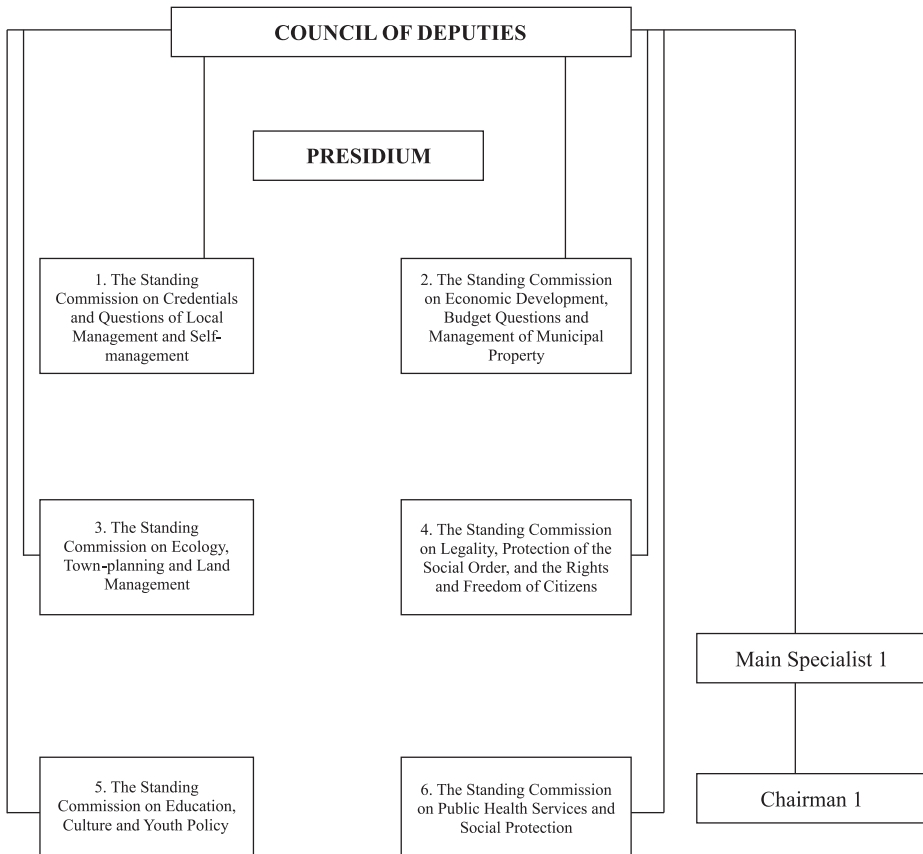
It is impossible to provide qualitative decisions on questions pertaining to local self-management exclusively at the sessions of the Councils. For their preliminary consideration and preparation, the organisation of control over the carrying out of Councils' decisions and of the higher state bodies in Council sessions from among deputies of the standing and other commissions of the Councils are established. The law «On local management and self-management in Byelorussia» provides for the obligatory election only of the Credentials Committee. Otherwise, Councils independently determine the list of the commissions and the number of members and functions. At that point, the following bodies are formed:

- The commissions on economic development, on finance and on the budget;
- The commissions on the consumer market and protection of the rights of consumers;
- The commissions on public health services and social security;
- Commissions on the control over the use and management of municipal property;
- Commissions on public communications and on law and order etc.

The commissions are not independent authorities; their decisions are only recommendations, which diminish the impact of their monitoring activities.

The Byelorussian Councils are headed by chairmen, elected from among deputies involved in their sessions. Except for the chairmen of Minsk city Councils, nominees for these posts are brought in by chairmen of higher Councils. Vice-presidents are also included in the structure of the councils. They replace the chairman of a council in his absence or when it is impossible for the Chairman to perform his duties. According to article 18 of the Law «On local management and self-management in Byelorussia» the Council independently forms the bodies, determines their structure and powers and establishes charges on their maintenance within the framework of the legislation. The structure of a local representative body is as follows:

Figure 1
Structure of a local representative body in Byelorussia¹



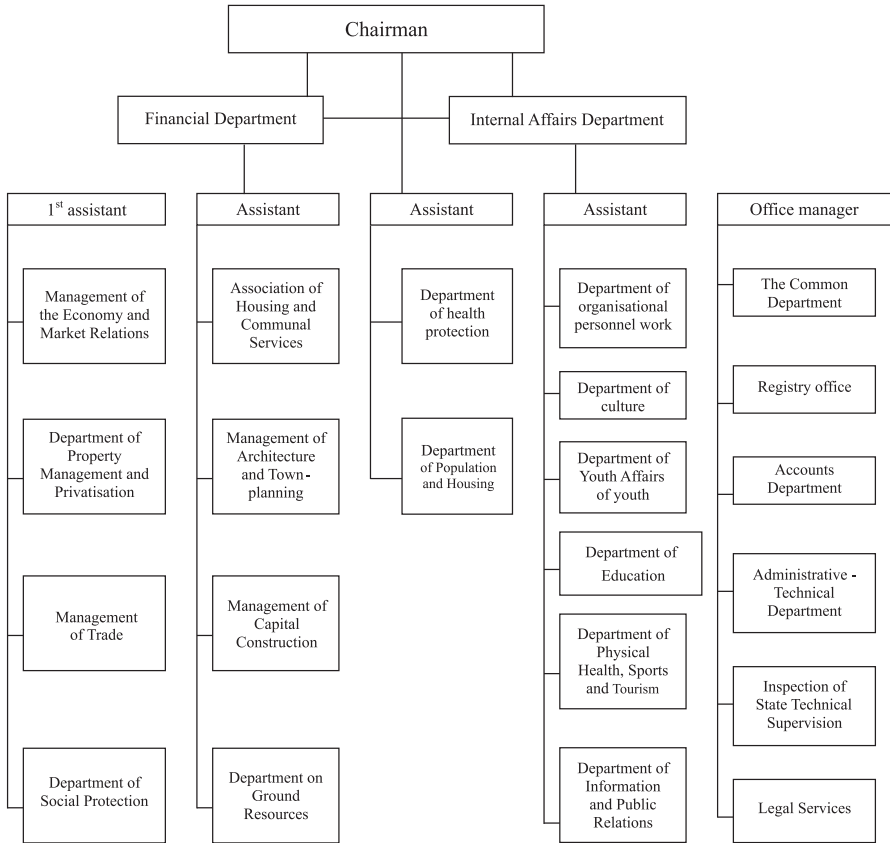
In the system of local self-management, the presence of a representative body is obligatory. The representative body of the Local Self-management Council generally forms an agency to implement the decisions of that representative body. But, in Byelorussia local agencies are a part of the centralised order and not included in the system of local self-management. Their priorities are merely the realisation of national (not local) functions. The executive committee is an agency of local management, designed to carry out executive authority within the territory of a Region, City, Settlement, or a Village Soviet. There are three kinds of executive committees:

- 1) Primary level – rural, city (cities of regional submission);
- 2) Base level – city (cities of regional submission), regional;
- 3) Regional level – regional and Minsk city.

¹ Сидорчук В. К. *Организация местного самоуправления*. – Мн.: Амалфея, 2002. – С. 100.

The provisional structure of the regional executive committee in Byelorussia is as follows:

Figure 2
Provisional Structure of the Regional Executive Committee in Byelorussia²



Local executive committees are accountable, i.e. they are obliged to make reports on their actions and to function according to the law. In the Law « On Local Management and Self-management in Byelorussia » it is established that regional (Minsk city) executive committees are accountable to the President of Byelorussia and to the Council of Ministers of Byelorussia on questions which are within their competence. Executive committees of primary and base levels are accountable to the President of Byelorussia and higher executive committees. Additionally, executive committees are responsible to the corresponding Council for questions related to their competence.

2 Сидорчук В.К. *Организация местного самоуправления* – Мн.: Амалфея, 2002. – С. 103.

Executive committees are to report on their activities as required, but not less than once per year to the Council. They must also inform citizens at assemblies of labour collectives and at home³.

The local administration is accountable to the city Executive Committee. Not less than once per year they must report on their activities to the city Executive Committee and also inform the public.

Thus, to executive committees and local administrations various forms of vertical and horizontal controls are applied. Vertically, the control is carried out by higher bodies. Horizontally, this is carried out by citizens on local Councils of Deputies. The Executive committee reports to the Council on questions regarding the Council's competence. The basic issues are:

- 1) Programs of economic and social development;
- 2) Budget performance;
- 3) Local taxes and tax collections;
- 4) The organisation of management and the issues of municipal property;
- 5) The statement of the Chairman of the Executive Committee;
- 6) Cancellation of orders from the Chairman of the Executive Committee, when decisions of the Committee are not in accord with those of the legislation of Byelorussia;
- 7) Definition of the management of municipal property;
- 8) Organisation for the protection of social order.

7.3 The Finances of the Bodies of Local Management

The basic acts regulating local finance in Byelorussia, the Constitution of Byelorussia, laws «On the Local Management and Self-management in Byelorussia», «On the Budgetary System of Byelorussia and Funds not Appropriated by the State» and also laws on the budget of Byelorussia are passed annually.

According to Article 121 of the Constitution, the statement of local budgets and reports on their execution, remain under the exclusive competence of local Councils of deputies according to the law of local taxes and tax collections.

The core of local finance is the municipal tax system. It is necessary to understand the system of tax collection. The Tax Code applies to local taxes and tax collections:

- On retail sales;
- On services;
- On advertising;
- Tax collections from users of public services.

3 Крамник А.Н. *Курс административного права Республики Беларусь*. – Мн.: Тесей, 2002. – С. 469.

For example, in the Byelorussian city, Kobrin, the City Council of Deputies has established the following local taxes and tax collections function with respect to:

- Parking motor vehicles;
- Retail sales;
- Taxes on imported goods;
- Sales of beer and tobacco products;
- Sales of products derived from precious metals and jewellery in retail trade;
- Hotel accommodation;
- Restaurants, cafes and bars;
- Advertising;
- Maintenance and development of the Infrastructure for the city of Kobrin.

The basic source of income of local self-management is *fiscal revenues*. Byelorussian local budgets are the beneficiaries in full or in part of the revenues from about ten taxes.

Therefore, Executive Committees and local administrations in the order established by the corresponding Council, have the right to transfer municipal properties over time or maintain constant possession and utilisation. They may lease or sell to other organisations, or individual citizens (Article 36 of the Law on Local Management and Self-management). However, the social orientation of its functions limits the owners' opportunities to receive maximum income from legally private (*частноправовых*) operations, through the collection of proportional payments in the budget for water, gas, heating, etc. As a result, the value of property payments is limited.

The low level of payment for children's pre-school establishments suggests some interest in creating conditions for parents to be part of the labour force (a surtax of not less than 29 per cent of income goes to the communal budget.) The limited financial support of education that this payment represents is a reflection on its high socioeconomic importance. However, the major determinant of the level of payment in the social state is to achieve a redistribution of consumer opportunities.

The availability of children's pre-school establishments is intended to reflect the principle that schools should not depend on the sizes of family incomes. Subsidising the younger and more elderly population is a form of state-intermediated self-financing by the individual. Citizens finance their own needs with funds generated during the period of their active participation in the labour market. Society and the state merely redistribute consumer opportunities during the citizens' entire lives.

There are two ways to achieve this redistribution: through taxation and subsidised consumption. Taxation is a prerogative of the state and self-management is offered for subsidised consumption (for culture and for food, for example). The

low prices permitted by the subsidies may well motivate citizens to consume in the manner to which the state has encouraged them.

Concessive payments are revenues accruing to self-management through business activities. Concessive contracts give a party the exclusive rights to conduct particular economic activities (transport, pipelines etc.). Without possession of this exclusive right, the performance of these tasks would be technically impossible.

A *monopoly position* guarantees public safety and enhances public revenues. Therefore, its value for self-management is the establishment of optimum tariffs and payments for the local budget.

Alienation of property is also a source of revenue for the local budget. Local self-management is limited in the use of the proceeds, however, since the sales revenues cannot be used to cover recurring charges on a regular basis. These revenues are to be used in other property transactions, including covering some public duties. In each case they are taken into account in the budget.

Legislation does not regulate in detail the use of credit for local governments. However, Article 43 of the Law on Local Management and Self-management discusses terms for the repayment of loans, duties and the payments of interest on them. The Modelling Act contains Article 43 «Participation of Institutions of Local Government in Credit Relations » according to which local self-management has the legal right to release municipal loans and lotteries, to give and enter into loans and to create municipal banks and other financial and credit establishments.

The term “*Credits*” is used to describe the concept used for various legal forms in which local authorities receive financial resources from other parties as revenues for the budget. They are used according to a special-purpose designation. As opposed to other means, incurring credits leads to stipulated obligations, so that the local budget must make provisions for the return of both the principle and interest.

Local authorities cannot incur debt, except for specifically approved purposes. Loans can be made, for example, to fund programs of social and economic development.

In the case where the municipality is unable to meet credit repayments because its resources are inadequate over the long-term for these repayments due to the interest rates, the central government can provide funds from the state budget or supply other financial assistance. As a result, local governments also participate in the taxation process, along with the central government.

According to Articles 41 and 42 of the Law «On Local Management and Self-management in Byelorussia» where local budgets are unable to meet credit

repayments, deductions can be made from the following republican taxes and incomes:

- The VAT,
- Excise taxes,
- Taxes on corporate incomes and on other private organisations, establishments and associations of all types of ownership⁴.

Higher governmental councils can specify what deductions can be made from republican taxes and other obligatory payments in public budgets and in the law on the budget of Byelorussia for the following year. At the central government level, the program of financial support for administrative and territorial units is drafted and funds used for the allocation of grants, subsidies, loans, etc. are specified. Grants from the fund for financial support of the administrative and territorial units awarded to local budgets include 6 to Minsk, approximately 11 to the greater Minsk region, roughly 16 to the Brest and Gomel areas and around 17 to other areas. Expected deductions should be included in local budgets as general purpose (non-earmarked) funds. Thus, in the relationship between the central government and self-management (municipal governments) some phenomena must be avoided, since they could potentially promote “enslavement” of local governments through an unwarranted expansion of delegated state powers. Another way is the granting of subsidies to institutions of local government to finance certain projects, unconnected to the primary activities of the municipalities. One would expect that subsidies from the state to the municipalities would not be granted for anything other than financially strengthening local self-management. However, if resources are allocated centrally without regard for the needs of population, then it may eventually lead to the *de facto* merging of central and local government bodies. Centralisation of allocation and spending in fact prevents local government to take care of local citizenry and eventually it will lead to decline of the local self-government system.

If the territory has sufficient financial resources of its own, it has no right to deductions from national taxes and incomes. It does not violate any principle of equality among territories and the solidarity among municipalities to render greater financial support to the less affluent regions. The allocation model operates on a per capita basis, which demonstrated disregard for the economic strength and capacity of a locality. In the case where local authorities completely exhaust their financial resources, they can petition higher bodies for financial help. Often, assistance is rendered by providing funds *carte blanche* to cover repayment obligations, but this can also be provided through funds with a special purpose designation.

Legislation determines whether grants to local budgets are given to fund activities to improve the economic structure, regional development and regional

4 Ханкевич Л.А. *Финансовое право Республики Беларусь. Практ. пособ.* – Мн.: «Молодежное научное общество», 2000. – С. 112.

policy, i.e. whether they are earmarked for special purposes. Targeted grants frequently do not take into account all of the various financial opportunities that territories have. They remain in the state's policy toolkit as a means of influencing the freedom of decisions of institutions of local government. As the name implies, these means are allocated as an addition to funds already available to self-management, under the state's system of grants provision. Such grants burden the recipient with obligations as to their use, which means that its freedom of action becomes limited. As opposed to the grants considered above, targeted grants are intended to cover specific obligations.

The financial and economic value of the general and targeted grants to municipalities varies appreciably and in some regions, general grants are more prevalent, whilst in other regions, targeted grants predominate.

Thus, *grants* are monetary resources allocated irrevocably from the central budget when the budgeted funds are insufficient to balance municipal budgets.

Subsidies from the central budget can be granted to local government institutions to enhance the performance of target programs and actions intended to enhance the economic structure or the development of regional policy.

Subsidies are the monetary resources allocated from the higher to the subordinate budget in pursuit of specific goals. It is quite obvious that subsidies, as opposed to grants, should be used strictly for earmarked purposes.

Subsidies are also allocated to help fund programs for welfare recipients as delegated to local Councils, as well as for the construction of major items of municipal property. Subsidies do not take into account all the potential financial opportunities, but are more a response to the particular, unique needs of the regions. The precondition of such subsidies is that the municipalities have first of all exhausted their resources and are compelled to petition for funds to cover concrete expenses. Subsidies influence the freedom of decision of self-government institutions and they are perceived as a supplement to local investment possibilities, as specified by higher authority bodies and communicated to the financial authorities of the municipalities.

For alignment of the levels of social and economic development of administrative and territorial units, *grants* for housing construction, construction of engineering networks, etc. are allocated from the state budget. The above-named act on the property of self-management does not imply liability to any party.

The legislation of Byelorussia provides the opportunity to redistribute budgetary funds by means of "budgetary loans." In particular, Article 35 of the Law on the Budgetary System on State Unappropriated Funds specifies that interest-free loans from regional and regional budgets can be given to local budgets when petitioned for by the local executive and administrative bodies. Repayment of these extra revenues (loans) is to be made in the current financial year.

The budgetary loan is also considered financial assistance, however – in contrast to grants and subsidies – it must be repaid with interest. The basic difference of the budgetary loan from the methods of budgetary regulation discussed above is that it is implemented at the stage of budget execution whilst all others *are implemented* at the stage of their formation.

Loans from higher local budgets to subordinate budgets are regulated by Regulations on the Order of Granting and Repayment of Loans, authorised by the corresponding executive committees.

Loans are granted for special purposes:

1. To executive committees short of cash in the execution of their budgets;
2. To municipal legal persons restructuring, expanding manufacturing, increasing exports and imports and increasing the level of productive competitiveness, creating seasonal stocks of commodities, material assets, introducing new technological processes and developing new kinds of products and processes.

In Byelorussia today there are about fifty different taxes. Local finance is almost strictly social in its orientation, which causes local representative bodies to establish taxes to finance programs and activities that reflect this social character of the municipal tax system.

Local Councils independently determine the allocation of local revenues, except for those funds transferred to them from a higher authority with a special-purpose designation. Within the framework of their powers, Councils increase within their financial constraints, charges for the maintenance of housing and communal services, the establishment of public health services, education, science, culture, sports, social protection, law-enforcement bodies, wildlife management, historical and cultural values. They also establish surcharges and extra charges on official salaries and tariff rates of workers in these areas; they determine side benefits and grants for separate categories of citizens; they set the charges for maintenance; they form reserve, target and other funds and they arrange for the sequestration of local charges. Local authorities can make assets available for economic activities and grant loans to enterprises and other legal persons.

7.4 The Monitoring and Implementation of Local Budgets

According to Article 35 of the Law «On the Budgetary System of Byelorussia and Unappropriated State Funds» the monitoring of local budget implementation is carried out by bodies of the State Monitoring Committee of Byelorussia which consists of both local and higher-level executive and administrative bodies. The operating control over all received incomes and expenditures of special purpose designation is the responsibility of local financial and tax bodies.

The principal auditing responsibility of the Ministry of Finance of Byelorussia and its organs have a special place among the supervisory bodies. Their controllers and auditors are responsible for the cities, the regions and for the special area, Minsk. The auditing of rural and municipal budgets is carried out by corresponding Councils of deputies through executive committees. The operative control over expenditures of special-purpose designation is carried out by financial bodies and inspectors of the State Tax Committee.

On September 23, 1998, the Ministry of Finance of Byelorussia authorised instructions on performing audits of municipalities, including those with memberships of regional Councils of Deputies responsible for budget implementation.

Budget audits of rural, village and City Councils of Deputies' work are organised and implemented through the annual planning procedures of regional or city Executive Committees and also under the quarterly plans confirmed by heads of financial bodies, at least once every other year by controllers and auditors of financial bodies, as specified by the above-mentioned ministerial Instruction. Audits of cash departments on reception of tax and other payments from the population are carried out by the State Tax Committee.

In case of a change in the structure of the Councils, or in the case of evidence of infringements of budgetary protocols, an additional audit is performed on the account, storage and delivery of financial resources. Checks on the implementation of decisions and on earlier audits are also made.

In the Law «On the Budgetary System of Byelorussia and on Unappropriated State Funds», measures pertaining to state budgetary relations and to infringements of the norms of budgetary legislation are stipulated.

According to Article 22 of the Law, local financial bodies have the right:

1. to limit and stop financial charges owed to the state, when the legislation of Byelorussia regulating budgetary relations has not been observed, with regard to information provision on the movement of the state financial assets under their accounts.
2. to freeze accounts when the financial resources have been spent in contravention of the positive legislation/regulation;
3. to collect the budgetary sums used for purposes other than the designated "special purpose" expenditures to repay the principle and interest on loans from the central government budget and unappropriated state funds and also debts incurred from the Government of Byelorussia for credits received.

Article 22 also provides the economic and administrative responsibility for budgetary relations.

So, when funds are erroneously received, are used inappropriately on a special purpose designation, or when their use is an infringement of the legislation of Byelorussia, including their use as returnable loans, the Ministry of Finance

or local financial bodies must repay the funds by collecting from either the legal persons involved or the businessmen carrying out the economic activities, which infringe on the designated use of the funds. Penalties for infringements can double the repayments.

Officials of the enterprises, associations, establishments and organisations guilty of receiving funds illegally, or of using them for purposes other than those specified, are responsible administratively according to the legislation of Byelorussia. The priorities for economic and administrative responsibility are spelled out in detail in a letter from the Ministry of Finance of 23rd September, 1993, № 118 «On the Organisation of Execution of the Law of Byelorussia – On the Budgetary System of Byelorussia».

According to that letter, the application of economic and administrative sanctions is determined by the head of the financial body either at the location of the enterprise or where the infringement took place. In cases where infringements of the budgetary legislation are established by audits and the checks made by higher supervising bodies, economic and administrative sanctions can be imposed by the Director of the Higher Financial Unit or the Ministry of Finance.

In cases where enterprises, organisations, or establishments independently determine illegal or misuse of budgetary funds and return such funds to the budget prior to the initiation or implementation of an audit, any administrative penalty will be imposed at the discretion of the head of the relevant financial body. These organisations are not released from payment of the double charge mentioned above.

Audits performed as a basis for determining financial sanctions are undertaken by officials of supervising bodies, with the participation of the Directors and Chief Accountants of the audited organisations. In the resulting documentation, both the offences and the consequent financial losses are reported. The director, the organisation and the guilty official are reported in the official audit. A refusal to sign these documents does not remove official responsibility, nor does it mean an immediate halt to the functioning of the organisation. The offending officials can give their explanations and objections to the audit or review and may also state their reasons for refusing to sign.

Economic sanctions are imposed on legal persons according to the decision of the Council of Ministers of Byelorussia on 27th May 1994 № 395. The rank order of administrative responsibility is stated in the Code of Byelorussia on administrative offences.

7.5 Enhancing Local (Fiscal) Capacity and Democratic Accountability

In 2003, the revenues of local budgets were planned in the sum of 5.4 billion roubles. That sum was supposed to be received in the form of tax revenues, net revenues (specifications of deductions which were increased for the Mogilyov area and city of Minsk), surtax from citizens, subsidies and grants and also from the Fund of Financial Support of the Regions, within the framework of the republican budget.

In 2004, a number of measures to improve the interaction between republican and local budgets are planned. Precise differentiation is proposed between their own revenues and those allocated by the central budget, in order to give to local authorities considerable financial independence, increase their managerial responsibility and promote a rational regional budgetary policy.

In 2003, revenues from the excise tax of 20 per cent on gasoline were transferred to the budgets of the areas and to the city of Minsk. Due to deliberate measures taken in the national budget to increase the share of the targeted revenues allocated to the regions, per capita subsidies (subsidies based on the local population) and grants increased from 4.4 per cent in 2002 to 4.7 per cent in the current year.

In the current year, the expense for maintaining social/cultural properties transferred to the municipalities will be subsidised at a rate 4.3 times greater than in the previous year. The amount planned is 31.6 billion roubles.

In 2003, local budgets will retain their social orientation. Planned utilisation of the budget up to the amount of 70 per cent is to be used to finance “non-productive” social sphere expenditures: public health services, culture, mass media, physical culture and sports, social support, etc. Charges for these are determined on the basis of the specifications of budgetary security for one inhabitant.

Approximately 35 per cent of expenses for the housing and communal services of the regions and 25 per cent for transport will be funded by grants. For these purposes, including output from the agricultural and other sectors of the economy, 20 per cent of local budgets are supposed to direct all⁵.

Problems experienced in local finance reflect the economic problems of the republic as a whole. The objective of the economic policy of Byelorussia is the construction of a socially-oriented market economy. Guided by this purpose, the state controls manufacturing, remains the owner of large-scale property and subsidises various economic activities.

Numerous economic and social functions are reserved for the state and are a principal cause of the domination of the public sector in the republic, charac-

5 Кошелева Л. *Финансы. Учет. Аудит. // Доходам – полновесность. Расходам – эффективность.* 2003. № 2. С. 24.

terised by state ownership and budgetary management. By 2002, the share of the public sector budget in the GDP reached 38 per cent.

It can be regarded as an achievement that the republic has been able to retain free-of-charge health services. But, at the same time, serious economic and social problems have arisen. Excessive budgetary tasks and the low efficiency of the public sector have produced high rates of inflation; high tax rates have reduced economic growth and the motivation to invest. The result of this is that it has become more difficult to carry out the social obligations guaranteed by the state.

The current system of distributing financial flows, given that only half of the revenues of the municipal budget come from the municipality's own and fixed sources cannot be described as effective. The current centralised order of distributing tax revenues assures the financial dependence of local authorities on the centre, fails to motivate the local authorities to generate their own resources and results in the subsidisation of local budgets with large financial flows from the regions to the centre, and back again. The formation of the capital budget as a component part of inter-budgetary relations is likewise lacking in rationality and effectiveness. The system still requires serious transformation and reform.

The tax code, which makes continuous changes in the tax system and, in particular, in local taxation, has reduced the amount of local taxes collected, as it has excluded targeted collections of transport funds and of funds for the maintenance and development of the municipal infrastructure. One should note that target collection consists of 70 per cent of total revenues of local taxes or 5 per cent of all revenues of the municipal budget. Opportunities to cancel some deductions in targeted budgetary funds are also considered, which will also entail a reduction of budgetary incomes.

A reduction of these heavy tax burdens is an essential step in the Republic's current stage of development. The tax system, as it currently functions, does not carry out to the full any of its intended functions, neither in providing sufficient fiscal resources, nor in motivating appropriate economic activity.

In 2002, the general tax burdens of our Republic remain excessive. The state social insurance system has been reduced to a "tax loading" level of 42 per cent, but the IMF estimates that for countries with a level of *per capita* incomes corresponding to that of Byelorussia, tax loading should not exceed 24 per cent.

An unreasonably high level of tax loading is the factor that constrains the development of business activity and, hence, prohibits increasing tax revenues for municipal budgets. The reduction of those burdens can stimulate manufacturing and legalise "shadow" business, allowing us to expand the tax base considerably in the long-term. Should this occur, there would initially be an unavoidable reduction in tax revenues which can be compensated for by cancelling tax exemp-

tions, which currently have a wide application. Moreover, budget revenues can be increased by promoting processes of privatisation, which have recently slowed down in the capital.

A market orientation for the economy implies that the state will cease to regulate or interfere in those fields of activity which can be served more effectively by private enterprises. This applies especially to housing and related services to households (electricity supply, water supply, sewage, etc.).

An optimisation of the responsibilities accruing to local budgets can be achieved under the following conditions:

- 1) The elimination of direct intervention of the state in the activities of enterprises;
- 2) The transfer of capital financing to the financial sector;
- 3) The termination of subsidies to unprofitable enterprises.

Half of the charges of the capital budget fall in the social sphere and the system of budgetary planning for the “non-productive” sphere requires reform. First of all, it is necessary to change the mechanism of planning expenditures on the basis of the specification of budgetary security for each inhabitant. That security is currently based on the actual data for recent years; it does not reflect the actual requirements for financial resources, but only establishes a principle of residual finance over a few years. This inadequacy can be eliminated by introducing budgetary planning of minimal state social and financial norms. For this purpose, it is essential to develop and ratify norms of minimal security for each citizen, including education, public health services, housing and municipal service.

The system of inter-budgetary relations, which should ultimately be created, would:

- 1) create for local authorities the motivation to generate tax revenues;
- 2) allow significant freedom of actions in questions of courses of action;
- 3) provide budgetary stability;
- 4) be based on objective, stable criteria.

All these elements represent a necessary condition for more effective activity and responsibility for local authorities and for the well-being of the population.

8. Building Up Fiscally Strong Local Governments – A Challenge for Ukraine

Sergii Slukhai

8.1 Introduction

Until recently in Ukraine, local governments have played the role of central government agents. Most of their expenditure assignments have been regulated and directly controlled by the central state, thereby creating a situation whereby the demand for local fiscal autonomy concerning revenues is highly limited. This has resulted in a situation where local authorities are mainly accountable, not to their citizens, but to the state. This system, inherited from the socialist past, still exists with its main features, despite new legislation proclaiming the autonomy of local governments.

According to the legislation, there are two types of local authority in Ukraine. One is the state administration at the oblast (region) level and rayon (county) level. The elected councils at these levels have no executive bodies which are incorporated into the structure of the territorial state administration.

The other group comprises bodies of self-government (councils elected in communities) at the oblast, rayon, city, village and township levels. The councils in cities, villages and townships form their own executive bodies. The current administrative-territorial composition of Ukraine, since its independence, is presented in Table 1.

Table 1
Administrative-territorial structure of Ukraine

Years	Autonomous republic	Oblasts	Rural rayons	Cities and towns total	Oblast capitals and cities of oblast significance	Urban districts	Townships	Villages
1990	-	25	479	436	145	120	927	8996
2001	1	26*	490	449	171	122	893	28651

* Includes two cities of national significance: Kyiv City and Sevastopol.

As the above data shows, the number of local communities has more than doubled since independence. This is due to the new legislation that proclaimed independent authority building for all rural communities. However, up until now, only about one-third of these communities have received their own budget. The current discussions concerning readjusting territorial composition to suit public needs, concern all levels of the present vertical governmental structure. It is obvious that these changes in the public sector were supposed to be carried out quickly. However, the problem is that the most important changes in intergov-

ernmental finance were introduced in 2001 and bore no connection to territorial changes. The new approach to intergovernmental finance was simply pulled together with the obsolete socialist administrative-territorial composition.

Suggestions have been made to reduce the number of oblasts and rayons and the most challenging is with regard to the number of rural communities (villages and townships). There is no doubt that their merging with neighbouring towns or with other units of the same status would be the first step towards an administrative-territorial reform.

The existing administrative-territorial composition creates duplicate fiscal statistics. Allowing for the fact that state territorial administrations are accountable for the delivery of a large part of local public services, this would mean that the overall fiscal data on local governments' involvement in economic activity (public service delivery) and revenue accumulation could be misleading (see Table 2) – the real role of the sub-national sector of government should be much less significant than is shown in the statistics.

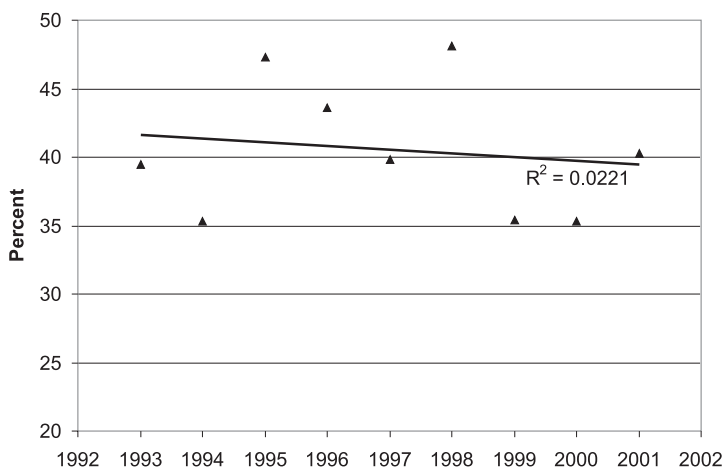
Table 2
Distribution of general government total expenditures and total revenues
(without transfers and State Pension Fund outlays and revenues)

Levels of government	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Expenditures											
Central government	68.57	62.18	60.49	64.66	52.70	56.36	60.10	51.86	54.58	64.70	59.70
Sub-national governments	31.43	37.82	39.51	35.34	47.30	43.64	39.90	48.14	45.42	35.30	40.30
Revenues											
Central government	54.08	52.44	53.28	57.96	47.62	52.43	56.82	54.31	60.03	70.86	67.38
Sub-national governments	45.94	47.56	46.72	42.04	52.38	47.57	43.18	45.69	39.97	29.14	32.62

Source: Own calculation on MoF data.

There is a very important trend in expenditure and revenue assignment: the data above shows that up until 2001 there was no clear trend towards decentralisation of public revenues and expenditures in Ukraine, due to the non-existent decentralisation policy. Only since 2001 when the first steps of budgetary reform were implemented, did the various ups and downs turn into some clear path towards decentralisation. (See Graph 1) Even with the decentralisation trend of the last few years, the overall situation demonstrates no definite growth in the sub-national governments' share as opposed to many other post-socialist countries, e.g. Russia.

Graph 1
Sub-national government share in total public expenditures in Ukraine



These facts mean that in Ukraine certain problems exist with sub-national governments' fiscal performance and one of these problems is the level of accountability. Finding ways to make the sub-national authorities more self-reliant from a fiscal point of view will raise their capacity in responding to local demands for public goods.

This paper aims to analyse developments in Ukrainian sub-national finance since independence, with the emphasis on the issues of enhancing sub-national governments' fiscal discretion.

List of abbreviations:

- EPT enterprise profit tax;
- GDP gross domestic product;
- MoF Ministry of Finance of Ukraine;
- PIT personal income tax;
- SNG sub-national governments;
- STA State Tax Administration;
- TFIM tax-free income minimum;
- UAH Hryvnya (Ukrainian currency unit);
- VAT value added tax.

8.2 Local Government in Ukraine: changing responsibilities

Ukraine could be characterised as a country with quite a large sub-national government portion of GDP (ranging between 10-15 per cent). The data below (Tables 3 and 4) demonstrates that there is a trend towards decentralisation of both public revenues and expenditures since 2000. However, as was previously men-

tioned, this data cannot characterise the real significance of sub-national governments' functions within the sector of public administration.

The expenditures within general government show a very uneven distribution across governmental tiers. From this data, the relative significance of governmental levels in the public sector economy can be determined. The majority of functions are concentrated in the intermediate tier, represented by governments at oblast and rayon levels.

Table 3
Governmental tiers' expenditure shares in GDP
(without transfers and State Pension Fund), percent

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Consolidated general government	32.58	38.23	38.61	44.93	37.02	33.06	37.10	30.41	26.69	27.84	26.31
Central government	22.34	23.73	23.34	29.07	19.51	18.63	22.30	15.77	14.57	18.01	15.72
Total SNGs	10.24	14.43	15.24	15.88	17.51	14.43	14.80	14.64	12.13	9.83	10.59
Oblast governments	2.65	4.39	3.64	3.61	6.37	5.10	4.41	5.16	4.47	3.30	-
Total sub-oblast levels	7.59	10.04	11.60	12.27	11.14	9.33	10.39	9.48	7.66	6.53	-
Cities of oblast significance	4.11	5.90	7.28	7.99	6.30	5.23	5.87	5.21	3.93	3.3	-
Rayons	2.42	2.92	2.90	2.82	3.40	2.89	3.34	3.32	2.87	2.43	-
Total sub-rayon governments	1.06	1.21	1.42	1.45	1.44	1.21	1.18	0.95	0.86	0.77	-
Cities of rayon significance	0.22	0.28	0.34	0.34	0.34	0.33	0.30	0.25	0.21	0.19	-
Townships	0.24	0.28	0.34	0.34	0.31	0.26	0.26	0.22	0.19	0.17	-
Villages	0.60	0.66	0.74	0.77	0.78	0.62	0.62	0.48	0.45	0.41	-

Source: Own calculation based on MoF data.

Table 4
Share of SNG in GDP (without transfers and State Pension Fund), percent

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Consolidated general government	25.15	24.40	33.47	35.62	30.27	28.24	30.40	28.19	25.20	28.40	25.71
Central government	13.60	12.80	18.28	20.64	14.41	14.81	17.27	15.31	15.12	20.12	17.32
Total SNG	11.55	11.61	15.19	14.98	15.85	13.44	13.12	12.88	10,08	8.28	8.39
Oblast governments	2.47	3.50	5.44	4.57	7.50	6.42	6.61	6.38	4.87	3.45	-
Total sub-oblast levels	9.08	8.11	10.59	10.40	8.35	7.01	6.52	6.50	5.19	4.82	-
Cities of oblast significance	6.43	5.15	6.87	7.49	5.33	4.38	4.50	4.13	3.22	2.91	-
Rayons	1.58	2.12	2.94	2.13	2.28	1.94	1.34	1.74	1.45	1.38	-
Total sub-rayon governments	1.07	0.84	0.78	0.78	0,74	0.70	0.68	0.63	0.53	0.53	-
Cities of rayon significance	0.30	0.22	0.20	0.22	0.22	0.25	0.22	0.21	0.19	0.19	-
Townships	0.29	0.22	0.20	0.21	0.19	0.17	0.17	0.16	0.14	0.13	-
Villages	0.47	0.40	0.38	0.35	0.34	0.28	0.28	0.26	0.20	0.22	-

Source: Own calculation based of MoF data.

The data above demonstrates that the relative size of sub-national governments in the national economy since independence has experienced wide fluctuations, but still remains quite high. The total economic instability greatly affected the state of the national public finance, so the governmental share in GDP was amplified. Independence contributed to the sub-national governments' share of growth in GDP; this was followed by the relative growth of the sub-national governments at different levels. The process of the relative growth of sub-national governments continued until 1994; after then the total general governmental quota of GDP began to shrink, decreasing to 26.31 per cent in 2001. The relative size of the total government did not reach the same level as before independence; it has begun to increase since 2000, but at the expense of the centralisation of public moneys. This year has seen the biggest drop in sub-national governments' GDP share.

Since 1996 there has been a drop in sub-national governments' GDP share concerning all sub-national levels but the most severe drop occurred from 1998: the sub-national share in 1998-2000 fell by one-third, reaching the lowest level since independence – 9.9 per cent in 2000. There was no significant drop in local government expenditure at the lowest level (villages and townships). The beginning of budgetary reform in 2001 depicted some relative growth of sub-national governments' share in GDP and further growth can be expected in 2002.

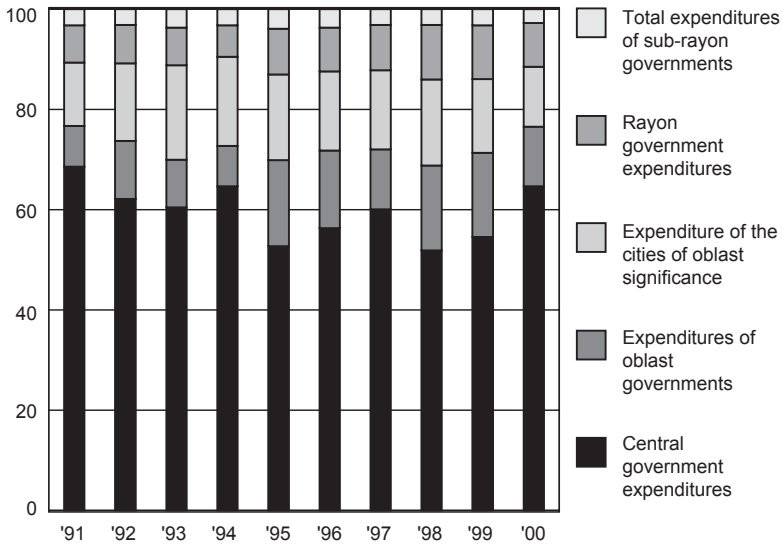
The dynamics in public participation in the economy shows, on the one hand, a lack of consistent and radical economic reforms in the country. This results in a significant role of the public sector in the economy. On the other hand, there was a lack of reforms in the sector of public administration itself – a trend towards centralisation being the indicator. Both factors prove that Ukraine is still far behind the other transitional nations from the point of view of economic reform.

The conclusion concerning the lack of fiscal decentralisation is strengthened by the evolution of expenditure distribution (Table 2 above). The share of the central government in the public sector total expenditures has grown and the sub-national governments' share has diminished. Most affected was the share of sub-national governments, which generate the most significant part of public revenues – of the cities of oblast significance; on the other hand, the share of intermediate governments (oblast and rayon) has increased.

The data in Table 2 and a diagram based on this (Graph 2 below) demonstrate that for the period 1991-2001 the sub-national governments' share in total public expenditure increased over the 5 years (1992, 1993, 1995, 1998, 2001) reaching its maximum in 1998; decreasing during 5 years (1994, 1996, 1997, 1999, 2000) reaching its minimum in 2000 (excluding 1991). The division of expenditures between the central government and sub-national governments has fluctu-

ated greatly: e.g. in 1995 the sub-national governments' expenditure share increased by 12 per cent points (up to 1/3); similar to 1998.

Graph 2
Expenditure distribution between levels of government



By the year 2000, the distribution of total public expenditures between governmental tiers had actually returned to how it was prior to independence. It is likely that full implementation of Budget Code provisions will bring about some changes in this field. Fiscal decentralisation has begun, which the results of the fiscal year 2001 seem to conclude: the central government portion of public expenditure has dropped by 5 percent points.

During a long period of time, the intergovernmental finance in Ukraine suffered from a lack of clarity in the function delineation between levels of government. The actual functional distribution was carried out through the annual budget laws and central government *ad hoc* regulations. The basic Law on Self-Government, approved in 1997, made the situation clearer by introducing two main categories of expenditures of sub-national governments – own and delegated. However, the sub-national governments' own competence in expenditure policy was formulated in a very loose way, with terms such as “adminstrating”, “securing”, “organising”, “fostering” and similar, which have little to do with real fiscal flows in the sector of public administration. The expenditure competence of governmental units was not differentiated according to their ability to be a public service provider, with big cities and small villages having the same responsibilities. This Law contains some provisions concerning obligatory delegation of

the most important functions assigned to the self-governmental bodies (such as education, health care, social care, etc. up to budget execution at rayon and oblast levels) to the local state administrations directly subordinated to the President's Office. This approach made the real self-governance in rayons and oblasts very doubtful; the only exception being the cities of oblast significance where there were no state administrations. The elected bodies of small cities, as well as townships and villages, delegated their functional authority to the bodies at rayon and oblast levels. So, in fact, about 90 per cent of total expenditures performed at the sub-national level were delegated, i.e. they were performed by the state bodies or under the direct control of the central government. The unclear competence delineation between governmental levels made the fiscal endowment of local public facilities very complicated: they received budgetary moneys from different governmental levels.

The enactment of the Budget Code (2001) made the situation a bit clearer. The Code made a delineation in delegated expenditure competence between governmental tiers (oblasts, rayons, cities of oblast significance, other types of sub-national governments), but it did not touch the function distribution and assigning expenditures on the own functions of sub-national governments. There is therefore a need to improve the basic legislation to reach more compliance between the distribution of functions and expenditures.

As Table 5 shows, the shifts in expenditure distribution among governmental tiers in Ukraine are obvious: (i) the sub-national governments began playing a bigger role in financing economics (first of all, subsidising industries); this is especially true for oblast governments; (ii) the expenditures on housing and amenities have been redistributed in favour of sub-national governments. In other spheres of the public sector, there were no significant changes over time, since independence.

From an expenditures point of view, one can see that the model of inter-governmental fiscal relations in Ukraine is characterised by a dominating agent approach, whereas local governments play a central government's agent's role, depending to a great extent on its desire to control all activities at the sub-national level. This situation corresponds to the structure of Sub-national governments' finance.

Table 5

The distribution of expenditures by function within sector of public administration

Sphere	Year	Central government	SNGs	SNGs of oblast level	Rayon governments	Cities of oblast significance	Cities of rayon significance	Townships	Villages
Total expenditures	1992	62.2	37.8	11.5	7.7	15.5	0.7	0.7	1.7
	2000	67.4	32.6	11.8	8.7	12.0	0.7	0.6	1.5
	2001	59.7	40.3	-	-	-	-	-	-
Social protection	1992	35.0	65.0	31.7	9.3	22.9	0.4	0.3	0.4
	2000	61.8	38.2	10.1	13.8	13.9	0.2	0.1	0.1
	2001	51.2	49.8	-	-	-	-	-	-
Economy	1992	84.0	16.0	5.1	1.5	8.4	0.6	0.4	0.1
	2000	63.9	36.1	28.3	2.1	5.2	0.2	0.2	0.2
	2001	77.3	22.7	-	-	-	-	-	-
Housing and amenities	1993	5.3	94.7	15.7	4.2	65.8	4.7	3.4	1.1
	2000	0.2	99.2	18.9	15.5	56.0	5.3	3.2	0.8
	2001	0.01	99.9	-	-	-	-	-	-
Total social branch	1992	24.9	75.1	13.5	20.45	31.6	1.8	1.9	5.8
	2000	29.6	70.4	18.4	20.3	25.3	1.6	1.5	3.4
	2001	29.6	70.4	-	-	-	-	-	-
Education	1992	33.9	66.1	6.6	17.0	28.1	3.0	3.1	8.3
	2000	38.8	61.2	8.0	20.0	23.2	2.5	2.3	5.1
	2001	38.0	62.0	-	-	-	-	-	-
Health	1992	10.1	89.9	22.2	25.6	39.3	0.4	0.6	1.8
	2000	14.8	85.2	31.8	21.7	29.8	0.3	0.4	1.1
	2001	17.4	82.6	-	-	-	-	-	-
State administration, judiciary, law enforcement	1992	75.3	24.7	7.4	3.2	7.6	0.5	0.9	4.8
	2000	84.4	15.6	4.3	1.8	5.9	0.4	0.5	2.6
	2001	87.0	13.0	-	-	-	-	-	-

Source: Own computation based on MoF data.

8.3 Local Government Finance ¹

The sub-national governments' finance in Ukraine depicts a high reliance on central government fiscal assistance. The structure of the revenues of the sub-national levels is characterised by the domination of direct or indirect transfers. As Table 6 below shows, the tax share in sub-national governments' revenues is quite high – around 55-65 percent; but almost all of these proceeds are national, shared with the sub-national governments. The portion of local taxes is insignificant (less than 3 per cent of total revenues). As to user charges, their importance is quite high, but they are not statistically assessed according to current methodol-

¹ The issue of Ukrainian local government finance was analysed by the author in detail in several publications: Slukhai (1999); Slukhai (2000); Slukhai (2002).,

Table 6
Sub-national governments' revenues in Ukraine

Revenues	1999	2000	1999	2000
	Thousand UAH		Percent	
Tax revenues	10,962,095	11,757,007	55.26	62.91
Taxes on revenue, profit, market value increase	7,935,693	8,494,878	40.01	45.45
PIT	3,111,491	6,377,739	15.69	34.12
EPT	4,824,202	2,117,139	24.32	11.33
Property taxes	296,233	529,498	1.49	2.83
Motor vehicle tax	296,233	529,498	1.49	2.83
Fees for special usage of natural resources	1,170,781	1,460,542	5.90	7.81
Fee for forest usage	10,588	9,902	0.05	0.05
Fees for water usage	38,715	39,698	0.20	0.21
Mineral resource tax	31,161	34,537	0.16	0.18
Land tax	1,090,317	1,376,403	5.50	7.36
Internal taxation of goods and services total	1,017,689	562,300	5.13	3.01
Excises on domestic goods total	584,280	150,591	2.95	0.81
Alcohol	-	125,900	-	0.67
Tobacco	-	6,196	-	0.03
Licenses for entrepreneurial and professional activity total	138,932	144,180	0.70	0.77
Craft tax	13,771	14,177	0.07	0.08
License and certificate issuance duty	5,763	1,356	0.03	0.01
Duty for registration of business entities	11,316	14,362	0.06	0.08
Duties on issuance of licenses on alcoholic beverages and tobacco retail trade	99,165	112,342	0.50	0.60
Trade patent duty	294,476	267,528	1.48	1.43
Other taxes	541,696	709,788	2.73	3.80
Local taxes and duties	441,524	485,495	2.23	2.60
Unified tax for small businesses	62,376	178,276	0.31	0.95
Non-tax revenues	551,643	1,782,496	2.78	9.54
Incomes from property and entrepreneurial activity	215,811	299,656	1.09	1.60
Interest on bank deposits	50,076	57,174	0.25	0.31
Incomes from property privatisation	127,804	215,747	0.64	1.15
Administrative duties and payments. incomes from non-commercial sales	134,171	151,241	0.68	0.81
Rent	41,077	62,454	0.21	0.33
State duty	88,522	88,060	0.45	0.47
Fiscal penalties	99,254	102,529	0.50	0.55
Other non-tax revenues	102,406	1,229,068	0.52	6.58
Own revenues of budgetary institutions	2,202	1,066,258	0.01	5.71
Special funds	2,202	581,308	0.01	3.11
Earmarked funds	-	283,979	-	1.52
Other revenues	-	200,970	-	1.08
Capital revenues	7,225	22,963	0.04	0.12
Earmarked funds	1,631,492	749,318	8.22	4.01
Environmental tax	48,271	85,317	0.24	0.46
Road tax	1,523,930	489,335	7.68	2.62
Other funds	17,058	12,220	0.09	0.07
Regional and local earmarked funds	42,231	162,446	0.21	0.87
Revenues without transfers	13,152,456	14,311,785	66.30	76.58
Official transfers	2,942,338	4,377,989	33.70	23.42
From the bodies of state administration of other levels	2,942,338	4,377,989	14.83	23.42
General donations from the state budget	2,029,185	4,126,462	10.23	22.08
Mutual settlements	795,078	68,910	4.01	0.37
Special subventions form the state budget	50,000	102,328	0.25	0.55
Budget borrowing	-	80,289	-	0.43
Fuel subventions	3,741,858	-	18.86	-
Total revenues	19,836,653	18,689,775	100.0	100.0

Source: MoF.

ogy; only subventions covering the deficits of communal units (transportation, water treatment, sanitation etc.) are reflected in the budgets of the sub-national governments. The share of official transfers is also quite high – about 1/3rd of total revenues; they are disbursed mainly as equalisation grants. The dominating number of rayon governments as well as small towns, townships and villages cannot perform their activities without having massive fiscal support from the state budget or budgets at higher levels.

The development of sub-national governments' revenues could be characterised as very unstable. Until 2001, the sub-national governments' revenue share in GDP demonstrated a downward trend (by about 25 per cent since independence); the central government revenue share soared (more than 20 per cent in 2000). This drop can be attributed mostly to negative financial development at the sub-regional level. As previously stated concerning expenditures, the same trend to centralisation was observed concerning revenues; the changes took place only after approval of the Budget Code. This also bears witness to the fact that the sub-national government's possibility to express its own view on how fiscal sources should be spent was diminishing.

The sub-national governments' revenue patterns in Ukraine were inherited from the Soviet period, when the sub-national bodies were funded mainly through the mixture of indirect and direct transfers, used as tools of fiscal equalisation.

The revenue sources in the SNG sector are traditionally distributed into three main categories: (i) own revenues in the broad sense (local taxes and local non-tax revenues together with so-called assigned national taxes²); (ii) regulating (shared) taxes and (iii) general and earmarked transfers.

After the approval of the Budget Code, the category of shared taxes was abolished in relations between national government and sub-national governments; it still, however, remains in relations between sub-national levels (Personal income tax and land tax are shared due to fixed rates).

This states explicitly that Ukraine has shifted from the system of shared taxes to the more progressive system of ceded taxes.

The method of calculating local shares, which was used prior to 2000, was based on a central assessment of local expenditures and granting them funding through regionally and locally differentiated shares of selected national taxes; those territories which had deficits after this procedure, received official transfers of the amount sufficient to bridge the gap. In 1995, this system was modified by the Law on the Budget System (the marginal sharing rates were introduced), but its main features did not change: selective tax sharing, annual corrections of

2 To the assigned national taxes belong those taxes whose proceeds are fully attributed to the sub-national budgets; at the sub-national level they could be shared.

sharing rates, revenue distribution based on the origin principle. One of the main problems with this system was its instability caused by turbulence in the national fiscal system. As Table 7 shows, the chaotic experiments with shared taxes and sharing rates appeared to come to an end by the year 2000, when the Personal Income Tax became essentially a shared tax.

Table 7
National tax sharing rates in Ukraine, 1992-2002

Tax	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
VAT	D	D	20	D	D	0	0	0	0	0	0
Excises on domestic goods	D	D	20	20	20 ^a	50	0	D	D ^b	D ^e	D ^c
PIT	100	100	50	50	50 ^a	100	100	D	100	100	100
EPT	D	D	50	70	70	100	100	D	D ^{b*}	D ^{b*}	D ^{d*}

Legend: D means that sharing rates are regionally differentiated.

^a AR Crimea and Sevastopol retain 100 per cent. ^b AR Crimea and Kyiv City retain 100 per cent.

^c AR Crimea retains 50 per cent. ^d Kyiv City retains 50 per cent. ^e AR Crimea retains 100 per cent.

* The regional governments received 1.5 per cent of EPT proceeds for financing expenditures on house constructing for military servants.

Source: Respective annual budget laws.

National tax sharing delivered a major portion of sub-national revenues up to the fiscal year 2000: it accounted for 50 to 80 per cent of total on average (Table 8). The data in Tables 7-8 demonstrates the permanent turbulence of the assignment of national taxes to sub-national governments. As a result, this practice made sub-national fiscal planning and sound fiscal management almost impossible and sub-national fiscal autonomy, insignificant. Under the precondition of a prevailing portion of national tasks in sub-national governments' activities, it is small wonder that they preferred to piggyback central government revenue sources rather than generate their own.

Table 8
Percentage of the most important national taxes in SNGs' revenues
(transfers included)

Taxes	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
VAT	23.0	32.9	20.6	30.5	28.7	0.0	0.0	0.0	0.0	0.0
Excises on domestic goods	3.5	5.2	2.5	1.0	0.9	3.2	0.1	3.6	0.8	1.4
PIT	16.6	10.9	10.9	8.7	11.1	22.6	23.7	19.3	34.1	44.8
EPT	17.0	33.4	45.6	36.0	33.3	39.6	37.5	30.0	11.3	10.2
Total	60.1	82.4	79.6	76.2	74	65.4	61.3	52.9	46.2	56.4
Shared taxes total	43.5	71.5	79.6	76.2	74.0	62.2	0.0	52.9	12.1	11.6

Source: Own computation based on MoF data.

Why was the system of tax assignment in Ukraine so unstable? The answer may be found in the specifics of functioning that were vested on tax sharing by the MoF: minimising the number of regional budgets subsidised by the state budget. Given the fluctuation in annual normalised expenditures and disbursed (due to the origin principle) revenues, the mismatch to be dealt with has changed from year to year. This made the reassessment of national sharing rates permanent. Of course, the process of reassessment affected the interests of regional governments, so some kind of bargaining process between centre and sub-national authorities concerning the list of shared taxes and, especially, sharing rates, took place. However, this process was conducted in a very non-transparent manner that caused wide deviations of the actual territorial revenue distribution from that legislated.

The effective sharing rates appeared higher than the planned ones because the deficiency of budgetary planning demanded “manual” budget execution. The data below demonstrates the non-motivated changes in national tax sharing. As some scholars emphasised, under such circumstances, a sound budgetary planning, even in the short run, is almost impossible (Kravchuk, 1999:392).

Table 9

The effective sharing rates at the national level for the most significant taxes

Tax	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
VAT	42.9	50.1	33.1	66.3	55.7	0.0	0.0	0.0	0.0	0.0
Excises on domestic goods	53.2	54.5	31.3	25.1	16.1	38.8	0.0	37.0	8.4	12.3
PIT	100.0	100.0	67.1	53.8	52.1	100.0	100.0	70.2	100.0	100.0
EPT	55.3	60.9	66.7	72.9	73.6	100.0	100.0	75.9	27.5	25.6

Source: Own calculations based on data of MoF.

Another problematic issue in tax sharing was that the bodies of the higher level (state administrations) were given the right “to regulate” the budgets of the bodies at the lower level. “Regulation” meant applying the deliberately differentiated sharing rates on the territory of own jurisdiction. This is why the instability at the national level was aggravated by instability and non-transparency at the regional level. The latter relations were even more characterised by unfairness and arbitrariness, since there was no legal procedure for calculating the sharing rates at the regional level. This was especially true for the biggest donors of the Ukrainian budgetary system – the cities of oblast significance, which sadly lacked a fair distribution of funds. As was observed in many cases, decisions of the local state administrations concerning tax sharing were motivated not economically (e.g. existing public facilities in a designated area), but politically (Parhomenko, 1998:87), often being used as a means of pressure on the city governments to push them to pursue the prescribed expenditure policy, or even to compromise the body in power in front of the electorate.

The most serious disputes were between oblast administrations and cities of oblast significance: in many cases the cities with quite large original revenue bases were artificially made out to be the ones with the budgetary deficit by using the shared-tax-mechanism. This deficit then had to be bridged by donations from the oblast budget.

This analysis might be concluded by the statement that the most important argument to maintain this system through the years was the desire of the centre to pursue strict control over fiscal flows within the sector of public administration. The negative results of this system for sustainable sub-national governments' finance, accountability and sound fiscal management resulted finally in it being abolished in 2001. Since then, the Personal income tax has been a shared tax that delivers the major share of sub-national revenues. It is equal to roughly half of the sub-national proceeds. However, it should be recognised that this change did not solve the problem of sustainable local revenues, due to the nature of this tax. On the one hand, it made sub-national budgets more vulnerable to economic performance because of the pro-cyclic development of the proceeds. On the other hand, the national government tried to use this tax as a tool for macroeconomic regulation. This endangers local budgets and causes significant resistance to changing the taxation of personal incomes. If the external sources of economic growth become exhausted, the state will try to create more favourable conditions for internal investments by lowering the rather high income tax rates. Finding a source of compensation for the short-term drop in sub-national revenues will be not an easy task. That is why the current debates in Parliament concerning the introduction of a 10 per cent flat rate for Personal income tax have not resulted in a positive decision³.

The structure of sub-national governments' expenditure by function, as presented in Table 10 below, suggests that the most important functions of sub-national governments are education, health care and social protection – together they account for about 60 per cent of the total. These functions are those which are delegated to sub-national governments by the state because they are considered national public goods with free access granted to all citizens, regardless of where they live. These functions are funded through shared national taxes (Personal income tax and land tax) and expenditures on them are subject to equalisation throughout the country.

The tight fiscal situation means that sub-national governments spend almost all the money they receive on current expenditures. Although the Budget Code introduced the division of budget items into current and capital ("current budget"

3 If the drafted Tax Code is adopted, the PIT proceeds will drop by ¼ according to MoF estimations. Only about half of this amount is supposed to be compensated to the sub-national governments through new taxes assigned to them: tax on bank deposits and real estate transactions. Being realistic, there is major doubt that, first, these taxes will be introduced; second, that proceeds will be sufficient to effectively compensate for the revenue drop or even half of it.

and “budget of development”), it can be easily seen that capital expenditures play a very humble role in local expenditure policy – their portion is only about 3 per cent of the total and tends to diminish with the passing of time.

Table 10
Sub-national expenditures by function in Ukraine

Expenditures	1999		2000	
	Thousand UAH		Per cent to total	
Public administration	493,429	735,288	3.07	3.99
Legislative	4,662	7,302	0.03	0.04
Executive	482,884	717,740	3.00	3.90
Judiciary	4,634	1,279	0.03	0.01
Science	6,542	9,873	0.04	0.05
National defence	8,358	7,033	0.05	0.04
Law enforcement and security	174,547	259,698.6	1.09	1.41
Education total	3,470,605	4,334,546	21.59	23.53
Preschool education	566,752	788,048	3.53	4.28
General secondary education	2,155,794	2,563,791	13.41	13.92
Educational institutions for those who need social care and rehabilitation	320,640	396,803	1.99	2.15
Off-school education	113,403	146,667	0.71	0.80
Vocational schools	18,088	23,263	0.11	0.13
Higher education	106,279	166,479	0.66	0.90
Post-diploma training	22,809	36,576	0.14	0.20
Other educational facilities and activities	166,838	212,917	1.04	1.16
Health care	3,449,656	4,165,938	21.46	22.62
General hospitals	2,093,510	2,368,007	13.02	12.86
Specialised medical institutions	820,819	10,34,359	5.11	5.62
Clinics and ambulances	120,702	152,734	0.75	0.83
Specialised clinics	22,468	38,223	0.14	0.21
Dentistry	43,794	87,340	0.27	0.47
Obstetric centres	45,810	52,646	0.28	0.29
Sanitary service	125,135	193,407	0.78	1.05
Other institutions	175,946	229,201	1.09	1.24
Social care and social protection	2,166,364	2,286,762	13.48	12.42
Benefits to veterans of war and labour	650,626	468,379	4.05	2.54
Benefits to families with children	240,310	397,878	1.50	2.16
Other kinds of assistance	916,394	947,941	5.70	5.15
Benefits for covering communal services costs	822,809	805,107	5.12	4.37
Boarding schools	35,887	43,105	0.22	0.23
Shelters for adolescents	10,373	14,429	0.06	0.08
Adolescent social protection	2,044	2,631	0.01	0.01
Homes for disabled and elderly	155,949	191,429	0.97	1.04
Social programs for families – women youths and children	25,642	37,582	0.16	0.20
Other institutions and activities in social policy branch	129,135	183,265	0.80	1.00
Housing and amenities	1,154,330	1,081,650	7.18	5.87
Housing	610,352	409,470	3.80	2.22
Capital renovation	116,388	155,107	0.72	0.84
Subventions to housing branch	482,924	155,760	3.00	0.85
Amenities	513,809	614,283	3.20	3.34
Urban amenities	459,164	534,125	2.86	2.90
Culture and art	351,873	500,596	2.19	2.72
Mass media	52,204	59,450	0.32	0.32
Physical culture and sports	132,582	143,040	0.82	0.78
Fuel and power	124,527	2,522	0.77	0.01
Construction	728,244	732,551	4.53	3.98
Capital investments	692,384	618,253	4.31	3.36
Farming, forestry, fishery, hunting	218,355	357,289	1.36	1.94
Transportation, roads, communication, telecommunications and informatics	1,736,418	1,249,138	10.80	6.78
Road transportation	81,141	105,188	0.50	0.57
Water transportation	474.8	1,261	0.00	0.01

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Expenditures	1999	2000	1999	2000
	Thousand UAH		Per cent to total	
Rail road transportation	23,379	28,848	0.15	0.16
Other types of transportation	154,319	15,101	0.96	0.85
Roads	1,475,862	955,392	9.18	5.19
Environment and nuclear security	4,300	4,549	0.03	0.02
Prevention and abolishing the emergency situations and results of natural disasters	59,765	53,875	0.37	0.29
Earmarked funds	120,346	220,790	0.75	1.20
Fund for environment preservation	40,479	64,039	0.25	0.35
Regional and local earmarked funds	36,867	154,934	0.23	0.84
Non-disbursed expenditures	1,347,403	719,870	8.38	3.91
Reserves	66,206	57,926	0.41	0.31
Elections	1,104	4,452	0.01	0.02
Repayment of arrears	922,962	488,145	5.74	2.65
Budget borrowings	152,738	-52,856	0.95	-0.29
Expenditures subtotal	15,815,811	16,994,001	98.39	92.27
Contributions to the state budget	228,647	1,228,322	1.42	6.67
Mutual settlements	29,570	4,660	0.18	0.03
Subventions to the central government	-	190,757	-	1.04
Payment of fuel subventions	3,741,858	-	23.28	-
Expenditures total	16,074,030	18,417,741	100.00	100.00

Source: Own computation based on MoF data.

The minor role of investment expenditures in sub-national governments' budgets should not create the impression that sub-national governments' investments are not as important as national investments; indeed the opposite is true: local participation in investments within the public sector are relatively growing, as the data in Table 5 above reveals.

Due to legal requirements, the budgets of most types of sub-national governments should be balanced. So no deficit budget planning for oblasts, rayons, urban districts, townships and villages is allowed. The fiscal shortcomings occurring in the course of the fiscal year in these units can be bridged by short-term (three months) borrowing from the budget at the higher level. This should be paid back by the end of the fiscal year, at the latest.

Some sub-national governments (AR Crimea, cities of oblast and rayon significance) are only allowed to have a deficit in their development budgets that can be bridged by borrowing.

8.4 Reconsidering the 'Original' Local Government Revenue Sources

As was previously stated (see Table 6), the local revenue sources play a minor role in sub-national governments' revenues. The major proceeds in the sub-national governments' budgets are national duties shared with them to finance delegated functions. The portion of local revenue sources does not exceed 2-3 per cent of the total – comparable to Soviet times.

There is not much available information on the user's fees, which would make it an important source of local revenues. The current statistical appraisal of the sub-national governments' activities that are paid due to the benefit principle

is insufficient. The sub-national governments operate many public utilities that are run though economically independent bureaux (transportation, sanitation, water treatment, power and gas delivery, amenities). The communal units delivering these services collect the user's fees and the tariffs are set in such a way that the service is affordable for most of the population. That is why communal services and utilities are subsidised by sub-national governments throughout Ukraine; only the balance of fiscal flows appears in the budget sheets i.e. the amount of subsidies paid to communal enterprises. This means that most types of communal economic activity are reflected in the expenditure side of the budget only.

It is remarkable that the non-tax revenues have increased very rapidly (they tripled in 2000 compared to 1999) and reached a relative value of about 10 per cent of total sub-national governments' revenues. The important components of this revenue category are administrative payments and fines. The share of interest on bank deposits in this revenue category is not too high and will diminish in time to zero, due to mandatory shifting of all sub-national governments' accounts from commercial banks to the State Treasury with no interest payments.

After enacting the Ukrainian legal act concerning local taxation (1993), it was quite rapidly introduced by many sub-national governments e.g. in 1995, 54.7 per cent of local communities had not introduced at least one type of local tax or duty; in 1996 the number was 6.3 per cent (Kyrylenko, 2000:225).

Currently, the list of levies that can be imposed by sub-national governments in Ukraine is long (most of them were enacted by the Decree of the Cabinet of Ministers in 1993): advertisement tax, communal tax, hotel duty, parking fees, market place fees, fees for permission to lease a private apartment, resort fees, fees for the use of local symbols, local auction and lottery fees, fees for crossing the territory of the bordering regions (the only local duty introduced by the oblast council), permission fee for establishing a trading facility, fees for shooting movies and TV programs, permission fees for office placements in the central part of populated areas, dog fee, fees for the acquisition of foreign currency and the imported goods sales fee⁴. The system of local taxes and duties is summarised in Table 11 below.

The most important tax from this list is the communal tax that delivers about half of the proceeds from local taxation; the second, in order of importance, is the market place duty.

As this list shows, the main portion of local levies is supposed to be paid by individuals, but in fact, the major part of taxation proceeds is borne by businesses. Some of the so-called "fees", such as hotel duty, foreign tourism fee, fee for the use of local symbols, resort fee etc. are, in fact, taxes because they do not suggest the delivery of any service from the local authorities.

4 The detailed description of the local taxes and duties in Ukraine is presented by Rozputenko et al (2000).

Table 11
Current local taxes and duties in Ukraine

Tax or duty	Object of taxation	Tax rate	
		Legal persons	Individuals
Advertisement tax	Value of service (actual cost by self-advertising); space and number of carriers	0.1 per cent of value of one-time service; 0.5 per cent of value of long-lasting service	The same
Communal tax	Total enrolment (public entities and agrarian businesses excluded)	Marginal rate 10 per cent to TFIM (17 UAH) for each employee	N/A
Duty for the issuance of a permit to locate vending and service facilities	Permit	85-300 UAH for permanent vending and service activities; 8-50 UAH one-day permit; 1-20 one-time permit	The same
Local symbol usage tax	Value of manufactured goods sold and services provided with the use of local symbols	0.1% to value	5 TFIM
Market place duty	Selling activity	0.2-2 TFIM per day	0.05-0.15 TFRM per day
Hotel duty	Value of service	Marginal rate 20 per cent to the accommodation cost	The same
Vehicle parking fee	Parking time duration	Marginal rates 3 per cent to TFIM in fit-out spots; 1 per cent to TFIM in non-fit-out spots	The same
Resort duty	Service consumption	N/A	Marginal rate 10 per cent to TFIM minimum non-taxable income (residents); 1-2 minimum non-taxable income (non-residents)
Fees for permission to lease a private apartment	Permit	N/A	30 per cent of TFIM
Fees for shooting movies and TV programs	Cost of organisation of activity	Actual cost	N/A
Local auction and lottery fees	Value of goods or emission	Marginal rate 0.1 per cent to value of goods or emission	The same
Fees for crossing the territory of the bordering regions	Motor vehicle to cross the border depending on type	Marginal rate 0.5 TFIM for residents, 5-50 USD for non-residents	The same
Dog fee	Dog possession	N/A	10 per cent to TFIM
Permission fees for office placement in the central part of populated areas	Area of space	Marginal rate 0.5-2 TFIM per square meter	N/A
Fees on participation in trotting matches	Horse	Marginal rate 3 TFIM	The same
Fees on prizes on trotting matches	Sum of prize	N/A	Marginal rate 6 per cent
Fees on participation in bidding	Payment for participation in bidding	N/A	Marginal rate 5 per cent

Source: Decree of the Minister's Cabinet on Local Taxes and Duties (1993, updated and amended).

The competence of the sub-national governments in levying local taxes is formally quite broad: imposing local taxes and duties, granting tax credits, reduced rates and privileges to the payers to the local budgets (item 18 of the Minister's Cabinet Decree). But the real discretion in this field is very limited, since the list of

levies granted to sub-national governments, the tax bases and the marginal tax rates are determined centrally. It must be said that sub-national governments do not have direct authority in administering their own taxes because the most important levies are collected and administered by the local offices of the State Tax Administration.

The local taxation may play a different role, depending on the sub-national government's type and location. As Table 12 suggests, it delivers a significant portion of revenues in cities of rayon significance and townships (around 15 per cent of total revenues, net of direct transfers over the past years). The trend is also quite remarkable: the relative size is likely to grow over the time.

Table 12

Local taxation portion of sub-national governments' revenues (direct transfers for the governments of a higher level are excluded)

Year	Combined local budgets	Oblasts	Cities of oblast	Rayons	Cities of rayon	Townships	Villages
1992	0.03	0.00	0.05	0.01	1.54	0.83	0.61
1993	0.13	0.00	0.27	0.03	0.34	0.10	0.63
1994	0.51	0.02	0.83	0.12	2.54	1.56	0.49
1995	1.46	0.35	2.96	0.35	8.86	6.94	1.90
1996	2.63	0.67	5.28	0.63	13.14	12.90	4.33
1997	2.94	0.78	5.42	1.24	15.38	14.38	5.21
1998	2.97	0.41	2.40	5.80	15.66	16.43	5.93
1999	3.36	0.29	3.16	6.66	14.59	16.41	6.88
2000	3.65	0.28	5.92	3.35	12.23	14.27	5.29

Source: Own computation based on MoF data.

Since the relative importance of local taxation is a measure of local fiscal autonomy, one could draw the conclusion that fiscal autonomy of the Ukrainian sub-national governments is very low, despite the fact there have been positive changes over the last years.

The existing system of local taxation is not in a position to deliver a basis for local fiscal autonomy because (a) the levies granted to sub-national governments do not have any significant revenue potential (most sub-national governments do not have the appropriate tax basis) and (b) most of these levies are connected with the heavy administrative costs that make tax collection inefficient.

Of all the local taxes and duties listed above, only five (communal tax, hotel duty, permission fee for establishing a trading facility, market place duty and advertisement duty) are important and deliver about 95 per cent of local taxation proceeds. Five local levies are seldom introduced (e.g. fees from trotting matches have been collected in only two regions out of 27) and could be excluded from the list because of their administrative inefficiency.

One of the striking facts is the low portion of local taxes in revenues of big cities: they do not have effective stimuli to exploit this source of revenues because of its insignificant role.

The problems of the Ukrainian local taxation are linked to the following:

- (1) Very low revenue potential of local revenues. Table 13 below delivers data showing that per capita local taxes and duties are not high – less than 10 UAH in 2000 (or 1.85 USD). Of course, this amount is not sufficient to cover a significant portion of the local expenditure programs.
- (2) The latter pushes the local authorities to perform activities in the revenue policy that could not be judged as being fully legal. They introduce certain levies disguised as ‘voluntary’ contributions of local businesses to SNG budgets (e.g. fee for fighting mosquitoes or local certification duty on alcoholic beverages, contributions for the purchase of wheelchairs for the disabled and similar)⁵. According to the Law on Local Self-Government, voluntary contributions could be imposed by a general meeting of local inhabitants (so-called “self-taxation”), but in many cases, this provision had been neglected. Another way to raise discretion concerning revenues is by introducing off-budget funds that are operated by local administrators without any accountability to the public. One other way is direct financing of expenditures to be borne by sub-national budgets through “voluntary” earmarked contributions of businesses and households. For example, in 1999, only 68 per cent of local expenditures on education were funded through public budgets and the remainder, by non-public entities (Vassylyk, 2001:183).
- (3) Low elasticity of the most local levies: the marginal rates (especially those based on TAX-FREE INCOME MINIMUM value) were set in national legislation in 1993 and have not been adjusted since. This means that in real numbers, the proceeds from local revenues cannot be regulated by sub-national governments; the positive changes in the economic situation of widening the scope of local levies may improve this.
- (4) The legislation does not impose any obligation to levy local taxes⁶ unequivocally. The result is that some local communities (especially in little townships

5 The list of local taxes and duties abolished lately as being illegal include the following: fee for being called before the commission of the local council; fee for the temporary attendance of Russian citizens on Ukrainian territory; duty on reference issuance; fee for pedestrians crossing the border; duty on cattle grazing; fee on property separation by divorced couples and many others.

6 A Law on Self-Government (item 69) requires that the self-government bodies *can* impose local taxes and duties. It leaves the issue of imposing local levies to the discretion of sub-national governments. An attempt to make the local taxation obligatory was undertaken in the Presidential Decree On Local Taxes and Levies (1999) that declared some types of local levies (communal tax, advertisement tax, foreign tourism tax, hotel duty, market place duty and some others) an obligation of the sub-national governments. This Decree was abolished because the corresponding draft law was cancelled. Some levies were declared obligatory for imposition, according to provisions of the Law on Tax System (1997): communal tax, parking fee, market place duty, fee for permission to lease a private apartment, duty for the issuance of a permit to locate vending and service facilities, dog fee.

and villages) do not impose any local taxes because they do not have a tax basis of mandatory levies and do not want to introduce facultative ones; some local governments do not even collect service payments. This kind of “local communism” has been performed in order to raise the prestige of some local administrators, but sometimes it was enforced by local economic developments. Some years ago, the local transportation services in Odessa were free, the same as the public telephone service in Kyiv City.

- (5) Very uneven distribution of local taxation bases across the regions. The most affluent are big cities, e.g. Kyiv City and some cities of oblast significance. Table 13 below shows the differentiation of regions concerning the exploitation of local revenue sources. This means that taken alone, the local taxation in its existing form, creates very heavy revenue differentials, claiming a strong equalisation policy performed by the centre.

Table 13

Ranking of Ukrainian regions by local revenue proceeds, UAH per capita

Region	1993	1996	2000
AR Crimea	1.8	5.2	10.1
Vinnitsa	0.0	4.0	6.7
Volyn	2.8	4.8	10.8
Dnipropetrovsk	7.9	6.6	9.4
Donetsk	0.6	5.4	9.0
Zhytomyr	1.3	5.2	7.6
Zakarpattya	5.5	4.1	3.8
Zaporizhzhya	3.3	6.9	11.3
Ivano-Frankivsk	1.4	3.6	6.7
Kyiv	1.5	4.2	6.3
Kirovohrad	14.4	4.0	6.2
Luhansk	4.2	6.2	7.7
Lviv	18.7	5.9	8.8
Mykolayiv	0.7	3.7	7.7
Odesa	0.0	5.5	12.3
Poltava	11.3	5.3	9.7
Rivne	6.7	4.6	7.6
Sumy	0.7	4.3	6.3
Ternopil	2.5	3.3	5.2
Kharkiv	12.9	8.1	12.0
Kherson	0.8	4.0	7.1
Khmelnyski	9.2	6.4	11.2
Cherkassy	5.9	4.8	6.8
Chernivtsi	3.2	5.6	13.0
Chernihiv	7.9	5.1	7.7
Kyiv City	18.8	10.7	25.8
Sevastopol	5.3	4.4	13.2
Average	5.9	5.6	9.7
Variation coefficient	0.93	0.28	0.42

Source: Own calculation based on MoF data.

From this, we may conclude that local taxation in Ukraine requires urgent reform. The portion of original local revenues should be much more significant, in order for some feasible degree of local accountability to be achieved.

The composition of the local revenues shows that they do not contribute to the sub-national governments' accountability. Since most revenues are national, sub-national governments are obliged to be accountable for their spending to central government and not to the local voters. The spending of money is strictly controlled by the State Treasury, which holds the accounts of sub-national governments. The low accountability is strengthened by the way the local administration functions. As was mentioned above (Section 2), most spending is performed, or directly controlled, by the territorial state administrations. Since the heads of these administrations are not elected, but appointed, objectively they should be accountable to the central government. In order to make them more active in solving local problems, the central Executive uses administrative punishment. For this reason, in 2002, several oblast governors were dismissed because they did not care much for the development of the local business activity.

Making heads of territorial units politicians, not merely state administrators (this is presently under discussion in the Presidential administration), by having them elected, could improve the situation somewhat. However, this will not alter the high level of dependence of sub-national governments on the central government. This financial bond should not be as tight as it is now.

8.5 Local Borrowing

Borrowing, a common source of local revenue in both developed and some post-socialist countries, has not yet occupied any significant role in local budgetary policy. There are two types of borrowing allowed by legislation: short-term to cover a current budgetary deficit (the lender could be the SNG of the upper level) and long-term, to cover a deficit in a sub-national governments' development budget. The debt servicing is carried out through allotments from the current budget.

It is stipulated that local long-term borrowing is the full responsibility of the respective sub-national government: the central state bears no responsibility for it.

The pioneer issues of municipal bonds during the years 1995 – 1998 remained experimental only, with no special positive outcomes and no further development. One of the main reasons for such a result was a very subjective, non-systematic regulation of the matter.

The Budget Code created some legal basics for regulating the procedure of local governments' borrowing on the fiscal markets. The borrowing practice in Ukraine is subject to very strict limitations. The local governments at the basic level (this means no oblasts, rayons or urban districts) are allowed to borrow money only for specified investment programs. Debt servicing must not exceed

10 per cent of the general fund of expenditures of any fiscal year in which the servicing is planned. In the event that there is a breaking of the terms of the repayment schedule in any given year, the guilty SNG will be suspended from new borrowing activities for a period of 5 years. Each borrowing has to be empowered by a separate regulation from the Minister's Cabinet.

Most current bond issues are subscribed by international investors.

The special legislation for local borrowing is still to be approved, so there has not been much development in this field since the last time.

8.6 Enhancing Local Fiscal Capacity and Democratic Accountability

The current reform activities do not seem to be too radical. The list of local taxes presented by STA to be included in the Tax Code (see Table 14 below) does not incorporate any new affluent sources of local revenues; it suggests shortening the list of duties to 10 by abolishing several levies (including the communal tax) and introducing a new one – a school tax. This measure would obviously not solve the fiscal problems of local authorities in general.

Table 14
Proposed local taxes and duties in Ukraine

Tax or duty	Object of taxation	Tax rate	
		Legal persons	Individuals
Advertisement tax	Value of service (actual cost by self-advertising); space and number of carriers	5% of value of service; 5-8 UAH per m ² of carrier with special discount for domestic products	N/A
Duty for the issuance of a permit to locate vending and service facilities	Permit	85-300 UAH for permanent vending and service activities; 8-50 UAH one-day permit; 1-20 one-time permit	The same
School tax	Value of goods and services sold	1-2% to tax base	The same
Local symbol usage tax	Value of manufactured goods sold and services provided with the use of local symbols	0.1% to value	85 UAH
Market place duty	Selling activity	50 UAH	1-4 UAH
Hotel duty	Value of service	10-20% to the accommodation cost	The same
Vehicle parking fee	Parking time duration	0.5-2.0 UAH	The same
Resort duty	Service consumption	N/A	0.5-1 minimum non-taxable income (residents); 1-2 minimum non-taxable income (non-residents)
Performers' touring duty	Proceeds from the ticket sell	3% to the object for non-domestic performers	N/A
Duty on issuance of permits to construct	Total area of a land plot	Differentiated according to settlement type and purpose of construction	Differentiated according to settlement type and purpose of construction

Source: Draft Tax Code of Ukraine.

An opposing view was argued by a group representing the academic community and local authorities: they suggested introducing about a dozen new local taxes, among them a local property tax.

Summarising ongoing discussions, one may conclude that the reform of local taxation in Ukraine might include the following strategies:

- (1) making some national levies (currently assigned to sub-national governments to finance delegated state functions) the real local taxes, by granting full discretion over them to the municipalities;
- (2) introducing new taxes that are the best candidates for becoming local taxes (taxes on real estate, for example);
- (3) granting more discretion in setting local tax rates.

The prospective candidates to be included in local levies are taxes on land and property and local motor vehicle tax. The tax on land is still a national tax and the motor vehicle tax is a national levy assigned to sub-national governments' budgets. In assigning these taxes fully to the sub-national governments, the centre should retain control by legal determination of the tax basis and marginal rates of taxation. The suggestion to make Personal Income Tax and EPT local taxes expressed by some researchers (Kyrylenko, 2000:235) seems to be non-applicable to the current Ukrainian situation.

Imposing a local property tax is a point under dispute. This problem has been an object of intense discussions for many years. There are many issues that still have not found a reasonable solution: (i) who is the tax payer? (Legal persons or individuals?); (ii) what is a tax base? (Buildings, inventories or luxuries?); (iii) how to assess the value of property by an under-developed market relations; (iv) the rates to be implemented; (v) means of social protection for disadvantaged households. The intense draft legislation (there were several variants of the law on property taxation drafted between 1995 and 2001) did not have any feasible result. There is no doubt, on the one hand, that this tax should be implemented and assigned to the local authorities. On the other hand, it will make the distribution in society fairer, by pushing the better-off social groups (they have the concentrated valuable properties) into the position of making larger contributions towards funding public outlays. The current situation, whereby the redistribution of wealth in society is merely excluded from the tools of public policy is very frustrating⁷.

The introduction of the property tax assigned to the sub-national budgets will benefit urban communities upfront. The big cities, of national and oblast significance, will receive a generous source of revenues. However, the rural communities will not benefit greatly from this innovation, since most of the valuable properties are concentrated in the cities or in neighbouring localities. To give them other revenue sources, one must look for other options.

⁷ The reluctance of the centre to introduce property taxation forced some regions into doing it themselves. So, in February 2003, AR Crimea legislated the regional tax on real estate.

Surtax might be an interesting option. In the case of a modest surcharge being imposed on Personal Income Tax, this would give the sub-national governments a sizeable (and highly expandable) revenue source.

Making local taxation a more affluent source of revenues requires taking some measures towards strengthening local discretion in the setting of tax rates. The current practice of capping marginal rates and linking them to the tax-free income minimum makes local revenues very inflexible. A better way of pushing sub-national governments to pursue an effective revenue policy of their own would be to set fixed minimum tax rates and free sub-national governments to choose an appropriate rate, in order to optimise relations between business activities and local public needs. The only type of tax that has no limitation at the moment is the so-called self-taxation, practised mainly in small settlements, such as villages. They are collected as a fixed sum, linked to some object (such as a household, number of horses or machinery etc.) to cover specific expenditures (such as maintenance of roads, bridges etc.). As such, it cannot be used in the big territorial communities. The portion of local revenues in Ukrainian sub-national governments' budgets should and may cover up to 1/4-1/3 of their revenues. That will guarantee (to a certain degree) much more discretionary power compared to the present. All these measures should be supported by certain institutional improvements, such as creating an independent local tax administration, in order to give the sub-national governments the tools to really control fiscal flows on the territories under their jurisdiction.

An important part of making sub-national governments more accountable is accomplishing the territorial-administrative reform. The current borders of the sub-national governmental units in Ukraine were cut decades ago, during the Soviet period, without paying much attention to their ability to provide local public goods effectively to the population. The ongoing discussions in Ukraine on this topic are still far from being completed. What is important is the synchronisation in changing the territorial borders of sub-national governments and making them more flexible in collecting revenues. Until this issue is resolved, all attempts to make local governments more accountable will bring a very modest result.

Another important issue is enhancing sub-national governments' administrative and technical capacities. This is of special importance in small communities such as townships and villages. In these sub-national governments, the administrative staffs are often limited to a council head and his secretary. The merging of such units will go some way to improving the situation, but there is a great need to provide local officials with basic training on fiscal management and on technical equipment.

8.7 Summary and Conclusions

The history of the Ukrainian public sector on the whole, demonstrates that the remains of the old (Soviet) system of public administration are still deeply rooted in the current intergovernmental relations. The attempts to overcome the reluctant behaviour of the sub-national authorities, which are accountable to the state, not to the population, will have no success without critical reassessment of what we have at present.

The enhancement of sub-national governments' accountability in Ukraine requires significant changes in their revenue basis. Without implementing serious reforms in this field, it will be almost impossible to make them more responsible in meeting the local population's demands for public services. Making the locally generated revenues a significant portion of regional and local incomes will ensure the relative growth of own (not delegated) responsibility in service delivery.

Recent steps in reforming intergovernmental fiscal relations, as presented in the Budget Code, do not affect many important aspects of this issue. Pure own revenues remain an insignificant part of the budget proceeds, especially in large territorial units.

What should the recommendations for implementation be?

Firstly, re-shifting the public revenue sources by making some of them really sub-national "own revenues".

Secondly, it is time to introduce a sustainable revenue source that could be the basis for a sub-national fiscal autonomy. The best candidate could be the local personal property tax because it can secure a stable inflow for budgets of all kinds of territorial communities.

Thirdly, the state regulations in the sub-national governments' spending policy should be made less rigid in order to clear space for local initiative.

And lastly, these steps will bring about good results if institutional reforms take place. The most important one of these is the reform of the territorial-administrative composition of the country, aimed at the creation of more fiscally self-reliant territorial units. On the other hand, the institutional strengthening of regional and local authorities needs to re-introduce the link between the elected bodies and the executives at the oblast and rayon level.

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PART TWO – RELATED ISSUES

9. Local Public Borrowing in Serbia: How May Local Authorities Raise Finances for Their Priority Investments?

Thomas Meekel

During the past ten years, local authorities in Serbia have suffered from a paucity of investment, maintenance and operating resources that have brought about a major deterioration in the quality of services that municipalities are able to provide. The magnitude of the investment challenge implies that financing cannot come only, or even primarily, from the government. Improvement of municipal infrastructure financing is crucial and this is directly linked with the question of local public borrowing.

New laws enacted in 2002 changed the municipal finance system by modifying some taxes transferred to local authorities, centralising the planning of municipal cash deposits and the establishment of local treasuries and setting new rules for local public borrowing. Nonetheless, further reforms must be enacted in order to develop the municipal credit market in Serbia, which remains weak. A strategy for fiscal decentralisation and the design of a comprehensive borrowing legal framework should be high priorities for Serbia.

9.1 Introduction: A Quick Overview of Municipal Finance in Serbia

9.1.1 Current Territorial Organisation:

The Republic of Serbia is a country of about 10 million inhabitants. Without Kosovo and Metochia, Serbia is composed of the Autonomous Province of Vojvodina, 160 municipalities, three cities (Novi Sad –250,000 inhabitants; Nis –200,000, Kragujevac – 140,000) and the City of Belgrade (2 million inhabitants), which consists of 16 municipalities¹.

The Serbian local government system relies on a single tier of administration – the municipality. According to the Constitution of the Republic of Serbia of 1990 and the Law on Self-Local Government of 2002, the main municipal responsibilities are urban and town planning; housing; communal services such as water, transport, and heating; local roads; kindergartens and preschools and facilities provision in the areas of sport and culture.

Some duties are shared with the Republic level: primary and secondary schools – where teachers' wages are paid by the Republic, school facilities' operat-

1 For a more detailed presentation, see Ž.Šević. (2001) "Local government in Yugoslavia" In Emilia Kandeveva (Eds), *Stabilisation of Local Governments*, Budapest, Hungary: Local Government and Public Service Reform Initiative.

ing and investment costs by the municipality and social care – for which social welfare centres are paid for by the municipalities, while staff and benefits are financed by the Republic.

Cities have the same functions as municipalities. Financing is the only difference between municipalities and cities. Cities including the City of Belgrade are entitled to an additional percentage of the sales tax (*Porez za Promet*) shared by the Republic. A municipality has an average of about 45,000 inhabitants, which is the highest average population of municipalities in Europe. In order to provide better information to citizens and allow them to discuss specific issues, a municipality has the possibility to establish and organise communities (*mesne zajednice*) within its territory.

The unique supra municipal local authority is the Autonomous Province of Vojvodina, which has no hierarchical power over the municipalities located in its territory. The Province is responsible for enacting a 'program of economic, scientific, technological, demographic, regional and social development' (Art. 109) and also for regulations in matters where the Republic and municipalities are directly involved (education, social care, health, etc.). In a highly centralised context, the real role of the Province has been strictly limited. The Autonomous Province of Kosovo and Metohija (Kosmet) is currently run by a special UN mission in Kosmet (UNMIK).

The 25 Districts (Okruzi) that have been established by Governmental decision in 1992 are local representatives of state bodies and not elected local authorities. A district is a territorial unit where departmental bodies of certain ministries and republican agencies are brought together in a single administrative centre for the particular area. They are mainly responsible for administrative control and some inspection duties. The City of Belgrade also has the competencies of a district.

9.1.2 Percentage of the Public Sector and Sub-National Government in GDP

The following table gives an overview of municipal finance in Serbia. Data on sub-national government expenditures are generally not thought to be reliable, therefore these figures deal only with public incomes.

The public finance situation has improved dramatically since 2000, especially for Serbian municipalities. Municipal revenues increased 187 per cent between 2000 and 2003. This recent rise is mainly due to an increase in GDP and to the new municipal legal framework. Despite their large duties, Serbian local authorities still represent less than 15 per cent of the public income and just reached 6 per cent of the GDP. State debt amounts to 8.6 billion dollars in 2002, which represents more than 67 per cent of the 2002 GDP².

2 This figure reflects the first phase of the Paris Club debt reduction and comparable treatment from other official bilateral and commercial creditors.

Table 1
Percentage of the Public Sector and Sub-National Government in GDP

		1997	1998	1999	2000	2001	2002
Nominal GDP Serbia	M Din	102,508.80	133,425.60	175,924.80	326,587.20	703,881.60	918,292.80
<i>excluding Kosovo</i>	Ex Rate	5.91	10.53	18.89	44.37	66.70	64.19
	M USD	17,344.97	12,666.77	9,315.17	7,360.75	10,552.95	14,305.85
Public income in Serbia		44,487.50	64,882.70	73,808.90	128,800.00	275,675.00	401,918.00
	M USD	7,527.50	6,161.70	3,907.30	2,902.86	4,133.06	6,261.38
	Struc. GDP%	43.40	48.64	41.95	39	39.2	43.8
Local Budget Revenues in Serbia	M Din	4,946.00	7,052.00	7,577.00	13,341.43	30,443.47	55,319.27
	Struc. PI %	11.1%	10.9%	10.3%	10.4%	11.0%	13.8%
	Struc. GDP%	4.82%	5.29%	4.31%	4.09%	4.33%	6.02%
	M USD	836.89	669.71	401.11	300.69	456.42	861.81
	Evol. %		-20%	-40%	-25%	52%	89%

GDP Serbia = 0.912 GDP FRY

IMF Report, Ministry of Finance and Economy

9.1.3 Influence of the New Legal Framework on Municipal Finance:

Serbia is a highly centralised country in which the process of decentralisation and modernisation of all levels of government is only beginning. The New Law on Local Self-Government³ has just recently initiated these structural changes. In addition to the clarification of the duties of municipalities, the main aim of the Law was to offer sufficient autonomy to local governments through adequate, sure and permanent financial resources. One-third of the law's 154 articles address financial issues.

The Laws on Local Self-Government, enacted in 2001⁴ and 2002 introduced a clarification of municipal incomes and, to a certain extent, provided more incomes to local authorities, but did not change the fundamental structure local revenues. Some minor resources formerly stated as transferred revenues became original revenues (the tourist tax and some other marginal public incomes). Nonetheless, expenditures of local authorities remained mostly financed from state transferred revenues (more than 79 per cent in 2002). Besides the tax on original incomes, where rates and base are set by local governments, the New Law entitled municipalities to receive additional transferred incomes from the State.

The Payroll tax, which in 2002 represents an average of 20 per cent municipal income, was introduced in 2001 to replace the contribution to mutual housing and communal fees. These revenues now belong entirely to the local governments. Moreover, the full yield of taxes on property (tax on real estate property,

3 *Official Journal [Sluzbeni glasnik RS]*, number 9/02, Belgrade, 2002

4 *Official Journal [Sluzbeni glasnik RS]*, number 49/99, 27/01, Belgrade 1999, 2001. See B. Raicevic and S. Stojanovic *Lokalne finansije: iskustva i mogucnosti Srbije In Ekonomika preduzeca*, Belgrade, Janv- Feb 2002 : 55-63.

inheritance tax, tax on gifts and tax on transfer of absolute rights) now flow to municipal budgets. The most important income of municipalities – the sales tax on products and services – which accounts for 33 per cent of local authorities' revenues in 2002 has been divided into a fixed and variable part⁵. According to some criteria and also resulting from negotiations with the most powerful cities, the central government determines the variable portion, which is not minor (up to 40 per cent of the sales tax yield). However, in enabling municipalities to obtain 50 per cent of the sales tax yield surplus, the new Law has created incentives for local authorities – especially the wealthiest ones – to collect more sales tax income.

Thus, crucial transferred taxes for local incomes have been slightly redesigned. However, municipalities are still dependent from the Republic for the vast majority of their finances since “the largest part of their budget comes from the Republic as a ‘return of taxes’”⁶. Still, it also seems that these new laws have a significant impact on municipal finance: Serbian municipalities increased their share in public income by 3 per cent, from 11 per cent in 2001 to 14 per cent in 2002. Because the Law was partially implemented in 2002, this observation should be confirmed once the figures for 2003 become known.

Enacted in April 2002, the Budget System Law reforms procedures for budget preparation and budget execution of every public entity. For instance, the establishment of modernised treasuries is planned at the republic and local level. Municipalities must implement this reform in 2004. Local authorities must, by 2003, respect the new legal calendar for budget preparation. Some amendments to the Budget System Law adopted in December 2002 plan to centralise municipal deposits, currently held with commercial banks, with the National Bank of Yugoslavia (through the Public Expenditures Agency), under the authority of the Republic Treasury.

However, because these changes aim at improving the control over public expenditures, which is today especially weak and sensitive in municipalities, it is likely that some resistance and difficulties will occur. Heavy training and strong commitment from the finance municipal officers will be required in order to perform in accordance with the law. Financial management capacities of municipalities will greatly improve if this law is correctly implemented.

5 First, the Republic gives a local authority a fixed percentage of the sales tax raised on its local territory: 8 per cent for each municipality, 10 per cent to cities, and 15 per cent to the City of Belgrade. Then, a special annual law sets up an additional percentage of sales tax and also defines the maximum amount of sales tax and income tax a local government may receive from the State. Since the new law on Self- local government of February 2002, a local authority that reaches its ceiling will receive 50 per cent of any additional sales and income tax.

6 S. Djordjevic (2002). ‘System of Local Self-Government in Serbia and Yugoslavia (1804-2000). In: *Compared experiences of local self-government*, Belgrade, Magna agenda: 241-278

9.1.4 Relations between the Local and Central Governments.

Until 1990, Yugoslavia had a highly decentralised system of government, where the municipality was the most important territorial and political unit. During the 90s, the central government has acted frequently to limit the autonomy of local government. Despite the new Law on Self Local Government, enacted on 26 February 2002, the Serbian local government system remains highly centralised for the following reasons: First, the legal and constitutional framework that enabled the heavy centralisation trend of the 90s is still in place. The unchanged Constitution of the Republic of Serbia of 1990 does not legitimise and protect the municipalities as it does for the Autonomous Provinces. In strictly delineating their authority, the Constitution avoids any general grant of authority or presumption of authority in favour of municipalities⁷. As a consequence, the Law may change what constitutes the core of a local authority: status, authorities, territory, and property. A large number of laws, enacted during the former regime, still endanger municipalities. For instance, since the nationalisation of all municipal properties through the Law on Assets Owned by the Republic of Serbia (1995), local authorities do not have any property rights. This impedes their economic development and enables control from the central government. The current Law on Self-Local Government also did not remove the ability of the central government to dismiss a municipal assembly, which has effectively occurred more than 30 times during the former regime for political reasons.

Second, despite some positive changes in the last two years, local authorities are financially in a dependent position regarding central government. Expenditures of local authorities are still mostly financed from transferred revenues. In addition, the current municipal finance system raises questions regarding its functioning. The annual allocation of state transfer to every local authority results from an opaque process between the Ministry of Finance and the biggest cities. In addition to that, municipalities still have little possibility to earn money or to develop public private partnerships, as their public utility companies are not operating in a sound legal framework. Third, it remains extremely difficult for a municipality to appeal a central governmental decision. These review mechanisms are not effective because of their length and the weaknesses of the relevant institutions (districts, municipal and regional courts, Supreme Court, Constitutional Court).

Even if the central government political control over municipalities ended with the new democratic regime, the instruments of this heavy centralisation have not yet been reformed. For example, the districts, which were considered as the main item of this former control, have to see their authorities clarified. In order to rebuild the confidence between central and local government, a clear and shared decentralisation strategy must be implemented in the coming years.

7 Milkov, D. (2000). "The Structure of Public Administration in Yugoslavia". UNPAN website.

9.2 A Nascent Market for Municipal Credit in Serbia?

From 1990 to 2000, frequent hyperinflation, international sanctions and theft of individual foreign currency savings by the State created an atmosphere of distrust in the relations between borrowers and financial institutions. This made lending operations, except for those related to the regime, extremely difficult.

Two years after the political events that have led to the present democratic government, we can analyse the extent to which a municipal credit market has developed in Serbia. Local governments need to finance local capital investment in support of essential municipal services. We can summarise our findings as follows: potential borrowers, that is to say municipalities, local public utility companies, but also joint public-private ventures and other entities that implement local capital investments have difficulty borrowing from credit suppliers, which are mainly domestic and development banks.

The current legal framework for local public borrowing, Article 58 of the Budget System Law (see annex 1) enables local authorities to borrow in domestic and foreign currency, provided that the annual amount of borrowing does not exceed 20 per cent of the last year revenues. This regulation must be improved since it does not provide any coherent limitations in regards to debt service and debt stock (each year, a municipality may borrow 20 per cent of the last year revenues!). A coming draft Law on Public Debt will most certainly establish clear debt limitations, such as:

- Debt stock: a municipality shall not borrow if the outstanding debt (capital) exceeds 50 per cent of total revenues realized by local government budget in the previous year.
- Debt service: a municipality shall not borrow if the debt service instalments, i.e. the principal and interest payable, in any single year, exceed 15 per cent of total revenues realized by the local authority.

It must be stressed that the BSL doesn't mention any general obligation pledge for local authorities. Therefore, sub-national government borrowing needs to be reinforced by a specific pledge of property, revenue or a third party guaranty.

9.2.1 Trends in Borrowing

As was found in Bulgaria some three years ago⁸, Serbia cannot be said to have a functioning market for municipal credits in the sense of either a primary market, where local governments can raise finances for their investment needs, or a secondary market, where primary lenders can negotiate and liquidate municipal credits instruments.

8 Municipal Credit Market Development in Bulgaria: Policy and Legal Framework, *East European Regional Housing Sector Assistance Project*, USAID, Urban Institute, P. Epstein, J. Pigeay, G. Peterson, R. Nyaar-Stone, Bulgaria, March 2000

The current situation of the municipal credit market in Serbia may be assessed through the level of municipal lending activity by primary lenders. In recent years, only four local authorities have signed a loan in foreign currency for a global amount of 76 million Euros. At this point in time, the dominant lender is the European Bank for Reconstruction and Development (EBRD). The city of Belgrade borrowed 60 million Euros at Euribor + 3, 99 per cent⁹, without any sovereign guarantee, in order to restore and improve their transport, water system and heating. Focused on rebuilding their water system, the cities of Nis (6 million Euros), Novi Sad (5 million) and Kragujevac (5 million) asked and obtained a guarantee from the State¹⁰. These three loans, granted by the EBRD, with a 12 year maturity and a two year grace period, were made at the same interest rate: Euribor + 1 per cent.

Concerning bank loans in domestic currency, it has been particularly difficult to identify any municipal credits contracts, although an average annual amount of 170 million Dinar (2.8 million Euros) municipal credit was stated in the ZOP¹¹ in 2002 for the whole Serbian local system, including local public utility companies. We could therefore assume that if such a domestic loan exists, it is rather small and has a very short maturity. It is likely that these loans are essentially short-term facilities offered temporarily to cities by the banks that hold their deposits. Another alternative is that a domestic commercial bank keeping the deposits of a municipality may lend to a municipal public utility company under a sort of gentleman's agreement. Relations between local commercial banks, municipalities and local public utility companies (PUC) are not transparent and need clarification. The lack of data regarding the indebtedness of the municipal public utility companies does not allow a complete assessment of the debt situation of local governments.

An irony of the Serbian situation is that if we consider local government deposits in domestic banks as short-term borrowing of these financial institutions, then Serbian municipalities are currently net lenders. The global amount of municipal deposits in domestic banks is significantly higher than the credits extended to municipalities: banks held 8.6 billion Dinars of local government deposits in November 2002, which is about 143 million Euros, versus 2.8 mil-

9 Euribor (Euro Interbank Offered Rate) is the benchmark rate at which euro interbank term deposits within the eurozone are offered by one prime bank to another prime bank. It is one of the two benchmarks for the money and capital markets in the euro zone (the other one being Eonia). Euribor is sponsored by the European Banking Federation (FBE), which represents the interests of 3,000 banks in the 25 Member States of the European Union and in Iceland, Norway and Switzerland and by the Financial Markets Association (ACI). The first Euribor was published on 30 December 1998

10 *Law on providing contra-guarantees of the Republic of Serbia and Montenegro as a guarantee for EBRD upon the loan for City of Kragujevac, City of Nis, and City of Novi Sad, March 2003*

11 Zavod za obracun i placanje (ZOP) is the former payments and settlements bureau. Since 2003, the Office of Public Payments (UJP) replaces it for the public expenditures.

lion Euros in credits. Current domestic banking loans to local authorities therefore represent only 2 per cent of the local public deposits in commercial banks. However, the net lending position of local governments is weakened over time because the deposits are paid a negative real interest rate. For instance, Belgrade's interest earnings in the four domestic banks, where it holds its deposits, is about 1 per cent per month, which roughly represents 12.4 per cent annually against an inflation rate in 2002 of about 16 per cent.

At present, local borrowing consists primarily of foreign development banks lending to the biggest municipalities (Belgrade, Niš, Novi-Sad, Kragulevac), almost always with a sovereign guarantee from the Republic of Serbia. The volume of lending activity in domestic currency is feeble or non-existent if we take into account deposits of municipalities.

9.2.2 The Demand Side: Municipal Credit Demand and Capacity to Borrow.

Serbian municipalities have massive investment needs because of years of under-investment and deferred maintenance in basic infrastructure. Water systems require major repairs to reduce leakage, wastewater systems require complete restoration and upgrading, public transport systems must be renewed, municipal facilities must be repaired and made more energy efficient. According to the Serbian Republic Bureau for Development, this investment need in 2002 amounts to Million Euro 1.765 which is almost four times the total amount of 2001 local authorities revenues.

In addition, local governments lack significant borrowing capacity. First, there is a lack of clear information on the real indebtedness of municipalities, including local PUCs. The financial information provided by local PUCs even to their municipalities is often incomplete. The ability to present creditworthy projects and municipal creditworthiness is also questionable. Once operating expenditures are taken into account, there is little revenue available to fund local investment or to repay debt for almost every Serbian municipality. Moreover, the ability and readiness to take on and repay debt is crucial. Measuring effective demand for municipal credit will depend on financial discipline and quality of management¹².

This raises a global fiscal decentralisation issue: does the present municipal finance system allow most local governments to borrow? The new legal framework gives some more stable and consequent revenues to municipalities, especially for the wealthiest cities. But it is doubtful these limited changes will be sufficient for most of the Serbian municipalities.

¹² On these issues, see Peterson, G. (1997). *Building Local Credits Systems*. The World Bank, Background Series.

Under the present financing system, a few municipalities with a stronger economic base (already spotted by the development banks) may constitute the base of an initially small municipal credit market.

9.2.3 The Supply Side: Willingness of Financial Sector Institutions to Hold Municipal Debt and Security Offered by the Present System.

Despite the progress in banking system reform, domestic commercial banks remain weak. Local banks are reluctant to lend, regardless of the purpose or type of borrower. Banks do not appear to be interested in lending to municipalities, partly because they lack knowledge of municipalities and partly due to their capacity to identify creditworthy municipal projects and to assess the financial situation of a municipality. Above all, for the time being, the forms of debt security offered by borrowers are not sufficient for a potential lender. The development of a sound municipal credit market is linked with the quality of the pledges offered to creditors.

Local government deposits are the predominant pledge for loans to municipalities. However, the last amendments to the Budget System Law should limit this possibility. As of 2004, local government deposits are centralised. An alternative form of collateral in order to secure a municipal loan would therefore not be available.

Pledging of physical assets is prohibited by the Law on Assets of 1995, which nationalised municipal property. Even if such collateral was possible, it would not be necessarily the most effective. "Experience in many countries suggests that in practice, it is difficult for private creditors to foreclose on pledges of sub-national government real or immovable property in the event of defaults. Most developing and transitional countries tend to rely heavily on general obligation financing – debt secured by a pledge of local government's budget resources."¹³

Pledging of selected revenues has proved to be successful in many countries. Developing the use of such collateral in the Serbian framework requires further development of municipal finance reform. The Budget System Law does not regulate this issue, which may be addressed by a forthcoming local public debt law. Nevertheless, the municipal budget model will need to clearly separate the current from the capital budget. It would be then possible to evaluate whether a Serbian municipality can or cannot generate a net operating surplus¹⁴ and therefore able to take a loan and repay it.

Within this context, foreign development banks usually request a sovereign guarantee. Because of uncertainty about loan repayments and municipal creditworthiness, the fragile domestic banking sector is not yet interested in lending

¹³ Michael A. De Angelis 'Local government Access to Credit Markets in Developing Economies', World Bank, 2002

¹⁴ Defined as current revenues minus operating expenditures minus debt payments.

to municipalities. Obviously there is a lack of information flows and interest between municipalities and investors. The municipal credit market in Serbia is today not yet established. Comparative international experience suggests that such a market is unlikely to develop without some incentives or assistance from the State.

9.3 Recommendations: Enabling Serbian Municipalities to Issue Debt to Finance Priority Investments.

Aside from the necessary improvement of the legal framework, immediate steps must be taken in order to enable municipalities to finance their urgent investments projects and launch a credit market for local authorities.

9.3.1 Immediate answer: Establishment of a Temporary Agency to Strengthen the Link between the Demand and Supply Side.

In Western Europe, central governments frequently establish national public institutions to extend long-term credits to municipalities¹⁵. In many countries in transition, the state has also often designed, with the help of an international organisation, a specific financial institution that lends to local authorities. Considered as transitional in order not to impede development of the nascent private municipal credit market, these initiatives have mixed results. A few countries report a positive experience with lending international donor funds (mainly from the World Bank) through some form of “municipal bank” or “development fund”. In Europe, the Czech MUFIS is given as a model. This financial intermediary lends medium-term funds to private banks that in turn lend to municipalities for infrastructure projects assuming 100 per cent of the risk for the loans they underwrite. However, municipal development loan funds may constitute a risk for a nascent credit market when they fail to achieve their primary goals, realising high default rates and interfering in private credit markets.

That is the reason why the Serbian government has planned cautiously to establish an administrative agency and not a financial institution that would enable municipalities and local public utility companies to access financial resources for creditworthy infrastructure projects. The success story of the MUFIS relies partly on a pre-existent commercial bank network already working with municipalities. This situation is not yet present in Serbia.

The Municipal Infrastructure Agency (MIA) will combine two roles: the organiser of grant funds and centre for project preparation. It will work as a liaison between the providers of funds, the municipalities and the Government. It

¹⁵ For instance, in France the *Credit Local de France*, which was recently privatised, or the *Caisse des depots et consignations*, which remains, especially in social housing.

will not borrow in its own name and has a life term of 5 to 8 years. MIA's specific objectives are:

- To improve the efficiency of service delivery in the selected municipalities by assisting municipal authorities and/or public utility companies with the preparation and implementation of priority municipal infrastructure projects;
- To assist municipalities and/or public utility companies raising financial resources for creditworthy projects;
- To improve financial management in selected municipalities and public utility companies; and
- To encourage the development of a self-sustainable private-sector municipal credit market.

Supported by the European Agency for Reconstruction, the MIA was enacted by the Serbian Parliament in the following months and became operational in 2003.

9.3.2 Medium Term Answer: Building a Comprehensive and Consolidated Framework for Municipal Credit.

One of the biggest advantages of the present situation is that no explosion of local government borrowing is underway. Many countries in transition "have found themselves confronted with the reality of large-scale borrowing, then have been obliged to try to construct *ex post facto* a legal framework that will accommodate the healthy borrowing that has occurred while curbing the excesses ... From Brazil to Russia, excessive borrowing by sub-national governments or debt issuance in the absence of an adequate legal framework has exacerbated national economic crisis¹⁶". Serbia is in a position to develop at its own pace the legal and policy framework in anticipation of future market development.

The Serbian Ministry of Finance and Economy set a comprehensive legal framework for municipal borrowing to be enacted in 2003. Besides the State Debt Law, local public borrowing is regulated in a specific document, which reform's the content of the present article 58 of the Budget system law. Debt limitations (debt stock and debt service), the purpose of any municipal borrowing (whether to finance capital investments or provide some liquidity) and the authority of borrowing within the municipality will be clarified. In one sense the security of both lenders and municipalities will be increased by limiting the risk of local governments taking on borrowing that defers substantial debt service costs into the future and that may not be repaid. The issue of PUC debt must also to be addressed in a specific law. Furthermore, the implementation of this new legal

16 Municipal Credit Market Development in Bulgaria: Policy and Legal Framework, *East European Regional Housing Sector Assistance Project*, USAID, Urban Institute, P Epstein, J. Pige, G. Peterson, R. Nayaar-Stone, Bulgaria, March 2000

framework has to be properly organised. Training of local officers should be a key aspect of these reforms¹⁷.

Financing of municipal infrastructure and development of a sound municipal credit market depends also, in no small part, on strengthening fiscal decentralisation in Serbia. Equipping local government with stable revenues requires a national strategy for decentralisation. Replacing the current sales tax on products and services, the reform of the Value Added Tax (VAT) in 2004 implies a completely new design for municipal finance. Because the VAT is collected nationally, it will be impossible to return part of the VAT collected and realised in the municipal territory to local authorities, as happens today for the sales tax. Given the importance of the sales tax in the municipal finance system, the complete system of municipal revenues most likely must be redesigned.

It is extremely difficult for Serbian municipalities to face the challenge of remedying years of underinvestment in basic infrastructure because of their poor access to the credit market. Developing the municipal credit market in Serbia is the starting point. The establishment of the Municipal Infrastructure Agency will be a useful tool for helping the demand and supply sides to meet. Further adequate regulations are needed in order to develop this credit market.

However, building a coherent framework for municipal borrowing will be senseless without simultaneously building the rest of the policy and legal framework that widens a local government's role and revenues. Fiscal decentralisation is important for establishing a legal framework to promote municipal creditworthiness. Such a project requires a new Constitution of the Republic of Serbia and therefore strong political commitment and general consensus among the citizens. One cannot be certain whether these conditions are fulfilled yet or not.

17 M. Damjanović (2001) "The Legal and Political Framework for Decentralisation". In B. Raičević and G. Illić-Popov (Eds.), *Forum for Fiscal Decentralisation in the Federal Republic of Yugoslavia Conference Proceedings* (Washington, D.C.: The Fiscal Decentralisation Initiative for Central and Eastern Europe, 2001).

ANNEX 1: Art. 58 of the (old) Budget System Law

1. Local governments cannot borrow except for the capital investment part of their budgets.
2. Local governments shall not issue guarantees.
3. Local government may borrow from domestic and foreign sources for the purpose of financing capital investment expenditures subject to meeting special criteria as determined by a decision of the Government.
4. The Decision for borrowing, referred to in paragraph 3 of this Article is made by the executive local government body.
5. The amount of such borrowing, referred to in paragraph 3 of this Article, shall be determined in accordance with the ability of the local government to finance the repayment of principal interest from its own revenues.
6. Should short-term liquidity deficit occur during a fiscal year, due to unbalanced movements in revenues and expenditures, financing MAY be obtained through borrowing from the Republic Budget based on criteria set by the Government.
7. The total amount borrowed from the Republic Budget, during the fiscal year, shall be repaid by November 30 of this year.
8. The amount borrowed at any point in time during the fiscal year, either for short-term borrowing or long-term borrowing for capital investments shall not exceed an amount equal to 20 percent of the total realised revenues of the previous year's budget for the local government.

10. Tax-like Fees in Local Government Budgets: The Case of Poland

Piotr Bury

10.1 Introduction

Local government in Poland was reintroduced in 1990, at first at the basic level of the *gmina*. In 1999, it was completed with two other tiers of government: *powiats* and *voivodships*, at the intermediate and regional levels, respectively.

Of these three tiers of local government, the tier of the *gminas* is the richest, both in terms of wealth and different revenue sources. Apart from the central government, only the *gminas* collect revenue from taxes.

Taxes are commonly the primary source of revenue for public budgets, which is also true in Poland. The most effective revenue-generating taxes are, however, reserved for the Central Government budget: four of them make up as much as 80-90 per cent (88 per cent in 2000 and 84 per cent in 2001) of its income. Taxes levied by the *gminas* are rather insignificant; the largest revenues, gathered from the property tax, delivers only about 12 per cent of the *gminas'* income in total.

Apart from the property tax, there are seven other taxes, which together produce less revenue than the property tax. These are the taxes levied on: agriculture, forestry, vehicles, dogs, legacies & donations and civil transactions¹. *Gminas* in Poland also use several other taxes as revenue sources, but they are officially called fees.

10.2 Types of Fees in Gminas' Budgets

The set of fees which supply the *gminas'* budgets is quite large and consists of different types.

One group consists of typical fees, where a fee-payer receives a public service in return. The value of that service may not correspond with the fee paid. An example is the treasury fee, paid when one applies for different permits or certificates, or when one submits different kinds of applications to the local government.

Another group consists of typical charges paid for using a municipal flat, for water or for the kindergartens.

Apart from those two groups, there is yet another set of fees for which the fee-payers obtain nothing in return from the public authorities (except the reas-

1 Local taxes are the subject of the paper "Local Taxes in Poland. Base for Local Accountability?" by Paweł Swianiewicz.

surance that they act legally). These fees are in fact hidden taxes, so they complete the tax sources of the *gminas'* revenue. Most of these fees-taxes will be discussed below, namely:

- 1) the market fee;
- 2) the health resort fee;
- 3) the mining fee;
- 4) the adjacent fee;
- 5) the planning fee;
- 6) the hunting fee;
- 7) the fee for licences to sell spirits;
- 8) the fee for operating a nuclear waste deposit;
- 9) the fee for removing trees or bushes.

The above set of fees shows not only different objects they are levied on, (all the fees) but also their other specific features:

- their complexity (the adjacent fee);
- the relationship between collected money and expenditures (the fee for licences to sell spirits);
- the sharing of money between the *gmina(s)* and the Central Government purpose fund (the mining fee);
- the sharing of money between the *gmina(s)* and the Central Government enterprise (the hunting fee);
- the fee paid to the *gmina* from the Central Government budget (the fee for operating a nuclear waste deposit);
- the peculiar way of supplying the *gmina's* funds (the fee on removing trees or bushes).

10.2.1 The Market Fee

The market fee is paid to a *gmina* by all persons (individuals, firms etc.) selling goods in market places. According to the law, a market place is any place where commercial activity is being executed². Because the last statement was unclear regarding normal shops, from 2003 the sale of buildings – except of covered markets and halls designed for fairs, auctions and exhibitions – was explicitly excluded.

The market fee is also not paid by the taxpayers of the property tax levied on properties (land, kiosks etc.) located on market places. Because the sellers have to pay separately to use market facilities, as well as for the services offered by the market manager, the market fee appears to be a tax levied on a commercial activity.

² Ustawa z dnia 12 stycznia o podatkach i opłatach lokalnych (Act on Local Taxes and Fees), *Dziennik Ustaw* 2002, No 9, Item 84.

The rate of the market fee is fixed in the above mentioned Act. For 2003 it is as high as 575.86 zlotys per day (ca. 144 EURO), but this is the maximum rate; each *gmina* has to decide on the rates on its territory. For example, in 2002 in the town of Łódź, the highest rate paid for a bar in a bus on the car market was 46 zlotys (ca. 11.50 EURO) and the smallest was 2 zlotys (ca. 0.50 EURO) per one square metre of land occupied in front of the shop; the maximum rate was then 560.17 zlotys (ca. 140 EURO).

10.2.2 The Health Resort Fee

The health resort fee is officially called a “local fee”, but was previously called and is still commonly known as a “climatic fee”. It is collected in municipalities with unique climatic and scenic qualities, positive from a health, recreational and tourist point of view³.

To secure the right to levy a health resort fee, a *gmina* has to submit an application to a Central Government *voivodship* head, proving not only that it has the required, unique climatic and scenic qualities, but also that it is equipped with the facilities necessary to make use of those qualities. These facilities may be owned by the *gmina* (e.g., a park or recreational ground), by health resort institutions (e.g., sanatoria or a pump-room) or by citizens (e.g. pensions and restaurants). Before the decision is taken, the application has to be consulted by the Minister of Environment, Natural Resources and Forestry.

The fee is generally paid by people visiting health resorts for longer than 24 hours. Patients in hospitals, payers of the property tax on properties located there, organised groups of pupils, as well as some other individuals are exempt from that duty. Since 2003, two types of municipalities have been permitted to collect the health resort fee. One is a municipality with the officially granted status of health resort (there are 42 of them in Poland), and the other – a municipality with the right to collect the health resort fee, but without the official status of a health resort. The rates of the fee are decided by a *gmina’s* council. For 2003, the rate for the first type must not exceed 3.20 zlotys, and for the second – 1.60 zlotys for one person per day (ca. 0.80 and 0.40 EURO respectively).

The above rates (even the new, doubled rate) are not high in comparison with what visitors have been accustomed to spending for a variety of attractions; but for some popular *gminas* they could deliver significant assistance to their budgets. The practical problems begin with the collection of money. According to the law, a person staying in one place within a municipality longer than three days is obliged to register before the fourth day begins; people in hotels, boarding-schools, hospitals or social homes are required to register in the first 24 hours. In both cases, the duties are simply neglected.

3 *Ibidem*.

10.2.3 The Mining Fee

Before the extraction of minerals begins, a firm must apply for a licence⁴. Licences are issued by the Minister of Environment, Natural Resources and Forestry, Central Government, or by voivodship heads or *powiat* leaders, depending on the kind of mineral and/or the size of planned activity. Licences may apply to a mining activity or to the extraction of minerals from spoils or waste after the process of concentration.

The rates for mining fees range from 2 to 10 per cent of the value of the extracted mineral. For coal it is 2 per cent, for rock-salt it is 6 per cent and for minerals extracted from waste, the relative rate is reduced by 50 per cent. The ultimate rate of the mining fee is fixed by the appropriate licence authority, which may increase or reduce it by half in the cases suggested by the above mentioned law.

The total amount of the mining fee paid by a firm is then shared by the *gmina* or *gminas* (60 per cent) and the National Fund for Environment Protection and Water Management (40 per cent). The local part is distributed among the *gminas* involved, proportionally to the value of the output from their territories. The mining fee may not exist in many *gminas* but in some, it is an important source of income.

10.2.4 The Adjacent Fee

The adjacent fee is regulated by the Act on Land Management⁵ and refers to all pieces of land except agricultural or forest plots. The application of this fee is much more complex than for the fees presented above. First, it may be levied due to three reasons and only if the value of a property has increased. In all cases, the rate may reach as much as 50 per cent of the difference in a property's value after the process provided for in the above mentioned act.

In one case the adjacent fee may be considered a kind of surcharge, originally dedicated to partially financing the expenditures made by public authorities in the sphere of technical infrastructure: electricity, gas, water, sewage or roads. In fact, this fee has more of a tax character since the only reason to levy it is that in financing the investments mentioned, the public funds, in total or in part, were provided by the Central Government.

In the other two cases the adjacent fee is nothing other than a tax.

One case is when an owner divides his property. Obviously, a one hectare plot will be of more commercial worth when divided into, for instance, five parcels of 2,000 square meters each.

4 Ustawa z dnia 4 lutego 1994 r. – Prawo geologiczne i górnicze (Mining and Geological Law), *Dziennik Ustaw* 1994, No 27, Item 96).

5 Ustawa z dnia 21 sierpnia 1997 r. o gospodarce nieruchomościami (Act on Land Management), *Dziennik Ustaw* 2000, No 46, Item 543).

The second case refers to a process of merging pieces of land and then subsequently dividing them again. This process is much more complicated. Such an action may be taken by a *gmina* to enhance the process of housing construction in an area designated in the local physical plan. This initiative may be necessary, since many pieces of land changing hands through inheritance over time, have been partitioned extensively within families and have often assumed shapes and sizes unsuitable for building purposes; quite often some of them do not even have road access.

The whole process consists of two main functions. First, the *gmina* expropriates temporarily all the owners in the area and merges their pieces of land into a single large plot. The next stage is to divide it into a number of regular parcels and to mark out a new road (or roads) to provide access. The size of the new parcels is proportional to what was taken from their owners, each – proportionally – diminished by a part designated for roads.

In both cases described, it is the owners of the land who have to cover the costs of these processes (surveyor's services, real-estate registers etc.). Costs are proportional to the size of the properties involved. One can see that this fee clearly has the characteristics of a tax.

10.2.5 The Planning Fee

The planning fee is somewhat similar to the adjacent fee. It may be levied when the value of a land property increases, due to a new or changed local physical plan. The necessary condition is that the owner has to sell his plot. The fee rate is up to 30 per cent of the increase in the value of each land parcel.

Land on which only family houses can be built is normally worth less than the same plot would be if, for example, a supermarket or a gas-station were to be located on it. So, changing the zoning in the physical plan may result in the land owners possessing plots of greater value than before. If they keep the land for themselves, nothing happens, but if they sell it, they will be charged with the planning fee.

In practice, however, developers (or property managers) first buy single plots then they start the procedure of making changes in the physical plan. So, even when paying the planning fee, they take the benefits over from the original owners of the land.

10.2.6 The Hunting Fee

The hunting fee is paid by hunting clubs as rent for a shoot. Therefore, it may be an income source only for rural *gminas*, especially for those having lots of woodlands or wet meadows.

Hunting fee rates depend on the type of hunt and are fixed in the Game Law⁶ as an equivalent of the price of rye. The minimum rate is the same as 0.4 kilogram of rye, while the maximum equals the value of 7 kilograms of rye per one hectare of the hunt. The shoots with more than 40 per cent of woodland (irrespective of their owner, although most are national) are rented by a regional director of the “National Forests” and those with less woodlands – by a leader of the *powiat* local government. These officers may eventually raise or lower particular rates due to the reasons specified in the Law mentioned previously.

The fee is then divided proportionally between the national woodlands and the rest of the land; the first part is an income of the “National Forests”, the other of the relevant *gmina(s)*.

So, in fact, only the part of the hunting fee taken by the Central Government enterprise “National Forests” can be treated as a rent. The other part which the *gminy* receive is based on the land, in most cases, owned by individual farmers or by the National Agency for Modernisation and Restructuring Agriculture (the manager of the land after the national agricultural enterprises).

For 2002, the price of rye used for calculation was 37.19 zlotys (ca. 9.30 euros) per quintal, so that the basic rates of the hunting fee were between 0.15 and 2.60 zlotys per one hectare of the shoot (ca. 0.04 and 0.65 euros respectively).

10.2.7 The Fee on Using Licences to Sell Spirits

Anyone who intends to sell retail spirits must first apply for a licence issued by that *gmina*, where the shop is (or will be) located. For wholesale trade, a licence issued by the *voivodship* local government leader or even by the Minister of Economy, Labour and Social Policy is necessary. The number of retail shops is limited by each *gmina* and their location is subject to the different conditions specified in the national law, for instance a shop must not be in the vicinity of a church or of a school.

The licence itself costs nothing but it is necessary to pay to use it.

In the act proper⁷, three groups of spirits are listed, according to their type and strength. The first group consists of spirits with low alcohol content, the second with medium content and the third with strong spirits. Roughly speaking, an example of the first group is beer, the second group is wine and the third group is vodka. Each group of spirits needs a separate licence.

6 Ustawa z dnia 13 października 1995 r. – Prawo łowieckie (Game Law), *Dziennik Ustaw* 1995, No 147, Item 713.

7 Ustawa z dnia 26 października 1982 r. o wychowaniu w trzeźwości i przeciwdziałaniu alkoholizmowi (Act on Upbringing in Sobriety and on Counteraction to Alcoholism), *Dziennik Ustaw* 2002, No 147, Item 1231.

The fee for the use of the licences must be paid in advance, and the rates for the first year for each shop (bar, restaurant) are as follows:

- Beer – 525 zlotys (ca. 131.25 euros);
- Wine – 525 zlotys (ca. 131.25 euros);
- Vodka – 2,100 zlotys (ca. 525 euros)⁸.

Those persons who continue their selling activity have to report the value of sales in the previous year. When the value of Beer and Wine exceeds 37,500 zlotys, the fee for the current year equals 1.4 per cent of the sale value; for Vodka the threshold is 77,000 zlotys and the relevant fee rate is 2.7 per cent. If the sales value was below these thresholds, the fees to be paid are the same as for beginners.

When individuals stop their sales activity, they may apply for a licence to sell the remaining spirits. The fee in this case is 1.4 per cent of their value in the cases of Beer and Wine and 2.7 per cent in case of Vodka. A new licence to sell spirits is obtainable no sooner than after one year from the end of the validity of the previous licence⁹.

Apart from those fees paid at permanent selling places, an occasional licence is issued and an occasional fee is levied on persons who want to sell spirits outside their shops or restaurants, usually during local events. The appropriate rate is then 1/12 of the basic levy for each group of spirits. Except for permanent licence holders, these occasional licences may also be obtained by Voluntary Fire Brigades, common in rural areas and in smaller towns.

The fee for using licences to sell spirits differs from other fees in the use of collected funds. Although it is a *gmina's* budget revenue, its use is limited. According to the previously mentioned act, such funds may be spent only for preventive actions as well as in a campaign against alcoholism.

10.2.8 The Fee for Operating a Nuclear Waste Deposit

The fee for operating a nuclear waste deposit, regulated by the Atomic Law, was introduced in 1994¹⁰. It is paid to a *gmina* on whose territory a national nuclear waste deposit is located.

The rate is fixed as a double income of that *gmina* collected from the property tax. The fee-payer is the National Agency of Atomics and the payee is the urban-rural *gmina* of Różan, located 90 kilometres north of Warsaw.

8 Until mid 2001, the rates, similar to the current ones, were based on the official price of a one litre bottle of luxury spirits, fixed each year by the Minister of Finance and until recently, in euros.

9 Between mid-2001 and late 2002 there were four thresholds of the sale value, each connected with the growing fee for the next year (up to five times the basic fee). That caused an immediate reaction: some people stopped their activity before the end of the year and began it anew in January, paying only the basic fee. The only risk was that, in the meantime, someone else could take advantage of the opportunity and occupy a vacated, limited licence.

10 Ustawa z dnia 10 kwietnia 1986 r. – Prawo atomowe (Atomic Law), *Dziennik Ustaw* 1986, No 12, Item 70.

Because only one *gmina* receives this fee for operating a nuclear waste deposit, it is unlike other fees (and, of course, all the different types of taxes). It does, however, have one feature typical of a tax: the fee-payer gets nothing in return.

10.2.9 The Fee on Removing Trees or Bushes

Except on woodlands, any person who wants to move or remove a tree or a bush on his property must apply for a permit to do so. Permits are issued by a *gmina* or, when the plants grow on historical properties, by a *voivodship* conservator (Central Government officer) of historical monuments. A permit costs only 76+5 zlotys (ca. 20.25 euros).

Permits are not required if the plants to be removed are fruit bearers, if they grow on plantations, if they are less than five years old, or if they are obstacles to aviation.

Having acquired such a permit, an individual (not a businessman) may remove the designated plants without any other costs. All other persons (individual businessmen, firms, organisations etc.) have to pay the special fee to remove trees or bushes. Fees are not levied when there is no obligation to have a permit, or – for instance – when necessary from the point of view of cultivation, when a tree or bush has to be removed due to safety reasons, i.e. when they are a threat to people, to property or to highway traffic, railway or navigation.

The Act on Protecting Nature¹¹ where the regulation of the fee discussed above was implemented in 2001 from the Act on Environmental Protection and Management provided new rules for fixing the fee rates. Now they should be fixed in relation to the minimum salary stated by the Minister of Economy, Labour and Social Policy; in 2003 it was 800 zlotys (ca. 200 euros).

For trees, the rates depend on the type and size of a tree measured at its girth, of a height of 1.3 metres above the ground and for the thinnest (up to 25 centimetres in girth) cannot exceed 60 per cent of the minimum amount per one centimetre of its girth, while for the thickest (with a girth of more than 200 centimetres) – 235 per cent of the same base. For bushes, the rate depends on the surface grown and cannot exceed 26 per cent of the minimum amount per one square metre.

When a person removes a tree or a bush without a permit, the penalty cannot be higher than three times the regular fee for the relevant tree.

These new regulations have not yet been adopted; the previous rates remain in use. They are also based on the girth of a tree trunk and on the value of the type of tree; for bushes, the rate is based on the plant's surface. For instance, removing a thin robinia or willow (up to 25 centimetres in girth) would “cost” 10.30 zlotys (ca. 2.60 euros). On the other hand, a thick yew or maidenhair-tree (over 200 centimetres in girth) would cost as much as 1423.70 zlotys (ca. 356 euros) for each centime-

¹¹ Ustawa z dnia 16 października 1991 r. o ochronie przyrody (Act on Nature Protection), *Dziennik Ustaw* 2001, No 99, Item 1079.

tre measured around their trunks. To be more realistic, for a poplar with a trunk of 1 metre in diameter it would be about 17.5 thousand zlotys (ca. 4.375 euros) and for an oak only half as thick, it would be about 109 thousand zlotys (ca. 27.251 euros). For any bush, the rate is 131.30 zlotys (ca. 32.80 euros) per one square metre.

The money collected from the fee under discussion is not revenue in a *gmina's* (net) budget, but an income for the *gmina's* Fund for Environmental Protection and Water Management, being a specific and practically separate part of its (gross) budget.

The fee for removing trees or bushes is a positive tool for the preservation of nature. The necessity of securing a permit reduces the hasty removal of trees. On the other hand, however, both the current rates and the limits to the new ones seem grotesque because of their enormous cost. Therefore, the common practice is that, especially in the rural areas, people easily get permits due to "social" reasons, or they remove trees, paying neither permits nor fees.

10.3 Fees in the Budgets of Two Gminas

This Section is to illustrate the practical effects of the fees discussed above.

These fees provide such little revenue for the *gminas* that they are not even reported in the official national statistics. Therefore, the example below is based on the 2001 budget reports of two *gminas* from the Łódź region, Łódź itself and the rural *gmina* of Wodzierady, which offer stark contrasts. Łódź is the biggest city of the region and the second largest in Poland. It is also a special type of urban *gmina*, a *powiat* (there are 65 such towns-*powiats* in the country). The city is also the capital of the local government and Central Government *voivodships*. Here only a part of Łódź's budget, that of the *gmina* tier, was taken into account.

At the end of 2001, Łódź had 762.4 thousand inhabitants, exactly the same as in 1970. From its maximum of 851.7 thousand in 1989 this number has been decreasing year by year. Such a loss is the result of economic changes associated with the transformation process: the fall of Łódź's traditional textile industry and growing unemployment have driven people to move elsewhere. This is strengthened by the decline of the population and, to a smaller extent, by inhabitants moving out to the countryside.

Wodzierady is a small rural *gmina*, ca. 20-30 kilometres South-west of Łódź, with a population of only 3.1 thousand. There is no industry; the inhabitants are mostly farmers. Although without unique recreational qualities, more and more people from Łódź build their week-end or even permanent houses there.

Table 1 below shows how much money these two *gminas* collected from fees in 2001, as well as how much those fees enhanced the *gmina's* budgets. The last line refers to the fee on removing trees or bushes, which is an income from a *gmina's* Fund for Environment Protection and Water Management, planned and decreed along with the *gmina's* "real" budget.

Table 1
Tax-like Fees as a Part of Budget Revenues in Two Gminas, 2001

Gmina	Łódź		Wodzierady	
	zlotys	%	zlotys	%
BUDGET INCOME in total in which:	1,066,495,842	100	3,513,650	100
Market fee	9,025,108	8.46	-	-
Health-resort fee	-	-	-	-
Mining fee	88,045	0.08	-	-
Adjacent fee	718	0.00	-	-
Planning fee	1 901	0.00	-	-
Hunting fee	-	-	3,703	1.05
Fee on Using Licences to Sell Spirits	4,233,011	3.97	32,480	9.24
Fee on Operating a Nuclear Waste Deposit	-	-	-	-
TOTAL of above fees	13,348,783	12.52	36,183	10.30
Fee on Removing Trees or Bushes	4,392,574	x	-	-

Source: Based on data from relevant gmina offices.

Figures in Table 1 show that:

- 1) Only two fees from those described in Section 2 were not collected in these *gminas*, namely the health resort fee and the fee for operating a nuclear waste deposit, which was fully justified: neither Łódź nor Wodzierady is a health-resort and the other fee is paid only to the *gmina* of Różan;
- 2) From the other fees, six were collected in Łódź, while in Wodzierady only two of them were; since Łódź is much bigger, it is more likely that the larger number would apply;
- 3) Nevertheless, the fees typical for urbanised areas, i.e. the adjacent fee and the planning fee, were both collected in Łódź. Their amounts were surprisingly small; they delivered as little as 0,00007 per cent and 0,00018 per cent of the *gmina's* budget income respectively;
- 4) The role of fees in the budgets of these two representative *gminas* was insignificant; together they delivered only 1.3 per cent of the total budget income of Łódź and just 1.0 per cent of that of Wodzierady;
- 5) The most productive tax-like fee in Łódź was the market fee (representing 67,6 per cent of the income from all fees combined); it may be interesting to note that this fee is not only an income source in Łódź's budget, but – at least in the case of the large market being managed by the Łódź Sport Club (ŁKS) – a means of support of the town club (it receives as much as 90 per cent of the collected market fee as a gratuity for this activity);
- 6) The second largest income in Łódź is produced by the fee for removing trees or bushes, mainly because firms and individuals are obliged, not only to get a permit, but also to pay this enormous fee; on the other hand, in rural *gminas* the removal of trees is common and this is also true in the case of Wodzierady.

It may be assumed that either the permits are issued too easily, or monitoring is ineffective;

- 7) The most important fee in the *gmina* of Wodzierady was the one for licences to sell spirits. It delivered as much as 89.8 per cent of the revenue from all fees combined. This fee was not negligible in Łódź. When compared with the number of inhabitants, however, in the *gmina* of Wodzierady it was almost twice as large (10.48 zlotys per head) as in Łódź (5.55 zlotys per head, or 2.60 and 1.40 Euros respectively).

10.4 Conclusions

The material presented above, set in the wider context of Polish local government finance, allows us to formulate the following conclusions:

1. The set of fees at the disposal of the *gminas* is relatively extensive for a transition country and it is differentiated and fairly complex. Moreover, the regulations are dispersed in many legislative acts, usually as additional points of the key problems. Therefore, one can scarcely find a complete description of the fees which are the *gminas'* revenue sources in financial books or papers¹².
2. A number of fees are in fact, as shown in this paper, disguised taxes. The situation needs to be addressed and changed. This would entail a long and tedious process, however, and is not likely to be undertaken soon by politicians. During the last thirteen years of the transformation, only two such cases were addressed. One was a forest fee which, in 1991, was replaced by a forest tax, although a separate act was issued on this tax as recently as late 2002. The second was the case of the treasury fee. In 2001, part of it, where the taxation likeness was evident, was excluded and a new tax on civil transactions was introduced.
3. The discretion of *gminas* in the case of local taxes is not high. In the case of the fees described, it is likewise not great. *Gminas* may decide on their own rates of the market, health-resort, adjacent and planning fees, but only up to the limits established in the relevant legislation.
4. Changes in the Polish tax system over the last ten years were mainly of a cosmetic character. Probably the next radical change will be the introduction of the cadastral tax, a property tax based on value unlike the present one based on physical measures (see paper by P. Swianiewicz). This change will also result in changes in the fees. Two of them, the adjacent fee and the planning fee, will lose much of their rationale.
5. Some of the fees discussed above are extremely minimal, such as the health resort fee; others are excessively high. The fee for removing trees or bushes,

12 Probably the mostly comprehensive attempt to address this problem is found in the author's handbook "*Finanse lokalne z elementami finansów państwa*" (Local Government Finance with Elements of the Central Government Finance), WSU, Kielce 2002.

due to its extremely high rates, forces unintended and undesired actions by the enabling legal statutes.

6. The final conclusion is rather pessimistic. *Gminas* in Poland can collect money from many different fees. In general, however, this does not generate a meaningful cash inflow to the local budgets.

Only a few *gminas* take advantage of the mining fee, as does the richest one in Poland, the small rural *gmina* of Kleszczów. There, due to that fee, but to other taxes and fees as well, the average per capita "own income" (i.e. income not including Central Government grants) in 2000 was about 192 times larger than in the poorest one.

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11. Local Taxes in Poland

A Base for Local Accountability?

Paweł Swianiewicz

The paper begins with a short introduction of theoretical principles related to local taxation, which are based on the fiscal federalism theory¹. As Rattso (2002) notes, the fiscal federalism model is based on four key assumptions: (1) local governments are mostly responsible for the delivery of public goods; (2) the base for local finance is provided by local taxes, i.e. those who pay for services also benefit from them; (3) there is considerable social (spatial) mobility and (4) in the case of local services, the relevant area is close to the area of administrative jurisdictions, i.e. spill over effects are minimal. Unfortunately, these criteria are, to a large extent, respected in the United States, but not necessarily in Europe. In reality, the European systems (including Poland) have local governments heavily involved in income redistribution programs; central grants play a significant role in financing local governments and people are much less mobile than in the US. Nevertheless, the principles of fiscal federalism remain a good normative base for the evaluation of local financial systems.

The second section gives a brief description of local taxation in Poland – beginning with a presentation of the legal framework and then discussing the actual role of local taxes in local governments' revenues and local tax policies.

In the concluding section, the author attempts to compare the present regulations and practices of local taxation in Poland with theoretical assumptions formulated in the introductory section. This leads to practical recommendations for the present Polish system.

11.1 Theoretical Issues – Why Local Taxation and What Local Taxation?

Why do we think that the existence of local taxes is important for local democracy and the efficient functioning of local governments? Why should local spending not be financed exclusively by other sources of finance²?

To answer these questions, let us start with a definition of local taxes as understood in this paper. First, local taxes are a part of own revenues of local governments. These own revenues include at least three elements:

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- 1 For a full explanation of the fiscal federalism concept see: Musgrave (1959), Oates (1972), King (1984).
 - 2 For a more complete discussion of revenue assignments' principles and their application for Central and Ekstern Europe see: Swianiewicz (2003, forthcoming)

- They are revenues allocated to local governments unconditionally, in full and for an unlimited period,
- They are related to the local economic base, i.e. the growth of the local economy leads to the growth of local budget own revenues;
- Local government has at least some amount of discretion to decide on these categories of revenues (for example, they may define – at least within some limits set by central legislation – local tax rates).

So, a tax yielding revenue to the local government budget needs to comply with these criteria to be counted as a local tax. It is important to stress that some tax revenues of local governments cannot be treated as local taxes. A typical example is provided by tax-sharing systems in most countries. Usually, local government has no discretion on tax policy related to shared taxes. In some countries, shared taxes are also distributed among individual jurisdictions in a way which is independent of the local economic base (the allocation per capita is a simple example of such a method). For both these reasons, shared revenues cannot be classified under the “local tax” label.

Local taxes are not the only, but are the most important category of local own revenues. It is recommended that a large proportion of local revenues come from own sources (in particular: in form of local taxes). There are several arguments, both political and economic in nature, which support this request:

- A system where a large part of the local budget comes from its own sources supports local government accountability towards the local population. The shape of the local budget depends, to a large extent, on decisions about local taxes. This stimulates councillors’ accountability and also increases citizens’ interest in local government activities. In general, such a system helps in the development of local democracy;
- Such a system exerts pressure on the “value for money” dimension – it presses towards the rationalisation of spending and looks for possible savings. It is much more difficult to argue for an increase in local public spending when it is going to be covered by higher local taxes, than in the case whereby additional expenditures will be covered by grants from the centre;
- Fiscal policy can follow local preferences. In one locality, citizens may expect a greater supply and better quality of services, even if it costs higher taxes, whilst in another area, people may prefer lower local taxes, even if fewer services are provided;
- Previous arguments suggest that the system with a high share of own revenues reduces the pressure on the overall level of public spending. If most of the local revenues are provided through central grants, there will be an excessive demand for local services by local citizens. The local government in turn, exerts pressure on the central government in order to receive higher grants.

- The suggested structure of revenues strengthens the political position of local governments within a state. This is because local governments are important partners who finance and provide significant functions, as opposed to the situation in which they are clients receiving and demanding resources from the centre.
- A system of high own revenues increases local government interest in supporting local economic development, although as Peterson (1981) noted, local authorities are usually interested in economic growth for other reasons.

It should also be noted, however, that high own revenues lead to increasing disparities between the rich and poor regions. Local shares in central taxes have the same disadvantage, but they do not have most of the positive features of local taxes, as enumerated above. That is why, in light of fiscal federalism, the shared taxes system is among the least attractive sources of local revenues.

There are several possibilities for local taxes and there are several criteria which help us to choose the most appropriate mix of taxes for a country. Some of these criteria are identical with the requirements for good taxes in general, but some of them are specific for local governments. The most important elements of the “check-list” may be summarised as follows:

- *The allocation of tax yields is proportional to the allocation of functions.* If we require that a large proportion of local revenues comes from own sources (as suggested in the previous section), we need a tax system which provides for this necessity. In the scale of the whole country, the local tax base should enable a municipality to collect revenues close to the resources required to perform the most important local functions.
- *An even geographical distribution of the tax base will keep differences between authorities with high and low local tax bases from being overwhelming.* For example, the tax base of the tax on exploitation of natural resources would be very unevenly distributed, since tax on housing properties is much more equally available for every local government. If this condition is not followed, there will be huge differences between “rich” and “poor” jurisdictions. If local government is responsible for important services, this will imply a complex system of horizontal equalisation. Obviously, there is no tax with yields distributed in a geographical space in a precise equal manner, but real candidates for local taxes do not share this point of view.
- *Tax is well-defined in a geographical space.* Is it easy or difficult to decide which local government should collect and receive the tax? For example, in the case of property tax, it is very easy – every property is located in a single jurisdiction. A similar, simple case is that of the personal income tax, regardless of whether we specify that it is paid in a place of residence (as in most European countries) or at the place of work (as in a minority of countries, such as Ukraine). But the case of corporate income tax is much more complicated. It happens that a company is registered in one city, but

it operates (and generates income) in several other places. Which local government should then benefit from the tax? A partial solution adopted in Poland is that tax revenues are distributed among local governments proportionally to the number of employees working in individual localities. But this solution is complicated and far from perfect. The case of the Value Added Tax is even more complicated, if not hopeless (from the point of view of the discussed criterion).

- *Visibility of the tax.* Some taxes (such as the property tax or the personal income tax) are more visible than others (such as a VAT, or excise tax). There is no doubt that visible taxes stimulate a local government's accountability.
- *The elasticity of tax yields with respect to inflation.* This item is important for every tax, but is probably of special importance in the case of local taxes. On the one hand, low elasticity (as in the case of the property tax) promotes more careful financial policies of local governments (increasing the tax rate, even if in reality it only reflects inflation, is always politically difficult). On the other hand, flexible taxes provide a better financial base for the delivery of local functions.
- *The tax base should be relatively immobile.* If this is not the case, tax payers can easily migrate between jurisdictions, which may lead to excessive tax competition. The property tax or even the personal income tax is better from that point of view than the corporate income tax.
- Finally, *the system of local taxes should be neither too fragmented nor too complicated.* In some countries there are a large number of small local taxes, none of which brings a really significant amount of resources to local budgets. The cost of tax collection in such a system is usually relatively high. Such a system is also unnecessarily complicated and non-transparent, which reduces the accountability values of local taxation.

In practice, in most European countries, there is more than one local tax, although one of them is usually more important than the others. The United Kingdom, with only one local tax (currently based on a property tax, although not in a typical, orthodox form) provides one of the rare exceptions to this rule.

In European countries there are basically two models of local taxation:

- One based on the property tax (there might be more local taxes, but the property tax is the most important). The United Kingdom provides probably the best example, but France, Spain and Poland also fall into this category.
- One based on local income taxes. All four Nordic countries are examples of this type of local taxation (note that a local income tax should not be combined with a local share in an income tax which remains a central tax). One of the very few countries in Central and Eastern Europe which has decided to go in the direction of building a local income tax is Croatia³.

³ There are several countries in Central Eastern Europe in which local budgets depend heavily on revenue from personal income tax. One can indicate here for example: Poland, Czech Republic, Hungary or Ukraine. But in each of these cases the system is based on a share in central tax, with no local discretion to regulate such an income.

There are some countries in which local governments may make a choice from among a wider set of available taxes. In the case of Hungary, local governments are entitled to introduce any or all of the following taxes: the land parcel tax, building tax, communal tax on private individuals, communal tax on entrepreneurs, tourism tax and local business tax (Hogye 2000).

Local governments in different countries have the discretion of deciding upon local tax rates. A typical solution is to set a maximum (ceiling) tax rate which the local authority cannot exceed. Such a solution is present, for example, in Italy (where in the case of the local property tax, the rate may differ from 0.4 to 0.7 per cent of the taxable values and in the case of the local surcharge to personal income tax, there is also a limitation on the extent of changes from year x to $x+1$, which cannot be larger than 0.2 per cent (Fraschini 2002)). In the United Kingdom, the freedom to set local tax rates was limited in the mid-1980s and presently is indirectly limited through caps on the overall level of local government spending (*Finance and...*, 1996). In Sweden, local governments which set excessively high rates may be “punished” through a reduction in state grants. In Denmark, local governments are basically free to set any local tax rate. Regardless of the particular solution chosen, in practice there is often a significant variation of tax rates between individual local governments. For example, in the UK in 1997 the basic rate of council tax differed from less than 300 to over 900 GBP. In Denmark, local tax rates vary by around 30 per cent in municipalities and around 10 per cent in counties (Pedersen 2002).

11.2 Local Taxes in Poland – A Brief Description of the Present System

11.2.1 Basic Regulations

11.2.1.1 Brief information on the structure of local government

The present local government structure is a result of two waves of decentralisation reform. The first wave took place in 1990, when the local government system was introduced at the municipal (*gmina*) level. The second stage of the reform introduced two new tiers of elected sub-national governments in 1999.

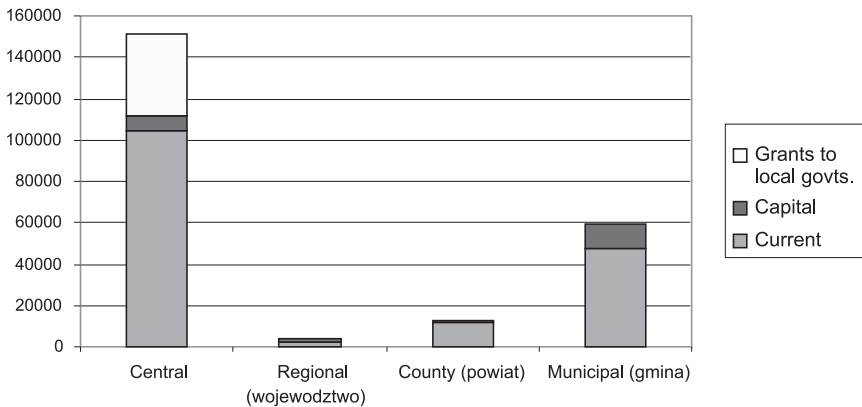
As a result of this process, there are currently three tiers of territorial governments: almost 2500 municipalities (*gmina*), 308 counties (*powiat*) (plus 66 cities of a county status) and 16 regions (*województwo*) which replaced 49 smaller units. Both at a municipal and county level, self-government is the only form of public administration. At the regional level there is a 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.

The goal of the reform was to separate clearly the functions and policy areas between tiers of government and to eliminate the vertical (hierarchical) dependency of the lower tier upon the higher. It has been achieved with regard to the three levels of sub-national self-governments. Obviously, municipal, county and regional levels cooperate, for example in economic development policies, but in terms of specific service delivery, the separation is close to perfect. The situation is much more complicated as regards the relationship between central and local governments. In some cases (such as education or social welfare benefits) nation-wide regulations are so strict that the local government's role is, to a large extent, reduced to that of being the agent of central government responsible for implementation of central policies.

The reforms granted a wide range of functions to municipal governments while the list of county functions is much shorter. The aggregate county budget is only a small fraction (about a quarter) of aggregate municipal budgets. This is illustrated by Figure 1.

Figure 1

Budget spending by the tier of government in Poland (2000, in million złoty)



Such a division of functions is possible because of the relatively large size of municipal units in Poland⁴. In contrast to many other countries in the region (such as the Czech Republic, Hungary or Slovakia) at the beginning of the 1990's, Poland avoided radical territorial fragmentation. As a consequence, the average *gmina* has about 16,000 inhabitants and 125 square kilometres. So, the Polish municipality is quite large in the European comparative perspective (see for example "The Size of Municipalities..." 1995). Although it is much smaller (in terms of the population) than British or Swedish municipalities, it is similar to the Norwegian,

4 Similar observation in a wider European perspective was made by Page and Goldsmith (1987) who noticed that territorial organisation is very much related to the allocation of functions. Small (fragmented) local governments are usually unable to take over responsibility for many services, which needs to be delivered by upper tiers of governments.

Danish or Dutch municipalities and much larger than Czech, Slovak, Hungarian, French or Italian municipalities. Only a few of the Polish municipalities are smaller than 2,000 and none of them have less than 1,000 inhabitants.

In 2001 local governments spent 10.6 per cent of Polish GDP or 38 per cent of total government expenditures. This represents an unambiguous increase from the 7.4 per cent of GDP and 16 per cent of total government expenditure spent by local governments in 1991. Almost 77 per cent of self-government budgets are spent at the municipal level (including big cities with county status), 18 per cent at the county level and only 5 per cent by regional self-government.

Polish municipal governments are responsible for the provision of a wide range of municipal services including:

- water supply and sewage treatment,
- street cleaning, refuse collection and waste disposal,
- local public transportation,
- street lighting,
- district central heating,
- maintenance and construction of local roads,
- maintenance of green areas,
- municipal housing,
- provision of education services, including kindergartens and primary schools,
- culture, including local libraries and leisure centres,
- numerous services within the social welfare sector, including services for the elderly, handicapped and homeless people, as well as housing benefits,
- physical planning and granting of building permits.

County governments are responsible for:

- secondary education,
- health care (the county manages only hospital and polyclinics. The health care reform implemented in parallel with the 1998 local government reform, has created independent health authorities which are responsible for most current medical operations),
- roads of county importance,
- several social services,
- labour offices (coping with unemployment problems),
- natural disaster protection,
- consumer protection,
- land surveying,
- various inspections such as sanitary, building etc.

The role of regional self-government in the direct delivery of services is very limited (although there are also some examples of such a role *e.g.*, higher education and main roads) but they are mostly focused on strategic planning and regional development programmes.

11.2.1.2 Basic regulations on local taxes

The most important regulations concerning financing local governments are included in the following Acts (with further amendments):

- The Polish Constitution;
- The 1990 Act on Municipal Government, The 1998 Act on County Government, The 1998 Act on Regional Government;
- The 1998 Act on Public Finance;
- The 1998 Act on Revenues of Territorial Self-Government;
- The 1991 Act on Local Fees and Taxes;
- The 1984 Act on Agriculture Tax.

Local governments in Poland are financed through a mixture of local taxes, other revenues from own sources, local shares in central taxes, central general purpose and specific grants. However, municipal government is the only tier of local government which has a limited power of taxation. Presently, both county and regional governments are financed almost exclusively by central general and specific grants with a very small share in central taxes and a few very minor revenues from own sources. Therefore neither the county nor regional financial systems are focused on in this paper. One may question however, whether the present system of county and regional finance is in compliance with the Polish Constitution, which in article 168 states that “territorial self-government units have a right to set the rates of local fees and taxes, within the limits established by Law”.

The following local taxes provide revenues for the municipal tier:

- The property tax;
- The tax on agriculture;
- The tax on vehicles;
- The forest tax;
- The tax on dogs;
- The tax on civil law activities;
- The tax on legacies and donations.
- The tax on small businesses.

With the exception of the last three taxes in the list above, local taxes are administered and collected by the municipal administration.

It should also be mentioned that there are some local fees in Poland which also have the nature of taxes which go to local government budgets. Such a case occurs when the fee-payer receives no (direct) return from the local government. A good example is provided by the extraction (mining) fee, 60 per cent of which goes to the *gmina(s)* and 40 per cent – to the National Fund for the Environment and Water Economy. Another example is the local fee paid by (some) visitors to health-resorts or the market place fee, especially when collected from people sell-

ing goods on the streets. Maximum rates for these fees are fixed by Parliament, but local councils can always reduce them, with some limitations in the case of the extraction fee. The general rule says that maximum rates of local taxes are established by central legislation, while local governments may set their own rates equal to, or lower than the “ceiling level”. Local governments can also use other instruments of their own tax policies; these instruments are presented and discussed in section 2.3.

11.2.1.2.1 Property tax

The property tax is paid both by physical persons and legal entities. The list of subjects of taxation includes:

- buildings or parts thereof;
- other architectural structures⁵
- plots of land which are not subject to agriculture or forest taxes;
- lakes, water reservoirs;
- plots of agricultural land or forests used for a commercial activity other than agriculture or forestry;

The general rule says that the tax is paid by the owner of the property (not, for example, by the tenant of the flat).

For most categories the tax is paid “per square metre”. The only exception is for “other architectural structures” (*budowle*) for which the tax depends on the value used for depreciation of these objects. If no depreciation is used by the taxpayer, the base of the tax is the market value of the object. However, this category provides an insignificant share of the revenues from the property tax.

As mentioned above, maximum rates are decided by central legislation and annually adjusted for inflation. The ceiling rates for the most typical types of properties are illustrated in table 1.

Table 1
The most significant maximum property tax rates in Poland

	2001	2003
- housing properties	0.46 PLN/sq. m.	0.51 PLN/ sq. m.
- commercially used buildings	15.86 PLN/ sq. m.	17.31 PLN/ sq. m.
- commercially used plots of land	0.56 PLN/ sq. m.	0.62 PLN/ sq. m.
- “budowle” (other architectural structures)	2 per cent of the value	

Note: 1 EURO = about 4.1 PLN

⁵ The Polish Law makes a distinction between buildings (*budynki*) such as residential houses, offices, factories and other agricultural structures (*budowle*). The Construction Law specifies that “*budowla*” (architectural structure) is an every object which is not a building. This distinction is very difficult to be reflected in English, but as we see later it is significant from the point of view of the property tax construction. Other agricultural structures include for examples airports, roads, bridges, antenna masts, sewage treatment plants, waste disposal plants (Etel, Ruśkowski 1996).

In some cases it is not obvious which category a property belongs to. A typical example of the problem is related to housing flats that are also used for commercial activity (for example, the owner of the flat is also the owner of a small firm and his/her economic activity is being performed in the same apartment). The legal interpretation stipulates that the rate for commercial use of buildings is paid only if the property is used exclusively for commercial activities. If the living room of the apartment is used, for example, for some part of the day as an office of the SME, the tax should still be calculated on the basis of a housing property rather than for a commercial property (Etel and Popławski 2001).

Article 7 of the Law on Local Taxes specifies several tax exemptions such as: properties used by local administration, by foreign embassies and properties having the status of historical monuments, schools, universities, or sport venues.

Local government administration is responsible for both property tax collection and administration. In the case of individual taxpayers, the administration is obliged to deliver information on the amount to be paid (i.e. the homeowner who has not received such information from the town hall does not need to pay). In the case of legal entities, the tax payer is obliged to calculate and pay its tax regardless of whether such notification has been delivered.

11.2.1.2.2 Agriculture tax

The tax on agriculture is not formally treated as a local tax (it is regulated in a separate Law) although it provides revenue for municipal governments and the local council has similar discretion to establish the rate. In that case, the rate is based on the average market price of rye, the size of the farm and the quality of the soil, but the local council may reduce the tax rate. The tax is typically paid by the owner of the farm or by the farmer who rents the farm. The farm is defined as an area used as arable land, pond or buildings used for farming activity and, if the total area is greater than 1 hectare, according to the tax regulations, it does not matter whether the area is actually cultivated.

The tax is paid per hectare, but the area is additionally weighted by the following factors:

- the quality of soil;
- the economic and climate environment for farming activities. In practice, this factor is reflected by the location in one of four major tax regions (Brzeszczyńska and Kazimierski 1997).

The rate from one (weighted) hectare is equal to the average market price of 250 kg of rye during the first three quarters of the preceding year.

There are several tax exemptions which are decided by law, such as:

- farms on soil of the lowest quality (V and VI classes),
- areas purchased by farmers to enlarge existing or create new farms. The tax exemption applies for 5 years and only to farms which are not larger than 100 ha.

- farms on which production has been stopped, but for no longer than 3 years.

The Law also specifies some tax reductions. There are several categories of taxpayers who are entitled to reductions, such as:

- for 15 years, a reduction related to investments in a farm's modernisation (the value of the reduction is 25 per cent of the value of an investment);
- a 60 per cent reduction for farms belonging to soldiers who serve their compulsory military service;
- 30 per cent or 60 per cent reduction (depending on the quality of the soil) for farms in mountain areas. The mountain village is defined as a village in which more than 50 per cent of the agricultural area is located 350 metres or more above sea level;
- reductions granted in case of natural disasters.

11.2.1.2.3 Tax on vehicles

The tax is paid to the municipal government of where the taxpayer lives or on where the company (which is the owner of the vehicle) is registered. Until 1998 it was a significant source of local revenues, since the tax was levied on every motor vehicle. But since 1998 the tax base has been limited. Presently, the tax is levied on owners of lorries with a load capacity of over 2 tons, tractors, buses and trailers with a load capacity over 5 tons.

For tractors the tax rate depends on the capacity of the engine; for lorries and trailers it depends on the load capacity and for buses, it depends on the number of seats. There are some tax exemptions included in the Act on Local Fees and Taxes, for example vehicles owned by foreign Embassies in Poland are exempt from the tax.

11.2.1.2.4 Other local taxes

The remaining local taxes have only very limited importance for municipal budgets and they will not be discussed in detail in this paper. The forest tax is based on principles very similar to the tax on agriculture and the base for the tax rate is the market price of a cubic metre of wood.

The tax on dogs generates very little revenue and is not imposed at all by some local governments. The rates of the remaining taxes which yield revenues for local governments (the tax on civil law activities, the tax on inheritances and donations and the tax on small businesses) are set at the central level and the municipal council cannot change them. The only discretion local authorities have in the administration of these taxes is in granting individual exemptions or reductions.

The tax on civil law activities is levied upon civil code transactions, such as, for example, the sale of motor vehicles or of housing properties. The tax on small businesses is a flat rate income tax levied on some small enterprises, such as taxi drivers, hairdressers etc.

11.2.2 Revenues from Local Taxes

As illustrated in Table 2, revenues from own sources constitute a significant, but over the last decade, a decreasing share of municipal revenues. The reasons for this diminishing role are twofold:

- the scope of local tasks has gradually been increasing. The most important, but not the only change, pertains to the assumption of responsibility for primary schools (a process which began in 1991 and was completed in 1996). New functions were usually financed through new components of the general purpose grant, or sometimes through an increase in the local share of central taxes, but almost never by adding new sources to the list of local own revenues;
- the base of local taxes has sometimes been weakened by central legislation. The most salient example of such a change was the change in the tax on vehicles, as discussed in section 2.1.2.3. The tax on private cars and motorcycles was abolished as a local tax and replaced by an increase in the excise tax on petrol. The loss of local revenues was compensated by the new component of the general purpose grant.

Table 2
Changes in the structure of municipal revenues 1992 – 2001

	1992	1995	1998	2000	2001
Revenues from own sources	47.3	40.1	33.5	33.2	33.0
Including:					
- property tax	16.4	14.1	11.4	11.8	13.9
- other local taxes	9.7	7.6	3.9	4.1	4.4
Transferred shares of central taxes	22.2	23.1	24.7	16.5	15.8
General purpose grants	11.7	15.2	25.4	32.8	35.0
Specific grants	18.8	21.6	14.3	17.6	14.7
Grants from off-budget funds	-	1.0	2.1	1.3	1.6

As shown in table 3, the local tax base of small rural governments is usually weaker, while in mid-size towns and cities, the largest proportion of total budgets comes from own revenues.

Table 3
The structure of municipal revenues in 2001

	Cities of County Status	Other Cities	Mixed (Urban and Rural) Govts.	Rural Local Govts.
Revenues from own sources	29.8	42.6	34.2	28.4
Including:				
- property tax	12.6	15.4	16.8	12.7
- other local taxes	2.6	5.0	5.2	6.1
Transferred shares of central taxes	17.2	21.9	13.3	8.9
General purpose grants	33.1	21.8	38.4	48.3
Specific grants	19.3	12.7	11.4	11.1
Grants from off-budget funds	0.6	1.0	2.7	3.3

The composition of local tax revenues is presented in table 4. As shown, the property tax is the only important source of revenue. The tax on agriculture brings significant revenues, but only in rural areas. All remaining local taxes provide insignificant revenues for local budgets, usually below 1 per cent of the total. For this reason, the property tax has been selected for a more detailed presentation in the following section.

Table 4
Revenues from local taxes as per cent of total municipal revenues (2001)

	All Municipal Governments	Cities of County Status	Other Cities	Mixed (Urban-Rural) Govts.	Rural Local Govts.
Property tax	13.95	12.59	15.35	16.82	12.74
Tax on agriculture	1.30	0.04	0.10	2.39	3.77
Tax on vehicles	0.69	0.58	0.84	0.82	0.63
Forest tax	0.18	0.00	0.01	0.35	0.51
Tax on civil law activities	1.44	1.22	2.84	1.04	0.78
Tax on dogs	0.02	0.02	0.04	0.03	0.01
Tax on inheritances and donations	0.30	0.32	0.54	0.19	0.13
Tax on small businesses	0.43	0.43	0.62	0.42	0.25

11.2.2.1 *The revenues from the property tax*

Compared to most other European countries, revenues from the Polish property tax constitute a significant proportion of GDP (close to 1 per cent). The variation is illustrated in Figure 2. Although the share is considerably lower than in the United Kingdom (especially if we include revenues from the non-domestic rate, which is not a local government tax), France or Spain, it is much higher than in most other European countries. For example, it is more than twice as large as in the Czech Republic and about three times larger than in Hungary. More precise information on the revenues from Polish property tax as against GDP is provided in table 5.

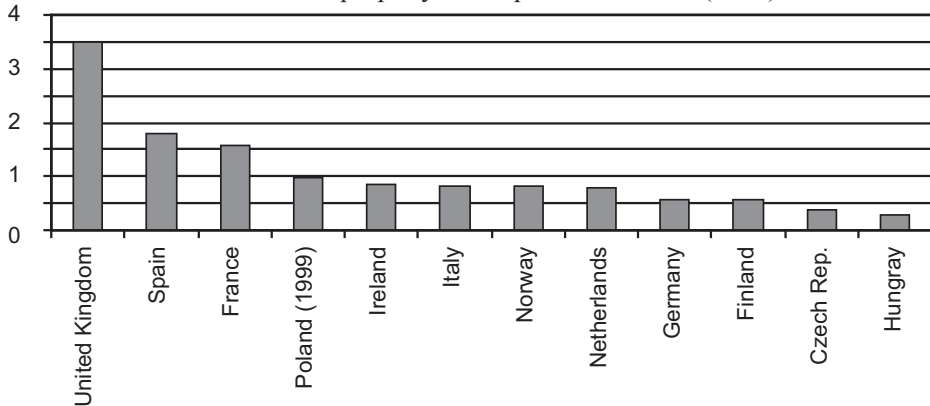
Table 5
The property tax as a share of GDP in Poland

1992	1993	1994	1995	1996	1997	1998	1999	2000
0.92	0.92	0.94	0.92	0.91	0.94	0.95	0.97	0.97

As mentioned in the previous section, revenues from the property tax provide a significant part of Polish municipal budgets. In 2000 the property tax brought 6.6 billion Polish zloty (approximately 1.9 billion EURO) and in 1991 8.5 billion Polish zloty (approximately 2.4 billion EURO). In 2001 it represented

13.9 per cent of all municipal revenues or over 40 per cent of revenues from own sources. More precise information is provided in Table 6.

Figure 2
Revenues from property tax as per cent of GDP (1994)



Source: Limitations of local taxation..., 1998.

note: in UK the revenues from non-domestic property tax has also been taken into account (the non-domestic property tax is currently not a part of local council tax in UK)

The importance of the property tax is greatest for medium-sized cities, while much lower in rural communities, especially in the smallest (see table 7). The relatively small significance of the property tax in the budgets of the largest cities (cities of county status) is a result of the domination of state grants in county (powiat) revenues (see the introductory section of this paper).

Table 6
Revenues from the property tax in Poland

	Revenues in billion PLN	As a share of total revenues	As a share of revenues from own sources
1991	0.766	15.3%	33.6%
1992	1.054	16.4%	34.6%
1993	1.428	14.8%	31.8%
1994	1.988	13.4%	33.3%
1995	2.827	14.1%	35.3%
1996	3.528	11.4%	32.8%
1997	4.427	11.2%	31.8%
1998	5.233	11.4%	33.9%
1999	5.944	11.5%	35.0%
2000	6.644	11.8%	35.5%
2001	8.505	13.9%	42.1%

Table 7
The role of the property tax in budget revenues of rural
and urban municipalities (2001)

		Share in total revenues	Share in revenues from own sources
Rural communities	Below 5.000 citizens	10.0%	35.9%
	Over 5.000 citizens	12.1%	43.7%
Mixed(urban-rural) communities	Below 10.000 citizens	12.6%	43.8%
	Over 10.000 citizens	17.0%	49.7%
Cities	Below 20.000 citizens	17.9%	49.8%
	20-50.000 citizens	19.4%	50.7%
	Over 50.000 citizens	20.1%	50.7%
Cities of county status		12.6%	43.6%

Which categories of properties contribute most significantly to budget revenues? Unfortunately, we do not have precise information on revenues from housing properties, plots used for commercial activities and for commercial buildings. But we can make some estimates from data on revenues from legal entities and physical persons (individuals). This is not precise information, since many small firms operate as physical persons, without legal entity status. But at the risk of over-simplification we may say that revenues from legal entities represent property tax paid on commercial activity, while revenues from physical persons represent property tax paid on housing and empty plots of lands allocated for housing purposes. As we see in table 8, the dominant (although gradually decreasing) share of revenues comes from legal entities (i.e. from properties used for commercial activities).

Table 8
Revenues from property tax paid by physical persons and legal entities

	1996	1998	2000
From individual tax-payers	16,2%	20,2%	24,0%
From legal entities	83,8%	79,8%	76,0%

Revenues from legal entities are especially important in big cities, while in small communities, revenues from individual tax payers play a more significant role (table 9).

Table 9
Revenues from physical persons and legal entities – variation by the
size of local government (2000)

	Below 5,000	5-10,000	10-20,000	20-50,000	50-100,000	Over 100,000
From individual tax-payers	30%	34%	32%	24%	20%	16%
From legal entities	70%	66%	68%	76%	80%	84%

11.2.3 Local Tax Policies

In general, there are three different ways in which local governments may express their independence in local tax policy:

- they can set local tax rates, within upper limits established by central legislation;
- they can grant tax exemptions to certain categories of tax payers, other than those listed in central legislation;
- the local mayor can grant tax exemptions, individual releases or reductions to individual tax payers.

In practice, most of the local governments levy taxes close to maximum rates, but in some cases, rate reductions are quite significant. As illustrated by Table 10, in the case of most local taxes, actual revenues are more than 10 per cent below what they would be if no rate reductions or tax exemptions were granted by local governments.

Table 10
Consequences of local tax policies for local budget revenues – rate reductions and tax exemptions as a per cent of potential revenues collected if maximum rates applied)

	Results of rate reductions	Results of exemptions, releases, and reductions
Property tax	8.7%	5.1%
Tax on agriculture	14.7%	4.6%
Forest tax	–	0.8%
Tax on vehicles	7.8%	5.1%
Tax on small businesses	–	1.3%
Tax on legacies and donations	–	6.7%
Tax on dogs	9.8%	7.8%
Tax on civil law activities	–	0.2%

What is the significance of local tax policies? The property tax is the only local tax which might be important for businesses' location decisions. It also has political significance, since the rate of the tax on housing properties is often a hot issue in local communities. For this reason, property tax policy is more carefully analysed in the following section. In some rural local governments, the debate on the tax rate for agriculture is also of some political importance.

11.2.3.1 Local tax policies on the property tax

As illustrated in Table 11, since 1990, actual annual property tax revenues have been more than 10 per cent lower than would have been possible if no rate reductions or tax exemptions had been granted by local councils and executive mayors.

Table 11

Results of reductions and exemptions from property tax as per cent of maximum available revenues

	1992	1993	1994	1995	1996	1997	1998	1999	2001
Overall reductions	16%	24%	29%	15%	16%	16%	16%	15%	14%
Results of rate reductions				10%	11%	10%	10%	10%	9%
Results of tax exemptions and tax releases				5%	5%	6%	6%	5%	5%

Results of reductions in tax rates are usually much more important than tax exemptions and individually granted tax releases.

There are important differences between tax policies implemented in small rural communities and in big cities. In general, tax rates are usually much lower in small municipalities. In big cities tax rates are usually very close to maximum and the main instrument of property tax policy is related to tax exemptions and individual tax releases. These differences are illustrated in table 12.

Table 12

Results of reductions, exemptions and individual releases from property tax as per cent of maximum available revenues – differences between small and large municipalities (2001)

	<5,000 citizens	5-10,000 citizens	10-20,000 citizens	20-50,000 citizens	Over 50,000 citizens	Cities of county status
Overall reductions	20%	21%	19%	14%	8%	8%
Results of rate reductions	15%	16%	13%	9%	4%	3%
Results of tax exemptions and tax releases	5%	5%	6%	5%	4%	5%

We know also that in small local governments, property tax reductions are more frequently offered to individual taxpayers, while in the large cities tax policy instruments are more often focused on legal entities and their commercial activity.

11.2.3.2 Local tax policies – typology

From the political economy point of view, one may distinguish between two types of local taxes in Poland:

- taxes which are paid by most local voters (the property tax on housing, or in many rural governments, the agriculture tax);
- taxes levied on local businesses (the property tax on buildings and plots used for business activity and the tax on lorries and buses).

Taking into account this distinction, tax policies might be classified as in Figure 3. If local taxes on businesses are high, but taxes on voters are low, such a policy

may be called populist, since its rationale is mainly to seek for the support of voters. Sometimes, however, the opposite is true – taxes affecting most of the voters are relatively high, while taxes on business are kept at a low level. The rationale for such a policy is to stimulate the local economy and I suggest calling this type “pro-business”.

As mentioned above, lower local tax rates are often found in small local governments. Interestingly, however, while a populist policy is more typical for small, rural villages, a pro-business type can more often be identified in mid-size urban governments⁶. This observation is based on research conducted in 1995, but more recent analysis (Pszczola 2002) seems to confirm the most important conclusions.

Figure 3
Typology of local tax policies.

		Taxes related to business activities	
		low	high
Taxes affecting most voters	low	conservative*	populist
	high	pro-business	fiscal

* *Conservative in terms of fiscal policy. The alternative label might be “liberal”, but because of different meanings of this label I suggest to use the term “conservative”.*

11.3 Local Taxes in Poland – An Evaluation

The future of the most important local tax – the property tax – is a subject of debate. There are two important lines of criticism of the present property tax system in Poland. One is that the tax, in its present form does not raise sufficient revenues, especially in big cities. The second line of criticism focuses on the equity of the tax – it is considered unfair that the tax depends on the type and area of property rather than on its value. Why should the poor owner of a cottage located in the countryside far from any urban centre, pay the same tax as the owner of a residence of similar size but of many times more value in the centre of Warsaw?

The most common conclusion of both lines of criticism calls for a reform introducing an *ad valorem* property tax. This advice has also been typical for USAID or World Bank advisors over the last decade. The draft of new regulations of the *ad valorem* property tax was prepared in the Ministry of Finance and approved by the Government in 1995 (Nowecki 1996). But negative public reaction has stopped preparation of the reform for some time. Most are afraid that the new tax would significantly increase the tax burden. As a result, in a 2000 survey by the Centre for Public Opinion Research (CBOS), 31 per cent of the respondents believed the new property tax would be less fair than the present regulation, while only 27 per cent expressed a positive opinion of the fairness of the new tax. 29 per cent of the

⁶ For a most extensive discussion of typology of local tax policies see: Swianiewicz (1996a, 1996b).

respondents expected that they would be negatively affected by the reform, while only 4 per cent expected a positive change (Kasperek 2002).

Both negative public reaction and technical difficulties slowed the pace of the reform significantly. Although an *ad valorem* property tax remains an official long-term goal of the Polish government, nobody expects it to be introduced quickly and the date of the reform remains unknown. 2006 is mentioned in some discussions, but this date is not official and far from certain. Introduction of the new tax is a long and costly process (it requires the valuation of many thousands of individual properties).

An alternative solution might be adopted in the short- or medium-term perspective. It calls for variation of the maximum rates depending on the location of properties. For example, different maximum rates would apply for small rural villages and for large cities, as well as different rates for the city centre and its suburbs). The first step towards such a change has been made in a recent amendment which allows local government to differentiate the actual tax rate depending on the location of property in an individual zone of the city. However, this first step is not sufficient, since maximum rates remain at the same level for the whole country. A similar solution to that discussed here has been applied in the Czech Republic and Slovakia. In Slovakia (see Kling, Niznansky, Pilat 2002) the maximum rate per square metre is dependent on the size of the settlement unit. The basic rate is multiplied by:

- 1.0 in villages below 1,000 citizens,
- 1.4 in local governments with 1 – 6,000 citizens,
- 1.6 in local governments with 6 – 10,000 citizens,
- 2.0 in local governments with 10 – 25,000 citizens,
- 2.5 in local governments with over 25,000 citizens,
- 3.5 in district capitals or in spa resorts,
- 4.0 in regional capitals,
- 4.5 in Bratislava.

It should be remembered, however, that in both the Czech Republic and Slovakia the overall capacity of the property tax is several times lower than in Poland. This suggested, alternative solution might combine the relatively high overall fiscal capacity of the present property tax in Poland with the variation of tax rates adopted in the Czech and Slovak Republics.

How may the Polish local tax system be assessed in the light of criteria formulated in the first section of this paper?

- *The allocation of tax yields is not proportional to the allocation of functions* – this negative assessment applies primarily to the county and regional governments, which do not have own tax revenues. The situation is much better on a municipal level – the ratio of revenues from own sources to total budget

revenues is somewhat lower than in some West-European countries (e.g. Denmark or Sweden), but similar or even higher than in most of the others (e.g. the United Kingdom, Netherlands or Spain). The negative point, however, is the gradually diminishing role of revenues from own sources in municipal budgets – it was around 47 per cent of total budget revenues in 1992, but 40 per cent in 1995 and only 33 per cent in 2001.

- *Uneven geographical distribution of the tax base* – there are significant differences in the distribution of the local tax base. In 2001, own revenues constituted well over 40 per cent of the budgets in cities, but just over 20 per cent in rural areas. If we take into account the inequalities among regions – the variation is even larger. But this inequality is probably inevitable regardless of the selection of local taxes.
- *The system of local taxes is fragmented and complicated*. There are many small local fees and taxes (such as the tax on dogs) which do not raise significant revenues but are costly to collect and unnecessarily complicate the system.
- *The taxes are well defined in geographical space* – Polish local taxes do not produce major problems in this respect. Taking tax sharing into account as well, there are problems with defining the local share of corporate tax in the case of companies registered in one municipality but operating branches in various locations. A partial answer to this problem is provided by a regulation which suggests an allocation of revenues to municipalities proportional to the number of employees working in each of the local branches, but this solution is far from perfect.
- *Visibility of the tax* – most Polish local taxes are visible.
- *The low elasticity of tax yields against inflation* – the property tax, the tax on vehicles and small local fees and taxes are not flexible with respect to inflation. Perhaps the only exception is a tax on agriculture which is related to the market price of crops.
- *The tax base is relatively immobile* – the property tax definitely corresponds to this principle and it is by far the most important local own revenue.

Recommended changes might go in two directions:

- (i) simplification of the system and,
- (ii) strengthening of the local tax base (perhaps at the expense of tax sharing), first at the county and regional levels, but also at the municipal level.

The former recommendation might lead to dropping the tax on dogs and perhaps some other minor local fees and taxes.

In my opinion, the implementation of the latter recommendation suggests:

- Transforming the present municipal shares in central income taxes into local surcharges to the income tax. Implementation of such a reform might produce outcomes similar to those experienced by the Scandinavian countries; or,
- Reforming the property tax (together, perhaps, with an introduction of county and regional parts of the tax). As discussed in Section 2 of this paper, reform

could, but need not necessarily, include the change to an *ad valorem* property tax system.

It is necessary to stress, however, that the overall tax burden on citizens and enterprises should not increase as a result of the reform. The reform of local taxes can never be discussed without considering the broader implications of changing the public finance system in general. If the overall burden of local taxes increases, it has to be compensated for by the reduction of some central taxes. Such a change would not imply any additional burden on the central government since strengthening the local tax base would allow a reduction of state transfers, which should focus on the equalisation principle, rather than on a general vertical equalisation (see next section).

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12. Intergovernmental Fiscal Relations in the Baltic Municipalities

Viktor Trasberg

12.1 Introduction

The Baltic countries'¹ local governments are functioning in a permanently changing environment. When they were part of the former Soviet Union, local governments were subordinate to the centralised administrative and bureaucratic structure. Their role was to implement state plans for economic and social development in their territory. Although residents were formally elected to local councils, local governments, in the true sense of the term, did not exist in terms of having any significant powers. After the Baltic countries regained their independence, the local administrative units followed the path to democratisation and became actual representatives of the local residents.

After excessive centralisation, there emerged a clear need to decentralise and devolve a number of expenditure functions and revenue sources to lower levels of sub-government. The democratisation process logically led to an increase in the sub-national governments' role, particularly in fiscal activities. The delegation of fiscal responsibilities to sub-national levels of government is likely to increase the amount and quality of services delivered, reduce the costs associated with the provision of public goods and services and enlarge municipalities' fiscal autonomy.

Often the Scandinavian model of municipalities with their large variety of functions and wide fiscal autonomy is considered the ideal model for the Baltic countries also. In contrast to the Nordic countries, almost all revenue sources in the Baltic local governments are still controlled by the central governments. Most authors consider that this factor is significant in limiting a municipality's fiscal autonomy and financial capability (Chandler, Reiljan, Vanags). In addition, there is a concern that municipalities' fiscal capacity is not adequate to act in accordance with the functions stipulated by laws. Often sub-governments' revenues from their own taxes and user-charges are insufficient to finance their expenditures at an efficient level.

In comparison with their European Union neighbours, the Baltic countries sub-national governments under-provide many public services. As soon-to-become members of the European Union, the Baltic countries have to follow the ideas of the European Charter of Local Self-Government. Its article 9 states clearly: "Local authorities' financial resources shall be commensurate with the responsibilities pro-

1 Estonia, Latvia and Lithuania

vided for by the constitution and the law” (European Charter of Self-Governments).

Baltic municipalities’ fiscal capacity varies regionally. Disparities in municipalities’ fiscal situations are correlated with unbalanced regional growth, social degradation in the low-income regions and growing disparities in the access to quality education and healthcare.

Considering the above-mentioned problems, this paper focuses on describing the current situation of local governments in Baltic countries. The main focus is to consider local municipalities’ fiscal autonomy conditions.

12.2 Baltic States administrative division and size

During the period after regaining their independence in the early 1990s, the main emphasis in Estonia and Latvia was put on developing new administrative systems that would resemble the historical situation before World War II. The mixture of nostalgia and economic naïveté led to the (re)establishment of numerous low populated and fiscally weak municipalities. In contrast to those countries, in Lithuania the number of municipalities remained limited and their role has been seen mainly as fulfilling administrative tasks handed out by the central government. Perhaps, local municipalities in Lithuania are still too large in terms of population, thereby limiting their functioning as democratic representatives of the residents living in their jurisdictions.

There are a number of sub-government changes that take place due to continuous administrative territorial reforms. Table 1 identifies the existing sub-national administrative divisions in the Baltic countries.

Table 1
Administrative Division of the Baltic Countries

	Estonia (1.01.2002)	Latvia (31.03.2000)	Lithuania (1.01.2001)
Rural authorities	205	486	48
Towns	42	72*	12
Total number of local governments	247	558	60
Regional government (counties, rayons)	15	26	10

Source: *Statistical Offices on Baltic Countries*

* includes so-named amalgamated municipalities

As the table shows, there are a larger number of municipalities in Estonia and Latvia compared to Lithuania. Estonia and Latvia, instead of using the old Soviet administrative system with large rayons and towns, quickly (re)established an impressive number of local municipalities. In Lithuania, the formation of new municipalities has been slower and the number of sub-governments is growing gradually.

Rural authorities and town governments in the Baltic countries are local administrative bodies to which residents elect representatives and which fulfil the functions delegated to them by laws.

Regional (county) government representatives in Estonia and Lithuania are appointed by the central governments and approved by local municipalities' elected bodies within their jurisdictions. County governments carry out mainly general regional tasks and implement state policy in the spheres of social maintenance, education, culture and health. In Latvia, elected representatives of local authorities form regional governments and their functions are wider than in other Baltic countries.

In Table 2 we see that sub-national governments are distributed by their size and proportion of the whole population in municipalities within the population range.

In Estonia and Latvia, the majority of municipalities are relatively small in terms of population. In these countries 86 per cent and 91 per cent of municipalities respectively have less than 5,000 inhabitants. Lithuanian municipalities are clearly larger. Thus, only 4 per cent of communities have a population less than 10 thousand inhabitants. In Lithuania, the number of municipalities still remains limited and will increase to 93 in 2003 (Fiscal Design across Levels of Government: Lithuania). A larger number of low population municipalities increase the need for grant-in-aid from central government in order to maintain a minimum revenue level. However, municipalities that are larger by population and territory, face the risk of discrepancies between the interests of the local population and elected sub-governments'.

Another apparent difference in Lithuania is that in Estonia and Latvia the population is concentrated in the large (capital) cities. During the economic and social restructuring, those large centres have developed faster than other regions. Larger towns' inhabitants have higher incomes, which is the basis for a prosperous municipal economy. In addition, high incomes attract new settlers from poorer regions, which weaken the low-income areas even more. As a result, the disparities on a revenue basis between capital areas and the remainder of the country, particularly low-density rural municipalities, became extremely wide (Raus).

Table 2
Baltic Countries Municipalities' Composition by Population Size

Number of inhabitants	Estonia (1.1.2002)		Latvia (31.03.2000)		Lithuania (1.1.2001)	
	Municipalities proportion by population size	Population proportion within population range	Municipalities proportion by population size	Population proportion within population range	Municipalities proportion by population size	Number of inhabitants
Less 999	13%	2%	33%	6%	0	0
1,000-1,999	41%	11%	39%	13%	0	0
2,000-4,999	32%	18%	19%	13%	2%	0.1%
5,000-9 999	9%	11%	4%	7%	2%	0.2%
10,000-49,999	4%	17%	3%	15%	63%	34%
50,000-99,999	0.4%	5%	1%	9%	25%	26%
More 100,000	1.2%	36%	0.4%	37%	8%	40%
Capital city and population	Tallinn (400,800)		Riga (764,300)		Vilnius (589,200)	
Total population	1,372,100		2,377,400		3,692,600	

Source: Statistical Offices in relevant countries and author's calculations

12.3 Local governments' fiscal situation in general

A decade of reforms in Baltic countries has changed local governments significantly. Municipalities became democratic and modern representatives of local interests. Nevertheless, fiscal relations between the central and local authorities are still far from optimal. General problems are not unique to the Baltic municipalities, but correspond to the situation in many transition countries (Bird). Here we emphasise some general weaknesses of Baltic municipalities' current fiscal situations.

First, there is often a clear mismatch between municipalities' functions and their fiscal resources to meet those tasks. Central authorities tend to delegate more new functions to local governments. Also, municipalities themselves are interested in having more functions because they are expecting to play an increased role and have more autonomy in the government sector. However, very often the increased number of tasks does not correspond to the available fiscal resources for local governments. Therefore, the delegation of functions to municipalities reflects not only the central governments willingness to enlarge municipalities' tasks and autonomy, but is often motivated by decreasing central government responsibilities towards the lower level of governments (Sootla). Many low populated municipalities' in Latvia and Estonia have inadequate tax bases to properly finance their new functions. As a result, the number of functions undertaken by the local municipalities has increased in all three countries, but municipalities' fiscal situations have become more unbalanced.

In Table 3, Baltic municipalities' expenditure level, structure and its share of the total consolidated budget is provided. The budget structures in general indicate municipalities' tasks and obligations, imposed on them by law. The largest expenditure in all three countries is for education, which ranges between 42 per cent in Latvia to 57 per cent in Lithuania municipalities' budgets' expenditures. All other expenditures, such as social security and general public services, consist of a much smaller proportion of the municipalities' total spending. Municipalities' educational expenditures in Estonia grew significantly in the year 2001, when expenditures for schoolteacher's salaries were transferred from the central budget to local budgets. Baltic municipalities' expenditures in 2001 were about one-fifth of the general governments' operating cost.

Table 3
Baltic Countries Local Governments' (LG) Expenditures (millions)
and Structure, 2001

	Estonia		Latvia		Lithuania (2000)	
	LG expenditure, EEK	LG expenditure structure	LG expenditure, LVL	LG expenditure structure	LG expenditure, LTL	LG expenditure structure
General public services	884	9%	55.312	11%	155.231	5%
Defence		-	115	0.0%		0.0%
Public order and safety	95	1%	6.231	1%	25.852	0.8%
Education	4.383	46%	222.039	42%	1.871.815	57%
Health	136	1%	7.073	1.3%	13.266	0.4%
Social security & welfare	895	9%	38.036	7%	478.300	15%
Housing	-	n/a	77.238	15%	231.892	7%
Recreational, cultural & religious affair	1.001	10%	35.980	7%	149.168	5%
Fuel & services	-	n/a	936	0.2%	80.614	3%
Agriculture and forestry	-	n/a	1.571	0.3%	49	0.0%
Mining, manufacturing & construction	-	-	86	0.0%	-	0.0%
Transportation	-	n/a	25.188	5%	74.341	2%
Other economic affairs	2.153	23%	14.597	3%	1.045	0.0%
Other functions	17	0.18%	43.083	8%	184.313	6%
Total	9.566	100%	527.485	100%	3.265.886	100.0%

Source: Estonian Ministry of Finance; Monthly Bulletin of Latvian Statistics, 2(93)/2001, p. 42-43; Lithuanian Ministry of Finance

** not included extra budgetary funds*

General public services comprise a larger proportion of local government expenditures in Estonia and Latvia than in Lithuania. The reason for this is that this expenditure also includes administrative costs, which is proportionally higher in smaller population sub-governments such as in Estonia and Latvia. Therefore, the decrease in expenditures for an administrative purpose provides a strong argument in those countries for municipal consolidation.

Second, municipalities are limited in their autonomy to raise taxes or other own revenues. Some authors consider the lack of tax autonomy the most significant shortcoming of intergovernmental fiscal relations (Reiljan). Principally, the need to increase the Baltic municipalities' tax autonomy is adequate, but requires certain preconditions. The revenue base of many municipalities is often so limited that even an increase in tax autonomy does not allow them to fulfil their statutory tasks. In addition, there is a risk that differences in municipalities' tax bases will lead to increasing disparities among them in public goods provision.

Third, in the situation where local governments' tasks and responsibilities are not very clearly defined, municipalities' tasks vary to a great extent between them. The provision of public goods depends heavily on municipalities' fiscal abilities. In addition, the question "who should do what?" generates permanent tension between local and central governments.

Fourth, sub-governments' fiscal abilities differ significantly. Usually such differences are seen as regional disparities. Disparities may lead to municipalities' competition and this problem may cause Tiebout economy-like movements. He argued that individuals choose to live in the local community where the provision of local public goods and tax levels best satisfies their preferences. In the Baltic countries, this practice means that population flows with the concentration of economic activities into capital city areas and continuous impoverishment results in rural areas. Another aspect of fiscal differences is related to the abilities to execute statutory functions. Some of the municipalities are ready to carry out more functions and some are not able to cope with their existing functions.

Fifth, sub-governments' financial decision-making processes are often not sufficiently transparent and understandable to local residents. Frequently unwanted outcomes are inefficient expenditure decisions or undertaking expenditures that support minority group interests. In addition, municipalities' elected councils and their local administrators often do not have the required skills and experience to manage fiscal issues in their jurisdiction. Limited fiscal administrative capacity results in taking unreasonable financial risks. In the situation of weak legal regulation, such decisions may cause a fiscal collapse of the local economy or even serious problems to the national economy in general.

However, there is a wide consensus on the pressing need for improving municipalities' fiscal capacity and autonomy in all three Baltic States. Nevertheless, the increase of fiscal autonomy requires certain conditions other than delegating to the municipalities more functions and enhancing their tax establishing authority. Unfortunately, limited progress has been made in all three Baltic countries in recent years to implement a local government reform agenda.

12.4 Municipalities revenue composition

In the following Table (4), data of the revenue level and composition of local municipalities in the Baltic countries is provided. Presented separately are the central and local governments' data and share of local governments in the total consolidated budgets².

Table 4

Overview of Baltic Municipalities' (LG) Revenue Level and Structure (per cent), 2001

	Estonia			Latvia*			Lithuania		
	Revenues	Revenue composition	LG on consolidated budget	Revenues	Revenue composition	LG on consolidated budget	Revenues	Revenue composition	LG on consolidated budget
Tax revenue	4.415	49%	15%	254	55%	17%	2.804	87%	22%
Personal income tax	3.942	43%	56%	204	44%	72%	2.512	78%	100%
Property and land tax	435	5%	100%	46	10%	100%	284	9%	100%
Non-tax revenue	777	9%	23%	19	4%	11%	117	4%	11%
Grants and transfers	3.363	37%	99%	159	35%	n/a	303	9%	73%
Other revenue	503	6%	60%	27	6%	30%	10	0%	26%
Total revenue	9.064	100%	26%	459	100%	25%	3.234	100%	22%
GDP level	95.275	-	-	4.802	-	-	47.958	-	-
LG revenue in GDP, %	9.4%	-	-	9.6%	-	-	6.7%	-	-

Source: Estonian Ministry of Finance; Monthly Bulletin of Latvian Statistics, 2(93)/2001, p. 39; Lithuanian Ministry of Finance and authors calculations

* also includes the regional level

Sub-national governments receive the majority of revenues from different taxes and the largest component of their revenue is from income tax. In Lithuania, the total tax revenue is as high as 87 per cent of total revenues, while in Estonia it is less than half and in Latvia it represents 55 per cent of total municipalities' income.

The main revenue of local governments in Latvia and Estonia is generated from the shared state taxes on personal income. In Latvia 71.5 per cent and in Estonia 56 per cent of total collection of that tax is transferred to municipal budgets. In Lithuania, the personal income tax was, until 2002, collected by local municipalities, but will be shared with central government thereafter.

Other main sources forming revenue are the property tax and the land tax. Only the land tax exists in Estonia, but other Baltic municipalities also receive a

² Consolidated budget includes different type of governments budgets and centrally established social funds

substantial part of their revenue from property taxation. In Estonia, local municipalities have the authority to establish land tax rates within defined limits, which are set by the central government. The tax is also administered by the central government. In Latvia, the property tax rates are set by central authorities, but administered locally. Similarly, in Lithuania, property and land tax rates are set by central authorities, but administered locally.

No local taxes have been established in Latvia. In Estonia, despite the 9 different local taxes, their total of the municipalities' total revenue is insignificant. In reality, such taxes do not play a major role in generating local income because municipalities demonstrate little incentive to collect them. Often the local tax base is extremely limited, local taxes are difficult to administer, tax revenues are hard to forecast and imposing local taxes is unpopular.

Municipalities' non-tax revenues consist of incomes from their economic activities, fees, fines and user charges. These sources cover less than one-tenth of all revenue in Estonia, but less than 5 per cent in Latvia and Lithuania.

In Estonia and Latvia, local municipalities receive a substantial part of their incomes in the form of grants from central government or special equalisation funds. The share of transfers and grants from the central budget in local governments' total revenues is often described as a vertical imbalance or mismatch between municipalities' own revenue and relevant expenditures. This vertical imbalance is highest in Estonia and relatively low in Lithuania. In future years, due to local budget reforms, the share of grants will considerably increase in Lithuanian municipalities' budgets as well.

Grants-in-aid serve to balance the per capita revenue among municipalities and maintain necessary expenditures, but they also increase municipalities' fiscal and political dependency on central authorities. Similar to world practice, the grant transfer scheme is criticised because equalisation adversely affects localities' efforts to collect own (tax) revenues. The limited tax base discourages municipalities' competition to raise their own revenues.

12.5 Grant transfers in the Baltic countries

In everyday practice, most developed countries have implemented at least some supporting mechanisms for sub-national governments, mainly in the form of grant-in aids. Intergovernmental grants are used by central government as a measure to expand services, to equalise municipalities' incomes and make greater use of the central government tax base by sub-national governments.

Theoretically, in a system of multi-levels of government, a balanced budget is not required at each level or unit of government. Revenue at one level of government, for example, can fall short of spending, if the difference is covered with transfers from other levels of governments. This provides the underlying principle for central government to issue grants to local authorities with respect to such services.

Theoretical aspects of grant transfers are extensively discussed in economic literature (Oates). The approach to grant transfer payments vary from “how much money is thrown to incapable municipalities” to “unconditional support of every single community” (Gramlich).

In general, there are economic, political and institutional reasons for grants. One rationale for grant transfers justifies the benefit spill over aspect. The general idea is that not all of the benefits of a local expenditure are captured within the community and therefore the central government provides subsidies, acting as the agent for other communities in carrying out specified tasks. This ensures that outlying communities will receive the spill over benefits and there is consequently greater efficiency.

Another reason for grants consideration is the simple redistribution of wealth. Intergovernmental grants support low-income municipalities because their own revenue base is limited. Supporting low income communities allows for the provision of education, health, public safety and other services at the same level or cost as in the richer communities. The European Charter of Local Self-Government supports this principle: The protection of financially weaker local authorities calls for the institution of financial equalisation procedures, or equivalent measures, which are designed to correct the effects of unequal distribution of potential sources of finance and of the financial burden they must support (European Charter of Self-Governments).

In the Baltic countries, despite the positive impact of transfers to local economies, in many cases the objectives set for use of grant transfers are not achieving the expected results. The fiscal disparities among municipalities still remain high and grants are not motivating municipalities to increase their own revenues. Also, the total amount of grants is limited to guarantee municipalities adequate resources for fulfilling their functions. Therefore the grant systems are permanently under revision and governments introduce different supportive and equalisation mechanisms for municipalities.

Often the regional income approaches to equalisation are hardly considered as part of regional policy programs. In practice, as mentioned by researchers, transfers to local municipalities are a powerful instrument for motivating local economies (Mønnesland). For example, the magnitude of grants allocated to Estonian municipalities exceeds significantly the funds transferred to regions within regional policy.

12.6 Increase of fiscal autonomy

The increase in fiscal autonomy is seen as the ultimate goal of the Baltic municipalities' fiscal development. Theoretically, greater fiscal autonomy of municipalities leads to a greater autonomy (ability) in spending, tax collection, debt management, budget execution and other fiscal activities. As a result, the task of

providing public goods and services and other public sector functions, can be shared efficiently across levels of government.

The municipalities' fiscal autonomy level indices are also called the decentralisation level indicators. The share of local governments' tax revenues in their total revenues, are considered as the tax autonomy level. Vertical imbalance measures the percentage of transfers and grants from the central budget in local governments' total revenues. In other words, how large is the municipalities' need for additional funding other than their own resources. In Table 5, some decentralisation indicators for Baltic municipalities are provided.

Table 5
Decentralisation Indicators in the Baltic Countries, 2001

	Estonia	Latvia	Lithuania
Local governments tax revenue as % of total tax revenue	15%	17%	22%
Tax autonomy	49%	55%	87%
Vertical imbalance	37%	35%	9%

Source: Ministry of Finance Internet websites respectively

Local governments' tax revenue in consolidated tax revenues varies between Baltic municipalities from 15 per cent to 22 per cent. Tax autonomy as an indicator is highest in Lithuania, mainly because the personal income tax is collected entirely by local municipalities. In the Nordic countries, the same ratio is from 21 per cent in Norway to 34 per cent in Sweden (Söderström, p.5). However, in all three Baltic States, most taxes are centrally established and administered, despite some of the taxes being allocated directly to local governments' budgets. Therefore, the share of local taxes in the total tax revenues and tax autonomy ratio only partially indicate the tax autonomy level. In this sense, all Baltic countries' municipalities still suffer from fiscal over-centralisation.

The largest tax revenue in the Baltic countries comes from shared personal income tax. Municipalities in Estonia and Latvia wish to receive a larger percentage of that tax to support local governments. However, such a requirement ignores the situation that the income tax base differs drastically by municipality. The enlargement of tax autonomy will significantly increase revenue disparities between municipalities (Trasberg, 2002).

In Lithuania, the situation where personal income tax was administered by the central government but transferred to local budgets, created problems for efficient tax collection. The national government institutions have shown a weak initiative to improve the tax collection because all revenues received are transferred to local governments. For this reason, in 2002, the state budget will receive approximately 40 per cent of personal income tax revenue and increase respectively the categorical grants to municipalities. Those grants must compensate for the decreased revenues from personal income tax (Chandler).

Increasing fiscal autonomy requires certain conditions. First, the municipalities' functions and sources for their financing should be clearly defined. Second, the decisive aspect for larger fiscal autonomy is the relevant tax base of the municipalities – in Estonia and Latvia that means proceeding with an administrative territorial reform with the main aim of optimising municipalities' population size. Amalgamation of many smaller municipalities to larger units will assure them of a more solid tax base and therefore take advantage of more fiscal autonomy.

12.7 Conclusions

In the Baltic countries, a new administrative system is being developed to establish the foundations for a pluralist and democratic society. The early phase of the democratisation process led to an increased number of sub-national governments and widened rights to municipalities' to decide over activities in their jurisdictions.

At the same time, sub-governments' activities are constrained with their limited budget resources. One of the sources for increased municipalities' budget capabilities is enlargement of their fiscal autonomy. Today, almost all revenue sources for local government are controlled by the central government, which clearly weakens the municipalities' fiscal autonomy. Therefore, the decrease in municipalities' dependency on the central authorities is under discussion in all three Baltic countries.

Increasing fiscal autonomy requires certain conditions. First, municipalities' functions and sources for their financing should be clearly defined. Second, the local government tax base or, more generally, their own revenue level must be adequate to implement the tasks in larger fiscal autonomy conditions. If the municipalities' tax base is not sufficient for fulfilling statutory functions, then any increase in fiscal autonomy might lead to an unwanted increase in revenue disparities among municipalities. Therefore, it is necessary to proceed with reforming municipalities through specifying their functions and responsibilities that optimise their size through their amalgamation.

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13. Vertical Imbalance and Bailout – The Case of Polish Local Government Borrowing

Bartłomiej Gurba

13.1 Introduction

This paper explores the link between the vertical fiscal imbalance and the borrowing of local governments in Poland. The focus of attention is the mechanism of eliciting a bailout from the central government through debt accumulation and the usefulness of borrowing restrictions to prevent such strategies.

Vertical imbalance takes place if expenditures for local goods cannot be covered from local taxes and fees and must be financed with the participation of the central government or by borrowing. The bailout problem means that central government has to use national revenues to pay for obligations of local governments that are in trouble because of a lack of revenue sources. That means a bailout is a form of extortion, a drain on the common pool of funds caused by a vertical imbalance and a result of institutional arrangements of decentralisation.

This paper is motivated by the latest institutional developments in Poland, particularly the decentralisation process and the restrictive borrowing rules, which, in my opinion lead to a situation where bailouts and extorted borrowing take place. Local governments, called *gminas*, experience significant vertical imbalance. The central government transfers amount to about 40 per cent of all *gminas*' total revenues, varying between about 10 to 90 per cent across jurisdictions. While the share of transfers in total *gmina* revenues has basically always been the same, the borrowing restrictions have changed dramatically. Until the decentralisation reform in 1998, there had been only one restriction: repayments of loans could not exceed 15 per cent of the planned revenues. In 1998, the central government decided to introduce borrowing restrictions directly related to the Maastricht criteria, limiting public debt to 3/5 of GDP. After the introduction of this new limit, local governments' debt grew about 35 per cent from 1999 to 2001, and the deficit of all *gminas* increased from a maximum of 0.15 per cent before 1998 to over 0.2 per cent of GDP each year.

The increase in borrowing may be directly related to the degree of vertical imbalance and useless borrowing restrictions. As Ernesto Stein (1999) shows, a high vertical imbalance, combined with discretionary transfers and high borrowing autonomy, may weaken budget constraints and thereby lead to larger government spending. The reason for that is simple: if one's own revenues are low, local governments may over-borrow and elicit grants from the central government. In the case of a high vertical imbalance, the central government may find it difficult not to bailout – this gives space for applying borrowing restrictions.

Local governments seem to issue new debts in order to elicit new grants instead of cutting less important activities, while the central government distributes new grants in order to avoid tax increases or expenditure cuts of local governments and to maintain the possibility of issuing new debt in the future. The borrowing restrictions of 1998, connected to high vertical imbalance, increase the potential for bailout instead of reducing it.

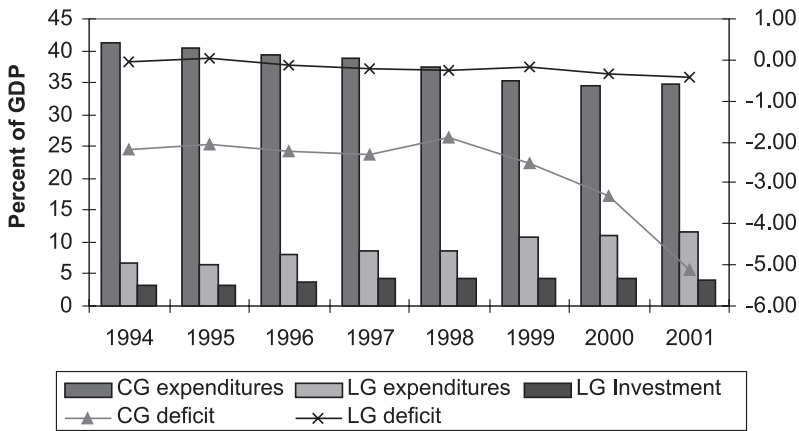
The paper is structured as follows. At first I explore the institutional developments of the decentralisation process including the financial situation of the local governments and the borrowing restrictions imposed. In order to give a full view of the process I briefly present the intermediate and regional levels of governments, although the gminas, as the most important in the system, are of most interest. After that, I present theoretical considerations concerning eliciting bailout in the presence of high vertical imbalance. The model of Carlsen, which I introduce for this purpose, provides a possible explanation of this mechanism. The paper ends with empirical results and conclusions.

13.2 Vertical imbalance and borrowing restrictions – shaping the Polish decentralised system

Political circumstances and developments divide the decentralisation process into two time periods: from 1991 to 1998 and after 1998. The year 1991 is important as the date for introducing self-governments at the local level in about 2500 gminas, whilst the year 1998 is important because of the decentralisation reform on intermediate and regional levels. Until the reform in 1998, 49 Voivodships with Voivods at the head and 254 regions at the intermediate level represented the central administration in the province. Regions were established in July 1990 in order to support the general administrative work of Voivodships, especially with regard to rural Gminas. The basis of the decentralisation reform of 1998 in Poland was the constitution of 1997, which set the conditions of 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 in the same year. These three units were given budgeting and action 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). As a result of the reforms, the share of local government in public sector expenditures increased from 6.62 per cent in 1994 to 11.45 per cent and the share of central government expenditures in relation to GDP decreased by 18.67 per cent. Local governments decide on about 24.5 per cent of expenditures and received 27 per cent of public sector revenues in 2001. Their deficits are 0.43 per cent while the central government's deficit is 5.12 per cent of GDP. Nevertheless,

there is a growth of 90 per cent of local government deficits for the period 1994-2001, mostly observable since the decentralisation reform of 1998. The public debt in 2001 was 42.15 per cent of GDP. Only 1.7 per cent of this is local government debt and 40.45 per cent is the debt of the central government. It is important to note that the growth rate of local debt is about 41 per cent for the years 1999 – 2001. These numbers show the importance of local governments to public finance and their relationship to the central government. They also show an increase of debt and borrowing during the last three years. I would now like to present the legal solutions, which reveal the full character of the decentralised fiscal system in Poland and will help to describe the borrowing behaviour of local governments.

Figure 1
Main indicators of self-government and central government



13.2.1 Decentralisation of expenditures

The most important tier of local governments is the gmina. Even if gmina expenditures and revenues make up only 5 to 6 per cent of GDP, it is the highest amount of all tiers of government. 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 meaning in the public sector than gminas and cities. The cities have to fulfil the tasks both of gminas and powiats and receive corresponding revenues. Thus, there is no need to describe the responsibilities of cities separately – one has simply to add powiats and gminas together. The assignment of responsibilities for every tier of government is a mixture of mandated and powiat or gmina tasks and some tasks are fulfilled according to the subsidiary principle. The subsidiary principle, in which the tasks are shared among 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. The system grants Gminas

responsibility for all public matters of local significance not legally reserved for other units called “own tasks”. In the case of local budget items, local governments are responsible for delivering services, but are subject to some supervision by the central government. Municipal services such as water belong to these services, as do heat and electricity supply, sanitation and the waste disposal system. In the transportation and communication categories, Gminas and cities are responsible for local public transport and local highways. Gminas are responsible for basic public health and nursing services are also supplied by gminas. Other local budget items are primary education, housing, local environmental protection, parks and cemeteries, running libraries, promotion of gminas and co-operation with non-governmental organisations and local communities. In addition, the central government may delegate mandated tasks to local authorities. The mandated tasks which are fulfilled by gminas are mostly in the area of social welfare.

Powiats organise and provide those services that extend beyond gminas’ boundaries. Powiats are responsible for space planning, construction supervision, reducing unemployment, running institutions providing specialised social services for families and childcare. There are a lot of tasks that are assigned according to the subsidiary principle. Examples include responsibilities for secondary schools and schools for disabled and hospitals, which definitely go beyond the basic needs and capabilities of many gminas and were assigned to powiats. Examples of mandated tasks include public order and fire protection.

The assignment of the tasks of voivodships – where a regional development strategy should be created – caused many conflicts between supporters of centralisation and decentralisation of the Polish state. The supporters forced the maintenance of the central government’s control of development strategies. With regard to this, Sejmiks (regional parliaments) were given responsibilities for regional development, but only very limited resources. Instead, voivodships can place so-called “voivodship contracts” and multiyear investment programs with the central government. Apart from the tasks mentioned above, the Law on Voivodships of 1998 included running cultural institutions, universities, counteracting unemployment by utilising Voivodship Employment Centres, the modernisation of rural areas, the preservation of the environment, water management and land improvement.

The provision of services is highly dependent on off-budget departments in jurisdictions that belonged to the central government before decentralisation began and were transferred to the sub-governments. This arrangement resulted in a lack of transparency, since it could not easily be determined who was responsible for what during the transition period. A great deal of discretion was permitted. This situation is mostly due to the fact that many tasks are assigned experimentally to lower levels of governments and there is still demand for an active role of the central government.

13.2.2 The degree of vertical imbalance

In order to define the degree of vertical imbalance, one may look at the dynamics of revenue categories of the whole self-government sector. It shows that the share of locally generated revenues has decreased since 1995, from 51.12 per cent to 40.84 per cent. This process began in 1995. Since that time, the share of locally generated revenues has fallen by one or two percentage points per year. Within this revenue group, shared taxes have decreased by 30.28 per cent, mostly due to the decentralisation reform in 1998. During this period, the subsidies share rose by 10 percentage points in 1996 and again by 10 percentage points in 1998 due to the increase in the number of tiers. This means a rise of 147 per cent in the total period from 1994 to 2001. The grants situation was different. Their share decreased from 21.65 per cent in 1994 to 14.25 per cent in 1998. After the decentralisation reform, this share rose by 2.48 per cent to about 22 per cent.

Each revenue category has a different meaning for each tier of government, depending on the legal regulations set by the central government and the individual situation of the particular jurisdiction. In order to finance their tasks, gminas have three revenue sources: their own revenues (local taxes and shares in central taxes, local fees and revenues from gmina properties), subsidies and grants for tasks fulfilled on the basis of agreements with the central government. Among the main sources of gmina revenues are “their own revenues”. Their share decreased from 54.8 per cent to 52.1 per cent of total revenues. Gminas are the only tier of government that may set rates of some local taxes within the limits set by the central government. To these taxes belongs the property tax, transport tax (liquidated in 1998), and agriculture and forest taxes. Gminas do not set the rates of inheritance tax and tax on business activity but both taxes belong to gmina revenues. The most important of the “local revenues” is the revenue from tax sharing, which is in fact a type of formula-based transfer. In the case of gminas, it amounts to 16 per cent (27.6 per cent and 32.6 per cent for mining gminas since 1998) of PIT revenues collected from gmina inhabitants and to 5 per cent of CIT collected from legal entities based in gminas. To other revenues belong the transfers from the central budget divided into general subsidies, road subsidies and matching grants. Subsidies are set and delivered on a formula basis, while matching grants are discretionary payments made by the central government to a local unit to fulfil a given task. The general subsidy is divided into three parts. The education part (minimum 6.6 per cent of central budget revenues) is distributed among gminas according to the number of pupils and the number of schools. Part is distributed according to the number of citizens living in a particular gmina. There are three grant types: 1) grants for delegated tasks, 2) grants from special purpose funds and 3) matching grants to co-finance self-governments’ own tasks. A modification of these rules was provided in 1998 as the decentralisation reform took place. General subsidies consist of three parts: the basic part, the compensation part, and the education part. The basic subsidies are divided into the equalisation part calculated in a similar manner to before and the remaining part,

which is distributed among all gminas and calculated per capita. The compensation subsidy is established to compensate for revenues from the former tax on means of transportation. The education subsidy depends on schools and pupil numbers as it did previously, but the amounts for all sub-governments have to be equal to a minimum of 12.8 per cent of central government budget revenues. The additional grants categories for gminas are grants from the state budget for the removal of public safety and order tasks and grants for tasks implemented by self-governments on the basis of agreements with central government agencies and other self-governments. New items included grants from foreign donors and grants from the central budget to co-finance foreign grants. In gminas, grants have a share of 11.7 per cent (with a small increase in 2000, when the share was 13.73 per cent) and are the most unimportant revenue source of all.

Powiats and Voivodships cannot set local taxes. Therefore the category local revenues contains only shares in central government taxes. Powiats get a 1 per cent share of PIT, while voivodships get 1.5 per cent of PIT and 0.5 per cent of CIT revenues. Other local revenues are incomes from properties, assets, off budget departments and enterprises, privatisation and interest on liabilities. The revenues from transfers comprise the General Subsidy and grants. Subsidies are very 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. General Subsidy consists of three parts, slightly different from those for gminas. The equalisation part is available for powiats with PIT-share-income per capita under 85 per cent and voivodships with PIT and CIT-share-income per capita under 70 per cent of the highest powiats or voivodship income in 1999, adjusted annually. The third part of the General Subsidy is the Road Subsidy. 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. The grants are delivered according to the same rules as for gminas. 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. The most important of all powiats grants are the grants for delegated tasks. The most important ones for voivodships in 1999 and 2000 are the grants for local revenues.

In summary, the system created in 1998 leaves the powiats and voivodships with little budgetary flexibility, no local taxes and a dependence on central government transfers. Gminas and cities, thanks to the high shares in income taxes and the possibility to set local taxes, receive less discretionary transfers such grants and subsidies than powiats and voivodships. Nevertheless the dependence on central government transfers varies between gminas with the income from local and shared taxes. Differences in the economic activity and the ability to collect such taxes are responsible for this. The variation in vertical imbalance is shown in table 1.

Table 1
Vertical imbalance of Gminas

Vertical imbalance / Grants+Subsidies to revenues/	Mean	Std. Dev.	Min	Max
1995	0.59/0.35/	0.13/0.14/	0.01/0.005/	0.94/0.83/
1996	0.68/0.52/	0.11/0.12/	0.12/0.05/	0.91/0.80/
1997	0.67/0.51/	0.10/0.12/	0.08/0.04/	0.90/0.82/
1998	0.70/0.54/	0.11/0.13/	0.08/0.02/	0.93/0.88/
1999	0.69/0.58/	0.11/0.13/	0.01/0.05/	0.92/0.85/
2000	0.69/0.58/	0.12/0.14/	0.14/0.11/	0.92/0.87/
2001	0.6778824	0.1105871	0.12/0.08/	0.91/0.86/

As we can see, the dependence on all transfers from the central government, shared taxes included, increased on average by about 60 per cent to 70 per cent. There are gminas where transfers are below 10 per cent of revenues and some with over 90 per cent. If we do not consider the transfers from shared taxes, we get a mean of about 10 per cent less. The same is true for the discrepancies between gminas. The questions that seem to be most interesting at this point are: does the degree of vertical imbalance influence the financial situation of local governments? Is there any bailout and is that bailout connected to high vertical imbalance? Do gminas equipped with higher local revenues borrow less in order to maintain an even distribution of taxes?

In order to begin answering these questions, I will first describe the conditions under which local governments have to borrow. The restrictions are also interesting because gminas' debt rose faster after the introduction of restrictions in 1998 and – as we have seen – the expenditures and revenues assignment did not significantly change.

13.2.3 Borrowing restrictions, control of financial matters and budgeting procedures

Since 1990, the restrictions changed immediately after every parliamentary election. The limitations in the years 1990 -1993 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 during the current year. Repayments were not allowed to 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 in 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 the payment of interest, potential guarantees and the repurchase of bonds. 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. This liberal position was introduced during the period of fast economic growth (5 per cent of GDP). The 1998 limitations of borrowing were set in the constitution

and in the Law of Public Finance of 1998. 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 new loans and credits is forbidden. It is important to emphasise that the only restriction on borrowing by the central government is contained in the Constitution.

The Law of Public Finance of 1998 introduced limitations in cases when the consolidated public debt exceeds 50 per cent of GDP. There are three possible situations where this might occur. One situation is where 50-55 per cent of GDP, the central government sets the budget with deficit to revenue ratio not higher than the deficit/revenue ratio of the previous year. This deficit to revenues ratio is the maximum allowed for any local government. Another instance is 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 central government deficit. If the public deficit to GDP ratio exceeds 60 per cent then local government deficits are not allowed. In addition to these limits, there are a number of other limits. Repayment of obligations must not exceed 15 per cent of revenues and 12 per cent in the case where 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. 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 denominated in the Polish currency. The nominal value of the loan has to be set on the day of the transaction. Additional local governments that plan to take long-term credit or issue bonds require an opinion of creditworthiness. Such an opinion, which the jurisdiction is obliged to give to the creditor, is drawn by the Regional Audit Offices (RIO).

In order to ensure that local government units follow the borrowing rules described by laws, they are legally regulated by the Voivods and in financial matters by the Regional Audit Offices (RIO) and Ministry of Finance. There are 17 Voivods, which represent the central government in voivodships. 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 violating the constitution (for example concerning the debt) or continuously breaking of the law by a sub-government, the Polish parliament (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-government bodies. Such a person can also be appointed in the case of poor fulfilment of tasks of local government, for a maximum of two years.

Regional Account Offices (RIO) were created in 1992 as units responsible to the Ministry of Home Affairs. 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. RIOs ensure the realisation of strict debt limitations established by the Polish government.

RIOs also approve all long-term debt resolutions adopted by the jurisdictions. Borrowing increased beyond the limitations may end in restructuring procedures imposed by the RIO and losing autonomy in setting the budget by a jurisdiction. The illegal decision made by local governments can be annulled by RIOs, which dictate the legal solution in this case. The crucial point is that RIOs can control the activity of local governments *ex post* but they cannot influence the decision making process. In order to make total control possible, some rules of reporting are established. In general, the rules present a chain of reporting. The off-budget departments report on revenues, expenditures and debt on a quarterly basis and no later than 10 days after the period expires to the executive boards. The executive boards give the same information quarterly (no later than 25 days after the period expiration) to the RIO and additionally report on deficits, while the RIO also reports quarterly (no later than 40 days after the period expires) to the Ministry of Finance, which is the third central government body directly involved in central-local relations.

The RIO must receive the report on the fourth quarter of a year no later than February 28 and the Ministry of Finance, no later than March 15. After that date, the Ministry can react and adjust the budget plans for the next budget year. The role 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 the interest. Treasury Offices also collect other revenues of local governments such as inheritance taxes, which have to be delivered no later than 14 days after being received by the Treasury Office bank account. The Treasury Office informs local jurisdictions quarterly about the realisation of expected revenues.

Three points have to be emphasised concerning the budgeting procedures. 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 up and that the budget is legally binding only for one year. This solution is good for the central government, but not an optimal practice for local governments because of other functions and a need to implement multi-year investments. Nevertheless, local governments in Poland realise long-term projects including them, each year, in the annual budgets. The second problem is of deficit constraints, which are necessary in the case of an increase of public debt/GDP ratio over 50 per cent. To have 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 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 repayment of former credits.

The third characteristic issue for the Polish system is the position of RIO and their prerogatives in the budgeting process. The fact that the RIO *ex post* opinion on budget proposal is needed to enact the budget by the council allows *ex ante* influence on the most important decisions of the council. If the council does not co-operate and, as a result, the budget is not ready until 31st of March, the RIO may set its own budget. The rule that local governments have to inform the spending ministers (such as the Minister of Education or Public Health) has a co-ordinating effect between local and central governments. The ministers receiving information on the financial plans of local governments before the final enactment of the budget 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 no later than November 30. These solutions increase the field of acting for the central government but, because of a lack of accountability, aggravate the position of local governments.

The borrowing restrictions change together with establishing new tiers of government that are very dependent on central government transfers. The restrictions set the limit on public debt that include local debt and make the implementation of adjustment procedures dependent on passing certain benchmarks. The reason for implementing such heavy restrictions was to impose fiscal discipline. These borrowing conditions were directly related to the Maastricht criteria, which Poland wishes to meet. According to the figure, it is easy to see the relationship 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. Nevertheless, the debt of local governments is increasing. Gminas and cities issued most of the debt, but powiats and voivodships debt growth rates are much higher – about 90 per cent compared to 30 per cent in gminas.

Figure 2
Debt of governments to GDP

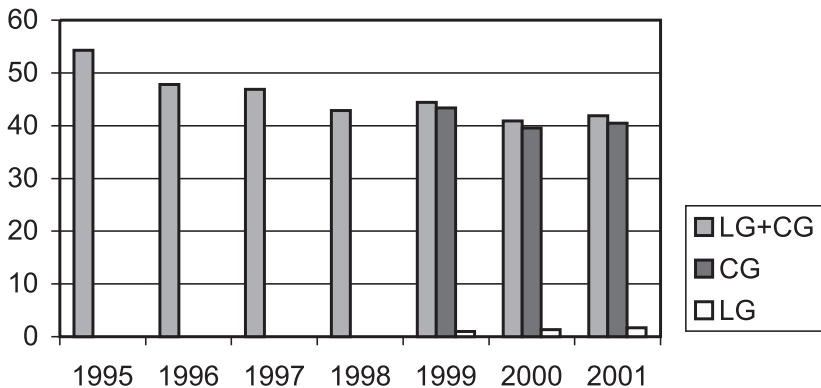
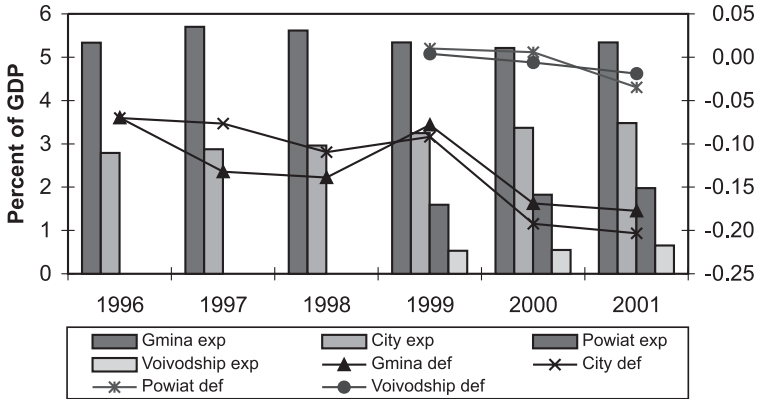


Figure 3
Local government deficits and expenditures



Since 1998, gmina deficits have increased, while the assignment of tasks and revenues has not significantly changed. Only the borrowing restrictions have changed. It is important to ask if there is perhaps a mechanism that motivates governments to borrow and to expect to be bailed out by the central government and that, for some reason, prevents the restrictions from working. To sum up, three questions are most important. Do local governments equipped with higher local revenues and lower vertical imbalances have lower deficits? Do the local governments extort additional grants or do they use their own revenue sources to cover the debt? Do the borrowing restrictions in Poland limit the issuance of excessive debt?

13.3 Theoretical considerations and possible answers

The theory and empirical results that we find in literature give us some hints about how these questions should be answered and what we can expect for the situation in Poland. Let us consider two cases. The first one is an ideal case, based on the fiscal federalism theory, where all programs with local benefits are decentralised and financed with local revenues. In such a system, local governments have no incentive to over-extend the budget and to over-borrow. They prefer the equal distribution of taxes. Issued debt may be paid from their own revenues. In this situation, a high degree of local governments' own revenues allows the central government to commit to the no bailout rule. Such a conclusion is supported by the results presented by von Hagen and Eichengreen (1996) on the relationship between bailout and vertical imbalance. They consider two extreme situations. The first is a situation in which all taxes belong to the central government. In case of regional shocks and resulting financial troubles of local governments, the central government can allow the local government to go bankrupt or bail it out. On the other hand, if taxes are collected by local governments, the central

government has a third option: it can put pressure on the local governments to increase their own revenues and service the debt.

The second case that we observe in reality is a high degree of vertical imbalance, which may be directly related to an increase in borrowing and insufficient borrowing restrictions. Let us first of all consider the situation in which there is a vertical imbalance that is not completely covered by intergovernmental grants, as the central government may wish to put pressure on local governments in order to cut the costs of provided services. In this case, we refer to the problem of unfunded mandates. The vertical imbalance in the case of unfunded mandates will lead to deficits and borrowing, as local governments will try to find sources to close the gap between expenditures and revenues. This gap may be very hard to close and may require higher borrowing, if the costs cannot be easily cut. This will be the case if local governments are responsible for the supply of certain services (health care or education), but the wages or standards are set nationally and local governments may have no leeway to manage the expenditures and will not feel responsible for financial troubles if the national obligation should be an unfunded mandate. In such a situation, there is scope for discrete bailouts.

In principle, there is a rationale for borrowing in the sense that the benefits of investments such as schools or roads are spread over time. Thus, financing should also be spread over time. Nevertheless, some dangers of borrowing do exist at the local level. The most important is in the case of soft budget constraints where the central government can be forced to bailout heavy indebted local governments, to avoid cutting goods and service provision. As Ernesto Stein (1999) shows, a high vertical imbalance, combined with discretionary transfers and high borrowing autonomy, may weaken budget constraints and thereby lead to larger government spending. The reason for this is simple: local governments may over-borrow and elicit grants from the central government. In the case of a high vertical imbalance, the central government may find it difficult not to bailout – this gives space for applying borrowing restrictions. In fact, borrowing restrictions exist mostly in countries that have a high vertical imbalance (Eichengreen and von Hagen 1996).

To sum up, the central government can choose between two strategies. It can give a lot of fiscal autonomy and try to commit to a no bailout rule and, in the presence of vertical imbalance, impose borrowing restrictions that would limit the danger of bailout caused by accumulation of debt.

13.4 A model bailout and borrowing restrictions

The model of Carlsen (1994) shows how a strategy of eliciting bailout through debt accumulation may work. The central assumption of this model is that local governments do not make long-term budget commitments. Such a situation emerges if there is a crisis and funds are needed immediately, or if there is a vertical imbalance and local governments are not allowed to plan expenditures for a longer period. The model de-

scribes the debt policy as an outcome of a two-period game between three agents: the local and the central governments and a bureau that produces services Q_j and slack S_j on behalf of the local government. Slacks are activities of low importance, which should be cut in order to improve the efficiency of providing services. The local government finances spending through local taxes T_j , grants from the central government G_j and net borrowing $D_j^{t+1} - D_j^t$. Debts have to be paid back in period two. The local government's payoff is $U(Q_j, T_j)$. The local government decides to accumulate debt and elicit grants from the central government if the initial debt level in period 1 passes a certain value D^*1 . This value describes the ability of the local government to pay for its own debt. If the local governments elicit grants, they have to accept an uneven intertemporal distribution of output and taxes. The central government provides grants for local authorities. The payoff is given by $U(Q_j, T_j) - G$ in which "are opportunity costs of providing grants. Grants are supplied if the local debt in period 2 passes a certain value D^*2 and the local government would not be able to pay its own debt without extraordinary tax increases or cutbacks in output.

The game consists of two periods with the central government moving first. In both periods, the central government first sets the grants, then the local government sets local taxes and the bureau's budget while at the same time, the bureau sets slack. There are two regime policy outcomes. The regime 1 policy applies if the grants are not needed. In that regime the central government observes that the initial local debt is below the value D^*1 and the local government can pay for its debt by itself, grants $G_1=0$. Then the local government sets taxes and decides about borrowing. It does not elicit grants because it is able to pay for its own debt by itself and it will not be credible to ask for a bailout. As the local government and the bureau move simultaneously, the local government has to assume some slack and therefore will spend more in the first than in the second period.

The accumulation of debt in the first period induces the local government to increase local taxes and the bureau to reduce slack to counteract the reduction in output and pay back the debt in period two. As a result, higher debt leads to higher taxes, lower slack and lower output in period two, but the local government pays for its own debt. If the initial debt of the local government in period one rises above the threshold D^*1 , the central government has to decide about the amount of grants. It may pay the whole difference $D_1 - D^*1$ and by doing so, induce the local government to behave as in regime 1, or it may provide smaller grants that do not cover $D_1 - D^*1$ in period 1, which leads to regime 2 policy. In that regime, the local government decides to maximise the output and set no local taxes in period 1, in order to accumulate maximal debt. The bureau's slack is not limited. In period two, D_2 exceeds D^*2 and the central government must bailout the local government. Thus, grants will be supplied only if the local government is sufficiently indebted. The presence of the threat to accumulate debt in period one if D_1 exceeds D^*1 induces the central government to provide sufficient grants in period 1 to prevent regime 2. The grants will be higher if the vertical imbalance is higher and the ability

to pay for local debts is lower. In order to decrease the taxes provided in period one and to eliminate the possibility of debt accumulation, borrowing restrictions may be improved. In order to reduce regime 2 utility and to prevent debt accumulation, $D^1 + Q_{max} + S_{max} > D_{restr}$. Thanks to these restrictions the local government knows that regime 2 debt is not possible and it has to set higher taxes or cut slack in period 1, which leads to an increase in value D^*1 . Therefore the central government can cut grants without pushing the local one into regime 2 policy. Smaller grants will not be a problem this time because restrictions make the tax policy of local government more credible and the bureau will cut the slack in period one.

The restrictions introduced in Poland actually mean that local debt in period 2 must be smaller than public debt minus central government debt ($D^2 < 1 - D_{central}$, $D_{central} + D^1 = 1$). The level of central debt depends on local debt D^1 . Thus the level of local debt in period two D^2 , is a result of the central government's decision on central debt and its decision on grant G_1 given the initial local debt D^1 . A low central debt means that $1 - D_{central} > D^1 + Q_{max} + S_{max}$, the restriction is useless and the threat that local government elicit grants still exists while the central government cannot reduce grant G_1 if $D^1 > D^*1$. A significant increase in central debt reduces the $1 - D_{central}$ limit to $1 - D_{central} < D^1 + Q_{max} + S_{max}$ making restrictions work. The restrictions work faster if the ability to pay its own debt D^*1 is higher, which means that lower vertical imbalance leads to more effective restrictions. If there is no space for new debt (the limits are exhausted) the central government may have the incentive to provide higher G_1 in order to have the possibility to issue new debt and not having to raise taxes as much as in the case of financing local debt. A sort of competition for the available debt pool may take place. If CG wants to pay back its own debt, it must supply G_1 , otherwise regime 2 has to be taken into account.

13.5 Empirical results and conclusions

As the theoretical considerations and the Carlsen model suggest, local governments may not be able to pay their own debts from their own resources in case of a high vertical imbalance. As local government expects that additional grants (bailout) will be supplied only in the case of sufficient indebtedness, it accumulates debt and so tries to elicit grants. Local government deficits force the central government to prevent the local debt from rising above the critical value and to supply grants. Therefore, I would expect a negative relationship between grants and budget balance.

If the local governments have more local revenues, the deficits will be smaller. There should be a negative relationship between vertical imbalance and borrowing on the one hand and a positive relationship between local revenues and borrowing on the other hand.

The borrowing restrictions, which limit the possibility of accumulating debt, allow the central government to commit to a no bailout rule and reduce grants.

Local governments will therefore cut activities of low importance and the ability to pay for their own debt will increase. A functioning restriction should limit the grants and improve the budget balance in relation to local revenues. The restrictions introduced in Poland give these results only if the central government is sufficiently indebted or if vertical imbalance is low.

For empirical analysis, I used the data of the Polish Main Statistical Office (GUS). There are data for 2,456 gminas (including cities) for the years 1995 to 2001. In order to analyse the data, I use the fixed effects model (FE) to explore the relationships within gminas. The following variables are used:

Dependent variables:

- log expenditures of gminas/revenues (Logexprev), [revenues-expenditures]/revenues (resrev),
- [revenues-expenditures] per capita with correction for inflation (resinflcap).

Explanatory variables:

- Local taxes/[subsidies+grants] (OwnSG),
- dummy for years of restriction*Local taxes/[subsidies+grants] (OwnSGrest),
- [subsidies+grants]/revenues (SGrev),
- dummy for years of restriction* [subsidies+grants]/revenues (SGrev)
- population share (Popshare)
- dummy for years of restriction (Restr)

Table 2
Empirical results

	FE	FE	FE	PCSE
	Logexprev	resrev	Logexprev	resrev
LocalSG	-0.002 (5.11)**	0.002 (5.85)**		
LocalSGrest	-0.003 (2.73)**	0.003 (2.58)**		
Sgrev			0.091 (13.71)**	-0.044 (0.020)**
Sgrevrestr			-0.024 (2.93)**	0.049 -0.031
Popshare	-9.38	7.242	1.224	-0.038
	-0.29	-0.21	-0.04	(0.020)*
Restr	0.016 (11.73)**	-0.016 (11.49)**	0.02 (4.28)**	-1.677 (0.518)***
Constant	0.016	-0.018	-0.034	0.009
	-1.18	-1.25	(2.36)*	-0.012
Observations	17192	17192	17192	17192
Gminas	2456	2456	2456	2456
R-squared	0.01	0.01	0.02	0.01

Standard errors in parentheses

* significant at 10 per cent; ** significant at 5 per cent; *** significant at 1 per cent

Table 2 gives the answer to the first question of interest: Do local governments equipped with higher local revenues and lower vertical imbalance have lower deficits? As we can see from the PCSE regression, higher vertical imbalance leads to higher deficits while higher share of local revenues in relation to grants and subsidies improve the balance result. Introducing another dependent variable – the log expenditures to revenues – shows that the increase of the share of local taxes to grants and subsidies leads to lower expenditures compared to revenues. The opposite happens if the vertical imbalance is increased. More grants and subsidies automatically lead to higher expenditures. These results are independent of the population size of the jurisdiction as the explanatory variable population share is insignificant. These results indicate that local governments equipped with higher grants borrow more than those enjoying higher local revenues. The observation that higher grants and subsidies shares in revenues lead to higher expenditures and higher borrowing of gminas keeps up the line of theoretical considerations presented before. Moreover, the model of Carlsen seems to give a good prediction of the behaviour of the local governments, which elicit grants by increased borrowing.

Table 3
Empirical results

	FE 95-98	FE 99-01	FE 95-98	FE 99-01	FE 95-98	FE 99-01	FE 95-98	FE 99-01
	Logexprev	Logexprev	resrev	Resrev	resrev	resrev	Logexprev	Logexprev
LocalSG	-0.003	-0.059	0.004	0.057				
	(7.54)**	(10.65)**	(8.52)**	(9.80)**				
SGrev					-0.105	-0.205	0.109	0.224
					(14.59)**	(6.70)**	(15.90)**	(7.73)**
Constant	0.014	0.061	-0.017	-0.063	0.038	0.089	-0.042	-0.103
	(17.04)**	(17.40)**	(19.95)**	(17.02)**	(10.61)**	(5.09)**	(12.45)**	(6.22)**
Observations	9824	7368	9824	7368	9824	7368	9824	7368
Gmina	2456	2456	2456	2456	2456	2456	2456	2456
R-squared	0.01	0.02	0.01	0.02	0.03	0.01	0.03	0.01

Standard errors in parentheses

* significant at 10 per cent; ** significant at 5 per cent; *** significant at 1 per cent

Table 3 gives the answer to the question as to whether the borrowing restrictions in Poland limit the running up of excessive debt. At the time when restrictions were applicable (1999–2001), the results quoted above became even more relevant. Higher share of local taxes compared to transfers means lower deficits, but the coefficient increased from 0.004 to 0.057. In contrast, gminas with higher vertical imbalance borrow twice as much as before. Similar results can be seen if we take log expenditures to revenues as a dependent variable. In the period 1999-2001 the central government increased deficits and central government debt share as well, making the borrowing restrictions stronger. This limited borrowing of those local

governments with low vertical imbalance. Those with higher dependence on transfers borrowed more.

The paper explored the link between vertical imbalance and borrowing of local governments in Poland. The empirical results confirm the theoretical considerations that self-governments equipped with higher local revenues borrow less, which may indicate that they feel more responsible for the debt that they issue, as less grants are available for them. In contrast, those local governments with high vertical imbalance spend and borrow more.

The pressure that they put on the central government using debt accumulation is credible and as a result, higher grants are available. The borrowing restrictions introduced in Poland work only in the cases of governments with higher local revenues. Local governments with higher vertical imbalance borrow more than before the restrictions were introduced.

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14. Strengthening Local Revenue Management is a Track for Introducing Fiscal Decentralisation: the Case of Bulgaria

Svetlana Alexandrova

14.1 Introduction

Bulgaria has carried out a comprehensive decentralisation reform since the inception of transition. Decentralisation is a focal point where we examined the social and economical problems of citizens, which are usually solved at the sub-national level. Fiscal decentralisation is not a rapid process, but in recent years in Bulgaria the transfer and subsidies to the municipalities have become more transparent. This is a result of the public debate on local finances, initiated by the civil society structures at the local level.

Despite the progress in the area of fiscal decentralisation, local finance management is still highly centralised.

Accession to the EU creates new challenges and opportunities for Bulgarian municipalities. To take advantage of these opportunities, municipalities need to be better managed and deliver quality public services. The ongoing decentralisation reform also brings with it the need for better municipal management and decision-making.

The decentralisation of government decision-making involves delegating more power to local authorities. In literature, there are different definitions of “decentralisation”. The most often-used term for decentralisation is the transfer of authority and responsibility for public functions from the central government to sub-governments¹. The resource allocation is determined by the degree of delegation of power required to deliver the services and relative finance. Bulgaria is faced with the problem of how to delegate responsibilities to the lower level to ensure that the necessary resources are available to support the ongoing building of institutional and administrative capacity.

The most theoretical rationale for decentralisation is to attain allocative efficiency in the delivery of local public goods (*Musgrave 1983*², *Oates 1972*³).

1 General definition of decentralisation is given by Rodinelli. The transfer of responsibility for management, planning and resource-raising and allocation from central to (a) ministries or agencies; (b) subordinate units or levels of government; (c) semi-autonomous public authorities or corporations and (d) wide-area regional or functional authorities. Rodinelli Denail, *Government Decentralisation in Comparative Perspective Theory and Practice in Developing Countries*, *International Review of Administrative services* -47, p (113-49)1981.

2 Musgrave Richard, *Public Finance Practice and Theory*, 1983 NY.

3 Oates Wallace *Fiscal Federalism*, NY, 1972.

Bulgaria accomplished a negotiation process for its EU membership. Further implementation of the regional policy development suggests active participation of the municipalities and strengthening their capacity in mobilising private and foreign investments.

14.2 The Legal framework of local finance

The Government of Bulgaria has demonstrated its commitment to broad fiscal decentralisation by the Council of Minister's approval in May 2002 of the proposed Fiscal Decentralisation Concept and Program. Once approved by the National Assembly, the reforms to the Municipal Budget Act, the Local Taxes and Fees Act and other laws governing intergovernmental relations, created a policy framework that enlarges local government revenue sources, clarifies expenditure responsibilities and imposes greater fiscal discipline.

Basic principles of good decentralisation relate to revenue autonomy, transparency and strong institutional capacity.

In Bulgaria, the evolution of decentralisation⁴ in terms of redistribution of authority and the responsibilities of the provision of public services among the different levels of governments have been achieved. The clear division of power contributes to the improvement of the administrative capacity of the municipalities in planning and budgeting. However, there are legislative gaps in respect to overlapping responsibilities and revenue autonomy.

The changes of the legal framework of the local finance and of regional development have been followed by the necessity to develop a sound financial management system at the local level.

Some changes have been made to the State Budget Act (2003), to the Local Tax and Fee Act and to the Municipal Budgets Act. In 2004 Parliament accepted a new Regional Development Act, which has been prepared according to the requirements of the EU regional policy development. Generally, the division of the tasks between the central

4 The three major forms of administrative decentralisation are distinguished – decentralisation delegation and devolution – each have different characteristics. Each of them shows a different degree of administrative decentralisation. There are debates in theory and practice on decentralisation and its effect on social welfare, but the problem is devolving the power and decision-making to local units (most economists assert the positive side of decentralisation, it brings decision closer to the people) but is not empirically proved.

De-concentration – is when the central governments distribute responsibilities to their regional offices. It is not a transfer of responsibilities to local authorities.

Delegation – the central governments transfer responsibility for decision making and public functions to local governments. The control is not centralised. It is based on the principal-agent relationship. Financing is not fully in the competence of local governments.

Devolution – is a way of transferring authority for decision-making, finance and management of the local authorities. Responsibilities are transferred to municipalities, mayors are elected, councils raise their revenues and make investment decisions.

government and local authority is regulated by the State Budget Act and the Municipality Budgets Act.

The amendments, which were placed in the acts, aim at facilitating local governments to execute empowered responsibility assignments.

The changes in the State Budget Act (2003) emphasised the funding required to delegate responsibilities to municipalities: The key amendments to the Act were as follows:

- Local tax, fees, grants and subsidies are the main sources for financing local activities.
- Delegating responsibilities by the government to municipalities is financed by shared tax and extra subsidies.
- The government will carry out permanent monitoring of financial decentralisation.
- The deficit on delegated responsibility assignments will be covered by the Ministry of Finance.
- The municipalities are completely responsible for collecting their own revenues.

Each year the State budget law specifies the intergovernmental relations.

The amendments to the Local Taxes and Fees Act are as follows:

Municipalities apply two types of levies: fees and prices of services, in compliance with the Local Taxes and Fees Act. Under the law, the municipalities are empowered to determine the fees and the prices of public services. The municipalities were empowered to manage those public services that are funded by own revenues. The local governments have the right to determine the base of the garbage fee and other fees. The management of the public services and the cash flow of the services funded by own revenue is a duty of the municipalities

Municipal Budget Act

According to the Municipal Budget Act, intergovernmental transfers include a share of the tax and two kinds of subsidies (general additional subsidies and general subsidies). The target subsidies are directed to finance capital costs for exceptional national and international projects within national investment programs. The shared taxes and general additional subsidies are tools for financing delegated municipal responsibilities. The general additional subsidy is calculated as the difference between budget credit for state activities and shared taxes revenues. The capital investments are financed by target subsidies which could be relevant to needs. The municipalities' councils accept the budget, but the indicators for financing delegated activities are decided entirely by the Ministry of Finance. The target grants for capital projects are not distributed in line with necessity and economic and social return of the capital projects. The limits on funding the municipality's debt have been placed under the law.

The cost of serving the budget debt, as well as debt amortisation, may not be more 25 per cent of the own municipal revenues. The municipality's debt could not be collateral for a mortgage.

The role of the municipality in the area of regional planning and development is designed within the Regional Development Act. Under article 14 (1), the municipality's plan for development is the basis for identifying the priorities, strategic objectives and the need for financial resources. The strategic municipal plans take into account the elaboration of the National regional operation program.

The transfer of power or devolution to local government is crucial for carrying out decentralisation reform. At present, the government is elaborating the Decentralisation Act, which will set up the principles for the division of responsibility for services and delivery. At present, municipalities are faced with a growing demand for services that they are not enabled to adequately finance. The efficient management of scarce resources becomes extraordinarily important for local governments.

In the context of devolution, Bulgarian municipalities are obliged to provide public services and to enhance accountability.

In spite of the amendments to the legislation, Bulgarian municipalities do not have significant revenue-raising power and the degree of devolution is low.

14.3 Management Revenue assignments

Fiscal decentralisation in Bulgaria began gradually. Over the past two years, local authorities have been unable to determine the fees on services which they delivered.

The short definition of fiscal decentralisation is financial responsibility. The main goal of fiscal decentralisation is to move governance closer to the people that require strengthening of local government finances. The idea is to give local governments some tax power and expenditure responsibility and to have some autonomy to make independent financial decisions.

The practice of financing municipalities in Bulgaria is centralised. The Ministry of Finance carries out its activities on drafting the state budget and implementation for the municipalities by dividing public service organisation and provision into municipal and state government mandates. Thus, the state provides the populations from both richer and poorer municipalities with equal access to a minimum level of public services. Funding is based on the state standards related to Government mandates financing through municipal budgets in the fields of education, health care, social care and culture (dividing public service organisation and provision into municipal and state mandates). The Ministry of Finance coordinates the process of drafting the municipal budget (Municipal budgets), implementation and finalisation (Cash performance of municipal budgets), and revises, where necessary, budget relations between the municipalities and the state budget. It also prepares an initial and

an agreed plan (Municipal Budgets) of budget relations between the municipalities and the state budget. The Ministry of Finance maintains a database on government and municipal mandates for municipal budgets. The database contains information on municipal budgets pursuant to the State Budget of the Republic of Bulgaria Act and the Local Self-Government and Local Administration Act within the calendar year. It prepares forecasts on municipal non-tax proceeds on the basis of analyses. It collects, summarises and analyses information on the amount of municipalities' arrears with a view to observing financial discipline. The Ministry of Finance develops reports and draft laws concerning municipal budgeting. Within the yearly budget procedure, the Ministry of Finance, together with the National Association of Municipalities, develops a mechanism for assessment of municipalities' investment needs and allocation of the targeted subsidy for capital expenditures on the basis of the national investment strategy. Based on approved methods (mechanisms) the Ministry of Finance provides methodological instructions to the municipalities. It supports municipalities methodologically, so that expenditures made, comply with the law. The Ministry of Finance coordinates the policy and activities related to financial decentralisation. It participates in the development of legislative concepts, programs and drafts aimed at implementing the financial decentralisation process.

The best practices of the fiscal decentralisation presume that the revenue assignments have to take into account expenditure responsibilities and the system must permit and encourage municipal revenue-raising efforts. Local revenue sources have to be selected in a way that binds them directly to economic growth, in order to meet the increasing needs of the local economy when a boom occurs. Tax sharing should correspond both to local revenue generation capacities and to the overall intergovernmental fiscal system. And finally, central government subsidies and transfers should make up any municipal sector fiscal shortfall under clear municipal financial discipline, without discouraging municipal revenue-raising efforts.

The municipal revenues should also come from the local fees. The municipality defines a range of fees such as: garbage, fees for using market places; auction places of pavements or squares; street lanes; use of kindergartens; day schools; vacation centres; hostels; social care centres and other forms of social service; holidays or medical treatment in a resort; extraction of aggregates; technical services; administrative services; dog fees; purchase of grave plots the for the safeguard and protection of agriculture plots.

For all of the above designated fees, the Municipal Council determines a base. Regarding the prices of services, the Bulgarian municipalities have the power to determine their type and size, so that the user charges should ideally cover the cost of the service. The fees are the main component of the own revenues. Thus, the exercising of full authority over fees and user charges would be a test of

the Bulgarian municipalities' competence and would be a precondition for gathering the required experience prior to obtaining taxation power.

Intergovernmental grants are further classified by their purpose (general or specific). For expenditure purposes, general-purpose grants can be used like own revenues, but they may be allocated based on either objective criteria, or at the central government's discretion. Specific grants are earmarked for certain purposes and the allocation may or may not be conditional across sub-national governments.

The intergovernmental fiscal system includes shared taxes, subsidies and transfers, which conform to the objectives of the economic and social development of municipalities. For example, Bulgaria has created a formula for allocating resources, but typically, towards the end of the year it provides extra, unplanned transfers to localities to finance unpaid bills. This action i) indicates that the formula itself must be inappropriate and ii) creates an incentive for all jurisdictions to stop paying their bills and to anticipate that additional resources may become available towards the end of the year.

In Bulgaria, approximately 70 per cent of sub-national governments' revenues come from shared taxes and grant transfers. The central government sets the rates and the base on shared tax and controls revenue split. In Bulgaria, purely local revenues constitute only 15 or 20 per cent of total municipal budget revenues⁵. According the legal framework, the municipalities' revenues stemmed from local taxes and fees and intergovernmental transfers. In the municipal budget, the following taxes are collected: real estate tax, inheritance tax, gift tax, property transfer tax and tax on transport vehicles. Municipal budgets occupy a significant place in the Bulgarian public sector: they amount to 18 per cent of the consolidated state budget and through them, financing is provided for: 55 per cent of public expenditures for education, 42 per cent of health care expenditures, 24 per cent of social assistance expenditures and benefits, 26 per cent of expenditures for culture and 64 per cent of those for public works⁶.

The *property tax* is the most appropriate source of local government revenue and it is a core source for revenues in Bulgaria. It is suitable for local-level governments because local government services tend to benefit property owners and occupants. It is a tax on wealth and is highly visible in the local area. Potentially, the property tax can be a major revenue producer, but it rarely produces significant revenue. However, a major problem associated with the implementation of the property tax is the determination or assessment of property values. The

5 In other words, the central government directly determines four-fifths of municipal budgets, while being in no way accountable to local constituencies or serviced populations (fiscal decentralisation – The Local Government Initiative is implemented by R.T.I. under USAID Contract 2001.

6 Reported data for 2003 by the Ministry of Finance

property tax is a difficult tax to administer effectively, particularly in some areas of the country with only nascent property markets. The revenue from the specific local taxes (such as dog taxes and vehicle tax) is relatively low and may not even outweigh the administrative cost to collect them. Property taxes account for 10.4 per cent of tax revenues in Bulgaria, against almost 40 per cent in Poland, 21 per cent in Latvia and 33 per cent in OECD Member countries. (2002)⁷

In Bulgaria, the largest and most reliable sources of local revenues are Personal Income Tax (PIT) and Corporate Income Tax (CIT). The shared income tax and corporate income tax remain a very important component of local revenues. The 2002 State Budget Act allocated fifty per cent (50 per cent) of PIT revenues to the municipal budgets. Pursuant to the Corporate Income Tax Act, the own-source component of the CIT is 10 per cent.

Instability and uncertainty are also elements of tax sharing arrangements. One source of uncertainty of the budget revenues is the unpredictable annual revision of sharing rates. Most shared taxes are allocated, based on where the taxes were collected – systems that employ significant shared taxes can find that revenue disparities can be substantial. Those localities that have the weakest revenue bases will be the worst off and other forms of redistribution will need to come into play. Shared taxes are effectively transfers, but they are likely to need to be complemented by equalisation schemes.

Tax autonomy

The share of the tax revenue relative to GDP characterised the tax autonomy and capacity of the local level authorities to mobilise resources. Using regression analysis, the relation between decentralisation and tax revenue is examined. The dependence between decentralisation and local tax revenue is positive and it is high for EU countries – 0.898, for these countries around 62 per cent of decentralisation is under the impact of tax autonomy. The relationship between both variables is less significant for CEE countries (0.437)⁸. The higher effect of tax autonomy on decentralisation is outlined for EU and Central European countries and less insignificant dependence accounted for South Eastern European countries. The lower dependence and weak impact of the tax autonomy on decentralisation relates to SEE countries. We can conclude that tax autonomy has a strong effect on governance in countries with a high degree of decentralisation, where the revenue autonomy is high. The SEEC and CEEC registered lower dependence between both variables, which is due to the small amount of non-tax revenue and constraints on the tax base determination by local authorities, because the state budget redistributes the tax revenue. According to statistical data of SEEC, the share of tax revenue is higher compared to the other countries, but it comes mainly from the larger part of shared tax and subsidies. (See Appendix, Table1). The tax revenue has no impact

7 OECD report 2002

8 The linear regression is adequate F is 0.5 – less 0.5 is for South Eastern European countries.

on decentralisation in Bulgaria, Romania and Croatia. The funding by the state budget is huge, more than 80 per cent and municipalities are dependent on state budget funding instead of their own revenues. In these countries and especially Bulgaria, the revenue autonomy is limited.

What are the dynamics of the local revenue?

The financial situation of the municipalities improved after the amendments to the legislation.

The main indicator for fiscal decentralisation is the share of local expenses to total consolidated expenses per GDP. Since 1999, the share of local expenses decreased. This is due to the following factors: some assignment responsibilities such as health care, social care (land commission does not come under local government competence).

Another positive feature is a decline in revenue deficits. This is due to the reduction in the assigned responsibilities – healthcare and social assistance. The intergovernmental transfers relatively decreased because some responsible assignments were eliminated. The expenditures of the municipality's budget decreased because the social benefits are covered directly by the state budget. (See appendix table 2 and table 3). Local government revenue increased because of the municipal property sales increase and because they charged some services to transfers. Nevertheless, privatisation and sales and the share of revenue from local tax continue at a low level. (See appendix table 4). Although there is increasing revenue from local tax, fees and from own activities, the municipalities continue to rely on subsidies. The assessment criteria for determining the share of extra subsidies has not significantly changed. The dynamics of the shares of subsidies is very changeable. The share of subsidies ranges from 20 per cent to 38 per cent. The data for the share of subsidies are as follows: 29.2 per cent (1989), 26.5 per cent (1999), 47.0 per cent (2000) 20.2 per cent (2001) 39.8 per cent (2002) 38.7 per cent (2003). The share of subsidies was highest in 1999 and it continued to account for around 39 per cent of total local revenue.

The policy of conditional current grants has not changed much. These grants usually take the form of an earmarked transfer for a particular service, such as education, health or social assistance. In the past, allocations for these current expenditures were focused on inputs and the funding required keeping the existing institutions functioning. Although the amounts of conditional capital grants are small, the central government provides some grants to lower level governments for investment. It is not a systematic method for doing so and the subjective approach predominates.

The practice is that line ministries: education, energy, transport, etc. are given a particular amount of resources, which they then allocate to lower levels of government. The share of the own revenues reached 23.7 per cent (2002) and 32 per cent

(2003). The contribution to own revenues of local tax was 6.9 per cent (2002) and 9.1 per cent (2003); local fees 9.2 (2002) and 12.00 (2003) and the share of not-taxable revenues was 7.6 (2002) and 11.0 per cent (2003). The state budget transfers (included shared tax, subsidies,) were 76.9 per cent (2002) and 66.2 per cent (2003). The share of the extra subsidies in the total state budget subsidies remains high – the data are evidence of this approach. The extra subsidy component grew by 17 per cent in 2003 compared with 2002.

Bulgaria made some progress in delivery of contracted out services and in identifying the required fees for managing these services. They still may be confronted with difficulties concerning the appropriate method for price determination and the ability to pay fees, which may require special assistance. The legal regulatory framework does not solve the provision of the necessary information base for effective pricing of such services. The imbalance in local budgets is an important issue and it is a consequence of a lack of the efficient equalisation policy. Some municipalities, usually the larger ones and those in industrially developed areas reached a budget surplus and other small and medium sized municipalities have deficits (the number of the municipalities with deficits is 170, approximately fifty per cent of all Bulgarian municipalities). The emerged disadvantages of the revenue management are as follows: bad financial planning, the central government subsidies are transferred to municipalities subjectively and a lack of good vertical and horizontal equalisation financial policy.

Divergence in revenue capacity management

The local authorities aim at greater fiscal autonomy, but the current institutional and administrative capacity in revenue management is low and central control is significant. The municipalities are not enabled to execute greater local control of local taxation and greater local expenditure responsibilities. The practice of developed countries shows that the fiscal discipline should increase in parallel with the increase in local autonomy. Balancing the budget is an important element for strengthening fiscal discipline. At present, municipalities are obliged to balance their budgets, but most of them continue to operate with deficits -financing supplemental appropriations during the year. The central government intervention is aimed at reducing municipal budget deficits, but it is structured in such a way that it does not encourage municipalities. The problem with balancing their budgets stems from funding current activities through deficit-financing supplemental appropriations, or long-term debt (particularly, for small and medium size municipalities).

Even where the legal and administrative capacity exists, local governments are faced with a lack of proper financial incentives to mobilise their own revenues. Experts in local finance considered that shared revenues can also create powerful incentives for local and regional officials to pursue informal and non-transparent methods for generating additional discretionary sources of revenue.

The limited amount of revenue autonomy at the local level is perhaps the most significant signal that the country has not really decentralised, but rather has de-concentrated delegated responsibilities. Given the legacies of central planning with its weak financial and administrative capacities in many countries, it will take many years before localities will be given the responsibility for raising their own revenues. Nevertheless, if the Bulgarian government is serious about improving service delivery through decentralisation, at some point the link between services delivered at the local level and the funds necessary to provide those services will need to be made.

There is a big divergence in economic and social development among municipalities. Only the towns with the largest industrial sectors have not suffered from a shortage of financial sources and capital investments. Rural municipalities with small tax bases receive equalisation allocation from the state budget. The principles of distribution allocation are based on the State Budget Act. The system of financial equalisation is not effective enough to cover the disparities in the socio-economic situations of municipalities.

Some municipalities have the characteristics of economic decline, high unemployment and reliance on state budget transfers. The administrative expenditures for small cities are 17 per cent of total expenditures, while they are 9 per cent, on average, for all cities. Social assistance expenditures in small cities are considerably higher (28 per cent of all expenditures) when compared with the average expenditures for social assistance of all cities (18 per cent). There are also differences in the distribution of revenues to small cities. While shared taxes amount to 49 per cent of revenues in all cities, on average, they are scarcely 17 per cent of the total revenues in small cities (based on 2001 data). On the other hand, state subsidies amount to 60 per cent of the revenues in small cities, compared with only 26 per cent on average for all cities. Of no less importance is the fact that revenue from local sources amounts to 22 per cent of the revenues on average for all cities and barely 11 per cent for the small cities group. The larger Bulgarian municipalities, as a rule, have better administrative and fiscal capabilities to provide public services and raise local revenues. A small city is officially defined as having a population of less than 10 000 people, based on the latest population census⁹.

The lack of an efficient equalisation system resulted in many Bulgarian municipal governments not having sufficient funds to operate essential services, such as schools, medical care and social services. The most important problem is that there is a significant vertical imbalance between expenditures and revenues, with consequent implications for autonomy, efficiency, and accountability.

Transfers constitute the principal way in which countries achieve what is sometimes called “vertical fiscal balance” – ensuring that the revenues and expen-

9 Using this definition, 98 of Bulgaria’s 264 municipalities are small cities.

ditures of each level of government are approximately equal. Such “fiscal gaps” may of course be closed in other ways – by transferring revenue-raising power to local governments, by transferring responsibility for expenditures to the central government, or by reducing local expenditures or raising local revenues. (Boadway and Hobson, 1993). In Bulgaria, however, a sufficient mismatch in the revenues and expenditures assigned to different levels of government requires some balancing role to be assigned to intergovernmental fiscal transfers, which need to be more objective and to be combined with public services needs.

According to the theoretical basis and practical experiences, all transfers from higher-level to lower-level governments will help close the fiscal gap. For many reasons, however, it is useful to think of vertical fiscal balance in an accounting sense as being achieved when expenditures and revenues (including transfers) are balanced for the *richest* local government, measured in terms of its capacity to raise resources on its own (R. Bird, 1993). Fiscal gaps will still remain for all poorer local governments, but such “gaps” are better considered in relation to the problem of achieving *horizontal* fiscal balance (within the local government sector).

14.4 Financing the municipalities through capital market and bank borrowing

Financing urban infrastructure is an important and persistent problem for countries in transition, especially in the larger cities where most of the infrastructure services are concentrated. Bearing in mind the overall shortage of budget funds, the financing of generally more expensive sites with own funds, is impossible. The capital market could be used for financing expensive public projects with high future returns through issuing municipal bonds.

The purpose of municipal credit market development is to enhance the volume of local capital investment in support of essential municipal services. The municipal credit market is underdeveloped. It is due to severe budget constraints and the necessity that the costs of capital expenditure can be spread over the years of a project’s use and the costs (debt amortisation) have to be predicted in the budget. The budget is completely elaborated by the central administration in the municipal financial plan and budget projections and for that reason, future earnings are not well-determined.

The development of municipal borrowing relates not only to the legal framework governing the borrowers, but also to the institutional regulatory environment for a variety of financial instruments, such as a well-developed capital market. The following acts regulate the municipal borrowing Law on Public Offerings of Securities, the Registered Pledges Act and also the Municipal Budgets Act and the Local self-government and Local Administration Act. The Law on

Public Offerings of Securities regulates the trading of municipal bonds, but most municipalities do not fulfil creditworthiness' conditions.

The practice of other countries shows that the models of financing through capital markets are public-private partnerships on the grounds of co-finance by private business; municipal bonds (general and revenue bonds) and borrowing from commercial banks. All these models are applicable, but local authorities are faced with legal and regulation restrictions. The public-private partnership (co-financing with the Private Sector) is appropriate for local authorities. The weakness of the municipality is the lack of skill in financial project projections, assessment of the costs and benefits of the project and the financial risk management. The business structures in most municipalities have no capacity to allocate investment for public service projects. The current tax legislation does not promote private businesses to invest in public services. The bond market is under-developed and consumer savings are very scarce (only 10 per cent of the whole population has savings and they are potential investors in municipal bonds). Although there is a weak bond market, six municipalities issued municipal general bonds. Municipalities avoid financing through the credit market due to restrictions on budget revenues under the local finance legislation.

Procedures for authorising municipal debt at the local level are contained in the Municipal Budgets Act and Local Self- government and Local administration act. According to both acts, municipalities in Bulgaria have the general power to borrow and issue bonds. The Local Self-Government and Local Administration Act delegates decision-making authority, in respect of bank loans and the issuance of municipal bonds to the municipal council. The Municipal Budgets Act similarly affirms that a resolution of the municipal council provides sufficient authorisation to effect lawful transactions with banks and other financial institutions. No other action or approval is required.

The Municipal Budgets Act permits a municipality to plan an annual budget deficit of up to 10 per cent of the total projected revenues. Based upon a municipal council resolution, that authorised budget deficits, it may also permit financing through the issuance of securities (i.e. issues), loans from financial institutions and from off-budget revenues and other sources.

Municipalities may also receive loans from the State Budget and from other municipalities. The Municipal Budgets Act permits short -term interest loans from the State Budget to be extended to municipalities in exceptional cases, based upon a procedure and within time limits set by the Minister of Finance. The Act permits municipalities, based upon municipal council resolutions, to conclude contracts between themselves for the extension and use of loans under terms established by that Act.

The State budget specifies limits on the revenue ceiling in terms of debt payments. The 2000 State Budget Act reduced the 10 per cent ceiling on local investment to five per cent of own source revenues. The 2001 State Budget Act contained no such limitation and the 2002 State Budget Act limits investment spending on the acquisition of long-term assets of up to 25 per cent of local taxes and non-tax revenues, a severe limitation on local discretion to finance infrastructure and other capital needs. The amount of loans undertaken by municipalities is a very small part of the local budget – 0.7 per cent (2002) and 1.6 (2003). Therefore, the general reasons for prudent borrowing in municipalities are severely restricted in their ability to generate their own source revenues. Debt limitations give comfort to both the central government and the lending community and decrease the financial risk. The pension fund and other institutional investors are not encouraged by the corporate tax law to deal with municipal bonds. The Corporate Income Tax, which applies to any interest income earned by “legal entities”, does not contain any such tax exemption. Commercial banks and insurance companies would pay taxes on interest income earned on municipal securities on the same basis, as would any other legal entity.

The municipalities succeed in covering the investment project costs by revenues from sales and own revenues of the last two years. The amount of the target subsidies for investments was 48.3 per cent (2003). It is considerably less than the previous two years. (See Tables 6 and 7)

14.5 Conclusions

Municipal expenditure responsibilities regularly exceed municipal revenues; they are not sustainable in the long run and there are overly detailed central regulations that unnecessarily dilute municipal management control. Moreover, the municipal revenue base must expand with the growing demand for more and better local public services.

The laws prescribe the division of tasks between local authorities and every year this is negotiated between the local authorities and government by intermediates of the National Municipal Association. Regulations specifying procedures for transferring appropriations and subsidies from the state budget to municipal budgets have constantly changed during recent years. Therefore it has been very difficult for local authorities to plan their budgets with a long-term perspective. Local revenues are a small part of municipal budgets and local authorities depend mainly on the decisions of the central authorities. Local authorities face difficulties in exercising their responsibilities and solving local problems relying on independent financial decisions.

The financial resource management must improve in accordance with the following principles:

- Communication between the powers on revenues and political responsibility.
- Link between the benefit of the activities and the sources of financing.
- Expanding the participation of civil society and local authorities in the budget process, as well as expanding the participation of citizens and their organisations in determining the financial and investment policy of municipalities.
- Balance between the legally regulated revenues and the legally entrusted expenditure responsibilities of municipalities.
- Expanding the powers of municipalities to independently determine and manage the revenue and the expenditure part of their budgets.
- Increasing the taxation powers of municipalities.
- Establishing a permanent legal framework for state transfers to municipalities.
- Allocating the subsidies for municipalities through clear, understandable and permanent criteria.
- Development of a municipal credit market.

The advantages of the governmental decentralisation program are that local authorities determine the fee base and management of the local revenues (from local tax and fees). The divergence of the non-own revenues and expenditure assignment responsibilities continues to be an obstacle for local revenue management.

Appendix

Table 1
Decentralisation and Tax Autonomy (Correlation)

Country	Correlation Coefficient	Country	Correlation Coefficient
All countries	0.605	Bulgaria	0.420
EU countries	0.898	Croatia	0.164
CEU countries	0.437	Romania	0.340
SEE countries	0.430	Slovenia	0.410

Source: IMF International Financial Statistic; Government Finance Statistic, own calculations

Table 2

Indicators	1998.	1999.	2000.	2001.	2002.	2003.
GDP(mln BGL)	21 577	22 776	26 752	29 617	32 606	35 285
Consolidate state budget(mln BGL)	8 689	9 913	11 343	12 096	12 663	13 637
Local expenditures (mln BGL)	1 736	2 022	2 178	2 114	2 3889	2 297
Share of local expenditure to GDP(%)r	8.0	8.8	8.1	7.1	7.3	6.5
Share the local expenditure to CSB(%)	19.9	20.4	19.2	17.4	18.8	16.8

Source: Ministry of Finance, National Statistic Institute, LGI- USAID

Table 3
The share of extra subsidies to total state subsidies (mln). BGL)

Indicator	1998.	1999.	2000.	2001.	2002.	2003.
Share of extra subsidies to total budget subsidies	29.2	26.5	47	20.2	39.8	38.7

Source: Ministry of Finance

Table 4
The net deficit of revenues

Indicators	1998.	1999.	2000.	2001.	2002.	2003.
Share of local expenses to GDP (%)	8.04	8.88	8.14	7.14	7.33	6.51
Share of local Expenses to Consolidated budget	19.97	20.40	19.22	17.47	18.86	16.84
The net deficit of revenues % of the total revenues	8.7	8.9	7.2	4.5	2.6	1.8

Source: Ministry of Finance

Table 5
Dynamics of Local Revenues (%)

Revenues	1998.	1999.	2000.	2001.	2002.	2003.
Intergovernmental transfers % of total revenues	84.2	84	83.5	82	76.9	66.2
Shared taxes	46.5	41.7	40.5	40.1	39.7	32.1
Subsidies	38.3	39.6	42.6	39.5	30.9	27.9
Own revenues	15.9	13.3	12.9	15.0	23.7	32.2
Local tax	7.7	4.8	4.5	6.0	6.9	9.1
Local fees	8.6	8.5	8.2	8.7	9.2	12.0

Source: Ministry of Finance

Table 6
The share of investments in local budgets

Indicators	1998.	1999.	2000.	2001.	2002.	2003.
Investments (mln. BGL)	211.2	172.5	158.0	121.2	196.0	240.0
The share on investments to the budget expenditures (%)	12.7	9.30.	7.9	6.5	8.6	11.0

Source: Ministry of Finance

Table 7
Sources for investments (%)

Indicators	1998.	1999.	2000.	2001.	2002.	2003.
Subsidies for capital investments	59.8	43.3	46.3	60.1	71.1	48.3
Sales	7.5	11.6	14.5	30.5	20.7	36.1
Own revenues	32.7	45.10	39.1	9.4	8.2	15.6

Source: Ministry of Finance

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15. Unanticipated Budgetary Consequences of Devolution: Capacity Enhancing Potentials within the Current Russian Constitutional Framework¹

Herrington J. Bryce

15.1 Introduction²

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 of probable solutions.

This paper draws very heavily and directly from an earlier published paper³. Its distinction is that this current document broadens the scope of the discussion

1 I am grateful for the assistance of Natasha Ryzhavoka, Oleg Batig, Alexander Alexin, Eugenia Firsova and Konstantine Efremov for translating documents from Russian and to Dr. Carole Neves of the National Academy of Public Administration for making the original project possible through Chemonic and its local administrator in Russia, Robert Sanders.

2 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 Lev Nikiforov, "A Mixed Society, Possibilities of Development in Russia," *Problems of Economic Transition*, February 1994, pp.6-16; and, in the same issue, Iurii Sukhotin, "Reform in Russia Science vs. Populism," pp.17-31; and Aleksandr Bim, "Privatisation in Russia: Problems of the Immediate Future," January 1994 issue of the same journal, p.7-22.

3 This paper draws heavily and directly from Herrington J. Bryce, "Unintended Budgetary Consequences of Devolution and Decentralisation: The Case of Cherepovetz Rayon, Russia," *Public Administration Quarterly*, Spring, 2000, pp. 25-45.

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 size and in number of local governments are not new in Eastern Europe. Sulev Maltse'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 rayon. This is an administrative, budgetary, economic and political unit that 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 rayon) 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 rayon (county) and to its composite units. This paper focuses on the impact of devolution on the rayon, its newly acquired responsibilities and the legal and budgetary constraints that define its ability to conduct these responsibilities.

In Russia, as elsewhere, the current infrastructure of the rayon including roads, schools, boilers, water and sewers 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 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 offsetting productive revenue sources and within an unchartered political environment, is at the foundation of the problems facing local public administrators. The basic chal-

lenge 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 at its relationship with those units (federal and state) that are higher up on 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 government⁴.

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 through⁵:

1. The assignment of specific revenues sources to the local government so that it can meet minimum expenditure requirements⁶.
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.
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 has no precedence in Russia and no counterpart even in the United States al-

4 Chapter 1, "General Provisions", Clause 2, Federal Law on General Principles of Self-Administration in the Russian Federation, 1995.

5 Ibid. See Chapter III, "Financial and Economic Foundation of the Local Self-Administration," Clauses 35-39, for the points being enumerated here.

6 The guarantee is specifically to meet the social minimum requirements (i.e., minimum standard of living). We shall describe these later in the paper.

though 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 include⁷:

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 on⁸.
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 conformance 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 law⁹. The federal government does not guarantee the existence of or the financing of the local government. This is not the case in democratic Russia.

The Oblast of Volgoda, for example, fully respecting federal law, guarantees home rule to the citizens of its rayons. 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

7 Ibid. See Chapter, “Federal Bodies Powers in Local Self-Administration,” Clauses 4-8, for the points being enumerated here.

8 State Minimum Social Standards for Defining Norms for State and Local Budgets, July 3, 1996. These norms are easily verifiable.

9 This is the familiar Dillon Rule.

reason that an oblast can reject a local charter is that it is in violation of the laws of the federation or of the oblast¹⁰.

With these powers, a rayon 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 classification¹¹. In the rayon, 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 accountability¹².

But the rayon is specifically assigned responsibilities for financing and managing social assets. These include roads, schools, boilers, hospitals, housing, police, utilities, water and sewer. Financing of these must be incorporated in the local budgets.

At the same time, local *fiscal* independence is guaranteed by the oblast¹³:

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 authorized and mandated by the central authority. There simply 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.

10 Ibid., Chapter I, “General Provisions,” Clause 8.

11 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.

12 Charter of the Volgda Oblast, Chapter 11, “Foundations of Local Self-Administration,” Clause 83 and Clause 88.

13 Ibid, Clauses 82-103, especially Clauses 86, 91, 92 and 100.

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 rayon for example, is divided into 26 geographic rural administrations. Each is headed by an administrator previously elected by village leaders but who, under the proposed charter, be appointed by the chief administrator of the rayon with the approval of the village population.

The rural administrator operates as an ombudsman between the rayon government and the village population and as a rayon 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 per cent of the income tax revenues the rayon collects in his or her area. The rayon 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 distributes land (at no cost); i.e., for the building of Dachas.

In 1992, 73 per cent of these areas had less than 2,000 residents. Just under half have no more than 1000 and none as many as 10,000 persons. Most of these areas are too small for efficiencies in most public services. Thus, to local public administrators, the 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 rayon 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

In the preceding pages, 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 rayon, 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 set by local law is 25 per cent of the central bank rate. At current levels, the subsidized rate would be between 40-50 per cent.

15.5 The Deficit

The most recent budget passed by the Legislative Assembly of the rayon shows expected revenues at 95,300,700,000 rubles¹⁴ and expected expenditures at 75,371,100,000 thus expected expenditures could exceed revenues by 13 per cent. Deficits are the usual budgetary expectation.

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 rayon workers. Wages can be 4-6 months behind. What options are there for dealing with a projected deficit now and in the future¹⁵?

14 At the time of original writing the exchange rate was 5355 rubles for one U.S. dollar.

15 A study of 1,300 U.S. cities, roughly the size of Cherepovetz, and their adjustment to economic crisis shows the importance of cutting back capital expenditures (67 per cent) and cutting back in services (32 per cent). Only 25 per cent of the cities chose to postpone wage increases. Holding wages in arrears is not a common option. See Herrington J. Bryce, *Planning Smaller Cities*, (Lexington, Mass: D.C. Heath, 1979), pp. 105-120.

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 and avoidance plague even the national government¹⁶. A discussion of specific reasons for this 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 minimizing 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 rayon. 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.

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 government. Furthermore, user fees are set by current federal law to net less than 100 per cent 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

¹⁶ See Betsy McKay, “Yeltsin to Step up Tax Collection, An Issue in Budget,” *The Wall Street Journal*, Monday, October 14, 1996, p. A14.

limited cash flow, so they postpone payment of wages; and, they are allowed to postpone withholding until salaries are paid¹⁷. Also many of these businesses are operating at a loss and have no profits to tax. Taxes are on 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 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.

¹⁷ 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 rayon. Therefore, paying the government payroll taxes when the payroll cannot be met is not done.

Indeed, rampant non-compliance may be a clue that the tax system is out of whack¹⁸. 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 that limit taxes and fees to about 30 per cent of income.

Increasing user fees so that there is 100 per cent cost recovery is an option. Two questions need to be asked. The first is 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 that 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 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 rayon laws require the budgets of rayons 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 handicap¹⁹.

18 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, "Thread- ing 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.

19 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.

Fortunately, as discussed earlier in this paper, the federal and oblast laws also provide that absent the ability of the rayon 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 per cent of the expenditures in the Cherepovetz budget fall into the social norm category²⁰.

The local assembly also limits budgetary discretion. 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 rayon's employees, medicine and medical supplies; meals, relief and benefits required by federal and oblast laws; and, finally, electricity, security, and heat²¹. The items in the two preceding paragraphs cover approximately 85 per cent of the planned expenditures in the rayon.

What is evident is the conflict between the Soviet model of setting minimum social standards that 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.

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

²⁰ 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.

²¹ Resolution of Borrowing, passed by the Legislative Assembly, Cherepovetz, Rayon, February 14, 1996.

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. 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, although 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 reorganisation, as corporate reorganisation, 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 specialized (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 setting the terms of these bonds, issuing them and contracting 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 principal. 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 principal. Therefore, any attempt to consider the recommendations made above must also provide for evaluation and monitoring²².

22 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 privatisation and my *Financial and Strategic Management for Non-profit Organisation*, 3rd edition, Jossey Bass 2000, pp 119-121 for a fuller description of the authority as a non-profit organisation. One 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 Rayon, Russia, *Public Administration Quarterly*, Spring, 2000, pp. 25-45.



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