Organisation for Economic Co-operation and Development
Organisation de Coopération et de Développement Economiques

Directorate for Financial, Fiscal and Enterprise Affairs
Fiscal Affairs

Fiscal Design Across Levels of Government
Year 2000 Surveys

Summary Note

FINAL

15th May, 2001

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1. INTRODUCTION - BACKGROUND

1.1 Introduction

1. This note summarises the overall results and comparative findings of the OECD Fiscal Design surveys which were carried out during 2000. The surveys took place in six countries in Central and Eastern Europe: three OECD Member countries, the Czech Republic, Hungary and Poland, and the three Baltic states, Estonia, Latvia and Lithuania.

2. In accordance with decisions made by the FDI, the OECD has initiated surveys on fiscal decentralisation for the purpose of providing international comparisons on the design of fiscal systems across levels of government. The FDI is a joint initiative of the OECD, the World Bank, USAID, the Council of Europe, The Open Society Institute, UNDP and OECD Member countries to assist transition economies in Central and Eastern Europe in carrying out intergovernmental reforms. The main objectives of the Initiative are: to encourage local democracies to improve the capacity of local governments to plan and administer expenditures and raise revenues; and to support local governments in their efforts to become more responsive and accountable to their constituencies.

3. In 1999, a number of development activities took place. At an FDI seminar in Paris, March, 1999, the OECD presented an overall framework paper for the project, including new concepts on local discretion in financial decision-making and national constraints on subnational fiscal policies. The paper was agreed on as the general framework for the further development of the project. During May-September 1999, the OECD developed and tested a draft questionnaire for the survey on Fiscal Design across Levels of Governments. The test activities took place in Denmark, Hungary and Latvia. In relation to the Annual FDI Steering Committee held in Strasbourg, February 2000, a summary report was presented, including the results of the three pilot studies. Based on the report, the Steering Committee approved the overall framework for the Fiscal Design surveys and agreed on initiating surveys in six countries: the Czech Republic, Estonia, Latvia, Lithuania, Hungary and Poland. Carrying out Fiscal Design surveys as part of the Stability Pact Programme for the Balkan region was also considered. To support the preparation of the specific country surveys, an FDI grant was approved.

1.2 Project activities during 2000

4. In April 2000, the OECD held the opening meeting with the six countries who all agreed on joining the surveys. The questionnaire for the surveys was presented and approved.

5. The surveys in the countries were carried out between April 2000 and January 2001, by representatives from the ministries and agencies responsible for subnational finance issues. The surveys were written in response to a questionnaire and follows the structure outlined therein.

6. The country reports, together with this summary note, were presented and discussed at a closing meeting in Paris, 22nd-23rd March, 2001.

7. The project activities in 2000 were led by Mr Leif Jensen of the OECD Fiscal Affairs Secretariat. Dagmar Balve-Hauff and Elisabetta Da Prati, Fiscal Affairs Secretariat also contributed to the project activities. On several occasions between late 1999 and the end of 2000, the OECD presented and discussed the overall framework of the project, the test country reports and draft 2000 findings. These occasions included: The Working Party 2 of the Committee on Fiscal Affairs who were briefed at their meeting in November 1999; the Workshop (arranged by the World Bank Institute) with the Swiss Government on "Federalism and Development", December 1999; Government missions to the OECD from Member countries, Spring 2000; a separate meeting with representatives from Sweden, Finland and Norway, January 2000; the Central European Summer University on Fiscal Decentralisation, July 2000 and informal co-ordination meetings with the World Bank country desks, July 2000.

1.3 Further information on the 2000 surveys

8. Full versions of the country surveys are available at the OECD Secretariat. The reports can be downloaded from the Fiscal Affairs web-site: *http://www.oecd.org.fa*.

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2. FISCAL DESIGN SURVEYS -- FRAMEWORK

2.1 Main purposes of the surveys

11. The need for a uniform notion of local governance is becoming more and more evident at a time when economies in Central and South Eastern Europe are carrying out a number of activities to complete local and regional government reform initiatives aimed at a decentralised political-administrative structure. Economies in transition do not have internationally consolidated data on fiscal autonomy and the actual design of fiscal relations to look to for policy guidelines and inspiration for reform processes.

12. The experience of other economies -- in Central Eastern Europe as well as Western countries -- are invaluable sources of information on the situation of different local government systems and as a comparative basis for assessing local government development in individual countries.

2.2 Main policy issues on fiscal design across levels of government

13. The surveys address these issues by indicating the state of the following fiscal decentralisation matters across the countries:

- The design of fiscal systems: which functions of expenditure and revenue sources are devolved or decentralised.
- The match between locally-managed expenditures and the corresponding revenues; the level of vertical imbalance in the context of local accountability and the fulfilment of national financial policies.
- The institutional arrangements for ensuring fiscal discipline and budgetary constraints.
- The design of intergovernmental fiscal relations -- the need for stable, transparent and formula-based procedures and relations.
- The profile of subnational revenues -- the composition of the revenue base.
- The profile of subnational expenditures -- local vs. national public services. National standard setting vs. subnational discretion in the provision of public services.

14. There is obvious no single or standard solution to these questions. The actual design of local finance and intergovernmental fiscal relations varies from country to country, reflecting actual decision-making processes and distributions of political power. The country's physical and political geography, and historical and cultural traditions are strong structural determinants of actual design of subnational governments' responsibilities and competencies.

2.3 The structure of the questionnaire

15. In the questionnaire these issues on fiscal design are addressed using two themes:

A. Basic government finance statistics for the subnational levels of government, covering comparative figures on subnational government revenue, including grants and expenditure. The figures are based on existing international definitions and classifications, developed by the OECD and other international organisations.

This information is reported in chapter 3 in the country reports and is summarised in chapter 3 in this note.

B. Country-specific analysis and evaluation of subnational government finance reforms in relation to ensuring the balance between local autonomy in financial decision-making and national targets and constraints on fiscal policy matters.

Information on these issues is reported in chapter 4 in the country reports and summarised in chapter 4 in this note.

3. SUBNATIONAL GOVERNMENT FINANCE. COMPARATIVE FINDINGS

3.1 Introduction

16. In this chapter, main findings on the level and composition of subnational expenditure and revenue are presented. This covers specifically the following dimensions:

– Profiles of subnational revenues

– Profiles of the tax and revenue autonomy of subnational governments

– Profiles of subnational expenditure

17. The summary tables are based on the statistics as reported in the country surveys. The definitions of subnational finance data were generally based on the System of National Accounts (SNA 93). The operational IMF classifications were preferred when setting up the classifications on expenditure, non-tax revenue and grants, whilst the OECD definitions and classifications provided a better base for tax revenue. Furthermore, as some of the countries in the surveys only report data to the IMF and not to the OECD, it was considered necessary, for practical reasons, to draw on both sets of classifications. The relevant classifications are defined in the following publications: the IMF, A Manual on Government Finance Statistics 1986 (GFS) and the OECD, Revenue Statistics 1965-98.

18. As far as **tax revenue** is concerned, the IMF definitions and classifications are consistent with those of the OECD, cf. Revenue Statistics, Part II, VII. In relation to **expenditure, non-tax revenue** and **grants,** the general classifications of the OECD National Accounts and the IMF Government Finance Statistics are identical, although the actual reported data may differ due to differences in the accounting bases of the two systems.

19. In the questionnaire, the countries were asked to report the figures in two main tiers of government: regional and local. In the absence of a regional tier of government, and if capitals and/or urban areas had functions/responsibilities which differed from "local governments", such areas could be identified separately and included as one of the two tiers.

– The six countries reported data across the following subnational tiers:

  • The Czech Republic, Lithuania and Estonia identified one tier of subnational government: local (municipal) government. All three countries have got an intermediate regional level between the central government and the municipalities. They have reported, however, that the "regions" do not have self-government functions, and are therefore not considered to be an independent government level. The intermediate regional level is treated as part of the central government. It is to be noted, however, that according to the

Czech report, regional Czech governments started operating at an independent government level this year, 2001.

In the Czech Republic and Lithuania, the municipalities are the only level of local government, whilst in Estonia, the local government sector consists of towns and rural municipalities (with the same set of responsibilities) which again can be divided into municipal districts with a limited right to self-government.

- According to the Hungarian report, the Hungarian system is characterised by a one-tier subnational local government. “In terms of type, a local government may be a municipal government (that of a village, town, county-rights town, the capital city and its districts) or a county government.

- Latvia identifies three tiers of subnational government: rural municipalities and towns, local urban governments (called Republican cities or big cities) and regional governments. The regions are considered a separate tier of government, according to the classification: own separate and independent budgets, with an indirectly elected political Council and nearly 100% financed by state grants. In this survey, Latvia has aggregated its subnational fiscal data from three levels into two, i.e. rural municipalities and towns and local urban governments have been aggregated to represent the local government level, although strictly speaking their functions are not identical: Rural municipalities which govern the less developed areas in the countryside have got fewer functions to accomplish than their urban counterparts.

- In Poland, subnational government has comprised three levels of subnational authority, since 1999: gminas and poviats as two levels of local government, and voivodships representing regional government. No subordination exists between these three administrative tiers. According to the Polish report, GFS-compatible data for local and regional levels have only been produced since 2000. Therefore, Poland has not been able to aggregate its three subnational levels into two but instead has aggregated the data of all the subnational governments into one level (“local government”).

20. With regard to the data reporting, only Latvia has been able to report data on two tiers, whilst in the other countries where two tiers of subnational self-government exist, reporting on one level was the only feasible solution, primarily for technical reasons.

21. In this note, for comparative reasons, data are presented and discussed on "subnational levels of government". This means that the Latvian figures on regions have been added to the Latvian local government figures.

3.2 Profiles on subnational revenues

22. Table 3.1 summarises the revenue profiles of the six countries.

Table 3.1 Profile of subnational revenues: Composition by revenue source. Share of national government revenue and GDP, 1997-99

Country / Year	Composition of subnational revenues (%)									Share of total subnational revenues in consolidated national government revenue			Share of total subnational revenues in GDP (tax revenue)		
	tax revenues			non-tax revenues			grants								
	1997	**1998**	**1999**	**1997**	**1998**	**1999**	**1997**	**1998**	**1999**	**1997**	**1998**	**1999**	**1997**	**1998**	**1999**
Czech Republic	54.9	55.6	47.7	26.4	26.8	36.3	18.7	17.5	16.0	18.0	18.3	20.8	7.15 (3.9)	7.2 (4.0)	8.6 (4.1)
Hungary	28.1	30.6	33.0	18.1	18.0	17.0	53.7	51.3	50.0	26.6	27.4	26.7	11.3 (3.2)	11.5 (3.5)	11.1 (3.7)
Poland	37.6	36.4	24.5	28.0	27.8	24.2	34.3	35.8	51.3	21.1	21.6	28.8	9.4 (3.5)	9.3 (3.4)	12.0 (2.9)
Estonia	64.6	67.7	68.4	12.9	9.3	9.1	22.5	23.0	22.5	20.0	21.0	22.1	7.8 (5.0)	7.7 (5.2)	7.8 (5.4)
Latvia	53.9	54.0	56.0	20.7	21.4	20.4	25.3	24.6	23.6	25.3	25.3	26.0	9.9 (5.3)	10.5 (5.6)	10.8 (6.0)
Lithuania	65.7	74.1	91.0	4.7	4.0	4.8	29.6	21.8	4.1	24.2	25.8	22.8	7.5 (4.9)	8.3 (6.2)	7.3 (6.6)
OECD. Unweighted average. Unitary states [(1)]	43.4	-	-	21.7	-	-	38.3	-	-	-	-	-	11.5 (5.0)	-	-

Note (1) *Source:* Revenue Statistics, 1965-1999, Paris 2000.

23. With regard to the size of subnational governments -- indicated by share of subnational revenue out of GDP in 1999 -- the countries seem to fall into two groups. Latvia, Hungary and Poland are centred around 11-12% of GDP, while the subnational revenues in the Czech Republic, Estonia and Lithuania make up about 7.3 - 8.6% of GDP. When considering total subnational revenues out of consolidated government revenues, the same pattern appears. By this proportion of subnational revenues out of GDP, Latvia, Hungary and Poland are just in the average of OECD unitary states (1997) where 11.5 % of GDP was attributed to subnational governments. Interpretation of the latter information, however, should be made cautiously. Due to the ongoing transition of the public sector in CEE countries, public expenditure and revenue make up a relatively large share of GDP compared to OECD countries.

24. There seems to have been some development in fiscal decentralisation for the period considered. In Poland, the subnational proportion of total government revenues has expanded by more than a third, for the Czech Republic and Estonia, there has been an increase of 10 percentage points, whilst in Hungary, the proportion remained unchanged during 1997-1999. Lithuania, however, reported a decrease in the proportion of local revenues out of total revenues.

25. The composition of subnational revenues varies a great deal between the six countries, and also compared to the unweighted average for OECD unitary countries. The latest reported profiles from 1999 show that Lithuania and, to a lesser extent, Estonia focus primarily on tax revenues for the financing of subnational government. The proportion of the overall revenues in 1999 make up 91% and 68% respectively, compared to 48% in the Czech Republic, 56% in Latvia, 25% in Poland and 33% in Hungary. The OECD average is 43% (for 1997). On non-tax revenues, compared to the OECD average, the Czech Republic is somewhat above, with Poland, Latvia and Hungary on levels close to the average, and Lithuania and Estonia somewhat below the average. In relation to grants, about half of the revenues in Poland and Hungary are made up of grants, which is somewhat above the OECD average of 38%, whilst the rest of the countries report proportions well below the average.

26. The distribution of the country reporting with regard to the composition of local tax revenues by tax base is shown in Table 3.2.

27. With regard to 1999, Lithuania, Estonia and the Czech Republic reported a biased focus on one tax base with 90% and more of local taxes based on taxes on income, profits and capital gains. This is more than double the OECD average of 41%. When taking into consideration the information in Tables 3.1 and 3.2, it can be said that more than 80% of all revenues of local governments in Lithuania is based on this tax base. Taxes on property (category 4000) are traditionally considered as an important and valuable local tax base. Almost 40% of the tax revenue for subnational governments in Poland is based on this source, which is well above the OECD average of 33%. For the other five countries, the share of local taxes from property is much lower than the average. In the Czech Republic, the revenue from this tax base makes up about 1% of overall tax revenue.

Table 3.2 Classification of local taxes by tax base (in %), 1999

	Czech Republic	Hungary	Poland	Estonia	Latvia	Lithuania	OECD unweighted average for unitary countries, 1998. 1)
1000 Taxes on income, profits & capital gains	89.4	45.0	56.7	90.7	77.4	91.3	40.8
2000 Social security contributions	-	-	-	-	-		-
3000 Taxes on payroll and workforce	-	0.3	-	-	-		-
4000 Taxes on property	5.6	13.9	39.6	8.6	21.0	8.7	32.5
5000 Taxes on goods and services	4.9	-	3.6	0.7	1.6		16.3
6000 Other taxes	0.1	40.8	0.1		-		10.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note (1) Source: (OECD benchmarks): Revenue statistics, 1965-1999, Paris 2000.

3.3 Profiles on tax and revenue autonomy of subnational governments

28. As referred to in Chapter 2, the issue on local discretion in financial decision-making is a central theme in the questionnaire for the survey. The country data on this issue are summarised under the following three headings:

- Own tax revenue, Table 3.3
- Classification of grants in relation to subnational autonomy, Table 3.4
- Overall presentation of own revenue sources, Table 3.5

3.3.1 Own tax revenue

29. In identifying own taxes of subnational governments, the essential question concerns the separation of tax revenues across levels of government. The OECD has taken the initiative of developing a new system of classification regarding own taxes of subnational government (SNG). Taxes of subnational governments are, here, subdivided into categories of decreasing tax autonomy and then ranked by decreasing order of control that the SNG's can exercise over this revenue source:

(a) SNG sets tax rate and tax base
(b) SNG sets tax rate only
(c) SNG sets tax base only
(d.1) SNG determines revenue-split
(d.2) revenue-split can only be changed with consent of SNG
(d.3) revenue-split fixed in legislation, may unilaterally be changed by central government
(d.4) revenue-split determined annually by central government as part of the budget.
(e) central government sets rate and base of SNG tax.

30. In cases (a) – (c), the subnational government has total or significant control over its taxes. In the remaining cases, involving tax-sharing arrangements, its tax autonomy is very limited or non-existent.

31. For further information on the system of classification, please address OECD Revenue Statistics 1965-98, Special features and "Taxing Powers of State and Local government" OECD Tax Policy Studies, no 1., 1999.

32. With reference to the results in this survey - Table 3.3 - when considering 'own taxes' -- categories a-c where local government has control over the tax base and/or tax rate -- Hungary and Poland report a very large share of local taxes under these headings, for 1999. In Hungary, 50% of the tax revenue is characterised by local control over the tax rate and tax base, whilst in Poland, 40% of the tax revenue covers taxes with local discretion on the tax rate. For Hungary and Poland, the local tax revenue as a proportion of total government tax revenue equalled 10% and 8%, respectively. The Czech Republic and Estonia can be 'classified' in a second category, reporting 10% of local taxes as own taxes, while the remaining 90% are dealt with as a tax-sharing arrangement with central government. For Latvia and Lithuania, no own tax revenue is given, since the tax rate and tax base are 100% set by central government.

33. The publication, Taxing Powers of State and Local Government, reports the results of a survey of 19 OECD Member countries (including the Czech Republic, Hungary and Poland), based of the same classifications as in this survey. No distinct pattern across states can be identified. The profile of Poland

and Hungary is, to some extent, parallel to the situation for local governments in Portugal and Germany (a federal country), whilst the design of local taxes in Latvia and Lithuania seems not to have a parallel in OECD survey countries.

Table 3.3 Tax autonomy at the subnational government level: degrees of control given as percentages out of all tax categories

Category	Subnational government taxes as % of total tax revenue	a	b	c	d.1	d.2	d.3	d.4	e
Czech Republic									
1997	10.8	2.2	6.0	-	-	-	91.8	-	-
1999	11.1	2.7	5.6	-	-	-	91.7	-	-
Hungary									
1997	8.9		43.5	-	-	-	-	-	56.0
1999	10.4		49.2	-	-	-	-	-	50.8
Poland									
1997	9.1	-	39.3	0.7	-	-	60.0	-	-
1999	8.3	-	41.9	0.6	-	-	57.6	-	-
Estonia									
1997	14.6	-	9.8	-	-	-	90.2	-	-
1999	16.2	-	9.2	-	-	-	90.8	-	-
Latvia									
1997	15.7	-	-	-	-	-	-	-	100
1999	17.1	-	-	-	-	-	-	-	100
Lithuania									100
1997	16.7	-	-	-	-	-	-	-	100
1999	22.0	-	-	-	-	-	-	-	100

3.3.2 The system of grants in relation to subnational autonomy

34. In the questionnaire for the survey, the main distinction is set between general grants and specific grants. Within these categories, different arrangements can be identified relating to varying policy mandates and objectives from national government, and the specific form of grant distribution (degree of discretionality).

35. **General-purpose grants** are those which can be used as if they were the receiving subnational government's own tax revenues. Within this category, **grants related to objective criteria** are those which are distributed according to some measure of taxable capacity and/or expenditure needs, whilst **grants also related to own tax effort** are those related to objective criteria *and* to an authority's own tax effort in such a way that an increase in the level of local taxation for a given authority results in an increase in the amount of grant for that same authority.

36. Under the heading, **Specific grants - c*onditional grants*** are those where the amount of the grant (seen as revenue for each authority) depends on the expenditure of that same authority. At ***standard cost*** means that the percentage refund only covers a certain standard cost or some similar amount. If local expenditure exceeds this amount, the grant is reduced or not given at all. At ***actual cost***, there is no limit as to standard or similar limits but this does not include 100 per cent grants. Sometimes, a 100 per cent grant is given because the local authority acts only as an administrative agent carrying out a precisely defined function on behalf of central government. ***Discretionary grants,*** on the other hand, include grants which the central government may or may not distribute and which are distributed at the discretion of the government according to the particular circumstances of the authority in question. Normally, there are no general criteria for the distribution of such grants.

37. For further details on the classification, please see the Questionnaire for the surveys (which can be obtained from the OECD Secretariat).

38. Parallel to the findings in Table 3.3, the reporting of the countries in Table 3.4 can be 'grouped' into three types: for the Czech Republic and Hungary, almost 100% of the grants are reported as specific grants. In Hungary -- where the grants make up about 50% of the overall subnational revenues -- 95% of all grants are given as conditional, specific grants, based on standard costs. For the Czech Republic, the specific grants are distributed with approximately 50% as conditional grants and 50% as unconditional grants.

39. For Latvia and Lithuania, in 1997, 60-65% of the grants are classified as tied resources i.e. as specific grants, whilst the remaining part is distributed as general purpose grants. For Lithuania, in 1999, however, a large part of the grants was 'generalised', leaving a proportion of 45% as specific grants. In Latvia, the opposite trend was seen, in 1999.

40. In Estonia and Poland, the distribution of grants seems tied to central government to a lesser extent than for the other four countries. 60% of the grants are distributed as general purpose grants, and 40% as specific grants. It should be noted that grants make up a relatively large share of subnational revenues in Poland (about 50%), whilst in Estonia, the proportion is at an 'average' level of 20-23%. With the changes from 1999, as mentioned, Lithuania is also close to the profile of these two countries. However, as illustrated in Table 3.1, in Lithuania, the proportion of grants out of total revenues is disproportionately small.

Table 3.4 Profile of grants to subnational governments (in %)

Country/ Year	Specific grants				General purpose grant				Total	Grants as proportion of total local revenue
	Current				Objective criteria		Discretionary	Total		
	Conditional		Not conditional	Total	Without own tax effort	With own tax effort				
	Standard costs	Actual Costs								
Czech Republic										
1997	12.8	41.2	46.0	100					100	18.7
1999	16.0	37.2	46.8	100					100	16.0
Hungary										
1997	95.0	1.7	0.6	97.3		0.6	2.1	3.7	100	53.7
1999	94.2	0.6	1.8	96.6		0.6	2.8	3.4	100	50.0
Poland										
1997	12.5	24.4		36.9	63.1			63.1	100	34.3
1999	14.3	25.1		39.4	60.6			60.6	100	51.3
Estonia										
1997	35.6			35.6		64.4		64.4	100	22.5
1999	40.2			40.2		59.8		59.8	100	22.5
Latvia										
1997	87.2			87.2	12.7			12.7	100	25.3
1999	90.0			90.0	10.0			10.0	100	23.6
Lithuania										
1997	57.0	4.6		61.6	38.4			38.4	100	29.6
1999	12.7	32.5		45.2	54.7			54.7	100	4.1

3.3.3 Overall presentation of own revenue sources

41. The findings in Tables 3.3 and 3.4, together with other information on subnational revenues (Table 3.1), are summarised in Table 3.5. The total subnational revenue is classified into the categories "own revenues", "other free revenues" and "tied revenues" – cf. Table 3.5.

42. There does not seem to be an overall pattern of 'revenue autonomy' across the countries. The profile of revenue sources across the subnational revenue base differs to a large extent, just as the deciding power for setting the base and rate of taxation and the grant designs, is very unevenly distributed across the countries.

43. However, when referring to the findings in Table 3.5, there do seem to be some common features. In the Czech Republic, Hungary and Poland, own revenues make up a large proportion of total revenues, unlike in Estonia, Latvia and Lithuania. For the former three countries, the proportion is between 33% and 40%, whilst in Estonia, Latvia and Lithuania, own resources make up 15%, 20% and 5%, respectively. The profile of own revenues, however, seems very different across the first group of countries. In the Czech Republic non-tax revenues make up about 90% of own revenues, as against to about 66% in Poland and approximately 50% in Hungary.

44. The major part of subnational revenues in Estonia, Latvia and Lithuania are classified in the next category, "other free revenues". Tax sharing arrangements or taxes set wholly by central government make up between 56% and 91% of the overall revenues in the three countries. Poland and the Czech Republic report about 45% under this category, whilst less than 20% of the revenues for subnational governments in Hungary are raised under this category.

45. Finally, when considering "tied revenues", Hungary reports approximately half of the revenues as tied revenues, whilst Lithuania, at the other extreme, reports 2%. In between, in the four remaining countries, this part of subnational revenues makes up 10% to 20%.

46. To summarise Table 3.5, from an overall perspective, Poland and the Czech Republic seem to have parallel profiles, as do Estonia and Latvia. The own revenues profile of Hungary and Lithuania seems to deviate from that of the rest of the countries, on more basic terms.

Table 3.5 Local government. Summary of profiles of current revenue, 1999

	% of financing					
	Czech Republic 1)	**Hungary**	**Poland**	**Estonia**	**Latvia**	**Lithuania**
I Own revenues:	40.2	33.3	35.2	15.4	20.4	4.8
– own taxes, category a - c	(3.9)	(16.3)	(10.6)	(6.3)	(0.0)	(0)
– non-tax revenue	(36.3)	(17.0)	(24.6)	(9.1)	(20.4)	(4.8)
II Other free revenues:	43.8	18.5	44.9	75.5	58.4	93.3
– general grants	(-)	(1.7)	(30.5)	(13.4)	(2.4)	(2.3)
– tax sharing , category d – e	(43.8)	(16.8)	(14.4)	(62.1)	(56.0)	(91.0)
III Tied revenues	16.0	48.2	19.9	9.1	21.2	1.9
– specific grants	(16.0)	(48.2)	(19.9)	(9.1)	(21.2)	(1.9)
Total	100	100	100	100	100	100

Note 1: The proportion of non-tax revenue out of total revenue was extraordinarily high in 1999. For the figures on 1997-98, please refer to Table 3.1

3.4 Summary of regional fiscal design in Latvia

47. As mentioned at the beginning of this chapter, Poland and Latvia are the only countries with a regional self-government level. However, only Latvia was able to report data on regional government finance.

48. The profile of regional revenue sources in Latvia is summarised in Tables 3.1 and 3.5 of the Latvian country report. Seen across the three reported years, some fundamental change in the composition of the revenues seems to have taken place. Regional governments depend largely on grants, which made up 73.1% of all their revenues, in 1999 this proportion is almost double that of 1997. 83.9% of all grants are reported as specific grants. In 1998-99, no tax revenue was assigned to regional governments.

49. This trend of continued deprivation of “own” revenues is accompanied by a sharp decrease in regional revenues: their proportion of consolidated government revenues dropped by 80% to a minor share of 2.0%, in 1999. The same pattern appears when looking at the share of GDP which, in the same year, made up only 0.8%.

3.5 Profiles on subnational expenditure

50. As referred to in the presentation of the revenue profiles, the level of decentralised expenditures -- seen as the proportion of total government expenditure of which subnational authorities dispose -- is somewhat higher in Hungary, Latvia and Poland than in the three other countries: the figures are almost 24%, 24% and 28%, for Hungary, Latvia and Poland, respectively, whilst in the Czech Republic, Estonia and Lithuania the proportion is 18%, 20% and 20%, respectively. (see Table 3.6)

51. There are some distinct differences in the composition of expenditure, by policy sector, across the countries (Column A). In the Czech Republic, more than 60% of subnational expenditure is divided between the three sectors of "Housing", "Transportation and communication" and "General public services". Such an expenditure profile to some extent reflects the transitional tasks subnational governments are given as part of the Czech Republic’s overall economic transition policies. For further information on this issue, please refer to the sections below on “housing expenditures”.

52. A similar concentration of expenditure, but in relation to quite different policy areas, is found in Lithuania. Almost two thirds of total subnational expenditure is divided between the welfare service fields of "education" and "social security and welfare". The same pattern, but to a lesser extent, is followed by Estonia.

53. In Poland, Hungary and Latvia, there is a more diversified composition of subnational expenditure. Only in Hungary does health expenditure make up a relatively large part of subnational activities. When considering this area, Hungary seems to have a similar concentration to Lithuania on welfare services, with the proportion of total subnational expenditure to education, health and social security & welfare making up 66-67%.

54. In all countries apart from the Czech Republic, education seems to be an important local policy sector. Education expenditure represents from 33% in Poland and Hungary to 50% or more in Latvia and Lithuania. As shown in Column B of Table 3.6, in these countries, subnational governments dispose of a large proportion of general government expenditure: from 50% in Estonia to 71% in Poland.

55. The same level of subnational proportion of overall government expenditure is found in the "Housing" sector. Although it makes up a minor part of the expenditure for most countries (apart from

Poland and the Czech Republic), for all countries, the local proportion of the overall expenditure on housing is between 80% and 100%.

56. In two sub-sections below, a further presentation is given on the fiscal design in these two sectors of "housing" and "education".

57. Parallel figures from Denmark -- one of the survey pilot studies carried out in 1999 -- have been added to Table 3.6. For a number of reasons, comparisons between the OECD profiles and the profiles for the six economies in transition should be made with some caution. It appears, however, that in Denmark subnational governments make up a somewhat larger share of total government expenditure than is found in any of the six countries. At the same time, expenditure is even more concentrated on the sectors of welfare service, education, health and social services than in the countries in the year 2000 survey.

Table 3.6 Current subnational expenditures by function, as a percentage of subnational government expenditure (A) and as a share of consolidated general government expenditure by expenditure issue (B) (1999)

		Czech Republic		Hungary		Poland		Estonia		Latvia		Lithuania		OECD-benchmark - Denmark – (1996) 1)	
		A	**B**	**A**	**B**	**A**	**B**	**A**	**B**	**A**	**B**	**A**	**B**	**A**	**B**
1	General public services	13.5	42.9	14.3	47.2	8.8	44.0	13.5	37.5	13.0	42.2	4.6	20.8	5.2	29.0
2	Defence	0.05	0.2	0.05	0.6	0.02	0.2	0.02	0.2	-	-	0	0	0	0
3	Public order & safety	2.5	9.8	1.2	7.6	5.1	32.6	0.3	0.9	1.6	6.3	0.8	2.6	0.3	9.3
4	Education	10.0	18.1	32.6	66.2	33.9	71.2	40.8	49.2	49.5	73.2	56.3	68.0	16.2	52.3
5	Health	1.1	1.3	18.6	43.8	2.5	7.0	1.2	1.5	1.1	2.6	0.5	0.7	21.5	98.1
6	Social Security & Welfare	9.3	5.1	16.1	11.1	10.9	6.8	12.5	7.5	8.7	4.9	16.1	8.7	43.9	48.8
7	Housing & community amenities	31.7	79.1	8.6	*	22.8	88.5	10.4	97.7	10.4	80.1	7.9	100	0.7	22.0
8	Recreational, cultural & religious affairs	6.8	54.6	4.6	46.5	5.1	74.4	9.0	40.6	5.6	47.1	4.9	36.2	3.5	57.0
9	Fuel & energy	0.04	1.8	-	-	-	-	1.0	100	0.06	50.0	3.1	94.3	0	0.2
10	Agriculture, forestry, fishing & hunting	0.6	5.1	0.7	5.2	2.2	32.5	0.07	0.6	0.1	0.6	0.01	0.02	0.04	4.8
11	Mining, manufacturing & construction, except fuel & energy	0.2	9.3	0.07	12.7	0.6	28.0	-	-	-	-	-	-	0.1	12.9
12	Transportation & communication	17.7	43.7	1.2	12.2	7.1	64.0	5.5	18.4	4.5	23.0	3.4	15.4	4.6	48.0
13	Other economic affairs	0.6	3.5	1.0	10.6	0.3	18.0	1.7	39.4	0.2	4.2	0.04	1.8	2.7	35.5
14	Other functions	5.7	42.9	0.8	1.0	0.6	2.3	3.8	26.8	5.1	39.0	2.2	6.2	1.2	4.3
15	Total	100	18.3	100	23.7	100	27.6	100	19.7	100	23.1	100	19.6	100	43.9
	Total current government expenditure. Consolidated % of GDP	43.0		44.0		43.6		36.2		41.4		32.1			
	Total current subnational government expenditure. % of GDP	7.9		10.4		12.1		7.1		9.5		6.3			

B-column: current local expenditure as % of current government expenditure.
NOTE: (*) Social security contributions are included in the figures, but not consolidated. Data is therefore not compatible.
Note 1 Source: FDI 2000, Danish country report.

3.6 Further information on "education" and "housing" expenditures of subnational governments

3.6.1 Education

58. The Czech Republic has a very distinctive subnational expenditure pattern in comparison with the other five countries. This is particularly obvious in the field of education. Whilst the other five countries have reported education as being amongst the most important subnational policy sectors, in the Czech Republic, education only makes up 10% of local expenditures. The local contribution to overall expenditures in the field of education (18%) is also far below the average of the other five countries (66%).

3.6.1.1 Expenditure assignment on education in the Czech Republic

59. In the Czech Republic, education is a shared function between the central and local governments. The responsibilities of each municipality are divided between own responsibilities and delegated responsibilities. Education belongs to the realm of own responsibilities of municipalities.

60. Local governments are responsible for providing children with pre-school education and a 9-year compulsory education. However, teachers are employees of central government which is also in charge of paying their salaries and buying a proportion of school textbooks. In addition, central government supports compulsory and pre-school education through a per-pupil grant, calculated as a percentage of the average operating costs of these schools. A small grant is also assigned to the capital costs of school building renovation.

61. Central government is also responsible for providing higher education and running special schools for handicapped and mentally-retarded children but some big cities also run these. Some local governments provide vocational education facilities, such as music and painting schools, which are partly financed through fees. When a child up to the age of 15 from one municipality attends a school in another municipality, the municipality in which this child resides pays a proportion of the school running costs.

62. Contrary to the Czech profile, Latvia and Poland report the most decentralised assignment of responsibility:

- In Latvia, subnational governments assume comprehensive expenditure responsibility for education. They contribute almost three-quarters of national expenditure. Table 3.6 of the Latvian country report clearly shows the distribution of expenditure responsibilities across levels of government: subnational governments are almost exclusively responsible for the provision of primary and secondary education, whilst central government is exclusively in charge of providing higher (tertiary) education. Subnational expenditures for primary and secondary education make up 82% of general government expenditure, the large majority of which (87%) is being paid by local authorities (republican cities, rural authorities and towns). The regions are mainly responsible for the further education of pedagogical staff and for deciding on teaching methodologies.

- In Poland, where subnational governments hold an equally high share in national expenditures on education (71%), education is also the most important subnational policy task, making up 34% of regional and local expenditures. Although central authorities and all three levels of subnational government share responsibility in this policy field, it is increasingly a subnational policy domain. The ratios are the result of a significant growth process over the years 1997-99 when subnational expenditure on education rose by

64.7 per cent (nominal growth). Although nominal growth has been seen in almost all areas of local expenditure, it has been highest in the field of education. Self-governing voivodships are responsible for higher vocational schools, poviats for the establishment and operation of special high schools, special secondary schools, high schools and sports schools, whilst gminas are empowered to manage kindergartens, primary schools and secondary schools. The central state, however, merely holds the financial and operational responsibility for state schools, art schools and tertiary education establishments.

3.6.2 Housing

63. The data in Table 3.6 show that housing is clearly a subnational policy field, although its importance locally seems to be relatively small. Only the Czech Republic and Poland report above average ratios. In the Czech Republic, housing and community amenities is the most important local policy sector, in Poland it is the second most important. In the Czech Republic, the sector represents nearly one third of local expenditures, whilst in Poland, the local share is 23%. However, the share of overall expenditures covered by the regional and local governments is even higher in Poland, at 90%, than in the Czech Republic, at 80%.

64. A closer look at the two countries shows that the high local proportion is due to the transfer of formerly central state-owned housing to local levels which became almost entirely responsible for the ongoing privatisation process. The high proportion seems to indicate that, compared to the other four countries in transition, the local governments in the Czech Republic and Poland seem largely to have maintained the former state-dominated structure of housing provision.

3.6.2.1 Expenditure assignment for housing in the Czech Republic and Poland

65. Generally speaking, in the Czech Republic, local governments are responsible for housing. Municipalities were transferred almost all housing facilities which were built by the state prior to 1990. However, since there are no national mandates or standards for the provision of subnational services, it is entirely up to each municipality to decide how they want to distribute their funds across the functions. As stated in the Czech report (p.18), the municipalities have dealt with this newly-enlarged responsibility for housing and community amenities in different ways: Some have rented the housing facilities out, some have sold them. It was up to them which part of the housing stock to keep and which one to sell, and under what conditions. Hence, the situation differs significantly across the country. Flats in municipal houses were sold predominantly to the occupiers of the time. For state-owned houses, there is rent regulation with central government setting the maximum increase in rent, each year. The regulation does not concern the newly built flats financed without central government assistance.

66. In Poland, all the housing stocks that are not in the hands of the State Treasury and are not in private or collective ownership, are owned by gminas. Accordingly, gminas are responsible for most of the maintenance for these state-owned housing stocks, making the repairs and renovations detailed in the Act on Renting Premises and Housing Allowances, of 2nd July, 1994. As the owners of apartments, gminas are also able to sell them.

4. THE BALANCE BETWEEN NATIONAL FISCAL TARGETS AND SUBNATIONAL FINANCIAL DISCRETION

4.1 Introduction

67. In addition to the overall government finance indicators on subnational governments, as presented in Chapter 3 of this note, the country surveys cover a number of matters to do with the specific mode of subnational financial decision-making, including the specific design of intergovernmental financial relations. This Chapter describes some of the main findings in the surveys on these issues.

68. The questions on the mode of financial decision-making are compiled under the overall heading of "Setting the balance between local discretion and autonomy in financial decision-making on the one hand, and macroeconomic control and fiscal discipline on the other". Setting the balance in the power distribution across levels of governments is, of course, at the focus of reform considerations in all countries - in OECD Member countries just as in countries in transition. Indeed, the surveys show that a certain amount of consideration has been given to policy and a number of policy decisions have been taken in the six countries. Reforms are taking place in all the countries, though there are still some outstanding problems and gaps in efficiency.

69. It is generally acknowledged that fiscal decentralisation results in a number of allocative efficiency gains. Local priorities and preferences regarding local public services are best met by allowing for local decision-making on the amount and standard of the services, and the local mobilisation of the relevant revenue sources. In economies in transition, however, political considerations on allocative efficiency should be taken in close connection with overall targets on stabilisation policies for the economy. This also includes political decisions on structural reforms, like labour market reforms, privatisation programmes, etc. Such structural reforms may require a strong central lead of the reform processes, which may, at the same time, imply a halt to furthering the fiscal decentralisation processes. For a more detailed introduction to stabilisation and structural policies in the six countries, please refer to the OECD Economic Surveys. The latest assessment of the three Baltic States were issued in February 2000, under the OECD Baltic programme, whilst reviews on the Czech Republic, Hungary and Poland can be found in regularly published assessments.

70. In this survey, for obvious reasons, focus is restricted to the prerequisites for making the allocative gains of fiscal decentralisation a reality. Do central governments impose a ‘package’ of hard budget constraints on subnational governments, to ensure political accountability for local government affairs and overall national fiscal discipline? What kind of regulations and agreements surround the decentralised expenditure and revenue powers, in order to ensure that the positive benefits of economic decentralisation come through, and that the overall national targets on expenditure and financial control policies are met?

71. In the questionnaire and, more specifically, as set out in the sections below, the following questions and issues were raised, in order to identify the country-specific ‘balances’ or designs:

Taxation

Measures on overall fiscal co-ordination and policy coherency. What kinds of measures are there to ensure co-ordination between central and local tax policies? Are there any national restrictions on local autonomy: targets for each local government on total revenue from a specific source; targets for the range (min./max.) of the specific tax rate; exemptions from the tax bases set centrally; etc.?

– Are subnational governments free to decide whether to impose taxes, or are taxes mandatory?
– Are they combined with minimum rates (cf. above)?

National measures for revenue-efficient local tax administration. Central assistance in general capacity-building of local tax administrations, including central systems in support of local administrations.

Central assistance in optimal exploitation of subnational tax sources, e.g. national systems of valuation.

Non-tax revenue

What kind of overall measures are set up to restrict and control subnational government revenue from non-tax sources? Are subnational governments generally allowed to deficit finance with non-tax revenues?

Grants

What overall measures are set up to avoid national budgetary pressures from subnational government? How are the annual overall amounts for grants determined e.g. automatically (as set out in substantial law); as a share of current revenue (identity of the revenue e.g. by base); or set as discretionary in the national budget law? How are the grants allocated – cf. the categories identified in the tables.

Have reforms taken place due to insufficiencies in the overall design of the system of intergovernmental relations, i.e. the lack of stable, reliable, transparent, well-documented and formula-based relations and procedures?

Borrowing

Procedures on the bail-out of subnational governments. To what extent can subnational fiscal imbalances be passed back to the national government? Does central government set conditions for helping subnational governments in deficit?

Expenditure

Is there clear assignment of expenditure responsibilities across levels of government? What is an appropriate size of unit for the cost-efficient operation of subnational government services?

Macroeconomic control of local governments -- Budget co-operation (expenditure) between central and subnational levels. Main characteristics of the instruments for the central control of expenditure Institutions and procedures for expenditure control. The decision-making processes.A summary of recent reforms of central-local relations. Background and objectives. Have there been reforms due to insufficiencies in the overall design of the systems of budget co-operation: the lack of stable, reliable, transparent, well-documented and formula-based relations and procedures?

Specific budget co-operation. Compensation when new activities are assigned to subnational governments: according to which principles is the compensation calculated?

72. The survey replies to these questions are summarised in the following subsections, 4.2 - 4.3. Section 4.2 deals with the issues on subnational government size and the expenditure assignments to subnational governments. Section 4.3 summarises the situation of the framework on subnational finance.

4.2 The framework of government size and expenditure assignments

4.2.1 Subnational government size

73. With regard to the size of municipalities, one substantial result from the six survey countries is the problem of fragmented government. Apart from Lithuania, in the other five countries, most local expenditure responsibilities are carried out by a large number of local governments, often with a small unit size. This is the case in the Czech Republic where almost 80% of the municipalities (1999) comprised no more than 999 inhabitants, and also in Hungary (53.7% of the municipalities in 2000). Latvia also shows a very fragmented picture of territorial administration with more than two thirds of the municipalities (71.4 %) having less than 2 000 inhabitants. In Estonia, in 85 % of the municipalities, the population does not exceed 5 000 inhabitants. Poland and Lithuania show a somewhat different territorial government structure, their municipalities being bigger. According to the Polish report, two thirds of the municipalities have less than 10 000 inhabitants. In Lithuania, the structure is indeed very different from the rest of the countries, with the most concentrated local government structure: populations of less than 10 000 people are only to be found in 3.3% of the municipalities.

74. Cost-efficient operation of local services does require municipalities of a certain size. As an example, municipalities smaller than 6 000-8 000 inhabitants are traditionally considered too small to run their own schools and facilities in relation to primary education. All countries except Lithuania, will apparently have severe problems in assigning precise and sole responsibilities to subnational governments to carry out decentralised tasks. Please refer to Section 4.2.2 below on these issues.

Table 4.1 The distribution of municipalities by size. Various years

Number of inhabitants	Proportion of municipalities (A), proportion of population (B)											
	Czech Republic (1999)		Hungary (2000)		Poland (2000)		Estonia (1999)		Latvia (2000)		Lithuania (2000)	
	A	B	A	B	A	B	A	B	A	B	A	B
- 999	79.6	16.8	53.7	7.5			10	1	32.3	5.6		
– 1 999	90.0	25.6	74.7	16.7	23.4	5.9	49	11	71.4	18.2		
– 4 999	95.8	36.2	91.0	31.5			85	30	91.1	31.5	3.3	0.3
– 9 999	97.9	45.3	95.5	40.9	66	25.4	94	40	95.5	38.8		
– 49 999	99.7	66.8	99.3	63.6	96	61.9	98	52	99.1	54.2	66.6	32
– 99 999	99.9	79.0	99.7	71.1	98.2		99	64	99.6	62.9	91.6	60
>100 000	100	100	100	100	100	100	100	100	100	100	100	100

75. In the Estonian country report, there is some evidence to indicate that smaller local government units have a smaller administrative capacity at the level of public service provision and infrastructure conditions. Research has been carried out on the local government socio-economic situation, stating that under-performance in some local government tasks in some of the smaller municipalities is mainly due to scarce financial resources. Such research and study results were not reported in the other country surveys.

4.2.2 The assignment of expenditure responsibilities across levels of government

76. All six countries reported on overlapping and shared tasks between the tiers of government. They reported a number of outstanding problems and issues that constitute major obstacles in ensuring overall efficiency and local political accountability.

77. In Latvia, local and regional governments are carrying out compulsory tasks (of a permanent or temporary nature) and voluntary tasks. The allocation of these tasks is often not explicitly allocated to a particular level of government. The Latvian contribution states that “the necessary standard of tasks is not demarcated in detail in the law and the minimum national standard service level very seldom is stipulated.” To this is added, “the division of these tasks {…} depends on the abilities of the regional and local governments in the region and personal initiatives from politicians and administrative employees.”. A municipal government can also give up certain functions by transferring them, by mutual agreement, to another municipal government.

78. The Hungarian contribution points out a very sub-divided structure of local government: for more than half of the local governments (54%), the population is less than 1 000. Within this structure, however, all local governments, irrespective of their size, are in principle attributed the same set of rights and duties. There is no specific regulation concerning the public services that the “smallest” local governments have to supply. “All the local governments have equal rights meaning that the soviet-type system of subordination and superordination was terminated”. As far as duties are concerned, “a local government is entitled to determine the ways and modes for the performance of the various duties – depending on the requirements and demand of the local population and its financial resources.”. Similar to Latvia, local governments can make arrangements to transfer certain services to other local governments.

79. In Poland, ipso iure competencies of local and regional authorities are specified by legislation. A distinction may be drawn between compulsory and optional tasks. Under the Act of 8th March, 1990, all public matters of local importance not assigned to other authorities by law fall within the competence of the municipalities. The poviats perform supra-municipal local tasks, while voivodships frame regional development strategies. In the Polish contribution, there is a clear indication of the role and mandate for local and regional governments in each policy sector, as set out by law. The principle governing the division of power is the principle of subsidiarity. As stated in the Polish report, the main problem seems to be that the decentralisation of functions to local and regional levels has not been accompanied by a sufficient decentralisation of own subnational revenues, “A considerable part of the given tasks, especially those realised by poviats and voivodships, is still financed by means of transfers from the state budget”.

80. In the Czech Republic, the responsibilities of local governments are divided between own and delegated responsibilities. Delegated responsibilities include the local contribution to the performance of administrative state tasks like keeping the birth, marriage and death registers. However, “not every municipality meets all the tasks included in delegated responsibilities.” Only 6% of the municipalities assume these duties, whilst the remaining 94% have delegated the functions to larger municipalities. Only housing and community amenities are the exclusive duty of local government. All the other local government functions are functions shared between state and local levels. However, in the field of recreational, cultural & religious affairs, local governments have the main responsibility for the service. Contrary to most states, social security and welfare functions, as well as health, are fields substanially in the hands of the central government.

81. Contrary to the Czech Republic, in Estonia “most local government responsibilities are full and exclusive, but there are some tasks shared between the municipalities and the central government.” An example of the latter is health care. There seems to exist a rather clear indication of the role and mandate for local governments for each policy sector, set out by law. Apart from their own functions, municipalities can also carry out some central government tasks “which can be passed on by a contract between an authorised central government body and a specific local government unit.”(p.18)

82. In Lithuania, public duties are carried out by central and local administrative governments. The regional governments, who exercise devolved central state authority, have also been prescribed their own duties, competencies and responsibilities. Only housing and community amenities are exclusively local functions, attributed by law. An untypical pattern of responsibility-sharing exists in relation to the fuel and energy policy where local governments have been assigned the overall competency.

83. To sum up on the assignment and “size” issues, the fragmented subnational government structure experiencing the “too many municipalities and too small” problem undoubtedly explains some of the problems on the opaque and dispersed task assignments. A number of special assignments, exemptions, etc. have to be in place in order to compensate for the fact that not all municipalities have the capacity to deal with the assigned tasks. Arrangements are set up to allow for (voluntary) transfer of tasks to other types or levels of government, just as the sector-specific laws and regulations have to be prepared with very weak or even absent standard requests for the local services to be provided.

84. These facts put a strain on the possibilities of ensuring local political accountability, including local provision of cost-efficient services whilst at the same time ensuring tight targets in the overall national expenditure policies.

4.3 Evaluation of the subnational finance framework

85. This section summarises the country surveys on the subnational finance framework. The findings are given, country by country, primarily by quoting from the relevant sections of the country reports. The summaries have been prepared with direct reference to the questions structure presented in Section 4.1. For a complete presentation of the country systems of finance framework, please refer to the full country reports.

4.3.1 Lithuania

86. **Tax revenues**. In accordance with Lithuania’s legal system, only central government can set the local government tax rate and base which are assigned to the tax revenues. This is done on a multi-annual basis.

87. Local governments have the right to set the tax base and rate for local levies and for municipal budgetary revenue obtained for the services rendered. The two types of revenue comprise up to 10% of all the **non-tax revenue** of the local governments.

88. The amount of general **grants** is determined according to the amount of expenditures expected for the planned years of all municipalities minus the expected amount of tax and non-tax revenues of all municipalities and minus special grants planned to be assigned from the state budget.

89. **Borrowing and bail out**. The municipal councils approve the budgets. The budgets should be approved as deficit-free, balanced budgets. If a municipality intends to re-borrow or make a guarantee or to give bail, it has to get permission from the Ministry of Finance. The Ministry of Finance controls municipal borrowing limits.

90. **Expenditure and budget co-operation.** The overall volume of expenditures of all municipal budgets is determined as a percentage of total expenditure of state and municipal budgets. Basic indicators determining the volumes of municipal budgets and equalisation degrees are planned for a three-year period in order to help municipalities achieve stable forecasting of their own activities, priorities and investments, and a better supply of services. Central Government together with the Municipal Association presents these indicators to Parliament for approval for the three-year period. The evaluation of the fiscal needs of a municipality is based on the calculated need of expenditures determined on a three-year basis.

91. **Compensation for new tasks**. Together with the proposed new laws, government resolutions and other legal acts concerning government institutions and municipalities, all new tasks presented must include an evaluation of their financial cost and of their impact on revenues and expenditures. No explicit guarantee of actual compensation for the increased local government expenditures seems to be given here.

4.3.2 Latvia

92. As in Lithuania there are no municipal **taxes** in Latvia. All taxes are set and collected by central government. Part of the revenue is allocated to the local government budgets. In relation to personal income tax (the main tax revenue source for subnational governments), the tax base and the tax rate of personal income tax are set by central government without the influence of local governments. The local authorities are guaranteed the central government prognoses of the tax revenue.

93. The Ministry of Finance forecasts the total amount of **non-tax revenues** for the fiscal year, using preferential macroeconomic developmental tendencies. This forecast is included in the annual Dispute and Settlement agreement between the Cabinet of Ministers and the Union of Local Governments. Local governments plan their own non-tax revenues and also administer these non-tax revenues. There are no controls on the amount of this revenue.

94. **Grants.** The volume and purpose of both earmarked and general grants are set annually in the national budget law. Earmarked grants are mainly for salaries, investments and development issues, whilst general grants are assigned inter alia to the *local government equalisation fund* and, since 1999, allocated to municipalities for the implementation of the territorial reform. As mentioned in the Latvian report, the most severe problem in the present grant system seems to be the calculation of the total expenditure needs of one year before the next financial year arrives.

95. The framework on **borrowing** was strengthened in 1996-97, with a detailed regulation introducing a yearly cap on borrowings and guarantees, to be determined by the annual State Budget Law. The annual debt level for the municipalities is limited, and set in the annual law on the national budget. In l996, a local government borrowing supervisory body (“Board”) was set up, based on a Regulation from the Cabinet of Ministers. The Latvian State Bank, the Government and the Union of Local Self-Governments are members of the board. All local government borrowing and guarantees have to be approved by this Board. The Board has considerable powers of regulation and supervision of local government borrowing and guarantees, including approval of these, which is delegated from the Cabinet of Ministers.

96. There is a special stabilisation fund for local authorities with severe economic problems that need bailing out. The bail -out procedures are regulated by law. There are no strict limitations on further local government borrowings.

97. **Budget co-operation**. The total financial envelope i.e. the total financing of local government expenses for the coming year, is set after negotiations between the central and local governments in the yearly protocols. These protocols contain the total local government expenses, revenues, state grants and revenue composition. Municipalities independently prepare, approve and manage their budgets, as well as make decisions on the expenditures. However, the municipality’s budget expenditures in the financial year shall not exceed the total amount of estimated revenue for the respective budget year plus the balance of previous year funds. According to law, local governments are compensated for new tasks or changes in the task portfolio. The sources of state financing to cover the increase in expenditure or decrease in revenue of the local government budget must be indicated in any new law or Cabinet Regulation. In practice, these procedures are not always followed.

98. **National standards on expenditures**. In general, there are no output controls of local government service provision. Local governments are free to provide services in accordance with the law, structure the provision of services, etc. Some sector areas e.g. education, welfare and environment, have very few norms, and, in general, the service level is decided by the local government.

4.3.3 Estonia

99. Utilisation of **own tax sources**. The amount of tax revenue from own taxes is marginal. In Tallinn, for example, only three of the potential municipal taxes have been levied: on advertising, on closing roads and streets, and on motor vehicles. The total revenue generated by local taxes only constituted 2.3 per cent of Tallinn's total gross revenue, in 1999. Out of all local taxes in Estonia, this revenue constituted about 85%. Several taxes (head tax, local income tax and entertainment tax) have not been imposed by any of the local authorities during the last few years. According to the Estonian report, some of the main reasons behind this are that: the financing system as such does not favour local taxes; local taxes are difficult to administer due to a lack of own local tax authorities; and municipalities prefer fees as a revenue source because imposing local taxes is considered unpopular, locally.

100. In Estonia, local governments are quite free to finance their expenditures through **non-tax revenues**. There is no special regulation for local government non-tax revenues. There is a regulation for property income (as for revenues on natural resources), fees and fines but the regulation covers general government.

101. The global amount and annual allocations of the general **grants** are worked out during negotiations between the government and the "co-operative assembly" created by local government associations.

102. **Borrowing**. Local budgets have to be in balance (outflows equal to projected inflows). In only a few cases has central government helped local governments in debt, by providing them with additional loans, and only one municipality has been bailed out so far (in 2000). No uniform regulation on bail-out has been prepared yet.

103. **Expenditure and budget co-operation.** Local governments are independent in their budget formation. There are no targets set for local expenditure. The central government has determined the normative level of the provision of certain public services but it has not attached any financial targets to this or any other field of local expenditure. Central government does, however, control local government expenditure by fixing the tax rate of state taxes and by allocating grants: Allocations to the Support Fund and setting the rate of special purpose allocations.

104. Financing additional tasks set by law always receives special attention. Local government units, however, claim a higher budget for tasks set to them by law, and feel that transfers from the support fund in order to fulfil these tasks are not in proportion with national requirements on standards set for service provision.

4.3.4 Czech Republic

105. **Taxation.** Central government bodies in the Czech Republic administer most of the local taxes, including collection and revenue assignment. Only small – from a fiscal point of view – taxes and fees on specific goods and services are completely administered by local authorities.

106. Municipalities are free to set tax rates on goods and services, respecting upper limits indicated by central law. They are also free to define the tax base through exemptions and various reliefs. Municipalities collect taxes and exclusively benefit from the revenues. As far as frequency of facultative implementation of the above-mentioned local taxes on goods and services is concerned, about 90% of municipalities use their right and impose at least one tax.

107. The tax revenues obtained by municipalities will be changed from 2001. In general, all tax revenues will be centralised, and partly distributed back to the municipality's budget. Lack of local

government discretion over tax rates, the tax base, the collection process, and their share in the revenue, would ordinarily make personal income tax on wages and salaries, personal income tax of unincorporated individuals, and corporate income tax and levies on the withdrawal of land, central government taxes. Only the fact that the proceeds of personal income taxes and levies on the withdrawal of land are distributed in the area in which they are collected, makes them close to the "own taxes" of local government. Local tax administration will be similar to the present local fee administration. There will be no national system of valuation or setting up of revenue benchmarks.

108. There are no national limits on deficit financing through **non-tax revenues**. Deficits may be financed with tax- as well as non-tax revenue and by debt. The only exception is that some central government grants provision includes as a criterion that a municipality deficit/operating revenue ratio does not exceed 15%. Municipalities, when providing local services, are mandated to set the price themselves.

109. The obligatory **grants** (mainly operating grants) are calculated each year when preparing the central government budget. Capital grants to local government are provided according to the approved central government budget. The system of grants is not designed in a way to avoid national budgetary pressures from local government. Grants to local government are not only distributed from the state budget but also from extra-budgetary funds, the most important being The State Environment Fund.

110. The Czech country report sees the grants system reform as overdue, in the light of overcoming the lack of stable, transparent, well-documented and formula-based relations and procedures.

111. There is no control on local **borrowing,** at present. Local government may borrow any amount, from any institution (even abroad) for any reason, at any terms of interest rate, maturity etc. Legislation says that central government is not responsible for local debt. There has not yet been a case in which central government has been called upon to assist a municipality in financial difficulty. One reason is that, through the tax sharing principle, each local government is granted a certain amount of money regardless of its activities. No rules on bail-out have been prepared.

112. **Expenditure and budget co-operation with central government.** There is no overall budget target for local government set by general budget frames or specified by sector or output targets. Local government is limited in its expenditure policy by law and by specific grants only.

113. When new activities are assigned to local government, the proportionate increase in expenditure is reflected in the increase in grant. The compensation is calculated by central government.

114. There are no national mandates for arranging subnational services. There are no standards of local services, no targets for local capacity. There are no expenditure norms and standards, no part of the budget is earmarked for specific activities, except central government grants. The choice between own production of services and contracting out is up to each municipality. The recruitment of personnel is also for the municipality to decide. The payment of personnel is ruled by a law valid also for state administration personnel.

4.3.5 Hungary

115. **Local tax revenue.** The Constitution in Hungary provides that a local government is entitled to raising its own revenues - for the performance of its law-defined duties - and that it is also entitled to state subsidies that are proportionate to such duties. A local government is entitled to establish the types and rates of local taxes within the limits specified by law. A local government is not under obligation to introduce and collect local taxes. The act on local taxes establishes the possibility of taxation.

116. According to the Hungarian report, local governments exercise their taxation right in a carefully planned way, in view of the local conditions, taking into account the taxpaying capacity of the local population. Local taxes have been collected for some ten years now as part of the Hungarian taxation system. The number of local governments collecting local taxes and their revenues have been steadily increasing. In 1999 93 percent of all local governments applied local taxes. Local taxes accounted for some 18 percent of all current revenues of logos in 1999 - to be compared with the mere 3.5 percent in 1990 when 'council taxes' were collected.

117. No direct central measure has been taken in order to increase local governmental revenues. In an indirect way, however, a local governmental tax authority is helped by the fact that - subject to statutory limitations - they may ask for and may be given information by the central tax administration on the taxpayers operating in their areas of competency.

118. **Non-tax revenues**. The rules on the establishment of service charge type fees are specified by decrees issued by the Government and line ministries concerned. In some cases these also specify the mandatory allowances to be applied by local governments. The expected annual revenue on non-tax sources appear not to be taking into account when estimations on needed state revenues to local governments are identified on the Budget bill to Parliament.

119. The system of **grants** from central government to subnational governments, as presented in details in chapter 3 in the country survey, allocate resources by a very comprehensive set of subsystems, based on a number of normative criteria. The system seems to weaken the possibilities for efficient local decision-making on the level and the standard of the locally provided services, and as such appears to be a significant barrier for political accountability at local levels. The system of grants seems difficult to administer in straightforward manners, just as the normative criteria apparently to some extent are subject to negotiation and as such potentially may be changed annually.

120. In the following textbox the grant system in relation to education matters is highlighted, to illustrate some of these issues.

Financing profile of subnational education services in Hungary

"The costs of the provision of public education services are financed from the contributions from the central budget, the revenues generated by the institutions themselves, the payments made by the users of the services and the funding sources of the organisations in charge of maintaining the institutions.

The contribution by the central budget is comprised of normative state contributions for discretionary utilisation, normative contributions for specific purposes and other contributions for specific purposes and the contributions provided from the chapter of the Ministry of Education, primarily for specific priority professional purposes.

Normative contributions are provided on the one hand for the various phases of education and teaching and for other services of public education (basic arts education and provision of student hostel services) (basic contributions). On the other hand, for supplementary services of public education (daytime care for children, teaching to help catching up) and to provide for requirements of specific conditions of public education (education and training in small municipalities, providing services for commuters from other municipalities etc.) (supplementary normative contributions).

Part of the normative subsidies for specific purposes provide funding for specific benefits (for the procurement of technical literature and books by teachers, textbooks by students), another part provides funding for the performance of district type responsibilities (including for instance the subsidies to public foundations for public education constituting one of the bases for the implementation of the above mentioned ‘development plan’ or the subsidising of special professional pedagogy services). Furthermore, contributions for specific purposes may be applied for in order to provide support to the further training of teachers".

121. As appears, in the operation of local educational institutions, local governments will have four sources of income. One of these sources, the grants from central government, comprises four elements and is allocated by two different central authorities. Most of the grants are provided for, and allocated for specific aspects of the activities connected to carrying out education services.

122. **Borrowing and bail-out**. Local governments are allowed to take out loans and issue bonds. However, they have to respect certain restrictions on borrowing. According to the Local Government Act, the ceiling of a local government’s annual debt commitment equals the adjusted current own revenues of that local government (i.e. 70% of the local government’s net own revenues - from local taxes, duties, interest, fines, etc.) in that year.

123. In general, the state does not assume liability for a local government. There is a debt settlement procedure for local government insolvency, which is set by law, as a separate regulation.

124. **Expenditure - budget co-operation** The Parliament specifies -- by passing the Budget bill -- the share of local governments of centrally regulated taxes and duties, the titles and amounts of the normative central budgetary contributions of local governments and the earmarked and targeted and other subsidies and grants to be provided for local governments. The funding is specified on a yearly basis. Along with the submission of the budget bill to Parliament central government makes available for local governments the data and regulatory proposals pertaining to them, for their preparation of the local budget proposals.

125. The possibilities of spending on local public services are determined, ultimately, by the amount of the funds from the central budget and the funds earned by municipal governments for discretionary spending. No overall consolidated targets on local revenue and expenditure out of total public finance seem to be set in Hungary.

126. The local governmental act provides that where a mandatory duty and/or power is imposed on or assigned to a local government the Parliament is to provide the necessary funding for the performance and exercising of such tasks and power, deciding on the amount and mode of the budgetary contribution.

4.3.6 Poland

127. Local **taxes** are deemed the basic revenue of gmina (local government) budgets in Poland, since they are fully administered by local self-governments; and local authorities are able to affect the taxation rate. (The voivodships and poviats are not covered by the following text on tax revenues.)

128. The statutory tax authority, however, is quite limited and only covers non-uniform functional powers. In most cases, it entails the possibility of reducing, to the extent laid down in statutes, upper rates of individual taxes (i.a., real estate tax, agricultural tax, and forest tax). The upper tax rates are determined and updated on an annual basis, by the Finance Minister, within the framework of the general tax policy of the state. It also covers the possibility of granting reliefs, deferment and remission of taxes that make up the gmina’s revenues and are directly paid to the gmina’s account. The same power is exercisable in the form of a waiver, if any, of collection of such taxes.

129. Local governments do utilise these instruments of tax authority. In 1999, they granted reliefs, deferments and remissions of taxes and reduced upper rates of taxes that make up gmina revenue totalling ca. 3.2% of total receipts, including reducing real estate tax receipts that were in excess of 78% of the whole amount of reliefs decided by gmina councils. This meant that gmina revenue from that tax was reduced by 18.1%.

130. The Ministry of Finance assists in the optimal exploitation of local revenue sources. There is general supervision of tax liabilities, which covers the uniform application of tax regulations by tax authorities, and the official interpretation of tax regulations. As part of the surveillance of local revenues, local governments are responsible for the preparation and submission of quarterly budget reports on, inter alia, budget revenues, and semi-annual and annual reports on the generation of basic revenue from taxes. The reports relating to the revenues from taxes, charges and other non-tax budget duties, must cover: information on planned revenue projections; receipts less returns made; the difference between revenues that a gmina could have got by applying ceiling tax rates and the revenues that it actually raised through the application of lower rates adopted by the gmina council; and finally, amounts reflecting the effects of reliefs, remissions, concessions and waivers of taxes and charges.

131. The legal system of rules setting out the construction and functioning of **non-tax revenues** of Polish local government is made up of several statutes of varying significance and character. There do not seem to be any co-ordinated measures on the central management and control of subnational government revenue generation from these sources.

132. The systems of **grants**, in Poland, seem relatively complex, with the possibility of some weak budget constraints on local governments, for example, general grants are distributed annually within three sub-sectors: basic, educational and fiscal equalising. The total amount of the sector-specific general grant on educational subsidy is allocated to individual gminas in accordance with the rules laid down in a regulation issued by the Minister responsible for education, following consultations with the representation of the units of local self-government.

133. Specific grants are set on an annual basis, for the financing or partial financing of own duties in the areas of social welfare; higher education; and "other duties". The design of the specific grants to some extent reflects efforts to overcome problems on the fragmented structure of local government and the redistribution of expenditure responsibilities to the newly-created regional governments.

134. **Borrowing and bail-out**. Borrowing limits are set by law, indicating that the total amount repayable during the budget year cannot exceed 15% of the revenue projection for that budget year, for that unit, and the total amount of debts at the end of the budget year cannot be more than 60% of the unit's aggregate revenue during the relevant budget year. Local governments are supposed to cover any budget deficit themselves. The measures that may be applied towards covering such a deficit are set by law. In the case of temporary financial difficulties, loans may be extended from the state budget in the course of rehabilitation proceedings**.** The conditions of such loans are considered individually for each municipality.

135. **Expenditure and budget co-operation.** In general, the central authorities do not have any influence on the level of local revenue or expenditure. The amount of revenue transferred from the state budget i.e., subsidies and specific grants, are implemented according to law. Neither are central authorities able to influence the amounts spent from local budgets since the sole supervisory criteria is the correctness of implementation of duties assigned to individual levels of local self-government.

136. Some indirect influence on the local budget level and composition seems, however, to exist in relation to the competencies of the regional clearing chamber. Prior to the adoption of the draft budget resolution, local governments have to submit their proposal to the regional clearing chamber for its review and comment. The chamber is a government authority for the supervision and control of local financial management. Its opinion covers, i.a., the amount of planned debt.

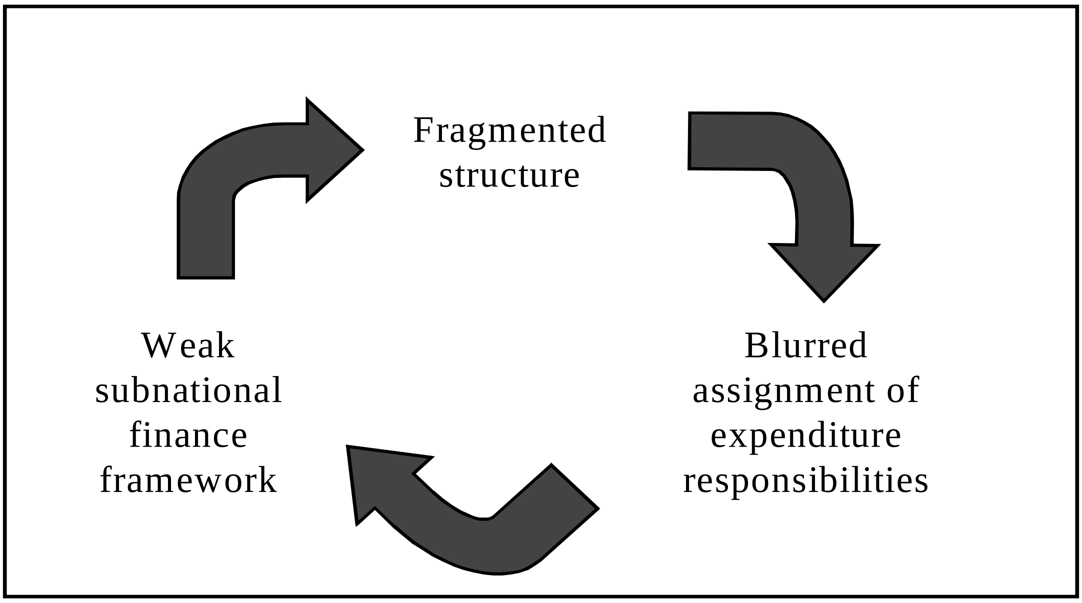
137. There does not seem to be any overall budget consolidation of government finance. On the other hand, there is comprehensive economic reporting from subnational government on the status of expenditures and revenues. However, the information from the reporting does not seem to lead to the formulation of overall expenditure and revenue targets for the public sector as such, including the subnational sub-sectors.

4.4 Some comparative findings on the balance between local autonomy in financial decision-making, central control and fiscal discipline

138. This section highlights a number of comparative findings on the specific mode of subnational financial decision-making across the countries, and is based on the presentation in Sections 4.2-4.3. Due to the complexity and comprehensiveness of the subnational finance systems in the countries, there cannot be a genuine comparative presentation and discussion across the countries in this section. As mentioned in Chapter 2, the main purpose of the surveys has been to provide each country with updated information on the status of fiscal design in similar countries, and by this means; to assist national policy discussions and considerations on further reform steps.

139. As stated in Section 4.1, the questionnaire focused on issues related to the framework of subnational finance. These issues, however, have to be presented and discussed within the context of the overall subnational government system: the structure of local governments, including the size of the units and the expenditure assignments to the separate tiers of governments. This is illustrated in Figure 4.1.

Figure 4.1 Main elements in relation to the subnational government system



140. As mentioned in Section 4.2, the combination of a fragmented structure and incomplete expenditure assignments raises a number of problems and constraints on the overall possibilities of ensuring an efficient local government system with extensive subnational political accountability.

141. Territorial reform is being considered in most countries. The creation of a regional level of government in Latvia, Poland and, recently, the Czech Republic can partly be seen as a way of solving the problems of the fragmented local levels of self-government. Considerations in Hungary on setting up regional governments -- in combination with other territorial restructuring -- have the same kind of objectives. As another example, to further the process of amalgamation of small local governments in Latvia, a lump sum grant has been set up. The grant is allocated to those municipalities that have decided to amalgamate or co-operate for the implementation of their functions.

142. Undoubtedly, the framework on subnational finance may be seen in this perspective. As an example, in some countries, the design of the grants system reflects the fragmented structure and the incomplete assignment of subnational tasks in a number of ways. The near absence of a finance framework and the extensive use of specific grants in the Czech Republic may partly be explained by the very fragmented local government structure, whilst the system in Lithuania, with consolidated multi-annual public sector targets and the absence of specific grants may be an example of the opposite situation.

143. In relation to the finance framework as such, some major findings across the countries can be highlighted:

– Some countries, Poland and Hungary notably, have implemented support systems for assisting subnational government in the optimal exploitation of local tax sources. However, undertaxation of local sources, as reported in Estonia for example, seems to be frequent, in any case, in the countries with evolving local taxing powers.

- Frameworks on bail-out are set by law in Latvia, Poland and Hungary. In other countries, explicit procedures have been prepared and are to be carried out by the government.

- In some countries, e.g. Latvia, the principle of full financing for additional tasks to subnational governments is set by law. In other countries, it is an issue that 'receives special attention' or 'a calculation has to be presented with an evaluation of additional costs'. In the Latvian case, however, it is stated that even within this framework "these procedures are not always followed".

- In some cases, e.g. Lithuania, the overall budget on public finance, by expenditures and revenues, are consolidated and planned from a multi-annual perspective. Budget targets are set and announced by revenue source and sector of expenditure. In most other countries, estimates are set on part of the subnational revenues and expenditure, typically on an annual basis. In most countries, as referred to in the Polish and the Hungarian reports, there is a comprehensive set of financial reporting from the subnational levels to central government. The reporting, however, does not seem to be used directly in relation to setting the budget estimates.

- In some countries, e.g. Hungary, Poland and Latvia, the grant systems seem relatively complicated, with too large a number of sub-specifications, 'sub-grants' and allocation criteria. This situation, as mentioned already, seems to reflect other deficiencies in the local government system. Reforms, aimed at simplifying and 'generalising' the system of grants, are to a large extent restrained by these factors.

- Some countries present a comprehensive set of agreements and involvements of subnational government associations when setting the overall revenue and expenditure envelopes, and, in some cases, as part of the implementation of the subnational government framework. Latvia provides an example of the latter case, where the subnational government associations is a member of a local government borrowing supervisory body ("Board"), where all local government requests on debts and guarantees are approved. In other countries, the associations are involved to a somewhat lesser extent.

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