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Municipal Finance and Governance in Poland, the Slovak Republic, the Czech Republic and Hungary

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Munich 2001

Die Deutsche Bibliothek - CIP Einheitsaufnahme

Nam, Chang Woon:
Municipal finance and governance in Poland, the Slovak Republic,
the Czech Republic, and Hungary / Chang Woon Nam; Rüdiger Parsche;
Bettina Reichl. ifo Institut für Wirtschaftsforschung,
Research Division Public Finance. - München: ifo Inst.
für Wirtschaftsforschung, 2001
ISBN 3-88512-387-8

ISBN 3-88512-387-8
ISSN 0081-7279

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Druck: ifo Institut für Wirtschaftsforschung, München

Abstract

The recent process of political and economic transformation in eastern European countries has not only contributed to the decentralisation of political structure but also significantly enhanced the fiscal autonomy of municipalities in these countries. In this context many similar types of public activities have recently been assigned to local governments, and some taxes were also declared to be local taxes. To be sure, this type of fiscal decentralisation has caused some additional problems, particularly for safeguarding the quality of publicly provided goods and services and for co-ordinating intergovernmental fiscal transfers between the central and local governments. For instance, some criticise that many small-sized municipalities in the transition economies have suffered from financial bottleneck and have not been able to receive sufficient financial support from the central government. However, such a fiscal devolution trend appears to continue. This study primarily deals with issues surrounding the impact of national fiscal policy and the regulatory framework on local governments' expenditure behaviour and their ability to mobilise necessary revenues under the particular consideration of the institutional and administrative co-operation with the central government and of the less well-developed financial market in Poland, the Slovak Republic, the Czech Republic and Hungary.

Keywords: fiscal decentralisation, local expenditures and taxes, shared taxes, intergovernmental transfers, municipal borrowings, Poland, the Slovak Republic, the Czech Republic, Hungary

JEL Classification: H7, H2, H4, H6, H8

* This study was financed by the World Bank and the Free State of Saxony. Its major outcome was highlighted in relation to the Saxon municipal resource allocation system by Prof. Hans-Werner Sinn at the Regional Conference on *Reconstruction of Economics and Administrations in Central and Eastern Europe*, Dresden, 30th November – 1st December 2000. Authors are specially grateful to Vera Kamenickova of the Czech Ministry of Finance in Prague, Viktor Niznansky and Miroslav Knazko of the Centre for Economic and Social Analysis in Bratislava, Jozsef Hegedus of the Metropolitan Research Institute in Budapest and Jacek Sierak of the City of Reguy (Poland) for their research contribution.

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1. Introduction and Basic Theoretical Background

1.1. Introduction and Major Research Topics

The relationship between central and local (and municipal) government is changing. For this reason it has traditionally been a major subject of political discussions. The idea of decentralisation of political decision-making has become increasingly fashionable world-wide, which is also accompanied by fiscal decentralisation in most cases. In some developed countries the systems of intergovernmental finance have evolved gradually and each country has unique features.[1] Emerging countries in different continents have had differing reasons and motivations for such reforms and their consequences for macro-economic stability and growth have also varied significantly from one country to another (Fukasaku and de Mello, 1999). More recently, the acknowledgement of subsidiarity as the basic principle for the European Union[2], the introduction of the west German federal system in the eastern part of the country, the revival of regionalism in Western European countries like Portugal are distinctive examples of the decentralisation process in Europe.

This kind of political decentralisation has also been pronounced in the transformation countries of Poland, the Czech Republic, Slovakia and Hungary. To be sure, such development is "a reflection of the political evolution toward more democratic and participatory forms of government, seeking to improve the responsiveness and accountability of political leaders to their electorate, and to ensure a closer correspondence of the quantity, quality, and composition of publicly provided goods and services to the preference of their beneficiaries" (Ter-Minassian, 1997, p. 3).

According to the conventional economic literature, the (political and fiscal) decentralisation of public spending responsibilities and activities can lead to additional gains in efficiency and welfare (Tiebout, 1961; Musgrave, 1969, Oates, 1972 and 1998; Frenkel, 1986; Hyman, 1993; Elzar, 1997 and Ter-Minassian, 1997). On

[1] For example, "in Australia, local (municipal) government is of modest importance, and the state governments depend heavily on federal transfers. Switzerland is characterised by strong local governments that meet most expenditure from their own revenues and depend relatively little on transfers" (Ahmad, Hewitt and Ruggiero, 1997, p. 28).

[2] According to this principle, "the central government cannot adequately meet the growing local demand for public goods and services. The centre often fails to improve fiscal efficiency, as it tends to ignore local differences in culture, environment and natural resource endowments as well as economic and social factors, all important determinants of public sector performance" (Fukasaku and de Mello, 1999, p. 9).

the other hand, some argue that such fiscal decentralisation effort can cause significant costs in relation to the distribution (equity) aspect. More critically, there is also growing recognition that such a type of decentralisation may aggravate fiscal imbalances by creating a deficit bias in fiscal policy and consequently endanger overall macro-economic stability (see below and also Prud'homme, 1995; Tanzi, 1996; Spahn, 1999 and Shah, 1999).

Compared to the case for cities and municipalities in western Europe, those located in the transformation countries have been confronted with more serious problems caused by the speedy industrial modernisation and de-industrialisation, the rapidly increasing public activities due to social, economic, health and environmental ills[3], as well as by the provision of additional new (city-specific) infrastructure that is often better adapted to newly emerging economic activities. In particular, the challenges for large cities in Eastern Europe have been more immediate and have also become more intensified in the course of the ongoing economic and political transition.[4] On the other hand, it is argued that since the large ag-

[3] For example, if the population and economic activities exceed a certain level in the limited area of a city, residents can no longer enjoy its prosperity but will suffer from its sub-standard living conditions. This is characterised by poor urban facilities and services such as congestion of commuter trains and roads, low waste disposal capacity, unchecked air pollution and the poor supply of affordable housing, all of which are in part triggered by the concentration of the large number of low-income households and social-welfare recipients (e.g. elderly people and unemployed persons) in the city. In other words, there is a point where the demographic and economic growth of a city reaches its limits.

[4] First of all, the increased competition within Europe stimulated by the completion and expansion of the EU Single Market, the introduction of the free market system in Eastern Europe and by the globalisation of markets have had significant impacts on the economic performance and development of (Western and Eastern) European cities than in other areas, mainly due to the concentration of economic activities in these urban areas as well as their function as major exporters of goods and services, and (national and international) gateways to the hinterlands. Such changes in the economic and political framework have increased the dynamism of economic competition among these central places. Apart from high-technology manufacturing and information processing activities, cities in Poland, the Czech Republic, Slovakia and Hungary have also been competing against each other to capture international (and national) management and other modern service functions, and, consequently, to secure sustainable growth in the future. The anticipated membership of these countries in the EU will make such competition more fierce. In this context, the improvement of 'hard' (energy and water supply, transport and telecommunications network, waste disposal facilities) and 'soft' (educational, cultural and social utilities) infrastructure, the ensurement of diversified economic structure, etc. have been in urgent need to enhance the location attractiveness and quality of the cities in Eastern Europe. Traditionally, cities and other large municipalities have been the driving force of regional economic development and centres of key (regional) political and business functions. For example, in the process of transformation from a planned to a market economy in Eastern European countries, direct investment from the West and economic modernisation have concentrated heavily on their capital cities and their surroundings, and these cities have played a significant role as growth poles for the economic development and recovery of the entire territory. At the same time, a large number of Eastern European cities are suffering from economic restructuring including de-industrialisation. In addition, the expansion of services has been unable to absorb the workers displaced from the industrial sector, partly due to the differences in required qualification and skills for the job. The inward-migration flow has made this type of structural unemployment more serious and persistent in the urban la-

glomeration areas provide an unparalleled business environment to economic sectors, rural regions and municipalities are at loss to compete, which, in turn, leads to the increase in regional disparity in a country. As a result, municipalities in disadvantaged regions suffer from a net reduction in population size, decreasing local tax revenue, fewer job opportunities etc.

Furthermore, cities and municipalities in transformation countries seem to be (in some cases seriously) suffering from a lack of necessary financial means to cover the increasing expenditures and to meet current challenges. Such fiscal stress usually takes place either when the costs of providing local services increase faster than revenues needed to finance them, or when, by given costs of public service provision, local government revenues are constrained by a declining economic base which reduces taxable resources.[5]

Following the so-called equalisation objectives, one easily tends to argue that those municipalities and cities with greater spending needs automatically require more financial support from central or upper-level government. Yet, the sum of grants to municipalities should basically be induced from the comparison of their (existing and/or anticipated) 'true' expenditure needs with local fiscal capacity from their own resources such as local tax revenue and fees.[6] To be sure, the expenditure behaviour of municipalities is also, to a great extent, influenced by their present fiscal capacity as well as by the size of local debts. In the provision of infrastructure, local governments tend to (critically) consider an increase in local taxes, especially when intergovernmental grants to municipalities do not adequately compensate the existing fiscal stress that is caused by large expenditure needs, and/or, when the total sum of local debts has already reached the maximum level that should not be exceeded. In addition, the city or municipality with well-equipped

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bour market. Additionally, a number of industrial and service firms have already left their traditional city sites for the surrounding municipalities or other areas, mainly due to high rents and/or restricted possibilities of expansion. In the process of suburbanisation there has also been the selective migration of higher income households from the central city to the suburbs.

5 For example, large German cities have continually lost part of their major income — revenue from trade taxes (*Gewerbesteuer*) and income taxes — due particularly to the ongoing suburbanisation process and the recent economic recession as well as the reduction of tax revenue caused by tax reforms. In addition, as a direct consequence of unification, grants from upper-level governments to the cities in the context of the German intergovernmental resource allocation system (*Finanzausgleich*) have been partly reduced.

6 It is widely accepted fact that 'needs' are subjective and, therefore, cannot be easily quantified. Nevertheless, a large number of resource transfer methods between different levels of government and of measurement methods of local expenditure needs have been developed in the past and also implemented in many industrialised countries, which range from exclusively political to straightforward statistical ones. Furthermore, there have been serious and ambitious efforts to devise as well as to improve these methodologies, so that the so-called true financial needs of municipalities could be measured in a more effective and systematic way. In particular, the dispute about the relationship between the per capita level of local expenditure needs and the size of the municipality (in terms of population size) has not yet been fully settled (Nam, 2000).

infrastructure is obviously more attractive for investors and firms looking for a new location, while the increase in local taxes immediately means the loss of regional and municipal competitiveness. In the case that the additional provision of infrastructure will mainly be financed by the higher local taxes, local governments should also be well aware of such a trade-off relationship and their short-term as well as long-term effects on the local economy (Nam, 2000; Nam, Nerb and Russ, 1990).

As mentioned before, the provision of public services and infrastructure and their finance is being decentralised in Hungary, Poland, the Czech Republic and Slovakia. However, the national fiscal policy and regulatory framework appears to still have a crucial impact on local governments' expenditure behaviour and to limit their ability to mobilise own tax income. In addition, the expanded local government role in providing public services and in obtaining the necessary financial resources remain disturbed by the weak institutional and administrative co-operation with the central government and by the less well-developed financial market. Major research topics of this study are briefly summarised in Table 1.

Table 1 Major research areas and topics for the study

Research areas	Major topics
Expenditure assignments	Outlay responsibilities and investments that enhance the tax base, service responsibilities assigned to local government and the minimum level of services expected from local service providers by state regulations.
Revenue assignments	Local own fiscal resources and ability to mobilise funds with independent local tax base, intergovernmental transfers through revenue sharing and grant entitlements, value-based property tax, business tax. The extent to which local governments have used taxing powers, legal power to vary the local tax rate, local tax administration and robustness of local tax against economic shocks.
Intergovernmental transfers	The share of local expenditures outstripped by own ordinary local resources (taxes, fees) and therefore funded by grants, revenue sharing, borrowing or proceeds from asset sales. The overall design of the *grant system*, its efficiency, the amount/proportion of financial transfers to local governments in the form of unconditional revenue grants or revenue sharing and legal entitlements of grants compared with state revenues or expenditures. The systems of *capital grants and current grants*, their allocation formula and the extent to which they are pulled into a single grants mechanism and are allocated between large cities providing infrastructure services for a region and smaller municipalities. The portion of local cost and risk sharing on urban infrastructure projects partially funded with capital grants to ensure stringent evaluation that selected projects are economically viable. The amount of distortion effects on municipal investment choices.
Municipal borrowing and contingent liabilities	How the relevant countries limit local borrowing ability to prevent an unsustainable level of municipal debt and state government bail-outs. Restrictions on local borrowing, the legal, regulatory and budgetary framework for municipal borrowing ability. Total municipal borrowing requirements, types and structure of debt, maturity, own local revenues to debt service, sensitivity of debt service to interest rate movements, liquidity risks, current revenues to expenditures. Market transparency towards sub-national debts including contingent liabilities and assets pledged as collateral by municipal borrowers.
Budgeting and financial reporting	Do accounting practices of municipalities account for guarantees and other contingent liabilities to prevent disguising the real financial situation?
Meeting the demand for sub-national investment finance	Are small local governments and other ad-hoc associations vested with powers to enter into contracts, to borrow, levy fees against service provided or to impose taxes against improved property values? Are they adequately capitalised and able to pledge project revenues as security for borrowings?
Debt instruments	Do municipalities or their utilities have access to an existing bond market or access through financial intermediaries and do they manage their risks through hedging instruments? Is there a long-term lending mechanism for viable, revenue generating infrastructure investments that would meet debt service out of revenues?

1.2. Expenditure Assignment

According to the well-known subsidiarity principle, efficiency in the allocation of financial resources is best achieved by assigning responsibility for each type of expenditure to the level of government that most closely represents the beneficiaries of provided public goods and services (Frenkel, 1986; Hyman, 1993; Ter-Minassian, 1997). In other words, the expenditure assignments involve decisions as to which level of government should be dominantly responsible for the formulation, financing and administration of policy activities and related follow-ups. Compared to the apparent cases for the central provision of national public goods and services like macro-economic stabilisation, redistribution, defence and foreign affairs,[7] those activities related to social protection, education and health as well as environment have generally been considered as typical public services which can be well provided by local or regional governments. Yet, in most cases public goods have a character of mixed goods, for which some degree of decentralisation combined with some centralised co-ordination appears to be feasible and desirable, due to unclear distribution of benefits among regions, externalities and spill-overs, etc. As a consequence, overlapping responsibilities in policy formulation, financing and administration of public goods and services are quite common, which have also partly contributed to the existing great variety of intergovernmental fiscal arrangements and expenditure assignments among different countries (Levin, 1990; Ahmad, Hewitt and Ruggiero, 1997). Furthermore, the central government in many countries can influence the decetralised provision of public goods through the regulation of their delivery in terms of quality and the ex post control of the use of financial means and transfers (see below).[8] The strong policy orientation of allocation objectives in terms of the devolution of expenditure responsibilities to local governments can create conflicts with the achievement of the macro-economic stabilisation and the redistributive goal, which appear to be better accomplished by the central government (Musgrave,

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7 According to the conventional literature, this type of centralisation is necessary when (a) certain public goods have non-rival consumption within an entire country as is the case for defence and macro-economic policies, (b) significant economies of scale are present in the provision of these goods, and (c) undesirable population and capital movement can result from variations in policy and the level of provision between jurisdictions.

8 “For instance, there are certain efficiency advantages to local supply of primary education and preventive health care, such as possibly better quality through local supervision, and allowance for communities to express cultural and curative preferences. For tertiary education and hospitals, existence of economies of scale and externalities (their benefits accruing to more than on jurisdiction) imply that more centralized control may be warranted. However, the demand for minimum standards often requires that centralized decision making of policies be ensured for all these [local public] services” (Ahmad, Hewitt and Ruggiero, 1997, p. 25).

1983; Oates, 1972). Although “the overall levels of expenditures of [regional or local] governments is effectively constrained by limits on their taxation and borrowing powers, changes in composition [for example, in favour of transfers to individuals with a high propensity to consume] may run counter to the stabilisation objective of the central government” (Ter-Minassian, 1997, p. 5). Empirical investigations (including Brosio, 1985) do not always confirm the so-called Leviathan hypothesis by Brennan and Buchanan (1980) that decentralisation generally limits the growth of total government expenditure. Furthermore, “with increased decentralisation comes the possibility of loss of macroeconomic control as local bureaucracies multiply, [which make] monitoring and evaluation more problematic [...]” (Ahmad, Hewitt and Ruggiero, 1997, p. 31).[9] In a country with large economic disparity among its regions, the ability of local or regional governments to deliver public goods and services can also vary widely, which, in turn, could trigger undesirable internal migration.[10] In countries in transition such type of economic policy conflicts appear to be more adequately taken into account in making decision about assigning certain expenditure responsibilities to local governments.

Spahn (1999) argues that the expenditure assignment, the overall budgetary dimension of local governments and the soundness of their activities can be examined on the basis of varied number of indicators, which include:

- outlay budget size and its change based on financial flows,
- sustainability of expenditure levels and ability to adjust expenditure to revenue levels,
- composition of outlays in terms of share of income-generating expenditures and investments that enhance the local tax base,
- inflexible budget items such as existing debt service,
- share of personnel expenditures and long-term commitments resulting from social and environmental policies imposed by the central government, etc.

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[9] The macro-economic stabilisation function is generally judged to be inappropriate for subnational assignment, because “(a) raising debt at the local level would entail higher regional costs while the benefits would spill beyond regional borders, and too little stabilisation would be provided as a result; (b) the monetisation of local debt will create inflationary pressure and pose a threat for price stability; (c) currency stability requires that both monetary and fiscal policy functions belong to the centre alone; and (d) cyclical shocks are usually national in scope and therefore require a national response” (Shah, 1999, p. 38).

[10] On the other hand, the Tiebout and tax competition models show that competition among local governments induces localities to provide an efficient configuration of local public goods (Tiebout, 1961). Since residents are mobile between localities, these theories argue that they will select the area which offers them the optimum combination of public service and taxes to pay.

1.3. Tax Assignment and Tax Sharing

The general principles of decentralisation also guide the assignment of taxes to different levels of government. In practice, two options of assigning funds to local jurisdictions are commonly adopted but quite often in a combined form:

- assignment of (some) taxing power to the central government and financing local expenditure needs by intergovernmental grants or other transfers, for example, in form of sharing tax revenue, and
- assignment of (some) taxing power to the local governments, if necessary complementing the revenue (raised locally) with tax-sharing arrangements with the central government (Norregaard, 1997).

Table 2 illustrates more precisely how different types of taxes and grants can be assigned to the lower level of governments.

Table 2 Fiscal autonomy in local governments

Own taxes	Base and rate under local control
Overlapping taxes	Nation-wide tax base but rates under local control
Shared taxes	Nation-wide base and rates, but with a fixed portion of the tax revenue (on a tax-by-tax basis or on the basis of pool of different tax sources) being allocated to the local governments in question, based on (1) the revenue accruing within each jurisdiction (also so-called the derivation principle) or (2) other criteria, typically population, expenditure needs, and/or tax capacity.
General purpose grants	Local government's share is fixed by central government (usually with a re-distributive element), but the former is free to determine how the grants should be spent; the amounts received by individual authorities may depend on their tax efforts.
Specific grants	The absolute sum of grant may be determined by central government or it may be open-ended (i.e. dependent on the expenditure levels decided by lower levels of government), but in either case central government specifies the expenditure programmes for which the funds should be spent.

Source: Norregaard (1997), Tax Assignment, Washington DC.

According to the standard theory of public economics (Oates, 1972; Musgrave and Musgrave, 1980; King, 1984), there are several characteristics for typical local taxes, which financially support a decentralised public expenditure system:

- The base of local taxes should be neither very mobile nor very unevenly distributed among jurisdictions. In the case of prevailing strong mobility, taxpayers will relocate the income activities or tax sources from high to low areas. This fact will also limit the freedom of local governments to change the rates.

- Local taxes should be accountable and clear to local taxpayers what the tax liabilities are. In addition, they should be fairly easy to administer on the local level.
- The link between payment of the tax and local service received should be intact. In other words, such benefits should be strongly internalised to the local taxpayers.
- Local taxes should be able to generate sufficient revenue to avoid large vertical imbalances and ideally be less sensitive to the changes in business cycle.

In accordance with such criteria mentioned above, land or property taxes and, to some extent, personal income taxes have been quite often suggested to be suitable local taxes, while corporate income taxes have usually been considered to be less appropriate for the same purpose (Paugam, 1999). For example, "[in] some countries, state-level taxation of corporate profits, in the absence of a coordinated approach, has been accompanied by strong competition (tax wars), leading to distortions in enterprise's location decisions, tax avoidance through transfer pricing by enterprises operating in multiple areas, and erosion of revenue" (Ter-Minassian, 1997, p. 10).

1.4. Intergovernmental Transfers

Intergovernmental transfers are aimed at rectifying not only the vertical imbalance caused by the unequal own tax revenues and expenditures of different levels of governments but also the horizontal imbalance which is led by the different fiscal capacities among same level jurisdictions. Although the local expenditure needs appear to be hardly measured in an objective way, the role of transfers becomes more crucial for those deficit jurisdictions on the sub-national level, especially when their increasing expenditures cannot be financed by borrowing or they lack direct access to capital markets. In the cases of existing externalities on other jurisdictions, the central government also needs to financially support sub-national authorities in order to guarantee the provision of certain public services on the local level like pollution control, inter-regional highways, etc. (Davis and Lucker, 1982; Frenkel, 1986; Ali, Lerme and Nakosteen, 1993; Boadway and Hobson, 1993; Hyman, 1993; Rosen, 1995; Dahlby, 1996; Ahmad and Craig, 1997). Furthermore, the amount of grants should vary with the local expenditure needs and inversely with local fiscal capacity, while their distribution must be transparent and fair. More importantly, an effective transfer system should neither encourage overspending nor weaken tax collection efforts on the sub-national level (Gage and Mandell, 1990; Jones and Cullis, 1994; Bahl and Linn, 1994; Shah, 1994a and 1994b; Winkler, 1994; Oates, 1998; Nam, Parsche and Steinherr, 2001).

Basically the re-allocation of fiscal resources from one level of government to another takes place through sharing of tax revenues or through a form of grants. In the case of revenue sharing, tax bases can be shared on a tax-by-tax basis (in some cases with different coefficients of distribution among levels of government for each tax),[11] or taxes can be pooled and shared systematically thereafter, as illustrated in Table 2. According to the previous experiences in emerging countries, such revenue sharing arrangements appear to be less successful in encouraging local revenue mobilisation (Fukasaku and de Mello, 1999). Grants from higher (federal or state) to lower levels (state or local) can be conditional (i.e. closely tied with specification regarding the use of the funds and/or the performance achieved in the supported programme)[12], or unconditional respecting the autonomy of local governments in spending such financial means. The so-called block grants also have a fixed character, which are, however, designed to support broad areas of local activities (like education, environmental preservation, etc.) rather than specific projects. On the other hand, intergovernmental grants can be open-ended[13] — regardless of the transfer size required to cover the expenditure needs of individual local governments — or subject to certain limits. In addition, the down-flow grants have been quite often made in the EU on the basis of the so-called additionality principle, which requires — as a eligibility criterion for the supporting grants — the partial financial participation of local governments in providing local goods and services in its territory.[14]

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[11] This type of arrangement "may provide an incentive for the [central government] to concentrate its collection and enforcement efforts on the taxes that are not shared or are shared to a lesser extent.[...] Fixed revenue-sharing [including the determination of revenue portion going to the local and regional governments, e.g. in terms of a constant rate to the shared tax base] can also have pro-cyclical [macro-economic] effects, as increases in shared revenues during periods of boom increase the capacity to spend of the [local or regional] governments, while decline in revenues during economic downturns force them to cut back spending. [...] The distribution of shared revenues among subnational jurisdictions is often made on a derivation basis, with each jurisdiction getting the share of the revenue collected in its territory. [Yet, such type of distribution method appears to be less suitable] to correct horizontal imbalances, under [the derivation principle] the level of the transfer from the centre to each subnational government is positively correlated with the taxing capacity of the latter" (Ter-Minassian, 1997, p. 12f).

[12] In most cases the imposition of conditions can be justified from the redistribution point of view, for example, to guarantee the minimum nation-wide standards for the provision of services of national concern like primary education, health care, pollution control, etc. (Ahmad and Craig, 1997).

[13] Those who favour the sound development of national budget and macro-economic stability as well as the reduction of corruption tend to be against those open-end types of grants.

[14] In countries like Canada, Australia, Japan and the United Kingdom, tax bases between the central and sub-national (state and local) government are divided in a way that the former receives a significantly or extremely higher share of total tax revenues. At the same time, the

1.5. Local Government Borrowings and Debt Management

Borrowing has traditionally been an important source to finance long-term public infrastructure projects in advanced countries, because it enhances intergenerational equity. In other words, these projects yield returns through several generations, over which the costs for the provision of public goods should be shared equally. Such type of intergenerational burden sharing enables small local governments to undertake the necessary large scale infrastructure investments (Shah, 1999). However, some countries still impose strict restrictions on local borrowing. For example, in some developing and transformation countries large infrastructure projects have recently been more strongly supported in terms of capital grants or on-lending from higher level governments, since local governments (especially in the small entities due to their weak economic power, small size of tax income and other unfavourable creditworthiness) quite often suffer from the lack of direct access to credit markets.[15]

More importantly, fiscal deficits and debt have continuously risen over time in a large number of countries both at the state and local levels. The rapid growth of local public debt in a country, which eventually endangers the macro-economic stability, also immediately questions whether the local borrowing is tightly oriented to the necessary financial needs for well-designed local public projects, and its process is transparent and efficient enough in an administrative term. In general there are four basic debt-control categories which are applied in practice in combined forms:

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central government provides specific and unconditional (i.e. general) grants for the lower level governments. The general grants are in most cases equalisation-oriented and aimed at rectifying regional disparities (Peacock, 1977; Chandler and Zollner, 1986; Watts, 1991; Boadway and Hubson, 1993; Elzar, 1997; Ma, 1997; Worthington, Dollery and Edward, 1998). The United States has a marked preference for conditional grants: In the early 1990s matching grants amounted to more than 90% of federal intergovernmental transfers to state and local governments (Rosen, 1995). Germany has a unique tax assignment system: All major taxes (personal and corporate income taxes as well as value added tax) are shared by the federal (*Bund*), state (*Länder*) and municipal (*Gemeinde*) governments.[2] Altogether these shared taxes currently amount to ca. two thirds of tax revenues in the country. In the context of the so-called German state resource allocation system (*Länderfinanzausgleich*) unconditional grants are made from states with above-average fiscal capacities (e.g. Bavaria, Baden-Württemberg and Hesse) to states with below-average fiscal capacities (e.g. Saarland, Lower Saxony and New German Länder). In addition, the federal government offers supplementary grants to the financially weak states in the eastern and western parts of Germany, of which some also have conditional character (e.g. for solving debt service problems in Bremen and Saarland). Unconditional transfers from state governments to local authorities also occur within a state in the context of the so-called municipal resource allocation system (*Kommunalfinanzausgleich*).

[15] Developing countries like India and Pakistan, for example, do not allow local governments to access credit markets.

- primary reliance on market discipline without the so-called bail-out guarantee of the central government when the credit market is free and transparent information prevails (Lane, 1993),
- a dialogue-oriented co-operation and negotiation among different levels of governments in the design and implementation of debt controls (including limits on the indebtedness of sub-national governments),
- rules-based controls as specified in the constitution or by law regarding, for example, setting on the purpose- or project-oriented limits of the absolute level of local debts,[16] and
- direct administrative controls of the central government over local borrowing, including setting of annual limits on the overall debt of individual sub-national jurisdictions, the tight review and authorisation of individual borrowing operations like credit approvals (or the centralisation of all government borrowing) and the ex post monitoring, etc. (Ter-Minassian, 1997; Ter-Minassian and Craig, 1997; Shah, 1999).

All these controls can also be classified into passive and active controls, as illustrated in Table 3.

Table 3 Active and passive controls over local borrowings

Passive controls	These types of local debt controls have many forms, from broad guidelines on allowable ranges of debt/revenue and debt charges/own-source revenue ratios, to more specific golden rules, which permit borrowing only for capital formation but forbid it for financing current deficits.
Active controls	More active controls on local borrowing include centrally specified limits on capital spending of each local government, central government approval of submitted local project and local debts (including bond finance) and seeking community mandates on borrowing plans through popular referenda.

Source: Shah (1999), Fiscal Federalism and Macroeconomic Governance: for Better or for Worse?, OECD, Paris; Spahn (1999), Decentralization, Local Government Capacity and Creditworthiness: Macroeconomic Aspects, Washington DC.

For the purpose of assessing the debt situation and the creditworthiness of local governments, Spahn (1999) suggests investigating several economic indicators:

- the total amount of (annual) public borrowing requirements which also include rescheduling of existing debt and their changes,

[16] "Rules-based approaches have the obvious advantage of transparency and even-handedness, as well as of avoiding protracted bargaining between the central and the [local governments, but] lack flexibility [...]" (Ter-Minasssian and Craig, 1997, p. 166).

- the structure of debt, maturity, interest payment mechanisms as well as institutional aspects such as the existence of a local bond market,
- the relationship between own local income (e.g. tax revenue + transfer) and the current debt services as well as between the level of debt and the net worth of local governments,
- the scope of current budget to finance the operating and maintenance costs of local services in addition to the coverage of capital formation through e.g. user fees,
- the sensitivity of local borrowing to the political cycle and other political factors,
- the record of repayment experience, etc.

1.6. Administrative Aspects of Fiscal Decentralisation

The intergovernmental devolution of tax administration and the delegation of expenditure responsibilities require a transparent, well-functioning and co-operative public (financial) management for both central and local governments to carry out all the expenditure- and revenue-related activities in an efficient way. In other words, a successful fiscal decentralisation can only take place in a country, when in all tiers of government the systematic tax collection and enforcement occurs in parallel with the sound expenditure choice of local needs and cost-effective delivery of public goods and services. To be sure, the implementation and realisation of such decentralisation ideas has posed new challenges to those European countries in transition and caused significant changes in political and fiscal as well as administrative system.

The following administrative aspects and prerequisites should be borne in mind to guarantee the optimal tax collection and expenditure assignments in different levels of government:

- Compared to the centralised tax administration with advantages like uniform procedures and economies of scale realised in tax collection, “the decentralised system [entails] greater responsibility and accountability of local authorities for the performance of taxes assigned to them, as well as greater flexibility in adapting [tax collection and administration] systems and procedures to local needs and conditions” (Ter-Minassian, 1997, p. 16).
- As mentioned before, a clearly defined administrative system related to the local expenditure assignments and intergovernmental transfers as well as local borrowing is crucial.
- Preparation of rolling financial plans, budgeting and accounting as well as information exchange can be efficiently carried out in all government levels by

adopting modern, comprehensive, standardised and transparent budget classifications and accounting rules (Potter, 1997).

- Finally, improvements in auditing and evaluation should occur at the central level, which also need to be replicated at the local level.

2. Municipal Finance and Governance in Selected Eastern European Countries: Country Studies

2.1. Municipal Finance and Governance in Poland

Polish municipalities called 'gminas' are self-governing units at the basic level of the country's territorial division which have their own budget and enjoy fiscal authorities. At present there are 2489 self-governing gminas in the country (including 11 gminas constituting the city of Warsaw), of which ca. 13% are urban gminas. Around 22% of total gminas are cities (or towns) with rural districts, while approximately 65% of 2498 gminas encompass typical rural areas where only small-sized villages are located.[17]

The Polish local government system was re-established and re-institutionalised in the context of the political and economic transformation. This subsidiarity principle-oriented process of localising public services was initiated by the Act of March 8, 1990 on Local Government — based on the changes in the Polish Constitution — and supplemented as well as modified by a number of regulations and laws. In particular, this legal system tackled — with a wide range of issues relating to the mutual relations between national and local governments — the tasks and authorities of local government the local budgetary systems, financial management and expenditure control mechanisms as well as the municipal business activity.

In 1999 Poland carried out the so-called self-government reform. The reform, however, did not aim at reducing the authorities or the responsibilities of gminas. On the contrary, additional functions like environmental protection were assigned to the municipal level. Furthermore, changes in the tax system appear to have increased the gminas' financial independence. As was the case before the reform, gminas are continuously subject to:

- perform public tasks and services under their own name and their own responsibility,
- have legal identities and independent budgets, and
- own fixed assets and control funds whose value is commensurate to their tasks.

[17] Out of 42 cities with more than 100000 inhabitants, 10 cities (including Warsaw) are located in the eastern half of Poland. Apart from these extreme cases, the size of population for the self-governing (urban and rural) gminas generally ranges between 2000 to 50000. Most rural gminas and also 73% of urban gminas currently have less than 20000 inhabitants.

2.1.1. Expenditure Assignment in Polish Municipalities

Typical activities of gminas consist of (a) land management and planning, zoning and local environmental protection, (b) provision of local roads, bridges, streets and public transport system, (c) electricity and water supply as well as municipal waste disposal treatment, (d) primary health care and social welfare services, (e) municipal housing, (f) elementary education including kindergarten, (g) promotion of culture and sport, (h) public order and fire protection, etc.

Table 4 Classification of real local expenditures of total Polish gminas according to the types of gminas (in million zlotys and at 1998 prices)

	1994	1995	1996	1997	1998
Total gminas	28004	29128	38996	45000	47495
Urban gminas	17429 (62.2%)	17576 (60.3%)	22064 (56.6%)	25312 (56.2%)	27157 (57.2%)
Cities with rural districts	4915 (17.6%)	5313 (18.2%)	7459 (19.1%)	8606 (19.1%)	8944 (18.8%)
Rural gminas	5659 (20.2%)	6239 (21.4%)	9472 (24.3%)	11083 (24.6%)	11394 (24.0%)

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo)

Expressed at 1998 prices a continuous growth of municipal expenditures is illustrated in Table 4 — from 28004 to 47495 million zlotys between 1994 and 1998. In the same period of time, local expenditures of urban gminas with strong economic bases comprised by far the highest share (over 55%) of the total amount for Poland, followed by rural municipalities (over 20%). A high concentration of (investment and operating) expenditures on large industrialised cities was also caused by the concentration of the wide range of public activities commissioned by the central government to these gminas. However, the former share showed a declining trend in the investigated time period, in contrast to the latter which is evidently growing trend. The increase in expenditure share in rural municipalities was mainly triggered by the realisation of a large number of large investment projects that were supported by means from the state budget and from the different levels of Funds for Environmental Protection and Water Management (see also Table 8).

The average amount of gminas' expenditure per inhabitant measured at 1998 prices rose rapidly from 727 zlotys in 1994 to 1228 zloyts in 1998 (Table 5). Yet, differences in the per capita expenditure level were remarkable between urban and rural gminas. In 1998, for example, its value reached ca. 2077 zlotys in Warsaw compared to 877 zlotys in the rural Zamosc Province.

Table 5 Real per capita local expenditures in different types of gminas (in zlotys and at 1998 prices)

	1994	1995	1996	1997	1998
Total gminas	726.6	754.9	1009.8	1164.0	1228.3
Urban gminas	897.8	904.9	1136.2	1303.7	1398.8
Cities with rural districts	592.7	640.6	893.1	1022.4	1059.4
Rural gminas	522.3	574.0	873.3	1023.6	1054.1

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

Among varied local activities of gminas the largest sum of expenditures was spent to finance the educational services (particularly for running elementary schools[18] and kindergartens) in 1998, followed by the municipal economic development (including water supply, waste disposal, environmental protection, etc.), local administration (especially salaries and wage costs for local government officials) and welfare (see Table 6). Concerning the educational activities, the central government's subsidy was insufficient to cover the entire costs for running schools, and, therefore, some additional financial means from the gminas' exclusive revenues were necessary to reduce the bottleneck (see also below). The provision of local public transport, road lighting etc. are included in the item of the municipal economic development, while the item transport in Table 6 solely encompasses the construction and repair costs for roads.

Municipal expenditures mainly consist of (a) operating expenditures for ensuring proper functioning of infrastructure and other local facilities as well as public services and the follow-up expenses caused by the realisation of gminas' infrastructure projects, and (b) investment expenditures for the provision of new infrastructure. For example, the operating expenditures of total gminas amounted to 36835 million zlotys (i.e. ca. 78% of 47495 million zlotys) in 1998, while the investment expenditures reached 10660 million zlotys (i.e. 22% of total expenditures) at the same year. The item municipal economic development

[18] This obligation was delegated by the central government to local authorities on 1 January 1996.

(especially in respect to water supply and waste disposal networks and facilities) comprised more than 53% of the 1998 investment expenditures (i.e. approximately 5746 million zlotys), followed by education (ca. 15%), housing (ca. 8%) and agriculture (ca. 7%), as illustrated in Table 7.

Table 6 Classification of total (operating and investment) expenditures of gminas according to the major local activities in 1998

Major local activities	Share in %
Agriculture	2.0
Transport	2.2
Municipal economic development	22.2
Housing	4.7
Education	36.2
Culture	2.8
Health care	6.1
Welfare	9.6
Sport	1.7
Local administration	9.7
Other miscellaneous activities	2.8

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

Table 7 Classification of investment expenditures of gminas according to the major local activities in 1998

Major local activities	Share in %
Agriculture	6.8
Transport	4.5
Municipal economic development	53.9
Housing	7.7
Education	14.8
Health care	2.1
Sport	3.7
Local administration	2.5
Other miscellaneous activities	4.0

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

In general, the volume and the growth rate of investment in individual gminas halve been closely linked to the own level of fiscal revenues, the volume of their property and the current infrastructure needs (see Table 8). However, as the total volume of municipal investment expressed at 1998 prices increased from 6286 to 10659 million zlotys between 1994 and 1998, local authorities were more strongly challenged to find or to create extra financial means to meet the needs. Furthermore, large cities suffered from the growing operating costs required for the maintenance of existing infrastructure quality and its network, while the lack of generated tax and other types of revenues further limited investment activities in rural areas.

Table 8 Major financial sources for municipal investments in gminas in 1996 and 1997

	1996	1997
Total amount of gminas' investment (in million zlotys) of which	8594	9523
Gminas' exclusive fiscal revenues	81.0%	78.5%
Grants from the National Fund for Environmental Protection and Water Management (NFOS)	1.0%	0.3%
Grants from Regional Fund for Environmental Protection and Water Management (WFOS)	1.5%	1.2%
Grants from Gminas for Environmental Protection and Water Management (GFOS)	3.6%	3.1%
Loans from NFOS	2.8%	1.7%
Loans from WFOS	3.2%	8.4%
Commercial bank credits	5.4%	4.8%
Municipal bonds	1.4%	2.0%

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

Local investment expenditures per inhabitant were always highest in urban gminas in the investigated period of time. In particular, its value reached 560 zlotys for Warsaw in 1998. This fact again clearly indicates that there has been a strong link between the level of investment expenditures and the gminas' fiscal income. A strong economic base generates higher budgetary revenues, mainly from the participation in shared taxes including personal and corporate income taxes as well as from the local tax revenues and fees. The rapid increase in investment activities in rural municipalities since 1996 led to the higher per capita investment value in these areas and bypassed the slowly-growing level for cities with rural districts (see Table 9).

Table 9 Per capita investment expenditures in different types of gminas (in zlotys and at 1998 prices)

	1994	1995	1996	1997	1998
Total gminas	163.1	175.7	222.5	273.7	275.7
Urban gminas	176.7	181.0	228.7	287.9	303.6
Cities with rural districts	161.4	176.9	209.9	245.6	240.7
Rural gminas	139.9	165.1	221.2	270.0	252.8

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

2.1.2. Tax Assignment and Tax Sharing in Poland

Fiscal income of gminas generally consists of :

- revenues from local taxes like real estate tax, agricultural tax, forest tax, transportation tax, tax on business activity paid in the form of a flat turnover tax as well as the inheritance and gift taxes; revenues from local fees and user charges; and income from gmina's property mostly from the sale or rent of municipal estate and bond dues as well as other interest income (*exclusive revenues*),
- gmina's surcharge on personal income tax and on corporate tax revenues (*shared taxes*),
- general subsidies and special subsidies for primary education and road construction (*subsidies*), and
- targeted grants from the central government for commissioned and entrusted public duties as well as those for compensating local fiscal deficits caused by the abrupt reduction in tax income, etc. (*grants*).

Regardless of the different types of gminas, the real fiscal income increased rapidly in the investigated period between 1994 and 1998 (see Table 10). This development automatically led to the fast growth of total income of gminas in Poland as a whole. Although its dominance is gradually decreasing, the urban gminas had the remarkable income share of over 55%. In addition, Table 11 illustrates that the exclusive revenues[19] mentioned above played the most im-

[19] Among different items of the gminas' exclusive income sources, the real estate tax and the income generated from the sale or rent of municipal estate have traditionally played the most important role.

portant role for financing the gminas' expenditure within the same period of time, followed by income from the shared revenues and the subsidies. The former form of budgetary revenues slightly lost its significance, while the two latter items gained their shares in the course of time. The share for the grant from the central government as the budgetary income source showed a declining tendency caused by the reduction in the so-called commissioned duties but fluctuated between 1994 and 1998. A more thorough analysis about the development of subsidies and grants is made in chapter 2.1.3.

Table 10 Classification of real fiscal income of total Polish gminas according to the types of gminas (in million zlotys and at 1998 prices)

	1994	1995	1996	1997	1998
Total gminas of which	27824	29370	38324	43905	46119
Urban gminas	17423 (62.6%)	17723 (60.3%)	21683 (56.6%)	24558 (55.9%)	26251 (56.9%)
Cities with rural districts	4785 (17.2%)	5318 (18.1%)	7264 (19.0%)	8421 (19.2%)	8688 (18.8%)
Rural gminas	5616 (20.2%)	6329 (21.5%)	9378 (24.5%)	10926 (24.9%)	11180 (24.2%)

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

Table 11 Classification of real fiscal income of total Polish gminas according to the types of revenue items (in million zlotys and at 1998 prices)

	1994	1995	1996	1997	1998
Total budgetary revenue of which	27824	29370	38324	43905	46119
Exclusive revenues	40.4%	41.1%	36.3%	37.6%	35.6%
Shared taxes	23.1%	23.1%	24.5%	24.2%	24.7%
Subsidies	14.9%	15.3%	25.3%	24.1%	25.4%
Grants	21.6%	20.5%	13.9%	14.1%	14.3%

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

As indicated in Table 12, the level of fiscal income per capita was the highest for urban gminas (with 1352 zlotys) in 1998, followed by that of rural gminas (1034 zlotys). Budgetary revenues per capita generated on the basis of the exclusive resources was evidently higher than the average for urban gminas (503 zlotys compared to the average of 399 zlotys), while subsidies were higher for rural gminas and cities with rural districts (412 and 327 zlotys, respectively compared to the average of 303 zlotys).

Table 12 Classification of 1998 per capita fiscal income of total Polish gminas according to different types of revenue items (in zlotys)

	All gminas	Urban gminas	Cities with rural districts	Rural gminas
Per capita fiscal income total of which	1193 (100%)	1352 (100%)	1029 (100%)	1034 (100%)
Exclusive revenues	399 (35.6%)	503 (48.2%)	325 (34.5%)	270 (29.9%)
Shared taxes	295 (24.7%)	295 (21.8%)	181 (17.6%)	144 (14.0%)
Subsidies	304 (25.4%)	233 (17.2%)	327 (31.8%)	412 (39.9%)
Grants	170 (14.3%)	173 (12.8%)	166 (16.1%)	168 (16.3%)

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

Regarding the composition of the gminas’ revenues from the shared taxes, personal income tax was the dominant income source and its share increased gradually in the years between 1994 and 1998 (Table 13).

Table 13 Classification of gminas’ real fiscal income from the shared taxes into types of taxes (in million zlotys and at 1998 prices)

	1994	1995	1996	1997	1998
Revenues from shared taxes total of which	6427 (100%)	6782 (100%)	9386 (100%)	10625 (100%)	11396 (100%)
Corporate income tax	688 (10.7%)	689 (10.2%)	698 (7.4%)	781 (7.4%)	777 (6.8%)
Personal income tax	5739 (89.3%)	6093 (89.8%)	8688 (92.6%)	9844 (92.7%)	10619 (93.2%)

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

2.1.3. Intergovernmental Transfers in Poland

In Poland intergovernmental transfers from the central government to the gminas consist of subsidies and grants. These are regarded in Poland as subsidiary incomes for gminas. With such types of financial supports the central government aims at releasing the local fiscal constraints, guaranteeing and enhancing the quality of local governments' services, especially those commissioned and delegated duties to the municipal governments.

Gminas' revenues from 'subsidies' increased in real term from 4155 to 10601 million zlotys between 1994 and 1998 (see also Table 11). First of all, such a rapid increase was the result of assigning the responsibility of maintaining elementary schools to the local level (in 1996) and the general expansion of subsidies for entire public educational activities. In addition, there was also a rapid increase in general subsidies to the less-developed rural areas (with low per capita tax revenues), which have compensatory character and are equity-oriented. For this reason, the share of subsidies for the gmina's total local income has generally been highest in rural areas in eastern and central regions of Poland (e.g. over 40% in 1998), while the same share has been the lowest in large cities including Warsaw (ca. 11% in 1998).

The next external resources for the gminas' budget and financing public activities are 'grants' from the central government. Expressed at 1998 prices, the total sum of grants directed to gminas increased from 6022 to 6572 million zlotys between 1994 and 1998, the dynamic of which was far slower than the growth of gminas' total budgetary revenues in the same period of time (see also Table 11). Although such grants are mainly aimed at financing the specific local projects which are defined, commissioned and entrusted by the central government, significant amounts have also been transferred to support the 'general' provision of local utilities and services in the selected gminas. In 1996, for example, the provision of the commissioned and entrusted activities comprised ca. 53% of the total grants from the Polish state budget, while approximately 47% were transferred to accomplish the latter purposes.

As already shown in Table 12, the per capita grant level was slightly higher in urban municipalities than that in rural areas in the investigated years. Such disparities are the result of financing a much wider range of the gminas' duties commissioned by the central government in urban municipalities.

2.1.4. Some Remarks on Gminas' Budget Balance

The comparison of expenditures and fiscal revenues of gminas show that the local budget registered a deficit in the years 1994, 1996, 1997 and 1998, while a budget surplus was noted in 1995. Since 1996, however, the deficit continued to grow rather rapidly from 672 million zlotys and reached 1376 million zlotys in 1998. The budget development in this period was also significantly disturbed by the imperfect planning processes on both central and local tiers: There were frequent changes in legal acts with respect to local responsibilities and competencies delegated to local governments as well as the state tax system. Moreover, the realisation of large infrastructure projects was quite often endangered, since the implementation of the municipal expenditure schedules was too much short-term oriented — therefore decisions made in many cases were 'accidental' —, and a large number of projects turned out to be flops, because their realisation was carried out without solid economic and feasibility analyses.

2.1.5. Local Government Borrowings and Debt Management in Poland

As also shown in Table 8, preferential bank credits and public loans — together with property revenues — played a minor role in financing municipal investment activities. In particular, the percentage share for preferred credits and loans gradually declined and the accessibility for grants for gminas' exclusive responsibilities became more and more restricted in the years between 1994 and 1998. This trend will likely prevail in the near future, which will probably lead to increasing demand for commercial credits from private banks on 'normal' terms and the issues of communal bonds.

The recent level of gminas' credits and loans taken from the Polish National Bank and various commercial as well as co-operative banks is illustrated in Table 14. During the period of 1994-99, the level of municipal indebtedness rose rapidly from ca. 198 to 2674 million zlotys. In the indebtedness structure, there was a remarkable movement of preponderance from short-term (less than 1 year of maturity) to mid-term credits (over 5 years of maturity), which was particularly popular for financing investment projects in large urban areas. In most cases companies owned by gminas contracted those long-term credits over 5 years, while short-term credits were mostly for covering budget deficits. The per capita indebtedness in gminas increased from approximately 5 to 69 zlotys in the same period.[20]

Table 14 Gminas' credits and loans taken from all banks between 1994 and 1999 (in million zlotys)

	31.12.94	31.12.95	31.12.96	31.12.97	31.12.98	31.12.99
Total credits and loans to gminas	197.6	378.9	748.2	1307.6	2071.0	2673.7
of which						
Under 1 year	101.5	114.1	129.2	183.0	173.8	131.8
From 1 to 5 years	94.3	237.7	287.2	442.8	629.0	997.9
Over 5 years	1.9	27.1	331.8	681.9	973.0	1483.7

Source: Polish National Bank database.

A considerable part of gminas' indebtedness in commercial banks was constituted by credits on preferential terms. Such credits have usually been available to gminas when financing local investments aimed at protecting the natural environment. In the future accessibility of such means is likely to become limited, and the increasing investment needs will force local authorities to continuously look for normal credits from private banks in commercial terms. At the end of 1997 the gminas' debt in a form of commercial credits amounted to 696.7 million zlotys, which comprised around 53.3% of the total debt level (= 1307.6 million zlotys). In general local authorities spent the biggest sum of credits to carry out the tasks in the fields of public transport (ca. 42%) — mainly for the purchase of means of transportation like busses — and to finance their budgetary deficits (approximately 14%). This trend was more evident for large cities, while small and medium-sized gminas utilised a higher share of commercial credits to finance schools, water-supply networks and waste disposal facilities, partly also in the context of environmental protection.

[20] The per capita credit level reached 10, 22, 37 and 54 zlotys for 1995, 1996, 1997 and 1998, respectively.

Table 15 Classification of 1997 commercial credits to gminas according to the expenditure purposes (in % share)

Expenditure purposes	
Total sum of commercial credits taken by gminas and companies owned by them	696.7 million zlotys
of which	
Schools	9.1%
Water supply and waste disposal	10.1%
Public transport	41.9%
Environmental protection	6.3%
Housing	6.6%
Heating	11.7%
Telecommunication	0.3%
Financing budgetary deficit	14.0%

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

Growing investment needs and the persistent budgetary bottlenecks have led gminas to look more actively for additional sources for financing the gradually increasing local expenditures. Furthermore, their attempts made in recent years to save operating costs related to the provision of local goods and services appear to be less successful. Apart from the traditional tax incomes and commercial credits mentioned above, communal bonds have rapidly emerged as an alternative financial means in Poland since mid-1990s. For the first time, a few cities including Gdynia took the legal steps of allowing the issuing of municipal bonds at the end of 1995 (see Table 16). In most cases they were aimed at purchasing new motor vehicles for the municipal transport system and at constructing and/or renewing roads.

Communal bonds will gain importance as an alternative source for financing infrastructure in the near future, although they play a minor role at present. In particular, cities which have already made their first bond issues are preparing the next ones. At the same time, financial institutions are increasingly interested in preparing and organising such actions in co-operation with gminas.

Table 16 Distinctive municipal bonds issued by gminas in recent years

1995-1996	1997-1998
Gdynia (28 million zlotys) Lodz (29 million zlotys) Krakow (15 million zlotys) Gdansk (99 million zlotys) Ostrow Wielkopolski (7.5 million zlotys) Gorzow Wielkopolski (20 million zlotys) Pabianice (5 million zlotys) Zielona Gora (20 million zlotys)	Krakow (138 million zlotys) Sosnowiec (95 million zlotys) Wroclaw (50 million zlotys) Lubin (30 million zlotys) Legnica (21 million zlotys) Proszowice (1 million zlotys) Wejherowo (1.1 million zlotys) Kosakowo (1.2 million zlotys) Bielawa (3 million zlotys) Chodziez (4.5 million zlotys) Smigiel (4.5 million zlotys)

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo).

2.1.6. Administrative Aspects of Fiscal Decentralisation in Poland

Laws and regulations defining the relationship between the national and local governments also determine the political scopes in which local governments can carry out local activities without any interference from the central government. Article 165 of the Constitution (Chapter VII) guarantees the proprietary interests and property rights of a local government by granting the gmina the status of a legal person. Article 167 guarantees a share of public revenue for local government bodies proportional to the tasks falling within their authority. Supervision of local government activities concerns only the legality of their actions and is exercised by the Prime Minister and Provincial Governors (Wojewoda). As far as the financial aspects and soundness of gminas are concerned, the supervision is performed by the regional accounting bodies responsible for producing official documents on the results of budgetary control among such municipal bodies.

The major principles of municipal financial management have been defined by Chapter 6 of the Act of March 8, 1990 on Local Government. This general rule tackles the formulation of a gmina's budget: its approval, execution and supervision. In addition, the budgetary law of local government was incorporated in the nation-wide budgetary law system. The Act of December 10, 1993 on Gmina Financing deals in more detail with issues related to preparing the gmina's budget with its own taxes or other types of financial means. Widely recognised as the basic normative act defining the unambiguous principles of local financial management, this act precisely determines the types of a gmina's revenue, the principles of calculating and providing subsidies from the national budgets to gminas, and the terms and conditions under which gminas may receive loans or issue own securities and bonds. For example, this act presents not only a clear difference of a gmina's tax revenue between those in the form of sharing national taxes and revenues from municipal taxes, but also detailed rules for calculating the general subsidy for gminas and the conditions for providing subsidies.

2.2. Municipal Finance and Governance in the Slovak Republic

Unlike the common practice in most European countries, municipalities in Slovakia enjoy financial autonomy and do not have to submit their annual budget to the central government. For this reason, the central government has an insufficient overview of municipalities' expenditures and revenues. Such a state is by no means suitable for the future. Apart from strengthening the fiscal income basis of local governments, it is also necessary to create a nation-wide information and control system on the use of public resources.

2.2.1. Expenditure Assignment in Slovakia

Under the Law on Municipality Establishment No. 369/1990, the Slovak municipalities are obliged to ensure the following public services:

- construction, maintenance and administration of local communications, public spaces, municipal cemeteries, cultural, sports and other municipal facilities, local historical monuments and buildings,
- provision of services like communal waste disposal and municipality cleaning, administration and maintenance of the public green spaces and public illumination, water supply, sewage water draining as well as public transport,
- provision of healthy living and working conditions for inhabitants, protection of the environment and provision of favourable conditions for education, culture, leisure activity and sports,
- provision and supervision of a general framework for the regular supplying of goods and services in municipalities (e.g. selling and operating times for retailers and administration of marketplaces, etc.),
- territorial planning for residential units and zones, development conceptions of the part of municipal territory,

- investment and business activities for meeting the citizens' needs and for economic development in municipalities.

In general, the minimal enacted level of local services does not exist in Slovakia. However, the assignment of these competencies to municipal authorities are defined in some cases less-precisely in the legal and administrative context. In the practical sense, for example, the relevant competencies and property in the are of the drinking water supply for citizens have not yet been transmitted to the self-governance of municipal authorities, which has caused many problems in Slovakia.

Table 17 Budgetary expenses of municipalities in Slovakia (in million Slovak crowns – SKK at current prices)

	1994	1995	1996	1997	1998	1999
Total expenditures of which	19097.7	18853.0	23153.7	26625.2	25651.7	23796.8
Current expenditure	12860.9 (67.4%)	12971.2 (68.8%)	14766.9 (63.8%)	16607.8 (62.4%)	15916.3 (62.0%)	16776.9 (70.5%)
Capital expenditure	6236.8 (32.6%)	5881.8 (31.2%)	8386.8 (36.2%)	10017.4 (37.6%)	9735.4 (38.0%)	7019.9 (29.5%)

Source: Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo).

Tables 17 and 18 present the basic classification of local expenditures in Slovakia in the years between 1994 and 1999. Expressed at current prices, the total expenditures (operating expenses and investment expenditures) grew from approximately 19 billion SKK in 1994, reached a peak in 1997 (at ca. 27 billion SKK) and gradually decreased in the following years. To a certain extent, this trend corresponds to the recent macro-economic fluctuation in the country. Compared to the cases in 1998, local authorities restricted their investment activities (i.e. capital expenditure) in 1999, while operating (i.e. current) expenses (like expenses for purchasing goods and services, making local grants and wages for government employees) continued to grow. Over all the investigated years, the operating expenditures of municipal governments were dominant: their share always amounted to over 60% of the sum of total expenditures and even reached ca. 70% in 1999.

Table 18 Structure of municipal expenditures in Slovakia

	1996	1997	1998	1999
Total current expenditures	14766.9 (million SKK)	16607.8 (million SKK)	15916.3 (million SKK)	16776.9 (million SKK)
of which				
Wages	20.2%	19.8%	20.0%	19.2%
Insurance payment	7.6%	7.3%	7.2%	6.9%
Purchase of goods & services	44.9%	44.4%	43.8%	44.9%
Interest payment	4.3%	4.4%	5.6%	6.1%
Current grants	23.1%	24.1%	23.5%	22.9%
Total capital expenditures	8386.8 (million SKK)	10017.4 (million SKK)	9735.4 (million SKK)	7019.9 (million SKK)
of which				
Capital assets	87.7%	89.9%	89.6%	88.0%
Capital transfers	12.3%	10.1%	10.4%	12.0%

Source: Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo).

2.2.2. Revenue Assignment in Slovakia

In the investigated period 1994-99 total revenues for Slovak municipalities expressed at nominal term continued to grow and reached its highest level in 1998 (= around 29 billion SKK), then declined in the following year (Table 19). Personal income and corporate tax as well as road tax are so-called shared taxes. Among these tax income sources, the former type of income tax has always been most important for municipalities, since its share (at ca. 25% of the total local budgetary revenues in 1999) has always been the highest of total local revenues. The level of municipality share of these types of taxes is the component of annually approved State Budget Act. For a long time the municipalities' share of the road tax was fixed at the level of 30% of the annual road tax revenues (i.e. the rest for the central government). On the other hand, the shares in the personal income tax and corporate tax have been changing annually, in accordance with the budget situation of the central government. This fiscal system has hindered municipalities' planning and developing process of long-term projects. Nevertheless, the share of income tax revenues remained quite constant (at over 20%) in the period 1994-99, although it fluctuated slightly from one year to another.

Table 19 Total budgetary revenues of Slovak municipalities between 1994 and 1999 (in million Slovak crowns - SKK)

	1994	1995	1996	1997	1998	1999
Tax revenues	**8883.8 (44.2%)**	**8544.9 (38.4%)**	**10163.1 (39.9%)**	**10569.4 (36.7%)**	**11402.2 (39.4%)**	**11608.5 (42.5%)**
Income tax total	4991.9 (24.8%)	5032.3 (22.5%)	5857.3 (23.0%)	6070.5 (21.0%)	6817.1 (23.6%)	6855.1 (25.1%)
Personal income tax	3514.9 (17.5%)	3484.1 (15.6%)	4656.0 (18.3%)	5284.2 (18.3%)	5459.2 (18.9%)	5875.1 (21.5%)
Corporate tax	1477.0 (7.3%)	1548.2 (6.9%)	1200.4 (4.7%)	786.3 (2.7%)	1357.9 (4.7%)	980.0 (3.6%)
Real estate tax	2032.0 (10.1%)	2051.8 (9.2%)	2861.0 (11.2%)	3124.1 (10.8%)	3199.5 (11.0%)	3352.6 (12.3%)
Land value tax	n.a.	n.a.	993.0 (3.9%)	1018.5 (3.5%)	1053.7 (3.6%)	1074.8 (3.9%)
Building tax	n.a.	n.a.	1841.2 (7.2%)	2089.7 (7.2%)	2123.5 (7.3%)	2234.9 (8.2%)
Road tax	370.6 (1.8%)	405.4 (1.8%)	425.7 (1.6%)	411.7 (1.4%)	450.7 (1.5%)	515.4 (1.9%)
Local charges	816.2 (4.0%)	863.2 (4.3%)	960.7 (3.7%)	866.8 (3.0%)	840.7 (2.9%)	866..9 (3.2%)
Other tax revenues	673.1 (3.3%)	92.2 (0.4%)	58.4 (0.2%)	96.3 (0.3%)	94.3 (0.3%)	18.4 (0.1%)
Non-tax revenues (e.g. property sales)	**7923.9 (39.4%)**	**8209.1 (36.9%)**	**8992.6 (35.3%)**	**10294.8 (35.7%)**	**10646.6 (36.8%)**	**9116.6 (33.3%)**
Grants (subsidies)	**2308.2 (11.5%)**	**1977.2 (8.8%)**	**3608.7 (14.1%)**	**5026.3 (17.4%)**	**3784.6 (13.1%)**	**3362.3 (12.3%)**
Current grants	n.a.	n.a.	1377.4 (5.4%)	2155.9 (7.4%)	1950.0 (6.7%)	1859.6 (6.8%)
Capital grants	n.a.	n.a.	2231.3 (8.7%)	2870.4 (9.9%)	1834.6 (6.3%)	1502.6 (5.5%)
Bank credits & municipal bonds	**926.8 (4.6%)**	**2231.0 (14.5%)**	**2565.7 (10.0%)**	**2733.2 (9.4%)**	**2942.7 (10.1%)**	**3162.9 (11.6%)**
Other revenues	**29.7 (0.1%)**	**273.6 (1.2%)**	**93.8 (0.3%)**	**161.9 (0.5%)**	**96.6 (0.3%)**	**93.4 (0.3%)**
Total municipal revenues	**20072.6 (100%)**	**22236.0 (100%)**	**25423.9 (100%)**	**28785.5 (100%)**	**28872.6 (100%)**	**27343.5 (100%)**

Note: The abbreviation n.a. means not available.
Source: Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo).

The exclusive local fiscal incomes consist of the revenues from real estate taxes (land value tax and buildings tax) and the local charges (dog tax, from the selling of alcoholic and tobacco products, for accommodation facilities on the basis of their capacity, for the usage of public land, from entrance fees, from advertisements, entrance fee for motor vehicles to the historical part of town, for entertainment and pin-ball machines, for spa cures and recreational stays, etc.) and other special duties (see Table 20 and 21).

Table 20 Significance of revenues from local charges for the municipal budget in the Slovak Republic

	1994	1995	1996	1997	1998	1999
Local charges in million SKK	816.2	963.2	960.7	866.8	840.7	866.9
% share of local tax revenues of municipalities	22.6	31.6	24.7	21.5	20.8	20.5
% share of total tax revenues of municipalities (e.g. incl. tax sharing)	8.5	11.3	9.5	8.2	7.4	7.5
% share of total fiscal revenues of municipalities	4.1	4.3	3.8	3.0	2.9	3.2

Source: Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo).

Table 21 Major sources of local charges in million Slovak crowns (SKK)

	1994	1995	1996	1997	1998	1999
Charges for dog ownership	29.9	36.5	44.5	46.8	49.0	51.3
Charges from alcoholic & tobacco products	314.0	355.0	425.8	418.4	403.6	380.0
Charges for entertainment machines	183.8	228.0	192.5	92.8	75.9	70.8
Charges for selling machinery	2.1	1.3	3.5	1.0	1.1	1.0
Entrance charges for motor vehicles to the historical parts of town	2.1	3.4	1.3	1.5	0.8	1.3
Charges for accommodation capacity	23.4	23.0	22.5	22.3	20.8	21.6
Charges for advertisement	13.8	20.7	26.1	32.1	36.4	42.9
Charges for entrance fees to public facilities	13.0	18.9	19.6	22.4	22.7	22.8
Charges for spa cures and recreation stays	29.9	31.5	34.6	33.9	33.0	32.2
Charge for flat exploitation or its part for other purposes	5.5	18.1	6.5	5.2	4.9	4.3
Charge for using public land and areas	105.2	113.0	137.0	168.9	179.3	222.3
Location fee	87.4	39.9	0.0	0.0	0.0	0.0
Charges for air pollution	0.0	0.0	7.7	8.0	6.8	6.2
Charges for waste storage	0.0	0.0	5.3	4.1	n.a.	n.a.
Other charges	6.1	73.9	33.9	9.3	n.a.	n.a.
Total	816.2	963.2	960.7	866.8	840.7	866.9

Note: The abbreviation n.a. means not available.
Source: Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo).

As shown above, revenues from both exclusively local income sources represent only a small part of the total budgetary revenue of Slovak municipalities (ca. 15% over the years between 1994 and 1999, as indicated in Table 19). The level of real estate tax base presently depends on the physical parameters (area, number of floors and the purposes of utilising land). In the near future the method of calculating the amount of real estate tax will be changed from the existing, less effective pricing system with the legally defined maximal prices for m^2 and dimensional coefficients of residences to the system of pricing and taxation based on the market value of real estate. However, the implementation of the new system appears to be taking some time, partly because of the poorly developed real estate market in the country.

The municipalities' capability to mobilise sources from their own tax basis is limited in Slovakia. First of all, it is mainly due to the small share of exclusive local taxes and municipal charges. Secondly, the current huge tax burden on the population makes neither the increase in rates of existing taxes nor the introduction of new taxes politically or economically feasible.

By contrast, municipalities in Slovakia have recently yielded a significant share of total revenue from the so-called non-tax revenues, the share reaching between 33% and 39% in the period 1994-99. This budget revenue item consists of the sale of municipal property including flats, property rental, the business incomes resulting from the running of state-owned firms and municipal participation in private companies, etc. It is expected in the mid-term that the non-tax revenues will slowly lose importance but remain as the major income source for local authorities beside the tax revenues.

2.2.3. Intergovernmental Grants in Slovakia

The central government provides subsidies and grants from the state budget to municipalities. Since 1997, this type of revenue source gradually lost its significance (see Table 19). For the year 2000 ca. 2 billion SKK will be spent for this purpose: The greatest part of this sum – approximately 70 % — is designed for the construction of public transport system in the five largest Slovak cities. The so-called supports for the execution of self-governmental functions in small-sized municipalities (with less than 3000 inhabitants) comprise 25% of 2 billion SKK. The rest, approximately 5%, will be used for completing schools and houses as well as for meeting other financial needs of municipalities.

The second type of grants made to municipalities are subsidies from the special funds owned by the central government (including the State Environmental Fund, the Pro Slovakia Fund, the State Fund for Housing Development, etc.).

The total sum of such grants amounted to approximately 536, 634, 1703 and 974 million SKK for the years 1994, 1995, 1996 and 1997, respectively.

The intergovernmental transfer system — particularly those down-flow grants from the state-owned special funds to municipalities — appears to be less transparent at present. Those specific-purpose oriented subsidies for providing urban public transportation systems and for housing have recently been exceptions. As mentioned before, such clear, large-scale grants have been concentrated on large urban municipalities. On the other hand, the equalisation-oriented, general grants aimed at ensuring the provision of local goods and services as well as achieving distributive goals have usually been strongly addressed to those small municipalities that are suffering from fiscal deficits. At present, a horizontal equalisation and resource transfer system from rich cities to smaller rural municipalities does not exist in Slovakia. Furthermore, this unbalanced system encourages the fragmentation of small municipalities, making them even smaller than now.

2.2.4. Municipal Borrowings and Contingent Liabilities in Slovakia

The central government presently does not provide any loans to municipalities nowadays. At the same time, there is practically neither a legal limit for credit nor intervention of the central government to restrict or to forbid the municipalities' borrowings. They can borrow from domestic as well as from foreign banks, issue bonds on the domestic or foreign markets, or borrow from non-banking institutions. The only existing control mechanism imposed by the central government is the approval from the Ministry of Finance of the Slovak Republic when issuing communal bonds. While the emission value of municipal bonds fluctuated between 1994 and 1999, the amount of bank credits rapidly increased from around 886 million SKK in 1994 to 3163 million SKK in 1999 (Table 22). Since the capital market is less well-developed in Slovakia, municipal borrowings in the form of issuing bonds are not yet popular or acknowledged as the way for obtaining additional financial sources. At this time, the mechanism of borrowing financial means for infrastructure projects with a long-term economic return, of which total costs are higher than the income base of municipalities, does not exist in Slovakia.

At present, the credit capacity of municipalities (and also 'creditworthiness') heavily depends on the amount and quality of possessed property by local governments — consequently, it can generally be said that it is proportional to the size of the village or town (see Table 23). Towns and villages are relatively attractive clients for the banks, as they have a stable level of tax income (especially from shared taxes) and attractive real estate.

Table 22 Emission of communal bonds and bank credits taken by Slovak municipalities in recent years (in million Slovak crowns - SKK)

	1994	1995	1996	1997	1998	1999
Municipal bonds	40.4	2057.7	93.8	118.5	77.9	252.5
Bank credits	886.4	1173.4	2567.7	2733.1	2942.7	3162.9
Payment of credits and loan principals	n.a.	n.a.	1218.2	1409.0	1626.9	n.a.
(% share of total municipal expenditures)			(5.3%)	(5.3%)	(5.9%)	

Note: The abbreviation n.a. means not available.
Source: Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo).

Table 23 Recent municipal borrowings per inhabitant in Slovakia (in Slovak crown - SKK)

Population size of municipalities	1995	1996	1997
Smaller than 500	63	106	71
501 – 1000	139	174	183
1001 – 2000	178	203	198
2001 – 3000	243	335	272
3001 – 4000	134	308	229
4001 – 5000	55	130	186
Larger than 5000	368	695	764
Average of all municipalities	271	479	510

Source: Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo).

There are no existing restrictions, neither on particular types of incomes and their levels nor on certain types of property, that can be kept for collateral purposes when taking bank credits. Such a system has encouraged some Slovak towns to increase borrowings and has led some to the brink of bankruptcy. In this situation municipalities were often forced by creditors to sell their property quickly and at relatively cheap rates to meet their valid claims.

2.2.5. Budgeting and Public Expenditure Management in Slovakia

In Slovakia, the budgetary processes and financial reports are required by law. The self-governments at the municipal level are liable for the observance of specified budget compositions. The local budget contains a detailed division of incomes and expenditures which consists of current and capital items. However, municipalities are not obliged to have current and capital budgets separately.

Apart from the real estate property (buildings and land), municipalities can offer to banks their regular incomes (own and shared taxes) as warranty, which are in many cases, however, by far insufficient for covering current expenditures. At present their confidentiality is disturbed, for some municipalities were not able to pay back their own debts to the creditors, as mentioned before. The future revenues from projects cannot be used as loan warranties. Accounting standards for local self-governments do not require the declaration of warranties granted by municipalities. For this reason, it is hard to identify how often such warranties were granted and in how many cases the municipalities had to pay.

Regardless of different government tiers, the budgetary year for municipalities is identical with the calendar year (from 1 January to 31 December). Proposals of the budgets made by the local government have to be made public 15 days before the negotiations start. Inhabitants have an opportunity to raise objections (comments) regarding the budget directly during public authority meeting. The budgets are not subject to any external audit. It is compulsory for towns and villages to use a double-entry accounting system, with the exception of municipalities categorised as ‘small villages’, which can have a simple entry accounting system.

2.3. Municipal Finance and Governance in the Czech Republic

There are presently 6237 municipalities in the Czech Republic (Table 24). Their number rapidly grew at the beginning of 1990s, immediately after the law allowed any part of a municipality, however small, to separate. For example, the number of municipalities grew by 50% between 1990 and 1992. This development was mainly the consequence of forced amalgamation that was put into effect in the 1960s. Following this political action many small villages were, however, not able to receive sufficient financial support from the central government that was required for their economic development and they consequently suffered from the outflow of their citizens to other parts of the country.

As shown in Table 24, approximately 87% of municipalities have less than 1500 inhabitants, and 96% of them less than 5000 inhabitants. More than half of the total inhabitants live in big cities with more than 10000 citizens. The size structure of municipalities is, therefore, quite fragmented, and small and very small municipalities prevail. However, the role and tasks of municipalities are generally defined by the Municipal Act (No. 367/1990 several amendments) regardless of their size.

Table 24 Present size and structure of Czech municipalities

Size of municipalities	Number of municipalities (Share in %)	Number of total inhabitants (Share in %)
Up to 100	592 (9.5%)	41844 (0.4%)
101-200	1165 (18.7%)	174254 (1.7%)
201-300	876 (14.1%)	214982 (2.1%)
301-1500	2771 (44.4%)	1820722 (17.7%)
1501-5000	567 (9.1%)	1452584 (14.1%)
5001-10000	134 (2.2%)	927426 (9.0%)
10001-20000	66 (1.1%)	929334 (9.0%)
20001-30000	27 (0.4%)	660344 (6.4%)
30001-40000	11 (0.2%)	371306 (3.6%)
40001-50000	6 (0.1%)	269836 (2.6%)
50000-100000	17 (0.3%)	1252788 (12.2%)
100001-150000	1 (0.0%)	103372 (1.0%)
150001 and more	3 (0.1%)	875260 (8.5%)
Prague	1 (0.0%)	1193270 (11.6%)
Total	6237 (100.0%)	10287322 (100.0%)

Source: The Czech Ministry of Finance database.

2.3.1. Expenditure Assignment in the Czech Republic

Every municipality represents a legal entity. Local responsibilities are divided between own responsibilities and delegated responsibilities. The own responsibilities mentioned in the law include tasks in the following fields: education, social care, health care and culture, public safety, local police (voluntarily), cleanness of municipality, solid waste management, water supply and sewerage systems. Also municipal property management, foundation of legal entities, municipal budget management, urban planning, approving the development program and supervising its performance belong to this group. Further municipal functions consist of electing and establishing local government and administration bodies. Municipalities may also issue municipal decrees and participate in municipal associations including foreign ones.

For education municipalities are responsible for the provision of pre-school facilities and primary schools (up to 15 years of age) as far as the maintenance of buildings and operating costs are concerned. Teachers' wages are paid out from the central budget. Social care mainly consists of the provision of homes and related public services for elderly and disabled people as well as for orphans. The majority of social benefits (pensions, sickness pay, child benefits and so forth) is provided by the central government directly through the district offices. In general private companies provide solid waste collection, although it is not a rule. Water supply and waste disposal systems were privatised. In the privatisation process municipalities obtained equity shares in these companies. The central government also passed 34% of stock shares of companies distributing gas and electricity to municipalities. The rest is owned either by the central government (the National Property Fund) or by private (domestic as well as foreign) bodies. Furthermore, the health care system is fully organised by health insurance companies.[21] The pension scheme is a national system and included in the central budget — local governments are not involved in this public activity at all. The supplementary pension schemes are private and voluntary.

Delegated responsibilities of local government include the performance of the public administration primarily in the field of keeping the birth, marriage and death registers, building law and physical planning law. The environmental protection, the provision of local transport system, ensuring water standards, sanitation etc. also belong to this responsibility group. Not every municipality provides all tasks included in delegated responsibilities. Out of 6237 municipalities only 383 do so. These particular municipalities also provide such delegated functions for smaller units, which are based on inter-municipal agreements or on the district office decrees. The municipal expenditures related to the accomplishment of delegated responsibilities are partly covered by the grants from the central government. The volume of this grant appears in the Act on the State Budget for a particular year (see also below).

There are no state regulations concerning the minimum level of services expected from local service providers. Nothing like that is under preparation. For the delegated responsibilities special laws prescribe the way how a municipality

[21] There is one big company – the General Health Insurance Company and a few smaller ones. Their revenues come directly from health insurance premiums paid by individual entrepreneurs, employers and employees. The central government is involved in the premium payments for special citizen groups like pensioners, people on maternity leave, soldiers, unemployed persons and so on. The rates of premiums are also determined on the central level.

should carry out these services. In the case that a municipality does not provide local services by itself but the provision is made by a private body or non-profit organisation, municipalities define the level and quality of the provided goods and services.

Table 25 Budgetary expenditures of municipalities in the Czech Republic (in billion Czech crowns – CZK and at current prices)

	1997	1998	1999
Total budgetary expenditures	**134.4 (100.0%)**	**141.7 (100%)**	**150.0 (100%)**
Total operating expenditures of which	86.4 (64.3%)	93.5 (66.0%)	98.9 (65.9%)
Wages	9.6 (7.1%)	10.3 (7.3%)	11.6 (7.7%)
Insurant payments*	3.2 (2.3%)	3.4 (2.4%)	3.9 (2.6%)
Purchases of materials	5.2 (3.9%)	5.4 (3.8%)	5.8 (3.9%)
Purchases of goods and services	34.7 (25.8%)	37.1 (26.2%)	33.9 (22.6%)
Interests	2.7 (2.0%)	2.3 (1.6%)	2.3 (1.5%)
Grants to private firms	8.7 (6.5%)	8.9 (6.3%)	9.7 (6.5%)
Transfers to contributory and similar organisations**	12.0 (8.9%)	12.2 (8.6%)	12.9 (8.6%)
Transfers to inhabitants	4.4 (3.3%)	5.9 (4.2%)	8.3 (5.5%)
Others	5.9 (4.4%)	8.0 (5.6%)	10.5 (7.0%)
Total capital expenditures of which	48.0 (35.7%)	48.2 (34.0%)	51.1 (34.1%)
Transfers to budgetary organisations**	42.1 (31.3%)	41.3 (29.1%)	45.5 (30.3%)
Grants to private firms	3.2 (2.3%)	4.5 (3.2%)	3.2 (2.1%)
Transfers to contributory and similar organisations**	1.8 (1.3%)	1.3 (0.9%)	1.5 (1.0%)
Others	0.9 (0.7%)	1.1 (0.8%)	0.9 (0.6%)

* Insurance payments include the social and health insurance payments made by employers.
** Contributory and similar organisations are non-profit organisations. The expenditures of budgetary organisations are an integral part of the municipal budget, while for contributory organisations only the transfers to them appear in the municipal budget. The contributory organisations have also other income sources, while the finance of budgetary organisations is 100% made by the transfers from the municipal budget.
Source: The Czech Ministry of Finance database.

2.3.2. Revenue Assignment in the Czech Republic

The Czech Republic had a radical tax reform in 1993. One of the reform goals was to bring the Czech system close to those which exist in EU countries. Although the revenues from real estate taxes and local fees are exclusively for municipal use, all taxes can be characterised as 'state' taxes, for the central government or the national parliament define all relevant attributes of taxes, i.e.

tax base, tax rates, tax deductibles, tax allowances and so forth. Tax offices that are part of the central government collect all taxes. The non-existence of 'local' taxes is compensated by the tax sharing principle.

Income taxes are subject to tax sharing between the central and local governments. Real estate tax is assigned as the exclusive financial source for the local governments just as the case of local fees (see below). Social security contributions as well as indirect taxes (value added tax, excise taxes, etc.), road tax, inheritance and gift taxes and real estate transfer tax are assigned to the central government budget. Local government has, therefore, a minimum scope to decide the volume of its own tax revenues.

Personal income tax consists of three parts (wage tax, small business income tax and taxes on dividends, interests, etc.). The wage tax revenues collected within each district are allocated only among municipalities in this district. There are 77 districts, among which 4 represent the magistrate cities. Magistrate cities include Prague and have special status. Such large cities have both municipal as well as district offices. District offices are the territorial units controlled by the central government. 70% of the wage tax revenues are directly transmitted to the central budget, while 20% are distributed among municipalities within a given district according to the number of their citizens and 10% go back to the municipality where the wage accounting unit of a business is located. The wage accounting unit is a place where wages are paid out to employees. Magistrate cities receive 70% of the wage tax collected within their territory and 30% is passed to the central budget. The second part of the personal income tax is the small business income tax, of which the yield is, by and large, transferred to the municipality where the entrepreneur has his/her permanent address. Revenues from taxes on interest, dividend and similar income are allocated to the central budget.

As mentioned above, there are two exclusively local resources at present: real estate tax and local fees. The decision on the real estate tax base, tax rate and deductibles is, however, in the hands of the central government or the national parliament. Each municipality may choose a weight coefficient that increases the effective tax rate given for a municipality of a particular size. There are six coefficients which can be applied according to the size of municipalities. The real estate tax consists of two parts – tax on land and tax on structures. Its rate is based on physical parameters, i.e. square meters of a piece of land or of a building, the number of floors of a building and the use of land and structure, etc. There are also different tax rates for buildings used for housing, for recreation or for different types of business. The ad valorem type of real estate tax is under preparation. The central government and the national parliament also determine the range and the upper-limits of local fees. Local fees are the only tax resources. They generally consist of fees on dogs, resort and recreational units based on capacity, use of public space, entry tickets, motor vehicle entry into selected parts of cities, operating gambling machinery, etc.

Table 26 illustrates the distribution of income tax revenues between the central and local governments. The local government tax revenues grew rapidly between 1994 and 1995 and then remained quite stable thereafter. The decline in growth dynamic in 1996 is due to the change in the tax sharing system. In particular local governments were assigned to receive more than 20% of corporate tax revenues in exchange for passing the extra portion of the wage tax income to the central budget. The decrease in 1999 compared to 1998 is caused by the slow growth of the personal income tax revenues, especially wage tax revenues. Real estate tax and local fees play a minor role as the financial sources for municipal budgets.

Table 26 Tax sharing in the Czech Republic and its significance for the local budget (in billion CZK)

	1994	1995	1996	1997	1998	1999
Total tax revenues	291.7	326.7	356.4	363.5	389.0	416.3
of which						
Value added tax	85.9	94.8	109.3	117.6	119.4	138.3
Excise tax	46.4	56.7	61.2	64.2	67.8	73.1
Custom duties	17.4	17.4	19.7	14.9	13.6	12.1
Corporate income tax	64.6	67.3	62.7	55.0	67.3	70.1
Personal income tax	54.5	68.6	80.6	87.6	94.9	95.2
Real estate tax	3.8	3.8	4.0	3.9	4.1	4.3
Property transfer tax	2.1	3.2	3.9	5.0	6.3	6.8
Road tax	4.2	4.8	5.2	5.6	6.0	7.2
Other taxes and fees	12.7	10.0	9.9	9.8	9.7	9.3
Local tax revenues	46.3	59.0	62.0	65.5	72.1	75.8
of which revenues from						
Real estate tax	3.8	3.8	4.0	3.9	4.1	4.3
Corporate income tax	0.1	3.1	14.1	13.4	16.2	18.8
Personal income tax	37.6	47.9	39.5	43.8	47.4	48.8
Other taxes and fees	4.8	4.2	4.4	4.4	4.4	3.9
Revenues from tax sharing as the % share of total tax revenues	15.9%	18.1%	17.4%	18.0%	18.5%	18.2%

Source: Final account of the state budget for particular years, The Czech Ministry of Finance.

Details of the local government revenue structure are shown in Table 27. Apart from the revenues from shared taxes, the local government revenues also consist of real estate tax, local fees, yields from local property (use or sale), charges for local services and grants. The decline of shares of tax revenue as well as grants can be observed in the last three years. Tax revenues still make up almost half of local government revenue, followed by grants with almost one fifth of the total. The rise of property sale receipts share was quite obvious in the investigated period. In 1998 and 1999 the sudden growth of capital receipts was influenced first of all by the sales of municipal shares of distributing companies involved in electricity and gas supply. Therefore, it was a kind of 'once-only' revenue, which will no longer appear to this extent in the future.

Table 27 Local government revenues in the Czech Republic between 1994 and 1999 (in billion CZK)

	1994	1995	1996	1997	1998	1999
Local budgetary revenues total	93.8 (100.0%)	107.4 (100.0%)	113.8 (100.0%)	123.9 (100.0%)	137.9 (100.0%)	169.5 (100.0%)
of which						
Tax revenues (incl. local fees)	46.3 (49.4%)	59.0 (54.9%)	62.0 (54.5%)	65.5 (52.9%)	72.1 (52.3%)	75.8 (44.7%)
Non-tax revenues (excluding property sales)	16.6 (17.9%)	17.3 (16.1%)	20.1 (17.7%)	21.6 (17.4%)	23.1 (16.8%)	24.2 (14.3%)
Grants	25.7 (27.7%)	26.7 (24.9%)	24.5 (21.5%)	27.1 (21.9%)	29.5 (21.4%)	32.8 (19.4%)
Property sales	5.2 (5.5%)	4.4 (4.1%)	7.2 (6.3%)	9.7 (7.8%)	13.2 (9.6%)	36.7 (21.7%)

Source: State Final Accounts, The Czech Ministry of Finance.

2.3.3. Intergovernmental Transfers in the Czech Republic

Concerning the intergovernmental grant system in the Czech Republic, it should be mentioned, first of all, that transfers from the central government do not include general grants. At present, all transfers are of a specific nature, which means that the central government prescribes the purpose of grants and the ways to use them. They are allocated in accordance with the particular government programs. In other words, there is no single equalisation-oriented general transfer mechanism in the Czech Republic. There are several reasons for the lack of a fiscal equalisation mechanism. Firstly, local governments are responsible neither for social benefits (they are in the hands of the central government) nor most of health care (it is in the hands of the health insurance system). Also wages for teachers in pre-school facilities and primary schools are paid out from the central budget. Such sensitive expenditure types are not assigned to local governments at all. Moreover, the pressure for equalisation has not been so strong, although a significant difference in the per capita budgetary revenues has always existed among municipalities. These are also in part led by the fact that the allocation of the district wage tax revenues is done among municipalities within the individual district. The total amount of wage tax revenues is unevenly distributed among individual districts due to the different levels of wages, rates of unemployment, structure of business activities and some other factors in these geographic entities.

Table 28 Intergovernmental grants to Czech municipalities (in billion CZK)

	1997	1998	1999
Total grants	27.1 (100.0%)	29.5 (100.0%)	32.8 (100.0%)
of which			
Operating grants	15.4 (56.8%)	19.8 (67.1%)	21.6 (65.9%)
Capital grants	11.7 (43.2%)	9.7 (32.9%)	11.2 (34.1%)

Source: The Czech Ministry of Finance database.

The breakdown of total grants according to the operating and capital grants is shown in Table 28. The proportion of operating grants has been gradually growing at the expense of capital ones in the last three years. The majority of operating grants is provided on a formula-based system. The list of particular operative grants includes, for example,

- per pupil grants in the pre-school and primary school facilities to ensure better education programmes and to attract more pupils,
- per bed grants in the social care facilities (day stay and longer stay are distinguished)
- per bed grants in the elderly people homes,
- social benefits (the entitlements are defined in the law),
- grants for selected health care facilities (also homes for orphans up to three years),
- contributions for the state administration duties,

- for fire rescue bodies (professional as well as voluntary bodies).

Capital grants to local governments are provided according to the programmes of individual ministries. The granting methods and controls are worked out by the Ministry of Finance. The Ministry of Finance distributes resources from the central budget for the development of approved municipal investment projects. These grants include capital transfers for hospitals, primary schools and water supply and waste water management. The Ministry for Regional Development is responsible for housing grants, in particular those transfers for construction of houses for rental purposes and the construction of houses for elderly and homes for disabled people. The Ministry of Agriculture transfers include capital grants for water supply and waste water collection pipelines as well as sewage plant construction. Grants for reconstruction and maintenance of historical buildings, theatres and libraries are provided by the Ministry of Culture. Moreover, the State Environmental Fund provides capital grants to municipalities for projects contributing to environmental preservation and improvement.

2.3.4. Municipal Borrowings and Contingent Liabilities in the Czech Republic

Local debts are relatively new financial means for the Czech municipalities. Such a system did not exist prior to 1990. However, the growth of local debt was rapid at the beginning of the 1990s and then became rather slow at the end of the decade (Table 29). This trend can partly be explained by the slow-down of capital outlays and the increase of property sale receipts. There is no special long-term lending mechanism. Only a small fraction of projects financed by debt instruments has the nature of revenue generating projects. As mentioned before, local debts have usually been paid back in the short-term from operating revenues or from the yields from local property sales.

Excluding the Prague bond issue (approximately 7.4 billion CZK in 1994) the most meaningful proportion of local debts has the form of bank loans. Although the situation is gradually changing, there is still one dominant creditor for local government – the Czech Savings Bank which holds approximately 65% of total local credits at present. The share used to be as much as 90% at the beginning of the 1990s.

Table 29 Local debts in the Czech Republic (in billion CZK)

	1993	1994	1995	1996	1997	1998	1999
Total local debts	3.4 (100.0%)	14.3 (100.0%)	20.3 (100.0%)	28.3 (100.0%)	34.4 (100.0%)	39.0 (100.0%)	40.0 (100.0%)
Bank credits	2.5 (73.5%)	4.9 (34.3%)	8.7 (42.9%)	11.6 (41.0%)	13.5 (39.2%)	18.0 (46.2%)	17.6 (44.0%)
Municipal bonds	0.0 (0.0%)	7.6 (53.1%)	8.5 (41.9%)	11.9 (42.0%)	13.2 (38.4%)	11.9 (30.5%)	10.9 (27.3%)
Other debts	0.9 (26.5%)	1.8 (12.6%)	3.1 (15.3%)	4.8 (17.0%)	7.7 (22.4%)	9.1 (23.3%)	11.5 (28.8%)

Source: State Final Accounts, The Czech Ministry of Finance.

Over time municipalities have become reliable debtors for the banking sector. Virtually every bank in the Czech Republic has some business with local governments. Municipalities co-operate with banks when issuing local bonds. Municipalities are widely acknowledged as safe partners that have regular income from the tax-sharing and grants, which form the major part of the local budgets each year.

There were 18 issues of municipal bonds. The largest and also the first one denominated in foreign currency was the 1994 Prague floatation which was already repaid in 1999 and replaced by a new one of a similar type. This issue amounted to 250 million US dollar (i.e. 7.5 billion CZK). Ostrava also issued local bond denominated in foreign currency (1.3 billion CZK). All other municipal bond issues were made on a much smaller scale. In some cases they were even too small to be an effective debt instrument compared to bank credits. For this reason, there was no hedging instrument involved.

Around 44% of all Czech municipalities had debts at the end of 1998. The share of indebted municipalities increased with the size of the municipality. For example, all cities over 20000 citizens and almost all towns over 5000 inhabitants are indebted (Table 30). As a consequence, a significantly larger part of total debts were allocated to larger cities and towns.

No limitations are presently in force in the Czech Republic regarding where a municipality borrows, what it borrows for, under what terms, for how long and so on. The only exception is the requirement for the approval by the Central Security Commission which examines whether conditions related to issuing local bonds satisfy legal requirements.

Table 30 Local debts classified by the size of Czech municipalities in 1998

Size of municipalities	Total number of municipalities	Number of indebted municipalities	Amount of debts in million CZK
1-100	594	72 (12.1%)	20.4 (0.1%)
101-200	1154	229 (19.8%)	171.0 (0.4%)
201-500	1192	723 (36.3%)	987.8 (2.5%)
501-1000	1236	651 (52.7%)	1781.6 (4.6%)
1001-2000	645	481 (74.6%)	2355.8 (6.0%)
2001-5000	349	304 (87.1%)	3737.3 (9.6%)
5001-10000	135	130 (96.3%)	3332.9 (8.5%)
10001-20000	66	65 (98.5%)	3554.9 (9.1%)
20001-50000	44	44 (100.0%)	3026.7 (7.8%)
50001-100000	16	16 (100.0%)	3304.1 (8.5%)
Over 100000	6	6 (100.0%)	16720.1 (42.9%)
Total	6237	2721 (43.6%)	38992.6 (100.0%)

Source: The Czech Ministry of Finance database.

The rapid dynamics of local debt and the growing local budget deficit at the first half of 1990s called for political discussion to elaborate the introduction of a local debt regulation by the central government. Local representatives considered this attempt as an unacceptable interference in the municipal affairs. The need for a certain local debt regulation rose also from the relatively short history of local debt in the Czech Republic. When the borrowing situation improved these debates stopped, however.

Fortunately, the Czech national debt ratio has remained below the relevant Maastricht criterion. Therefore, the relatively low level of the overall public debt, of which the local debt represents roughly one-fifth, may be one of the reasons why there is no local debt regulation in place. A further reason may be that there has not been a case of a municipal default yet. All local borrowings have recently been repaid without substantial delays. As stated in the law, the central government is not responsible for local government loans. There has not been any central government bail-out.

As mentioned above, municipalities can get loans both from local and foreign banks, may issue municipal bonds and accept loans from non-financial entities. They may also freely provide loans to private entities for the purpose of supporting business development and other necessary activities in their territory. The provision of guarantees for bank credits taken by a private company also belongs to the municipal competence. On the other hand, the fact that municipalities or local governments in general were excluded from the provisions of the Bankruptcy Law, and have not been subject to any other such type of acts, has always been a potential factor reducing their creditworthiness. Furthermore, the Czech Commercial Code recognises as collateral only those local assets which were in existence at the time of signing the debt agreement. In other words, future revenues to be generated from the project cannot be used for collateral purposes.

2.3.5. Budgeting, Financial Reporting and Public Expenditure Management in the Czech Republic

Budgeting and financial reporting is clearly prescribed by law. Municipalities are obliged to follow budgetary composition, which was changed in 1996 to be close to the practice of EU countries. The budgetary composition provides a very detailed list of revenue and expenditure items in the division of operating and capital items. However, municipalities are not obliged to report the split of the total local budget into the operating and capital items.

Accounting practices of local governments do not indicate or record guarantees or other contingent liabilities of municipalities. This sort of information has not yet been legally required to be recorded. Only guarantees made by the central government are subject to reporting. In fact, nobody knows the extent of guarantees that individual local governments have provided.

Municipal budgets cover one fiscal year that is identical with the calendar year. According to the law, the draft of the budget and final financial statement must be available to the citizens 15 days before the discussion takes place in the municipal assembly. Citizens have a chance to make their recommendations either in a written form or personally during the assembly meeting. The final financial statement must be audited, also according to law. The budget auditing is performed either by an auditing firm or by the particular district office. The latter is the most frequent case, as it is free of charge. District offices provide the auditing service for more than 95% of all municipalities.

2.3.6. Future Changes in the Czech Republic

In the context of the public administration reform several changes of the local government system are under preparation. First of all, a self-governing intermediate tier of local government – regional government – was legally founded. The Czech Republic is now divided into 14 regions, with the first elections to the regional assembly in autumn 2000. This level of government will be responsible for secondary education, social care for the elderly and disabled people and children, road maintenance, theatres, galleries and so on. However, their responsibilities will be quite limited in the first two years because the district offices which are presently responsible for the similar fields of activities will be abandoned only in 2002. Transfer of responsibilities from municipalities is planed to be only on a voluntary base. The related financial issues have not yet been settled: major income of regional government will probably be from the shared-taxes and grants.

Parallel to this reform some changes of the tax sharing system are also scheduled. However, the final picture is not yet clear, as this proposal is now being discussed in the national parliament. One of the core changes may be the abolition of distributing wage tax revenues collected within a district among municipalities located in the same district. Instead, wage tax revenues are planned to be collected nation-wide and distributed among municipalities in the country, regardless to which district they belong. Such a change aims at reducing the existing great disparities of per capita tax revenue among municipalities. Also selected excises will be involved as an additional part of the tax sharing. All municipalities will be divided into 14 groups according to the number of inhabitants, and there will be a weighting coefficient for each group, favouring bigger municipalities. Shared taxes will be then distributed according to these coefficients. Therefore, the tax revenues of individual municipalities will depend on its population size more strongly than before.

Local fees will be changed into local taxes collected by municipalities. The ad valorem real estate tax is also under consideration, which will eventually increase tax revenues. The administration of this tax will remain unchanged and be carried out by the central government tax offices.

2.4. Municipal Finance and Governance in Hungary

After a series of legislative acts and reforms in 1990 and 1991, Hungary established the legal framework for a two-tier system of government, eliminating the middle tier in its previous form. The 19 counties, the former middle tier which used to be one of the strongest power centers, still exist but their responsibilities have been strongly scaled back. The counties are now parallel authorities and unrelated to the localities.[22]

[22] The goal of the Act on Regional Development and Regional Planning which passed in 1996 was to ensure that Hungarian regional policy is compatible with the EU system. The law itself is quite general, and the details are being ironed out in practice and through implementing regulations. The government is still discussing the future of the region. Today there are

The number of municipalities multiplied from 1523 (1990) to 3154 (1999), as many of the local councils broke themselves up into separate units. This was a political reaction to the forced amalgamation policy of the 1970s. Municipalities with an average of 3482 inhabitants are relatively small, but they have a wide range of responsibilities. The Local Government Act of 1990 defined the economic bases of municipalities, their expenditures and revenues. The ministries have no direct control over the local governments, and the enforcement of the laws and guidelines given to local governments is critical. Centralist tendencies are based on the view that 'local governments have more freedom than is necessary'. Furthermore, the lack of co-ordination among the individual ministries has led to situations where the so-called sectoral (i.e. public activity-oriented) laws transfer tasks and responsibilities to local governments without guaranteeing sufficient financial supports. It is not rare that local governments are not able to provide services described by the law.

2.4.1. Expenditure Assignment in Hungary

Compared to other European countries the size of the overall public sector is large in Hungary. General government expenditures (including social security) were about 48% of GDP in 1999, which was, however, 15 percentage points lower than in the early 1990s. The government's plan is to reduce the share to 40% by the year of 2003.

The Local Government Act of 1990 transferred a number of important public functions to lower tiers of government. Mandatory tasks include the provision of safe drinking water, kindergarten and primary school education, provision of basic health and social welfare services, public lighting, maintenance of local public roads and public cemeteries, enforcement of the rights of national and ethnic minorities. Though mandatory and optional tasks[23] of local governments were defined in the Local Governments Act, they have been continuously modified by the latest (sectoral) laws and regulations, such as the Act on the Budget, Bankruptcy Act, Social Act, Housing Act, Act on Public Education etc. Hence, a 'quiet' reform is taking place.

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seven statistical regions and seven Regional Development Councils with limited authority. There is a six-year programme for a regional reform, which would lead to the creation of seven regions within a regional structure with a locally elected level of government, able to channel EU structural funds.

[23] For example, the provision of technical and vocational schools usually belong to the so-called optional tasks of local governments.

Table 31 Structure of local government expenditures in Hungary (in billion Hungarian forints (HUF) and at current prices)

	1993	1994	1995	1996	1997
Current expenditures	479.4	597.8	639.7	744.2	889.0
	(78.5%)	(78.7%)	(82.7%)	(83.8%)	(80.1%)
Capital expenditures	131.4	161.4	133.5	143.4	220.1
	(21.5%)	(21.3%)	(17.3%)	(16.2%)	(19.9%)
Total expenditures	610.8	759.2	773.1	887.6	1109.2
	(100.0%)	(100.0%)	(100.0%)	(100.0%)	(100.0%)
of which					
Education	33%				36%
Health	20%				22%
Social security	6%				7%
Housing & water supply	5%				6%
Transport & communication	6%				2%

Sources: The Hungarian Ministry of Finance; Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo); estimations of the Ifo Institute for Economic Research

Table 31 shows that the sectoral shares of the local government expenditures have not changed very much over the period 1993-97. The largest expenditure category has been education. Secondary, technical, and vocational schools, while not mandatory, are typically financed by county governments or larger towns. The second biggest item was the health sector but local governments generally act as agents of the National Health Insurance Fund in providing health services including hospitalisation: Services are determined by the central government, and local governments are reimbursed for the cost of providing services and medicine. With the transfer of communal housing and other assets to municipalities, their maintenance has become a local responsibility since the mid-1990s. Considerable responsibility for administrating social welfare and several forms of social assistance has also been delegated to municipalities through the Law on Local Self-Government and the Law on Social Assistance (1993). These Responsibilities also include the management of long-term social care facilities such as homes for the elderly and for the handicapped.

Current expenditures have recently comprised around 80% of total expenditures of Hungarian municipalities. In 1990, local governments have also become responsible for investment activities in those assigned public activities. Such investments have remained quite stable in the last years at 16% to 22% of total local expenditures. While local governments have spent ca. 2.2% to 2.5% of GDP annually on infrastructure investments, off-budget service enterprises have carried out investments of an additional 1.5% of GDP, accounting for up to 30% of total sectoral investments.[24] Important non-budgetary institutions (service providers) are public companies, NGOs (non-governmental organisations) founded by local governments and private companies owned partly or regulated by local governments. According to Hegedus (1999) municipal enterprises with off-budget expenditure and revenues have a net turnover of 40% of the local governments' total expenditures.

The definition of tasks made in the Law on Local Self-Government gives wide room for local governments to set the quantity, the quality of public goods and service and the ways that their provisions are organised (contracting out, privatisation, public-private partnership).[25] This feature also makes flexible adjustments possible. However, the freedom of expenditure decisions is controlled by the grants system (see below). Sector laws have also re-defined the local tasks. For instance, the proposal for the Law on Waste Management (to be discussed in 2000 by the national parliament) intends to take the waste management for business units out of the hand of local governments, which could eventually cause financial problems for them because of losing the advantages of economies of scale and the possibility of cross subsidies.

The Local Government Act does not encourage inter-municipal cooperation or association, and the transfer system does not address the problem of inter-juridical spill-overs but gives space for non-cooperative behaviour. Hence, there is little willingness among local authorities to cooperate on the provision of efficient local services. Reformers believed that the free association and cooperation of local governments would gradually solve the problem of the fragmented system, but the process is taking place very slowly.

Despite the fiscal shortage, local governments have been able to maintain acceptable local service delivery. The wide scope of expenditure decisions transferred to local governments certainly led to the mismanagement of public resources in several cases, but such a devolution has significantly enhanced assignment management as a whole. The local governments appeared to be quite innovative in adjusting the expenditure side, but were not able to improve their capacity on the local revenues side. Their revenue mobilisation efforts

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24 Of these investments 31% were undertaken by gas and electricity companies. Basic and supplementary public service companies invested nearly HUF 130 billion in 1997 (1.5% of GDP). Within supplementary services, telecommunication accounts for more than half of the investments. District heating, sewage and waste treatment take up to 13% each, water management and local transport account for 25% to 29% of the total basic service investment.

25 Basically Hungarian law defines neither the minimum delivery requirement of local services nor the ways that local services are provided.

have recently been judged to be less successful and moderate, partly due to political reasons.

2.4.2. Revenue Assignment in Hungary

The share of local government revenues has decreased from 16% to 12% of GDP in the period of 1993-98. According to the Local Self-Government Act own local revenues which comprise 26% to 35% of total revenues (without non-tax revenues) in the same period, include five local taxes (see below), local user charges, and revenues from entrepreneurial activities, sales and rents of commercial properties and assets. Central government transfers (63% to 71% of the corresponding total revenues) consist of those equalisation-oriented normative grants, targeted matching grants and non-matching grants for investments, etc. (Table 32). Local governments can borrow, however, when these financial instruments are not sufficient to cover expenditure needs. The structure of revenues has proved to be quite stable over the last 5 years.

Table 32 Local government revenues in Hungary 1995-2000 (in million HUF)

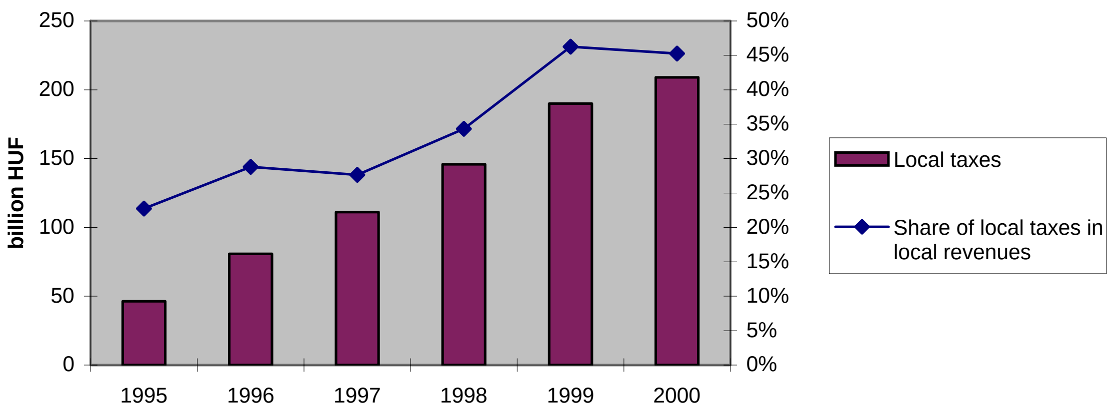
	1995	1996	1997	1998	1999	2000
Total revenues	791810	935982	1154394	1353353	1379752	1513861
of which						
Own revenues	203946	280706	402218	424718	410693	461850
	(25.8%)	(30.0%)	(34.8%)	(31.4%)	(29.8%)	(30.5%)
Intergovernmental	564646	632498	726192	867623	943058	1015711
transfers	(71.3%)	(67.6%)	(52.9%)	(64.1%)	(68.3%)	(67.1%)
Loans	23218	22778	25984	61012	26000	36300
	(2.9%)	(2.4%)	(2.3%)	(4.5%)	(1.9%)	(2.4%)

Source: The Hungarian Ministry of Finance; for 1999 preliminary data, for 2000 estimates.

The 1990 Act on Local Taxes established five local taxes: business tax, communal tax, urban land tax, property tax on buildings and the tourism tax. Ranges of tax bases, rates and types of exemptions are, however, set by the central government. The business tax is a gross turnover tax on manufacturers and retail sales are not relevant for this tax. It may be levied on all public and private enterprises on gross sales net of VAT and other consumption taxes. Communal Tax can be levied on household dwellings (owned or rented) and on businesses. The land tax applies only to urban land and is levied on the property owners of idle lots.[26] Property tax is imposed on privately-owned buildings,[27] commercial and industrial property.[28] The current tax on tourism relates to rents, guest nights, and summer cottages.[29]

The number of municipalities that levy at least one of the different types of local taxes has increased: 84% in 1999 compared to 73% in 1996. The two taxes which are most commonly levied are the business tax and the communal tax on private persons (Table 33).

Figure 1 Local taxes and own revenues in Hungary



Source: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

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[26] Its maximum rate is HUF 200 per m^2, or 3% on the 'corrected value' of the plot. The corrected value is given by 50% of the 'assessed value' determined by the local government and is supposed to reflect the actual market value.

[27] Privately-owned buildings include flats, single family houses, summer cottages, garages, storehouses, workshops, and other residential housing facilities.

[28] The tax may be levied on area size (m^2), or on the assessed value of the property. The maximum tax rates as established by the CG are HUF 900 per m^2, or 3% of the 'corrected value'.

[29] The maximum rates as established by the CG are HUF 300 per night for guests, 4% on the rental fee, and HUF 900 per m^2 for cottages.

Table 33 Number of Hungarian municipalities collecting local taxes 1998

		Number of local governments
Total		2672
of which collecting		
Business tax		2527
Communal tax	private	1525
Communal tax	business	825
Property tax	(non-housing)	633
Tourism tax		482
Urban land tax		388
Property tax	(housing)	215

Source: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

Table 34 Local taxes in Hungary 1991-1999 (in million HUF)

	1991	1993	1995	1997	1999
Total local taxes	9478	27089	46383	111162	198360
Business tax	2300	21632	38452	93133	171470
Property tax, buildings	200	2294	4145	10752	16620
Tourism tax – bed tax	270	510	768	1878	2390
Urban Land tax	15	474	813	1717	2260
Communal tax – business	646	1222	1075	1178	1350
Tourism tax – building	92	407	363	524	824
Others	5451	-	-	-	-

Source: Hugedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

In 1999 the total local tax revenues reached ca 7.5% of the central government tax revenues which are from value added tax, personal income tax and corporate tax, excises, etc. Local taxes also increased substantially over the years, and are more and more concentrated on the item business tax. In 1999 86% of local tax revenues were derived from the business tax (Table 34). The taxation of households, on the other hand, has always been less significant. Since taxing business income too heavily on the local level may discourage investors, there is high pressure to increase exemptions and incentives, which, in turn, leads to inequity across the tax base. The central government is presently trying to centralise the local business tax revenues. If the central government is successful, the business tax would be collected by the central tax administration and redistributed then to local governments on the origin bases. Most business tax revenues are currently collected in large municipalities including Budapest.

Concerning local user charges and fees, the main revenues come from public housing and building rents, garbage collection, gas and water supply. Local governments have the autonomy to set their own charges and fees for public services like water supply, sewage treatment, housing, district heating and lighting, and garbage collection, but not for education, social and health services. For local services conceded to the private partner, adjustments in charges are agreed on with the local government. The collection of user fees is generally in the hand of the institution providing the services. Charges and fees collected outside the mayor’s office or other public institutions are called off-budget revenues. Overall, the size of off-budget revenues is estimated to be 10% to 30% of the total local government budget (Hegedus, 2000).

On the basis of the 1991 Property Transfer Law, considerable assets were transferred from the central to local governments in the period of 1990–95 which include primarily housing and non-residential properties, basic assets necessary for the functioning of local administration, education, health and social services, as well as assets related to the provision of other types of infrastructure, etc. The effects of such transfers cannot be easily measured or evaluated, since such assets can also be managed by those off-budget institutions and the real value of the local assets has hardly been properly computable: The official estimate amounted to 1800 billion HUF in 1998, but other estimates stated a figure of 6000 billion HUF. Moreover, their market and book values are quite different. After the redefiniton of suitable prices and their structure in the mid-1990s, local assets turned out to be a new source for local revenues. Yet, one should bear in mind that these assets have been very unevenly distributed among municipalities. Revenues from the sales of local government property shown in terms of the share of total own revenues were substantial in 1995-97. However, the decrease in 1998 reveals the one-time-revenue character of this item.[30] Generally, asset management on the local level has attracted public attention. For example, the Budapest Municipal Government was criticised for selling shares of the biggest Hungarian company (Matáv) when the market situation was unfavourable.

[30] The windfall gains through asset revenues are significant. One example is Györ, the fourth largest city in Hungary, realised a 3.5 HUF billion revenue from selling its cable television company, which is 20% of its budget in year 2000.

Table 35 Local government revenue from selling assets in Hungary 1995– 2000 (in million HUF)

	1995	1996	1997	1998	1999	2000
Total revenue from assets	**69394**	**90364**	**141751**	**71038**	**70000**	**55100**
Physical assets	4699	42968	51242	51404	53000	47,100
	(63.0%)	(47.5%)	(36.1%)	(72.4%)	(75.7%)	(85.5%)
Shares	19757	27332	81251	15665	12000	7000
	(28.5%)	(30.2%)	(57.3%)	(22.1%)	(17.1%)	(12.7%)
Privatisation	5938	20064	9258	3969	5000	1000
	(8.6%)	(22.2%)	(6.5%)	(5.6%)	(7.1%)	(1.8%)
% of total own revenue	34.0%	32.2%	35.2%	16.7%	17.0%	11.9%
Total own revenue	203946	280706	402218	424718	410693	461850

Source: Central Government Budget, the Hungarian Ministry of Finance.

2.4.3. Intergovernmental Transfers in Hungary

Intergovernmental transfers (shared-tax revenues, normative grants, earmarked grants and deficit grants) provide about two thirds of the total local government revenues. Three national taxes are designated for tax-sharing: personal income tax, motor vehicle tax, and tax on land rents.[31] The share and the distribution rules of personal income tax revenues are modified annually in the State Budget Law. In 1990, 100% of personal income tax revenues were allocated to municipalities and then this share was reduced to 40% at the end of 1990s. As a consequence, its share of total local government revenues decreased substantially from 24% to 2% in the same period of time, which reflects the fact that this type of transfer has been basically eliminated. In 2000 only 30 billion HUF are budgeted for shared personal income tax. Up to 1994, the personal income tax revenues were allocated solely on the basis of the residential principle (normally with a delay of two years), but since 1995, the distribution, gradually been endowed with complicated rules and an additional share, was allocated even to counties. According to the Hugarian Budget law, local governments with per capita personal income tax revenues less than 90% of the national average are entitled to a supplement, of which the total sum has generally reached 9%

[31] From the analytic point of view, the import duty can also be classified as a shared tax. Duty fees were approximately 40 billion HUF in 1998. The revenues have mainly been allocated to the county local government and the municipal government of Budapest.

to 12% of total personal income revenues. (The size of the supplement is equal to the difference between the local governments with per capita shared personal income tax revenues and 90% of the average.) Local governments above this standard are not equalised down. Most of the small local governments (95% in 1997) were eligible for such a grant.

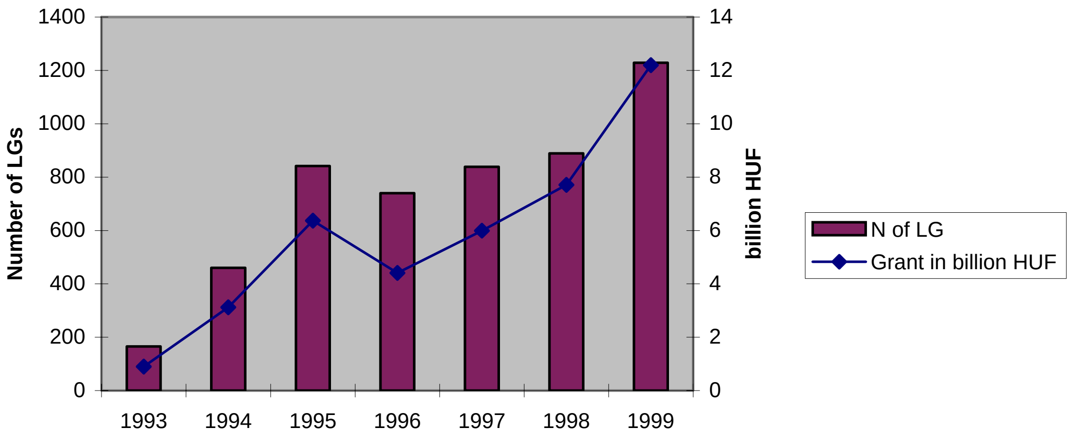
Unfortunately, different types of grants are subsumed in the general budget under one heading. The largest transfers are normative subsidies, but their share decreased from 40% to 25% of the total local budgetary revenues between 1993 and 1998 (Hegedus, 2000). At present, there are four types of normatives: per capita grants based on population, grants for core public services based on the number of beneficiaries, capacity grants made on the basis number of beds in shelters for homeless people, and matching grants for the tourist tax. Types of grant normatives and criteria for allocation are subject to annual adjustments. There was an attempt to simplify and reduce the number of normatives in 1995/96. However, subsequent modifications have further complicated the grant system and the calculation has become less transparent. Generally, normative grants are not earmarked, but for those beneficiary grants, e.g. for education, they can be. The largest amount (about 70% in 1998) of normatives is distributed for education and the second largest for social welfare tasks. Normative grants calculated on the basis of relevant indicators of local needs do not adequately cover the costs.

Other types of transfers (i.e. matching grants) have increased considerably in the same period of time, with shares in total local revenues within a range of 18% to 22%. The largest of these transfers is the social security transfer for health care which is directly addressed to health care institutions. The financial means of 30 to 50 billion HUF distributed to municipalities in this context are quite significant.

Deficit grants are designed to support municipalities incurring deficits through no fault of their own. While the rate for acceptance is changing (both in terms of applicants and claimed amounts), the number of beneficiaries has increased rapidly: in 1997 approximately 840 local governments (including counties) received ca. 6 billion HUF, in 1999 around 1230 local governments received 12 billion HUF. In 1998 50% of sums applied for were paid out. This type of grant discourages efforts to raise own local revenues and rewards inefficient expenditures at the same time. Therefore, many local governments seek the solution of their fiscal problems by claiming deficit grants rather than through internal reforms. However, the amount of deficit grants has remained relatively small (e.g. around 0.1% of GDP in 1999).

The most important sector of ‘addressed’ and ‘targeted’ subsidies for municipal investments over the last years was the water supply sector with 47% of the grants, health and social sector with 35% and education with 14%. The total volume of such subsidies is defined by the annual budget law, which amounted to 52 billion HUF in 2000. In the case of targeted subsidies the share of the subsidy as a percent of total investment costs is set for each specific project. In 1999/2000 the priorities are given to waste treatment and sewage networks (with 50% of matching rate), solid waste landfill (40%), special medical equipments (40%), and educational buildings (50%). Addressed subsidies often cover the investment costs up to 100%. They were originally introduced to support the completion of huge regional development projects (hospitals, waste water plants) that had begun before the reform. However, they have been granted for new investments, too.

Figure 2 Number of local governments and cost of ‘deficit grant’ programme in Hungary



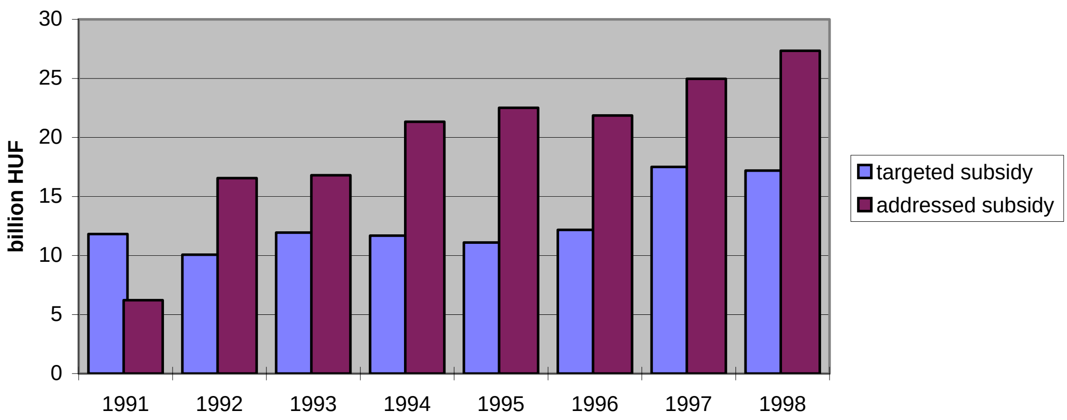
Source: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

Horizontal equalisation is also an important issue in the Hungarian intergovernmental finance system. However, there is no standardised budgetary scheme to equalise the fiscal capacity and the expenditure needs of local governments. There are several intergovernmental grants which have equalisation effects on an ad hoc basis. Normative grants based on general need criteria or formula using fiscal capacity variables are also aimed at meeting local expenditure needs. Between 1991 and 1996 specific equalisation grants were applied by the Ministry of Regional Development, but in 1996 they were gradually decentralised to County Development Agencies. In 1999 a new ‘grant to equalise fiscal capacity’ was introduced (38 billion HUF in 1999 and 44 billion HUF in 2000).

Such a type of grant is calculated on the basis of municipal business tax capacities and supplements are paid up to a certain per capita normative level, varying according to the type of municipalities.[32]

From 1993 to 1998, there was a significant shift from a general purpose grant system toward a more specific project-oriented transfer system, as indicated in Table 36. As mentioned before, the size of transfers and grant allocation rules are subject to annual budget negotiations, making any long-term financial planning impossible for municipalities. The fiscal autonomy of local governments is furthermore disturbed by sectoral grant allocation policies of individual ministries and sometimes by direct political intervention of the central government through discretionary grants.

Figure 3 Targeted and addressed subsidies in Hungary 1991-1998



Source: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

Table 36 Typical intergovernmental grants in Hungary classified into major categories (% of total transfers).

	1993		1998	
	General purpose	Earmarked	General purpose	Earmarked
Formula-driven grants	37.3%	56.0%	23.0%	70.0%
Beneficiary and discretionary grants	-	6.8%	-	7.1%

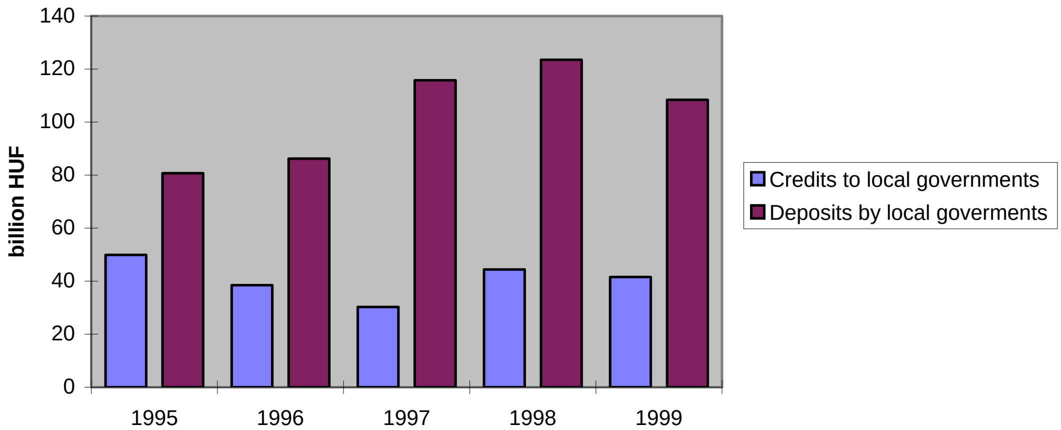
Source: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

[32] The per capita normative supplement level reaches for villages 12500 HUF, for cities 16500 HUF, for county seats 17700 HUF and for Budapest 20000 HUF.

2.4.4. Municipal Borrowings and Contingent Liabilities in Hungary

According to the 1990 Local Government Act, municipalities are, in principle, free to finance their budget deficit through borrowings from capital markets. Between 1990 and 1995, there were practically no formal rules constraining local governments' borrowing.[33] In other words, the control of sub-national borrowing was essentially based on market discipline. However, capital markets and private banks did not play an important role. On the other hand, the availability of large amounts of central government grants encouraged strategic 'grant-maximisation' behaviour of many municipalities. A second factor for low borrowings was the large share of revenues from the sales of assets that were also used for repaying outstanding loans. Due to these reasons, deposits of municipalities in private banks have gradually decreased but they have remained as net depositors (see Figure 4). Debt service that reached ca. 5% of total expenditures in 1995 decreased to 2% in 1999 (Figure 5).

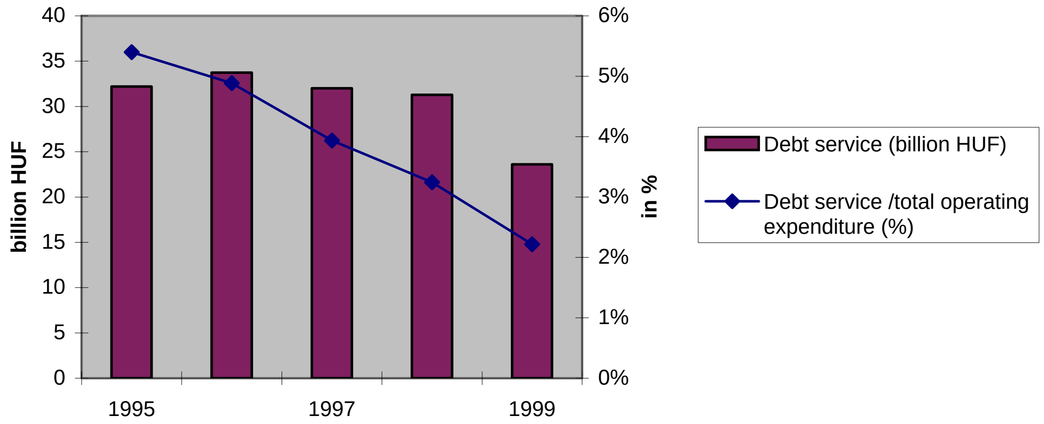
Figure 4 Loans and deposits of Hungarian municipalities 1995-1999



Source: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

[33] This means that there were no debt service limits, no reporting requirements and no separate specifications for the issuance of municipal bonds

Figure 5 Local government debt service in Hungary 1995-1999



Sources: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

In the second half of 1990s regulations for local borrowings were implemented. For example, a debt service limit for local governments was introduced in 1996. Now, annual debt service is limited to 70% of corrected own current revenues.[34] In 1997 local governments realised around 20% of their available debt service limit and close to 30% in 1998. For the protection of creditors, the Municipal Debt Adjustment Act (1997) imposes definite financial and moral costs on local governments who default on debt or other payments. Both the Municipal Debt Adjustment Act and the Securities Act (1997) include rules on issuing and trading municipal bonds. Public offerings require the publication of a catalogue and a bond offer announcement, both are subject to approval of the national Supervisory Commission. These 1997 Acts do not regulate private placement of municipal bonds, which is currently becoming popular. The Supervisory Commission has set the minimum amount of a private issue at 5 million HUF, investors must be specified in advance and a brokerage firm must be employed in the transaction. The issuance of bonds by local governments is presently undeveloped. Since 1992, there has been a total of 24 municipal bond issues. Limiting factors were the lack of relevant regulations, the weak capital secondary market, and finally high costs for issuing bonds.

[34] This sum includes local taxes, duties, interest revenues, environmental fines and other own revenues. Revenues such as rents and user fees are excluded although these are 'own local revenues' in local government budgets. Own local revenues are 'corrected' by subtracting the amount of short-term liabilities (not including cash flow credits which are used to ensure funding of local government operations).

2.4.5. Meeting the Demand for Sub-national Investment Finance

The revenues from asset sales were the main source for financing municipal investments in the years between 1995 and 1997 and this type of financial means accounted for 60% to 80% of total investments. From 1997 its share has decreased. Capital grants from the central government accounted for around 20 % in the period 1995-2000, while loans played a rather limited role in this context (Table 37).

A recent World Bank study made clear forecasts for the future financial structure of municipal investments in Hungary. Enterprises owned by municipalities will play an important role, as their investments will double as a share of GDP. While the revenues from asset sales are expected to decrease significantly, borrowings and EU grants are meant to increase considerably.

Table 37 Financial sources of municipal Investments 1995-2000 (in billion HUF)

	1995	1997	1999	2000
Capital investment financed by	136.1	216.9	237.0	314.4
Revenue from property sales	80.3 (59.0%)	175.2 (80.7%)	50.7 (21.4%)	94.9 (30.2%)
Loan	19.7 (14.5%)	17.6 (8.1%)	12.0 (5.1%)	21.3 (6.8%)
Capital grant	24.2 (17.8%)	38.1 (17.6%)	55.6 (23.4%)	70.1 (22.3%)
Operating surplus	11.9 (8.8%)	-13.9 (17.6%)	118.7 (50.1%)	128.2 (40.8%)

Source: Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo).

Table 38 Local investment finance in Hungary (as a percentage of GDP)

	Local governments		Municipal enterprises	
	1997	2003	1997	2003
Total investments financed by	**2.2**	**3.0**	**1.6**	**3.2**
Savings (current revenue – current expenditure)	0.8	0.8	-0.3	0.2
External resources of which	1.4	2.2	1.9	3.0
EU grants	0	0.8	0	0.7
Central grants	0.5	0,7	0,6	0
Asset sales	1,6	0,2	0	0
Borrowings	-0,7	0,5	1,3	2,0

Source: World Bank (2000), SNDP Report 2000, Washington DC.

2.4.6. Budgeting and Financial Reporting in Hungary

Local budgets and financial reporting are subject to strict national regulations, and, at the same time, determined by the information needs of the national budget preparation process. The form of budget classification is standardised: budgets should be structured by organisational units and within each unit by special groups of expenditures (salaries, operating expenses, welfare payments, capital expenditures, etc.). Current and capital expenditures as well as revenues should be presented in two separate statements. This separation serves solely presentation purposes, since cross financing between current and capital budgets is allowed. In Hungary a 'rolling' plan is required along with the annual budget for an additional two-year period. Information on local municipal budgets and those of service providers, including balance sheets and property registration data, is collected by the local offices of County Government Finance, and Public Administration Information Service (TAKISZ).

Basically, there are three problems with the present local government budgeting and reporting systems: the lack of strategic vision in the budget preparation process, shortage of trained staff equipped with modern budgeting techniques, and limited access to comparative information on municipal finances and service delivery. Most importantly, budgets do not give proper information on the local governments off-budget activities. Only estimates about the size of off-budget revenues such as user charges, profits, expenditures and cross-subsidies outside the budgetary institutions are available. The net turnover of the municipal enterprises is estimated to be about 500 billion HUF, or 60% of total operating expenditures of local governments. The focus of local governments reports to the national government is mainly a line-item accounting, rather than a programme with the output or performance view of municipal activities. Such reports neither deliver clear overviews on municipal activities nor indicate the manner in which the tasks are accomplished.

However, some improvements in financial management were achieved at the local level through the rationalisation of the budget execution process. The improvement of local ability to organise efficient cash management, to introduce cost controls, to monitor expenditures, and to create an effective financial reporting system have been the key issues. To perform these functions, many municipal governments also created local treasuries.

In 1989, the State Audit Office (SAO) was established, which is responsible for reporting to the national parliament. Its major function is to audit the use of national budget grants, to verify municipal financial statements, and to conduct general audits for public authorities. From 1992 to 1996, due to the lack of capacity the SAO was able to conduct only 30 to 50 general and approximately 1000 thematic audits. Since 1994 larger local governments themselves have to conduct independent auditing of their books. Moreover, local governments are required by law to conduct internal auditing, although most of them do not comply.

3. International Comparison of Similarities and Differences in Municipal Finance and Governance

3.1. Fiscal Decentralisation in Selected Eastern European Countries

The recent process of political and economic transformation in eastern European countries has not only contributed to the decentralisation of political structure but also significantly enhanced the fiscal autonomy of municipalities belonging to these countries. For example, the number of Czech and Hungarian municipalities rapidly grew at the beginning of the 1990s, whose development had been significantly hindered by the politically forced amalgamation policy under the former communist regimes. As a consequence, the size of municipalities measured in terms of the number of inhabitants is rather small in these European transition countries. Although the degree of self-governing ability of municipalities seems to vary from one country to another, many similar types of public activities have recently been assigned to local governments, and some taxes were also declared to be so-called local taxes. To be sure, this type of fiscal decentralisation has caused some additional problems, particularly for safeguarding the quality of publicly provided goods and services and for co-ordinating intergovernmental fiscal affairs between the central and local governments in an efficient way. For instance, some criticise that a large number of small-sized municipalities in the Czech Republic, the Slovak Republic, Hungary and Poland have suffered from financial bottleneck and have not been able to receive financial support from the central government that was necessary for their economic development. However, such a fiscal devolution trend appears to continue, in parallel to the ongoing democratisation and decentralisation.

In these investigated countries, the process of ‘real’ political and fiscal decentralisation took place at the beginning of the 1990s. In 1990, Hungary and Slovakia introduced similar types of laws to guarantee the municipal finance and governance, while a large number of traditional Polish gminas acquired true self-governing autonomy after the long socialist-era. However, the implementation of fiscal decentralisation has been a ‘trial and error’ process. These transformation countries have had a series of legislative acts and several relevant reforms (including tax reforms) in the past 10 years which dealt with the mutual fiscal relations between different tiers of jurisdictions, the tasks and authorities of local governments, the local budgetary systems, financial management and expenditure control mechanisms, etc. The Hungarian Law of Local Self-Government gives, for example, a wide scope for local governments to set the quantity and quality of public goods and services and the ways that their provisions are to be organised and administered. On the other hand, this law has been criticised because it does not emphasise the so-called inter-juridical spill-overs of public goods and services and, as a consequence, this law encourages non-cooperative behaviour of local governments when providing such goods and services. As the 1999 self-government reform in Poland shows, municipalities are expected to gain additional responsibilities, and their tax autonomy appears to be expanding in the future. The establishment of regional governments (a self-governing intermediate tier of local governments) in the Czech Republic and Poland at the end of 1999 was not aimed at reducing the autonomy of municipalities at all.

3.2. Expenditure Assignments

Typical public activities assigned to local governments in the investigated Eastern European countries include:

- land management and planning, zoning and local environmental protection,
- municipal budget and property management,
- provision of local roads, bridges, streets and public transport system,
- water supply as well as municipal waste treatment,
- primary health care and social welfare services,
- municipal housing,
- elementary education including kindergarten,
- promotion of culture and sport,
- public order and fire protection, etc.

In the Czech Republic the provision of such local public goods and services is somewhat differently organised. For education (the most important ‘own’ local activities), municipalities are responsible for the provision of pre-school facilities and primary schools (up to 15 years of age), as far as the maintenance of buildings and operating costs are concerned. On the other hand, teachers’ wages are paid out of the central budget. In general, private companies carry out the task of solid waste collection. Water supply and waste disposal systems were also largely privatised, although municipalities have substantial equity shares in these companies. Local governments have also 34% of stock shares of companies distributing gas and electricity. The health care system is organised by health insurance companies in the Czech Republic. The so-called ‘delegated’ responsibilities of municipalities include, e.g. keeping the birth, marriage and death registers, the implementation of construction and physical planning law.

Environmental protection, the provision of local transportation, ensuring water standards, sanitation etc. also belong to this responsibility group. Only 6% of municipalities provide currently all these delegated functions, from which the surrounding smaller municipalities can also benefit in the context of inter-municipal agreements or by the district office decrees. The municipal expenditures related to the provision of delegated local activities are partly covered by grants from the central government.

In all the investigated countries, there are no regulations and norms set by the central government concerning the minimum level of services expected from local service providers. For the above-mentioned delegated responsibilities in the Czech Republic special laws clearly prescribe the ways a municipality should carry out these activities. In case a municipality does not provide local services by itself but the provision is made by a private body or non-profit organisation, municipalities usually define the level and quality of the provided goods and services.

The analyses on the mid-term development of municipal expenditures are generally concentrated on the years between 1993 and 1999. The recent changes in local expenditures of a country well correspond to the development of the macro-economic business cycle in the same country. For example, a continuous growth of total local expenditures was observed in Poland from ca. 28 to 48 billion zlotys (expressed at 1998 price) between 1994 and 1998. In Slovakia, the amount expressed at current prices reached a peak at 27 billion SKK and declined gradually thereafter, while the Czech annual values between 1997-99 showed a continuous upward trend. Hungary's municipal expenditures also grew from ca. 611 to 1110 billion HUF over the years 1993-97.

Municipal expenditures generally consist of (a) operating expenditures for ensuring the properfunctioning of existing local goods as well as public services and the follow-up expenses caused by the realisation of local infrastructure projects, and (b) investment expenditures for the provision of new infrastructure. Over all the investigated years the operating expenditures dominated: In Hungary and Poland, the operating (i.e. current) expenditures comprised around 80% of the total sum of municipal expenditures, while the share reached over 60% in the Czech Republic and Slovakia. Among major local activities, the largest expenditure category was education in Hungary and Poland: both countries spent more than 30% of total (operating and investment) annual expenditures for this activity. The Polish gminas were very eager to improve the endowment of water supply and waste disposal networks and facilities: consequently, gminas spent approximately 50% of total investment expenditures (i.e. half of 6 billion zlotys in 1998) for such infrastructure projects every year. While Hungarian local governments have allocated ca. 2.5% of GDP for financing municipal investments each year, those off-budget service enterprises like public companies, NGOs and private firms owned partly by local governments have also carried out investment activities of which the annual sum corresponds to 1.5% of GDP. In addition, it is to be noted that Polish municipalities' investments have been financially covered mostly by the gminas' exclusive tax revenues which have also been supplemented by borrowings from private banks and various public funds for environmental protection and water management. In comparison, the same activity has been substantially financed by the sales of local properties and the grants from the central government in Hungary.

In Poland, local expenditures of urban gminas with strong economic bases comprised by far the highest share (on average over 55%) of the total amount of municipal expenditures, followed by rural municipalities (over 20%) and cities with rural districts (under 20%). However, the share of urban gminas declined in the years between 1994 and 1998, in contrast to the rural types where the share was evidently growing. Such a positive trend for rural areas was caused by the implementation of investment projects which were initiated and supported by the central government and the different levels of Funds for Environmental Protection and Water Management. The average amount of gminas' total expenditure per inhabitant rose rapidly from ca. 730 zlotys in 1994 to 1230 zloyts in 1998, but its disparity has remained quite high between urban and rural gminas (compare, for example, ca. 2100 zlotys for Warsaw and 880 zlotys for the rural Zamosc Province). The level of per capita investment expenditures for urban gminas was also far above the average for total municipalities (e.g. 560 zlotys for Warsaw compared to the average of 276 zlotys in 1998). This fact again indicates that there has been a strong link between the level of investment expenditures and the gminas' fiscal income.

3.3. Revenue Assignments

In recent years, the development of local budgetary revenues was quite expansive in the investigated Eastern European countries. For instance, Polish, Hungarian and Czech municipalities experienced continuously increasing total fiscal revenues, although relevant statistics are available in the latter two countries only in nominal terms. Municipal revenues increased in Poland from approximately 28 to 49 billion zlotys in the period 1994-98 in real terms, in the Czech Republic 108 to 210 billion CZK between 1994 and 1999 and in Hungary from 861 to 1568 billion HUF over the years from 1995 to 2000. In addition, the size of so-called 'off-budget' revenues is estimated to be ca. 10% to 30% of the total local government budget in Hungary. The Slovak case is rather different: municipalities in this country experienced the peak of the total revenue level (also including bank credits and municipal bonds) in 1998 (at ca. 29 billion SKK). Furthermore, the per capita fiscal income level was always the highest for urban municipalities in Poland (e.g. 1352 zlotys for urban municipalities compared to 1193 zlotys for all in 1998). This was mainly caused by the highest level of exclusive local revenues yielded in this type of gminas (= 503 zlotys compared to 399 zlotys for all municipalities at the same year).

The total fiscal capacity of municipalities is basically determined by (a) exclusive revenues from local taxes, local fees and user charges, (b) municipality's surcharge on shared taxes mostly on personal and corporate income (c) revenues from the sale or rent of municipal property, (d) bond dues, bank credits and other interest income, (e) income of municipal companies, and (f) general and special subsidies and grants of the central government, etc.

The local tax system differs from one country to another. In Slovakia and the Czech Republic, real estate taxes (e.g. land value tax and buildings tax) are typical local ones. On the other hand, the list of local taxes is quite long for Poland and Hungary. In the former country, real estate tax, agricultural tax, forest tax, transportation tax, tax on business activity and inheritance and gift taxes are part of those local taxes, while in Hungary, business tax, communal (poll) taxes on business and households, real estate tax, tourism tax and urban land tax are presently collected by municipalities in a selective way. The business tax — by far the most important financial source — has been increasingly gaining significance in recent years. Yet, the relevant decisions on tax bases, rates and deductibles of local taxes are generally made by the central government in these investigated countries.

Local fees and charges — the second source of exclusive local fiscal income — are imposed, for instance in the Czech Republic as well as in the Slovak Republic, on the ownership of dogs, the sales of alcoholic and tobacco products, the usage of public territory, on municipal advertisements, for entrance of motor vehicles to the historical part of town, for entertaining and pin-ball machines, for spa cures and recreational stays, etc. The Czech and Slovak central governments determine the range and the upper-limits of local fees that are practically administered by local governments. In Hungary, local governments are free to set their own level of charges for water supply, sewage treatment, housing, district heating and lighting, garbage collection, etc., but not for charges for education, social and health services. For those conceded services to private partners (i.e. public-private partnership), adjustments in user charges are generally made on the basis of agreements between the two parties in Hungary.

Those exclusive revenues (i.e. local taxes and local fees) have recently comprised around 35% of the total fiscal revenues (with bank credits and loans but excluding non-tax revenues) and consequently were the most important financial means to meet municipal expenditures in Poland and the Czech Republic, although their significance declined slightly between 1994 and 1998. In Hungary, the corresponding share remained around 30% between 1995 and 2000. By contrast, real estate tax and local fees have played a minor role as revenue sources for the Slovak municipalities (with around 15% of total local fiscal revenues).

As mentioned before, personal and corporate income taxes are the most common shared taxes in the Czech Republic, Poland and Slovakia. Road tax is additionally designated for tax sharing in Slovakia. In particular, revenues from personal income tax sharing (at ca. 60% to 80% of the total shared tax revenues) have recently been dominant in these countries, although corporate income tax has gradually gained significance in the course of time. In Hungary, personal income tax was an important shared tax until the mid-1990s, together with motor vehicle tax and tax on land rents. In this country the municipal shares and distribution rules of personal income tax revenues have been modified annually: e.g. in 1990 the entire sum of revenues was allocated to municipalities but the municipal share reduced to 40% at the end of 1990s. Subsequently, the share of revenues from the sharing of personal income tax for the total local fiscal capacity decreased from 24% to 2% in the 1990s.

The so-called non-tax revenues from the sale of municipality property like real estates, flats, municipal firms, etc., the property rental, the business incomes resulting from the running municipal firms and local governments' participation in private companies have recently been quite significant in the Czech Republic and Slovakia. For example, the share of this item amounted to more than 35% and 33% respectively of the total budgetary revenues in these countries in 1999. The sales of local assets turned out to be a new crucial financial source for Hungarian municipalities just after the redefinition of asset price structure in the mid-1990s, although they usually have the 'one-time' revenue character. In this country the share of non-tax revenues reached its maximum in 1997 at 11% of total local revenues. In addition, these assets have been quite unevenly distributed among municipalities.

3.4. Intergovernmental Transfer Systems

The intergovernmental transfer and grant system is quite heterogeneous in the investigated European transformation countries. In the Czech Republic general (i.e. equivalence-oriented) grants do not exist and all transfers from the central government are specific and purpose-oriented. In particular, capital grants (e.g. for hospitals, schools, water supply facilities, libraries, theatres, etc.) are generally allocated in line with the particular government programmes. On the other hand, important operating grants are provided on the formula-based system, and the basic down-flow transfer sum is defined, for example, per pupil in the pre-school and primary school facilities, per bed in the elderly people homes, etc. In 1999 operating grants amounted to 22 billion CZK compared to the total sum of intergovernmental transfers of 33 billion CZK (= ca. 16% of total budgetary revenues with bank credits and municipal bonds): both figures gradually increased between 1994 and 1999.

In the Slovak Republic grants are made by the central government and the various state-owned funds (like the State Environmental Fund, the State Fund for Housing Development, etc.). Their absolute and relative significance (the latter measured in terms of the share of total local revenues) experienced ups and downs in the period 1994-99 with a peak of 5 billion SKK (= approximately 17% of the total local revenues) in 1997. Over two thirds of such grants were project oriented (e.g. for providing public transport system, construction of housing facilities, etc.) and strongly concentrated on large urban areas. The equalisation-oriented general transfers have usually been addressed to small municipalities (with less than 3000 inhabitants) that were particularly suffering from fiscal bottlenecks. At present, a horizontal equalisation and resource transfer system from rich cities to poor rural municipalities does not exist in Slovakia.

The Polish intergovernmental transfer system is quite simple and aims at achieving the traditional goals of relieving the local fiscal constraints and guaranteeing and enhancing the quality of local goods and services provided by local governments. The additional assignment of maintaining elementary schools in 1996, the massive supports for general educational activities and the (equity-oriented) promotion of economic development of rural areas contributed to the rapid growth of gminas' (real) revenues from 'subsidies' of ca. 4 billion (= 15% of the total revenues with bank credits and loans) to 12 billion (= 24% of the corresponding total revenues) zlotys between 1994 and 1998. On the other hand, 'grants' are aimed at financing the specific municipal infrastructure projects that are exclusively defined and commissioned by the central government: the total sum remained quite stable at around 6 billion zlotys but their share changed from 21% to 14% of the total revenues (with bank credits and loans) in the investigated years.

Hungary currently has a quite complicated intergovernmental system and the most important sources for municipal finance in this country have been grants that comprised around 60% of total budgetary revenues of local governments in the last 6 years. In general, the down-flow transfers can be classified into the following different groups: (a) normative grants, (b) purpose-oriented matching grants, (c) deficit grants, and (d) special ‘addressed’ and ‘targeted’ subsidies for supporting municipal investment activities, as well as (e) the new grant for equalising fiscal capacity. The most substantial transfers are those normative (partly also equivalence-oriented and formula-based) types that include per capita grants based on the size of population, grants for core public services based on the number of beneficiaries, capacity grants made on the basis of bed number in shelters for homeless people and matching grants for the tourist tax. Their share amounted to ca. 40% of the local budgetary revenues in 1993 but declined to 25% in 1998. Matching grants with the increasing share of ca. 18% (1993) to 22% (1998) were mainly addressed to health care institutions. Deficit grants are aimed at supporting municipalities with high fiscal deficits: in 1997 840 local governments received ca. 6 billion HUF of which the sum increased to 12 billion HUF for 1230 municipalities in 1999. Although the size of such deficit grants appears to be negligible, they tended to discourage revenue-raising efforts of local governments and to reward increasing expenditures at the same time. Investment activities related to water supply, health and social security, and education have been promoted by the addressed and targeted grants of which the total sum is defined annually (e.g. 52 billion HUF for 2000). The targeted subsidies aim at reducing the effective investment costs for promoted projects by a certain percentage share (usually 40% to 50%), while the traditionally addressed types often cover the entire investment costs. The new grants for fiscal equity introduced in 1999 are calculated on the basis of municipal business tax capacities and paid up to a given normative per capita level that varies according to municipal types (e.g. villages, cities, etc.). In 1999 a sum of 38 billion HUF was distributed for this purpose. As a whole, the shift from a general grant system toward a more project-oriented down-flow transfer system was observed in the 1990s.

3.5. Municipal Borrowings and Debt Management

Local debts in forms of bank credits and communal bonds are relatively new financial measures to cover the increasing expenditure needs of municipalities in the investigated transition economies. Basically, there is neither a legal limit for local credits nor the intervention of central government to restrict and to forbid such borrowing activities. Municipalities can borrow from domestic as well as from foreign banks, issue bonds on the domestic or foreign markets, or borrow from non-banking institutions. In the Czech Republic, municipalities have generally been acknowledged as reliable debtors, because there has not been a case of municipal default yet and all local borrowings have recently been repaid without substantial delays, and a larger share of Czech municipalities have a stable level of own and shared tax revenues and attractive real properties that, in turn, determine the creditworthiness of municipalities in general. When issuing local bonds (normally in co-operation with private banks), however, the approval is required by the central government or its specific commission which examines borrowing conditions under the relevant legal framework. Hungary is an exception: e.g. a debt service limit for local governments and the general rule on issuing and trading municipal bonds were introduced in 1996. Moreover, it has been quite rare to find special long-term oriented lending mechanisms in the investigated countries by which the total credit sum can be paid back through the revenues generated by future projects.

In Poland, bank credits and public loans played a minor role in financing municipal activities, although such types of borrowings rapidly increased from 198 million (i.e. 0.7% of total revenues including bank credits and loans) to 2674 million zlotys (i.e. 5.5% of the corresponding revenues) between 1994 and 1999. Instead of old measures like preferential bank credits and public loans, it is now becoming increasingly popular to take bank credits on ‘normal’ commercial terms and to issue communal bonds. Regarding the bank credit structure of municipalities, there was also a movement of preponderance from short-term to mid-term credits: the latter type was particularly important for financing investment projects in urban areas (like public transportation systems). A number of urban gminas issued municipal bonds (with the total value of more than 570 million zlotys between 1995 and 1998), which were mainly for purchasing motor vehicles for the municipal transport system and/or for the renewal of roads.

Apart from the Prague bond with a value of 7.4 billion CZK issued in 1994, the most meaningful proportion of local debt has recently been the bank loans in the Czech Republic (notably from the Czech Savings Bank). Bank credits comprised ca. 44% of the total local debts of 40 billion CZK compared to 27% for municipal bonds in 1999. According to the available data, the share of municipal borrowings amounted to 3.5% of total local revenues of 97.2 billion CZK (including bank credits and loans) in 1994, of which the share reached ca. 19.1% of the corresponding total revenues of 210 billion CZK in 1999.

In Slovakia, the amount of bank credits continuously increased from around 886 million SKK in 1994 to 3163 million SKK in 1999, while the emission value of municipal bonds fluctuated in the period between 1994 (40 million SKK) and 1999 (253 million SKK). The comparable figures (40 and 253 million SKK for 1994 and 1999, respectively) indicate that municipal borrowings in the form of issuing bonds are not yet acknowledged as the way to obtain additional financial sources in this country. The share of bank credits and municipal bonds increased from 4.6% to 11.6% of total budgetary revenues of Slovak municipalities in the period between 1994 and 1999.

Hungarian municipalities have traditionally had low borrowings (e.g. around 23 billion HUF in 1995 and 363 billion HUF in 2000). This item comprised, on average, ca. 2.7% of the total local budgetary revenues for the individual years between 1995 and 2000. Such low local borrowings were partly led by the weak engagement of private banks in this matter and the grant-maximisation strategy of municipalities. The issuance of communal bonds (22 cases) is presently underdeveloped in Hungary.

3.6. Budgeting, Financial Reporting and Other Administrative Aspects of Fiscal Decentralisation

In all investigated countries, the relationship between the central and local governments as well as the political 'self-governing' scopes (i.e. local activities) are defined by laws and regulations. Such legal frameworks also guarantee the proprietary interests and property rights of local governments as legal persons. A matching share of public revenues for local government bodies is additionally guaranteed proportional to the tasks falling within their authority. The major principles of municipal financial management have also been legally defined: such general rules tackle the formulation of a standardised municipal budget — its approval, execution and supervision. In addition, the budgetary law of local governments is generally incorporated in the nation-wide budgetary law system. In most cases, the relevant legal framework determines the types of local revenues, the principles of calculating and providing subsidies from the national budgets to municipalities, the terms and conditions under which municipalities may receive loans or issue own securities and bonds, etc. Furthermore, municipalities are obliged to follow a very detailed list of budgetary composition like revenue and expenditure items in the division of operating and capital items.

Apart from the above-mentioned common features regarding the budgeting, financial reporting and public expenditure management, there are also some minor differences and country-specific aspects to be noted. For example, Czech municipalities are not obliged to report the classification of the total local expenditures in the operating and capital items. In Hungary a separate 'rolling' financial plan is to be prepared by local governments parallel to the annual budget. Slovak municipalities do not have to submit their annual budget to the central government. Financial aspects and soundness of municipalities are supervised by the regional accounting bodies in Poland, while the auditing of local, budgets can be carried out by private firms in the Czech Republic. By contrast, local budgets are not subject to any external audit in Slovakia.

The municipal budgeting and accounting system is generally criticised in the investigated transition countries because local government budgets and financial reports deliver — partly due to the shortage of trained people equipped with modern budgeting techniques — limited information about the provision of local goods and services. For instance, municipal budgets do not contain adequate information about the so-called off-budget activities of local governments. In addition, the local governments' reports to the central government have been criticised in Hungary because such line-item accounting documents do not include any output-oriented view of municipal activities, and therefore, fail to give a real overview of the accomplishment of local governments. In the Czech Republic and Slovakia, accounting standards for local governments do not require the declaration and record of guarantees and/or other contingent liabilities granted by municipalities. For this reason, it is hardly possible to identify the extent of the warranties that individual local governments have provided. Finally, it should be noted that there have recently been intensive efforts in the investigated countries to enhance the municipal ability to organise efficient cash management, to introduce cost control mechanisms, to monitor expenditures more efectively and to establish a well-functioning financial reporting system, etc.

4. Conclusion and Prospects

The idea of decentralising the political decision-making process has become increasingly popular world-wide, usually along with fiscal decentralisation. Such a trend has recently been quite pronounced in the Eastern European transformation countries like Poland, the Czech Republic, Hungary and the Slovak Republic, and appears likely to continue in the future. In the context of political and economic transition these countries have been trying to implement democratic and participatory forms of governments on different levels not only to improve the responsiveness and accountability of political leaders to their electorate but also to ensure a closer correspondence of the quantity, quality, and composition of publicly provided goods and services to the preference of their beneficiaries. To be sure, this type of political and fiscal decentralisation has caused some additional problems, particularly for safeguarding the quality of publicly provided goods and services and for co-ordinating intergovernmental fiscal affairs between the central and local governments in an efficient way. In the investigated Eastern European countries the number of self-governing municipalities grew rapidly in the 1990s and their average size, measured in terms of the number of inhabitants, is quite small. This has quite often limited the expansion of the local economic base for generating own revenues and hindered the realisation of economies of scale in collecting municipal tax revenues and providing local public goods and services. Despite the insufficient availability and poor quality of relevant statistics, one easily tends to argue that many small-sized less-favoured municipalities have suffered from fiscal bottlenecks and have not been able to receive financial supports from the central government that are necessary for their economic development and for the provision of local infrastructure.

Conventional economic literature deals more intensively with the potential efficiency and welfare gains that can be achieved by the political and fiscal devolution, including the decentralisation of public spending responsibilities and activities on the local level. On the other hand, there is growing academic and political concern that a strong allocation- and equity-oriented decentralisation policy may aggravate fiscal imbalances and endanger overall macro-economic stability. As briefly indicated above, this comparative study aims at examining more principal and immediate issues on political and fiscal decentralisation carried out in the selected European transformation countries including expenditure and revenue assignments, intergovernmental transfer systems, local borrowings and administrative aspects of budgeting and financial accounting, etc. More precisely, this study primarily tackles crucial issues surrounding the impact of national fiscal policy and the regulatory framework on local governments' expenditure behaviour and their ability to mobilise necessary revenues under the particular consideration of the institutional and administrative co-operation with the central government and of the (still existing) less-well developed financial market in the Czech Republic, Poland, Hungary and Slovakia.

Although the degree of self-governing ability of municipalities seems to vary from one country to another, many similar types of public activities have been legally assigned to local governments in the investigated countries which include (a) land management and planning, zoning and local environmental protection, (b) municipal budget and property management, (c) provision of local roads, bridges, streets and public transport system, (d) water supply as well as municipal waste disposal, (e) primary health care and social welfare services, (f) municipal housing, (g) elementary education including kindergarten, (h) promotion of culture and sport, (i) public order and fire protection, etc. In general, there are no specific regulations and norms set by the central government concerning the minimum level of services expected from local service providers. The concentration of local expenditures on large urban municipalities can also be explained by their specific function as the so-called central places for surroundings as well as by their strong economic bases that generate higher fiscal revenues shown, for example, in terms of per capita local revenues. The importance of inter-juridical external effects of public goods appears to be less adequately acknowledged by municipalities in the selected transition economies until now, which has, in turn, encouraged the non-cooperative behaviour of local governments when providing such goods. The so-called public-private partnership is increasingly becoming popular for local activities such as water supply and waste treatment as well as public transport services. In such cases local governments usually define the level and the quality of provided goods and services.

In general, local expenditures of municipalities in the investigated Eastern European countries tend to increase gradually, although their annual trend can be partly disturbed by the development of the macro-economic business cycles. Operating expenditures aimed at ensuring proper functioning of existing local goods as well as public services, and the follow-up expenses caused by the realisation of local projects will further exceed the investment expenditures for the construction of new infrastructure. Education will remain in the mid-term (due in part to the related high operating expenses) as one of the largest local expenditure categories, while municipal investments will continuously concentrate on areas like water supply and waste disposal facilities, local transport network, etc. Yet, there are differences among countries in finding financial means for infrastructure investments. For example, the exclusive tax revenues (local taxes and fees), supplemented by borrowings from private banks and various public funds, were major resources for investments of Polish local governments in the fields of environmental protection and water management that have, however, been substantially financed by the local property sales and the matching grants from the central government in Hungary. Furthermore, the so-called varied types of off-budget enterprises including municipal (public) companies, NGOs, etc. will further significantly contribute to the enhancement of infrastructure endowment, as shown most distinctively in Hungary. In the past, however, the construction of large infrastructures was quite often encountered difficulties, since the implementation of the municipal expenditure schedules was too short-term oriented, and various projects turned out to be flops, because their realisation was carried out without solid economic and feasibility analyses.

According to the experts' view, the provision of local goods and services made in recent years are generally assessed to be quite satisfactory in the investigated transformation countries, although some public tasks could not be accomplished by municipalities as prescribed by the law. In spite of the continuous growth of local budgetary revenues in previous years, the ability of municipalities to mobilise own fiscal resources that are required to meet the rapidly increasing expenditure needs is generally judged to be rather limited, partly because relevant decisions on local tax bases and rates as well as tax sharing schedules have been made by the central government and/or subject to strict restrictions indicated in the national tax law. The total fiscal capacity of municipalities is basically determined by (a) exclusive revenues from local taxes, local fees and user charges, (b) municipality surcharges on shared taxes, (c) revenues from the sale or rent of municipal property, (d) bond dues, bank credits and other interest income, (e) income of municipal companies, and (f) general and special subsidies and grants of the central government, etc. Moreover, one should bear in mind that the size of the off-budget revenues of municipal companies, NGOs, etc. is also estimated to be quite significant (e.g. 10% to 30% of the total budgetary revenues of local governments in Hungary).

The local tax and charge system is heterogeneous in the investigated European transition economies. Real estate taxes (e.g. land value tax and buildings tax) are legally defined as local taxes in Slovakia and the Czech Republic. In Poland real estate tax, agricultural tax, forest tax, transportation tax, tax on business activity and inheritance and gift taxes are local taxes, while business tax, communal (poll) taxes on business and households, real estate tax, tourism tax and urban land tax are presently imposed by Hungarian municipalities in a selective way. The Czech and Slovak central governments define the range and the upper-limits of local fees on the ownership of dogs, the sales of alcoholic and tobacco products, the usage of public territory, on municipal advertisements, for entrance of motor vehicles to the historical part of town, etc. Hungarian municipalities set own levels of fees for water supply, sewage treatment, housing, district heating and lighting, garbage collection, etc. Such exclusive local revenues will remain the most important financial means to meet municipal expenditures in Poland and Hungary. By contrast, real estate taxes and local fees have played a less crucial role as revenue sources for the Czech and the Slovak municipalities.

Personal and corporate income taxes are common as shared taxes in the Czech Republic, Poland and Slovakia. The revenues from personal income tax sharing have recently played a more dominant role for the local budget in these countries, although corporate income tax has gradually gained significance. The tax sharing is supplemented by a road tax in Slovakia. In Hungary personal income tax was an important shared tax until the mid-1990s, together with the motor vehicle tax and the tax on land rents. At present the significance of revenues from shared taxes for the total fiscal capacity of local governments is negligible in this country.

The contribution of non-tax revenues — from the sale of municipality property like real estate, flats, municipal firms, etc., the property rental, the business incomes resulting from running of municipal firms and local governments' participation in private companies — to the total local budgetary revenues has recently been quite substantial in the Czech Republic and Slovakia. The sales of local assets emerged rapidly as an additional revenue source for local governments in Hungary just after the redefinition of the asset price structure in the mid-1990s but gradually lost their importance at the end of the 1990s. In spite of the 'one-time' revenue character, this item will remain as one of the major budgetary resources in the mid-term for Czech and Slovak municipalities.

Although the dominance of a purpose- and project-oriented grant system is apparent, the intergovernmental transfer system is constructed differently and varies from the simple, traditional Polish style to the rather complicated (i.e. less transparent) type in Hungary. In the Czech Republic all transfers from the central government are specific and purpose-oriented: capital grants are allocated according to the government infrastructure programmes, while important operating grants are determined on the formula-based system and the basic downflow transfer sum is defined in a normative way, e.g. per pupil in the pre-school and primary school facilities, per bed in the elderly people homes, etc. In the Slovak Republic grants are made by the central government and the various state-owned (environmental and housing) funds. Over two thirds of such grants are aimed at supporting large scale infrastructure projects and, consequently, strongly concentrated on large urban areas. The rest has been the equalisation-oriented unconditional transfers directly addressed to small municipalities that particularly suffered from fiscal bottlenecks. In Poland, the intergovernmental transfers are classified into ‘subsidies’ with an unconditional and block grant character that support general educational activities in municipalities and the (equity-oriented) promotion of economic development of rural areas, and those ‘grants’ with decreasing significance that mainly aim at financing the specific municipal infrastructure projects which are exclusively defined and commissioned by the central government. Hungary currently has quite heterogeneous down-flow transfer types. The most substantial transfers are those normative types that include per capita grants based on the size of population, grants for core public services based on the number of beneficiaries, capacity grants made on the basis of bed numbers in shelters for homeless people and matching grants for the tourist tax. A large share of purpose-oriented matching grants are presently addressed to health care institutions. The equity-oriented deficit grants (with the unconditional character) for supporting municipalities with high fiscal deficits are currently criticised, because they tend to discourage revenue-raising efforts of local governments and to encourage the increasing expenditures. The fiscal equity grants introduced in 1999 are, therefore, calculated on the basis of municipal business tax capacities and paid up to a given normative per capita level that varies according to municipal types (e.g. villages, cities, etc.). Local investment activities have been promoted by the targeted and addressed grants: the former type reduces the effective investment costs for promoted projects at a certain percentage share, while the latter usually covers the entire investment costs. The amount of intergovernmental transfers from the central government has traditionally made a substantial contribution to the total municipal fiscal capacity in Hungary, Poland, the Czech Republic and Slovakia, in descending order, and such a trend is likely to continue in the future. In other words, in adopting such abundant financial means, the central government in these countries will further try to lead and support the provision of local public goods and services effectively, which, on the other hand, could make the process of carrying-out legally assigned public activities by municipalities less ‘self-governing’. At present, a horizontal equalisation and resource transfer system from rich cities to poor rural municipalities does not exist in the investigated countries.

Local borrowings in forms of (mostly short- and mid-term) bank credits and communal bonds have rapidly emerged as financial means to meet the increasing municipal expenditure needs in the investigated transition economies, although their significance has remained rather moderate (except in the Czech Republic). Basically, there are a neither legal limits for local credits nor intervention of central government to restrict and to forbid such borrowing activities (except in Hungary), which means that the debt control primarily relies on market discipline without the so-called bail-out guarantees of the central government. The creditworthiness of municipalities in these countries is generally assessed to be favourable because of their stable tax revenue level and attractive real properties possessed. Partly due to the less well-developed financial market, the long-term oriented lending mechanism is not yet popular in the investigated countries, by which the total credit sum can be paid back through the revenues generated by future infrastructure projects. For issuing local bonds (made in previous years by a number of large urban municipalities in co-operation with private banks), an approval on their terms and conditions is generally required by the central government. However, such a borrowing mechanism seems to be still underdeveloped, particularly in Hungary and Slovakia.

The major principles of the municipal financial management primarily deal with the formulation of a standardised local budget, its approval, execution and supervision, a process which is legally defined in all the investigated countries. In addition, the budgetary law of local governments is generally incorporated in the nation-wide budgetary law system. In spite of such a well-defined legal framework and recent efforts to enhance the municipal ability to organise efficient cash management, to introduce cost control mechanism, to better monitor expenditures and to establish a well-functioning financial reporting system, etc., the budgeting and accounting practice of local governments still fails to deliver adequate information and a real overview on the financial situation and the accomplishment of municipal activities. Most importantly, municipal budgets do not contain any information about the off-budget activities of local governments. Since accounting standards for local governments (particularly in the Czech Republic and Slovakia) do not require the declaration of granted guarantees and/or other contingent liabilities, it is nearly impossible to estimate the extent of such warranties that individual local governments have provided.

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