40538

WORLD BANK WORKING PAPER NO. 111

Intergovernmental Fiscal Relations in the New EU Member States

Consolidating Reforms

William Dillinger

THE WORLD BANK

WORLD BANK WORKING PAPER NO. 111

Intergovernmental Fiscal Relations in the New EU Member States

Consolidating Reforms

William Dillinger

THE WORLD BANK
Washington, D.C.

Manufactured in the United States of America
First Printing: June 2007

printed on recycled paper

1 2 3 4 5 10 09 08 07

ISBN-10: 0-8213-7147-9 ISBN-13: 978-0-8213-7147-1
eISBN: 978-0-8213-7148-0
ISSN: 1726-5878 DOI: 10.1596/978-0-8213-7147-1

Cover photo: © Roman Milert, courtesy of BigStockPhoto.com.

William Dillinger is Lead Public Sector Manager in the Poverty Reduction and Economic Management sector unit of the Europe & Central Asia regional department of the World Bank.

Library of Congress Cataloging-in-Publication Data has been requested.

Contents

List of Boxes

List of Tables

List of Figures

Acknowledgments

This report was prepared by William Dillinger. Signe Zeikate provided research assistance and prepared the section on debt controls. Ken Davey and Deborah Wetzel were peer reviewers. Valuable comments were also provided by Thomas Laursen. An earlier version of this study was discussed in a regional workshop in Budapest in June 2005, and the final report was discussed at an international conference in Prague in November 2005.

The report is part of a series of studies on current issues in public finance reform in the Central European and Baltic countries (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia—the "EU8") which joined the European Union on May 1, 2004. These studies have been undertaken since 2005 and coordinated and edited by Thomas Laursen, Lead Economist for Central Europe and the Baltic States in the World Bank. Marta Michalska provided excellent administrative and logistical support throughout the process of preparing these studies.

Executive Summary[1]

Overall, the EU8 countries have made remarkable progress in reforming their systems of intergovernmental fiscal relations, and the eight new EU countries now have much more in common with the longer-standing members of the Union than they do with the Soviet-era systems they inherited. Subnational governments are an important part of the public sector in the EU8 countries, accounting for about one-quarter of total government spending. They provide basic public services in both the social sectors (education, health, and social assistance) and in infrastructure (water supply, sewerage and transport). How well they perform these functions has an important influence on the quality of both human and physical capital in these countries, and therefore on the prospects for economic growth. It also has equity implications, as the social services performed by municipal governments have important distributional effects. Further, subnational government operations may affect macroeconomic stability as independent fiscal actions by local governments could undermine central control over fiscal policy. The study by William Dillinger takes stock of developments in intergovernmental fiscal relations and discusses current challenges in this area in the EU8.

Organizational reforms generally took the form of scaling back the responsibilities of deconcentrated units of central administration while creating autonomous units of self-government and, in the larger EU8 countries, new, consolidated regional governments. Privatization had two important implications for local governments. First, it eliminated important providers of public services. Second, it drastically altered the revenue base. Profits (where such were generated) from local-government-owned enterprises were no longer a source of revenue, and as central governments revised the tax structure to capture revenues from the growing private sector, the fundamental basis for tax sharing had to be altered. Functional decentralization required an increase in local government revenues. Privatization changed the nature of the tax base, and changed political conditions increased pressure for local fiscal autonomy while raising the risk that local governments would use that autonomy to thwart central government fiscal and equity objectives.

The new local government legislations assigned an extensive list of functions to the newly independent municipalities. Education is the largest single item of local government expenditure, with local governments (including intermediate levels of elected government) accounting for about two-thirds of total public sector spending on education in most EU8 countries. The extent of municipal management control over education, however, is limited, owing to legal constraints which set out the framework for teachers' salaries, teaching loads, and rules for recruitment and promotion. Local governments play a major role in managing healthcare in the EU8, but only a minor role in its financing. All these countries now finance the majority of healthcare costs through compulsory insurance schemes. In most of the countries, health insurance funds (HIFs) provide funding directly to healthcare providers (primary physicians and secondary and tertiary healthcare facilities), and subnational governments thus account for only a small share of total public sector health spending in most countries. In all EU8 countries, central governments provide the vast majority of

1. Prepared by Thomas Laursen.

Box 1: Objectives of Intergovernmental Finance Systems

What are the objectives of a system of intergovernmental finance? According to conventional economic theory, the primary aim should be to promote efficiency in the allocation of resources while the central government would be responsible for stabilization and income distribution. Theory argues that if the benefits of particular services are largely confined to local jurisdictions, welfare gains can be achieved by permitting the level and mix of such services to vary according to local preferences. Local consumers, confronted with the costs of alternative levels of service can express their preferences by voting for rival political candidates (voting with their hands) or moving to other jurisdictions (voting with their feet). In this respect, local politics can approximate the efficiencies of a market in the allocation of local public services by "pricing" municipal services and relying on the local political process and household mobility to clear the market. On this basis, a successful system of intergovernmental relations would be one in which each level of government (1) performs only functions whose benefits are confined to its boundaries and (2) derives its revenues from sources (such as local taxes and fees) that confront its residents with the costs of these functions.

In practice, there are a number of limitations to this model. First, the benefits of public services can be difficult to define in geographical terms. While most of the benefits of spending on public health, for example, may be confined to a local jurisdiction, failure to control infectious diseases can have national or international implications. Second, spending on public services—particularly education and health—can be important instruments of distributional policy. Where these functions are assigned to local governments, their distributional implications cannot be ignored. Third, high levels of local taxation or widespread deficit spending could weaken the central government's control over fiscal policy.

In practice, the intergovernmental fiscal systems of the EU8 countries must be held to somewhat different standard: (i) *Transparency and predictability:* The principal challenge confronting the EU8 countries was to devise a system for financing local government that would be perceived as fair and stable. The emergence of multi-party democracy in the EU8 required transparency in order to allay charges of partisan favoritism and reduce the transaction costs that would result from continued reliance on bargaining. Predictability was required to provide local governments with a stable basis for budget planning; (ii) *Equity:* Because local governments assumed responsibility for social services, the new system had to ensure that such services would be available to people living in poor jurisdictions; (iii) *Macroeconomic control:* The system had to ensure that local government fiscal behavior would not threaten macroeconomic stability. Central governments needed sufficient control over aggregate local taxing to conduct fiscal policy and sufficient control over local borrowing to ensure that aggregate deficit targets were achievable; and (iv) *Effectiveness:* Finally, the systems needed to encourage effectiveness in the production of services under local control. The EU8 countries inherited over-scaled schools and hospitals and inefficiently run public utilities. Incentives for rationing services therefore had to be incorporated in the new system of intergovernmental finance.

social protection, including old age and disability pensions, sickness benefits, and short term unemployment benefits.[2] Local governments, nevertheless, are responsible for a variety of assistance to other vulnerable segments of the population, including the long-term unemployed and their dependents. They have varying degrees of discretion in determining who is eligible for such benefits and what form they should take.

With the privatization of the housing stock, municipal responsibilities for housing management and maintenance have declined sharply in the EU8 countries. Municipalities have, on the other hand, assumed responsibility for water supply, sewage, district heating, solid waste management, and third tier roads, although these do not necessarily account

2. Pension systems have been partially privatized in several countries in the region.

for a large proportion of budgetary expenditure.[3] Water, sewage, district heating and solid waste management are generally organized as separate, tariff-supported, enterprises. Poor standards of original design and construction, high energy requirements, changing patterns of demand, and long periods of deferred maintenance have resulted in deteriorating and obsolete infrastructure networks.

The revenues of local governments consist of discretionary funds, largely revenue sharing and funding for specific functions, principally education and health.[4] Revenue sharing generally relates to the personal income tax (PIT)—in all EU8 countries, the shared taxes are administered by the central government at nationally uniform rates, and fixed shares of the revenues are then assigned to local governments. The distribution mechanisms for the PIT include a high degree of equalization. None of the EU8 countries assign a major unrestricted—in the sense that municipalities have the authority to set the rate and retain the revenue—tax base to local governments. The most widespread form of local taxation is the property tax, but local discretion over tax rates varies among countries and even in those that have moved to marked-based valuation, the property tax generates very little revenue.

All the EU8 countries have supplementary arrangements for financing education and health. The post-Soviet-era systems of education financing reflect an ongoing tension between ensuring a basic level of education financing in all jurisdictions, regardless of the strength of local tax bases, and encouraging efficiency in the use of education funding. All the EU8 countries finance the largest component of education—teachers' salaries—through some form of intergovernmental transfer. A few countries rely solely on central government administrative procedures to ration the level of local spending on education, while most distribute funding for education on a per pupil (capitation) basis and allow local governments considerable discretion over how these funds are used. The latter approach ensures a minimum level of education financing in all jurisdictions while allowing the central government to ration the level of such spending through its control over the per-capita amount. In particular, it forces rationalization in jurisdictions with under-enrolled schools. However, the success of capitation based financing is challenged by the inability of local governments to dismiss staff as well as the unwillingness or inability of central governments to increase the level of capitation transfers to reflect centrally-mandated increases in costs, notably wages.

The EU8 countries have also attempted to use the health financing system as a tool to achieve efficiency. All have created HIFs to finance the majority of primary, secondary, and tertiary healthcare costs. These funds are financed from payroll taxes, supplemented by central government payments on behalf of certain categories of non-contributors (pensioners, workers on maternity or sick leave, and unemployed). Health funds were generally created to protect healthcare spending from the vicissitudes of the annual government budget process (although funding remains subject to fluctuations in the payroll tax base and the rate of the payroll tax). In principle, they also function as a ceiling on healthcare

3. They do, nevertheless, constitute an important source of contingent liabilities (as these enterprises often have high levels of arrears) and a claim on scarce investment resources.

4. In most of the EU8 countries, the specific purpose of this funding is to cover the full costs of the function to which it is assigned. Poland and Hungary are exceptions, with the level of funding for education determined independently of the costs of this function in the expectation that any shortfall will be funded from discretionary revenues.

spending: with few exceptions, spending on primary, secondary, and tertiary healthcare is not allowed to exceed the revenues of the HIF. However, in practice hard budget constraints are often breached through arrears and extraordinary budget support. Attempts to use fiscal instruments to ration the supply of health services on a more micro level have had mixed results. One of the major sources of inefficiency in the Soviet model of healthcare was its excessive use of secondary and tertiary facilities. To varying degrees the EU8 countries have addressed this issue by introducing "family medicine" models of primary care, but performance incentives have proven incompatible with cost containment due to the tendency of providers to respond to fee-for-service forms of compensation by increasing the volume of services they provide. Rationing secondary and tertiary care has been even more difficult.

EU8 countries have also strengthened controls on local government borrowing. Following liberal access of local governments to capital markets in the early 1990s and several instances of default, the majority of EU8 countries have introduced quantitative ceilings on municipal borrowing and debt service. Several of the EU8 countries also impose case by case administrative controls on local borrowing and restrict certain forms of borrowing. Further, several countries impose penalties on municipalities that fail to meet their debt obligations, and a few have introduced formal municipal bankruptcy laws (although the use of these measures has been limited so far). Central government bailouts remain a possibility in most countries.

The study argues that the EU8 countries have made substantial progress in the reform of intergovernmental relations as measured against the criteria outlined above. Most countries have come a long way on transparency and predictability, although Hungary remains a source of concern. Countries in the region also manage to achieve a high degree of redistribution in the financing of social services, perhaps even too much: while there is a strong case for equalizing spending on social assistance, the case for equalizing spending on other functions financed from discretionary revenues—road maintenance, community amenities, or general administration—is less obvious. Local government finances have not been a source of fiscal and macroeconomic instability, reflecting limited fiscal autonomy and strict borrowing constraints in most countries. On the other hand, attempts to use the system of intergovernmental relations to encourage greater efficiency in the production of public services have been less successful. While the majority of the EU8 countries now finance education on a capitation basis, this has not been sufficient to prompt the closure of under-enrolled classrooms or schools. In the health sector, efforts to encourage primary providers to increase the volume of services they provide have been thwarted by over-billing, and efforts to ration secondary and tertiary care using variants of the German points system have run aground for similar reasons.

Over the longer term, this study points out that sustainability of EU8 intergovernmental fiscal arrangements will depend on the ability of central governments to keep their agreements with local governments. In monopolizing the major sources of tax revenues, central governments have arrogated to themselves the power to decide how large a share of total public sector revenues local governments should receive, and how they should be spent. In the process, they have made themselves vulnerable to the claim that the level of funding which they provide to local governments is insufficient. In the case of sector specific financing, the implication is that central government mandated increases in costs of service provision must be accompanied by increases in the level of financing. In the case of funding discretionary expenditures, the main issue is risk related to the annual negotiations

between the central and local governments. Experience from Western Europe suggests that countries might deal with these issues through either increasingly sophisticated estimates of the costs of providing discretionary—in effect treating these as if they were mandatory (England is a good example of this approach), or allow the local governments to decide for themselves on the appropriate level of spending on the basis of their constituents' willingness to pay. The latter approach would require the assignment of a broad based tax such as the PIT to the local level. Some Scandinavian countries have gone this way (and is also cited in the European Charter of Local Self-Government and actively promoted by the Council of Europe), but it appears to have few supporters among the EU8. At present, central governments prefer to retain near-total control over tax policy, and local governments prefer to avoid the onus of taxation.

CHAPTER 1

Introduction

Subnational governments are an important part of the public sector in the EU8 countries. They provide basic public services in both the social sectors (education, health, and social assistance) and in infrastructure (water supply, sewerage and transport). They account for about one-quarter of government spending. How well they perform these functions has an important influence on the quality of both human and physical capital in these countries, and therefore on the prospects for economic growth. It also has equity implications, as the social services performed by municipal governments have important distributional effects. Further, subnational government operations have implications for macroeconomic stability, as independent fiscal actions by local governments could undermine central control over fiscal policy.

The period since the fall of the Berlin Wall and the breakup of the Soviet Union has seen dramatic changes in the political and economic institutions of the EU8 countries. All abolished the Communist party's monopoly on political power, abandoned central planning as a device for allocating resources and setting targets for deliverables, and were prompted, in reaction to the high degree of centralization under the former regimes, to grant substantial power to subnational units of administration. The EU8 countries have spent the last 15 years devising a new system of intergovernmental arrangements that will respond to these changes. The aim of this study is to see how far along they have come and how well they now perform.

CHAPTER 2

Evaluation Criteria

According to conventional economic theory, the primary aim of a system of local government finance is to promote efficiency in the allocation of resources (Box 2). Theory argues that if the benefits of particular services are largely confined to local jurisdictions, welfare gains can be achieved by permitting the level and mix of such services to vary according to local preferences. Local consumers, confronted with the costs of alternative levels of service can express their preferences by voting for rival political candidates (i.e., voting with their hands) or moving to other jurisdictions (voting with their feet). In this respect, local governments can approximate the efficiencies of a market by "pricing" municipal services and relying on the local political process and household mobility to clear the market. On this basis, a successful system of intergovernmental relations would be one in which each level of government (1) performs only functions whose benefits are confined to its boundaries and (2) derives its revenues from sources (such as local taxes and fees) that confront its residents with the costs of these functions.

In practice, there are a number of limitations to this model. First, the benefits of public services can be difficult to define in geographical terms. While most of the benefits of spending on public health, for example, may be confined to a local jurisdiction, failures to control infectious diseases can have national or international implications.

Other aspects of the theory confront practical obstacles as well. As described in Box 2, theory assigns the role of income redistribution to the central government. It is presumed that central governments will use the instruments under their control (for example, progressive taxation and direct payments to low income households) to achieve a desired level of income equality, leaving local governments to focus only on the level and mix of services they provide. However, spending on public services—particularly education and health—can be important instruments of distributional policy. Where these functions are assigned

Box 2: A Snapshot of the Economics of Expenditure Assignment

Which functions should be assigned to which level of government? The literature on fiscal federalism provides a useful framework for thinking about this question. It begins by assigning three roles to the public sector as a whole: macroeconomic stabilization, income redistribution, and resource allocation (in the case of market failure). The model assigns the first two roles to the central government. The central government is assigned responsibility for stabilization on the grounds that local economies have no access to an independent monetary policy and are too open for effective countercyclical measures to be effective. The income redistribution function is also assigned to the central government, on the grounds that local attempts to address income disparities are likely to provoke inefficient migration: higher-income groups will move to low-tax areas and low-income groups to high-benefit areas (even with their populations *in situ*, local governments in poor regions would have little income to redistribute anyway). Subnational governments enter the picture only with respect to the third function: resource allocation. If the benefits of particular services are largely confined to local jurisdictions, residents can choose the level and mix of services that best matches their preferences (and pocketbooks). In this way, a system of intergovernmental finance can approximate the allocative efficiencies of a market in the allocation of local public goods.

to local governments, their distributional implications cannot be ignored. Theory also assumes that macroeconomic stability is not a local government concern. Yet, high levels of local taxation or widespread deficit spending could weaken the central government's control over fiscal policy.

As a practical matter, the intergovernmental fiscal systems of the EU8 countries must be held to somewhat different standard:

- Transparency and predictability: The principal challenge confronting the EU8 countries was to devise a system for financing local government that would be perceived as fair and stable. The emergence of multi-party democracy in the EU8 required transparency in order to allay charges of partisan favoritism and reduce the transaction costs that would result from continued reliance on bargaining. Predictability was required to provide local governments with a stable basis for budget planning.
- Equity: Because local governments assumed responsibility for social services, the new system had ensure that such services would be universally available, regardless of the strength of the local tax base.
- Macroeconomic control: The system had to ensure that local government fiscal behavior would not threaten macroeconomic stability. Central governments needed sufficient control over aggregate local taxing to conduct fiscal policy and sufficient control over local borrowing to ensure that aggregate deficit targets were achievable.

Effectiveness: Finally, the systems needed to encourage effectiveness in the production of services under local control. The EU8 countries inherited over-scaled schools and hospitals and inefficiently run public utilities. Incentives for rationing services therefore had to be incorporated in the new system of intergovernmental finance.

CHAPTER 3

The System Ex Ante

The current structure of intergovernmental relations in the EU8 countries represents a substantial departure from the system that preceded it. The former system had two key characteristics: a prominent role for state enterprises in the financing and delivery of public services and a system for allocating resources based on the Communist Party's monopoly of political power.

The hallmark of the socialist-era economies was the state's ownership of the means of production. While private ownership existed in some sectors in some countries (for example agriculture in Poland and small businesses in Hungary) it was the state that dominated both the economic and social sectors. State enterprises provided services directly to their employees. They built and supported hospitals, constructed and maintained housing, built and ran kindergartens and preschools and made donations toward public transportation and subnational extra-budgetary funds. However, the majority of social and infrastructure services—education, health, and public utilities—were provided through separate sectoral ministries. Sectoral ministries' policies were implemented through a hierarchy of subnational units of administration. As these units reported to a variety of sectoral ministries, they functioned not only as deconcentrated units of the ndividual ministries but, in some respects, as local governments.

The territorial units of administration derived revenue from four major revenue sources. The first was profits on enterprises. If an enterprise were directly subordinate to a municipality, that municipality would derive revenue directly from its profits. If the enterprise were subordinate to a higher tier of government, the municipality would receive revenue from profit tax levied on it (Berkowitz and Mitchneck 1992). In addition, the local government would receive revenues from shares of the turnover tax (on consumer goods, foods and certain extractive and light industries) and from the personal income tax. As a

result, a municipality's revenues were partly dictated by the number and scale of enterprises within its territory, and by their ownership. Local budgets were also subject to a complex process of negotiation. Budgets could be supplemented from higher levels of government and by contributions from large enterprises within their 60 boundaries. Thus, the level of resources available depended upon the ability of the local party secretary to remain on good terms with the party bosses at higher levels and with the managers of state farms or factories (Kocan and Regulski 1994).

Politically, the system had the trappings of Western democracies. At the republic level, there was a legislative body (congress of people's deputies) elected by universal adult suffrage which (since it met infrequently) had a standing legislature. The chairman of the standing legislature functioned as head of state and oversaw the council of ministers, which acted as the executive branch of the government. A parallel structure existed at each subnational level. Each unit had its own council elected by universal suffrage. Like their counterparts at the national level, these met infrequently. Between sessions, each council delegated its authority to an executive committee whose chairman acted as chief executive and oversaw the functioning of the various departments of administration.

Effective political power was, however, exercised by Communist Party. The Party had its branches at the republic and subnational levels. The leadership of a local branch of the Party was, in theory, chosen by local party members. In practice, candidates were chosen by the local branch of the party, so that ultimately the existing party leadership designated the people who would be put on the ballot to elect it.

In the classic characterization, it was the Party that set policy and the government that implemented it. In practice, the relationship between the Party and the government was more intimate. The Party determined which candidates would be on ballot for local councils and appointed the key officials of the administration. And it was the Party secretary, not the exective the local government who had to lobby central planners for low plan targets and then find the resources to meet them (Zikel 1991). The result was a system that depended on bargaining and negotiation, most of which occurred within the Party structure.

CHAPTER 4

Political and Organizational Reforms

All EU8 countries began to dismantle the Soviet era structure in the early 1990s. In political terms, this took the form of an end to the Communist Party's monopoly on political power. As shown in Table 1, national level multi-party Parliamentary elections in Poland in 1989 were followed by similar elections in Czechoslovakia, Hungary, and Lithuania (1990), Estonia, and Slovenia (1992), and Latvia (1993).

Changes in the political and organizational structure of local government quickly followed. In Poland, the first Solidarity-led government introduced a Law on Local Self Government establishing the existing gminy as the basic administrative unit of local government (Barbone and Hicks, 1995). Multiparty elections at the gmina level were held in May of 1990. Subsequent legislation—an act on local revenues and rules of financing (1990), a budget law (1991) and an act on taxes and local fees (1991)—designated the revenue bases of the gminy and separated their budgets from that of the central government.

Most of the other EU8 countries followed suit. In the former Czechoslovakia, the new Constitution and subsequent enabling legislation recognized the existing municipalities as self-governing units, guaranteed their autonomy and provided for local assemblies chosen by universal suffrage.[5] The first post-Soviet elections in the former Czechoslovakia were held in 1990. In Estonia, similarly, the existing units of local government were recognized as legal entities, with independent budgets and councils elected by universal suffrage (Maeltsemees, 2000). Elections were held in 1993. In Latvia, the 1994 Law on Municipalities provided much of the legal structure and political arrangements. Local elections were held in 1989.

5. Czechoslovakia split into two separate republics in 1993.

Table 1. Timetable of Post-Soviet Reforms

	Year of First Post Soviet-era Elections		Percent of GDP Privatized	
	National Parliamentary	Local	Year of Data	Percent
Czech Rep.	1990	1990	1996	75
Estonia	1992	1993	1997	67
Hungary	1990	1990	1997	86
Latvia	1993	1989	1997	60
Lithuania	1990	1995	1997	70
Poland	1989	1990	1996	65
Slovakia	1990	1990	1997	83
Slovenia	1992	1994	1998	55

Source: Freedom House (1998 and 2004): Nations in Transit.

Organizational reforms in Hungary were more radical. The 1990 Law on Local Self-Government abolished the existing local governments and dramatically scaled back the responsibilities of the deconcentrated units of central administration. To replace the former local governments, citizens were granted the right to create autonomous units of self government. As a result, the former local governments broke up into discrete units, roughly doubling in number (Ebel and others 2000). The Law on Local Self-Government and related legislation established local governments as legal entities and established a system of local elections with directly elected councilors and mayors (mayors were indirectly elected in towns above 10,000 inhabitants in the period 1990–94 but are now directly elected).

Lithuania took an opposite track. In 1990, the Supreme Council of the Lithuanian Soviet Socialist Republic adopted the Law on the Foundation of Local Self-Government guaranteeing the autonomy of local units of self-government and providing for the election of local councilors on the basis of universal suffrage. But subsequent legislation substantially reduced the number of individual local units. The 1994 Law on Territorial Administrative Units and Their Boundaries replaced the former system of 581 rayons, cities, and villages with a system of ten counties (which function as deconcentrated units of central administration) and sixty municipalities (Beksta and Petkevicius 2000).

Democratization did not stop at the lowest tier of subnational administration. In a second phase of reform in the late 1990s, Poland added an additional tier of elected subnational government by resurrecting a former intermediate tier of government, the powiats. The powiats, with directly elected councils which appoint an executive from among their members, have assumed most of the tasks that formerly belonged to the voivodships. Voivodships, nevertheless, remain fully self-governing authorities, with elected councils and chief executives. In 2001, the Czech Republic dissolved the former 77 deconcentrated units of central administration and transferred the majority of their functions to 14 newly-created regional governments, each with an assembly elected by universal suffrage and president elected from among its members. Slovakia has followed suit. In a

series of reforms from 2002 to 2004, the 79 deconcentrated units of central administration were abolished and replaced by eight elected regional governments. These will, however, continue to operate alongside eight existing regional units of central administration.

In economic terms, the dismantling of the socialist-era structure took the form of privatization. This took different forms in different countries. In the Czech Republic, it began with the restitution of Communist-confiscated property (houses, farms, and shops) to their former owners or their descendents. Small enterprises were then sold through open auctions (as opposed to auctions restricted to workers and managers). Privatization of large scale enterprises began with the conversion of 100 large trusts into 330 independent enterprises. These were then privatized through a voucher program.[6] By 1996, 75 percent of the Czech Republic's GDP was in private hands (Table 1). Poland's initial privatization strategy envisioned sales to foreign investors, IPOs on the stock exchange, and insider (management and/or worker) takeovers. But all privatizations had to be approved by the firms' managers and employees. The privatization of larger firms was therefore slow and controversial. By 1996, only 1,895 firms (out of a 1989 total of 8,853) had been privatized through these methods. Small privatizations—the sale of state-owned stores/shops and small firms to individuals or groups of private investors—proceeded relatively quickly. By the mid-late 1990s, all the economies of the Baltic and Visegrad countries were at least two-thirds privatized. Only Slovenia lagged (Freedom House 1998).[7]

Privatization had two important implications for local governments. First, it eliminated an important provider of public services. Second, it drastically altered the revenue base. Profits from local-governmentowned enterprises were no longer a source of revenue, and as central governments revised the tax structure to capture revenue from the growing private sector, the fundamental basis for tax sharing had to be altered.

6. There were two major waves of voucher privatization, the first in 1992–3 and the second in 1993–4. In each wave, each citizen received 1000 points, which could be exchanged for shares in privatized companies. Citizens were free to sell the shares they had been allocated through a special stock exchange created for this purpose.

7. Note that figures may underestimate the size of the private sector by undercounting informal economic activities.

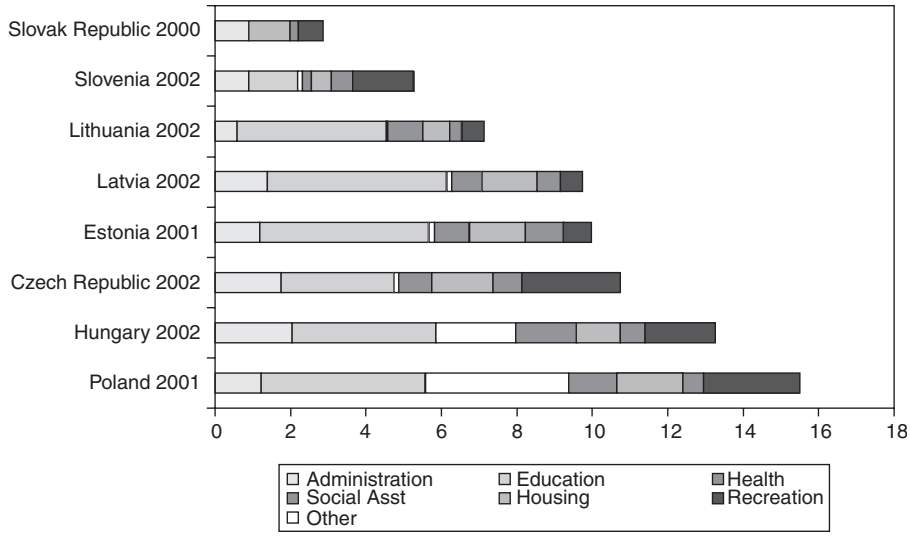
CHAPTER 5

Assignment of Functions

The new local government legislations assigned an extensive list of functions to the newly independent municipalities. In Poland, the gminy were made responsible for nurseries, kindergartens, pre-schools, primary and lower secondary education, social assistance to the elderly and handicapped, the homeless, and families in crisis, social housing, primary and preventative healthcare, theaters, museums, libraries, parks, public utilities (water, sewer, electricity, gas, central heating, telephones), waste collection and disposal, street cleaning, cemeteries, environment protection, local roads, public transportation, and so forth.[8] In Hungary, local government tasks included the provision of kindergartens, primary education, health and social provision, looking after children and youth; support of scientific and artistic activities and sports, ensuring the enforcement of the rights of national and ethnic minorities; housing management, water resources planning and drainage (of rain water), canalization and sewerage, maintenance of public cemeteries, maintenance of local public roads and public areas, local mass transit, public sanitation and ensuring the cleanliness of the settlement, and providing for local fire protection and public security. In Latvia, under the Law on Municipalities of 1994 as amended, municipalities must provide residents with access to elementary (basic) education and general secondary education, kindergartens and schools for children at pre-school

8. *Powiats* later became responsible for upper-secondary and technical education, welfare homes, social assistance for the elderly, handicapped, homeless and families in crisis, unemployment assistance, protective and curative health, public health, culture and sport, environment protection, county roads, county planning, police and fire protection, etc. *Voivodship* responsibilities include university education, welfare homes, unemployment assistance, healthcare, sports and culture, environmental protection, natural disasters, regional roads, regional planning, tourism, police, fire protection, civil defense, electoral rolls and regulations.

Figure 1. Structure of Local Government Expenditures as Shares of GDP



and school age; healthcare, social assistance to poor families and socially vulnerable persons, along with housing for orphans, the elderly and the homeless, public utilities (water and sewage, district heating, collection and transportation of household waste, collection and treatment of sewage), construction and maintenance of streets, roads and squares, street lighting and the collection and transportation of industrial wastes. They must also promote entrepreneurship within their jurisdictions, engage in unemployment reducing measures, ensure public order and combat alcoholism. This list is not exhaustive.

Education

Education is the largest single item of local government expenditure. It accounts for one-quarter to one-half of total government expenditure in the EU8 countries (Figure 1).[9] By the same token, local governments dominate the provision of education in the EU8. Local governments (including, in this case, intermediate levels of elected government) account for roughly two-thirds of total public sector spending on education in all but two of the EU8 countries (Table 2).

Municipalities do not necessarily discharge this function directly. In Hungary, for example, only about one-half of the municipalities operate their own schools. Smaller municipalities tend to discharge this function through municipal associations or by contracting with outside providers, including larger municipalities (Fiszbein 2001). In Poland,

9. The figures for Slovakia predate the decentralization of education in 2002. Figure II.2 is based on the IMF Government Finance Statistics Yearbook, 2004.

intermediate tiers of government provide the more specialized higher levels of education. *Gminas* are only responsible for operating the six-year primary schools and the first three years of secondary education. District-level governments *(powiats)* are responsible for the last three years of secondary education. In the Czech Republic similarly, municipal governments provide only primary education, with regional governments assuming responsibility for secondary schooling. Slovakia has recently followed suit (EC 2003). In Slovenia, municipalities provide primary education, with the central government providing schooling at the secondary level.

Table 2. Local Share of Total Public Education Spending

Country	%
Czech Republic (2002)	65
Estonia (2002)	67
Hungary (2002)	61
Latvia (2002)	70
Lithuania (2002)	64
Poland (2001)	72
Slovakia (2002)	27
Slovenia (2002)	21

The extent of municipal management control over education is limited. In Poland, locally-appointed school directors are theoretically free to make their own decisions about staffing levels and salaries. They are constrained, however, by legislation which sets out the framework for teachers' salaries, teaching loads, and the rules for recruitment and promotion. Rules governing the salaries of teachers, for example, are established in the Teacher's Charter and Ministry of Education regulations (Fiszbein 2001). Although a teacher may be dismissed when a school is totally or partially liquidated, gminas must provide six months severance pay and re-employ the teacher at the first opportunity. In most of the EU8 countries, collective bargaining agreements at the national level determine the extent of annual changes in teachers' wages.

Health

Local governments play a major role in managing healthcare in the EU8, but only a minor role in its financing. All of the EU8 countries now finance the majority of healthcare costs through compulsory insurance schemes. As discussed below, these are generally funded through payroll taxes (including employeecontributions), supplemented by central government budgetary contributions on behalf of pensioners and the unemployed. In most of the EU8 countries, HIFs provide funding directly to healthcare providers—primary physicians and secondary and tertiary healthcare facilities. As a result, subnational governments account for less than three percent of the total public sector health spending in the Baltics, the Czech Republic, Slovakia, and Slovenia (Table 3).

Local governments, nevertheless, continue to play a major role in healthcare management, both as employers and as owners and operators of medical facilities. Primary healthcare is typically provided through municipally owned facilities. In some cases, Lithuania for example, the staff are municipal employees. In Hungary, municipalities have the option of employing primary physicians on the municipal payroll, but can also employ them as private contractors operating in municipally owned facilities (in which case they are paid according to the number of patients registered to them). Primary doctors can also work as private providers without a municipal contract, receiving capitation payments from the HIF. In the

Table 3. Subnational Spending on Health and Social Assistance (as % of total public sector spending on these functions)

	Health	Social Assistance
Czech	2	6
Estonia	3	9
Hungary*	44	10
Latvia	3	6
Lithuania	1	9
Poland*	93	6
Slovak	0	1
Slovenia	1	1

Source: GFS . Data is for 2002 (except Poland-2001). Includes spending by intermediate tiers of elected government.
* Includes spending financed by regional health insurance funds.

Czech Republic, most family doctors take the latter option, setting themselves up in private practices, renting facilities from the municipality, and billing the health insurance funds.

In Poland, primary healthcare has, since 1972, been provided by integrated healthcare units (ZOZs). These offer primary, outpatient, and secondary (non-specialized) treatment through a network of facilities in a defined geographical area (Girouard and Imai 2000). Most are subordinate to the voivodships, although some larger municipalities operate facilities on behalf of the ZOZs in their territory. The 1994 policy document Transforming Primary HealthCare in Poland called for primary care to be separated out and become the responsibility of the gminy, and by 1998, one-third of the 3300 primary healthcare centers were administered by gminy. Since the introduction of a national health insurance system in 1999, primary care providers have been paid on the basis of a per enrollee capitation fee, although the majority continue to be public sector employees.[10]

In most of the EU8 countries, responsibility for managing secondary and tertiary care is divided between municipal governments, intermediate tiers of government, and deconcentrated units of the central government. In Lithuania, responsibility for secondary and tertiary care is shared between municipalities and counties. In general, county governments own large multi-specialist hospitals which provide secondary and tertiary inpatient and outpatient care to the acutely and chronically ill. Municipalities own polyclinics providing outpatient specialty care and dispensaries. Some municipalities also own multi-specialty hospitals providing secondary acute and chronic inpatient and outpatient care (not only to their own residents but also to residents of neighboring jurisdictions). In Poland, the majority of secondary and tertiary care is provided through the ZOZs, which (as noted earlier) are subordinated to the *voivodships*. In the Czech Republic, hospital care is largely the responsibility of the newly-created regional governments. Prior to the recent abolition of the districts (deconcentrated units of central government) larger hospitals were operated by these. Smaller hospitals (less than 200 beds), health centers and polyclinics were owned by the municipalities. After the abolition of the districts (2001) the majority of district facilities were transferred to the newly-created regions (Jaroŝ and others 2004). While the majority of funding for secondary and tertiary care is provided by the

10. The system was initially organized as sixteen separate regional funds, but in 2003, it was consolidated into a single national fund, with sixteen branches.

health insurance funds, municipalities continue to bear management responsibility for the facilities they own.

Social Assistance

In all the EU8 countries, central governments provide the vast majority of social protection. This includes old age pensions, disability pensions, sickness benefits, and short term unemployment benefits.[11] These are provided in the form of direct transfers to eligible individuals. Local governments, nevertheless, are responsible for a variety of assistance to other vulnerable segments of the population, including orphans, the homeless, those with physical or mental impairments, alcoholics, drug addicts, and particularly the longterm unemployed and their dependents.

Local governments have varying degrees of discretion in determining who is eligible for such benefits and what form they should take. In Latvia, for example, this has become increasingly circumscribed. Until 2002, the Law on Social Assistance authorized municipalities to provide a "poor family social assistance benefit" as well as a housing benefit—generally in the form of a subsidy for rent or utilities—and subsidies for food costs and medical assistance. Local governments enjoyed a high degree of autonomy in the way they administered these programs. The mayor (or in larger jurisdictions, the local social worker) had considerable discretion in determining who was eligible and often used this discretion to exclude the households they believed were "undeserving." Benefits were more often provided in kind than in cash, taking the form of vouchers for the purchase of groceries at municipal stores, free lunches for the children of poor families, or part-time home care for the elderly or disabled. In 2002/2003, Latvia consolidated the various municipal benefits into a single Guaranteed Minimum Income (GMI). GMI benefits are now provided in cash and are allocated on the basis of explicit income criteria. To guard against applicants' propensity to hide informal sources of income, the income test is supplemented by an estimate of the value of the applicants' assets.

In Lithuania, similarly, social assistance (as of legislation enacted in 2003) is provided to families (and single persons living alone) with incomes falling below a government-determined minimum income level. The benefit is equal to 90 percent of the difference between the applicant's actual income and the GMI. As in Latvia, the income test is supplemented by an estimate of assets. Although the benefit is funded from the government budget, it is administered by the municipalities, which retain some discretion over its application. Municipalities can, for example, require unemployed members of the household to participate in "socially useful activities." They can substitute in-kind benefits for cash payments, and they can reject any application that appears to be based on false or incomplete information. The new law also permits municipalities to supplement the GMI benefit with additional benefits, in cash or in kind, at their own discretion. Estonia has followed suit. Social assistance is guaranteed to persons whose income, net of housing expenses, falls below a government defined minimum level.[12] Municipalities are entitled, however, to

11. Pension systems have been partially privatized in several countries in the region.

12. In 2003, the subsistence level was 500 EEK (US$36) for the first member of the household and 400 EEK for each additional member of the household. For 2005, the benefit was increased to 750 EEK (about US$63) for the first member and EEK 600 for other family members.

refuse subsistence benefits to any "person who has without justifiable reason, turned down suitable work offers or refused to participate in training programs authorized by the municipality" (Leetmaa and Vork 2005).

Outside the Baltics, the pattern in much the same. In Poland, eligibility for social assistance is defined in income terms (although beneficiaries must also demonstrate a cause, such as mental or physical disability, alcoholism, and, increasingly, long-term unemployment.)[13] The eligibility thresholds are changed every 3 years, on the basis of recommendations from the Institute for Labor and Social Issues. In Hungary, eligibility for social support is based on the level of the old age pension. Working-age applicants must have lost at least two-thirds of their ability to work and have a monthly income of less than 80 percent of the minimum old age pension. Benefits are equal to the difference between actual income and 80 percent of the minimum pension.[14] Hungarian municipalities also provide a wide range of other forms of social assistance, including cash support to low-income families with dependent children, and medical benefits (free pharmaceuticals) and supplementary old-age pension to individuals meeting income eligibility criteria. In the Czech Republic, municipalities maintain homes for the elderly. The regional governments maintain facilities for handicapped children and adults and homes for abandoned children.

Housing and Infrastructure

With the privatization of the housing stock, municipal responsibilities for housing management and maintenance have declined sharply in the EU8 countries. Municipalities have, on the other hand, assumed responsibility for water supply, sewage, district heating, solid waste management, and third tier roads (urban streets and rural feeder roads). These do not necessarily account for a large proportion of budgetary expenditure. Water, sewage, district heating and solid waste management are generally organized as separate, tariff-supported, enterprises.[15] They do, nevertheless, constitute an important source of contingent liabilities (as these enterprises often have high levels of arrears) and a claim on scarce investment resources. Poor standards of original design and construction, high energy requirements, changing patterns of demand, and long periods of deferred maintenance have resulted in deteriorating and obsolete infrastructure networks (World Bank 1998).

Generally, EU8 governments initiated the process of water company decentralization by transferring ownership of the assets and operational responsibilities from central or regional water companies to municipal governments. Laws governing tariffs and private sector participation were enacted much later, leaving the municipalities to confront deteriorating assets, declining government subsidies, and inadequate tariffs on their own. Once the regulatory framework was in place, municipalities were free to conduct their own

13. Cash benefits are provided to single person households with income not higher than PLN 461 (US$138) monthly; and persons in families whose income per capita is not higher than PLN 316 monthly.

14. Unemployed persons whose income does not exceed 70 percent of the minimum pension are also eligible for social assistance.

15. Under GFS rules, revenues and expenditures of municipal enterprises are not recorded as budgetary expenditures, except to the extent they receive subsidies from the general budget.

reform initiatives. Some have responded by concluding operating or concession contracts with private operators (OECD 2002).

In Poland, water supply was initially the responsibility of the 49 (pre-reform) voivodships. Each was responsible for water supply and wastewater discharge and controlled domestic and industrial tariffs. Legislation in 1990 authorized municipalities to organize water companies as municipal budgetary units or as commercial enterprises.[16] Although some State-owned companies remain, the majority of utilities are now owned by the *gminy*. These are generally organized as budgetary enterprises or as commercial code companies.[17] Where a single water and wastewater utility serves multiple municipalities, municipal associations are often organized. Although legislation permits private sector participation, most municipalities retain 100 percent ownership of the utilities operating on their territory (Szulinska 2002).

A similar process of decentralization took place in the Baltics. In Lithuania, prior to 1991, potable water supply and wastewater collection and treatment were managed by a state water company operating through 14 regional companies (Pietila and Spokas 2004). After Lithuania regained its independence, responsibility for public water supply and sewage transferred from the state to municipalities. The assets and employees of the 14 regional companies were transferred to 45 newly created municipal water companies.[18] During Estonia's Soviet era, a single State Water Supply and Wastewater Board served all jurisdictions except Tallinn. In 1992, the Board was converted into a state-owned enterprise. In 1995, it was liquidated and its assets were transferred to the municipalities. Most became public-limited liability companies, wholly owned by the municipalities. The ownership of the Tallinn water company was transferred from the State to the city in 1991. In 1997 a limited liability company was formed, owned 100 percent by the city. In 2001, a majority of shares in the utility was sold to the private sector.

In Czechoslovakia, decentralization was begun under a Government Notice of 1991 and subsequent legislation in 1992. Nine State utilities (seven regional and two in the capital) were subdivided into 38 smaller state utilities (along the boundaries of district administrative units). This was followed by a complete transfer of ownership from the State to the municipalities. As no standard form of transfer was imposed, some municipalities set up independent water companies, while others formed joint companies serving several jurisdictions. The former was more common where municipalities possessed their own sources and networks; the latter, where they had supply/collection networks which crossed municipal boundaries. Private sector management is more common in the Czech Republic than in other EU8 countries. The French company Veolia, for example, operates the water supply systems serving Prague and much of northern and central Bohemia.

16. A second law (in 1996) required water companies to be organized as commercial enterprises, but has not been universally implemented.

17. In 1999, there were 740 municipal water companies in Poland. Of these, 396 were organized as budgetary units and another 344 organized as commercial enterprises.

18. The number of companies is smaller than the number of municipalities (60), because some water companies operate the water supply and sewerage systems of more than one municipality.

CHAPTER 6

Revenues

To finance these expenditures, the EU8 countries had to make fundamental changes in the revenue structures of local governments in the post-soviet period. Functional decentralization required an increase in local government revenues. Privatization changed the nature of the tax base, and changed political conditions—hostility to the former centralized model and the emergence of multiparty democracy—increased pressure for local fiscal autonomy, while raising the risk that local governments would use that autonomy to thwart central government fiscal and equity objectives.

Financing Discretionary Expenditures

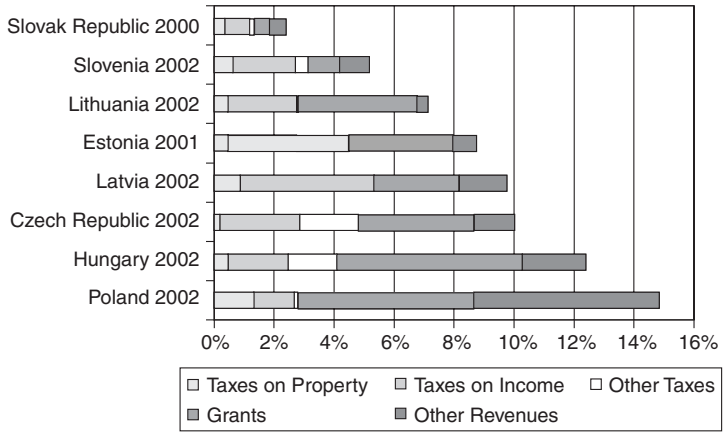
The revenues of local governments can be grouped into two main categories. The first consists of discretionary funds, largely revenue sharing (and to a small degree local tax revenues and income from fees and charges). The second is funding for specific functions, principally education and health. In most of the EU8 countries, the specific purpose of this funding is to cover the full costs of the function to which it is assigned. There are two exceptions to this: Poland and Hungary. In both cases, the level of funding for education is determined independently of the costs of this function in the expectation that any shortfall will be funded from discretionary revenues.

Revenue Sharing

The primary source of discretionary revenues in all the EU8 countries is revenue sharing. As shown in Figure 2, in all but one country, it is a share of the personal income tax (PIT).[19]

19. The exception is the Czech Republic, where the PIT, the VAT and the corporate income tax are all subject to sharing. Figure II.3 is based on the IMF Government Finance Statistics Yearbook, 2004.

Figure 2. Structure of Government Revenues as % of GDP



In all the EU8 countries, the shared taxes are administered by the central government at nationally uniform rates. Fixed shares of the revenues are then assigned to local government.

The percentage of the PIT that is shared with municipalities varies among the EU8, ranging from 30 percent in the Czech Republic and Poland to 73 percent in Latvia and 94 percent in Slovakia (Table 4). These variations are partly explained by the presence or absence of supplementary forms of central government funding. In the Czech Republic, shares of the PIT are supplemented by an equal percentage of the revenues of the corporate income tax and the value added tax. Variations are also explained by the rate of the tax and its consequent yields. Both Latvia and Slovakia impose the PIT at a relatively low, flat rate (9 percent and 19 percent, respectively.) Large shares are associated with comparatively low yields. Variations are also explained by the nature of functions to be financed from tax sharing. For example, until 2002, Lithuanian municipalities received an average of 70 percent of the PIT.[20] With the introduction of a capitation based transfer to fund teachers' salaries, that share was reduced to a uniform 43.5 percent. It has since been increased to 47.4 percent (2005).

The stability of the tax sharing arrangements varies. In Latvia and Estonia, the municipal share is fixed in the Income Tax Law and can only be changed by amendments to these laws (although this has not prevented it from changing: in Estonia, the local share fell from 100 percent in 1991–93 to 52 percent in 1995, but it has remained stable at 56 percent since 1999). In Slovakia, the percentage share is also fixed in legislation, although the formula for distributing it is, at present, determined by government resolution. In the Czech Republic, Lithuania and Hungary, the municipal share of the PIT is specified only in the annual budget law and can be changed annually.

The distribution mechanisms for the PIT include a high degree of equalization. Distributing PIT shares solely on the basis of origin would result in wide disparities in per

20. The share varied from 30 percent in the biggest cities to 100 percent in the smallest ones.

capita revenues among local jurisdictions. All the EU8 countries employ some form of equalization to reduce these variations. Three techniques are used. The first is to distribute the PIT on the basis of origin and provide additional funding to poorer jurisdictions from general central government revenues. In Estonia, for example, the local share of the PIT is distributed solely on the basis of origin. The central government then provides additional funding to poorer jurisdictions until they reach a fixed percentage of the national per capita average. In Slovenia, similarly, local governments receive 35 percent of the PIT, distributed on the basis of origin. The government then uses a complex formula to supplement the revenues of poorer jurisdictions. The fiscal equalization formula in Slovenia attempts to ensure an equal level of "relevant" spending' in all jurisdictions. In principle, 'relevant spending' is defined as the amount needed to comply with local government tasks as provided in legislation. In practice, it is a nationally uniform per capita figure fixed annually by the Parliament. To calculate the amount of subsidy to a given municipality, this figure is first multiplied by the population of the municipality and four adjustment factors (favoring municipalities with lengthy road networks, large territories, and disproportionately large numbers of children and people over 65). The expected tax revenues of the jurisdiction (including revenue from the PIT and various local taxes) are then subtracted from this figure. Municipalities whose relevant expenditures exceed their projected revenues receive a subsidy covering the difference. Municipalities whose expenditure falls below estimated revenues are allowed to keep the surplus.

Table 4. Personal Income Tax Shared with Subnational Governments (2002)

Czech Rep.	30%
Estonia	56%
Hungary	40%
Latvia	73%
Lithuania	43%
Poland	30%
Slovakia	94%
Slovenia	35%

The second technique is to distribute the PIT entirely on an origin basis and then require richer jurisdictions to share part of their PIT revenues with poorer ones. This so-called fraternal equalization method is used in Lithuania and Latvia. In Lithuania, municipalities with per capita revenues over 165 percent of the national average must transfer all of the surplus to an equalization fund. The fund is then used to bring poorer jurisdictions to 65 percent of the national average. Any funds that remain once this target is achieved are transferred to municipalities on the basis of need indicators, the most important of which is school enrollment.

Latvia uses a more complicated technique. The process begins with a calculation of expenditure needs. Aggregate expenditure needs are first calculated on the basis of total municipal expenditures in the preceding year, adjusted for inflation (the figure is further refined during negotiations with the Union of Local Governments). The projection of aggregate spending is then divided between republic cities and other local governments on a 45/55 basis. Within each of these two groups, the relative expenditure needs of each municipality are then calculated on the basis of six criteria: population; the number of children aged 0–6; the number of children aged 7–18; the population above retirement age; the number of children in orphanages; and the number of elderly in retirement homes. If a given municipality's projected revenues exceed its projected expenditure needs by more than 10 percent, the municipality is subject to a revenue cap.

Forty-five percent of the surplus is taken away and allocated to an equalization fund. If projected tax revenues are less than 90 percent of estimated expenditures needs, the gap is fully met, using proceeds from the equalization fund. Any shortfall between contributions into the equalization fund and payments out of it are to be covered by the central government.

The third technique is to distribute the PIT on a basis other than origin. The Czech Republic, for example, distributes the municipal share of the PIT (as well as the VAT and CIT) on a per capita basis, weighted to favor larger jurisdictions (a separate, more complicated, formula is used to distribute the PIT to a regional government). In Slovakia, similarly, the municipal share of the PIT is distributed on a per capita basis.

Poland uses a combination of the first and second methods. Municipalities are entitled to 27.6 percent of the PIT (powiats receive another one percent and voivodships 1.5 percent). The municipal share of the PIT is distributed on the basis of origin. Municipalities whose per capita revenues exceed 150 percent of the average are required to contribute to an equalization fund. These contributions, plus additional funding from the central budget equal to at least one percent of state budget receipts, are used to bring poorer jurisdictions up to 85 percent of the national average.[21]

Hungary uses a combination of the first and third methods. Ten percent of the PIT is distributed on an origin basis. This is subject to equalization: municipalities with per capita revenues less than 90 percent of the national average receive a supplement to bring them up to the average. The remainder of the municipalities' share of the PIT is distributed according to various "normative criteria." These include a flat Ft2 million (approximately US$10,000) for each village, with an additional US$2.20 equivalent per capita to cover "administrative, communal, and sports related tasks" and US$10.50 per resident living outside the municipal administrative area. County governments also receive a flat US$1.3 million equivalent plus US$2.85 per capita from the subnational share of the PIT, and an additional US$77 per person served at county institutions (as described later, these normative grants are partly financed by central government general revenue).

All of these approaches produce a largely similar result: the disparities that would result from distributing the PIT on the basis of origin are substantially flattened. Using general government revenues to top up the PIT receipts of poorer jurisdictions has much the same effect as requiring richer municipalities to transfer some their PIT revenues to poorer ones, or distributing the PIT on a per capita basis (the degree of flattening depends, of course, on the specific parameters of the formula). Their more important difference may lie in their differing degrees of complexity. The Lithuanian system, which targets a fixed level of equalization of a single parameter (per capita revenues) is perhaps the most straightforward. The Hungarian system, with its multivariable distribution criteria, is perhaps the most complex.

Local Taxes

None of the EU8 countries assigns a major unrestricted tax base to local government—unrestricted in the sense that municipalities have the authority to set the rate and retain

21. Revenues subject to equalization include not only the PIT but also the municipal share of the CIT (5 percent), as well as smaller locally administered taxes, whose revenues are estimated on the basis of standardized rates (OECD, 2001).

Table 5. Property Taxes (% of GDP)

EU8 Countries		Selected Western European Countries	
Czech	0.201	Denmark	1.18
Estonia	0.444	France	3.48
Hungary	0.202	Germany	0.4
Latvia	0.898	Netherlands	0.7
Lithuania	0.492	UK	1.8
Poland	1.369		
Slovakia	0.386		
Slovenia	0.001		

Source: IMF Government Finance Statistics Yearbook; Office of the Deputy Prime Minister (UK data).

the revenue. The major taxes of the EU8—the VAT, payroll taxes, excise taxes and the personal income tax—are imposed at centrally determined rates and retained or redistributed by the central government. As a result, local discretion over revenue is limited.

The most widespread form of local taxation is the property tax. All of the EU8 countries impose a property tax for the benefit of local government (Table 5). The nature of the tax base varies. Estonia taxes only land. In Poland, the real estate tax includes buildings and land (except agricultural and forest land which are subject to separate taxes). Lithuania has three forms of property taxation: one on buildings; one on leased land; and the third on land itself. The building tax is imposed only on buildings owned by enterprises. Lithuanian authorities are currently drafting plans for a residential property tax which would include both land and buildings.

Local discretion over property tax rates varies among countries. In Latvia, it is virtually nil. Local governments receive the revenue of the property tax, but the rate is fixed by the central government and the revenue is distributed on the same basis as the PIT transfer. In Poland, the Ministry of Finance sets a ceiling on the property tax rate, but local governments are free to fix the rate below that ceiling and to grant exemptions and deferments to individual taxpayers. In the Czech Republic, municipalities can set real estate tax rates within a bandwidth (0.3 percent to 4.5percent) (Oliveira and Martinez-Vazquez, 2001). In Hungary, similarly, municipalities may impose a building tax rate of up to 3 percent of market value, or a communal tax rate of up to 2 percent.[22]

Regardless of local particulars, the property tax generates very little revenue in any of the EU8 countries (Table 5). Property tax revenues are less than 0.5 percent of GDP in all the EU8 countries except Latvia and Poland. In Hungary and Slovenia, their contribution is virtually nil. Even in Poland, the property tax constitutes only 1.4 percent of GDP. To

22. The communal tax has two parts. The so-called 'communal tax on individuals' is payable by property owners, based on the floor space or market value of their property. The 'communal tax on entrepreneurs' is payable by any person who performs an economic activity in his own name, and is assessed on the basis of the number of staff. Municipalities are not permitted to impose more than one form of property tax on the same property.

some degree, this is due to technical constraints. At the beginning of the 1990s, none of the EU8 countries had a well-functioning property market. The lack of reliable market prices forced governments to value property on the basis of arbitrary point values. Land was assigned an arbitrary value per square meter depending on location, while buildings were assigned an arbitrary value per square meter according to use. These values were deliberately set low in order to avoid controversy. Valuations were also suppressed in order to avoid the particular problem involved in imposing a tax on assets that do not produce the income to pay it. In the recession that followed the Soviet collapse, the owners of privatized housing lacked incomes commensurate with the value of their newly acquired assets (Malme and Youngman, 2001).

Several of the EU8 countries have attempted to address the technical constraints. In 1993, Estonia became the first country in the region to introduce a tax-based on market value (on land only). It was followed by Latvia in 1998. Lithuania has introduced market elements in its area-based rates (on buildings and land) and has developed up-to-date land value maps in anticipation of a new Law on Land Taxation in 2005 (Malme and Youngman 2001). Slovenia, similarly, has developed a property registration system and cadastre and is preparing for the introduction of market value-based tax on real estate in 2005. Poland has been debating to shift to market-based valuation for nearly a decade, although it has not yet done so.

However, there is little evidence that shifting the basis for valuation will have a dramatic effect on revenues. International experience suggests that the constraint on property tax revenues is ultimately more political than technical (Dillinger 1995). Unlike the VAT or excise taxes, the property tax is imposed directly on the ultimate taxpayer, rather than being hidden in the form of higher prices. And unlike payroll and income taxes, it cannot be withheld at source. As a result, it tends to generate a level of political opposition that is disproportionate to its yield. Western European countries, which already value property on the basis of market prices, derive little revenue from it. The EU8 countries can expect the same.

Sector-Specific Financing

The second category of revenue consists of funding for specific services. All the EU8 countries have supplementary arrangements for financing two major items of municipal expenditure: education and health.

Education

The post-socialist-era systems of education financing reflect an ongoing tension among multiple objectives.[23] The first is to ensure a basic level of education financing in all jurisdictions, regardless of the strength of their local tax bases. Thus, all the EU8 countries finance the largest component of education—teachers' salaries—through some form of

23. See study "*Higher Education Financing: Leveling the Playing Field*" for an extensive discussion of higher education financing.

intergovernmental transfer. The second is to encourage efficiency in the use of education funding. All the EU8 countries, therefore, use some method to constrain the demand for transfers for central government support. One particular focus has been on spending on under-enrolled schools. The EU8 countries inherited an over-dimensioned system of primary and secondary education from the Soviet era. Schools were designed for an expanding population and one that was still to a large extent rural, but the number of school age children has dropped precipitously in the EU8 countries, and in rural areas more so than in urban ones. As a result, Ministries of Education confront an oversupply of school rooms and teachers. The education financing system of most EU8 countries now reflects attempts to address this problem using fiscal instruments.

At one extreme are two countries—Estonia and Slovenia—that rely solely on central government administrative procedures to ration the level of local spending on education. In Estonia, the level of funding for teachers' salaries is based on the number of teaching positions authorized by the Ministry of Education and salary levels are agreed upon during annual negotiations with the teachers' unions. The government finances these costs through earmarked transfers to the municipalities' budgets. Slovenian local governments are only slightly less constrained. Although the občine (municipalities) are the legal owners of public elementary schools, the rules of job classification, which determine the number and type of posts in a school, are subject to approval by the Minister for Education who also lays down the criteria of financing (which are applied without variations to the whole country).

At the other extreme are countries that distribute funding for education on a per pupil (capitation) basis and allow local governments considerable discretion over how these funds are used. In theory, this approach has several advantages. It ensures a minimum level of education financing in all jurisdictions while allowing the central government to ration the level of such spending through its control over the per-capita amount. At the same time, it permits local governments to find the most efficient means of providing education within this overall spending envelope. In particular, it imposes efficiency measures on jurisdictions with under-enrolled schools. Under a capitation-based formula, falling enrollment will cause a drop in school funding, forcing local government to close schools they can no longer afford.

Five of the EU8—Poland, Hungary, Lithuania, the Czech Republic and Slovakia—now employ some form of capitation-based financing for primary education. None of them employs a single, nationally uniform amount, however. In all five countries, capitation rates are adjusted to reflect ostensible differences in the costs of providing education. In Poland, for example, rural schools receive a 33 percent supplement over the basic per capita amount. Towns with populations under 5,000 receive an 18 percent supplement. [24] Hungary also supplements its standard per capita amount (equal to about US$440 per student in grades 1–8 and US$570 per student in grades 9–13) with additional funding (US$58) for primary education in villages with populations of 3,000–3,500 and those with fewer than 3,000 inhabitants (US$116).[25] In Lithuania, the capitation amount is determined according to a complex formula that differentiates among

24. To encourage gminas to hire qualified staff, the formula continues to distinguish among teachers with different levels of qualifications, based on five centrally determined pay categories.

25. The Hungarian education transfers are not intended to cover the full costs of education, nor are they earmarked for that purpose.

both school characteristics and grade levels. For students in grades 1–4, rural elementary schools receive roughly twice as much funding per student as those in municipal capitals and big cities. Schools with fewer than 150 children receive 50 percent more than those in the 150–299 student bracket and nearly twice as much as those with 300 or more students. In the Czech Republic, capitation figures distinguish among different levels and forms of education as well as among regions. Regional variations are intended to reflect variations in labor costs, and therefore favor, rather than discriminate against, Prague.

These differentials have been used, in part, to soften the impact of the switch to capitation based financing in rural areas. Additional transitional arrangements have had to be introduced in order to smooth the adjustment process. In Poland, for example, the initial weights reflected teacher characteristics so that places with unusually high wage levels did not experience extreme cuts (this provision has since been phased out). The transition legislation also specified that no gmina's subvention could be changed by more than ten percent in a given year, adjusted for inflation.

Two issues threaten the success of capitation based financing. The first is the inability of local governments to dismiss staff. While falling enrollments trigger a drop in funding, local governments often lack the legal authority or political will to make corresponding cuts in staff. In Poland, for example, school directors are, in theory, free to make their own decisions about staffing levels. However, regulations constrain dismissals: although a teacher may be dismissed when a school is totally or partially liquidated, a gmina must provide six month's severance pay and re-employ the teacher at the first opportunity. Similar constraints on downsizing exist in Lithuania and Hungary. Political constraints appear to be particularly acute in municipalities where downsizing implies the closure of entire schools. The Czech Republic has addressed this problem by assigning the authority to establish or eliminate schools to the newly created regional governments (Hendrichova and others 2001). While government funding for education is distributed among the regional governments on an (adjusted) per capita basis, each region is able to devise its own system of allocating funds to individual municipalities (EC 2002, 2003).

The second threat comes from the unwillingness or inability of central governments to increase the level of capitation transfers to reflect centrally-mandated increases in costs. The principal determinant of costs—the wage level—is largely determined by the central government in the EU8 countries. In Lithuania, the national civil service laws sets out a structure of pay scales for municipal employees, based on grade, years of employment, and—in the case of teachers—class size and number of classes taught. The pay structure is expressed as a multiple of the so-called basic wage. As a result, government changes in the basic wage trigger automatic increases in salaries. In Poland, similarly, teachers' salaries are determined on the basis of the Teacher's Charter and annual ministerial regulations on the remuneration of teachers (Fiszbein op. cit.). Legislation in some of the EU8 countries requires the government to increase capitation grants in line with annual salary adjustments. The legislation enabling Slovakia' recent shift to capitation based financing, for example, requires the capitation amount to be based on annual salary negotiations (EC, 2003). On the other hand, other countries have no provision linking education financing to increases in wages. In Poland, the level of central funding is determined as a fixed percentage (currently 12.8 percent) of the total projected government expenditure. In Hungary, the level is determined through annual adjustments in the normative grant distribution formula.

Health. The EU8 countries have also attempted to use the health financing system as a tool to achieve efficiency.[26] All eight of the EU accession countries have created health insurance funds (HIFs) to finance the majority of primary, secondary, and tertiary healthcare costs. The HIFs are funded from payroll taxes, supplemented by central government payments on behalf of certain categories of non-contributors: pensioners; workers on maternity or sick leave; and the registered unemployed.

Health funds were generally created to isolate healthcare spending from the vicissitudes of the annual government budgeting process. As such, they supply a guaranteed source of funding for health, albeit one that is subject to fluctuations in the payroll tax base and in the rate of the payroll tax. In principle, they also function as a ceiling on healthcare spending. With few exceptions, spending on primary, secondary, and tertiary healthcare is not allowed to exceed the revenues of the HIF. (Latvia is one such exception: there, the health financing system explicitly contemplates annual subsides from the central government budget).[27] In this way, the HIFs should impose a hard budget constraint on overall spending in the sector.

Attempts to use fiscal instruments to ration the supply of health services on a more micro level have had mixed results. One of the major sources of inefficiency in the socialist model of healthcare was its excessive use of secondary and tertiary facilities. Primary physicians were trained in a narrow range of fields, requiring referrals to more expensive secondary and tertiary facilities. Performance incentives were also weak, including because compensation to medical staff was not linked to the volume of services they provided.

To varying degrees the EU8 countries have addressed the excessive use of secondary and tertiary facilities by introducing the so-called family medicine model of primary care. Under this approach, patients register with an individual doctor of their choice who becomes the primary point of contact in the healthcare system. These doctors receive training in a broad range of primary healthcare fields, limiting the need for referrals. To encourage physicians to register patients, the HIFs pay providers a standard rate for each patient on their roster. To encourage physicians to actually serve these clients, they often provide additional funding on a fee-for-service basis.

Performance incentives have proven incompatible with cost containment, however, due to the tendency of providers to respond to fee-for-service forms of compensation by increasing the volume of services they ostensibly provide. Slovakia, for example, introduced a capitation based system for primary care system in 1994. To encourage performance, it replaced it with a mixed system (60 percent capitation, 40 percent fee-for-service) in the following year. The resulting explosion in the number of claims forced the government to revert to an exclusively capitation-based system in 1998. It has now reintroduced a fee-for service element but limited it to specific preventive procedures (EOHCS, 2000 and 2004).

The Czech Republic arrived at a similar system by a different route. The Czech Republic initially attempted to control primary care costs by fixing an overall spending ceiling for

26. See study *Health Care Spending: Controlling Costs and Improving Quality* for an extensive discussion of health financing issues.

27. Hungary is also an exception, although not an intentional one. In Hungary, the national health fund has been in deficit since its inception. The national government has responded by introducing an additional tax—the "hypothecated health care tax" and expanding the base and removing caps on the payroll tax.

primary care and allocating it among individual physicians on a fee for service basis. Physicians responded by inflating the number of treatments they claimed. Because the spending ceiling was fixed, more services meant smaller reimbursements per treatment. This prompted physicians to further inflate the number of treatments they claimed. The Czech Republic eventually brought an end to this vicious circle by introducing a strict capitation-based system in 1997. Under the current system, primary physicians receive a fixed amount per registered patient, differentiated by age group (0–4 year olds, for example, are worth 4.2 times as much as patients in the 20–24 year old range). Hungary, similarly, now reimburses primary care solely on a on a capitation basis, using a points system that distinguishes among patients in five different age groups. In Lithuania, the HIF reimburses health facilities on the basis of the number of patients registered with it. Each facility, in turn, is allowed to reimburse individual physicians on a fee-for-service or capitation basis.[28]

Rationing secondary and tertiary care has been even more difficult. To varying degrees, all the EU8 countries have experimented with the German points system. Under this system, each treatment eligible for reimbursement is assigned a number of points, based on its complexity and cost. A total budget (in monetary terms) for eligible healthcare is then agreed (in the German case) between individual health insurance funds and regional physicians' associations. Individual physicians report the number of points they have accumulated to the physicians association, which calculates the value of a point by dividing the agreed budget by the total number of points reported. Individual physicians are reimbursed according to the number of points they have billed and the value of an individual point. In effect, this system encourages the physicians' association to ration the supply of health services, as more points for one physician means lower reimbursements for all.

Hungary experimented with this approach during the 1990s. Between 1993 and 1997, separate points systems were introduced for outpatient services, acute inpatient services and chronic inpatient services. The amount of funding for each category of service was fixed in the yearly budget of the HIF. Points were added up nationally and the monetary value of one point was calculated by dividing the predetermined budget by the total number of points. But the Hungarian HIF proved less adept at restraining performance inflation than the German physicians associations. Claims increased and the value of a point dropped. In 2000, the HIF abandoned this approach. For outpatient care, the value of a point is now fixed in advance. To control the supply of services, fiscal penalties are imposed on individual providers. As of 2004, providers receive 100 percent reimbursements only for the level of services provided in the previous year—or more precisely, for 98 percent of that level. The excess, up to five percent, is reimbursed at 60 percent; between five and ten percent, at 30 percent; and above that level, at only ten percent. Individual providers therefore have a strong incentive to turn away patients once their quota has been filled (the HIF contracts for inpatient services on the basis of fixed numbers of beds for specific types of services).

Poland, similarly, now fixes the level of reimbursement per treatment in advance. To ration supply, the number of cases to be treated (under separate diagnostic-related groups) is also agreed in advance, and specified in the annual contracts between the sickness funds and individual healthcare providers.

28. Salaries, however, remain the predominant form of compensation.

The Czech Republic has largely abandoned the points system altogether. The Czech Republic experimented with a points system during 1993–97. A total of 4,500 distinct procedures were reimbursable, with points based on the amount of time required to carry out a given procedure. Hospitals also billed points for each day spent by patients in the hospital. Under the Czech system of regional sickness funds, each fund calculated the value of a point separately, by dividing its revenues from contributions by the total number of points billed to it. But, as in Hungary, the volume of claims exploded. In 1997, the Ministry of Health published a new list of procedures with new point numbers. This met with criticism both from providers, who believed that the new point numbers were insufficient to cover the costs of services, and from insurers, who argued that their revenues from contributions would be insufficient to pay the providers even the stipulated amounts. The points system was therefore largely abandoned. Sickness funds now reimburse individual hospitals on the basis of aggregate budgets, which are largely based on expenditure in the preceding year. The points system is merely used to determine whether each hospital has delivered an equivalent volume of services.

CHAPTER 7

Debt Controls

At the beginning of the nineties, many of the EU8 countries (Hungary, Latvia, Slovakia, and Slovenia) permitted local governments to operate freely in the capital markets. Lacking experience in the preparation of bankable projects (and having a weakness for high-risk profit making ventures) many later defaulted. To prevent excessive borrowing in the future, most of the EU8 countries have introduced various forms of debt controls.

Ex-ante Quantitative Restrictions

The majority of EU8 countries impose some form of ex ante quantitative ceiling on municipal borrowing (Table 6). Estonia, Lithuania, Poland, Slovakia and Slovenia all place ceilings on the stock of debt as a percent of recurrent revenues (including revenue sharing): Estonia, Poland, and Slovakia set the ceiling at 60 percent; in Lithuania, the ceiling is 35 percent (except for the two major cities of Vilnius Kaunas, where the ceiling is higher); and in Slovenia the ceiling is ten percent. To assist in complying with Maastricht provisions, Poland also links growth in the stock of municipal debt to ceilings on the stock of debt in the public sector as a whole. Once the consolidated public debt exceeds 50 percent of GDP, growth in the stock of municipal debt cannot exceed the central government's planned deficit, expressed as a percent of revenue. Local borrowing is entirely forbidden if the aggregate stock of public sector debt exceeds 60 percent of GDP.

The majority of EU8 countries also impose ceilings on debt service as a percent of recurrent revenues. These range from 10 percent (Slovenia) to 25 percent (Slovakia). Hungary also imposes a ceiling on debt service: there, the denominator excludes revenue sharing, and debt service is limited to 70 percent of own source revenues.

Table 6. Summary of Municipal Debt Regulations

Country	Limitation on Stock of Debt (Limits on Total Outstanding Debt)	Limitation on Flow of Debt (Limits on Debt Service Payments)	Requirement for Higher Administrative Body's Permission to Borrow	Requirement to use Long Term Borrowing only for Capital Investments	Municipal Insolvency Procedures
Czech Republic	No	No	No	No	No
Hungary	No	70% of the local governments' own-source revenues	No	Yes	Yes
Estonia	60 % of planned recurrent revenues, excluding earmarked grants	20% of the recurrent planned revenues, excluding earmarked grants	No	Yes	No, but under consideration
Latvia	No	No	Yes	Yes	Yes
Lithuania	35% (for Vilnius and Kaunas 50%) of the recurrent revenues, excluding earmarked grants and short term loans.	20% of the recurrent revenues, excluding earmarked grants and short term loans.	Yes, if above the set limits	Yes	No
Poland	60% of recurrent revenues.*	15% of the recurrent revenues	Yes, unless loan is obtained from the bank that holds the municipality's major account.	No	No
Slovakia	60% of the previous year's recurrent revenues	25% of the previous year's recurrent revenues	Yes, if above the set annual limit	Yes	Yes
Slovenia	10% of the previous year's recurrent revenues	10% of the previous year's recurrent revenues	Yes	Yes	No

* also subject to Maastricht ceilings.

Source: Local Government and Public Service Reform Initiative. 2004. Local Government Borrowing: Risks and Rewards; and country sources.

Ex Ante Administrative Controls

Several of the EU8 countries also impose case by case administrative controls on local borrowing. In Slovenia and Latvia, local governments are eligible to borrow only after receiving permission from the Ministry of Finance and the Local Government Borrowing and Guarantees Board, respectively. In Lithuania and the Slovak Republic such permission is required if the proposed debt would exceed the quantitative ceilings. In Poland, local government borrowing must be approved by the Regional Accounting Office, unless loans are taken from the bank where the local government holds its main account.

Restrictions of Certain Forms of Debt

Several of the EU8 countries restrict certain forms of borrowing. In Poland and Slovenia, for example, local governments are not permitted to borrow externally. In all but two of the countries, legislation explicitly requires that long term loans be used for capital investment financing. In Estonia, local governments are allowed to take long term loans only for those capital investment projects which are included in the Local Development Plan.[29]

Bankruptcy

To discourage excessive local government borrowing, EU8 countries do not rely on ex ante controls alone. Several of them impose penalties on municipalities that fail to meet their debt obligations. These include the loss of budget autonomy, the forced sale of assets, and the dismissal of the local council. In principle, this should discourage other municipalities from following suit in the future.

Three of the EU8 countries—Hungary, Latvia, and Slovakia—currently have municipal bankruptcy laws governing such circumstances. Hungary relies on the court system to administer bankruptcy proceedings (Box 3). Remedies available to the court include the sale of assets and (with the concurrence of Parliament) the dismissal of the council, and the calling of new elections. In Latvia, the process is overseen by the Ministry of Finance, which appoints a financial supervisor to assist the municipality to prepare a stabilization plan, specifying budget cuts and refinancing needs. If the municipality fails to agree on a plan, the Cabinet of Ministers has the right to impose one. At the request of the Minister of Finance, the supervisor can also control all municipal expenditures and sign the municipality's payment orders.

Slovakia, similarly, relies on the Finance Ministry to oversee bankruptcy procedures. Under the Slovak regime, local governments are obliged to introduce a recovery regime once any financial obligation falls more than 60 days overdue. Municipalities have 120 days

29. Local governments are not allowed to borrow in foreign currency in Poland. However, there is a Ministry of Finance Ordinance that determines that loans in another currency maybe incurred if they are issued by multilateral financial institutions or have an investment grade rating by an international rating agency.

Box 3: Hungary's Municipal Bankruptcy Procedure

Under the terms of Hungary's local insolvency law, bankruptcy proceedings can be initiated—by a creditor or by the local government itself—when a debt is 60 or more days overdue. Cases are submitted to a court, which, after examination, can either order the start of debt settlement procedures and designate a financial trustee, or decline the debt settlement procedure if it determines that the local government can meet its obligations from existing cash flows and assets. Once a bankruptcy case has been approved by the court, the local government has fifteen days to appoint a "crisis committee" and 30 days to prepare an emergency budget (by law, the budget may only finance priority functions as specified in legislation). During this period, the court-appointed financial trustee must endorse all invoices prior to payment made by the municipality. The municipality and the creditor have 210 days, once the bankruptcy procedure begins, to agree on a mutually acceptable resolution of the debt. If this deadline is not met, the court-appointed trustee prepares an asset and debt adjustment plan. On this basis the court can proceed to auction the local government's assets. The court may also request Parliament to dissolve the local government and call for new elections. Criminal and civil proceedings can also be initiated.

The law has a successful record of implementation, although it has been used sparingly. Since 1996, there have been eleven municipal bankruptcy cases approved by court decision in Hungary. Nine cases resulted in a voluntary debt settlement agreement between the parties. In two cases the courts had to liquidate assets and liabilities based on the recommendations of the trustee.

to demonstrate an improvement in their financial condition. If they fail to meet this deadline, the Ministry of Finance has the authority to impose forced administration, which includes the authority to approve all financial transactions of the municipality and to request the local government to adopt measures to increase revenues or decrease expenditures. If the municipality fails to do so, the administration may impose such measures unilaterally.

To date, these measures have been used sparingly. As noted in Box 3, there have been only eleven municipal bankruptcy bases submitted to the courts in Hungary, and in Latvia seventeen municipalities have been subjected to the financial stabilization process.

CHAPTER 8

Directions for Further Reform

Over the long term, the sustainability of all eight of these intergovernmental fiscal arrangements depends upon the ability of central governments to keep their agreements with local governments. In monopolizing the major sources of tax revenues, central governments have arrogated to themselves the power to decide how large a share of total public sector revenues local governments should receive, and where it should be spent. In the process, they have made themselves vulnerable to the claim that the level of funding which they have provided to local governments is insufficient.

In the case of sector specific financing, this has one clear implication. When the central government increases the costs of providing the service, it must increase the level of financing. Thus (as noted earlier) centrally-negotiated increases in teachers wages must be matched by an increase in capitation grants.

The implications for funding discretionary expenditures are less clear. In the absence of a central government mandate, local governments are under no obligation to provide a specific level or mix of discretionary services. Thus, in principle, they are in no position to claim that they are underfunded. At present, the level of discretionary funding—the percentage of the PIT to be shared with local governments—is determined through annual negotiations between the central government and associations representing local governments. Such negotiations could easily break down.

Experience in Western Europe suggests that there are two solutions to this problem. The first is to rely on increasingly sophisticated estimates of the costs of providing the services on the discretionary list—in effect, to treat discretionary services as if they were mandatory. The British have perhaps the most elaborately developed version of this approach (Box 4). It is echoed in Latvia's intergovernmental transfer formula, which distinguishes the costs of a variety of specific services, as well as the revenue potential of individual jurisdictions.

Box 4: Calculating the Formula Grant in England and Wales

Like their counterparts on the European continent, British local governments have limited taxing authority. They are confined to a property tax, which itself is limited to residential properties. The majority of local revenues are therefore derived from intergovernmental transfers, the most important of which is a so-called formula grant. In principle, the formula grant is calculated on the basis of revenue gaps. Expenditure needs are first calculated on the basis of national norms for education (preschool, primary, secondary, and adult education), social services, police, fire, highways, environment, and "capital finance" (the norms are based on biennial spending reviews and annual negotiations with the local government association). The norms are then adjusted according to the characteristics of individual jurisdictions—high poverty levels, high prevailing wages, and low population density all result in higher figures—yielding an estimate of each jurisdiction's expenditure needs. Estimated revenues from the residential property tax are then subtracted from this figure, yielding an estimate of each jurisdiction's revenue gap (to avoid discouraging tax effort, the revenue estimates are based on the average national rate rather than the rate actually imposed in each jurisdiction). The central government is under no obligation to fully fill these gaps, however. The level of Government spending on the formula grant is determined in the course of annual budget preparation. As the allocation normally falls short of the aggregate revenue gap, available resources are rationed by fixing a cap on the percentage increase allocated to any one jurisdiction.

Source: Local Government Association (2005) *RSG Settlement 2004/05: a Guide.*

The alternative would be to reduce the central governments' role in financing discretionary expenditures and allow the local governments to decide for themselves on the appropriate level of spending, on the basis of their constituents' willingness to pay. This would require the assignment of a broad based tax to the local level.[30] The PIT is an obvious candidate. This approach has been attempted in some Scandinavian countries. Danish local governments, for example, are permitted to impose a surcharge on the national personal income tax at a locally-determined rate (the rate must be flat, rather than progressive). In 2004, the combined county and local tax rate ranged from 28.5–35.6 percent, with an average of 32.6 percent.[31]

The possibility of a Scandinavian-style PIT surcharge has been discussed in a number of EU8 countries, including Hungary, Poland, and Slovakia. It is also cited in the European Charter of Local Self-Government and actively promoted by the Council of Europe. However, it has few supporters among the EU8. At present, central governments prefer to retain near-total control over tax policy, and local governments prefer to avoid the onus of taxation.

30. The incidence of such a tax would have to be limited to the local jurisdiction, in order to prevent local governments from "exporting" the burden of their expenditures onto other jurisdictions.

31. The Danish system, nevertheless, includes a revenue equalization feature, based on the fraternal equalization principle.

CHAPTER 9

Conclusions

Measured against the four criteria defined at the beginning of this paper, the EU8 countries have made substantial progress in the reform of intergovernmental relations.

Transparency and Stability

The allocation of central government budget resources to local governments is no longer a matter of closed-door negotiations within a Party hierarchy. The major source of discretionary expenditure financing—revenue sharing—is determined as a fixed share of specified taxes, distributed according to formulas. Education financing, similarly, is also largely formula based (except in Estonia and Slovenia, where the central government determines the funding directly). Primary healthcare is financed on a capitation basis in most of the EU8 countries.

Some of the EU8 countries perform better against the transparency and stability criterion than others. Hungary's structure is perhaps the most problematic of the eight. As noted earlier, while some discretionary funding is provided from a fixed share of the personal income tax, the majority is funded from annual appropriations from general government revenues, raising uncertainty about the annual level of funding. These funds, moreover, are distributed on the basis of over forty variables, undermining its transparency. In this respect, Hungary would benefit from the examples of the Czech Republic or Slovakia, both of which determine the aggregate amount of revenue sharing on the basis of fixed shares of specified taxes, and distribute the funds on a per capita basis.

Equity

The EU8 countries also manage to achieve a high degree of redistribution in the financing of social services. Primary and secondary education is financed from central government revenues with funds distributed on the basis of enrollment. Primary healthcare, similarly, is financed from pooled funds (in this case, HIF contributions) and distributed on a per-patient basis. Social assistance is an exception. Unlike education or health, social assistance is financed from the discretionary revenues in most of the EU8 countries.[32] But discretionary funding is, itself, highly equalized. Through the various combinations of fraternal equalization schemes, top-ups, and equalizing distributional formulas, all eight countries substantially reduce the disparities that would arise from distributing discretionary funding on the basis of origin. This permits poorer jurisdictions to spend more on social assistance than would otherwise be the case. In fact it could be argued that discretionary funding is over-equalized. While there is a strong case for equalizing spending on social assistance, the case for equalizing spending on other functions financed from discretionary revenues—road maintenance, community amenities, or general administration—is not as strong.

Macroeconomic Control

All the EU8 systems are highly effective in asserting central control over tax policy. As in the rest of the EU, the vast majority of subnational revenues is derived from intergovernmental transfers. A local government's tax authority is largely limited to the highly sensitive property tax. Local discretion over property tax rates is limited by rate caps. All except the Czech Republic also impose some form of control over municipal debt.

Effectiveness

Attempts to use the system of intergovernmental relations to encourage greater efficiency in the production of public services have been less successful. While the majority of the EU8 countries now finance education on a capitation basis, this has not been sufficient to prompt the closure of under-enrolled classrooms or schools. In the health sector, efforts to encourage primary providers to increase the volume of services they provide have been thwarted by over-billing. Efforts to ration secondary and tertiary care using variants of the German points system have run aground for similar reasons.

Overall, the EU8 countries have made remarkable progress in reforming their systems of intergovernmental fiscal relations. The eight countries now have much more in common with the longerstanding members of the Union than they do with the socialist-era systems they inherited. However, the process is not completed. In the same way that Western European countries continue to adjust their systems to reflect ongoing changes in political and economic circumstances, the countries of the EU8 are likely to continue to adjust their systems for a long time to come.

32. Lithuania and Estonia are exceptions. In both cases, social assistance is funded directly by the central government.

References

Barbone, Luca, and J. Hicks. 1995. "Local and Intergovernmental Finances in Poland: an Evolving Agenda." In Bird, Richard, and Wallich, *Decentralization of the Socialist State.*

Beksta, Aruna, and A. Petkevicius. 2000. "Local Government in Lithuania." In Tomas Horvath, ed., *Decentralization, Experiments and Reforms.*

Berkowitz, Daniel, and B. Mitchneck. 1992. "Fiscal Decentralization in the Soviet Economy." *Comparative Economic Studies 34.*

Dillinger, William. 1995. "Urban Property Tax Reform: Guidelines and Recommendations."

Ebel, Robert, and others. 2000. "Sorting out Government Roles and Responsibilities in the Hungarian Transition." World Bank Institute Working Papers # 21025.

European Commission. 2002. "The Education System in the Czech Republic 2001/2002." Eurydice Education Data Base.

———. 2003a. "Structure of Education, Vocational Training and Adult Education Systems in Europe: Czech Republic." Eurydice Education Data Base.

———. 2003b "The Education System in Slovakia 2001/2002." Eurydice Education Data Base.

European Observatory on Health Care Systems. 2000a. "Health Care Systems in Transition: Lithuania."

———. 2000b. "Health Care Systems in Transition: Czech Republic."

———. 2004a. "Health Care Systems in Transition: Slovakia."

———. 2004b. "Health Care Systems in Transition: Hungary."

Fiszbein, Ariel. 2001. "Decentralizing Education in Transitional Societies." In T. Levitas and J. Herczynski, *Decentralization, Local Governments, and Education Reform in Post-communist Poland.* Washington, D.C.: The World Bank.

Freedom House. 1998. "Nations in Transit."

Girouard, Nathalie, and Y. Imai. 2000. "The Health Care System in Poland." OECD Economics Department Working Paper No. 257.

Hegedus, Jozsef. 2002. "Decentralization and Structural Adjustment in Hungary."

Hendrichova, Jana, and others. 2001. "Czech Republic." In T. Levitas and J. Herczynski, *Decentralization, Local Governments, and Education Reform in Post-communist Poland.* Washington, D.C.: The World Bank.

IMF. 2004. *Government Financme Statistics Yearbook*.

Jaroš, Jan, and others. 2004. *Decentralization and Governance of Healthcare in the Czech Republic in the 1990s*. LGI.

Youngman, Joan, and J. Malme. 2004. *The Property Tax in a New Environment: Lessons from International Tax Reform Effort*. Lincoln Land Institute.

Leetmaa, Reelika, and A. Vork. 2005. *Social Insurance and Social Assistance in Estonia*.

Maeltsemees, Sulvlev. 2000. "Local Government in Estonia." In Tomas Horvath, ed., *Decentralization, Experiments and Reforms.*

Malme, Jane, and J. Youngman. 2001. *The Development of Property Taxation in Economies in Transition*. World Bank Institute.

OECD. 2001a. "Fiscal Design Across Levels of Government." Hungary Country Report.

———. 2001b. "Fiscal Design Across levels of Government." Poland Country Report.

OECD/DANCEE PROGRAMME. 2002. *Models of Water Utility Reform in the Central and Eastern European Countries*.

Oliveira, Joao, and Martinez-Vazquez. 2001. "Czech Republic: Intergovernmental Fiscal Relations in the Transition."

Open Society Institute. 2002. "Local Government and Public Service Reform Initiative and Energy Regulators Regional Association." Training Material No. 1 Sector Background.

Pietila, Pekka, and R. Spokas. 2004. "Comparison of Water Services Development in Finland and Lithuania." In European Water Association: European Water Management Online.

Regulski, Jerzy, and W. Kocan. 1994. "From Communism toward Democracy: Local Government Reform in Poland." In Robert Bennett, ed. *Local Government and Market Decentralization: Experiences in the Industrial Developing and Former Eastern Bloc Countries*.

Regulski, Jerzy. 2003. "Local Government Reform in Poland, an Insiders' Story." In Open Society Institute, *Local Government and Public Service Reform Initiative*.

Szulinska, Justyna. 2002. "Water Supply Systems in Poland—The Safety Aspects."

World Bank. 1998. "Living by Serving: Infrastructure Sector Strategy."

———. 2002. "Lithuania: Issues in Municipal Finance."

———. 2003a. "Latvia: Beyond Territorial Reform."

———. 2003b. "Poland: Toward a Fiscal Framework for Growth—A Public Expenditure and Institutional Review."

———. 2004 "Implementation Completion Report, Latvia Welfare Reform Project."

Zickel, Raymond. 1991. *The Soviet Union: A Country Study*.

Eco-Audit

Environmental Benefits Statement

The World Bank is committed to preserving Endangered Forests and natural resources. We print World Bank Working Papers and Country Studies on 100 percent postconsumer recycled paper, processed chlorine free. The World Bank has formally agreed to follow the recommended standards for paper usage set by Green Press Initiative—a nonprofit program supporting publishers in using fiber that is not sourced from Endangered Forests. For more information, visit www.greenpressinitiative.org.

In 2006, the printing of these books on recycled paper saved the following:

Trees*	Solid Waste	Water	Net Greenhouse Gases	Total Energy
203	9,544	73,944	17,498	141 mil.
*40' in height and 6–8" in diameter	Pounds	Gallons	Pounds Co_2 Equivalent	BTUs

green press INITIATIVE

Intergovernmental Fiscal Relations in the New EU Member States is part of the World Bank Working Paper series. These papers are published to communicate the results of the Bank's ongoing research and to stimulate public discussion.

This paper evaluates reforms in the structure of intergovernmental relations in Eastern Europe since the breakup of the Soviet Union, focusing on eight recent EU accession countries: the Czech Republic, Estonia, Hungary Latvia, Lithuania, Poland, Slovakia, and Slovenia. It reviews each country's response to the economic and political upheavals of the immediate post-Soviet era and their gradual convergence on a common "eastern European model" of intergovernmental relations.

World Bank Working Papers are available individually or on standing order. Also available online through the World Bank e-Library (www.worldbank.org/elibrary).

ISBN 978-0-8213-7147-3

THE WORLD BANK
1818 H Street, NW
Washington, DC 20433 USA
Telephone: 202 473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org