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INTERGOVERNMENTAL FISCAL RELATIONS. THEORETICAL ASPECTS AND POLAND'S EXPERIENCE

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Abstract The distribution of public revenues is one of the fundamental elements in the shaping of the system of public finance in any country. The process is difficult from both the political and economic points of view. Also the objective conditions make the ideal distribution impossible and any solution results in a greater or lesser fiscal imbalance. An attempt to solve the problems of vertical and horizontal fiscal imbalance and consequences of a greater contribution of territorial self-government tasks and finance leads to complex fiscal relations between the state and the territorial self-government. The aim of this paper is to point out the basic characteristics of the financing system of the local government and the areas of fiscal relations between the national and local government in Poland against the traditional principles of fiscal federalism. Statistical measures of financial independence of territorial self-government entities and their restrictions have also been presented here. The paper ends with conclusions which synthetically present the current problems in fiscal relations in Poland and conclusions de lege ferenda.

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INTRODUCTION

For many decades fiscal relations between different levels of public government have been a pillar of the theory of fiscal federalism (Musgrave, 1959; Musgrave & Musgrave, 1973; Atkinson & Stiglitz, 1980; Oates, 1972, 1999). The theory emerged in federal states but for some time now, due to the ongoing decentralization processes, it has been employed in public finance analyses in unitary countries as well. The notion of “federalism” and a clear distinction between the federal and unitary structure of the state has a fundamental importance in political sciences. From the economic point of view, however, a vast majority of public finance systems are of federal nature (decentralized) as they are based on several tiers of government that provides public service. The

sub-national levels are comprised of territorial self-government which constitutionally enjoys certain autonomy and financial independence. Stiglitz (2000) contributed largely to the debate on fiscal policy in federal systems, particularly in the context of redistribution, market efficiency and unreliability. In central-local government relations, the focal points of interest are the distribution of tax revenues, transfers from the state budget and the level of local government debt, specifically their inevitability and manifold economic and social consequences. The aim of this paper is to assess the Polish system of financing the territorial self-government from the point of view of its financial independence and fiscal relations with the central government. The most disputable and problematic areas of central-local government relations in Poland will be presented.

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DISTRIBUTION OF PUBLIC REVENUE AND FISCAL IMBALANCE

The distribution of public revenue between the central and local government is one of the major aspects shaping the public finance system. The vertical distribution of public revenue between local entities is of fundamental importance. It dominates the horizontal distribution which usually plays a complementary role.

In the theory of fiscal federalism vertical distribution refers first of all to taxes and quasi-tax charges and governs their allocation to the state and other public legal entities of higher and lower levels. Individual taxes which exist in a given system of revenue should be distributed between the state, municipalities and other territorial self-government entities which belong to the vertical organizational structure according to the tasks assigned to these communities (Tiebout, 1956).

Similar aspects have been raised by other authors who emphasize the fact that the distribution should be closely related to the allocation of tasks across the tiers of public government, and that taxes should be allocated to individual territorial communities in accordance with their structure and economic consequences (Musgrave & Musgrave 1973, p. 519). All territorial self-government entities, from the lowest to the highest level, should have their own revenue i.e. revenues allocated to them by virtue of law which add directly to their budget, and whose selected structural elements can be shaped by the entity. Pursuant to the Constitution and Acts of Law, these are usually tax revenues but also different revenues in the form of fees, subsidies, subventions and contributions (Borodo, 1997, p. 19-26). Therefore, the vertical distribution of public revenue reflects, to some extent, the scope of decentralization of public tasks and finance (Spahn, 1993, p.71) as it depends on the distribution of functions between the levels of public government (Hockley, 1970, p. 293). The revenues allocated to a given level of government should allow it to finance the public tasks imposed on it, which means that they should be adequate to the allocated tasks. The origin of territorial self-government necessitates the allocation of proper financial means. The principle of adequate means for tasks is, in theory, alongside the subsidiarity principle, the basis for the correct structuring of sources of local government budget revenue. The principles result in the fundamental tenet which says that any increase in

local government competences should be correlated with a distribution of increased public financial means for their implementation.

Transfer of tasks and competences to local communities without providing proper sources of revenue is against the idea and role of territorial self-government. Transfer of financial means and property without the right to decide on these resources should be assessed similarly. Currently the capacity to incur debt on the financial market is an important, though strictly limited, element of local government financial independence (Dafflon, ed., 2002).

In practice, there is often a disparity between the sources of revenue and the necessary expenditure which results from the assigned tasks. The local government units of a given level can, more easily than others, finance their tasks from their own revenue allocated to them. The imbalance of revenue and expenditure between the individual levels of public government is called a problem of inadequacy or vertical fiscal imbalance (Herber, 1979, p. 329). The imbalance usually results from the distribution of tax revenues between the national and local government. The most efficient fiscal taxes such as income tax and sales tax as a rule add to the state budget whereas less efficient fiscal revenues such as property tax go to local budgets. Moreover, it is the state's almost sole competence to pass the tax laws and regulations. The system of tax competition as a form of the distribution of tax revenues can only be observed in countries of federal structure. However, even in these countries the system does not function in its pure form.

Horizontal fiscal imbalance occurs between the territorial self-government entities of the same level and it is connected with the problem of equalization. Individual local government entities differ in the level of economic and social development, wealth of local community, natural resources in the area, industries, etc. Therefore, the indices of own revenue per capita in different entities of territorial self-government may vary extensively. The second, complementary distribution of revenue is carried out between the entities at the same level of territorial structure of government. Such redistribution can take different forms and scope. One of them involves wealthier local government entities transferring part of their own revenues to poorer entities. Also the horizontal distribution of revenue appears in situations where a union of several municipalities allocates the part of expenditure which is not balanced by their own

revenue to the member communities in the union. In such a case different solutions are applicable. The burden for individual entities of territorial self-government may be the same or diversified. The diversified burden may be calculated according to own financial potential (own revenue per capita) or the scope of service provided by the communal union for an individual community. In practice, supplementation of revenues for financially weaker entities requires subventions and subsidies from the state budget. General-purpose and specific-purpose transfers are used most frequently. The structure of general subsidies is of performance-based or equalizing character whereas appropriated allocations are to cover specific, strictly defined costs.

To sum up, vertical fiscal imbalance results in the problem of inadequacy whereas horizontal fiscal imbalance leads to the necessity of financial equalization.

BASIC AREAS OF FISCAL RELATIONS BETWEEN THE NATIONAL AND LOCAL GOVERNMENT

Fiscal relations between the individual levels of public government can be defined as a system of solutions and financial relations that caters for the needs and implementation of public services, which are organized and financed at the level proper for their scope and nature. In this approach, fiscal relations also include the mechanisms of negotiations of competences, responsibilities and fiscal power, which result in a certain amount of local government financial independence. The pillars of the enumerated areas and the fundamental principles of fiscal relations are usually enshrined in constitutions. However, volatile conditions raise many current, operational questions and arguments which must be addressed. It is often emphasized in the theory of public finance that derives from the tradition of unitary states that the state (state government) is the sovereign in the system of public government and that the independence of the territorial self-government is not unlimited. The fiscal federalism theory draws on the natural right of the territorial communities, other than the state, to independence and autonomy. In this approach authority is passed, as if, from down up. In the traditional approach, the following can be listed among the basic areas of fiscal relations in both of the trends:

- 1) distribution of tax revenues between the national and local government,

- 2) the scope of taxing power and influence on the structure of revenues allocated by acts of law,
- 3) the principles and scope of transfers from the state budget to territorial self-government budgets,
- 4) the principles and scope of financial equalization,
- 5) independence in budget spending,
- 6) capacity to incur debt and limitations in this area.

A vast range of problems in these areas spawn abundant, diversified research in the field of fiscal relations across different levels of public government. The subjects of research most often include either general tendencies in larger groups, categories of countries (Joumard & Kongsrud, 2003; OECD 2007, 2010; Mello Jr, 2000) or systems shaped in individual countries (Laubach, 2005; IEB, 2011).

The main and common challenge of highly developed economies is to ensure the administrative and allocative efficiency in the public sector (OECD, 2003). Despite its benefits, decentralization has not been implemented evenly over the last decades and now the relations between the national government and the territorial self-government remain highly heterogenic in the OECD countries. One of the causes can be traced back to, among others, the difficulties in redistribution policy and the consequences of decentralization in the form of losses in budget policy efficiency. The importance of objectives of general state policy, including redistribution policy, may vary considerably between countries. This is due to the accepted and implemented social and economic doctrine as well as more objective factors such as regional inequalities and their consequences in the form of external effects.

The most important questions concerning fiscal relations between national and local government, emerging from the OECD study, are grouped by Joumard and Kongsrud (2003) into three areas:

- 1) on the spending side, as to how sub-national government can tailor the supply of public goods, which may have different constituencies, to local preferences while ensuring efficient provision and the fulfillment of distributional objectives
- 2) on the revenue side, as to how financing schemes for sub-national government should be designed so as to allow them to respond to local preferences without creating efficiency concerns and compromising distributional objectives nationwide
- 3) from a macroeconomic perspective, as to how sufficient co-ordination across government levels can be engineered, using fiscal rules, co-operation

arrangements or market forces, so as to ensure compatibility with national fiscal targets (p. 156-157)

The three areas were somehow verified after 2008 by the consequences of the global crisis which limited public revenues in many countries. Poland has not been influenced much by the consequences of the crisis due to the relatively limited openness of the economy and poor internationalization of the financial system. However, the economic slowdown revealed complications in fiscal relations between the national and local government. They can be defined by two basic problems. The first one is the problem of inadequacy which means inadequate revenues of the territorial self-government in relation to the transferred tasks. The second problem is the macroeconomic coordination of fiscal rules, i.e. the necessity of limiting the public debt, part of which is the local government debt.

SOURCES OF FINANCING TERRITORIAL SELF-GOVERNMENT ENTITIES IN POLAND

At present the territorial self-government in Poland has a three-tier structure which comprises municipalities (gminy), counties (powiaty) and regions (województwa). They have been shaped as

a result of decentralization that has been going on for over 20 years. In its major part, the system of financing the territorial self-government is based on the Act of 13 November 2003 on the Revenues of Local Government Units. The principles of financial economy are regulated by the Act of 27 August 2009 on Public Finance whereas the structure of taxes and local charges are regulated by several separate Acts of Law. In short, the system of local government finance has some characteristic features.

As a result of the vertical distribution of tax revenues, relatively less efficient taxes were allocated to municipalities: property tax, tax on agriculture and forest, tax on vehicles, tax on civil law activities, tax on legacies and donations, lump sum tax in the form of the so-called tax chart. Property tax plays the key budget role. Supramunicipal local government units (counties and regions) do not have typical local taxes allocated to them.

Common taxes were used in the vertical distribution of revenues: personal income tax and corporate income tax. As a result, shares of the local government across all the tiers in PIT and CIT play an important role. In counties and regions share in income taxes is the basic source of own revenues. The amount of this share in 2011 is presented in *Table 1*.

Table 1: Share in PIT and CIT in 2011

Type of share (in %)	Municipalities	Counties	Regions	Total
Share in PIT	37.12	10.25	1.60	48.97
Share in CIT	6.71	1.40	14.75	22.86

Source: State Budget Report for the period between 1 January and 31 December 2011. Local Government Units Budget Report, Council of Ministers, Warsaw 2012, p. 5-6

In such a situation, the financial independence of the territorial self-government entities differs substantially across the tiers. County towns and municipalities enjoy the highest amount of financial independence. In 2011 in these units, the share of own revenues in total revenues was 59.7% and 45.5% respectively. Warsaw, the capital city, had an exceptional share of 77.4%. Counties, however, enjoy very limited economic independence as the own-revenue share in total revenues amounted to 28% in 2011. The index looks better in the case of regions –

44.4% (Regional Accounting Chambers, 2012). It is worth remembering, though, that the share in PIT and CIT is included in own revenues.

Transfers from the central budget are an important source of revenue for all the levels of local government. General subsidy is of major importance whereas appropriated allocations for the assigned tasks play a lesser role. General subsidy consists of three parts: equalizing, compensatory and educational, and in the case of regions: equalizing, regional and educational.

The calculation of the subsidies is highly complex, which blurs the expected functions they are to play. In 2011 the share of general subsidy in total revenues in municipalities amounted to 30.7%, in counties to 42.9% and in regions to 16.6%. The performance part, that is the educational part, dominates the general subsidy. The equalizing part aims at the equalization of revenues and comprises elements of horizontal redistribution. The scope of equalization is a source of controversy as the units where the tax revenues are higher than 150% of state average contribute disproportionately to the amount of their current revenue. The mechanism is rendered unfair as the data for calculations are 2 years old.

In the field of local government debt, the Act of 2009 on Public Finance introduced new regulations which limit the level of such debt. They will fully take effect in 2014. On the one hand, this is the result of

a tendency to set individual, not uniform, limits for local government debt. On the other hand, this is the consequence of a dynamic increase in debt in the local government sector. The increase in debt is connected with the implementation of the EU funds. It allowed for an improvement in the structure of expenditure towards investment expenditures (pro-development). From the point of view of the Finance Minister, the rate of increase in debt seems to be worrying as it was PLN 21 billion in 2005 and in the years 2009-2011, PLN 40, 55, and 65.5 billion respectively (Regional Accounting Chambers, 2012)

As a result of the above system of financing, the level of fiscal autonomy and independence at different tiers of local government is, as has already been stated, highly unequal. *Table 2* presents the basic statistical measures of local fiscal autonomy in Poland in selected years.

Table 2 : Measures of local fiscal autonomy in Poland in selected years

Measures of local fiscal autonomy	Share of local expenditure in GDP (in %)				Share of own revenue in total revenue (in %)			
	1999	2000	2004	2011	1999	2000	2004	2011
Total	10.76	11.12	9.80	11.90	42.50	40.70	50.0	48.9
Municipalities	5.36	5.34	4.40	5.23	52.71	50.70	46.5	45.5
County Towns	3.27	3.40	3.50	4.03	48.15	47.86	63.3	59.7
Counties	1.60	1.87	1.30	1.58	6.13	7.77	24.1	28.0
Regions	0.52	0.56	0.63	1.06	17.72	15.90	58.8	44.4

Source: Author's own calculations based on the data provided by the General Statistical Office and Regional Accounting Chambers

Figures on the share of local government expenditure in GDP point to the higher level of decentralization at all tiers of self-government. Statistical measures fail, however, to assess the real fiscal independence of local government. High expenditures at the local government level do not prove high financial independence if they are covered by external revenue, for example, from appropriated central budget transfers. The share of own revenue as a source of financing is a better measure. However, in this case it is also necessary to look at the categories of revenues

which belong to the so-called own revenues. It is questionable in Poland to treat the shares in PIT and CIT as own revenues, all the more so as they stand for a substantial source of financing. Local government units do not exert any influence on the structure and amount of PIT and CIT. They enjoy, however, just as they do in the case of general subsidy, absolute expenditure independence. The structure of a specific source of financing and the definition of revenue independence and expenditure independence play an important role in the assessment of the real level

of local government fiscal independence. This is extremely important in international comparisons as each system has its specific character which springs from the national and historical conditions. A high level of external transfers from the state budget does not have to mean a high level of local government dependency if the subsidies are of general character and if the local government decides on their purpose. The above comes from the fact that in the face of growing scope and costs of tasks, such a solution may be more beneficial than the system based on numerous, small and inadequate local taxes and charges. In such a situation what becomes important is the principles that shape the total amount of transfer in individual years and the criteria for its allocation to the local government units.

CURRENT PROBLEMS IN LOCAL GOVERNMENT FINANCE

Basic areas of current problems in the fiscal relations between the national and local government in Poland can be outlined against the background of considerations presented so far. The conclusions are coherent with the problems that, for some years now, have been pointed out by representatives of local government and unions of local government entities. The Joint Commission of Government and Territorial Self-Government is the main body to solve fiscal problems and search for common opinion between the national and local government. The Commission consists of central government and local government representatives and comprises seven task forces. Unfortunately, the systemic problems raised by the local government party have remained unsolved. In April 2012, the representatives of local governments stressed the considerable worsening of the local government financial situation as the central government had not respected the adequacy and subsidiarity principles which were enshrined in the Constitution of the Republic of Poland. In the minutes of the Commission meeting, the local government party outlined the problems in four points:

- 1) local government units do not gain compensation for the losses in own revenues which result from the passing of Acts of Law – the legislative activity of the state,
- 2) the local government tier is burdened with new tasks without adequate allocation of financial means,

3) new standards for task implementation which generate higher costs are introduced without, however, higher funding,

4) the above unfavorable situation is aggravated by the consequences of an economic slowdown.

At the same time, the years 2011-2012 witnessed a debate on additional debt limits for the territorial self-government entities. On top of the legal limits, the Ministry of Finance proposed amount debt limits which would be administratively allocated to individual entities. Several proposals were presented. All of them met with unanimous criticism from local government units as superfluous and destabilizing their economy.

A considerable increase in debt of the local government sector is accounted for by numerous investments co-funded by the EU. It must be pointed out, however, that it is also due to the inadequate revenues and years-long failure to respect the adequacy principle. The allocation of additional tasks by the central government without additional funds for their implementation is common in the whole of the public finance sector, especially in the situation of budget restrictions.

Therefore, the vertical distribution of tax revenues should be revised. It seems necessary to increase own revenues, particularly tax revenues proper, of all tiers of local government. It should be mentioned in this context that the reform of the basic municipal tax, that is the property tax, which is now paid based on property surface area, not by the value of the property (ad valorem), has been neglected for years now. Lack of political will to implement such a reform is also due to the fact that it would cover all types of property including tax on agriculture and forest. Such a general reform would involve a reform in the taxes levied on farmers' income.

The amount and structure of general subsidy requires a certain revision in the area of transfers from the central budget. Despite the objective criteria for the distribution of the educational part of the subsidy, it has been known for years that the costs of educational tasks have been underestimated. Therefore, it is advisable to create a system which would correctly estimate the real costs of such tasks, with a view to the entities' different functions and character in the system.

After the financial crisis of 2008, the principles of horizontal equalization of revenues were challenged. The equalization is based on the equalizing part of

the general subsidy in the case of municipalities and counties and on the regional part in the case of regions. The system of financial contribution by the most well-off entities (the so-called *janosikowe*) is based too much on the revenues which are susceptible to fluctuations in the economy and on the calculations based on historical data (two years old). The economic crisis, which clearly left its mark on, for instance, the finance of Mazowieckie region, meant that in order to cover the obligatory contribution, the region had to acquire a loan and verify its investment plans. It is, therefore necessary to reform the methodology of estimating the revenue potential which serves as the basis for redistribution. It is also necessary to equip the horizontal equalization mechanism with a varied level of costs that is the expenditure needs of individual local government units. The elements of performance-based budgeting at the local tier which would be introduced by the Acts of Law should rationalize the expenditure side of a budget economy.

CONCLUSIONS

It must be stressed that even in the EU countries a deeper unification of fiscal solutions is not possible. This is due to some objective conditions such as different tradition, different economic potential and other preliminary factors in the state of their finance. Therefore, in any system of public finance, the sources of external financing in the form of transfers from the central budget play an indispensable role. The problem is to structure them in such a way as not to restrict the financial independence of the territorial self-government units.

In the long term, it is possible to observe a certain regularity which shows that the allocation of higher own revenues to the local governments, which result from the process of power decentralization, leads to greater disparities in the levels of revenue of individual local government entities both on the regional and central scale. This, in turn, necessitates the central distribution of means to compensate the differences, which results in centralization of public finance (Kornberger-Sokołowska, 2001, p. 152). This leads to fiscal cycles in decentralized systems where tendencies to centralize and decentralize public financial resources occur consecutively.

The system of local government finance in Poland is based too much on the revenues of a transfer character. This refers not only to general subsidy and appropriated allocations from the central budget but

also to shares in income taxes, which are considered to be a transfer of a general character in the theory of fiscal federalism. Such a system is inefficient as the so-called Wicksellian relations are broken (Wicksell, 1851-1926). In the model approach, there is a correlation between the amount of individual goods and services provided by the public sector and the level of charges and taxes that the residents are willing to pay for such goods and services. If they are not aware of the taxation at the local level, the taxpayers will not require rational decision-making on the level and direction of communal expenditure from the local politicians (Guziejewska, 2008, p. 78). The break of correlation between the level of revenue and the level and structure of expenditure has various negative consequences which have been described in the theory of fiscal federalism for a long time. The oversized system of internal transfers and the diminished importance of direct taxation at the local tier both contribute to the above.

The specific detachment of revenues from local expenditures in the decentralized systems has its political, economic and social consequences, which may lead to both increased local government debt and different fiscal illusions. Atkinson and Stiglitz (1980) say:

Perhaps most important is the fact that individuals as voters have only limited control over the local government. The authority may enjoy considerable room for manoeuvre, with the electorate responding vigorously only to substantial increases in the local tax rate or serious shortfalls in the provision of local services... We noted a "corporate veil", such that individuals do not necessarily take fully into account the income accruing to firms in which they are shareholders. In the case of local government there may be a similar phenomenon. Central grants to local authorities may not be fully "integrated" into the income of voters, and revenue-sharing may provide greater scope for the expansion of local public services than otherwise would be possible (p. 554).

The problem has been regularly raised by economists in the contexts of the traditional approach to taxes and the concept of public choice. It is worth mentioning in a situation of economic slowdown and fiscal problems across the sector of public finance. Blankard (2002) rightly and accurately observes:

From a public choice point of view, revenue generation is not a goal per se. Taxes are not legitimized as such but only by the public expenditures citizens want to undertake. Public choice wants to make this evaluation explicit. Citizens should be empowered to express their opinion. Only they can reveal whether an increment of public expenditures is worth the increment of taxes (p. 368-369).

Local governments in Poland, which stress the problem of inadequate finance in relation to the

allotted tasks, should have more competence to implement their own tax policy and thus to increase their revenues. Such a solution would be beneficial from the point of view of public choice theory and the rationalization of expenditure. It would diminish the demanding attitude towards the government and raise the level of responsibility before the taxpayers and voters. It would require, however, systemic changes which would lead to greater fiscal independence of all the tiers of local government by statutorily allocating efficient local taxes and other competences to shape their structure to local government units.

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