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Article

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TRANSITION AND THE RECENT REFORMS IN INTERGOVERNMENTAL FISCAL RELATIONS IN THE CZECH REPUBLIC

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Over the period 1991–2000, the Czech Republic largely overcame the inertia of socialism and the 1993 break-up of the Czech and Slovak Federal Republic. During this period, the Czech Republic also embarked on an accelerated transition to a market economy. Also, a fast evolving agenda in intergovernmental fiscal relations had to address critical emerging issues, including the need for substantial improvement in the overall efficiency of the public sector and joining the European Union.

During 1991–2000, the Czech Republic made important advances in the decentralisation of the government structure. At the time of the significant reforms that took place in 2000, the Czech Republic still faced several important challenges: (a) a fragmented and inefficient structure of local governments; (b) the existence of vertical and horizontal imbalances; (c) limited access to and control of municipal credit; and (d) deficient budgetary institutions.

The reform of intergovernmental fiscal relations in 2000

With the aim of improving the system of intergovernmental fiscal relations, the Parliament approved

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in 2000 a reform, package, which: (a) eliminated the de-concentrated structure of the State territorial administration, based on 77 districts, and replaced it with 14 new intermediate self-governing regions; and (b) restructured the tax-sharing system between the central government and municipalities. The new regions have elected representatives, who are intended to be autonomous on fiscal matters and directly accountable to the citizens.¹ The 2000 reform addressed two long brewing problems – an increasing vertical imbalance (against the State) and increasing horizontal disparities among municipalities – by restructuring the pool of shared taxes and by shifting its distribution rules from a derivation basis towards a per capita basis. The goals of the reform were a more diversified shared-tax pool, a more equitable distribution, and tax shares more stable for all levels of government.²

These measures were important because the 2000 reform was, to a large extent, motivated by the increasing vertical and horizontal fiscal imbalances observed during the 1990s (see Figure 1). The increasing vertical imbalance against the central government was seen as the result of the lower GDP-elasticity of non-shared taxes (customs duties, excise and VAT) vis-à-vis shared taxes (especially personal income tax).

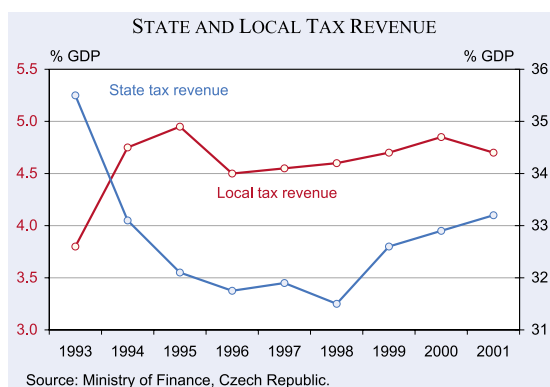
The increasing horizontal fiscal imbalances across local governments were seen as the result of growing disparities in social and economic conditions and growth,³ and the fact that shared-tax distribution was essentially based on a derivation principle. Because the Czech Republic lacked a system of equalisation grants, local expenditures reflected the uneven distribution of regional tax capacity.

¹ The new regions' fiscal responsibilities and resources have been defined during the last three years, while the old districts were being phased out.

² Previously, the pool was based on different proportions of personal and corporate income taxes. The new pool is based on a uniform share of total revenues from both income taxes (PIT and CIT) and the value-added tax (VAT). The starting uniform sharing rate was 20.59 percent, which reflects the 1999 municipalities' aggregate share.

³ For example, higher incidence of some diseases, unemployment and poverty in structurally distressed industrial regions owing to causes associated to the transition as well as to short-term economic adjustment policies – e.g., Usti nad Labem, Most versus Prague or Brno.

Figure 1



Despite the shortcomings of the system and the differences in fiscal resources, municipalities have to a large extent followed a responsible expenditure pattern. While the coefficient of variation for total per capita expenditure (aggregated at district level) increased to 0.60 in 1999 from 0.56 in 1997, its distribution (1997–99 average) by type of functional expenditure (Figure 2) demonstrates that disparities in expenditures per capita have been the lowest for basic services, such as education and water, and the highest for “economic functions”, such as telecommunications or financial operations.⁴

Some challenges for the future

Despite many of the virtues of the 2000 Reform, the issue of fragmentation of municipalities was addressed only marginally by allowing the Ministry of Finance to use an adjustment coefficient on the per capita distribution of shared-taxes. Although allegedly to reflect agglomeration costs and equity concerns, this coefficient was poorly conceived and designed. The coefficient had no clear economic rationale and it was perceived as arbitrary and confusing. There were several other important issues not sufficiently addressed by the 2000 reform. These included the effective transfer of fiscal powers to subnational self-governing units; the restoration of local tax effort incentives; the equalisation of fiscal opportunities; access to municipal credit; and autonomy of local governments and budgetary transparency.

⁴ Notice, however, that the small per capita variation of local expenditures for certain social programs, like “education”, reflect central government policies designed to equalize services, mainly through earmarked transfers. Services for which local governments have been only complementary to national programs, such as “health care” and “unemployment”, show greater variations across region.

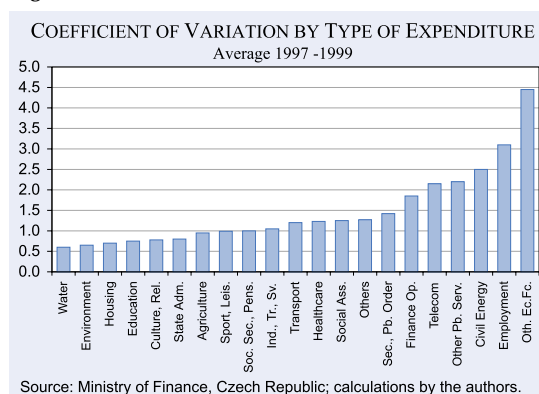
Fragmentation at the municipal level

Eighty-seven percent of the 6,254 Czech municipalities have fewer than 1,500 inhabitants, and 42 percent have fewer than 300 inhabitants. By international standards this is an extremely fragmented administrative structure, with critical political and efficiency implications. Politically, this structure may be justified on the grounds of the strong democratic representation and horizontal accountability that it may allow. However, the small size is associated with low fiscal autonomy, given the insignificant size of the tax bases, low technical/administrative capacity and inability to take advantage of economies of scale in public service delivery. Furthermore, the privatisation of local services is still taking off and municipalities have been slow in cooperating on service delivery.

Four possible options have been considered to address the issue of excessive municipal fragmentation. The first option, mandatory amalgamation, has been discarded so far, as politically impractical. The strong local opposition to this solution is rooted in the negative experiences during the 1960s and 1970s with forced amalgamations of local governments and the subsequent perception of arbitrariness and lack of representation.

The second option, voluntary amalgamation, would avoid political distress and can be efficient for taking into account residents’ preferences. But this option may require too costly financial incentives and it may be too slow in achieving results. The third option, the central encouragement for greater municipal cooperation on joint local service delivery and the creation of large special districts for services with significant economies of scale, may also likely require a long maturation period. The fourth option is the asymmetric assignment of responsibilities (and resources) to local govern-

Figure 2



ments.⁵ In the end, it probably will take a combination of these options to adequately address the problem of fragmentation.

The effective transfer of fiscal powers to the self-governing units

There still is a risk that the 2000 Reform will become a mere re-design of the previous de-concentrated State territorial administration. The 2000 reform left it entirely to the discretion of the line ministries to define the functions to be “transferred” to the regions. This process by nature is a murky one and the commitment of the central government and the Parliament to transfer a meaningful degree of revenue and expenditure autonomy to the regional/local authorities remains unclear. The 2000 Reform did not clearly commit either to promoting private sector participation both in the financing and the provision of “public services” at the local level, especially on housing and education.

The restoration of tax effort incentives

The 2000 reform practically removed all positive incentives for local governments to increase their own tax effort.⁶ However, there appears to be wide consensus on the need to restore positive incentives to revenue mobilisation at the local level. Fortunately, there is considerable room to improve local/regional revenue autonomy and revenue mobilisation in the Czech Republic, without negatively affecting the central government budget. An attractive possibility is to exploit the potential of the “property tax”, by adequately defining and expanding its base and by providing local/regional authorities with limited discretion to establish their own tax rates. A second possibility is to introduce a regional/local proportional personal income tax piggybacking the national progressive personal income tax.

The equalisation of fiscal opportunities

Access to similar standards of public services by all citizens – regardless of location where they live in the country – is an explicit objective of the Czech government. However, the current decentralisation system may not deliver that objective because it

lacks an explicit equalisation grant mechanism. The equal distribution in per capita terms of shared revenues among local governments, introduced by the 2000 reform, does not take into account the differential social and economic conditions and developments among regions, that is, local governments’ specific expenditure needs and/or their distinct revenue capacities. The implementation of a true equalisation mechanism is still a major challenge for the government in the near future.

The gradual reform to define expenditure responsibilities will help guarantee sustainability to the fiscal decentralisation process. However, a tax sharing allocation mechanism alone can hardly satisfy multiple objectives. If tax sharing (on a derivation basis) targets incentives for tax effort, then a complementary instrument is necessary to address equity issues. This is the need for an equalisation grant mechanism.

Access to borrowing

Although from the information available the level of municipal debt does not appear to be excessively high, it has increased rapidly in recent times. The true figure for the municipal debt is still not entirely transparent, and it is exposed to several fiscal risks and guarantees experienced by the Czech Republic during transition. Excluding the implicit contingent liabilities, municipal debt grew to 24 percent and 53 percent in 1999, from 5 percent and 11 percent in 1993, respectively, as a proportion of municipal total revenues and tax revenues. Local government borrowing in the Czech Republic remains unregulated, and formally municipalities have free access to credit. However, in practice there are restrictions to local borrowing: (a) the Ministry of Finance controls supply through moral suasion over the financial system; (b) there is a perception that the Commercial Code still restricts the use of collaterals by municipalities, which affects creditworthiness; and (c) the lack of revenue capacity limits access to capital markets by smaller municipalities.

However, financial market discipline in a transition economy like the Czech Republic is still in the make. Therefore, a disciplined, regulated subnational government borrowing system would be a good insurance against potential financial instability created by irresponsible borrowing behavior at the subnational level.

⁵ This could be achieved, for example, by delegating upwards most responsibilities now assigned to smaller communities to “designated” or “statutory” towns or to the new regions.

⁶ The only exception is 30 percent of the un-incorporated income tax proceeds, which will continue to be allocated on a derivation basis.

The Czech government has been considering options for increasing municipalities' responsible access to capital markets as an alternative source for infrastructure financing. The pre-conditions include establishing regulations to increase transparency and competition, and preserving the right market incentives and hard budget constraints. These regulations should essentially cover: (a) explicit limits for the overall level of debt and debt service obligations; (b) stronger bank supervision and internationally recommended prudential rules; and (c) a bankruptcy law and/or a law on fiscal responsibility which includes municipalities/regions as a subject. Moreover, development of public and private institutions (including private credit rating agencies) should be encouraged in order to guarantee proper monitoring and to avoid moral hazard situations.

Autonomy, transparency and accountability.

During the transition, local governments have gained substantial discretion for making expenditure decisions. However, there is still little revenue autonomy, which limits local authorities' accountability. Predictability and transparency in budget preparation have been affected by: (a) the lack of de facto synchronisation with the State budget; (b) uncertainty on the basic budget parameters; and (c) insufficient information on guarantees and contingent liabilities. While there has been no major disruptions in budget execution, budget control and performance evaluation remain weak.

The improvement of transparency and accountability at the subnational level in the Czech Republic will require: (a) empowering local authorities to determine tax rates within a bandwidth for meaningful local taxes, such as the property tax; (b) lifting central control on rents and tariffs; (c) allowing more freedom for mixing factors of production in the most economical way; and (d) publicizing all (approved and executed) transfers and guarantees. Budget predictability at the subnational level could be substantially improved by setting the basic parameters (including tax-sharing ratios, transfer/grant formulas) in organic laws instead of in the ordinary annual budget laws. With the elimination of the districts, the oversight function over municipalities (including accounting audit) was left undefined. Addressing this issue may present an opportunity to expand the scope of the audit function over subnational governments beyond the legal and procedural aspects (the input

approach) to also cover program performance evaluation (based on outcomes).

The path ahead

Joining the EU will place new challenges on inter-governmental finances in the Czech Republic. With EU membership will come an obligation for consolidating its public finances, including that of reducing and maintaining general government deficit within the limits of the EU's Stability and Growth Pact. The question then arises of the appropriate division of this responsibility between the national and subnational levels in meeting this aggregate fiscal objective. Consequently, the problem of developing new institutions for fiscal coordination among different levels of government has become critical for the Czech Republic.

There is a need to establish legal and procedural frameworks for ensuring subnational governments fiscal behavior that is consistent with the obligation of EU membership. In this regard, the Czech Republic can learn from other European countries, which had to develop different institutions and procedures to conform themselves to the EU. For example, Belgium adopted a mechanism based on multi-lateral negotiations, which resembles the German approach, and created a High Financial Council to supervise the budgetary policies of regions and communities. Spain, in the context of the convergence program, has relied on bilateral negotiations leading to a set of agreements between the central government and each individual subnational government, where targets are set for deficit and debt. Austria and Italy have instead used a policy based on statutory rules, where the law fixes for a period of time the criteria for distributing the limit set in the Maastricht Treaty of European Monetary Union on public deficit among levels of government.

Furthermore, the EU regional policy, including a number of programs such as the structural funds, will impose constraints and set directions for the Czech Republic's own regional policies. Interestingly enough, unlike in most other European countries, the new regions in the Czech Republic were not created along historical lines (e.g., Bohemia, Moravia), but instead following the EU's Territorial Statistical Units Nomenclature (NUTS). This may facilitate the mobilisation of EU pre-accession and structural funds, without sensitising traditional regional sentiments.