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The intergovernmental relations and their regulation in the context of decentralization of fiscal policy

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Abstract. The suspension of economic relations as a result of the global pandemic has severely affected the country's peripheries. Unequal development of territorial units and overcoming socio-economic problems is the biggest challenge of any country. To address these challenges, the country needs to mobilize large amounts of finance and make optimal allocations. Intergovernmental relations play an important role in the effective implementation of the transformation of the country's economic and political system. The aim of the paper is to study the characteristics of revenue mobilization and distribution between the levels of the fiscal system. There are developed some recommendations for improving inter-budgetary relations based on the experience of different countries. The recommendations proposed as a result of the research analysis can be used for both theoretical (for lecture) and practical (for legislative) purposes.

1 Introduction

The virus originated in 2019 has taken the form of a global pandemic by 2020. As a result, the global world is facing the conditions of the greatest economic recession and economic crisis has arisen in many countries (Fig. 1). Especially, developing and small open economy countries found themselves in a particularly difficult situation [1-4].

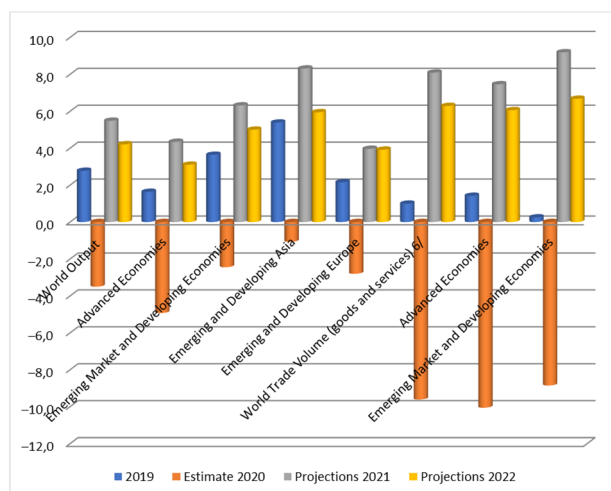


Fig. 1. World Economic Outlook [1-3]

Socio-economic problems are especially evident in territorial units. The suspension of economic relations has further aggravated the social situation and it increased unemployment, inflation and etc. To address these issues, states have implemented relevant budget policies. So, funding for the management and regulation program is reduced and funding for the subsidy program is increased [5, 6]. Despite the model of budget arrangement to get out of the economic recession of the country and achieve

economic growth, it is very important to provide financial resources to the budgets of local self-governing units (municipalities), where one of the most important places is inter-budgetary relations. Inter-budgetary relations include not only economic subsidies, but also a fair distribution of revenues and expenditures between levels of the fiscal system.

In my opinion, to organize of inter-budgetary relations should be based on the following principles:

- Equality of rights and responsibilities of all municipalities must be protected in the process of financial relations with the centre;
- Areas of financial activity and responsibilities should be divided between the state government and all levels of local self-government;
- Different levels of government should not depend on subsidies, but also they should be able to receive revenues from their own sources and dispose of these funds independently.

Thus, the scope of the policy should be redistributed between the centre and the local self-government bodies. The centre should define the relevant legislative framework for action, within which local self-government will be free to make decisions, especially in solving socio-economic tasks.

Fiscal autonomy of local government is a relative concept that is determined by whether governing bodies have a sufficient amount of their own revenues and whether they have the right to manage them independently the functions they have to performed. This does not mean that they are completely isolated from each other. On the contrary, the centre and the municipalities have common interests for the public good and relevant coordinated strategic actions in economic and political priorities [7].

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2 Methodological foundations

2.1 Legislative regulation

The economic and financial basis of self-governing units is regulated by five main laws: the Local Self-Government Code of Georgia [8], the Budget Code of Georgia [9], the Tax Code of Georgia, the Law of Georgia on Grants and the Law of Georgia on Local Fees [10-12]. In addition, Georgia has ratified the European Charter of Self-Government and self-governing legislation is based on it.

Fiscal relations are mainly regulated by organic laws: the Local Self-Government Code, the Tax Code of Georgia and the Budget Code.

Local self-government is the right and opportunity of the citizens of Georgia to regulate and manage issues of local importance in accordance with the interests of the population through local self-government bodies. The Code of Self-Government defines the powers of self-government, which are divided into delegated, self-governing and voluntary categories [8].

In order to minimize socio-economic inequality between different territorial units, it is necessary to analyse the welfare conditions of the regions and adopt legal norms.

2.2 Literature review

The theoretical-methodological basis of the research is the papers of various scientists on the research problem, where the inter-budgetary relations [13], financial mechanisms for the development of territorial units [14-25], the characteristics of state fiscal arrangement models are studied [26-34]. This includes works by Aidt and Dutta, Ehrlich, Enikolopov, Ejobowah, Gaizatullin, Kline, Sow, Staehr, and others [35-38]. They studied in depth and published the issues of formation and improvement of the state governance system, budget regulation, financial equalization and organization of budget relations [30, 39-58]. These scientists have identified problems in this field, but the fiscal arrangement and fiscal system require continuous improvement and research.

3 Discussions

Decision-making at a low hierarchical level has a great importance for the establishment and improvement of the state governance system. This in turn is a prerequisite for decentralization. Understanding systemic actions at the level of territorial units, laying out appropriate ways and developing real self-government play a major role in the proper and efficient functioning of the state. In particular, the formation of stable sources of revenue for territorial units, the implementation of an objective and transparent process of redistribution of funds between upper and lower level budgets creates a precondition for

stabilization of the country. Local self-government will inform the interests of the society at a high hierarchical level and will create a driving force for the effective implementation of relevant socio-economic policies.

One major theoretical issue that has dominated the field for many years is the absence of a well-grounded strategy leads to a further deterioration of the situation and a manifestation of the severity of fiscal policy [59]. Any action and any policy implementation at a high state or low hierarchical level, takes place within the existing legal space. It is the correct definition of this legal space that means avoiding the contradictions between the defined priorities of the common welfare in the society, as well as the contradiction between the common tactics and the strategy of action [5, 59].

The legal aspects that are of great importance for the harmonization of interests and actions between the governing bodies of the country are the budget legislation [9], according to which territorial (regional) budgets are independent and theoretically the supreme governing bodies have no right to interfere within their competencies (Budget Code of Georgia, Article 7) [9]. In fact, the budgets of territorial units (regional) are significantly dependent on the budget of the upper (central).

According to the Budget Code of Georgia, the legislation was limited to listing the sources of revenue of territorial budgets [9] and ignored a number of methodological and organizational issues of inter-budgetary relations. At the present stage, many things are disorganized and faulty in the relationship between different levels of the budget. In particular, the rights and responsibilities of each level in revenue mobilization and spending are not clearly defined. Also, the division of taxes between the centre and the budgets of the regions is not strictly defined, as well as the issue of economic subsidies and many other things. All of this leads to numerous misunderstandings and difficulties between the centre and other levels of budgets. It seems in the amount of tax revenue mobilization at the budget levels and their ratio to GDP (Fig. 2).

The lack of local budget funds in Georgia, which is filled with regulatory revenues, is the result of minimizing the quality of tax authority for local self-government. The centre is still trying to mobilize financial resources entirely in its own hands, while delegating its responsibilities for financing various activities entirely to entities and territorial unit budgets.

3.1 Foreign experience of fiscal arrangement

Over the past two decades, fiscal arrangement reform has taken place in all Central and Eastern European countries. However, the redistribution of powers and finances between central and local governments is still the subject of active debate in many countries.

The fiscal system of Germany as a state with a high degree of decentralization includes three levels: federal, land and local [40].

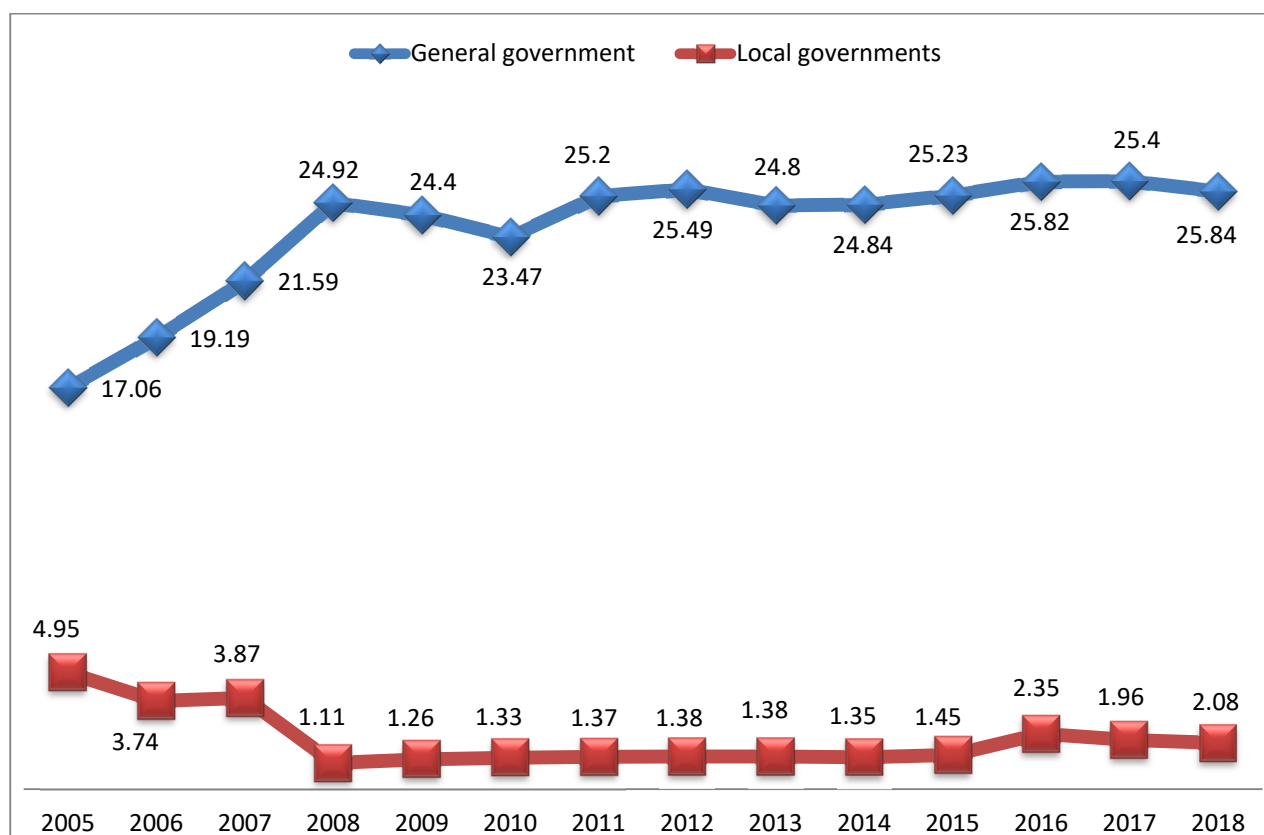


Fig. 2. Distribution of tax revenues between the budget levels of Georgia, % of GDP [60].

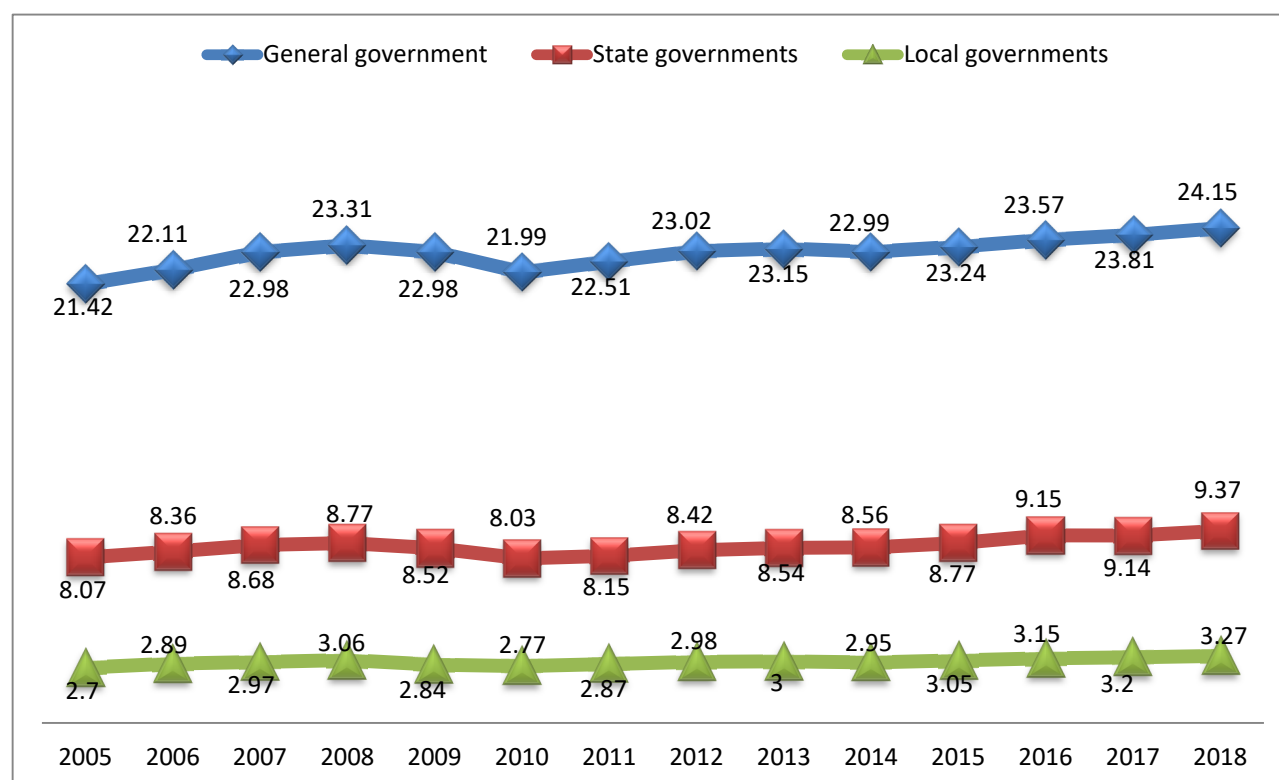


Fig. 3. Distribution of tax revenues between German budget levels, % GDP [60].

The tax revenues of the three levels of the budget of Germany in 2005-2018 are as follows (Fig 3). The German local government finances its own expenditures mainly from the local budget, whose tax revenues account for about 13.5% of total national tax revenues.

The Austrian fiscal system is divided into three levels: central government, land and local self-government. In accordance with the Budget Law, the amounts received from the income tax are distributed in the following proportions: 60% of the funds go to the central budget,

22% to the land budgets and 18% to the local self-government budgets. Also, 69% of value added tax go to the central budget, 19% to the state budget, and 12% to the local government budget (Fig. 4).

France, although a unitary state, is divided into regions, departments and municipalities. Municipalities and departments receive revenue from all taxes, while the region is financed by land and business taxes. The tax

revenues of the three levels of the budget of France in 2005-2018 are as follows (Fig. 5).

Since 1990, the central government has delegated important powers to all three levels of regional government (region, department, commune) planning and developing areas such as infrastructure, education, health, culture, regional economic development, employment, etc. which are financed from local budget revenues (Fig. 6).

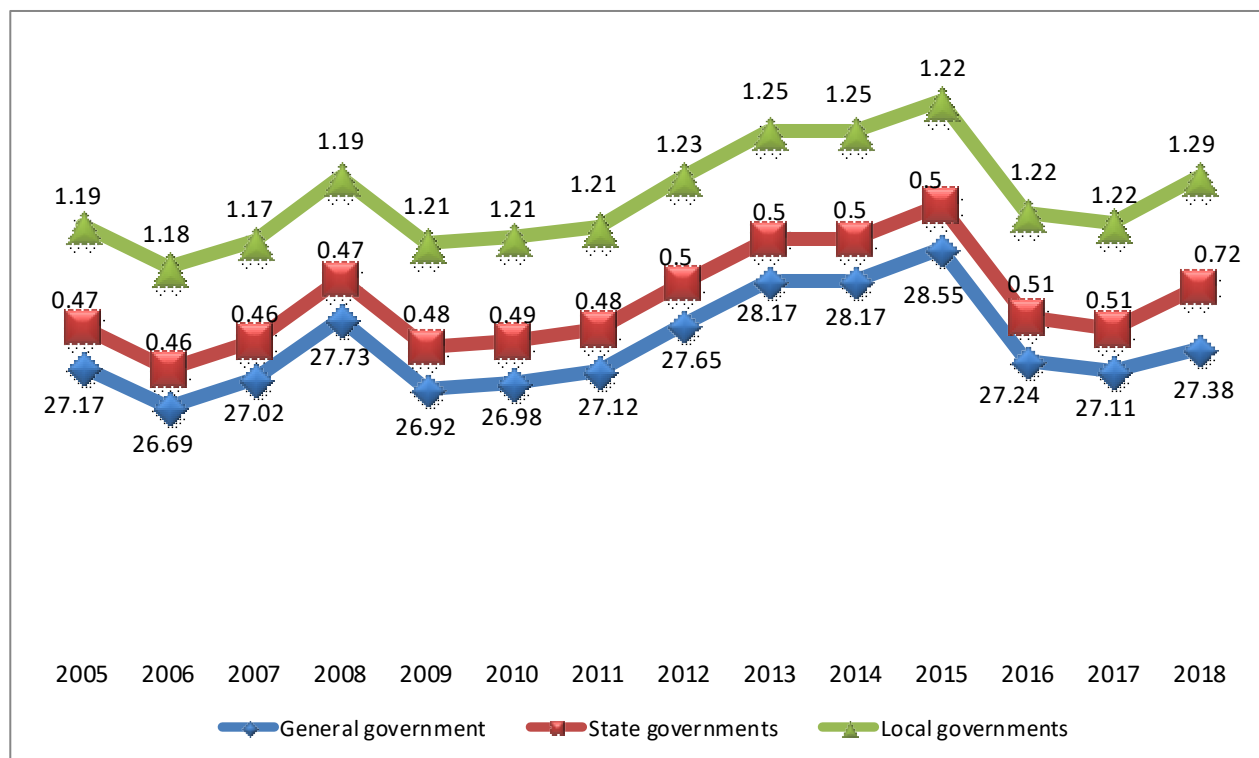


Fig. 4. Distribution of tax revenues between Austrian budget levels, % GDP [60].

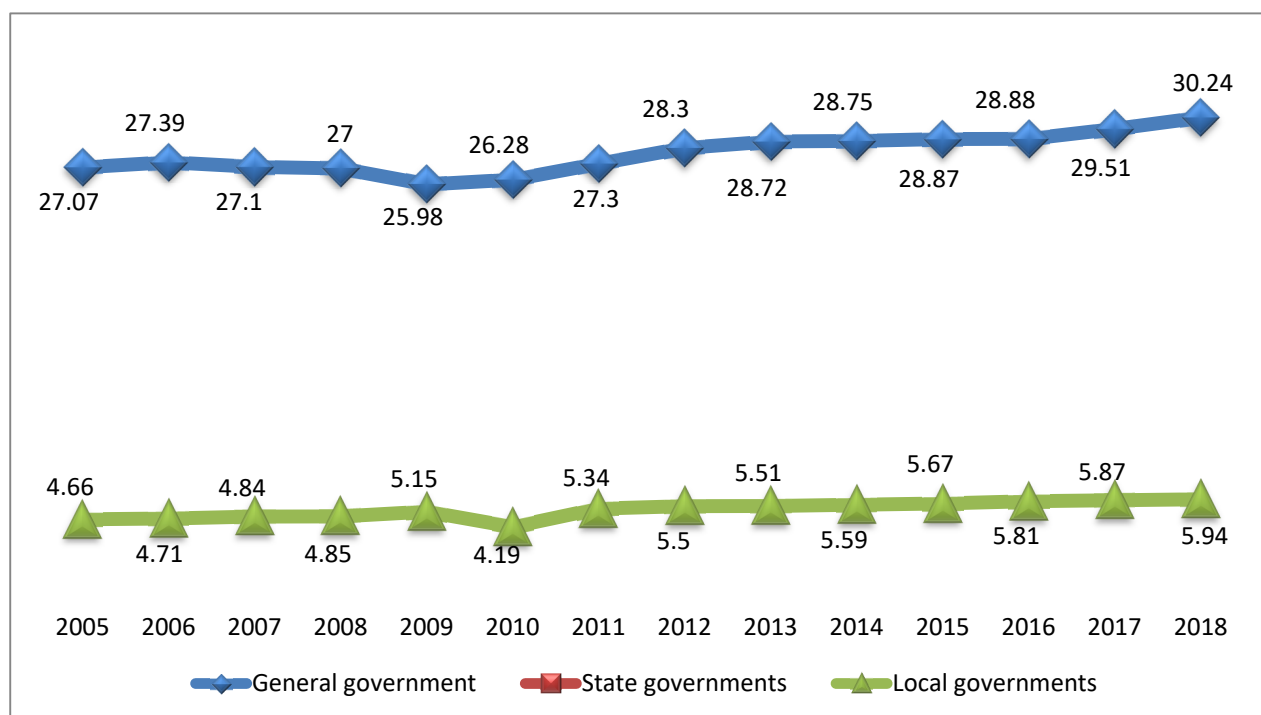


Fig. 5. Distribution of tax revenues between French budget levels, % GDP [60].



Fig. 6. French local budget revenue sources [61].

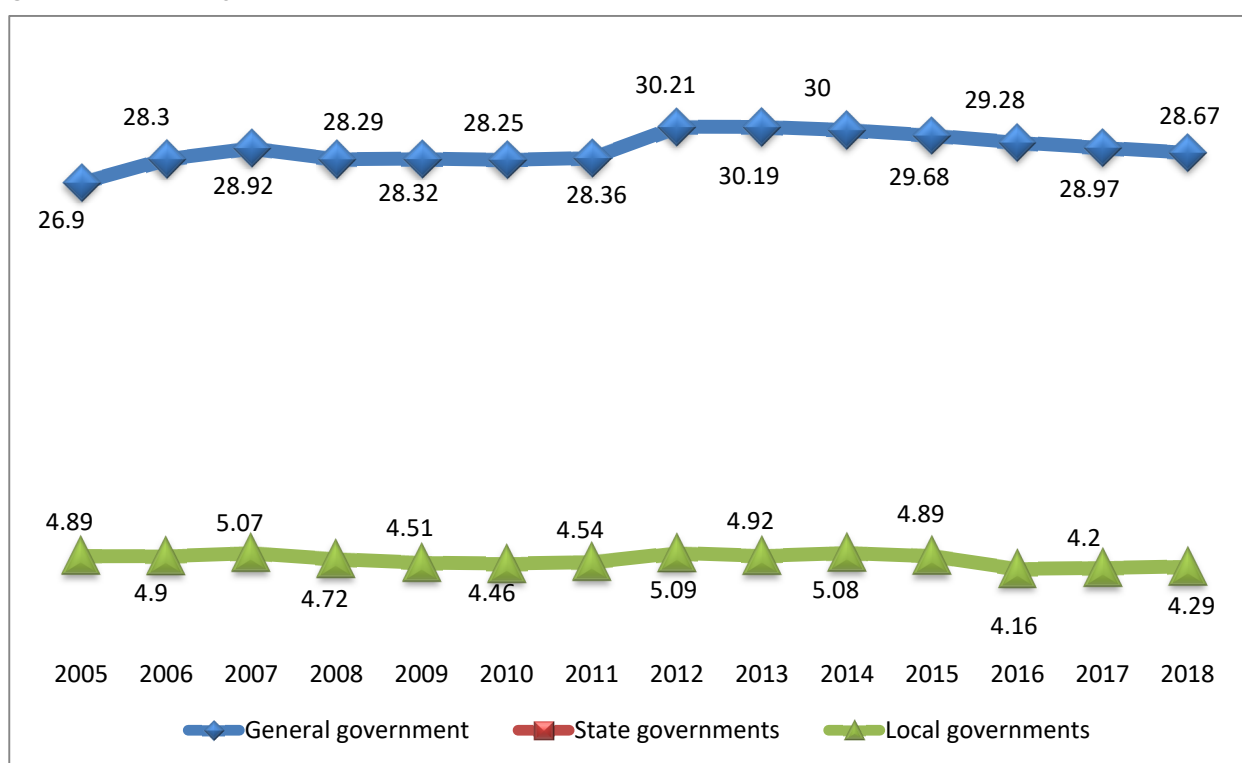


Fig. 7. Distribution of tax revenues between Italian fiscal levels, % GDP [60]

Table 1. German fiscal system.

Federal Budget	Land Budget	Local Budget
Income tax 42.5%	Income tax 42.5%	Income tax 15%
Corporate tax 50%	Corporate tax 50%	
Value-added tax	Value-added tax	
Industrial tax	Industrial tax	Industrial tax
Customs tax	Property tax	Land tax
Other federal taxes	Other land budget	Other local budget
48% of total tax revenue	34% of total tax revenue	13% of total tax revenue

Like France, the unitary parliamentary republic is Italy, which is divided into regions, provinces and municipalities [62]. Management functions are distributed at all levels. The ratio of tax revenues in the budget of Italy in 2005-

2018 to the country's GDP looks as follows (Fig. 7). Local budget revenues consist of own taxes, shared taxes and transfers, and other revenues (Fig. 8).

Fiscal independence in Sweden is very high and 69% of tax revenues remaining in local self-government budgets. The budget revenues of the counties are: amounts received from taxes (68%), transfers (7%), amounts received from fees and taxes (25%). Tax revenues are formed entirely from income tax. The income tax rate is set by the county itself. The sources of revenue of the municipal budget are: funds received from taxes (60%), transfers (14%), funds received from fees and taxes (23%). Tax revenues are formed entirely from income tax (99.5%), while 0.5% comes from sales tax on goods and services (Fig. 9).



Fig. 8. Italian fiscal system.

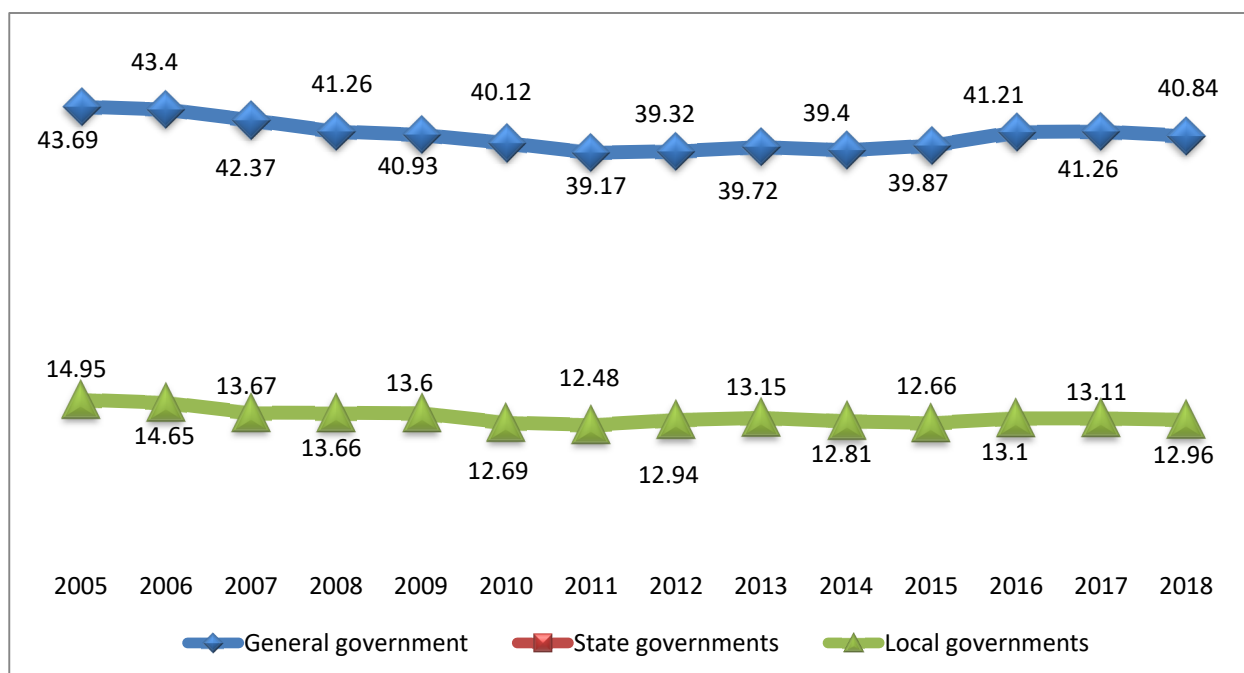


Fig. 9. Distribution of tax revenues between Swedish fiscal levels, % GDP [60].

The sum of tax revenues of the central budget of Estonia in 2014 is 6 656 949 euros, which is characterized by a growing trend in the coming years and by 2018 it amounted to 8 821 243 euros. As for the tax revenues of local self-governments, this figure is 859,527 euros in 2014, in the following years the budget tax revenues will also increase and reached 1,173,550 euros for 2018. As for the ratio between levels - the sum of tax revenues of local budgets is about six times less than the state budget. And the ratio of fiscal levels to tax revenues in relation to the country's GDP looks like this (Fig. 10).

Poland was one of the first to make the transition from the post-socialist system to the European system, which from the very beginning focused on the development of

self-government and, unlike many other Eastern European countries, made it a priority to move to a decentralized model. Today, it is one of the most decentralized countries in Europe and it is far ahead of many European countries.

The territorial arrangement of Poland is based on three levels - region, side and municipality. The sources of revenue generation for each level are: 1) own revenues, mainly local taxes, the rate of which is set by the local government based on the right granted by law. However, at the same time the maximum rate is set by Parliament. 2) Shared income and profit taxes; 3) Basic and special transfers. The ratio of fiscal levels to budget revenues in relation to the country's GDP is as follows (Fig. 11).

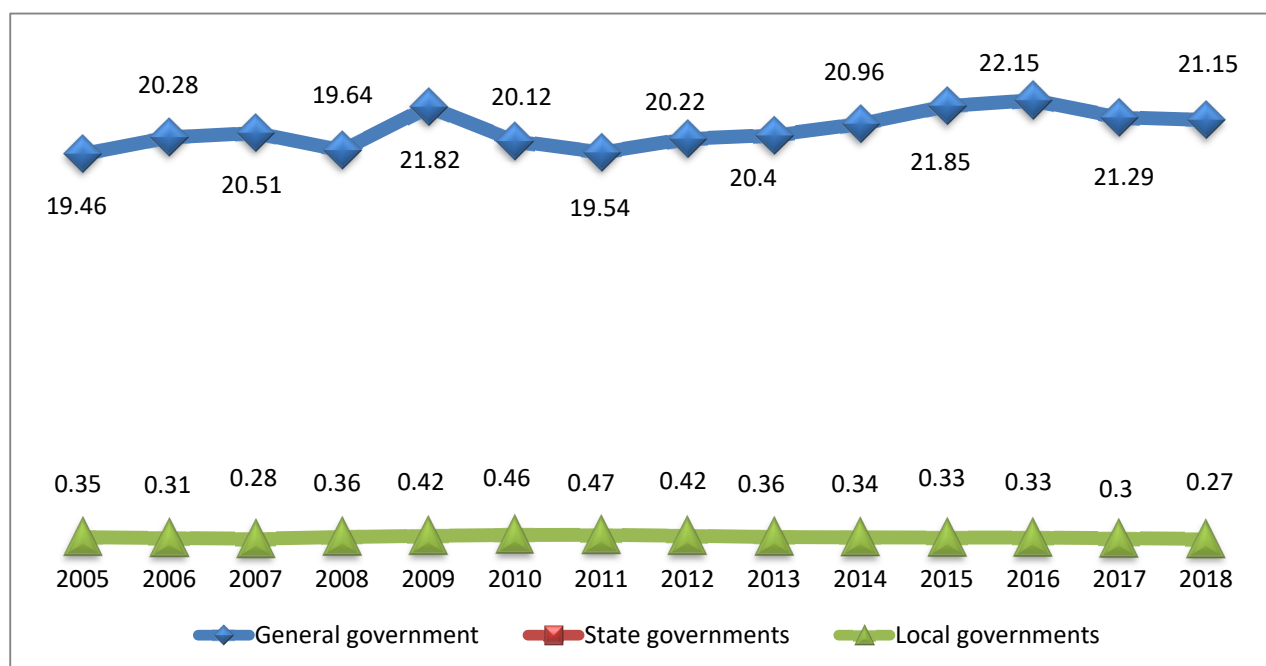


Fig. 10. Distribution of tax revenues between Estonian fiscal levels, % GDP [60].

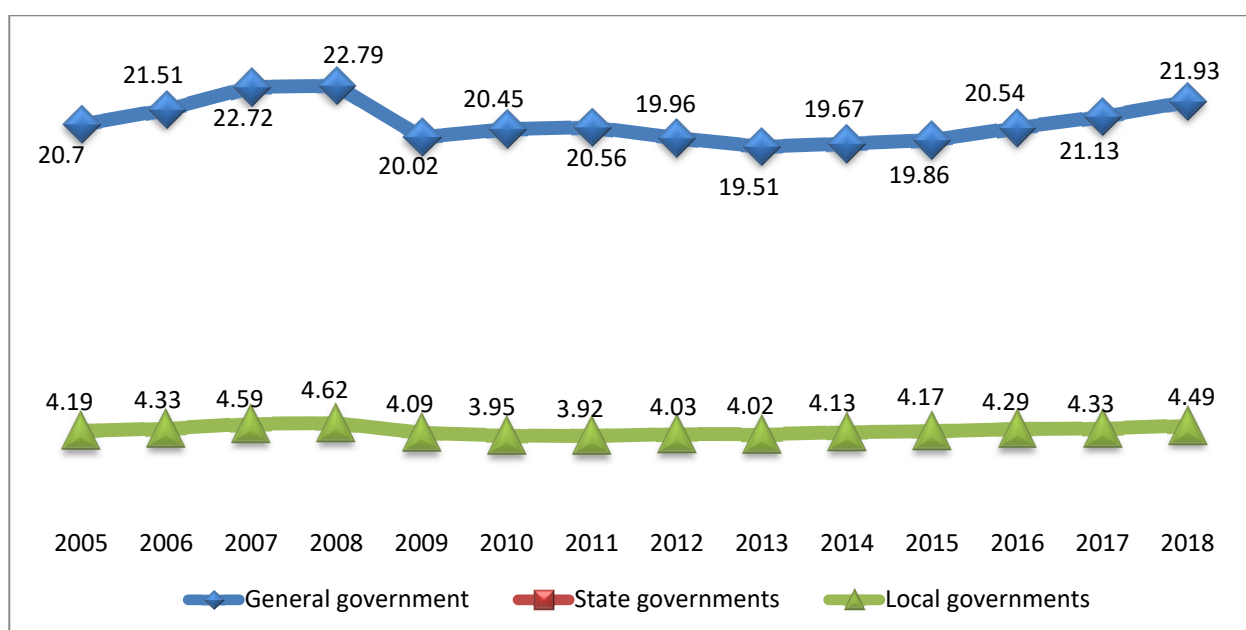


Fig. 11. Distribution of tax revenues between the fiscal levels of Poland, % GDP [60].

3.2 The peculiarities of the countries of the Caucasus and the Black Sea Region in fiscal arrangement

In Armenia, as a unitary, partially decentralized country, self-government operates only at the municipal level. They can set the tax rate within the limits set by law. Property and land taxes are 100% accumulated in the municipal budget. Profit tax and various fees are shared with the local budget each year. However, the ratio of tax revenues to GDP for 2005-2018 looks as follows (Fig. 12).

Azerbaijan is a unitary, partially decentralized state. Local self-government operates only at the lowest level - the level of the municipality. According to the constitution, municipalities have the right to impose local taxes and fees. Local taxes are: land tax, property tax, profit tax, which is taxed on municipal property. The share of own taxes and fees in the local budget is about 25%, tax revenues are a major part of them (about 22%), while the share of transfers in local budgets is about 10% [61] (Fig. 13).

In Turkey, municipal expenditures account for 11% of total state expenditures and revenues for 7%. Municipalities are funded from three main sources: 42% from general government taxes, 6.8% from utility taxes,

35.5% from non-tax revenues and 10% from local taxes. The central government collects the following types of taxes: personal income tax, corporate income tax, profit tax and value added tax. Local governments are left with

9.25% of the collected income taxes. Real estate tax accounts for 54.9% of tax revenues collected by local governments (Fig. 14).

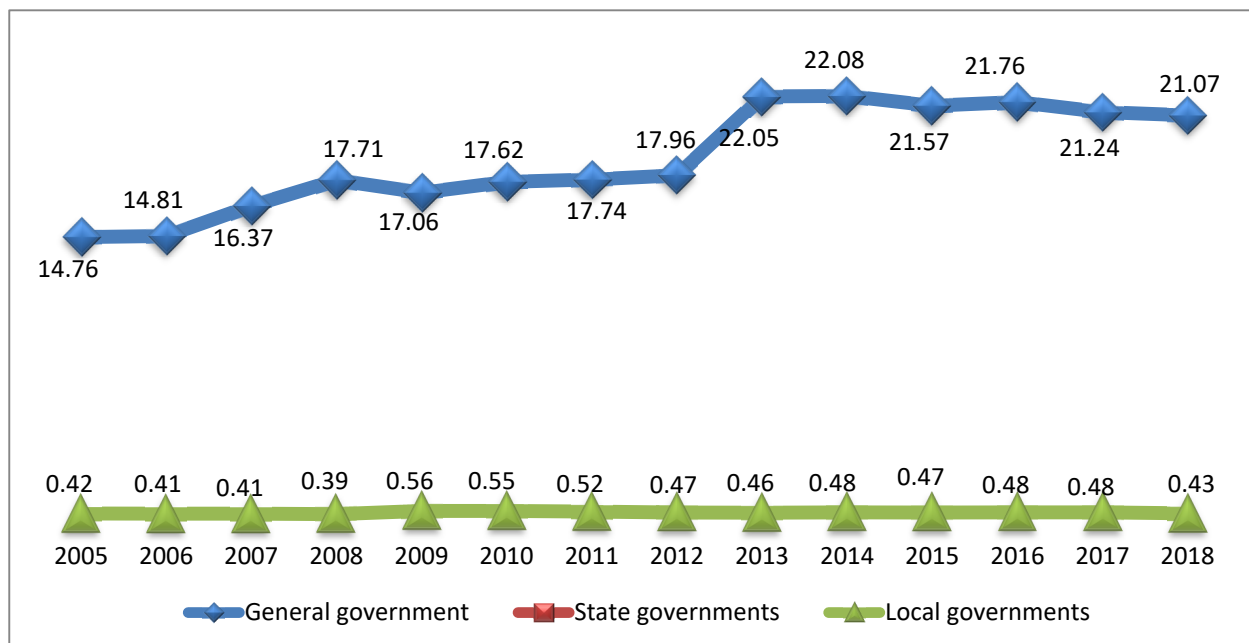


Fig. 12. Distribution of tax revenues between fiscal levels of Armenia, % GDP [60].

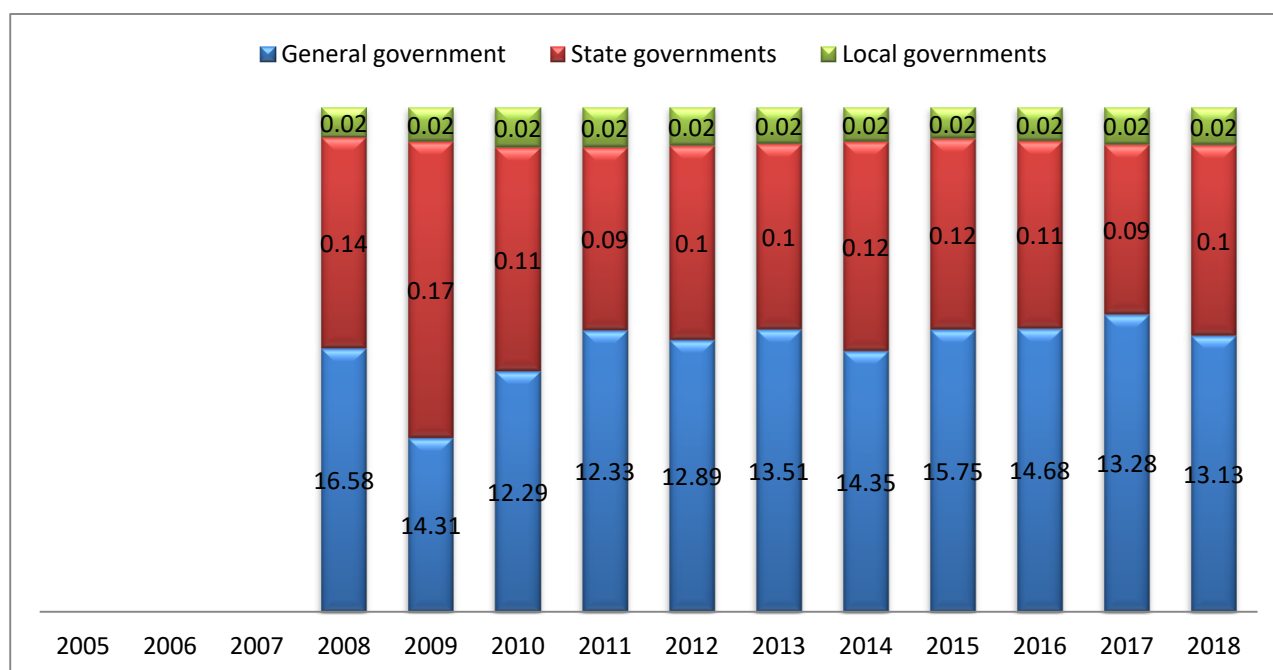


Fig. 13. Distribution of tax revenues among the fiscal levels of Azerbaijan, % GDP [60].

4 Research results

The research of the experience of different countries revealed that it was especially difficult to implement fiscal decentralization reform in post-socialist countries, where the pre-existing administrative-planning structure was characterized by a high degree of centralization. Successful implementation of decentralization requires a relevant institutional environment and development. Especially, in

post-socialist countries where state institutions are at an early stage of development, the implementation of decentralization reform has solved some problems. Most of these countries have not yet emerged from these problems. In Central and Eastern European countries, the main goal of economic policy at the initial stage of transformation was to ensure macroeconomic stability. This was accompanied by structural changes in the economy, political and ethnic conflicts, which created an unfavorable conditions for fiscal decentralization [61].

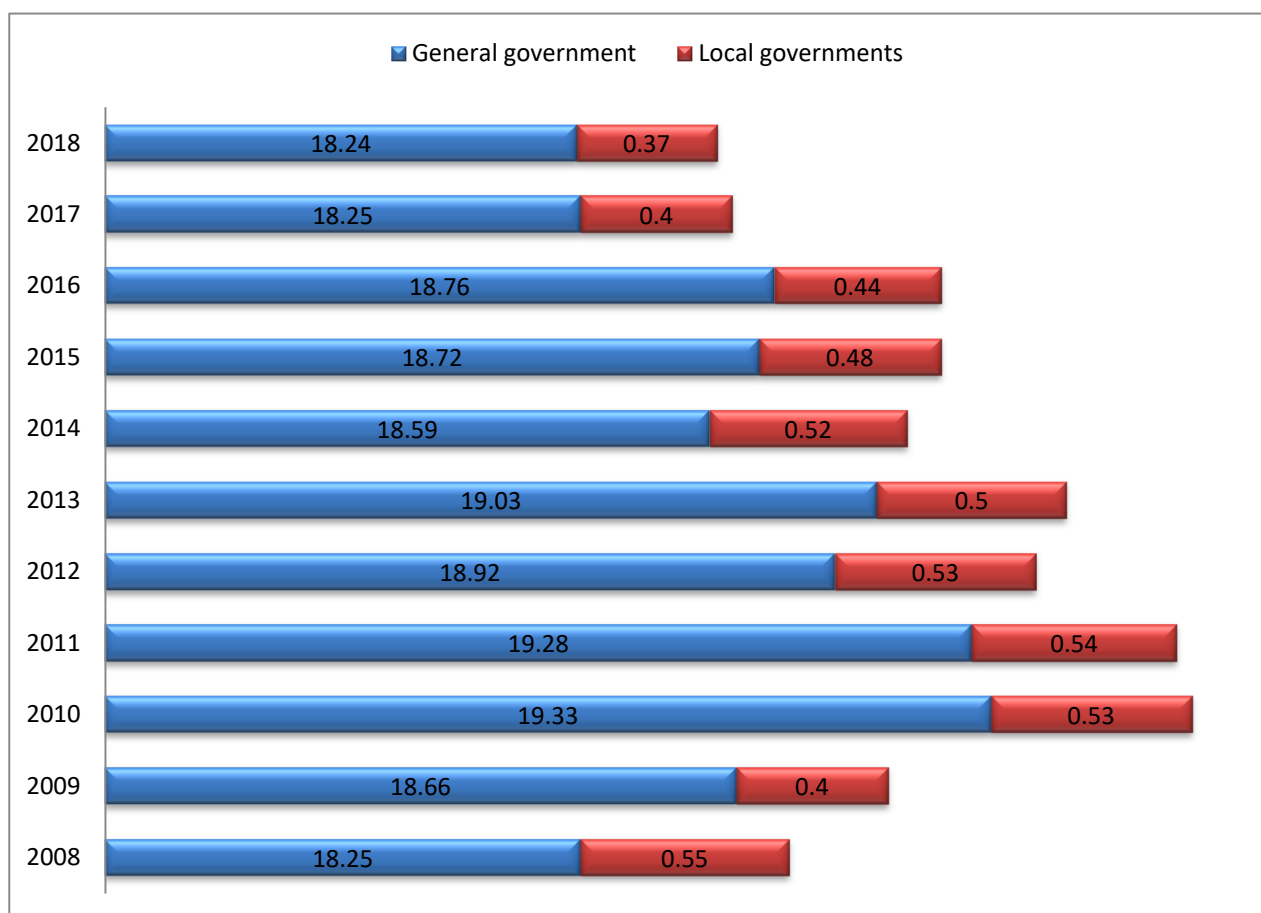


Fig. 14. Distribution of tax revenues between fiscal levels of Turkey, % GDP [60].

Local governments in Central and Eastern Europe have been financed through shared taxes and transfers. Income tax goes directly to local government in the Nordic countries and Switzerland. Income tax is shared in many countries, for example Austria, Germany, Hungary. In these countries the tax is levied by the central government and distributed to local governments.

Due to the simplicity of property tax administration, in almost all European countries, property taxes go entirely to the local budget [61].

Table 2. Distribution of taxes between budget levels [61].

Types of taxes	Local is in the following countries
Income tax	
a) direct	Nordic countries, Switzerland
b) shared	Austria, Germany, Poland
Income tax	Austria, France, Germany, Norway, Portugal
Property tax	All European countries (except Sweden)

Only a few developed countries have reached local governments autonomy in revenue, but they used to receive and still receive assistance in the form of transfers. In Slovakia, Hungary and Poland, for example, own revenues account for up to 40% of total revenues. Local budget revenues in local budget revenues are highest in Sweden, France, Italy, Germany, Poland and the Czech Republic

(Fig. 15) and the smallest in Austria, Estonia, Georgia, Azerbaijan, Turkey, Armenia.

Inter-budgetary relationships vary according to different models. In particular, in Anglo-Saxon model countries (USA, UK, Canada, Sweden) regions have high fiscal autonomy and local taxes dominate budget revenues. In the Continental model countries (Germany, France, Italy, Spain, Belgium) the fiscal autonomy of the regions is relatively limited and the principle of financial equalization (granting subsidies and subsidies) is essential [5, 63].

Policies in the field of municipal finance should be directly related to the economic activity of the self-government. In this regard, against the background of the general crisis, the municipalities in Georgia are in a particularly difficult condition. Their situation is further aggravated by the price disparity in industrial and agricultural products, the monopolization of privatized processing enterprises and the lack of profitable enterprises. Many of the problems facing the territories are caused by the fast and reckless privatization of the service sector of processing enterprises and other sectors. Problems of economic development are particularly acute:

1. A general decline in production, which leads to a reduction in budget revenues;
2. Limited economic base in rural areas, which is manifested, first of all, in the absence of profitable enterprises in the territories;

3. Changes in municipal ownership caused by the transfer of social sphere facilities to local administrations;
4. Uncertainty in the status of branches of enterprises and organizations located in the districts;
5. Restriction of rights to natural resources of local authorities.

In our opinion, in order to improve the financial situation of the municipalities, it is necessary to solve the following problems: 1. Expanding the tax base of the area; 2. Ensuring social equality in the distribution of subsidies and the implementation of social protection measures for the population; 3. Resolve the territorial issues related to the relations between the local administration and the governing bodies of the republic.

Due to the tourism potential of Georgia and the large flow of tourists, the establishment of a tourist fee can be one of the important sources of income for self-governments. This type of fee is used by many European countries: including: Spain, Italy, Croatia, Belgium and others on average 0.15-7.5 euros per day. Tourist tax in

Dubai ranges from \$ 2 to \$ 6. From November 1, 2015, a similar tax was introduced in the Emirate of Ras Al Khaimah. Also, every tourist who stays at a hotel in Abu Dhabi pays a daily fee of \$ 5 and it does not matter what type of hotel they stay at. Tourists arriving in Rome have to pay from 1 euro to 7 euros as a tourist tax for overnight stay at the hotel and it depending on the type of hotel. According to the National Tourism Agency, up to 4.8 million tourists entered Georgia in 2018 (individuals who voluntarily travel outside their permanent residence for leisure, recreation, business or other purposes for at least 24 hours and not more than one year. And whose travel is not refund from the financial sources of the place of temporary stay). If we take the minimum tariff of 1 GEL per tourist (regardless of the number of days), it means an additional income of 4.8 million, and on average 3 GEL additional 14.4 million. This will significantly help self-governments to better meet public needs, implement infrastructure and other projects.

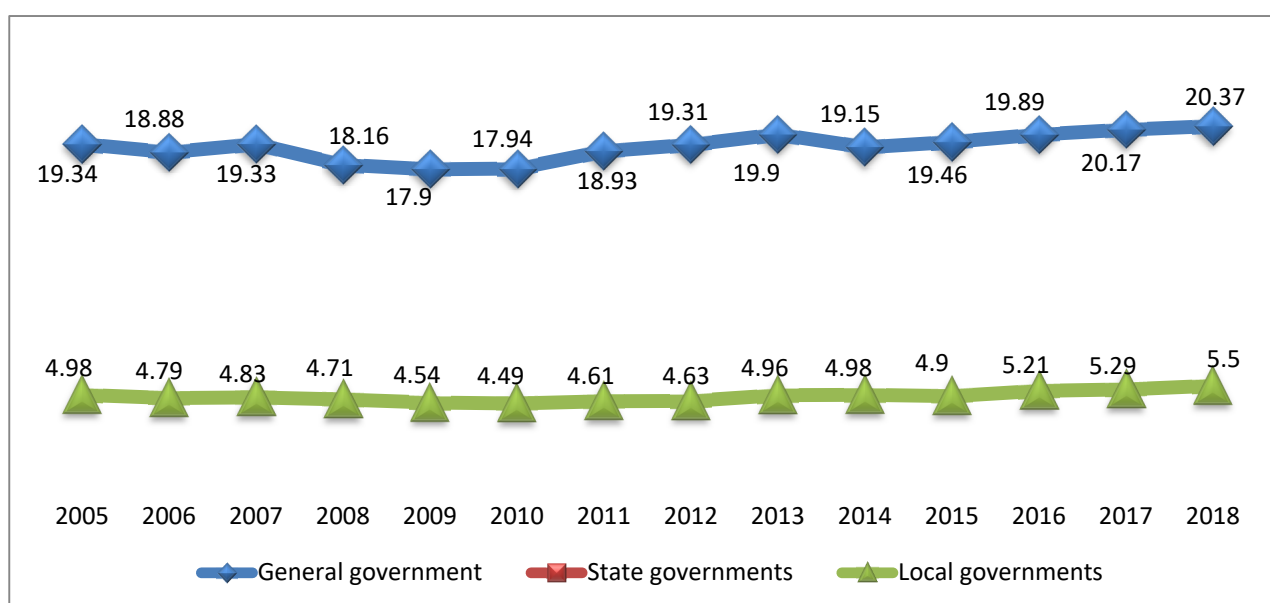


Fig. 15. Distribution of tax revenues between fiscal levels of Czech Republic, % GDP [60].

The second important issue of strengthening self-governments is the transfer of property to them. Only the transfer of finances and leaving taxes on the places will not lead to the development of the economy and will not create additional value on the places. Financial decentralization creates a mechanism to make economic activity profitable for municipalities [64-69]; And economic activity is possible only if land, property and other resources are transferred to local governments. With financial instruments, self-governments need to be motivated to see benefits and financial gains by using the property transferred to them in authority, to create investment projects, to find investors and to promote employment.

Georgia is one of the Post-Soviet countries in Eurasia, which has been actively involved in EU integration processes [5]. Therefore, for the success of the reform, it is necessary that the transfer of finances and property be carried out in parallel, and as soon as the new tax system

enters into force. The municipalities will have the property resources by which they will be able to increase economic activity and revenues. Of course, such an approach does not mean the phasing out of both types of decentralization, when the rate of tax rates left on the ground and the transfer of property take place according to a plan outlined for a certain period of time. It should also be noted that due to the unequal economic development of municipalities, leaving part of the income tax on the ground can have a positive impact on only a small part of municipalities where the share of employees is relatively high. For some self-government, in terms of revenue growth, the transfer of agricultural and/or non-agricultural lands and natural resources may be more important. Therefore, creating the necessary basis for the economic development of municipalities requires a complex approach and focusing on only one area (either finance or property) will ultimately have less effect. One of the tasks of the policy should be,

at the initial stage, to identify the municipalities that, through their economic development, can exercise their powers independently of the central budget. At the same time, the government should be given the opportunity to pursue an effective equalization policy for the development of economically weak, depressed economies [8].

One of the important issues of local self-government financial independence is the right to borrow, especially in terms of low income they have. As it is known, local self-governments have the right to economic activity, which is difficult to believe without the full right to take a loan. According to Article 21 of the Budget Code of Georgia, "Autonomous Republics and local authorities have the right to borrow from the Government of Georgia and/or other sources only with the permission of the Government of Georgia." The caution of legislators with respect to borrowing by the municipality based on negative practice when a local government took a loan from a commercial bank and then could not repay it, or it was repaid from a targeted transfer. In fact, in most cases, borrowing was done with the intervention of the central government for various political reasons. Consequently, the Budget Code continues to be a bad practice and the central government continues to restrict borrowing by the self-government. In our opinion, local self-government should have the right to take a loan. While exercising this right, there may be different conditions and mechanisms in this Code or other normative act defined by law.

Thus, it is important that the powers of the municipality should be adequate to its sources of revenue. However, this should not be understood in such a way that since the municipality does not have sufficient budget revenues, the scope of its authority should also be reduced. On the contrary, municipalities should be given the authority to address issues of local importance as much as possible and adequate funding should be provided for this. In this context, in addition to tax revenues, it is important that the municipality be given as much property of local importance as possible, the conditions for the proper use of which the municipality will have additional opportunities to generate revenue.

5 Conclusions and recommendations

Creating a universal model of decentralization is practically impossible, as every country has its own history and specifics of self-structuring. Thus, each of them must individually define the principles of separation of functions of central and local government and the degree of autonomy of self-governments.

The main function of fiscal policy in any arrangement state was and is to ensure the socio-economic status (welfare) of the society. The level of welfare of a country depends on how developed its economic system is and what security guarantees are created. Prosperity is defined by the material goods and services necessary for a comfortable and secure human life. The material progress and prosperity of a nation is achieved only if it leads to the moral and material well-being of each citizen.

Therefore, when forming the municipal budget, the following approaches should be taken into account:

1. Extended tax discretion of the self-government. Local governments should have the authority to impose both direct and indirect taxes. Basic tax categories should be introduced (one is not sufficient, property tax). Such segregation / attribution of tax revenues will minimize redistribution processes and establish a stable relationship between the centre and the municipalities.

2. Establishment of fixed interest rates for tax revenue sharing based on the starting economic indicators of self-governing units. In this case, tax revenues are divided between the autonomous state and local budgets according to certain types/percentages. This method will increase the ability to optimally allocate resources. Regions under the influence of the centre receive certain budgetary tax benefits by differentiating their respective interest rates.

3. Determining the percentage of transfers from the total amount of taxes collected in the territorial units to the budget of the centre.

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