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**Working Paper**

## Municipal Finance in Poland, the Slovak Republic, the Czech Republic and Hungary: Institutional Framework and Recent Development

CESifo Working Paper, No. 447

**Provided in Cooperation with:**

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

*Suggested Citation:* Nam, Chang Woon; Parsche, Rüdiger (2001) : Municipal Finance in Poland, the Slovak Republic, the Czech Republic and Hungary: Institutional Framework and Recent Development, CESifo Working Paper, No. 447, Center for Economic Studies and ifo Institute (CESifo), Munich

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# Working Papers

## MUNICIPAL FINANCE IN POLAND, THE SLOVAC REPUBLIC, THE CZECH REPUBLIC AND HUNGARY: INSTITUTIONAL FRAMEWORK AND RECENT DEVELOPMENT\*

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CESifo Working Paper No. 447

April 2001

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\* This paper will be presented at the 41<sup>st</sup> Congress of the European Regional Science Association on European Regional Development Issues in the New Millennium and Their Impact on Economic Policy, Zagreb, 29<sup>th</sup> August – 1<sup>st</sup> September 2001. The original study was financed by the World Bank and the Free State of Saxony. Its major outcome was highlighted in relation to the Saxon municipal resource allocation system by Prof. Hans-Werner Sinn at the Regional Conference on Reconstruction of Economics and Administrations in Central and Eastern Europe, Dresden, 30<sup>th</sup> November – 1<sup>st</sup> December 2000. Authors are specially grateful to Vera Kamenickova of the Czech Ministry of Finance in Prague, Viktor Niznansky and Miroslav Knazko of the Centre for Economic and Social Analysis in Bratislava, Jozsef Hegedus of the Metropolitan Research Institute in Budapest and Jacek Sierak of the City of Reguy (Poland) for their research contribution.

# MUNICIPAL FINANCE IN POLAND, THE SLOVAK REPUBLIC, THE CZECH REPUBLIC AND HUNGARY: INSTITUTIONAL FRAMEWORK AND RECENT DEVELOPMENT

## Abstract

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

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

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

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## 1. Introduction and Basic Theoretical Background

The relationship between central and local (and municipal) government is changing. For this reason it has traditionally been a major subject of political discussions. The idea of decentralisation of political decision-making has become increasingly fashionable world-wide, which is also accompanied by fiscal decentralisation in most cases. In some developed countries the systems of intergovernmental finance have evolved gradually and each country has unique features (Ahmad, Hewitt and Ruggiero, 1997). Emerging countries on different continents have had differing reasons and motivations for such reforms and their consequences for macro-economic stability and growth have also varied significantly from one country to another (Fukasaku and de Mello, 1999). More recently, the acknowledgement of subsidiarity as the basic principle for the European Union, the introduction of the west German federal system in the eastern part of the country, the revival of regionalism in Western European countries like Portugal are distinctive examples of the decentralisation process in Europe. This kind of political decentralisation has also been pronounced in the transformation countries of Poland, the Czech Republic, Slovakia and Hungary. To be sure, such development is “a reflection of the political evolution toward more democratic and participatory forms of government, seeking to improve the responsiveness and accountability of political leaders to their electorate, and to ensure a closer correspondence of the quantity, quality, and composition of publicly provided goods and services to the preference of their beneficiaries” (Ter-Minassian, 1997, p. 3).

Compared to the case for cities and municipalities in western Europe, those located in the transformation countries have been confronted with more serious problems caused by the speedy industrial modernisation and de-industrialisation, the rapidly increasing public activities due to social, economic, health and environmental ills, as well as by the provision of additional new (city-specific) infrastructure that is often better adapted to newly emerging economic activities. In particular, the challenges for large cities in Eastern Europe have been more immediate and have also become more intensified in the course of the ongoing economic and political transition. On the other hand, it is argued that since the large agglomeration areas provide an unparalleled business environment to economic sectors, rural regions and municipalities are at loss to compete, which, in turn, leads to the increase in regional disparity in a country. As a result, municipalities in disadvantaged regions suffer from a net reduction in population size, decreasing local tax revenue, fewer job opportunities etc. Furthermore, cities and municipalities in transformation countries seem to be (in some cases seriously) suffering from a lack of necessary financial means to

cover the increasing expenditures and to meet current challenges. Such fiscal stress usually takes place either when the costs of providing local services increase faster than revenues needed to finance them, or when, at given costs of public service provision, local government revenues are constrained by a declining economic base which reduces taxable resources.<sup>1</sup>

Following the so-called equalisation objectives, one easily tends to argue that those municipalities and cities with greater spending needs automatically require more financial support from central or upper-level government. Yet, the sum of grants to municipalities should basically be induced from the comparison of their (existing and/or anticipated) ‘true’ expenditure needs with local fiscal capacity from their own resources such as local tax revenue and fees.<sup>2</sup> To be sure, the expenditure behaviour of municipalities is also, to a great extent, influenced by their present fiscal capacity as well as by the size of local debts. In the provision of infrastructure, local governments tend to (critically) consider an increase in local taxes, especially when intergovernmental grants to municipalities do not adequately compensate the existing fiscal stress that is caused by large expenditure needs, and/or, when the total sum of local debts has already reached the maximum level that should not be exceeded. In addition, the city or municipality with well-equipped infrastructure is obviously more attractive for investors and firms looking for a new location, while the increase in local taxes immediately means the loss of regional and municipal competitiveness. In the case that the additional provision of infrastructure will mainly be financed by higher local taxes, local governments should also be well aware of such a trade-off relationship and their short-term as well as long-term effects on the local economy (Nam, 2000; Nam, Nerb and Russ, 1990).

According to the well-known subsidiarity principle, efficiency in the allocation of financial resources is best achieved by assigning responsibility for each type of expenditure to the level of government that most closely represents the beneficiaries of provided public goods and services (Frenkel, 1986; Hyman, 1993; Ter-Minassian, 1997). In other words, the expenditure assignments involve decisions as to which level of government should be

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<sup>1</sup> For example, large German cities have continually lost part of their major income — revenue from trade taxes (*Gewerbesteuer*) and income taxes — due particularly to the ongoing sub-urbanisation process and the recent economic recession as well as the reduction of tax revenue caused by tax reforms. In addition, as a direct consequence of unification, grants from upper-level governments to the cities in the context of the German intergovernmental resource allocation system (*Finanzausgleich*) have been partly reduced.

<sup>2</sup> It is widely accepted fact that ‘needs’ are subjective and, therefore, cannot be easily quantified. Nevertheless, a large number of resource transfer methods between different levels of government and of measurement methods of local expenditure needs have been developed in the past and also implemented in many industrialised countries, which range from exclusively political to straightforward statistical ones. Furthermore, there have been serious and ambitious efforts to devise as well as to improve these methodologies, so that the so-called true financial needs of municipalities could be measured in a more effective and systematic way. In particular, the dispute about the relationship

predominantly responsible for the formulation, financing and administration of policy activities and related follow-ups. Compared to the apparent cases for the central provision of national public goods and services like macro-economic stabilisation, redistribution, defence and foreign affairs,<sup>3</sup> those activities related to social protection, education and health as well as environment have generally been considered as typical public services which can be well provided by local or regional governments. Yet, in most cases public goods have a character of mixed goods, for which some degree of decentralisation combined with some centralised co-ordination appears to be feasible and desirable, due to unclear distribution of benefits among regions, externalities and spill-overs, etc. As a consequence, overlapping responsibilities in policy formulation, financing and administration of public goods and services are quite common, which have also partly contributed to the existing great variety of intergovernmental fiscal arrangements and expenditure assignments among different countries (Levin, 1990; Ahmad, Hewitt and Ruggiero, 1997).<sup>4</sup> Furthermore, the central government in many countries can influence the decentralised provision of public goods through the regulation of their delivery in terms of quality and the ex post control of the use of financial means and transfers.

The strong policy orientation of allocation objectives in terms of the devolution of expenditure responsibilities to local governments can create conflicts with the achievement of the macro-economic stabilisation and the redistributive goal, which appear to be better accomplished by the central government (Musgrave, 1983; Oates, 1972). Although “the overall levels of expenditures of [regional or local] governments is effectively constrained by limits on their taxation and borrowing powers, changes in composition [for example, in favour of transfers to individuals with a high propensity to consume] may run counter to the stabilisation objective of the central government” (Ter-Minassian, 1997, p. 5). Empirical investigations (including Brosio, 1985) do not always confirm the so-called Leviathan hypothesis by Brennan and Buchanan (1980) that decentralisation generally limits the growth of total government expenditure. Furthermore, “with increased decentralisation comes the possibility of loss of macroeconomic control as local bureaucracies multiply,

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between the per capita level of local expenditure needs and the size of the municipality (in terms of population size) has not yet been fully settled (Nam, 2000).

<sup>3</sup> According to the conventional literature, this type of centralisation is necessary when (a) certain public goods have non-rival consumption within an entire country as is the case for defence and macro-economic policies, (b) significant economies of scale are present in the provision of these goods, and (c) undesirable population and capital movement can result from variations in policy and the level of provision between jurisdictions.

<sup>4</sup> “For instance, there are certain efficiency advantages to local supply of primary education and preventive health care, such as possibly better quality through local supervision, and allowance for communities to express cultural and curative preferences. For tertiary education and hospitals, existence of economies of scale and externalities (their benefits accruing to more than one jurisdiction) imply that more centralized control may be warranted. However, the demand for minimum standards often requires that centralized decision making of policies be ensured for all these [local public] services” (Ahmad, Hewitt and Ruggiero, 1997, p. 25).

[which make] monitoring and evaluation more problematic [...]” (Ahmad, Hewitt and Ruggiero, 1997, p. 31).<sup>5</sup> In a country with large economic disparity among its regions, the ability of local or regional governments to deliver public goods and services can also vary widely, which, in turn, could trigger undesirable internal migration.<sup>6</sup> In countries in transition such type of economic policy conflicts appear to be more adequately taken into account in making decision about assigning certain expenditure responsibilities to local governments.

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

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

Table 1 illustrates more precisely how different types of taxes and grants can be assigned to the lower level of governments.

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<sup>5</sup> The macro-economic stabilisation function is generally judged to be inappropriate for subnational assignment, because “(a) raising debt at the local level would entail higher regional costs while the benefits would spill beyond regional borders, and too little stabilisation would be provided as a result; (b) the monetisation of local debt will create inflationary pressure and pose a threat for price stability; (c) currency stability requires that both monetary and fiscal policy functions belong to the centre alone; and (d) cyclical shocks are usually national in scope and therefore require a national response” (Shah, 1999, p. 38).

<sup>6</sup> On the other hand, the Tiebout and tax competition models show that competition among local governments induces localities to provide an efficient configuration of local public goods (Tiebout, 1961). Since residents are mobile between localities, these theories argue that they will select the area which offers them the optimum combination of public service and taxes to pay.

**Table 1     Fiscal autonomy in local governments**

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

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

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

- The base of local taxes should be neither very mobile nor very unevenly distributed among jurisdictions. In the case of prevailing strong mobility, taxpayers will relocate the income activities or tax sources from high to low areas. This fact will also limit the freedom of local governments to change the rates.
- Local taxes should be accountable and local taxpayers should know what the tax liabilities are. In addition, they should be fairly easy to administer on the local level.
- The link between payment of the tax and local service received should be intact. In other words, such benefits should be strongly internalised to the local taxpayers.
- Local taxes should be able to generate sufficient revenue to avoid large vertical imbalances and ideally be less sensitive to the changes in business cycle.

In accordance with such criteria mentioned above, land or property taxes and, to some extent, personal income taxes have been quite often suggested to be suitable local taxes, while corporate income taxes have usually been considered to be less appropriate for the same purpose (Paugam, 1999). For example, “[in] some countries, state-level taxation of corporate profits, in the absence of a coordinated approach, has been accompanied by strong competition (tax wars), leading to distortions in enterprise’s location decisions, tax



avoidance through transfer pricing by enterprises operating in multiple areas, and erosion of revenue” (Ter-Minassian, 1997, p. 10).

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

Basically the re-allocation of fiscal resources from one level of government to another takes place through sharing of tax revenues or through a form of grants. In the case of revenue sharing, tax bases can be shared on a tax-by-tax basis (in some cases with different coefficients of distribution among levels of government for each tax),<sup>7</sup> or taxes can be pooled and shared systematically thereafter, as illustrated in Table 1. According to the previous experiences in emerging countries, such revenue sharing arrangements appear to be less successful in encouraging local revenue mobilisation (Fukasaku and de Mello, 1999). Grants from higher (federal or state) to lower levels (state or local) can be conditional (i.e. closely tied with specifications regarding the use of the funds and/or the performance

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<sup>7</sup> This type of arrangement “may provide an incentive for the [central government] to concentrate its collection and enforcement efforts on the taxes that are not shared or are shared to a lesser extent.[...] Fixed revenue-sharing [including the determination of revenue portion going to the local and regional governments, e.g. in terms of a constant rate to the shared tax base] can also have pro-cyclical [macro-economic] effects, as increases in shared revenues during periods of boom increase the capacity to spend of the [local or regional] governments, while decline in revenues during economic downturns force them to cut back spending. [...] The distribution of shared revenues among subnational jurisdictions is often made on a derivation basis, with each jurisdiction getting the share of the revenue collected in its territory. [Yet, such a type of distribution method appears to be less suitable] to correct horizontal imbalances, under [the derivation principle] the level of the transfer from the centre to each subnational government is positively correlated with the taxing capacity of the latter” (Ter-Minassian, 1997, p. 12f.).

achieved in the supported programme),<sup>8</sup> or unconditional respecting the autonomy of local governments in spending such financial means. The so-called block grants also have a fixed character, which are, however, designed to support broad areas of local activities (like education, environmental preservation, etc.) rather than specific projects. On the other hand, intergovernmental grants can be open-ended<sup>9</sup> — regardless of the transfer size required to cover the expenditure needs of individual local governments — or subject to certain limits. In addition, the down-flow grants have been quite often made in the EU on the basis of the so-called additionality principle, which requires — as a eligibility criterion for the supporting grants — the partial financial participation of local governments in providing local goods and services in its territory.<sup>10</sup>

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

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<sup>8</sup> In most cases the imposition of conditions can be justified from the redistribution point of view, for example, to guarantee the minimum nation-wide standards for the provision of services of national concern like primary education, health care, pollution control, etc. (Ahmad and Craig, 1997).

<sup>9</sup> Those who favour the sound development of national budget and macro-economic stability as well as the reduction of corruption tend to be against those open-end types of grants.

<sup>10</sup> In countries like Canada, Australia, Japan and the United Kingdom, tax bases between the central and sub-national (state and local) government are divided in a way that the former receives a significantly or extremely higher share of total tax revenues. At the same time, the central government provides specific and unconditional (i.e. general) grants for the lower level governments. The general grants are in most cases equalisation-oriented and aimed at rectifying regional disparities (Peacock, 1977; Chandler and Zollner, 1986; Watts, 1991; Boadway and Hubson, 1993; Elzar, 1997; Ma, 1997; Worthington, Dollery and Edward, 1998). The United States has a marked preference for conditional grants: In the early 1990s matching grants amounted to more than 90% of federal intergovernmental transfers to state and local governments (Rosen, 1995). Germany has a unique tax assignment system: All major taxes (personal and corporate income taxes as well as value added tax) are shared by the federal (*Bund*), state (*Länder*) and municipal (*Gemeinde*) governments. Altogether these shared taxes currently amount to ca. two thirds of tax revenues in the country. In the context of the so-called German state resource allocation system (*Länderfinanzausgleich*) unconditional grants are made from states with above-average fiscal capacities (e.g. Bavaria, Baden-Württemberg and Hesse) to states with below-average fiscal capacities (e.g. Saarland, Lower Saxony and New German Länder). In addition, the federal government offers supplementary grants to the financially weak states in the eastern and western parts of Germany, of which some also have conditional character (e.g. for solving debt service problems in Bremen and Saarland). Unconditional transfers from state governments to local authorities also occur within a state in the context of the so-called municipal resource allocation system (*Kommunalfinanzausgleich*).

and other unfavourable creditworthiness) quite often suffer from the lack of direct access to credit markets.<sup>11</sup>

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

- primary reliance on market discipline without the so-called bail-out guarantee of the central government when the credit market is free and transparent information prevails (Lane, 1993),
- a dialogue-oriented co-operation and negotiation among different levels of governments in the design and implementation of debt controls (including limits on the indebtedness of sub-national governments),
- rules-based controls as specified in the constitution or by law regarding, for example, setting on the purpose- or project-oriented limits of the absolute level of local debts,<sup>12</sup> and
- direct administrative controls of the central government over local borrowing, including setting of annual limits on the overall debt of individual sub-national jurisdictions, the tight review and authorisation of individual borrowing operations like credit approvals (or the centralisation of all government borrowing) and the ex post monitoring, etc. (Ter-Minassian, 1997; Ter-Minassian and Craig, 1997; Shah, 1999).

All these controls can also be classified into passive and active controls, as illustrated in Table 2.

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<sup>11</sup> Developing countries like India and Pakistan, for example, do not allow local governments to access credit markets.

<sup>12</sup> “Rules-based approaches have the obvious advantage of transparency and even-handedness, as well as of avoiding protracted bargaining between the central and the [local governments, but] lack flexibility [...]” (Ter-Minassian and Craig, 1997, p. 166).

**Table 2 Active and passive controls over local borrowings**

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

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

As mentioned before, the provision of public services and infrastructure and their finance is being decentralised in Hungary, Poland, the Czech Republic and Slovakia. However, the national fiscal policy and regulatory framework appears to still have a crucial impact on local governments' expenditure behaviour and to limit their ability to mobilise own tax income. In addition, the expanded local government role in providing public services and in obtaining the necessary financial resources remain disturbed by the weak institutional and administrative co-operation with the central government and by the less well-developed financial market. This comparative study aims at examining principal and immediate issues on political and fiscal decentralisation in the selected European transformation countries including expenditure and revenue assignments, intergovernmental transfer systems, local borrowings, etc. In addition, an empirical attempt is made on the basis of available data to identify the recent development of municipal expenditures and revenues in these countries.

## **2. Comparison of Similarities and Differences in Municipal Finance in Poland, the Slovak Republic, the Czech Republic and Hungary**

### **2.1. Fiscal Decentralisation in Selected Eastern European Countries**

The recent process of political and economic transformation in eastern European countries has not only contributed to the decentralisation of political structure but also significantly enhanced the fiscal autonomy of municipalities belonging to these countries. For example, the number of Czech and Hungarian municipalities rapidly grew at the beginning of the

1990s, whose development had been significantly hindered by the politically forced amalgamation policy under the former communist regimes. As a consequence, the size of municipalities measured in terms of the number of inhabitants is rather small in these European transition countries. For example, the number of Czech municipalities increased by 50% between 1990 and 1992 and reach 6237 municipalities at present, of which 87% are with less than 1500 inhabitants. In Hungary the number multiplied from 1523 (1990) to 3154 (1999) and the average size of municipality is currently 3482 inhabitants.

Although the degree of self-governing ability of municipalities seems to vary from one country to another, many similar types of public activities have recently been assigned to local governments, and some taxes were also declared to be so-called local taxes. To be sure, this type of fiscal decentralisation has also caused some additional problems, particularly for safeguarding the quality of publicly provided goods and services and for co-ordinating intergovernmental fiscal affairs between the central and local governments in an efficient way. For instance, some criticise that a large number of small-sized municipalities in the Czech Republic, the Slovak Republic, Hungary and Poland have suffered from financial bottleneck and have not been able to receive financial support from the central government that was necessary for their economic development.

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

tier of local governments) in the Czech Republic and Poland at the end of 1999 was not aimed at reducing the autonomy of municipalities at all.

## **2.2. Expenditure Assignments**

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

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

In the Czech Republic the provision of such local public goods and services is somewhat differently organised. For education (the most important 'own' local activities), municipalities are responsible for the provision of pre-school facilities and primary schools (up to 15 years of age), as far as the maintenance of buildings and operating costs are concerned. On the other hand, teachers' wages are paid out of the central budget. In general, private companies carry out the task of solid waste collection. Water supply and waste disposal systems were also largely privatised, although municipalities have substantial equity shares in these companies. Local governments have also 34% of stock shares of companies distributing gas and electricity. The health care system is organised by health insurance companies in the Czech Republic. The so-called 'delegated' responsibilities of municipalities include keeping the birth, marriage and death registers, the implementation of construction and physical planning law. Environmental protection, the provision of local transportation, ensuring water standards, sanitation etc. also belong to this responsibility group. Only 6% of municipalities currently provide all these delegated functions, from which the surrounding smaller municipalities can also benefit in the context of inter-municipal agreements or by the district office decrees. The municipal expenditures related to the provision of delegated local activities are partly covered by grants from the central government.

In all the investigated countries, there are no regulations and norms set by the central government concerning the minimum level of services expected from local service pro-

viders. For the above-mentioned delegated responsibilities in the Czech Republic, special laws clearly prescribe the ways a municipality should carry out these activities. In case a municipality does not provide local services by itself but the provision is made by a private body or non-profit organisation, municipalities usually define the level and quality of the provided goods and services.

The analyses on the mid-term development of municipal expenditures are generally concentrated on the years between 1993 and 1999. The recent changes in local expenditures of a country well correspond to the development of the macro-economic business cycle in the same country. For example, a continuous growth of total local expenditures was observed in Poland from ca. 28 to 48 billion zlotys (expressed at 1998 prices) between 1994 and 1998. In Slovakia, the amount expressed at current prices increased from 19 billion SKK (1994), reached a peak at 27 billion SKK in 1997 and declined gradually thereafter (24 billion SKK in 1999), while the Czech annual values between 1997-99 showed a continuous upward trend from 134 to 150 billion CZK. Hungary's municipal expenditures also grew from ca. 611 to 1110 billion HUF over the years 1993-97.

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

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

### **2.3. Revenue Assignments**

In recent years, the development of local budgetary revenues was quite expansive in the investigated eastern European countries. For instance, Polish, Hungarian and Czech municipalities experienced continuously increasing total fiscal revenues, although relevant statistics are available in the latter two countries only in nominal terms. Municipal revenues increased in Poland from approximately 28 billion to 49 billion zlotys in the period 1994-98 in real terms, in the Czech Republic 108 billion to 210 billion CZK between 1994 and 1999 and in Hungary from 861 billion to 1568 billion HUF over the years from 1995 to 2000 (Table 3). In addition, the size of so-called 'off-budget' revenues is estimated to be ca. 10% to 30% of the total local government budget in Hungary. The Slovak case is rather different: municipalities in this country experienced the peak of the total revenue level in 1998 (at ca. 29 billion SKK). Furthermore, the per capita fiscal income level was always the highest for urban municipalities in Poland (e.g. 1352 zlotys for urban municipalities compared to 1193 zlotys for all in 1998). This was



mainly caused by the highest level of exclusive local revenues yielded in this type of gminas (= 503 zlotys compared to 399 zlotys for all municipalities at the same year).

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

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

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

**Table 3**      **Classification of recent municipal budgetary revenues according to the individual revenue items**

	Poland	Czech Rep.	Slovakia	Hungary
Absolute amount of total revenues	28 billion zlotys (1994) → 49 billion zlotys (1998) (at 1998 prices)	108 billion CZK (1994) → 210 billion CZK (1999) (at current prices)	20 billion SKK (1994) → 29 billion SKK (1998) → 27 billion SKK (1999) (at current prices)	861 billion HUF (1995) → 1568 billion HUF (2000) (at current prices)
of which				
Revenues from local taxes and fees	35% on average	35% on average	15% on average	30% on average
Revenues from tax sharing	25% on average	7% on average	25% on average	2% in 1995 (24% in 1990)
Non-tax revenues	Marginal	21% on average	35% on average	8% in 1995 (4% in 2000)
Intergovernmental transfers and grants	35% on average	20% on average	15% on average	60% on average
Bank credits & municipal bonds	3% on average (1% in 1994 → 6% in 1998)	17% on average (4% in 1994 → 20% in 1999)	10% on average (5% in 1994 → 12% in 1999)	3% on average

Source: Sierak (2000), A Study on the Municipal Finance in Poland, Warsaw (mimeo); Knazko (2000), Municipal Finance and Governance in the Slovak Republic, Bratislava (mimeo); Kamenickova (2000), Municipal Finance and Governance in the Czech Republic, Prague (mimeo); Hegedus (2000), Municipal Finance and Governance in Hungary, Budapest (mimeo); Estimation of the Ifo Institute for Economic Research, Munich.

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

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

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

## **2.4. Intergovernmental Transfer Systems**

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

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

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

Hungary currently has a quite complicated intergovernmental system and the most important sources for municipal finance in this country have been grants that comprised around 60% of total budgetary revenues of local governments in the last 6 years. In general, the down-flow transfers can be classified into the following different groups: (a) normative grants, (b) purpose-oriented matching grants, (c) deficit grants, and (d) special 'addressed' and 'targeted' subsidies for supporting municipal investment activities, as well as (e) the new grant for equalising fiscal capacity. The most substantial transfers are those normative (partly also equivalence-oriented and formula-based) types that include per capita grants based on the size of population, grants for core public services based on the number of beneficiaries, capacity grants made on the basis of bed number in shelters for homeless people and matching grants for the tourist tax. Their share amounted to ca. 40% of the local budgetary revenues in 1993 but declined to 25% in 1998. Matching grants with the increasing share of ca. 18% (1993) to 22% (1998) were mainly addressed to

health care institutions. Deficit grants are aimed at supporting municipalities with high fiscal deficits: in 1997 840 local governments received ca. 6 billion HUF of which the sum increased to 12 billion HUF for 1230 municipalities in 1999. Although the size of such deficit grants appears to be negligible, they tended to discourage revenue-raising efforts of local governments and to reward increasing expenditures at the same time. Investment activities related to water supply, health and social security, and education have been promoted by the addressed and targeted grants of which the total sum is defined annually (e.g. 52 billion HUF for 2000). The targeted subsidies aim at reducing the effective investment costs for promoted projects by a certain percentage share (usually 40% to 50%), while the traditionally addressed types often cover the entire investment costs. The new grants for fiscal equity introduced in 1999 are calculated on the basis of municipal business tax capacities and paid up to a given normative per capita level that varies according to municipal types (e.g. villages, cities, etc.). In 1999 a sum of 38 billion HUF was distributed for this purpose. As a whole, the shift from a general grant system toward a more project-oriented down-flow transfer system was observed in the 1990s.

## **2.5. Municipal Borrowings and Debt Management**

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

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

Apart from the Prague bond with a value of 7.4 billion CZK issued in 1994, the most meaningful proportion of local debt has recently been the bank loans in the Czech Republic (notably from the Czech Savings Bank). Bank credits comprised ca. 44% of the total local debts of 40 billion CZK compared to 27% for municipal bonds in 1999. According to the available data, the share of municipal borrowings amounted to 3.5% of total local revenues of 108 billion CZK in 1994, of which the share reached ca. 19.1% of the corresponding total revenues of 210 billion CZK in 1999.

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

Hungarian municipalities have traditionally had low borrowings (e.g. around 23 billion HUF in 1995 and 36 billion HUF in 2000). This item comprised, on average, ca. 2.7% of the total local budgetary revenues for the individual years between 1995 and 2000. Such low local borrowings were partly led by the weak engagement of private banks in this matter and the grant-maximisation strategy of municipalities. The issuance of communal bonds (22 cases) is presently underdeveloped in Hungary.

### **3. Summary and Concluding Remarks**

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

Several similar types of public activities have been legally assigned to local governments in the investigated countries which include land planning and local environmental protection, municipal housing and property management, local transport system, water supply and waste disposal, primary health care and social welfare services, elementary education, culture and sport, fire protection, etc. In general, there are no specific regulations and norms set by the central government concerning the minimum level of services expected from local service providers. The concentration of local expenditures on large urban municipalities can also be explained by their specific function as the so-called central places for surroundings as well as by their strong economic bases that generate higher fiscal revenues. The importance of inter-juridical external effects of public goods appears to be less adequately acknowledged by municipalities in the selected transition economies until now, which has, in turn, encouraged the non-cooperative behaviour of local governments when providing such goods. The public-private partnership is increasingly becoming popular for local activities such as water supply, waste treatment and public transport services. Local expenditures of municipalities in the investigated

Eastern European countries tend to increase gradually, although their annual trend can be partly disturbed by the development of the macro-economic business cycles.

In spite of the continuous growth of local budgetary revenues in previous years, the ability of municipalities to mobilise own fiscal resources that are required to meet the rapidly increasing expenditure needs is generally judged to be rather limited, partly because relevant decisions on local tax bases and rates as well as tax sharing schedules have been made by the central government and/or subject to strict restrictions indicated in the national tax law. Although the intergovernmental transfer system is constructed differently from one country to another, the dominance of a purpose- and project-oriented grant system is apparent. The amount of intergovernmental transfers from the central government has traditionally made a substantial contribution to the total municipal fiscal capacity in the investigated transformation countries, and such a trend is likely to continue in the future. In other words, in adopting such abundant financial means, the central government in these countries will further try to lead the provision of local public goods and services, which, on the other hand, could make the process of carrying-out legally assigned public activities by municipalities less 'self governing'. Yet, it should be emphasised that a full-scale realisation of the subsidiarity principle in the field of local expenditure assignment should ideally be accompanied by the provision of sufficient own fiscal resources and unconditional transfers which can be appropriately and efficiently adopted by the individual municipalities according to their own needs.<sup>13</sup> In spite of the 'one-time' revenue character, non-tax revenues appear to remain as one of the major budgetary resources in the mid-term for Czech and Slovak municipalities.

Local borrowings in forms of (mostly short- and mid-term) bank credits and communal bonds have rapidly emerged as financial means to meet the increasing municipal expenditure needs in the investigated transition economies, although their significance has remained rather moderate. Basically, there are neither legal limits for local credits nor intervention of central government to restrict and to forbid borrowing activities (except in Hungary), which means that the debt control primarily relies on market discipline without the so-called bail-out guarantees of the central government. This can, however, encourage the excessive borrowing behaviour of the individual municipalities. Partly due to the less well-developed financial market, the long-term oriented lending mechanism is not yet popular in the investigated countries, by which the total credit sum can be paid back through the revenues generated by future infrastructure projects.

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<sup>13</sup> See, for example, the intergovernmental resource allocation system between the *Länder* and their municipalities in Germany (Steinherr, et al., 1997).



The intergovernmental devolution of tax administration and the delegation of expenditure responsibilities require a transparent, well-functioning and co-operative public (financial) management for both central and local governments to carry out all the expenditure- and revenue-related activities in an efficient way. In other words, a successful fiscal decentralisation can only take place in a country when in all tiers of government the systematic tax collection and enforcement occurs in parallel with the sound expenditure choice of local needs and cost-effective delivery of public goods and services. Apart from the legally defined formulation of a standardised local budget, its approval, execution and supervision in all the investigated countries, the budgetary law of local governments is generally incorporated in the nation-wide budgetary law system. In spite of such a relatively well-defined legal framework and recent efforts to enhance the municipal ability to organise efficient cash management, to introduce cost control mechanism, to better monitor expenditures and to establish a well-functioning financial reporting system, etc., the budgeting and accounting practice of local governments still fails to deliver adequate information and a real overview on the financial situation and the accomplishment of municipal activities. Most importantly, municipal budgets do not contain any information about the off-budget activities of local governments. Since accounting standards for local governments (particularly in the Czech Republic and Slovakia) do not require the declaration of granted guarantees and/or other contingent liabilities, it is nearly impossible to estimate the extent of such warranties that individual local governments have provided.

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