

Joint Integrated Local Development Programme

**Report on
Local Government Finances
International Practices and Models**



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Introduction and executive summary

The objective of this report is to describe and reflect different financial aspects of local governments in different European countries, to show the variety and complexity of local government finances. The task of this report is to provide reference on international practice within following analysis of the local government finances in Moldova and for proposals for development of local finance system in Moldova, particularly for own revenues, shared taxes and transfers of Moldova local governments.

The report consists of 11 chapters and Annexes.

With to aim to provide complete picture of finance decentralization first two chapters of the report are devoted to general aspects of local governments and their responsibilities. Third chapter provides provisions of European Charter of Local Self-Government on finances and reflects the trend of dynamics of local government finance autonomy indicators in Europe. In fourth chapter one can find characteristic of local government budget as well as data on main expenditure categories in local governments of European countries. In fifth chapter the structure of local government revenues is provided and chapter six follows with kinds of own revenues. Next two chapters detailed describe tax revenues, both own-source taxes and shared taxes, local fees and user charges. Chapter eight is about the grants, their importance and kinds, and special attention in this chapter is devoted to equalization. Chapter nine contains information on local capital investments, but the tenth chapter describes the borrowing rules, what is one main capital investment sources for local governments. Last chapter is devoted to government and local government consultations issues. Definitions, descriptions, general aspects and data provided in chapters are illustrated with cases from countries rather similar to Moldova, longer cases are included in Annexes.

As the Moldova has ratified the European Charter of Local Self-Government in 1998 without any reservations, and the Government of Moldova is obliged to follow principles of the Charter during the decentralization process, the Recommendations of the Council of Europe on local government finances are included in the Annexes.

Project team would like to express its gratitude to Mr. Gabor Peteri, UNDP Moldova project quality assurance expert for methodological guidance and valuable inputs provided in designing this report.

This report will be distributed to the key project stakeholders: Ministry of Finance, UNDP Moldova, State Chancellery and interested parties from local governments.

Abbreviations

AT	Austria
BE	Belgium
BG	Bulgaria
CH	Switzerland
COFOG	Classification of the Functions of Government
CoE	Council of Europe (47 countries)
CY	Cyprus
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
ES	Spain
EU	European Union (27 countries)
EUR	euro
FI	Finland
FR	France
GR	Greece
HU	Hungary
IE	Ireland
IS	Iceland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
NO	Norway
OECD	Organization for Economic Cooperation and Development (34 countries)
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia
TUR	Turkey
UK	United Kingdom

1. General aspects of local governments

It is accepted to view the combination of local decision making (legislative) and executive authorities as a local government. Local government is the touchstone of every democracy, its cradle and also its mirror – the better developed the local governments, the higher the level of democracy in a country.

One can find the main principles of local self-governments in the *European Charter of Local Self-Government* that is the first internationally binding treaty that guarantees the rights to communities and their elected authorities. The Charter was opened for signature as a convention by the Council of Europe member states on 1985, it entered into force on September 1, 1988 and by now it had been ratified by 44 of 47 Council of Europe member states¹.

The European Charter contains the definition of local governments:

*Local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population*².

In Europe there are the federal and the unitary states, which determine the basic characteristics of the administrative-political conditions of decentralization. Among the unitary countries the territorial organization of local governments is characterized with great diversity – different are the number of local governments' levels (tiers), relations between levels, size of local government by population, area and their disparities within the country. Territorial organization of local governments varies not only from country to country, but in some cases within a country.

There are countries what have only single local government level. For example such countries are Bulgaria, Cyprus, Estonia, Latvia, Lithuania, Finland³, Luxembourg, Malta, and Slovenia. These countries tend to be small in geographical and/or demographic terms⁴.

Such countries as Czech Republic, Denmark, Greece, Hungary, Ireland, Netherlands, Norway, Romania, Slovakia and Sweden have two local governments' levels, namely the municipal as local or first level and regional as second level. In Europe these countries tend to be medium-sized in geographical and/or demographic terms. The second sub-national government level can take very different forms, depending on the country history and administrative traditions: regions, counties, districts, departments, provinces etc⁵.

Some countries has three local government levels, they are France, Italy, Spain, Poland. In the United Kingdom the higher sub-national level covers the three "devolved nations" of Scotland, Wales and Northern Ireland, but the number of local government levels in the different parts of the country differs.

¹The Charter came into entry in Moldova in 1998 without any reservations, so the Government of Moldova is obliged to follow these principles during the decentralization process.

² European Charter of Local Self-Government, Article 3.1.

³ There is the autonomous region of Åland and the experimental Kainuu region in Finland, but the country is considered as county with one level local government system.

⁴ Dexia, 2008, pp. 37

⁵ Dexia, 2008, pp. 37

Besides there are countries with federated entities in sub-national level, like Austria, Germany, Belgium, Switzerland and Spain might be regarded as a federal country with very strong regional entities. Total number of sub-national levels in Austria are two (local governments and states as federal level), in Germany, Belgium, Switzerland – three (two local government levels and federal level).

Till 2009 the provisions of the European Charter of Local Self-Governments was applied both to local and to upper levels of local governments, but in November 2009 the new recommendation document for governments between local and national level was adopted – the Council of Europe Conference of Ministers responsible for Local and Regional Government adopted *Council of Europe Reference Framework for Regional Democracy*.

Mostly in developed countries first level local authorities are not hierarchically subordinated to second level or higher level local authorities which do not exert surveillance of local authorities at first level.

In Europe in average the largest local governments (municipalities) by population are in United Kingdom (140 thousand inhabitants), then follows Lithuania (60 thousand), Denmark (56 thousands). The smallest by population local governments are in Cyprus (1500), France (1600), the Czech Republic (1660) and Slovakia (1870). The average area of municipalities ranges from 5 km² in Malta to 1550 km² in Sweden⁶.

Table 1. Number and size of local governments in some European countries.

Country	Number of population (millions)	Surface area (thousand km ²)	Number of local governments' levels	Number of local governments in first (lower) level	Average size of local government of first level	Data sources
United Kingdom	61.6	242.51	2	434	140 000	Oxford, 2011
Lithuania	3.3	65.30	1	60	60000	Oxford, 2011
Serbia*	7.5	77.47	1	145/174**	51 710	2002 Census
Denmark	5.5	43.10	2	98	51000	Oxford, 2011
Latvia	2.3	64.59	1	119	19 240	Central Statistical Bureau of Latvia, 2011
Slovenia	2.0	20.27	1	210	9 600	Oxford, 2011 Dexia, 2008
Romania	21.5	238.39	2	3176	6 780	Oxford, 2011
Estonia	1.3	45.23	1	226	6005	Oxford, 2011
Moldova	3.3	33.83	2	898	3 675	Data provided by experts
The Czech Republic	10.5	78.87	2	6249	1 660	Oxford, 2011
France	61.4	547.03	3	36 683	1 600	Oxford, 2011

*Population of Serbia without Kosovo

** 145 LGU in Serbia without Kosovo, 174 in Serbia with Kosovo in 1999. The Serbian Government doesn't recognize the new municipalities organized in Kosovo after 1999 war.

⁶ Dexia, 2008

Data in table 1 reflect the great disparities of local governments' average size in European countries (countries with largest and smallest local governments). Table also contains some examples of administrative territorial organization in countries rather similar by size to Moldova, former Soviet republics what had similar administrative territorial division heritage at the moment of the renewal of independence, as well as Moldova's neighboring countries, which practice later in this report is used as examples.

The municipal spread in Europe is constantly changing.

The first wave of territorial consolidation reforms in Western Europe was started in the 1960s. It was rooted in the economy of scale paradigm stressing, that local services may be delivered cheaper and with better quality in larger local government units. The first wave involved several countries of Western Europe (Austria, Denmark, Sweden, the Netherlands, Belgium, the United Kingdom and Germany) and was also visible in Central and Eastern Europe, where it was implemented without any democratic debate (Poland, Czechoslovakia, Hungary)⁷.

The early 1990s showed a significant fragmentation in most of the transition countries. The number of municipalities has significantly increased in the Czech Republic, Hungary, Macedonia and Slovakia. The public choice argument and the strengthening of local democracy were behind many decentralization policies, which were reactions against the former forced amalgamation. Later there was a trend towards a merging (amalgamation) and cooperation and reduction of number of municipalities with one of objectives being to compensate for the disadvantage linked to the small size of many of municipalities concerned (insufficient financial resources to carry out their responsibilities, limited tax base, high administrative costs etc.).

More recently administrative territorial reforms were implemented in Denmark (in 2007 the number of municipalities in local level was reduced from 247 to 98, and instead of 14 counties 5 regions were created) and in Latvia (in 2009).

Within administrative territorial reorganization process countries try to find optimal first level local government size (scale) and decide on regional level (level between local and central government) responsibilities and administrative territorial solution. In general there is a regionalization process in Europe. Such countries as Ireland, United Kingdom, Poland, Czech Republic, Slovakia has created the regional local governments in the past two decades. But in Estonia, Latvia and Lithuania after independence instead of two level local government system single level local government systems are created. Three neighboring Baltic countries have chosen different ways of the creation of new administrative territorial division – in middle of nineties Estonia abolished previous districts, in Lithuania district level government remained as a single local level, in Latvia at the end of nineties within two level local government system voluntary amalgamation of local governments started, and in 2009 administrative territorial reform was finished with creation of single level local government system. In 2005 also Georgia implemented administrative territorial reform like Lithuania – local governments were amalgamated within territories of previous districts and instead of two level system single level local government system exists.

⁷Swianiewicz, 2010

Box 1. The Administrative Territorial Reform in Lithuania.

In 1994 Lithuania carried out the administrative territorial reform with establishment of 54 local governments with directly elected councils. Before there was two level local government system with 54 units in district level and 580 authorities in the local level.

After the reform in Lithuania in average there are second largest local governments in Europe (after United Kingdom). Now they seem too large, some splitting processes already were implemented in 2000 and total number of local governments is 60. More possible “de-mergers” are being discussed to improve ties between local populations and their elected representatives.

Box 2. The Administrative Territorial Reform in Latvia.

Till local elections in June 2009 local governments in Latvia were organized in two levels. Before 2009 the total number of local governments was 548, including 26 districts (*rajons*), 7 republican cities, 50 towns, 424 rural municipalities (*pagasts*) and 41 reformed municipalities (*novads*). First level local governments were republican cities, towns, *pagasts* and *novads* (522 local governments in total), second level (county level) was formed by 26 districts and republican cities. Seven republican cities were included in both local government system levels as well as they provided both first level local government and district government functions. First level local governments were not subordinated to district governments.

The average population in one local government before the reform was 4.26 thousand, but the number of residents in the smallest municipality was 251. In more than a third of local governments the number of population was under one thousand. After the reform the average size of local government by population is 19.2 thousand. But still after the reform there are significant disparities between municipalities by size. The largest local government is capital city Riga (703 thousand in 2011) and there lives one third from all population of Latvia. The smallest by population *novads* has less than 1400 residents, 3 municipalities has population less than two thousand residents, in 36 the number of residents is 2000-5000.

The information on the reform process is included in Annex 1.

Besides local governments there are five planning regions in Latvia. Planning regions started to develop in Latvia in 1996, based on cooperation between local governments. In 2003 according to the Law on Regional Development (passed in 2002) the government regulations defined the territories of five planning regions. Initial reason of the creation of planning regions was socio-economic planning. Since amendments in Regional Development Law were passed in 2006, the planning region has legal status of derived public person. According the Law the decision making institution of the planning region is the Planning Region Development Council. The members of the Planning Region Development Council are elected from among the councilors of the relevant local governments by the general meeting of the chairpersons of local governments (located in planning region). Already for long time there are discussions in Latvia about the planning regions as second (sub-national) level self-governments or stronger state administration institution with function (service) provision in this territorial level. As the previous real authority level between central government and local authorities (districts) is abolished, those discussions strengthen. In February 2010 the Parliament passed the amendments in the Regional Development Law that introduces the right of state administration institutions to delegate tasks to planning regions. But the discussion on the status and future of planning regions still is in process⁸.

The arguments in favor of territorial consolidation are following:

- Larger local governments have more capacity to provide a wider range of functions, so territorial consolidation allows an allocation of more services to the local level.⁹

⁸ Vilka, 2010

⁹⁹ Swianiewicz, 2010, pp. 3

- There is economy of scale that allows for a less expensive, more effective provision of services in the larger local government units. The most straightforward evidence of this rule has been presented on the issue of spending on municipal administration. It means that unit costs of public services are supposed to be lower in proportion with the increasing size of the service entities. But one has to remember that in case of human service organization the unit cost curve is “U” shaped. It means schools, hospitals, public administration etc. unit costs are decreasing to the optimal size local government, but beyond this point they start to increase, due to more complicated management structures, higher communication costs, etc¹⁰.
- Since large local governments can provide more functions, it is more likely that citizens will be interested in participation in local politics. In this interpretation, consolidation helps to promote local democracy.
- Territorial organization with large local governments produces less income disparities among municipalities, so there is a diminished pressure for horizontal equalization system, which may be costly for the national budget and/or a sensitive issue.
- Administrative capacity of local governments is higher in larger local governments, they have more professional staff and quality of management and service provision is higher. Larger local governments can be more effective in planning and in economic development policies.
- In territorially consolidated system it is easier to reduce problems of free-riding, i.e., situations when locally provided services are consumed by residents who live (and pay local taxes) in another jurisdiction. In other words, consolidation helps to reduce the mismatch between administrative boundaries and catchment areas of services¹¹.

Although there is significant number of advantages reached by the amalgamation of local governments, the process of expected territorial reforms in many countries is very slow or even does not move from standing point. It is concluded about the decentralization in the countries of Central and Eastern Europe: Territorial consolidation, indeed, allows for the allocation of more functions to the local level, but it is not a guarantee of decentralization. It may happen that territorial reform introduced under the flag of strengthening local governments is not followed (or accompanied) by allowing municipalities to assume new responsibilities. Territorial consolidation has not been a decisive factor for functional decentralization. Such factor as political determination for the decentralization agenda, have played much more important roles¹².

Many European countries, especially with large municipalities, have an additional local authority breakdown in the form of “localities”, for example as towns, parishes, villages, city districts, communities etc. Some European transition has chosen such model to introduce and develop decentralization – they have large-sized local governments with developed submunicipal forms of governance. For example, in Bulgaria these are *kmetsvo*, in Poland *solectwo*, in the former Yugoslavia *mesnazajednica*, in Kosovo *bashkesia locale*. In metropolitan local governments submunicipal units brings administrative and social services closer to citizens, in rural areas they have mixed functions of community development and of provision for administrative and public services¹³.

¹⁰ Peteri, 2008, pp.6

¹¹ Swianiewicz, 2010, pp. 3

¹² Swianiewicz, 2010, pp. 5

¹³ Peteri, 2008, pp.9

There is number of countries where some of their municipalities have dual political and administrative status (municipal and higher sub-national level), for example, in Germany, Denmark, Italy, Hungary, Poland, Moldova. There are countries where only capital city has dual status, for example in Austria – Vienna, in Belgium – Brussels, in the Czech Republic - Prague.

In some countries capital city and some other major cities has special status conferring an institutional organization and in some cases additional functions that is different from other municipalities, for example, the Czech Republic, France, Hungary, Poland, Slovakia, United Kingdom. There is special law on the capital city in some countries, and in some cases it contains special provisions of financing issues.

Box 3. The Capital City Law in Slovenia.

The capital city of the Republic of Slovenia is Ljubljana. Ljubljana has constitutional recognition as the capital city but it does not have special administrative status. Slovenia has a special Law on Capital City (2004). The Law primarily regulates co-operation between central government and the city municipality in implementing common tasks, special capital city tasks, spatial planning and development. The Law provides for a special agreement between central government and the capital city, defining additional responsibilities for Ljubljana and additional resources to carry out those tasks. Significant amendments to the Law were introduced in 2009, whereby 0.73% of personal income tax goes to the budget of the capital city (approximately EUR 16 million) to finance special capital city functions¹⁴.

2. Decentralization trends and local governments competence

The European Charter of Local Self-Governments contains the following principles concerning the competence division between public administration levels and competence of local governments:

1. *The basic powers and responsibilities of local authorities shall be prescribed by the constitution or by statute. However, this provision shall not prevent the attribution to local authorities of powers and responsibilities for specific purposes in accordance with the law.*
2. *Local authorities shall, within the limits of the law, have full discretion to exercise their initiative with regard to any matter which is not excluded from their competence nor assigned to any other authority.*
3. *Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy.*
4. *Powers given to local authorities shall normally be full and exclusive. They may not be undermined or limited by another, central or regional, authority except as provided for by the law.*
5. *Where powers are delegated to them by a central or regional authority, local authorities shall, insofar as possible, be allowed discretion in adapting their exercise to local conditions¹⁵.*

¹⁴ Local and Regional Democracy in Slovenia. Council of Europe CLRA, 2011

¹⁵ European Charter of Local Self-Government, Article 4

The core principle among above mentioned is a **principle of subsidiarity**. It is the main principle of power division in EU. Its significance since 1992 is increasing by each amendments of EU primary legislation. It is also formally recognized in the majority of national legal systems.

The principle of subsidiarity may justify the allocation of a task to a local authority, since it is closest to citizens, or justify the allocation of this task to central government, because of the extent or the nature of the task or for reasons of efficiency or economy. The principle of subsidiarity does not simply call for devolving more responsibilities to the local level, but rather involves assessing the relevance of the allocation of tasks among several government levels¹⁶.

The principle of subsidiarity is clear, but implementation is flexible, depends on various conditions of legal, administrative traditions and characteristics of public services to be devolved. There is room for centralists and promoters of decentralization for advocating intent to centralize or decentralize. There is always room for arguments, that centralization could be preferable taking into account extent or nature of competence.

Decision about centralization or decentralization depends on place, technological progress, readiness of society and politicians.

It is important to stress, that decentralization according to principle of subsidiarity concerns first of all decision making – legislative and regulatory power. Sometimes interpretation of subsidiarity is wrongly linked with executive functions. If function is decentralized, that means allowing of autonomous local policy, which could differ from national policy. Such local policy shall be executed taking into account all requirements of national and regional legislation.

The main principle concerning delegated functions is a **principle of proportionality**. That is second main principle of competences division in the EU. According that principle influence of public authorities towards activities of lower level authorities or in the matters of private sector shall be minimal. The principle of proportionality is principle of minimal state.

There is wide diversity between individual states in the scale of tasks devolved to local government. In many cases local government is responsible for schools, social services, social housing, leisure and culture, public order, living environment and public services what are often called "communal services": local roads and lighting, water supply and sanitation, waste management, parks and sports facilities, cemeteries.

One can recognize as first level local government functions: pre-school childcare institutions; primary school, secondary school, adult education; social services; primary medical care; culture, sport, recreation, and tourism; local roads, streets, parks, and gardens; public transport; water supply and sewage; collection and disposal of waste; use of land, construction and maintenance of residential housing; spatial planning and economic development.

Usually regional level governments' responsibilities cover larger geographic and their range is not so wide as of local level. In practice one can recognize following regional

¹⁶ The Kosovo Decentralization Briefing Book. LGI, 2007, pp. 54

functions:hospitals; special schools; regional institutions for culture; roads and transport of regional importance; environment protection; regional planning.

In the Annex 2 the examples of local governments' functions in Romania and in Latvia are reflected.

The classifications of local governments' competence according its character include:

- 1) Mandatory or optionally (voluntary) competence;
- 2) Autonomous, delegated or shared competence.

Performance of autonomous functions is core of local government concept. Devolved autonomous competencies mean full political responsibility. Namely political responsibility gives sense for elections of local councils and local mayors.

Rights to introduce voluntary functions in smaller or larger extent are allowed in any country. First of all, it concerns necessity to ensure public services, which are not offered by central authorities, but for which exist clear local demand. Sometimes central authorities offer corresponding public good, but it is not sufficiently available. From point of view of local democracy existence of voluntary competences is very principal issue.

Box4. Examples of voluntary competences in Latvia.

Such functions as fire protection, police are national government functions. Creating of municipal police and local fire protection bands are not mandatory. Such functions need substantial finance resources, which are ensured from own incomes according the local politicians decision. The Law authorizes local government to organize these services.

In terms of large groups of functions exclusive competence practically does not exist. In each country such large groups of function are not exclusively autonomous. National governments share some elements of power with local governments, such as national planning, setting service standards, financing rules, supervision and audit, etc.

Sub national governments have a variety of powers to carry out their responsibilities:

- 1) Regulatory powers (issuing of legislative acts being in force in corresponding administrative territories and normative acts, concerning physical persons and legal entities)
- 2) Powers to levy taxes;
- 3) Administrative powers (administration of own or national legislation, organization of own administration);
- 4) Management powers over the conditions of public services and over allocation of resources.

Such more detailed division of competences allow better describe situation with power division.

Box5. Division of competences concerning secondary education in Latvia.

State has legislative function – General legal norms about organization of secondary education are issued by the national parliament. Complementary there are large scope of delegated secondary legislation, performed by the Cabinet of Ministers and regulating different issues of education and its supervision process.

State shares regulative function with local governments. Local governments can issue complementary legal norms of general and individual appliance about secondary legislation in its territory, if they do not contradict with national legislation. For example – local governments can regulate additional

motivation of teachers and students, introduce additional options for education etc. State shares financing of secondary education with local governments. State is responsible for teachers' salaries. All other expenditures are responsibility of local governments. State shares administrative function with local governments. State administrates process of education programs accreditation, establish and control education standards. Local governments determine directors of schools and organize process of education etc. Local governments have management function - buildings of schools, its technical equipment and large scope of different subsidiary functions are responsibility of local government. Therefore dividing of secondary education to exclusive components is possible, but leads to high level of detalization. It could be noted, that approximately half of secondary education expenditure is covered from earmarked state grant, the other half – from own revenues of general purpose. That proportion depends on decision of local politicians and is not regulated by legislation in any way.

Local government responsibilities are the base for resources' allocation to them and local governments' budgets expenditures part (see chapter 4) reflects local responsibilities and priorities.

3. Local government finances and financial autonomy

The ability to regulate and manage local public affairs in the definition of local government provided by the European Charter¹⁷ is closely connected with the local government finance capacity – local revenue sources, decision making over expenditures, and relation between available amount of resources and the competence.

The real power of local authorities depends very much on financial autonomy and liability coupled with opportunity for independent decision making¹⁸.

Fiscal decentralization means that local governments make decisions regarding the provision of public services and at the same time, they bear a significant share of associated costs through their own revenue base¹⁹.

In the European Charter of Local-Self Governments special section is devoted to the local government finances(8 points in Article 9 – Financial resources of local authorities):

1. *Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.*
2. *Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.*
3. *Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.*
4. *The financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.*

¹⁷ Local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population.

¹⁸ Horvath T.M., 1999, pp.28

¹⁹ Sedmihradská 2010, pp.7

5. *The protection of financially weaker local authorities calls for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility.*
6. *Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.*
7. *As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.*
8. *For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law.²⁰*

To provide implementation of Charter principles in practice the Council of Europe has worked out and adopted several recommendations for the member states state institutions and local governments. At this moment following recommendation documents on local public finances are actual:

- Recommendation Rec(2004)1 of the Committee of Ministers to member states on financial and budgetary management at local and regional levels;
- Recommendation Rec(2005)1 of the Committee of Ministers to member states on the financial resources of local and regional authorities;
- Recommendation CM/Rec(2011)11 of the Committee of Ministers to member states on the funding by higher-level authorities of new competences for local authorities.

In Annex 3 the main objectives and principles on local finances from mentioned recommendations are included.

Local public finances in Europe could be characterized by heterogeneity that reflects in various systems of public accounting at local level, a wide variety of specific concepts and a disparate vocabulary.

Finance autonomy of local governments could be characterized by following quantitative and qualitative indicators:

- Local government revenue / expenditure share (%) in GDP;
- Local government revenue / expenditure share in total revenues / expenditures of public sector or in general government revenues/expenditures;
- Local government own revenues share in total local governments revenues;
- The actual discretion to decide upon local revenues and spending allocations.

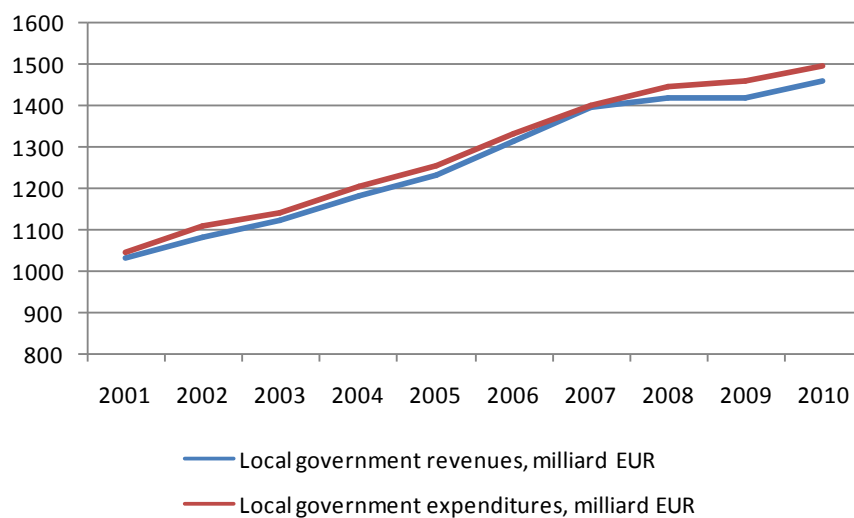
In OECD report on revenues of sub-central governments is concluded that in the decade 1995 to 2005 spending has become more decentralized but taxation less so²¹. The economic crises changed this trend.

Data in pictures 1 and 2 reflects the dynamics of total situation in 27 EU countries. Till 2008 there was increase of total amount of local government finance resources, but with the economic crises it stopped for year, but after it there is again increase trend. There is general increase trend of local government expenditures as share of GDP, although there

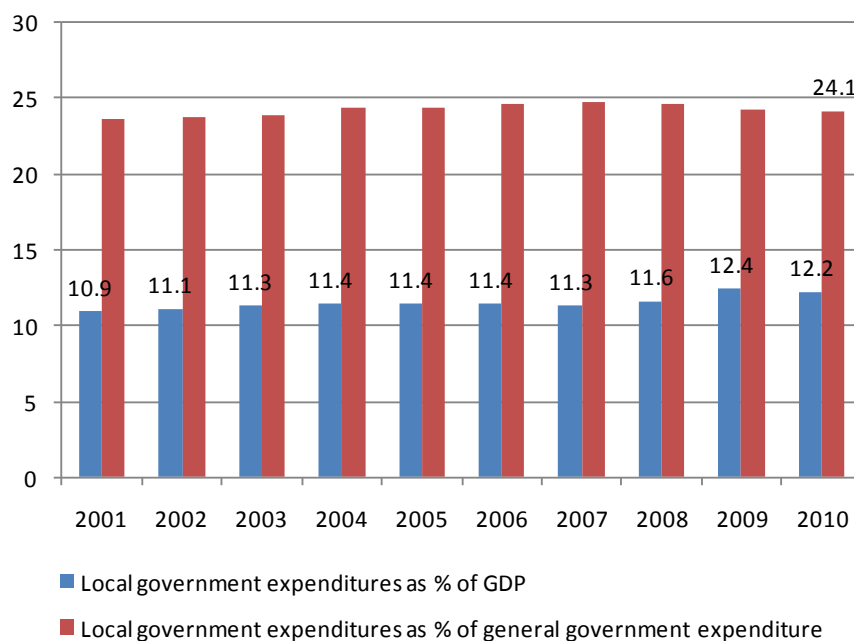
²⁰ European Charter of Local Self-Government, Article 9.

²¹ OECD COM/CTPA/ECO/GOV/WP(2009)7

has been some years with small decrease. But the local government share in general government expenditures since 2007 decreases. In 2010 local government revenues in EU(27) total was 11.9% of GDP and 27% of general government revenues, expenditures was 12.2% of GDP and 24.1% of general government expenditures.



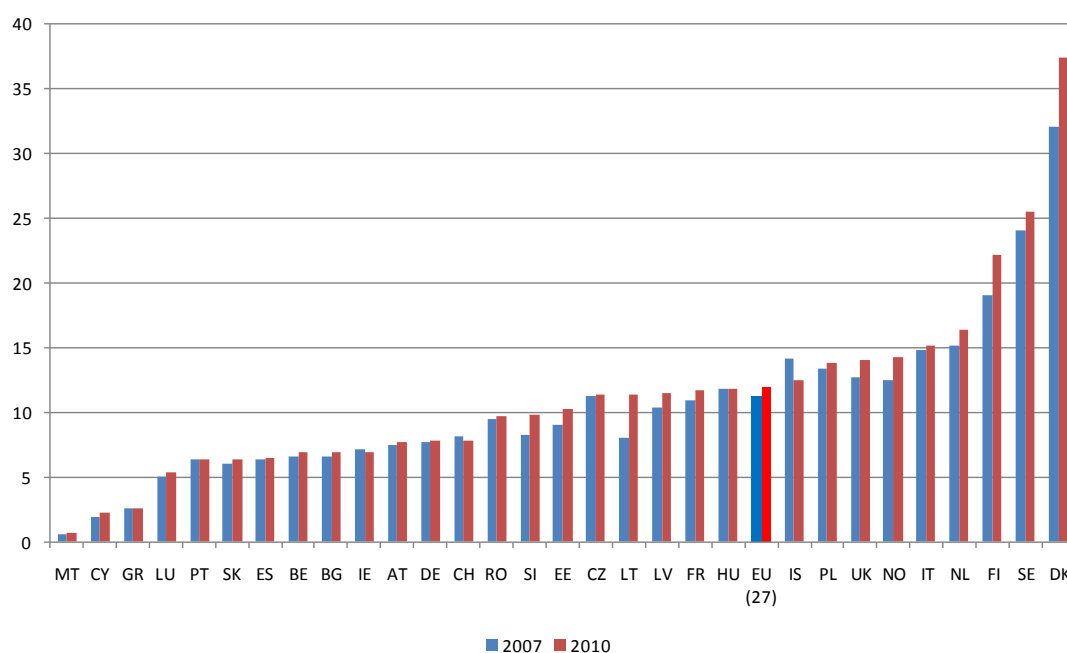
Picture 1. Local government revenues total in EU(27) countries, milliard EUR.
Data source: Eurostat



Picture 2. Local government expenditures total in EU(27) countries as % of GDP and as % of general government expenditures.
Data source: Eurostat

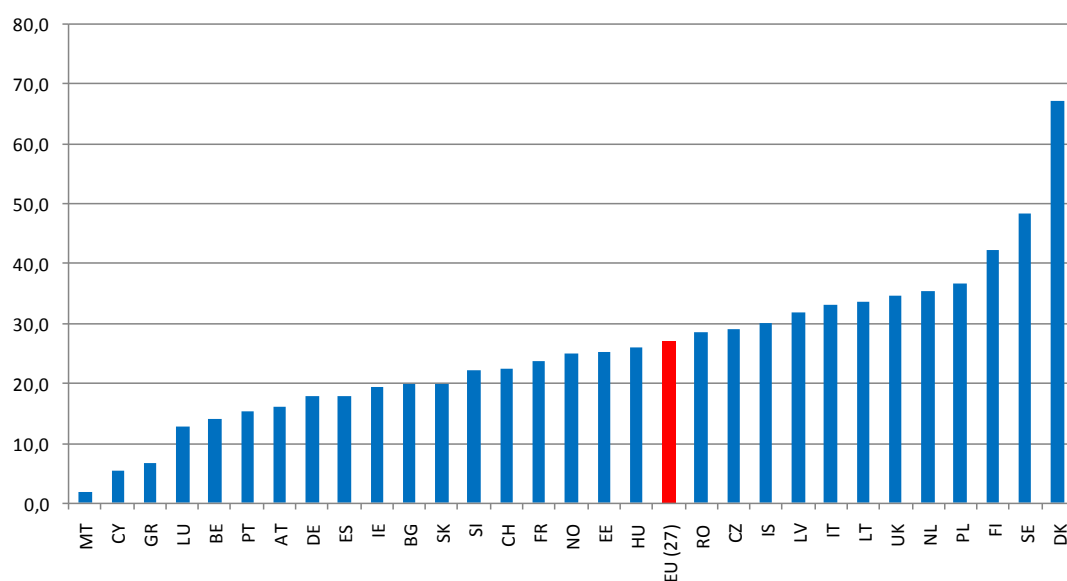
Data analysis shows that the importance of the local government sector varies considerably from country to country and local financial autonomy differs significantly (see pictures 3 – 6).

Most decentralized countries with the highest local government share in GDP and in general government in Europe are Denmark, Sweden and Finland. For instance, in 2010 in Denmark local governments expenditures formed 37.5% from GDP and 64.4% from general government expenditures. Here one has to add that in Denmark the municipalities and regions are heavyweights in the Danish public sector. The most important municipal functions are basic welfare services, municipalities administer a number of social transfers and they have responsibilities in utilities sector. Regional level responsibilities include health care (hospitals, primary health care), institutions for disabled and regional development.



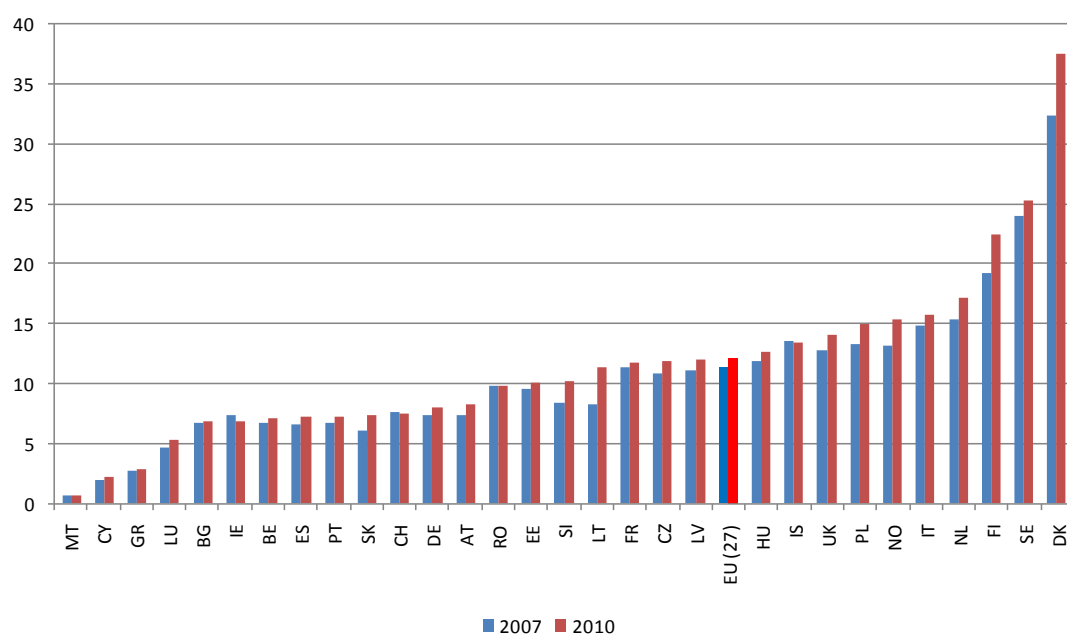
Picture 3. Local government revenues as % of GDP in EU countries and Iceland, Norway, Switzerland in 2007 and 2010.

Data source: Eurostat



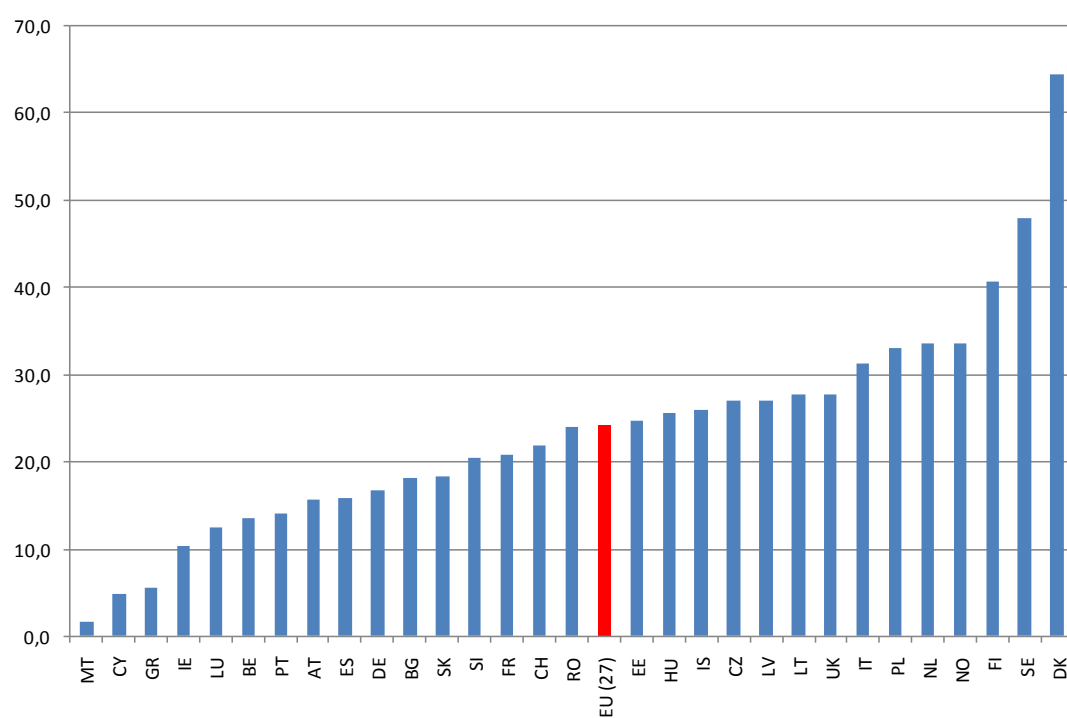
Picture 4. Local government revenues as % of general government revenues in EU countries and Iceland, Norway, Switzerland in 2010.

Data source: Eurostat



Picture 5. Local government expenditures as % of GDP in EU countries and Iceland, Norway, Switzerland in 2007 and 2010.

Data source: Eurostat



Picture 6. Local government expenditures as % of public sector (general government) in EU countries and Iceland, Norway, Switzerland in 2007 and 2010.

Data source: Eurostat

4. Local governments budgets and expenditures

One of characteristics of real local government is to establish their independent budget.

The local budget may be viewed as plan for the use of eventual financial resources of a local authority for attainment of the set objectives. Local government budget document has to serve multiple purposes, such as:

- To express the policy decisions and priorities for action by the municipality for the fiscal year;
- To serve as a road map and guide in the implementation of policies, priorities and services over the fiscal year;
- To serve as a financial management tool in carrying out investment and borrowing decisions;
- To serve as communication tool for municipal councilors, local government officials, and the central government and local constituents.

In Annex 4 main recommendations of the Council of Europe on local governments budget formation is included.

Local government budgets disclose local authority revenues by their type and the use of those revenues in expenditure side. The structure of public budget revenues and expenditures in different countries differ.

Besides the division of local government budget to revenue, expenditure and financing parts, there is practice to divide separately the regular (operational) and capital (investment) budget parts. In such cases the budget of a municipality is established with an operating section and an investment section, both for revenues and expenditures. Although above mentioned budget division is most popular, some countries use other division. For example, in Latvia local governments have basic budget and special budget.

As the budget is one of main documents that reflect real priorities of local government it is very important to ensure the publicity and openness of it for local society and other parties.

Box6. Public data base of local governments budgets in Latvia.

Local governments in Latvia have to submit to the Ministry of Finance monthly reports and annual budget report (accepted by the sworn auditor or audit company and by the State Audit Office). Annual and monthly reports are publicly available in special data base in the webpage of the Treasury.

The real power of local authorities depends very much on financial autonomy and liability coupled with opportunity for independent decision making²². Actual discretion to decide upon local spending allocations is one of criteria that characterize financial autonomy of local governments.

High share of earmarked grants, as well as significant number of different norms demanded from the state on issues that influence local government spending indicate low level of financial autonomy. For examples such directions and restrictions are mandatory social benefits and their amount, necessary staff and staff loads, restrictions on staff salary etc.

²² Horvath T.M., 1999, pp.28

To reflect the local expenditures economical and functional categories (classification) are applied for local government budgets. In reports expenditures are reflected by each category, as well as combining them - each functional subcategory are divided by economic classification.

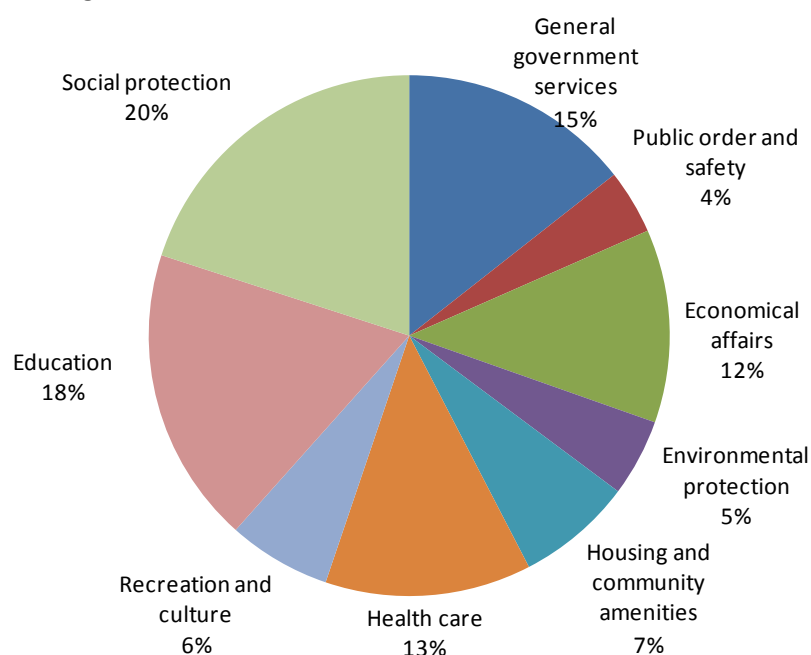
Economic classification shows the current expenditures and capital expenditures, this classification includes also such categories as staff expenditures, social benefits.

Functional classification contains main sectors and branches of expenditures. Many countries have based their functional classification on COFOG (Classification of the Functions of Government).

Box7. Main categories of functional classification according COFOG classification

01	General government services
02	Defense
03	Public order and safety
04	Economical affairs
05	Environment protection
06	Community amenities and housing
07	Health care
08	Recreation, culture and religion
09	Education
10	Social protection

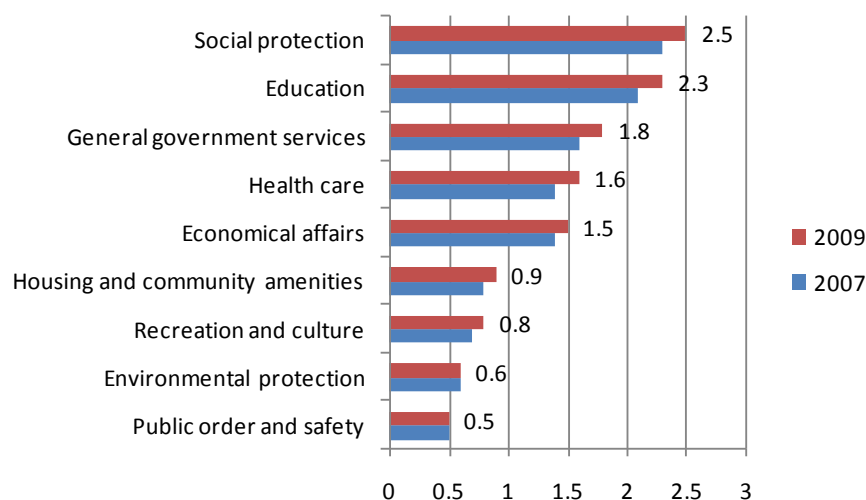
In picture 7 and 8 one can see total local government expenditures breakdown in EU(27) by functional categories in 2009.



Picture 7. Local government expenditures' breakdown by functions in EU(27) countries in 2009.

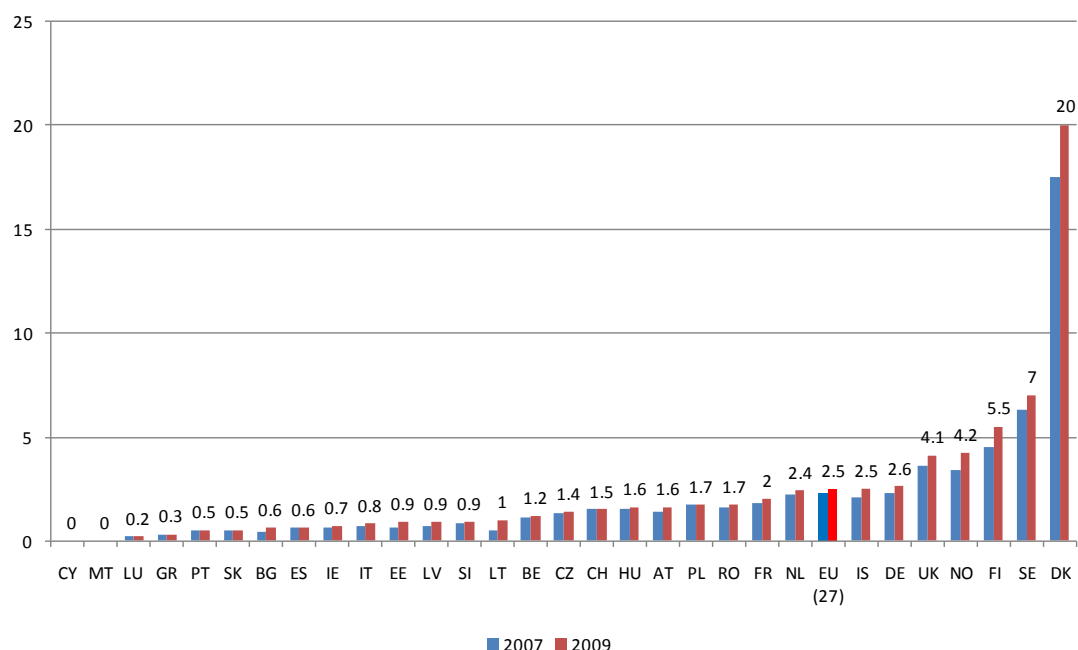
Data source: Eurostat

In the EU the largest expenditures' share is for social protection (20% of expenditures, 2.5% of GDP) and in time of economic crises it has increased. Next larger share is for education (18% of expenditures, 2.3% of GDP), third – for general government services (15% of expenditures).



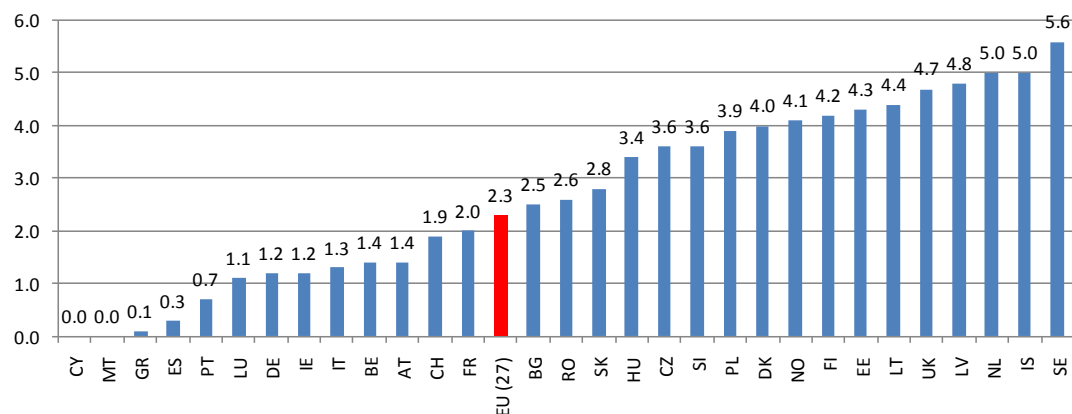
Picture 8. Local government expenditures in EU(27) countries as % of GDP in 2007 and 2009.
Data source: Eurostat

Data in picture 9 reflects that in past years share of local government expenditures for social protection had increased. In Nordic countries, also called social welfare countries, and in United Kingdom those expenditures are higher than in average in EU, the highest share is Denmark and it is connected with new social protection functions of regions transferred from the state after the administrative territorial reform.



Picture 9. Local government expenditures for social protection in EU countries and Iceland, Norway and Switzerland as % of GDP in 2007 and 2009.
Data source: Eurostat

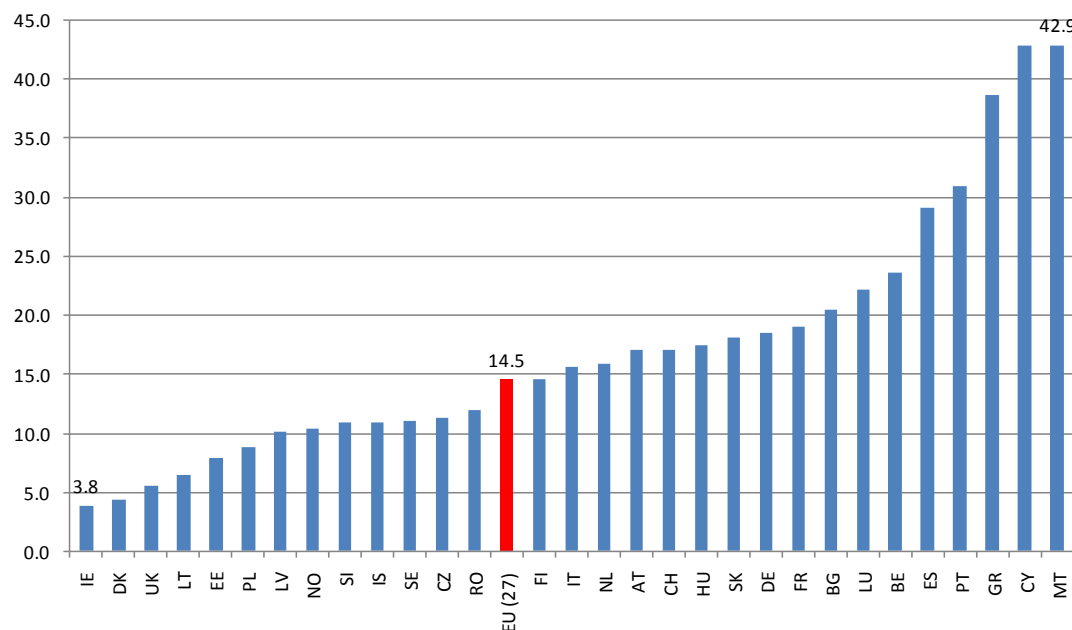
Although in EU(27) in average expenditures' share for education is the second largest (2.3% of GDP) in most countries local governments the largest share of expenditures is for education. In countries where education is within local responsibilities its expenditure share varies from 0.1% of GDP in Greece till 5.6% of GDP in Sweden (see picture 10). Some countries count more than third of local government expenditures for education – Lithuania (40.7%), Slovakia (38.9%), Estonia (37.7%), Latvia (37.2%), Iceland (36.5%) and Slovenia (35.6%).



Picture 10. Local government expenditures for education in EU(27) countries and Iceland. Norway and Switzerland as % of GDP in 2009.

Data source: Eurostat

Third larger expenditure share is for general government services (15% of expenditures in EU average). Sometimes it is called administrative expenditures, but at the same time often includes loans interest payments, transfers to other level local governments etc. In general for countries with smaller local responsibilities (Malta, Cyprus), as well as for countries with several government levels (Greece, Portugal, Spain) share of those expenditures are larger than average (see picture 11).



Picture 11. Local government expenditures for general public services in EU countries and Iceland. Norway and Switzerland as % of total expenditures of local governments in 2009.

5. Local government revenue structure

Local government revenue structures vary throughout Europe and there is no one common classification or practice of revenues grouping.

It's rather common practice that in the law local government revenues are grouped in one way, but used classification for budget reports use different grouping (see example of Latvia).

Box8. Local government revenues according the laws in Latvia.

The Law "On Local Governments" (1994) determines the financial resources of local governments in following way:

The economic basis of self-governments is property, including financial resources, which is composed of:

- 1) tax payments of legal and natural persons into the self-government budget;
 - 2) state budget grants and earmarked grants;
 - 3) loans;
 - 4) local fees and other payments into the self-government budget;
 - 5) fines that are transferred into the self-government budget;
 - 6) revenue from the management of self-government property and from the economic activity of self-government institutions;
 - 7) voluntary payments of legal persons and natural persons for the achievement of specific goals;
- and
- 8) other revenue.

According the Law "On Local Government Budgets" (1995) local budget revenues are:

- Shares from state taxes and fees;
- Local government fees;
- State budget grants and earmarked grants;
- Grants from the Local Government Finance Equalization Fund;
- Transfers from local government budgets;
- Charges for services;
- Shares from companies' profit;
- Revenues from property (rent);
- Revenues from property sale;
- Other revenues according to laws.

Box9. Main groups of local government budget revenues according the budget revenue classification in Latvia(introduced since 2007).

- | | |
|------|--|
| 1.0. | Tax revenues |
| | Personal income tax |
| | Real estate tax |
| | Taxes for goods and services |
| 2.0. | Non tax revenues |
| | Revenues from commercial activities and property |
| | Fees |
| | Penalties and sanctions |
| | Other non tax revenues |
| 3.0. | Revenues from service charges and other own revenues |
| 4.0. | Foreign financial assistance |
| 5.0. | Transfers |

	State budget transfers
	State budget transfers for operational puposes
	State budget grants
	State budget earmarked-grants
	Operational transfers from foreign assistance projects
	Grants from the Local government finance equalization fund
	State budget transfers and earmarked – grants for capital expenditures
	State budget transfers for EU projects
	Special budget transfers and earmarked – grants
	Local governments budget transfers
6.0.	Donations and gifts

From the point of view of the authority's capacity to alter their level, resources may be classified as either own or transferred resources²³.

Local government's "own resources" are resources of which elected local governments set the revenue base, the rate and manage the revenue administration within the framework of the overall legislation. These resources may, for example, be fiscal or non-fiscal.

Local governments "transferred resources" are shared revenues and grants whose base, level and allocation is determined by the central government. The necessary condition for the efficient functioning of local governments is their ability to influence their revenues.

6. Own revenues

Main groups of local governments own revenues are:

- Local taxes;
- Local fees;
- Other own revenues as user charges, property sale, rent etc.

Box10. Local government original (own) revenues according the law in Serbia.

According the law (2007) the main local resources of local government in Serbia are:
1. Property tax, excepting the notary stamp taxes on different property transactions (selling, donations, inheritance);
2. Local administrative fees;
3. Local communal fees;
4. Hotel fee;
5. Construction land use charge;
6. Construction land development charge;
7. Charges for the protection and improvement of the environment;
8. Revenues from concessions;
9. Fines and penalties
10. Revenues from the rental or lease of state-owned fixed property used by local government unit and its indirect budget beneficiaries;
11. Revenues from the sale of movable assets owned by local government unit and its indirect budget beneficiaries;
12. Revenues generated through the activities of municipal bodies and organizations of the local government unit;
13. Interests accrued on the budget funds owned by the local government unit;
14. Donations;
15. Self-contribution fee;
16. Other revenues determined by law.

²³ CoE CM Rec(2005)1

Box11. Own revenues of local governments in Romania.**Fiscal Own Revenues**

- 1) Property tax:
 - a) On buildings for physical persons;
 - b) On buildings for juridical persons;
 - c) On land (within built-up area) for physical persons;
 - d) On land (within built-up area) for juridical persons;
- 2) Fee on vehicles, for both physical and juridical persons;
- 3) Fee for the issuance of certificates, permits and authorizations;
- 4) Fee for using means of advertising and publicity;
- 5) Tax on shows;
- 6) Hotel/tourist fee;
- 7) Especial fees to develop a specific infrastructure or to finance a specific public service;
- 8) Other local fees.

Non-fiscal Own Revenues

- 1) Revenues from using the public and private property of the local government unit (rents, concessions);
- 2) Revenues from goods and services;
- 3) Revenues from fines (traffic fines, other types).

7. Tax revenues

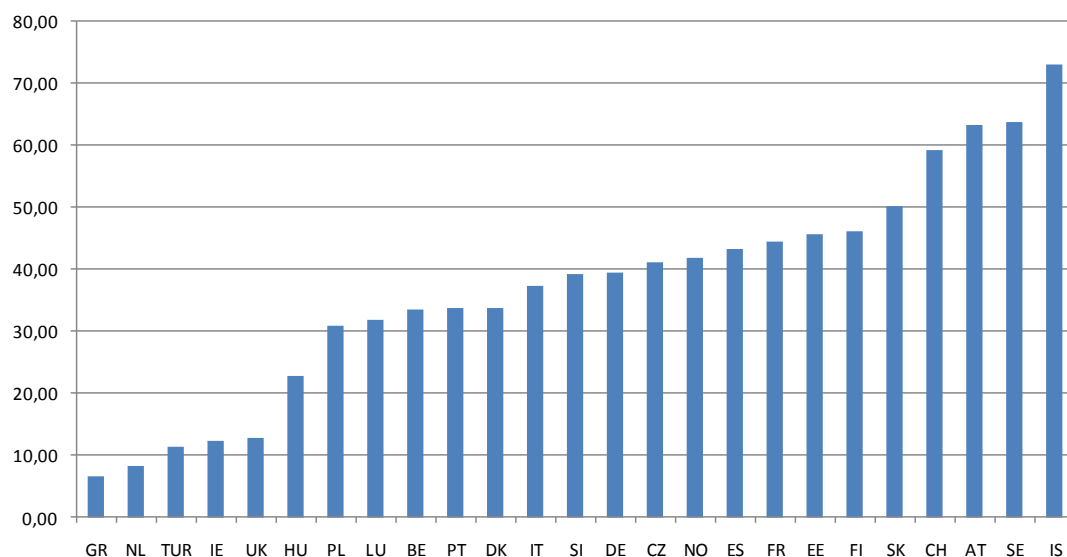
Taxes are levied centrally or locally. Local governments as revenue type have:

- (i) Local tax revenues or own tax revenues (in literature also used own-source tax revenues);
- (ii) shared tax revenues (or tax share revenues) from national taxes.

Besides above mentioned there are cases that local government have the possibility of applying an additional local rate to a central state tax (local surtax), which can be regarded as a way of tax sharing. There are several variations, from local authorities' total freedom to set their rates to complete lack of flexibility when the surtax is decided by the central government.

Share of tax revenues in local government budgets differs country by county starting from some percents till more than two / third of all revenues (see picture 12).

Technical efficiencies of tax administration rather often promote centralized solution of tax administration and collection. But the more centralized the taxation system is, the less a linkage can exist between the locally collected sources and local spending.



Picture 12. Tax revenues as share (%) of local government revenues in European countries, OECD members in 2009.

Data source: OECD data base

One can find in literature principles for tax assignment to local governments:

- 1) Highly progressive taxes should be centralized e.g.?
- 2) Sub-national governments should be stable and avoid taxed with a highly mobile tax base;
- 3) Volatile taxes such as CIT, profit tax should be kept at central level;
- 4) Central governments should collect taxes with an unequally distributed tax base (e.g. natural resource taxes);
- 5) Costs of tax administration are kept low, so the nuisance taxes should be avoided (e.g. dog tax)²⁴.

7.1. Local taxes

Local taxes go directly to the local government and they are important feature of decentralized system. In case of own tax revenue, local governments have a certain leeway over rates and bases, although this liberty may be regulated (caps on rate increases or limitations on exemptions). In some countries local governments have right to introduce new local taxes not only those, what are defined in the laws.

The analysis of different countries reflects that in one country the same financial instrument is called tax, but in another – fee (or duty).

In Annex 5 the recommendations of the Council of Europe on local taxes are included.

Local taxes are very important for decentralization and local finance autonomy because:

- Raising the relative importance of local taxes will increase the autonomy of local authorities²⁵.

²⁴ Sedmihradská L., 2010, pp.7

²⁵ Boorsma P.B., 2006, pp. 48

- A strengthening of the local tax capacity will improve the allocative efficiency²⁶.
- Raising a local tax will make the local politicians more accountable for their decisions²⁷.
- Local taxation as a municipal income source may strengthen local democracy²⁸.

Local government own taxes tend to make local governments more responsive to citizens needs and preferences, thus improving resource allocation, and they tend to improve budget management efficiency as citizens became directly aware of the costs of publicly funded activities. Own taxes also promote democratic accountability, since those who benefit from public services decide on taxation levels and finally pay the bill²⁹.

Local taxes can be either direct or indirect. The main categories of local taxes are property tax, local business tax and local income tax. Besides there are other local own taxes, especially large variety is countries, where local governments have rights to create new local taxes (Belgium, Germany, Spain)³⁰.

Main beneficiaries from local own taxes are first level local governments. In some countries other local governments' levels (regions, districts) have very limited or no freedom to levy their own taxes.

Tax on property

Tax on property (real estate tax, property tax, land tax etc.) is most popular local tax. Generally one of the oldest taxes, it is especially well-suited to the local level because property itself is immobile, visible as it is located in one particular place. Tax bases can therefore be geographically distributed in a relatively fair way among local governments, which, for their part, can count on a stable source of income³¹.

However, in general taxes on property are not significant in developed countries (in OECD countries average 1.8% of GDP), at local level they constitute even 15-20% of local revenues in some European countries(France, UK, Spain, Italy, Belgium, see pictures 13, 14).

In some countries property tax is the only local tax (United Kingdom and Ireland), in a number of countries property tax provides local government with most of their own source tax resources (Estonia, Lithuania, Poland, Slovenia, Slovakia). In some countries property tax is as shared tax. For instance, in Latvia the real estate tax is the state tax, but the local government, where the property is located, receives 100% share of this tax, local government administers and collects this tax, local government has rights to set tax reliefs, but local government till 2012 had not right on any leeway over the rate and the tax base.

In vast majority of countries, property tax is an exclusively municipal tax (tax of first level local governments). In some countries it is levied by other tiers of local governments (in Belgium, in France, in Denmark before the reform).

²⁶ Boorsma P.B., 2006,pp. 49

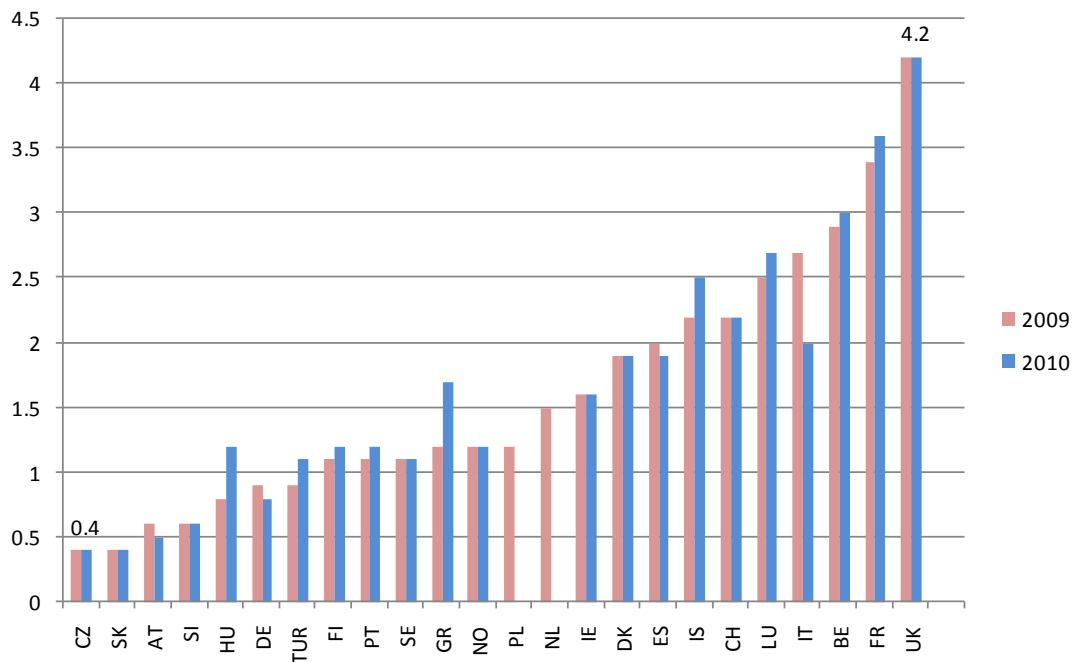
²⁷ Boorsma P.B., 2006,pp. p51

²⁸ Boorsma P.B., 2006,pp. 52

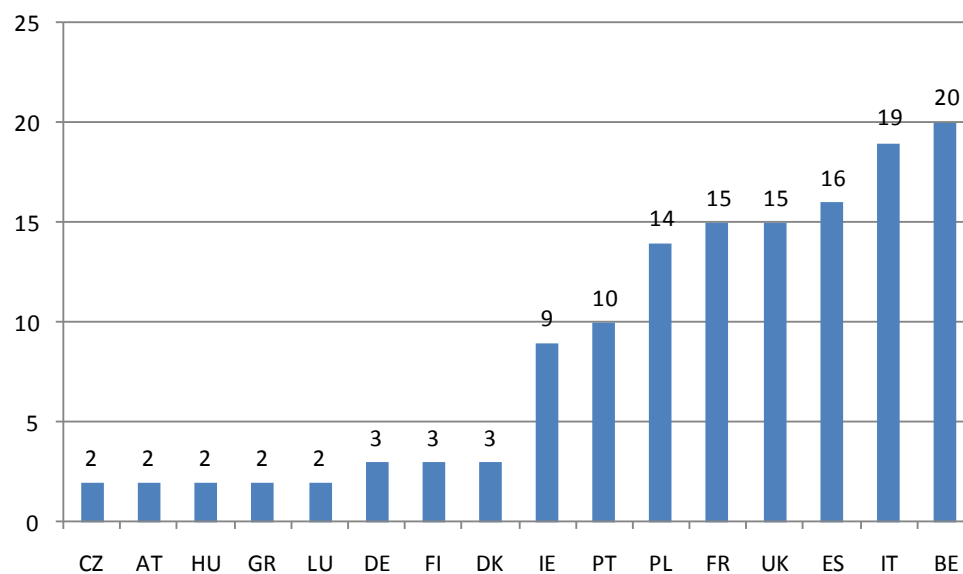
²⁹ OECD COM/CTPA/ECO/GOV/WP(2009)7

³⁰ Dexia, 2008. p 99

³¹ Dexia 2008. p100



Picture 13. Taxes on property as % of GDP in European countries, OECD members in 2009.
Data source: OECD data base



Picture 14. Taxes on property as % of local revenues in some European countries, OECD members in 2009.
Data source: OECD data base

There might be several objects of property or real estate tax – land only, real property only; combination of land and real property. Land tax is usually easiest to administer and it is also politically less offensive than real property taxation. But the taxing only land limits local government revenue base. The land value is usually much lower compared to the total property value³².

³² Trasber, 2010, pp.97

The extent and character of property tax exemptions differ across countries. Generally, some of owners, such as the state or local governments, are exempt. In some countries, the exemptions are not directed at the owner, but to the use or purpose of property, such as agriculture land, forests, churches or museums. In some countries exemptions are socially motivated, e.g. handicapped, poor or retired people are exempt from the tax on their permanent residence³³.

Property tax is generally paid by both individual (owners and sometimes tenants) and business. It is calculated based on land and/or buildings.

There are two main methods of calculating the tax bases:

- Method based on the area or usable area of the real estate assets (Czech Republic, Hungary (optional), Poland, Slovakia);
- Method that estimates the property value. This can be the market value, or land register value. Assessment methods are market (comparable) valuation, calculating the replacement costs, or rent capitalization.

Property tax rates can vary depending not only on the category and the purpose of the real estate assets (residential, commercial building, agriculture land etc.), but also on geographic zones within the local government. Local governments' power to set the property tax rate is usually limited by law (minimum and/or maximum rates).

Box12. Land tax in Estonia³⁴.

The land tax in Estonia was introduced in 1993 with the adoption of the Land Tax Law. Its purpose was to regulate land use, stimulate more productive use of land and provide a wider revenue base for local governments.

The land tax is the only significant tax in Estonia over which local governments have certain discretionary power. Estonian Parliament has set land tax rates within certain limits. The tax rate range is established within 0.5-2.5 per cent of the assessed value of the land. The municipalities' councils have right to decide about tax rates within their territories and within the given limits. The tax collecting institutions send information to land owners about their land tax obligations and due payments.

Land tax is collected and administered by central authorities and afterwards the tax revenues are transferred to local municipalities' budgets. Land tax collection procedures are the responsibility of the Estonian Tax and Customs office and the system is functioning efficiently. The Estonian Land Board is responsible for the valuation of land for tax purposes.

Estonian land taxation is based on recent transactions prices. Valuation is the major technical challenge in the fair and efficient taxation system.

All land use is classified into 11 different zones on the basis of the purpose of utilization. Land value differs widely through the Estonian regions.

Box13. Real estate tax in the Czech Republic³⁵.

The real estate tax in the Czech Republic is regulated by the Real Estate Tax Law (1992) and consists of two parts – building tax and land tax.

All buildings, flats, and non-residential premises located in the territory of the Czech Republic are subject to building tax. There are many different exemptions. A land tax is collected from all types of land registered with the Land Register. All real estate, including the property descriptions, are recorded in the Cadastre of Real Estate.

The tax base is either monetary (in CZK) or it is expressed in physical units (square meters) depending on the type of land. A buildings tax base is the area of the ground plan of the building in square

³³ Sedmiharska, 2010, pp.10

³⁴ Trasberg 2010, pp.95-105

³⁵ Sedmihradská, Bryson, 2010, pp.70-94

meters. The tax base for flats and separate nonresidential premises is the surface area in square meters.

Calculation of the actual real estate tax is made by the property owners/taxpayers themselves in a tax declaration. Tax is collected by the central government.

Municipalities have very limited flexibility in setting exemptions or influencing tax rates. Currently, they can only influence the tax rate for buildings and land by changing the correction coefficient.

Box 14. Real estate tax in Latvia as shared tax.

The Real Estate Tax law is in force since 1998 (before there were separate land tax and property tax laws). In Latvia real estate tax is the state tax, but local governments receive all it (100%) and also administers and collect it – local governments send to landowners the information and invoices on tax payments and they are paid to the account of the municipality, where the property is located. Municipalities collect this tax, they have no levy over the tax rate, but they can decide on tax reliefs within laws limitations.

Till 2010 the real estate tax was levied on all lands and those buildings, what are used for commercial activities with some exceptions (municipal and foreign government, religious organisations). In period 2006 - 2009 the tax rate was 1% of the land cadastral (registry) value, since 2010 the tax rate for land is 1.5% of the land cadastral (registry) value.

When the Law was passed (1997) it stipulated that starting from 2004 the residential houses also will be taxation object, but when this time came closer it was postponed with amendments of the law. Only since 2010 the real estate tax has been levied on housing, too. Tax rate for housing in 2010 was 0.1% - for housing with cadastral value less than 40 000lats (LVL), 0.2% - for housing with value 40 000 - 75 000 LVL, 0.3% for housing with cadastral value over 75 000 LVL. Minimal tax payment was 5 LVL, in 2011 those rates was doubled (0.2%, 0.4%, 0.6%).

There is no common understanding of how property taxation influences the efficiency of land use. Some economists argue that local property taxation promotes efficient location and fiscal decisions on the part of households. On the opposite side, some economists view local property taxation as having a distorting effect on local decisions. As a result, such tax tends to discourage the use of capital, land and property improvements³⁶.

Although property tax is considered to be an almost perfect revenue source for local governments in many countries, it plays a role far behind central government transfers or tax sharing³⁷.

Local business tax

Local business tax recently after the fiscal crisis of 2008 is not so popular. It exists in several old European democracies (Austria, Germany, Italy, Spain, also Cyprus, Luxembourg), and only one transition country (Hungary).

Conceptually business value tax is paid for using local infrastructure. It is preferred by local councils, because they are less accountable towards the companies as taxpayers. The local business tax is calculated on different bases depending on the country: payroll, the number of employees, the rental value of capital assets, profits, the sector of activity, the added value or the capital structure.

³⁶ Trasberg 2010, pp.96

³⁷ Sedmiharska, 2010, pp.14

Local income tax

Only in few European countries there is an own source local tax on personal income. In the three Nordic countries – Denmark, Finland and Sweden a local tax exists alongside the national tax, levied on the same tax base. In some countries it is an additional tax on top of the national income tax (Belgium, Italy). In the Balkans Croatia and Montenegro also levy a surcharge on national personal income tax.

Table 2. Sub-national personal income tax rates, 2010.

Country	Level of taxation	Tax base	Rate structure	Representative rate	Minimum rate	Maximum rate
Belgium	Local	Central govt. tax	Flat	7.40	0.00	
Denmark	Local	Taxable income	Flat	25.64	22.80	27.80
Italy	Local	Taxable income	Flat	1.90	0.90	1.90
Norway	Local, regional	Taxable income	Flat	15.45	0.00	15.45
Sweden	Local	Taxable income	Flat	31.56	28.89	34.17
Spain	Region	Taxable income	Progressive	4 thresholds with marginal rates 8,34; 9,73; 12.86; 15.87		
Finland	Local	Taxable income (modified)	Flat	18.89	16.25	21.00
Iceland	Local	Taxable income (modified)	Flat	13.12	11.24	13.28

Source: OECD Tax Database.

Other own taxes

Other local taxes include taxes on real estate transactions, inheritance, tourism, dogs, advertising, vehicles, sales of tobacco and alcohol, gambling, and, hotels, markets or tourist activities³⁸. Most often national legislation defines the list and rate of these taxes.

Box 15. Local taxes for specific services Estonia.

According the law local governments have rights to impose following local taxes:

- Boat tax;
- Commercial and advertisement tax;
- Tax on closing roads and streets;
- Motor vehicle tax;
- Tax on keeping animals;
- Entertainment tax.

³⁸ Dexia, 2004.

7.2. Shared taxes

Systems of shared taxes are widespread in Europe. They are especially common in federal and regionalized countries, also quite frequent in former socialist countries, where by replacing grants, they clearly represent a step forward for decentralization and the autonomy of local governments.

The Council of Europe recommends the following on shared tax issues:

Where taxes are shared with local tiers of government, the local share should be commensurate with the local tax effort in order to encourage local officials to strengthen and develop the local tax base (derivation or origin principle)³⁹.

In shared tax schemes, sub-national governments receive a percentage of national tax revenue which is redistributed by the place of origin or via specific allocation methods, using formulae. Equalization system might be built upon shared revenues, as well.

Taxes distributed via shared tax arrangements are most often high-yielding taxes, such as the personal income tax (most popular) (PIT), the business tax, and the value added tax (VAT). For instance in 2007 in EU PIT as shared tax for local government revenues was used in 15 countries, business tax in 9 countries, and VAT in 6 countries⁴⁰.

In Central and Eastern Europe the main shared tax is the personal income tax. Substantial shares sometimes go to local governments: 100% in Bulgaria, 82% in Romania (municipalities and counties), around 80% in Latvia (in 2009 - 83%, 2010 – 80%; 2011 – 82%; 2012 – 80%), 80% in Serbia, 70% in Slovakia (municipalities) and 40% in Hungary.

VAT revenue is shared in the Czech Republic, but in Romania revenues from VAT are used for financing equalization and conditional transfers. In the Balkans VAT is shared revenue in the quasi federation of Bosnia and Herzegovina and in Macedonia.

The company income tax share examples are the Czech Republic (both for municipalities and for regions) and Poland (for all three levels).

Besides there are other cases for shared taxes: In Hungary – vehicle tax (100%), the pollution tax – in Lithuania, the tax on natural resources in Estonia and Latvia, gambling tax in Latvia, excise tax in Spain.

In a narrow sense shared taxes are those the sharing rules are set by law (predictable), the risks of tax revenue fluctuation is shared between the central and local governments and no direct compensation is built into the sharing mechanism.

³⁹ CoE CM Rec(2005)1

⁴⁰ Dexia, 2008.

Table 3. Tax sharing methods (selected cases)

<i>Country (eligible tier)</i>	<i>Sharing rules: set ratio or individual decision</i>	<i>Tax allocation: origin based or formula</i>	<i>Risk sharing: equalization exists or not</i>
<i>France (Département, Region)</i>	national petrol tax, tax on insurances calculated by sub- national governments	individual needs based	supplemented up to a threshold
<i>Germany (Länder)</i>	PIT: 50% VAT: negotiated	origin based	second stage horizontal equalization
<i>Spain (Regions)</i>	VAT: 35% Excise tax: 40%	based on “consumption index”	no
<i>Switzerland (Cantons)</i>	Federal income tax: 30%	17% by origin	13% by fiscal capacity (equalization)
<i>Hungary (county, municipal government)</i>	PIT: 40%	8% by origin to municipalities 32% by formula to county and municipal governments	equalization: up to per capita PIT minimum threshold

Source: Blöchliger, H.-Petzold, O., 2009a

In practice, national tax revenue can be re-distributed in two ways:

- Localization or the principle of “fair return”; origin based
- Redistribution through a formula as a grant⁴¹.

There is no common opinion can one call as shared taxes the taxes what are set and collected by central government, but distributed to local governments by formula and with guarantee of planned amount from state budget, or they must be considered as transfers (grants).

In the case of shared tax redistribution through formula as grant, the shared tax revenue is levied and the sum is re-distributed to local governments, according to various criteria: population size, land area, physical indicators reflecting the exercise of responsibilities (lengths of roads, number of schools, etc.).

This formula closely resembles grants: firstly, local governments are not able to negotiate the level of tax transfers and, secondly, redistribution does not take the geographic localization of resources into account (it can even be opposite in the case of equalization measures for equalization purposes)⁴².

The pros and cons of the two preceding approaches explain the development of a combined, mixed approach which aims to reconcile “wealth localization” (fair return on development of the territory) and equalization. These mixed approaches, often very complex, aim to redistribute tax revenue based on the amount collected in each jurisdiction but also according to various equalization criteria intended to reduce income inequalities between sub-national governments.

⁴¹ Dexia, 2008, pp. 116-118

⁴² Dexia, 2008. p.117.

Box 16. Shared taxes in Romania.

There are two types of shared taxes: based on Personal Income Tax (PIT) and the Stamp Tax (for juridical and notary activities). The last one is set by law, collected by central fiscal administration and transferred 100% to the local government.

Most important is the sharing system for PIT. For the sharing system is used the derivation base method: what is collected in local government area (for both tiers: local and county). The sharing ratio is:

- Commune, small towns and municipalities (the first tier of the local government) receive directly 47% from the PIT collected within their boundaries;
- County councils (the second tier of the local government) receive 13% from the PIT collected within county boundaries;
- 22% of PIT collected within county boundaries is used for equalization at the level of county (intra-county equalization) for the budgets of all local government units (first and second tier) according with a formula.

For Bucharest the sharing ratio is different: 23.5% form collected PIT, within their boundaries, remains at the level of capital districts (6 sectors); 47.5% from the collected PIT, within Bucharest boundaries, remain at the level of capital (General Town-Hall) and 11% form PIT is used for equalization among districts and General Town-Hall.

In this way 82% from the PIT collected at county level remains within the county (directly 60%: 47% for the first tier local government budgets, 13% for the county council budget; for equalization within county boundaries 22% form county collected PIT).

Central fiscal administration, through its de-concentrated units (at county level) collects the PIT and transfer the revenues to the local government units account (only in Treasury) based on formula described above. The system has been introduced in 1999 and the derivation formula suffered many changes: initially the first tier of local governments received only 35% and the county councils 10%, the rest of PIT (55%) was used centrally to equalize the local budgets. After the introduction of the flat tax for PIT (in 2005) the derivation formula was changed to the actual form and a new law on local public finance set a new equalization system in 2006.

Box 17. Shared taxes in Latvia.

There are no local government taxes in Latvia. The Law "On Taxes and Fees" stipulates that in Latvia there are only state taxes. Local government tax revenues are shares from four state taxes:

- Personal income tax (share in local budgets in 2011 – 82%);
- Real estate tax (share in local budgets - 100%);
- Lottery and gambling tax (share from gambling in local budget – 25%, share from local scale lottery – 100%);
- Natural resource tax (in special budget share for pollution – 60%, share for radioactive waste – 30%, share for burning of dangerous waste and for mineral deposits – 100%) .

Box 18. Shared taxes in Serbia.

Shared tax system in Serbia is based on derivation formula and it includes the following sources:

- a) 100% PIT paid for the income generated by: agriculture and forestry, private business, real estate, renting property, personal insurance, other incomes
- b) 80% PIT from salaries according with the residence of the employee
- c) 100% of notary taxes on real estate transactions (selling, donations, inheritance).

Box 19. Personal income tax share in Lithuania.

In Lithuania the personal income tax is the main tax revenue of local government budgets levied on all type of revenue (dividends, assets, retirement funds and social security pensions, etc.), personal income tax had a flat rate, bet it differs for different incomes. The receipts from personal income tax are shared between the state, the Compulsory Health Insurance Fund and municipalities. 30% of the receipts go directly to the Health Fund. The remaining 70% are shared between the state budget and municipal budgets based on breakdown fixed every year by the Law on the Approval of Financial Indicators of the State Budget and Municipal Budgets⁴³.

⁴³ Dexia, 2008, pp.449

8. Local fees, user charges and other own revenues

Besides local taxes local governments own revenues also are fees, user charges and such revenues from property as rent and dividends, and also revenues from property sale or privatization.

Whilst taxes are charged generally and the amount paid by the individual taxpayer cannot be (easily) traced to a particular service (but rather is seen as a contribution to the pool), the fees and user charges are seen as an exchange of money for a service rendered⁴⁴. A “service” could be the use of land, area, roads or paying indirectly for using the environment (entertainment tax) or infrastructure (trade, business tax).

If there is no doubt about the difference between the tax and user charge, then the border between taxes and fees is rather diffuse, especially between earmarked taxes and fees, and also between the fees and charges it is not clear in all cases.

Like with local taxes in some country local governments can decide to collect only those fees what are determined in the law and there is countries where local governments has rights to introduce new fees.

Box20. Local fees in Latvia.

According the Law on Taxes and Fees local governments has rights to introduce following fees in their administrative territory:

- 1) receipt of official documents prepared by a territorial local government city council (county or parish council) and certified copies of such;
- 2) organisation of events of a recreational nature in public places;
- 3) vacationer and tourist accommodation;
- 4) trade in public places;
- 5) keeping of all types of animals;
- 6) driving of means of transport into special regime zones;
- 7) placement of advertisements, posters and announcements in public places;
- 8) keeping of boats, motorboats and sailboats;
- 9) utilisation of local government insignia; and
- 10) receipt of a construction permit;
- 11) on local government infrastructure maintenance and development.

Box21. Local fees in the Czech Republic.

- Dog fee;
- Resort and recreation fee;
- Fee on use of public space;
- Fee on entry tickets;
- Free on recreational use;
- Motor vehicle entry fee;
- Fee on operating gambling machines;
- Fee on standard waste collection and treatment;
- Fee on appreciation of building land by the provision of water and sewage connections;
- Advertisement fee;
- Dislocation fee;
- Fee on sale of alcoholic beverages and tobacco products⁴⁵.

⁴⁴ Ševic, 2006, pp.20

⁴⁵ Sedmihradská, 2006, pp.130-138

Revenues from service charges are playing increasingly important role in local budgets. There are number of such public services where no doubt about the necessity to pay for it, but in several cases local governments are faced with the challenge of whether to charge (leave the financing to tax payers) and how much to charge for provided activities and services.

Since local public service pass the cost of a public service to the user instead of the taxpayer, charging for public services is common in Europe. These user charges help to finance a number of local public services and facilities, particularly in the areas of water treatment, municipal solid waste collection and disposal, sports (e.g. swimming pools), the arts (e.g. theaters, libraries), public transport, car parks, school canteens, nursing homes etc⁴⁶. Users have to pay a price in return for service provided by local authority, and price must not be too far removed from real cost of the service rendered.

As the public service provision often faces the problems of natural monopoly, mandatory nature of the service, in some countries the regulated authorities are founded to impose the charges at marginal cost level. In practice user charges are more determined through political rather than market interactions⁴⁷.

For transition countries, especially former Soviet countries with the history of free services or services for symbolic price, it is rather complicated and politically hard to introduce user charges for urban services and cover necessary for service provision expenses.

Local governments are increasingly taking notice of the value of their physical and financial assets and are taking steps to use them to bring in ad hoc revenues (selling assets) as well as recurring revenues (rental charge and dividends).

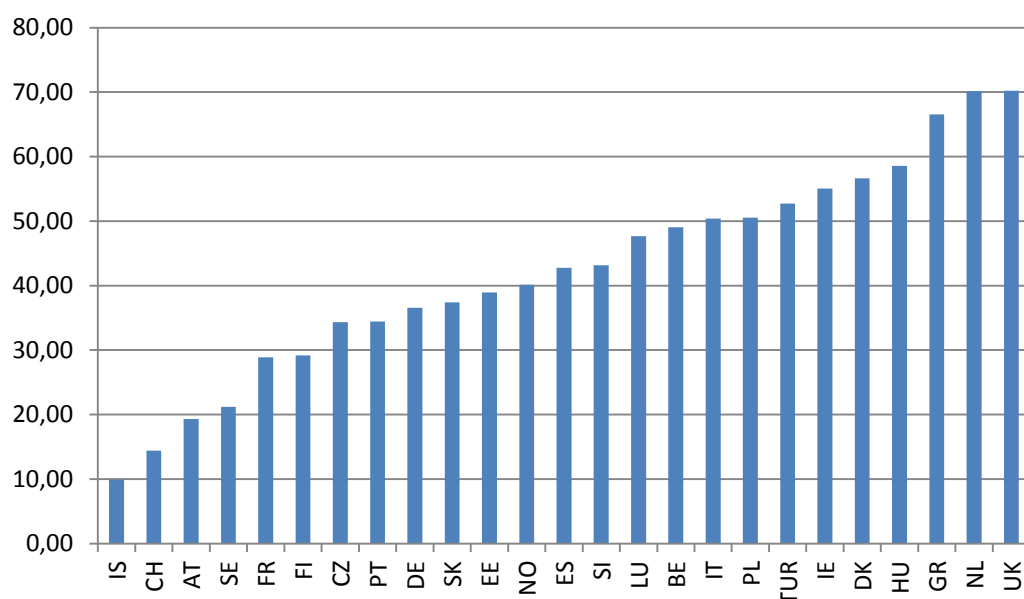
9. Grants

Grants are financial flows that are allocated to local governments, most often by the central governments. They can also come from federated states in federally-structured countries, from other local governments or from foreign or international sources. Several types of grants exist however which have a more or less limiting effect on local autonomy.

Financing through grants is generally considered as being unfavourable to local autonomy in that local governments remain dependent upon the authority allocating these grants. However, transfers from the central state form the largest share of grants received by local governments. So not the mere size of central budget grants, but more the methods of allocation define the local fiscal autonomy.

⁴⁶ Dexia, 2008, pp.93

⁴⁷ Ševic, 2006.



Picture 15. Transfers as share in subnational revenue in European countries, OECD members in 2009.

Data source: OECD data base

Intergovernmental transfers aim to provide funds for delivering local government services. They ensure the resources for financing external cost of services (e.g. borne outside the jurisdiction or having environmental, social benefits) and compensate local governments with limited access to own tax revenues. These grants should balance the vertical inequalities in the intergovernmental fiscal system. Secondly, transfers are necessary to compensate the differences between local governments of similar type, but having diverse revenue potential or faced with different unit costs of services (for horizontal equalization purposes). Intergovernmental transfers should also create sufficient *incentives* for the efficient local service management and for raising own source revenues.

Classification of grants vary from country to country, reflecting different approaches. Priority can be given either to the end use (i.e. funding capital or operating expenditures) or to the way grants are used (general, specific or earmarked grants). Those two classifications can also overlap.

In EU generally operating grants form the largest share of grants to local governments in most countries, investment grants are less frequently the most important part⁴⁸.

Grant allocation models

Three alternative models are followed by the European countries:

- 1) Gap-filling model;
- 2) Grant schemes;
- 3) Grants based on local *expenditure needs* and the local *fiscal capacities*

The simplest one, widely used earlier in the transition countries of Central and Eastern Europe is the (1) *gap-filling model*. It means that the expenditure level is calculated for each local government, in parallel with the planned (required) local own source revenues. The

⁴⁸ Dexia, 2008, pp.120

transfers are provided as the difference of these two amounts. This method presently followed typically in the case of the delegated or deconcentrated local services.

Greater local autonomy is ensured when only the (2) *grant schemes are controlled*. Countries such as Denmark, Finland, Hungary and Poland are the best examples which follow this allocation logic. In these cases the calculation of transfers, the revenues sharing mechanisms and assessment of own source revenues are not connected directly. Local governments raise their own revenues within the framework of the tax legislation and the transfers or the shared revenues are set by the national government. This revenue pool made available for local governments determine the level of local expenditures. These appropriations by local individual local governments are not budgeted at the upper tier of government. They are determined as sums of local revenues and grants received ($R+G=E$)

The third model aims to measure both the (3) *local expenditure needs* and the *local fiscal capacities*. The level of accepted local expenditures is calculated by using objective indicators of demand, such as the population age groups, area of the municipality. Then a standard tax rate is levied on the assessed local tax base, which would result the required, average tax yield. The transfers are made as a difference of the estimated expenditures and required own revenues for each local government. Obviously local governments can spend more if they reallocate funds or raise more own revenues. But under this model extreme spending needs will not be compensated. On the revenue side, local taxes should be levied the standard level, because the transfer system does not pay for the tax effort below the average.

Table4. Alternative models of grant allocation.

<i>Transfer mechanisms (with examples)</i>	<i>Expenditure</i>	<i>Revenue</i>	<i>Transfer</i>
1. Gap-filling (former Socialist countries)	Defining expenditure appropriations by municipality ($E_{estimate}$)	Assessment of own revenues by municipality ($R_{planned}$)	Bargaining between central and local governments ($G_{transferred}=E_{estimate}-R_{planned}$)
2. Control over grants (Denmark, Finland, Hungary, Poland)	Local decision on expenditure levels ($R+G=E$)	Local authority to generate own revenues (R)	Grants, determined by the upper tier government (G)
3. Needs and fiscal capacity based (UK, Slovenia)	Accepted expenditure levels based on objective (policy neutral) measures of "needs" ($E_{estimated}$)	Potential revenue at standardized revenue bases subject to nationally average tax rates ($R_{required}$)	Calculated grant ($G_{calculated}=E_{estimated}-R_{potential}$)

Source: Peteri, Sevinc, 2011

All these alternative models are used in *a complementary way* even in one country. The dominating model of the transfer system might have supplementary elements for specific sectors or for meeting a policy objective.

Techniques of intergovernmental fiscal transfers can be characterized along the following dimensions:

1. *How central grant allocation is controlled?* Whether – within the framework of the sector and financial regulations - national government has full discretion in

allocating transfers or it is limited by a formula, either on the total amount of grants or on the methods of allocation (or both);

2. *What are the fiscal requirements on the recipient local governments?* That is the grants are conditional with local co-funding obligations or transfers are unconditional. In the first case they might be open or closed ended matching grant;
3. *How much autonomy local governments enjoy in spending?* So are the received funds earmarked as categorical, block grants or they are general purpose transfers, with full local autonomy in using them?

There are various combinations of these intergovernmental transfers and obviously there are huge variations by the role of local government tiers, by public services and whether they target current or capital budgets, etc. Even in one service area, like public education several techniques of grant allocation might work in parallel. Countries apply a mix of financial support schemes and they try to combine funding methods for the various services or for typical, standard activities and for supporting the specific programs.

Table 5.Examples of grant allocation methods in Europe.

Recipients' obligations:	1.Method of grant allocation (upper govt. tier's decision)	
	<i>discretionary</i>	<i>formula based</i>
2. Local funding requirements		
<i>conditional (matching)</i>	capital investment grants	specific grants
<i>unconditional</i>	education financing in France, Germany	revenue equalization transfers (Denmark, Hungary, Poland)
3. Local spending autonomy		
<i>earmarked (categorical), block</i>	program based	education grant: UK
<i>general purpose</i>	not applicable	by age groups: Denmark, Finland by service capacity: Hungary, Poland

Source: Peteri, Sevinc, 2011

General and earmarked grants

General grants are non-earmarked financial transfers. They are also called municipal funds, general funds, primary autonomous revenues etc. And they can be used freely by the local governments who benefit from them.

Specific grants are earmarked financial transfers. They grant specific types of spending. Most often they are intended to finance:

- A specific responsibility which has been transferred or delegated to local governments. Examples include earmarked grants to finance teachers' salaries, social spending, infrastructure spending (often consisting of funds of roads), as well as spending on the environment, social housing or policing.
- A particular operation set up by the authority which provides the grant (e.g. specific investment)⁴⁹.

⁴⁹ Dexia 2008, p.120

Local governments' decision-making power is more limited in the case of earmarked grants than that of general grants, particularly since earmarked grants can come with implementing directives and precise, binding guidelines as well as ex-post control⁵⁰.

General and earmarked grants generally co-exist in varying proportions depending on the country.

Other types of grants include:

- Incentive grants, the goal of which is to orient local government initiatives, for example merger or cooperation incentive grants;
- Conditional or matching grants which are only allocated in exchange of co-financing for example, in most cases for capital spending projects;
- Special grants, allocated on a temporary or permanent basis, can also be provided to governments that face specific economically – or geographically – based difficulties including economic decline, a high unemployment rate and additional spending requirements as a result of geographical factors (for example remote areas, mountain regions or under-populated areas), etc.;
- Exceptional grants for unforeseeable events, in particular natural disasters;
- Revenue equalization grants, supplementing own or shared revenues up to a set level⁵¹.

Box 22. Grants for local governments within administrative territorial reform in Latvia

Within reform process local governments could receive from the state budget earmarked grants for elaboration of amalgamation projects (approx. 5-10 thousand lats (3.5-7 thousand EUR) for project), but very significant was earmarked grants for investments in *novads* infrastructure. Recipients of this grant were those *novads* what agree sooner or later to implement amalgamation. In period of 2005-2009 the total amount of this grant to local governments was 97 million lats (68 million EUR). Amount for *novads* are calculated 200 thousand lats per unit (*pagasts, pilsēta*) that are amalgamated (for instance, *novads*, where 5 *pagasts* were amalgamated, received 1 million lats).

General grant amounts are distributed among local governments according to criteria which are generally designed to give each government the financial means necessary to cope with compulsory spending and provide basic services to the population.

This allocation criteria try to take into account either the obligations facing the local governments (its structural needs), its ability to meet those obligations in relation to its resources, or both. These criteria are generally established at the national level, except in federal countries where federated authorities establish criteria that are adapted to their territory's specific conditions⁵².

Categories of criteria include:

- Demographic criteria;
- Geographic criteria;
- Financial criteria;
- Socio-economic criteria⁵³.

⁵⁰ Dexia 2008, p.121

⁵¹ Dexia, 2008

⁵² Dexia 2008, p.122

⁵³ Dexia, 2008. P.122

Generally, a grant allocation combines a few of these criteria, but also specific grants can be awarded based on extremely wide range of criteria.

It is not common, but grant allocation may also depend on government performance evaluations. This practice is becoming common in the United Kingdom, the Netherlands and Ireland. In the UK for example, the local public service performance system created by the government and the Audit Commission effects how awarded grants are used. If governments score well, they can make grants fungible and therefore flexible in terms of how they are used⁵⁴.

Box23. General grants and earmarked transfers in Kosovo.

General Grant is an operational transfer set by law at 10% from the total operational revenues of the central budget. The general transfer is allocated in two steps:

- a) First step: each municipality receive 140,000 EUR – minus number of inhabitants*1Eur. The municipalities over 140,000 inhabitants (only Prishtina and Prizren) receive nothing in this stage. In this phase the allocation is inverse proportional with the population, trying to cover the “fixed” costs of the local administration – which are not proportional with the size. This instrument has an implicit equalizing effect;
- b) Second step: the remaining money are allocated among municipalities based on following indicators:
 - Number of population – 89% weight;
 - Number of minority population – 3% weight;
 - If minority population is in majority in a specific municipality – 2%;
 - Area of the municipality – 6% weight.

The law designs two earmarked transfers: for Education and for Health. For Education these resources should cover the minimum standards in providing pre-school, primary and secondary education. The law doesn't fix precisely the formula, but establishes the general indicators:

- a) Enrollment number of pupil;
- b) Standardized number of teachers;
- c) Class size and school location;
- d) Non-wages expenditures;
- e) Special needs education.

The precise formula should be set by Ministry of Education, Science and Technology.

In the case of Health, the earmarked transfer should cover the minimum standards for the primary health care. Like in the case of education the law describe only the general indicators, doesn't fix a precise formula:

- a) Age and gender distribution of the population among municipalities;
- b) Elderly persons;
- c) Persons with special needs;
- d) Number of primary health care providers – family doctors.

Box 24. Earmarked grants in Romania.

Earmarked grants in Romania form 41% from total local governments revenues.

Operational transfers – in the Romanian practice are used two earmarked transfers: one to pay the teacher salaries from the pre-university education system and the second to cover six different programs:

- 1) Scholarships and materials for primary and secondary education;
- 2) Benefits of the disabled person assistants;
- 3) GMI/Social Aid
- 4) A special aid for heating the houses during the winter;
- 5) Local services for issuing the identity cards;
- 6) State aid for free economic areas administrated by local governments;

⁵⁴ Dexia, 2008. P.122

7) Expenses for nurseries.

For the second earmarked transfer the allocation among the six programs is the result of a long bargaining process at county level involving the county council decision-makers and the mayors from the first tier local government units. Generally the volume of this transfer is set based on historical expenditures and possible volume of arrears and it is set by MoF in the annual budget law (and possible changed by annual budget rectification laws – usually 1-2).

The transfer for the teacher salaries is set based on teachers number and salary evolution and it is fixed by the MoF in the annual budget law (and possible changed by annual budget rectification laws).

Investment grants – this type of transfers is relatively rarely used in Romania and the share in the total local government budget or in transfer volume is very low. Usually for this type of transfers, the government set a limited number of eligibility criteria and “flexible” allocation rules (as first in-first out), which are very easy to be manipulated by politicians.

Box 25. Earmarked grants in Latvia.

In 2010 the ear-marked grants formed 16.7% from local government’s budget revenues. The main share of earmarked grants is for teachers’ salaries.

Besides there is such earmarked grants as:

- Earmarked grants for children in children’s home, that are placed there till 1998 and for
- residents in old people’s home, that are placed there till 1998;
- Earmarked grants for school literature (books);
- Earmarked grants for free diner for 1st class pupils;
- Earmarked grant for public access internet points in public libraries;
- Earmarked grants for spatial planning;
- Earmarked grants for local roads and streets;
- Earmarked grants for public transportation compensation.

As with the economic crises necessity for social benefits are increasing since the end of 2009 local governments receives from the state budget compensation for following social benefits: Guaranteed minimal income (GMI) – 50%, housing benefit – 20% from paid amount.

Separate type of transfers from state budget to local governments is grants for EU project implementation. In 2010 it formed 10.7% from local governments’ budget revenues. It is based on project tenders, applications and their results.

Local government finance equalization

Due to their demographic, geographic and economic features, local governments are not all capable of providing the same level of services. This results in three main types of inequalities:

- Greater needs on the part of certain local governments being responsible for different services;
- Higher unit costs for a given service, e.g. in rural or urban municipalities;
- Limited resources due to weaker tax bases and difficulties in imposing high fees⁵⁵.

Reducing these inequalities and also avoiding competition between territories seemingly requires the creation of equalization systems, re-distribution mechanisms that promote a certain level of equality and solidarity.

⁵⁵ Dexia 2008. P.128

The Council of Europe recommends:

*Where there are large inter-jurisdictional disparities between local financial capacity and spending needs, central authorities should ensure the compensation of the financially weaker local authorities. These transfers should be unconditional and secure financing of a reasonable standard level of public service provision for all local authorities*⁵⁶

The specific provisions on equalization what the Council of Europe recommends are included in Annex 6.

A higher local government tax autonomy is connected with higher fiscal disparities and hence with more need for equalization⁵⁷.

There are vertical equalization and horizontal equalization.

Vertical equalization is re-distribution from the state to local governments (or from higher level to lower level local governments). This involves selectively allocating resources, via grants or tax shares, to finance the devolved functions with external costs or limited local revenues.

Horizontal equalization is re-distribution among same-level local governments (between regions, municipalities). It might involve reallocating resources from sub-national governments considered “the wealthiest” and to those that are more disadvantaged. In this system, wealthy local governments contribute to an equalization fund that is re-distributed to beneficiary local governments⁵⁸. It is also called as “Robin- Hood principle”.

These two ways of equalization could be applied separately and also jointly (Latvia case).

Equalization can be achieved:

- Revenue equalization through taxation, either own-source or shared taxes or both;
- Expenditure and revenue equalization through grants.

Box 26. Equalization in Romania.

The actual equalization system (introduced in 2006) in Romania is designed at two levels: inter-county equalization and intra-county equalization.

For the inter-county equalization system the pool of resources is formed by 18% of PIT, which remains from the sharing system, and an annually fixed lump-sum from VAT, determined by the budget law. This resource pool is allocated to counties based on a formula: 70% inverse proportional with the fiscal capacity of the counties calculated based on PIT per capita and 30% direct proportional with the county area. The allocation is done by annual budget law.

For the intra-county equalization system is used the sum received by every county during the inter-county equalization process and the 22% of PIT collected within the county boundaries. The allocation is done by the county deconcentrated branch of the MoF based on a complicate process:

- a) From the total county equalization pool, the county council budget receives directly 27%;
- b) The rest of the pool is allocated only for first tier local governments in this way:
 - 80% by the county deconcentrated branch of MoF based on three criteria: population, area and fiscal capacity per capita based on PIT only. The process is done in two steps: in the first step receive money only those LG units with a PIT per capita under the county average PIT per capita, based on

⁵⁶ CoE CM Rec(2005)1

⁵⁷ OECD COM/CTPA/ECO/GOV/WP (2009)7

⁵⁸ Dexia, 2008, 129

two indicators: population 75% and built-up area 25%. The sum received by local government units in this phase is limited by a threshold (what the local government unit received directly from the sharing system together with what it receives during this step must not be bigger than the county average collected PIT per capita). In the second step the not-allocated money are distributed inverse proportional with the fiscal capacity per capita, based on PIT, for all first tier local governments

- 20% by county council to support local (first tier) development programs of infrastructure investments.

Box 27. Equalization grant in Lithuania

Revenue equalization grant has very small share of grants: municipalities with revenue per capita that is 165% higher than national average contribute to an equalization fund distributed to municipalities with revenue per capita that is less than 65% of the national average⁵⁹.

Box 28. Equalization in Serbia

Total equalization and general transfers should be 1.7% of GDP from the previous year. The equalization target is 90% from the average of shared taxes per capita at the level of all municipalities (without cities) from Serbia. Every local government unit is entitled to receive the difference between its estimation of shared tax revenues per capita and the average shared taxes per capita for municipalities (excluding the cities).

The local government units, which have shared taxes per capita, above 150% from the national average of shared taxes per capita (municipalities and cities together) will suffer a reduction of 40% of this difference from the entitlements of general transfer, compensation transfer and transition transfer. The money collected from this deduction are allocated to local government units (i) with shared taxes per capita up to 90% of the national average and (ii) according to the criteria from general transfer. These criteria are, as follows:

- 65% of the general transfer is allocated according to the population;
- 19.3% of the general transfer is allocated according to the area;
- 4.56% of the general transfer is allocated according to the number of classes from the primary schools;
- 1.14% of the general transfer is allocated according to the number of buildings of primary schools;
- 2% of the general transfer is allocated according to the number of classes from secondary schools;
- 0.5% of the general transfer is allocated according to the number of buildings of secondary schools;
- 6% of the general transfer is allocated based on the number of children included in the child care program;

1.5% of the general transfer is allocated according to the number of buildings used by child care program.

Box 29. Local government fiscal equalization in Latvia.

As there are significant differences in the financial capacity among different local governments in Latvia, since 1995 local government finance equalization system has been applied. Existing Law "On Local Government Finance Equalization" was passed in 1998. According this law the annual regulations of the Cabinet of Ministers (CoM) are passed, that contains the results of calculation of local government payments in the Local Government Finance Equalization Fund (LGFEF) and grants from the fund.

System before the end of administrative territorial reform

Local government finance equalization system ensures both equalization of revenue and equalization by different necessity (needs) for expenditures for municipalities, and till 2010 (while the district local governments exist) the fund was the main source of general revenues of the district (*rajons*)

⁵⁹ Dexia, 2008, pp. 449

governments since they did not have their own revenue base.

State budget grant and local government payments constitute the Local Government Finance Equalization Fund. The amount of the LGFEF constitutes approximately 5-6% of the total amount of basic budget of local governments. At the same time there are municipalities in whose basic budget revenues the share of grant from the LGFEF forms even 55% from revenues.

The financing mechanism includes the calculation of local government estimated revenues and determination of financial necessity. The Law stipulates that local government revenue for equalization calculation is estimated on the basis of the personal income tax and real estate tax. Personal income tax total value is forecasted by the Ministry of Finance and discussed in the annual negotiations between local governments and government. Total local government share of the PIT is divided for each local government based on actual personal income tax performance in the year prior to the budget preparation year. Real estate tax revenues are forecasted in accordance with official data of the State Land Service and local governments about cadastral (registered) value of real estate located in the territory of the local government.

The criteria used to evaluate the expenditure need called financial necessity of each local government are following:

- local government group (republican cities group and rural group),
- the number of residents,
- the number of children up to age of 6,
- the number of young people of the ages 7 to 18,
- the number of people above working age,
- the number of children in children's home, that are placed there till 1998,
- the number of residents in old people's home, that are placed there till 1998.

The values (weight) of criteria are included in the Law. Those criteria identify connection of expenditures with providing basic local services to the population (education, social services, etc.). Last 2 criteria (the number of children in children's home, the number of residents in old people's home that are placed there till 1998) were included in the system because since 1998 the mutual payments for those social services are used, but before not. In the Law is stated that the weights of the criteria have to be recalculated (existing are based on calculations for 1995), but there is no stated legal mechanism how to do it without opening of the Law. As the number of last two criteria year by year is reducing, but weights for criteria stay unchanged, the value for one unit of those criteria became in-proportionally high and equalization became deformed.

The use of the term of financial necessity in the equalization system is the most disputable. Although the sequence of the calculations is determined in the Law, in practice it is different – calculation's starting points are estimated revenues and constant state budget grant (7.15 million Ls) to the LGFEF and then in iteration process the financial necessity is calculated. After such calculations total financial necessity is lower than estimated revenues.

Those municipalities whose estimated revenues are higher than non-equalized upper border of financial necessity (financial necessity plus 10% of it) pays to the fund 45% from surpass between estimated revenues and non-equalized upper border. Those municipalities whose estimated revenues are lower than non-equalized lower border of financial necessity (for rajons – 100% of financial necessity, for republican cities - 95% of financial necessity, for other municipalities - 90% of financial necessity) receive the grant from the LGFEF in the amount to reach the level of non-equalized lower border. Those municipalities whose estimated revenues are lower as non-equalized upper border of financial necessity but higher than non-equalized lower border of financial necessity, are neutral – nor paying, nor receiving the grant.

For instance the equalization level in 2008 in the group of municipalities was following - the difference between estimated revenues (min, max) before equalization was 9.9 times, but after equalization – 2.4 times. Opinions on that, is this level of equalization sufficient or not, are different. For normal economical situation it could enough, but for crises, it seems not enough.

System after the administrative territorial reform

As after the finish of the administrative territorial reform since 2010 there are no more district governments (*rajons*), in October 2009 the *Saeima* passed amendments in the Equalization Law. Those amendments could be considered as quick fixes for old equalization system adaptation for new local government system. According those amendments:

- state budget grant in the LGFEF stays without changes – 7.15 million Ls;
- for calculation of financial necessity four demographic criteria are used, new weights for them is calculated;
- the breakdown of the finance necessity into two groups stays, but as two more cities moves to republican cities group the proportion between cities and *novads* are following:
 - republican cities (9) - 47%
 - *novads* (109) – 53%.
- Additional special earmarked grant from state budget for children in children's home and for residents in old people's home, who have been here before 1998 (in 2010 2.57 million lats).

Although some changes are done, the following can be noted as the most significant flaws of the current equalization system:

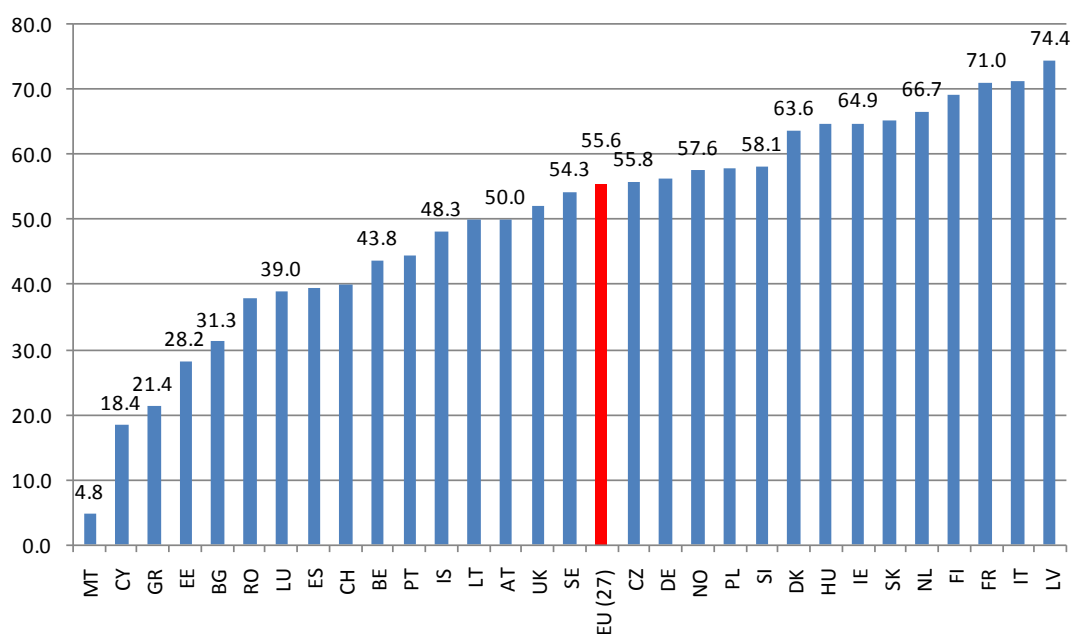
- Assessing the disparities in determination of the financial necessity of each local government the system uses only demographic criteria and the division of local governments into two groups – republican cities and *novads*. First division in groups for *novads* is more favorable than for cities, but at the same time the richest local governments (that can use city infrastructure) are among *novads*.
- The volume of state budget grant to the LGFEF has remained unchanged since 2001. System does not react to decrease of total local budget revenues.
- For local governments which receive the grant from the LGFEF by increase in tax revenue but not reaching the lower non-equalised border, the increase of tax revenue does not ensure the increase of entire budget revenue, but it ensures decrease of the grant from the fund. Therefore recipient local governments have no financial motivation for promoting increase in tax revenue.
- System is very complicated. Only some local governments understand it. Applied order of calculation differs from the order what is stated in the Law.
- Lack of sufficient monitoring and evaluation is a feature of the system; forecasts used for calculations are not compared with the actual situation, no regular analysis of the system is performed.

The decision concerning the desirable degree of equalisation is an eminently political one. There is no optimum level of equalisation at European level. It is important, however, that, once the decision has been taken, an efficient equalisation system is set up to implement it⁶⁰.

10. Local governments capital investments

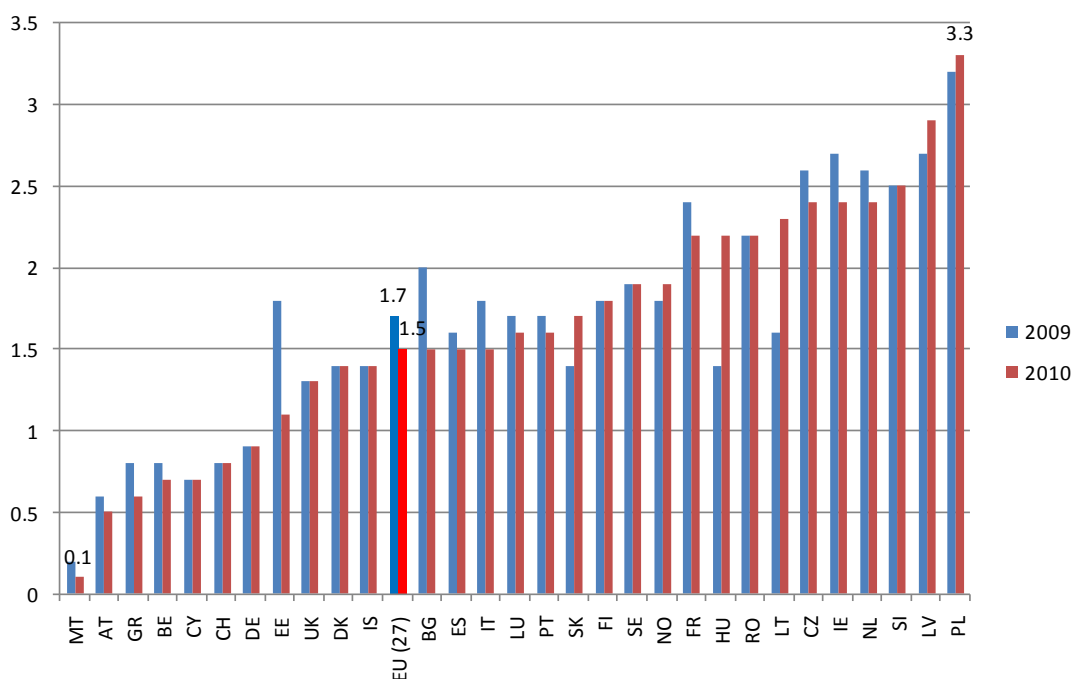
Local government capital investments, their total amount, amount per capita, share in total expenditures reflects the development capacity of local government. Local government capital investments are significant among public investments. In EU subnational (local government and state in federated countries) expenditures formed more than half from general government capital expenditures in 2010 (picture 16).

⁶⁰ CoE CM Rec (2005)1



Picture 16. Local government capital investments as % General Government investments in EU(27) countries and Iceland, Norway and Switzerland in 2010.

Data Source: Eurostat



Picture 17. Local government capital investments as % of GDP in EU(27) countries and Iceland, Norway and Switzerland in 2009 and 2010.

Data Source: Eurostat

The data indicates significant differences of share of local investments between countries. This is an indication of huge variation of capital investment and decentralization policies in different countries.

In general main resources of local government capital investments are:

- Local government own capital revenues, e.g. sale of local government property;
- General grants;
- Earmarked grants for investments;
- Special local funds (for instance Privatization fund);
- Special national funds (for example, Regional development fund)
- Funds generated through partnerships, such as concessions;
- EU or other international, foreign funds;
- Borrowing.

Local governments are often able to devote operating surplus to capital expenditure and any revenue from sale of assets are spent on investment, not covering current costs.

To describe European practice characterising systems of local government capital investment in different countries an important factor is interaction between local financing, national financing and in the case of European Union – role of supranational financing.

It is obvious that there are huge differences between capital investment financing approach in the EU member states and other European countries.

In all European Union member states national operational programming framework is strongly influenced by EU Structural and Cohesion funds, that ensures Community co-financing for national and local government projects that meets EU Structural and Cohesion funds criteria.

EU funds are essential tool for financing sub-national public capital expenditure in less favoured EU regions (GDP per capita less than 75% of EU average).

In the new EU member states most of local government capital investment projects (mainly water, sewage, solid waste and transport) are co-financed by national budget and EU Cohesion fund and Structural Funds. In many cases local governments finance only 5-10% of total investment, while national budget finances 10-15% and Cohesion funds up to 75% of the investment cost. This explains radical increase in Local capital investment in European countries (Estonia, Latvia, Lithuania, Poland, Czech republic, Slovakia, Hungary, Malta, Romania, Bulgaria) after these countries acceded the European Union. Operational programming framework in each EU member state defines capital investment areas, project eligibility criteria, co-financing rules and administrative mechanisms and evaluation, monitoring and control systems. This system provides strong incentive for local authorities to be involved in the design of socio-economic strategies, as well as preparation, financing and management of projects.

In former communist block countries that are still in their way with regard to EU accession local capital investment policies are quite different (e.g. Ukraine, Moldova). In most cases volume of local capital investment is rather limited and based on residual principle. At the

end of fiscal year if there is a budget surplus, the political decision is made to invest in capital infrastructure. This system does not allow strategic investment planning framework in medium or long term and in many cases investment has *ad hoc* or local government elections centered character. Currently central government role in local capital investment is rather limited and grant based, therefore reaches few beneficiaries. The system in which local government demand for national grants significantly exceeds central government funding possibilities leads to politically biased project selection. The national capital investment framework lacks operational programming and clear project eligibility criteria.

11. Borrowing

Borrowing is a form of financial resources primarily used to fund capital expenditures.

National laws and policy should permit local governments to borrow money for investment (though not for operating budget deficits), although it may be necessary to impose limits to prevent excessive debt.

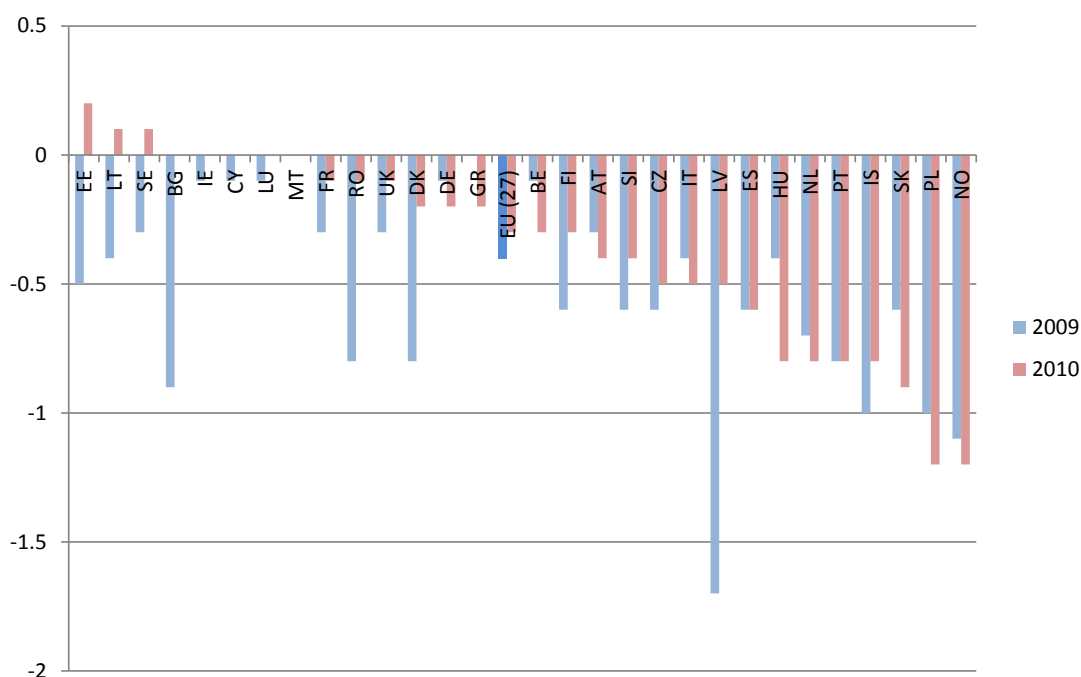
In Annex 7 the recommendations of the Council of Europe on local government borrowing is included.

In EU in 2010 local governments net borrowing was 0.3% of GDP, in comparison with previous year this share has decreased.

Table 6. Government Net lending (+)/Net borrowing (-) in 2007-2010

	2010	2009	2008	2007
<i>General government borrowing in % of GDP</i>				
EU27	-6.6	-6.9	-2.4	-0.9
Euro area	-6.0	-6.4	-2.1	-0.7
<i>Local government borrowing in % of GDP</i>				
EU27	-0.3	-0.4	-0.2	0.0
Euro area	-0.3	-0.3	-0.2	-0.1

Source: Eurostat



Picture 18. Local government net lending / net borrowing as % of GDP in EU (27) countries and Iceland, Norway in 2009, 2010.

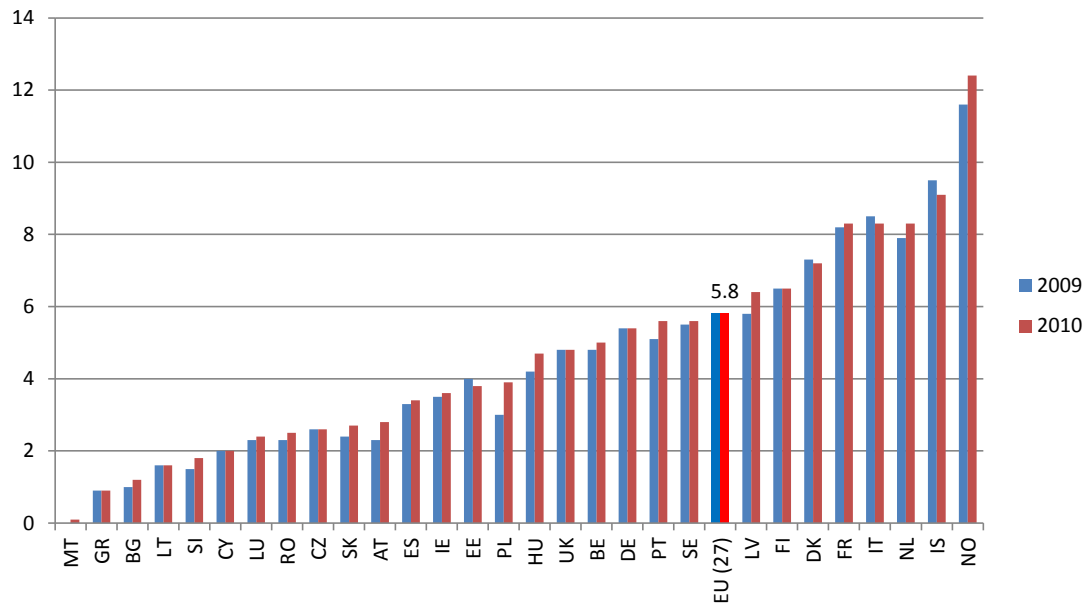
Data source: Eurostat

Local government borrowing is authorized everywhere in Europe, but it is strictly monitored by tight prudential rules that seek to control the use of loans and keep local governments from falling too deeply into debt. In EU in 2010 local government debt formed 5.8% of GDP, but between countries it varied from 0.1% in Malta to 12.4% in Norway (see Picture 19). Local government debt has been controlled, there is a trend of local governments debts share in general government debt decrease in the period of the economic crisis – since 2009 it is less than 8% in EU, but between countries there are significant differences. Local government debt share (%) in general government debt in 2010 varied from 0.1% (Malta) to 55.6% in Estonia (see Picture 20). But in Estonia was the lowest general government debt – 6.7% of GDP, while in Greece general government debt in 2010 was 144.9% of GDP.

Table 7. Government debt in EU in 2007-2010

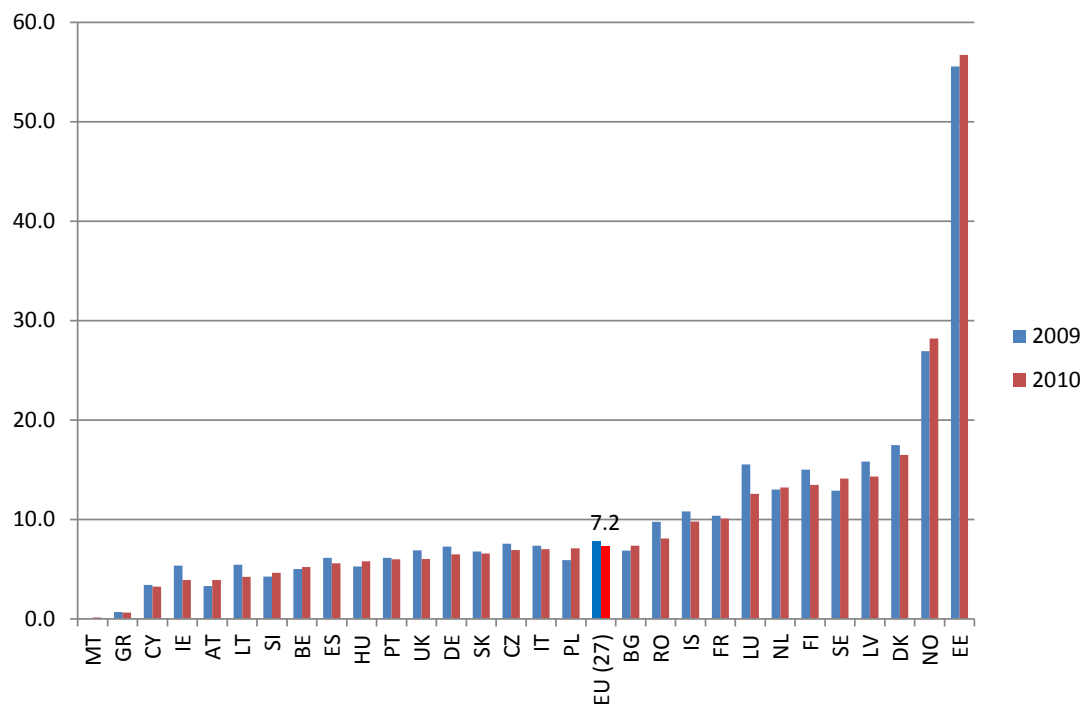
	2010	2009	2008	2007
<i>General government debt in % of GDP</i>				
EU27	80.1	74.7	62.5	59.0
Euro area	85.3	79.8	70.1	66.3
<i>Local government debt in % of GDP</i>				
EU27	5.8	5.8	5.2	5.1
Euro area	6.2	6.1	5.7	5.5
<i>Local government debt in % of general government debt</i>				
EU27	7.2%	7.8%	8.3%	8.6%
Euro area	7.3%	7.6%	8.1%	8.3%

Data source: Eurostat



Picture 19. Local government debt as % of GDP in EU (27) countries and Iceland, Norway in 2009, 2010.

Data source: Eurostat



Picture 20. Local government debt as % of general government debt in EU (27) countries and Iceland, Norway in 2009, 2010.

Data source: Eurostat

In several countries, the right of municipal borrowing is subject to prior approval of the central administration.

The most common rule concerns the end use of the loan: most countries allow long-term borrowing to finance investments, but not to cover operating expenses⁶¹. Most common quantitative rule is cap on debt service. Debt annuity (interest and capital reimbursement) is capped at a specific percentage of revenues of the previous year of forecast revenues from current year (for example, the Czech Republic – 30% of total revenues, Estonia – 20%, Romania – 30%, Slovakia – 25% of operating revenues)⁶².

In most countries local governments have ability to borrow from the financial institutions (banks) of their choice.

Box30. Local governments borrowing in Romania.

The local government in Romania can borrow under few forms: contracting bank loans, issuing bonds, financial leasing, supplier credit, local guarantee to a local owned company. The debt can be guaranteed with fixed assets or with future revenues (only the own revenues, shared taxes and equalization transfers). The services of the debt should be lower than 30% from own revenues and sharing tax revenues – initially this limit was 20%, but it was increased imprudently during the boom period and the consequence was an overindebtedness of many local governments, especially major municipalities. The local government debt should be recorded in a special register by MoF. In the last years, trying to limit the local government debt, Ministry of Finance introduced an administrative tool: a fixed volume of new credit (including guarantees) that local governments can contract in one year respecting the provisions of the law on local public finance – the allocation rule for this credit volume is first in-first out.

Box31. Local governments borrowing in Latvia.

Local governments can borrow to finance capital expenditure only. Short term borrowing is only allowed to cover a short term fiscal deficit and must be repaid within a fiscal year. The legislation of Latvia states a number of conditions and limitations that apply to local government borrowings. A total annual limit on borrowings and guarantees by the local government sector is established in the annual state budget law. There are no explicit borrowing limits put on a single municipality; the set limits are for the whole sector, and the whole local government sector can not exceed them. It is already tradition that total borrowing limit accepted in the annual budget law in the middle of year is completed and increased by amendments in the budget law. Each case of local government borrowing must be approved by the Local Government Borrowing and Guarantee Board, made up of representatives from several ministries (Ministry of Finance, Ministry of Environmental Protection and Regional Development, Ministry of Economics), State Treasury, the Central Bank and the Association of Local and Regional Governments of Latvia. Loans must be contracted with the State Treasury. Borrowing from another institution is possible with special permission of the Minister of Finance if it can be proved that institution offers better borrowing conditions than the Treasury. Local governments can guarantee loans to local government companies when the local government owns more than 50% of the company's capital (65% for joint municipal enterprise). Besides there is special law on local government finance stabilization – those local governments could receive loans for debt refinancing. A financial stabilization process may be initiated by the troubled local government council, the Minister of Finance, the minister responsible for local governments (since 2011 Minister of Environmental Protection and Regional Development) or by State auditor. The law lists three conditions which may be the basis for financial stabilization action: 1) a debt service ratio greater than 20% of the budget; 2) the inability of the local government to settle its debt commitments; and: 3) a value of debts which exceeds the market value of local assets. There is a special Stabilization board like for the borrowing. To get the stabilization loan and start stabilization process local government has to prepare stabilization plan. To ensure stabilization process a Supervisor is appointed. The role of the Supervisor includes making proposals to improve the budget (which should include finding cost efficiencies to reduce local expenditures), proposing amendments

⁶¹ Dexia, 2008, pp.137

⁶² Dexia, 2008, pp.138

to the Stabilization plan, and monitoring budget implementation to ensure compliance with the terms of the Stabilization plan. Supervisor can also control all municipal expenditures and sign the municipality's payment orders.
17 local governments were in stabilization process before the end of the administrative territorial reform, in 2011 one municipality is in stabilization process.

12. Government consultation with local governments

The European Charter of Local Self-Government states the need of consultations of state institutions and local governments on issues of local government importance, as well as it contains particular provision on consultations on financial resources.

Article 4 – Scope of local self-government

6. Local authorities shall be consulted, insofar as possible, in due time and in an appropriate way in the planning and decision-making processes for all matters which concern them directly.

Article 9 – Financial resources of local authorities

4. Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.

Consultations within the context of the Charter mean a genuine opportunity of local governments to influence decision-making what includes information ability and possibility to express opinion.

Both sides – central and local governments have vested interested in consultation process. Reasons for central government why to seek local governments' opinion are: to draft better concepts or laws; to establish more suitable administrative procedures, to get political support or initiate constructive discussion.

If agenda is of individual interest, then communication is between two interested parts, one of them – particular local government. If agenda is of general interest of local government sector, then local government opinion is represented either by higher level of government that has gathered opinions from lower level or most common way that local governments are represented by association or several associations representing different groups of local governments (for example local government association and regional government association). Besides one can find cases where a joint body is set up by government decree made up of representatives of government and local authorities (for example, in Finland, Austria the advisory council on local government finance and administration).

To ensure consultation process local governments have to be able to negotiate among themselves to establish their representative institutions – associations. Not in all former Soviet countries local governments are able to solve this task and establish such organizations.

In developed countries with more extensive democratic experience negotiations between the state and local governments are performed on the bases of traditions and political culture.

If there are no such traditions the base on negotiations could be strengthened with legislation requirements. An example of such approach is negotiations' system of Latvian central government and Latvian Association of Local and Regional Governments.

Box33. Central government and local government negotiations in Latvia

Formal system of Latvian negotiations between central government and local governments was set up in 1994. The right of local authorities to be consulted is recognised by laws.

The Law on Local Governments (1994) determines:

The Cabinet (Government) shall agree (negotiate) with self-governments all issues that affect the interests of all self-governments:

- 1) draft laws and draft Cabinet regulations that pertain to self-governments;
- 2) the amounts of grants and earmarked grants to be provided to self-governments for the current financial year;
- 3) procedures for equalisation of self-government financial resources, unless specified in law;
- 4) sources of financing for the functions specified in this Law; and
- 5) other issues on self-government activities regarding which the Cabinet has agreed to with self-governments each year prior to the start of the financial year.

Self-governments shall be represented in the co-ordination process by a self-government association that has been established in compliance with the requirements of this Law.

The Minister of the relevant sector shall represent the Cabinet in the co-ordination process or a person authorised by the Minister.

The procedures by which the Cabinet shall co-ordinate with self-governments the issues referred to in this Article shall be determined by the Cabinet.

Also the Law on Local Government Budgets (1995) determines necessity of annual negotiation on budget issues, where the government is represented by the Minister of Finance, but local governments by the association mentioned in the Law on Local Governments.

The organization that represents all local governments mentioned in the Law is the Latvian Association of Local and Regional Governments (LALRG) founded in 1991. Currently all 119 local governments in Latvia are the members of the association.

According the Law on Local Governments the issues necessary to negotiate and the procedure of annual negotiations is regulated by the Cabinet (Government) regulations "The procedure for the cabinet of ministers agreeing issues with local authorities" (2004).

The process of regular annual negotiations is following:

- Till 1 March of each year the LALRG submits the list of local government officials what will participate in the annual negotiations with ministries to the sector ministries and responsible for local governments ministry (currently – the Ministry of Environmental Protection and Regional Development).
- Till 1 April ministries agree with the LALRG on issues what will be discussed.
- Till 1 August annual negotiations with sector ministries are held. Minutes of discussion with each ministry are signed by the minister and the chair of the LALRG. Till 10 August signed minutes are submitted to responsible for local governments' minister and copies to the Minister of Finance. In the framework of the negotiations with the Ministry of Finance financing of sectoral issues are negotiated. Final minutes according to the Law on Local Government Budgets are submitted with the draft Annual State Budget Law to the Parliament.

All minutes are published in the webpage of responsible for local governments ministry.

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Administrative Territorial reform in Latvia

In 1993 the Government approved the Concept of Local Government Reform. Local government reforms were part of public administration reforms. The purpose of the proposed reforms was and still is to bring local public administration closer to citizens. The main objectives of the reform have been: democratization and decentralization of state authority; increase of local authorities' responsibility for the implementation of entrusted functions; improvement of the quality of services delivered; and extensive involvement of citizens in the activities of local authorities. The steps in the reform of local government include:

- a new law on the elections of local government councils;
- a new law on local governments common for rural and urban municipalities and regional (district) governments;
- administrative territorial reform;
- improvement of the local budget system;
- creation of territorial information systems;
- establishment of training institutions for the deputies and staff of local governments;
- organization of the system of negotiations between the government and local governments;

Later in 1998 the Administrative Territorial Reform Law was passed. At the beginning the Law determined that till 2005 the amalgamation (consolidation) of local governments will be implemented. In general there was very low support of local governments to the reform. Lack of political will, as well as a change of the proposed territorial division with the regular change of government (in average government in Latvia works approximately one year) postponed the implementation of the reform till local elections in 2009.

According the Administrative Territorial Reform Law (1998) local governments could amalgamate voluntary. Although the number of voluntary amalgamations was rather small, each year because of this process, the number of local governments in Latvia decreased. Not for all voluntary formed new local governments implemented amalgamation was the last one, part of them at the final reform stage was included in largest territories.

Within reform process local governments could receive from the state budget earmarked grants for elaboration of amalgamation projects (approx. 5-10 thousands lats (3.5-7 thousands EUR) for project), but very significant was earmarked grants for investments in *novads* infrastructure. Recipients of this grant were those *novads* what agree sooner or later implement amalgamation. In period 2005-2009 total amount of this grant to local governments was 97 million lats (68 million EUR). Amount for *novads* are calculated 200 thousand lats per unit (*pagasts, pilsēta*) that are amalgamated (for instance, *novads*, where 5 *pagasts* were amalgamated, received 1 million lats).

The new administrative territorial division (118 local governments) was approved by the "Administrative Territories and Settlements Law" (18.12.2008.). In 2009 one municipality was divided into two and now there are 119 local governments in Latvia.

Still after the reform there are significant disparities between municipalities by size. The largest local government is capital city Riga (703 thousand in 2011) and there live one third from all population of Latvia. The smallest by population *novads* has less than 1400 residents, 3 municipalities has population less than two thousand residents, in 36 the number of residents is 2000-5000.

The district level within the Administrative Territorial Reform was abolished. The reorganization (abolishing) of *rajons* were regulated by the District Governments' Reorganization Law (19.06.2008.). According it each *rajons* prepared and approved the reorganization plan that includes delivering of all institutions, property, finance resources, projects, rights and liabilities to new local governments and planning regions. The delivery object (institution, property, project etc), local government and expected data of delivery were included in that plans. Almost all objects were delivered to local governments, only the responsibility for agreements connected with public transport services were delivered to planning regions (as since 2010 the function to organize public transport services from districts is passed to planning regions, but the republican cities still has this responsibility).

Fact that the time of economical crises coincides with the reorganization of municipalities within administrative territorial reform and with local elections, after what significant part of local councilors was changed, make situation since 2009 very complicated.

The delay of the reform has negative impact on development of the country. Both the central government and local governments are responsible for the hesitation of the Administrative Territorial Reform.

Local Government functions in Romania and Latvia

The main responsibilities assign to the local government **in Romania** are:

- 1) Communal services - to the first tier:
 - a) water supply;
 - b) sewerage and used water filtering;
 - c) collection, sewerage and evacuation of rain waters;
 - d) sanitary engineering and management of solid wastes;
 - e) thermal power supply in centralized system;
 - f) local public transports;
 - g) public illumination;
 - h) public parks, green areas, cemeteries;
- 2) Education (preschool, primary and secondary) – to the first tier:
 - a) Maintenance of the school buildings, current and capital repairs, some of the investments in education infrastructure – from general revenues of the local government units;
 - b) Teacher salaries, scholarships and materials for primary and secondary education financed through an earmarked transfer;
- 3) Social assistance:
 - a) Cash benefits (guaranteed minimum income, benefits for disabled persons and their assistants) and some (a limited number) of social services in kind to the first tier;
 - b) The great majority of the social services in kind for children, disabled persons and elderly together with the planning function to the second tier;
 - c) Social housing to the first tier;
- 4) Urban and territorial planning to both tiers according with their territorial competences;
- 5) Local economic development to the first/second tier of local government;
- 6) Community police, some civil defense services, mountain and sea protection services, but not emergency situation services (firefighters) , which are de-concentrated at the level of counties;
- 7) Management of the public and private property of the local government unit, including the selling (for the private property) and the concession (for the public property);
- 8) Health public system:
 - a) Development of the primary health system to the first tier of local government;
 - b) Secondary health system:
 - Town and municipal hospitals to corresponding first tier of local government;
 - Emergency county hospitals to the second tier of the local government;
- 9) County roads to the second tier;
- 10) Conservation of the historical patrimony to the first tier/second tier;
- 11) Sport, youth and leisure activities to the first tier;
- 12) Culture activities (libraries, theatres, philharmonics, museums) and support for religious cults to the first/second tier;
- 13) Civil and marital status services, including issuing of ID cards to both tiers of local government.

Local governments **in Latvia** are responsible for very wide range of public functions that includes responsibility to organize of utility services for residents, to ensure the education for residents, to ensure social assistance and social care for residents, to maintain culture activities and other.

The Law “On Local Governments”, article 15, stipulates 22 autonomous functions for local governments. Apart from them there are autonomous functions in other laws and local governments also are responsible for a number of temporary functions and tasks (laid down by laws and regulations) and voluntary tasks.

Local governments have the following autonomous functions, that are stated in the Law “On Local Governments” (Article 15):

1. to organize municipal services to the residents (water supply and sewerage, heat supply; collection, disposal, storage or recycling of household waste);
2. to be responsible for the improvement of, and sanitary condition of, their administrative territory (laying of streets, roads and arrangement of squares, their restoration and maintenance; lighting of streets, squares and other territories of public use; planting and maintenance of parks, green squares and other green areas; control over collection and disposal of industrial waste; taking anti-flood measures; opening and maintenance of cemeteries and places for burying dead animals);
3. to establish rules for the use of public water and forests, unless another procedure is prescribed by law;
4. to be responsible for the education of the inhabitants residing in their territory (ensuring that the inhabitants may exercise their right to primary and general secondary education; provision of places for children of pre-school and school age in educational institutions; provision of organizational and financial assistance to non-school educational institutions and institutions supporting education, etc.);
5. to be responsible for giving support to culture, and the preservation of traditional cultural values, as well as giving support to people’s cultural activities (organizational and financial assistance to cultural establishments and activities, to the preservation of cultural monuments, etc.);
6. to guarantee the accessibility of health care and to promote a healthy lifestyle and sport;
7. to ensure social assistance (social care) to inhabitants (social assistance to low income families and socially vulnerable people, provision of places in old people’s homes, provision of places in educational establishments and homes for orphans and children left without parental care, provision of night shelter for homeless people, etc.);
8. to be responsible for matters of guardianship, trusteeship and adoption;
9. to give housing support to inhabitants;
10. to encourage business activity in their administrative territory and to take measures to decrease unemployment;
11. to issue permits and licenses for entrepreneurial activity, if so provided by laws;
12. to maintain public order, to fight against the abuse of alcohol and against moral degradation;
13. to set the order of construction works in compliance with the territorial plans of their respective administrative territory;
14. to monitor building activity in their respective administrative territory;
15. to keep the Civil Register;
16. to collect and issue data required for national statistics;
17. to organize the necessary measures for holding the local government elections;

18. to participate in civil defense;
19. to organize public transport services;
20. to organize training for pedagogical staff and to organize education methodological work;
21. to conduct, in the relevant administrative territory the registration of children residing therein;
22. to implement the protection of the rights of children in the relevant administrative territory.

Implementation of local government functions and council decisions is ensured by the local administration, institutions, companies. Local government has rights to delegate functions to other local government as well as to form inter-municipal entities (establishments, agencies, companies, associations, funds.

Main principles and objectives of Recommendations of the Council of Europe on local finances

Rec(2004)1 of the Committee of Ministers to member states on financial and budgetary management at local and regional levels recommends that the governments of member states:

take inspiration for their policy on financial and budgetary management at local and regional levels from the following principles of:

- a. *securing consistency with the macro-economic targets of the national economic policy;*
- b. *establishing and ensuring financial stability of local and regional authorities;*
- c. *looking for cost-effectiveness of services provided to the community;*
- d. *ensuring openness and accountability of decisions.*

Rec(2005)1 of the Committee of Ministers to member states on the financial resources of local and regional authorities recommends that the governments of member states:

guarantee local authorities a system of financing their expenditure that is based on the following principles:

- *local authorities' resources and their allocation must be consistent with the requirement that they discharge their responsibilities effectively;*
- *local authorities are entitled, within the framework of national economic policy, to raise adequate resources of their own;*
- *a substantial proportion of transfers, and, generally, of their own resources, must not be earmarked for specific purposes;*
- *the amount of state grants must be fair, transparent and foreseeable; fairness demands that allocation rules be universal, non-discriminatory, stable, and neither arbitrary nor negotiable on an ad hoc basis;*
- *the financial equalisation system should allow local authorities to provide their citizens, if they so wish, with broadly comparable levels of services in return for comparable levels of taxation and charges; this system should take account both of disparities in the financial capacity of local authorities and disparities in their spending needs;*
- *where the demands of national economic policy so require, measures should be taken to ensure that the system of financing local authorities is consistent, overall, with those demands; such measures should:*
 - a. *not be disproportionate to the demands in question;*
 - b. *should be negotiated with these authorities or their representatives; and*
 - c. *should be introduced by law;*
- *specific limitations which apply to a limited number of local authorities should be lifted as soon as the situation permits.*

The main objectives in developing intergovernmental financial relations should be following:

- *to secure revenue for each tier of government according to the assignment of their responsibilities and standard financial needs (vertical fiscal balance);*
- *to achieve an equitable distribution among local authorities (horizontal fiscal balance);*
- *to enhance the efficiency of the public sector.*

Main principles on local budgets in Recommendations of the Council of Europe on local finances

Rec(2004)1 of the Committee of Ministers to member states on financial and budgetary management at local and regional levels in the guidelines for local and regional governments of member states provides following general principles:

- *The local or regional authority should draw up pluri-annual budget plans (covering the two to four years following the current year) setting out the overall budget objectives, an indication of the cost of pursuing the policies and undertakings subscribed to, and future budgetary consequences of decisions taken or to be taken.*
- *Budget projections and proposals should be prepared with the involvement of in-house experts (for example, receiver, treasurer, internal auditor) and outside opinions (such as economists, independent auditors, etc.), particularly in the event of public debate (hearings before the relevant committees, the local or regional council, etc.).*
- *Whenever a decision is taken by the executive or the local or regional council, the budgetary expenditure for the current year and the following financial years should be clearly explained.*
- *As a general rule, the proceedings of committees dealing with budget matters should be open to the public and their documents should be published and accessible to the public.*

Main principles on local taxes in Recommendations of the Council of Europe on local finances

Rec(2005)1 of the Committee of Ministers to member states on the financial resources of local and regional authorities recommends following on local tax issues:

Taxes (right to levy, proceeds and capacity to set the rate, if necessary inside a pre-established bracket) should be assigned to local authorities unless these taxes would exhibit significant horizontal spillovers, entail an inequitable pattern of revenue among local authorities, or discrimination or distortions among authorities, which warrants these taxes being administered at higher levels of government (subsidiarity principle). Where taxes are assigned to local authorities, they should also be given some power to intervene in their administration in order to improve their efficiency and to appropriate their proceeds (fiscal autonomy). Fiscal autonomy includes some tax policy discretion on behalf of local authorities, especially in the setting of tax rates.

The Council of Europe recommend following on local tax issues:

- *The tax revenues of a local authority should come from resident individuals or property or businesses on the territory of the local authority in question.*
- *Local taxes should have a sufficiently high yield and low administrative and inspection costs.*
- *Local taxes should be neutral and create little negative economic distortion (minimum impact on growth and the economic structure of the municipality), demographic distortion (so as not to prompt people to migrate) and social distortion (so as not to cause further problems for social groups in difficulty).*
- *The central authorities should be able to help local authorities draw up local tax regulations. The establishment of a single database (or a single access point) for all local taxation can make for greater openness.*
- *Consideration should be given to the possibility of the central authority's registering and collecting the taxes. The main advantage of such a system is that the regulations are drawn up by the central authority, registration costs are reduced and collection and litigation costs are lower, because there are economies of scale, and are borne by the higher authority.*
- *If the taxes are collected by the local authorities, the central authority should provide them with logistic support (training, access to information, integrated, interoperable software, etc.) and set up special databases at national level.*
- *Local authorities should be able to establish the level of their (exclusive or additional) taxation, if appropriate within predetermined limits, so that they can vary the quantity and quality of their services according to local needs and preferences and so that elected representatives are more accountable.*
- *Local authorities' freedom in tax matters should be restricted only for reasons relating to fairness or national economic policy constraints.*

Main principles on local government finance equalization in Recommendations of the Council of Europe on local finances

Rec(2005)1 of the Committee of Ministers to member states on the financial resources of local and regional authorities recommends following on finance equalisation issues:

On equalization system:

- *The purpose of financial equalisation should be to allow local authorities to provide their citizens, if they so wish, with services of generally similar levels for similar taxation levels.*
- *When designing their equalisation systems, central authorities should take account of the fact that the differences in the tax burden that authorities have to impose on their residents to achieve the same level of services are generally the result of differences in their financial capacity, their spending needs or their managerial efficiency.*
- *The equalisation system should compensate, at least in part, for differences in authorities' financial capacity (so as to provide more resources to financial weaker authorities) and spending needs (so as to provide more resources for authorities that either have additional responsibilities or, by virtue of their geographical location, demographic situation or other factors, are obliged to spend more in order to discharge their responsibilities). It should not compensate for differences in managerial efficiency or differences in cost stemming from the adaptation of service levels to local preferences.*
- *A substantial degree of financial equalisation is a prerequisite for the success of fiscal decentralisation and sound local self-government. At the same time, financial equalisation is a prerequisite for the success of policies geared to economic stability and balanced, sustainable regional development. The decision concerning the desirable degree of equalisation is an eminently political one. There is no optimum level of equalisation at European level. It is important, however, that, once the decision has been taken, an efficient equalisation system is set up to implement it.*
- *Local authorities should be provided with appropriate information about the way in which equalisation systems work, for they cannot accept a system with which they are unfamiliar or which they do not understand.*
- *Equalisation may be achieved by means of grants from a higher authority (vertical equalisation) or the redistribution of local tax revenues, particularly if they are collected by central government departments (horizontal equalisation) or a combination of both. Vertical equalisation generally lessens the risk of resentment among local authorities. Horizontal equalisation (provided for by law, in accordance with the principle of solidarity between authorities of the same level) has the advantage of strengthening inter-municipal solidarity and giving local authorities greater independence from the central authority; it should be envisaged, in particular, in cases where local taxation capacity varies too much for it to be possible*

to achieve the desired level of equalisation solely by means of financial transfers from the state. The extent to which local authorities with above average per capita revenues are expected to contribute to horizontal redistribution should not be so great, however, as to discourage them from the exploitation and development of their revenue base. The volume of resources contributed by the national budget to vertical equalisation should reflect the priority of the services for which local authorities are responsible within the overall framework of public expenditure; their stability should be guaranteed by a permanent law and some form of indexation to the growth of aggregate national budget revenues is highly desirable.

- *The desired degree of equalisation of disparities in spending needs and in financial capacity should be clearly and foreseeably specified.*
- *Equalisation systems should specify openly and foreseeably which local parties are eligible for financial transfers to equalise financial capacity and spending needs. Eligibility criteria should be laid down by law.*
- *Although equalisation systems normally operate at national level, it may be worth encouraging systems for pooling certain local taxes or redistributing certain local taxes among local authorities that make up an urban area and, in particular, between municipalities that constitute the industrial and commercial heart of the urban area and those which are residential areas. A local equalisation system of this kind makes it possible to compensate, at least in part, for externalities and may be set up by means of an agreement among the municipalities concerned. In some cases, if it is impossible to reach such an agreement, it may be necessary to legislate.*
- *In all cases, the mechanisms adopted to equalise among jurisdictions should be based on standardised (not actual) levels of revenues and expenditures. The standardisation of costs and revenues acts as a safeguard against implicit financial bail-outs that would otherwise eliminate the local authorities' (and their officials') accountability and result in wasted public resources. It also avoids moral hazard by local authorities because it precludes the manipulation of distribution criteria by recipient governments.*
- *Central authorities should regularly check how their equalisation systems are working and consider, with local authorities, improvements that can be made in order to ensure that the adverse effects of an unequal distribution of resources and spending needs are effectively remedied.*

On equalization of spending needs:

- *The equalisation of (standardised) specific spending needs should be effected through grants based on appropriate and objective criteria. Even when these grants are programme-specific, they should allow some limited discretion as to their use within programmes, and should avoid onerous monitoring and reporting.*
- *Spending needs should be estimated primarily on the basis of criteria which:*
 - *are objective and which local authorities do not directly control;*
 - *are unlikely to affect local authorities' freedom of choice, within the limits of the budgets available;*

- *do not penalise local authorities that endeavour to streamline the management of their services to make them more efficient, either by lowering unit costs or by trying, by means of co-operation arrangements or mergers, to increase the number of users and units produced in order to obtain economies of scale, and which do not involuntarily provide incentives to indulge in behaviour that is contrary to the objectives of local accountability and efficiency in the provision of public services;*
- *take account, as far as possible, of demographic, geographical, social and economic features leading to disparities in costs.*
- *The calculation formulae used to estimate spending needs should fulfil the following conditions:*
 -
 - *the weight afforded to the various individual indicators should be determined on the basis of objective information about the impact of variations in those indicators on the actual cost of local services;*
 - *insofar as the assessment of needs nevertheless entails value judgments as to the weight to be afforded to the various indicators, it is necessary to identify and assess the results of these judgments in conjunction with representatives of the local authorities concerned or their associations;*
 - *formulae for evaluating needs (models) should be as simple as possible, so that they are easy to understand and make for openness and accountability, but comprehensive and detailed enough to be reliable;*
 - *formulae for evaluating needs should remain as stable as possible, to allow local authorities to make long-term forecasts and so that changes in estimated needs reflect genuine changes in the situation of local authorities over which they have no control.*
- *The equalisation of spending needs should take account of as many local authority activities as possible, and in particular those that are very important or compulsory. A different formula should be drawn up for each spending need in respect of which equalisation is to apply.*

On equalisation of financial capacity:

- *The equalisation of (standardised) financial capacity should aim at reinforcing a deficient revenue base of a local government measured against a national yardstick (benchmark); such transfers should be unconditional general grants at the discretion of local authorities.*
- *The estimate of the financial capacity of local authorities should preferably include all sources of revenue. The aim should be to gauge overall financial capacity.*
- *Care should be taken to ensure that the equalisation of financial capacity does not undermine local self-government by, in practice, inducing authorities to provide the same level of services or apply the same taxation rates.*
- *Equalisation of financial capacity should not deter local authorities from improving the tax base and ensuring efficient tax collection. The measurement of financial capacity for equalisation purposes should be based on the assumption that all local authorities levy taxes at the same rates and are equally efficient in assessing and*

collecting taxes, so that authorities are not penalised for the efforts they make or rewarded for laxity. This assumption should be used solely to calculate equalisation funds and should not undermine the authorities' right to vary the actual rates of the taxes levied. Local authority decisions should not directly affect the amount of equalisation funds received or paid.

- *In contrast to the equalisation of spending needs, where there is more than one local tax, equalisation should not take place for each tax: a representative fiscal system should be devised that reflects the total local tax-raising potential. A resource equalisation fund should be set up and the money allocated according to discrepancies between the various authorities' tax capacity and the average tax capacity.*
- *Actual fiscal pressure should not be used as indicator of the financial capacity.*

Main principles on local government borrowing in Recommendations of the Council of Europe on local finances

Rec(2005)1 of the Committee of Ministers to member states on the financial resources of local and regional authorities recommends following on borrowing issues:

- *Local authorities should be able to borrow in order to finance their capital expenditure projects. Such projects are intended to benefit future generations, and recourse to borrowing may therefore make it possible to spread the burden fairly among generations. As future generations do not have a say in the choice of projects to be financed, however, financing through borrowing is mainly suitable for services for which the loan will be repaid by means of charges to users.*
- *Except in the case of cash advances and in exceptional circumstances, local authorities should not be allowed to take out loans to finance current expenditure. Current expenditure benefits the current generations and financing it through loans would mean that the costs would be borne by future generations. In addition, financing current expenditure through borrowing would make elected representatives less accountable for the financial implications of their decisions.*
- *Local authority access to borrowing may be restricted on account of national economic policy constraints, in order to limit the risk of non-repayment and to avoid decisions that would transfer an excessive financial burden to future generations. Any such restrictions should be fair, commensurate with the constraints in question, discussed in advance with the local authorities or their representatives and lifted as soon as the macro-economic situation permits.*
- *In order to make decision-makers more accountable, local authorities should be held fully answerable for their decisions to resort to borrowing. The central authority should not offer guarantees for loans raised by local authorities, save in exceptional circumstances.*