THE PROPERTY TAX – A MISSED OPPORTUNITY FOR FISCAL DECENTRALIZATION IN TRANSITION COUNTRIES?
The Czech and Slovak Cases

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Introduction

The study of the transition of the former Soviet Union and the bloc countries of east Europe has focused mostly on the transitioning private sector. How centralist governments get out of the business of trying to micromanage the nation's productive enterprises is a fascinating story indeed. The rest of the story, how the public sector is decentralized and local democracy achieved is scarcely an insignificant part of the transition. But less attention has been paid to it.

This is not without consequence for the peoples of the transitioning countries. The central planning tradition was for all public goods and services to be provided at the behest of the central government and its ministries. There were no real subnational governments, since all policy decisions related to taxation and the distribution of public services were made at the center. The only work done at the subnational levels was "state administration," the faithful implementation of the central will and plan.

Transitioning to a set of decentralized, democratic institutions, *i.e.*, the process of fiscal decentralization, would seem to be a difficult problem, given the tendency of Marxist-Leninist legacies to persist. The central planning countries had no new public and private managerial elites, no opposition party waiting in the wings to replace the old *nomenklatura*, the party elites, and the entrenched bureaucracy. Only the new *Bundesländer* of east Germany could obtain new personnel from the big brother country to the west, a possibility not available to other transitioning countries. So the personnel that manage the public sector transition are usually those trained under the old system. But a tendency to block the devolution of power to subnational governments is not explainable merely by the durability of traditions and personnel. As we shall see, the political environment and the centripetal forces inherent to center/periphery relationships would make decentralization extremely difficult even without the impetus of the actors and customs involved.

It was our expectation that the forces of decentralization would enjoy some fortuitous support along the way, especially as our research was focused mostly on the Czech and Slovak Republics, which enjoy a history of fierce independence of local governance. But centrist forces have remained exceptionally strong throughout the region, so we welcomed the two fortuitous and converging forces that seemed to offer a way out. On the one hand, the countries of east Europe perceived the manifest necessity of membership in the EU and evinced a strong desire to accede. The EU demanded of member states that they develop viable democratic governments and market economies. But any hope that the EU would in fact demand a devolution of power to the subnational governments, as we will see below, was frustrated.

Section I will introduce the problems associated with the fiscal decentralization effort, especially in the provision of local public services in the transitioning nations. The problems of local finance in transition countries *e.g.*, the use of the property tax and the provision of funds transferred to municipalities from the center, are addressed in Section II. Section III reviews the Czech and Slovak cases, illustrating how fiscal decentralization looks in practice. Here we will show some of the ways that fiscal decentralization, in spite of the more hopeful transition developments, is failing. A review of the grants system in the Czech Republic is the focus of Section IV, and the potential role of the EU as a promoter of democracy and decentralization will be reviewed in Section V. Implications and conclusions will be discussed in Section VI.

Chapter 1: The Fiscal Decentralization Problem in Transitioning Countries

As in all other aspects of the transition from central planning to market democracy, the problem of overcoming the legacies of the former regime remains large. The problem is greater than the mere poverty of local governments in the region, who must wait on transfers from governments in continual fiscal crises of their own. The problem extends to the institutions of intergovernmental relations that seem to guarantee a lack both of resources and of autonomy for local governments.

For the private sector of transitioning countries, the problems of central control and the soft budget constraint were addressed through privatization. But firms were permitted to extend the age of the soft budget constraint by obtaining unjustifiable loans from the banks. The state tacitly supported this because if non-viable firms were permitted to disappear, it was feared that unemployment and social unrest would be outcomes that would prove fatal to tender transition governments.

In the public sector, the nascent democratic republics faced some serious moral hazard problems1, likewise a legacy of former planning systems. Such problems arise because the center is unwilling to inaugurate daring change in the provision of local public services. Because certain aspects of the central planning system retain strong appeal to policy agents, they would prefer to continue to behave as they did under the planning system. Specifically, they would like to keep taxes indirect and non-transparent, and they would like to provide whatever public services can be afforded without political opposition. Under central planning, citizens were not aware of having to pay for services received and they remained disinclined to shoulder the fiscal burdens implied in public service provision today. Thus, local public services should be financed by transfers from the center rather than from taxation abhorrent to local electorates. Central governments are likewise scarcely averse to the traditional ways; the state can provide the funding for local service provision and retain complete control over the programs funded.

In the transition, the institutions of capitalist democracies dictated to the transitioning Eastern Europeans a new philosophy and a new combination of social mechanisms for public goods provision. The new system obviously required the abandonment of the public sector system they had previously known, but also the public and private goods provided by state-owned enterprises. It will be recalled that under central planning several kinds of public and even private goods were provided directly to the workers through their enterprises.2 In humanizing their formerly capitalist firms, communist governments elected to provide much of the housing, health care, nursery care, vocational training, general education, recreation, and even sports and vacation facilities through enterprises. Because this generous provision would clearly strain budgets, the state was willing to retain a soft budget constraint for enterprises, which funded not only the highly-publicized inefficiency, but the costs of public goods and services provision as well.

It is not surprising that the transition's demand for hard budget constraints produced unemployment not previously experienced. The state had been subsidizing its production entities to retain superfluous workers for many years prior to the decline of central planning. But at the same time, privatization and marketization caused the now-private firms to cease providing the goods and services taken for granted as "entitlements" are in the western social market economies. Naturally, citizens *qua* consumers were not terribly opposed to foregoing generous public goods provision at the outset of the transition, since they anticipated that their long-pent-up demands for the much richer menu of private goods common to market economies would now be satisfied. The generosity of socialism was far greater with respect to public goods provision than it was for private goods, so consumers were expected to forego for a time such things as excellent schooling, health care, and housing. The willingness to wait, however, was predicated on more abundant provision of private goods, such as electronics and automobiles, which had been in such short supply under central planning.

The transition thus far has not greatly improved the provision of public goods and services. As we will see, the Czech Republic is an example of a country that has done better in terms of the transfer of funds to subnational governments than have some other countries of the region. But in spite of the somewhat better provision, we will also see that the development of genuine autonomy for local governments has not been a Czech priority.

Perhaps supplying private citizens with acceptable public services in the municipalities of transition countries can be postponed almost indefinitely. Perhaps statist-socialism trained the peoples of east and central Europe to be very patient indeed. But it is still not clear how countries that are extremely anxious to be associated with the European Union can indefinitely ignore acceptable provision of public services. The transition to democracy, market economics, and self-determination at the local governmental level suggests, nay, demands that the question of municipal finance must be addressed in a more satisfactory manner.

Chapter 2: Provision of Public Goods and Services under Central Planning and in the Transition

Under central planning, the government planned the provision of public goods and services; local offices were expected only to implement state plans. Local autonomy, so highly valued by Czechs, Slovaks, and others in east Europe, was lost until the post-communist era began in 1990. This section begins a review of progress since that time, finding that to this point decentralization has been suboptimal.

As in other transition countries, Czechoslovakia began the attempt to decentralize its fiscal system immediately after the transition away from central planning began in 1990. Legislation to establish a taxation and budget system of a more western-European type was passed early. The property tax, potentially a primary source of local revenues, was left largely unchanged from the nominal tax it had been in the central planning era.

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1 Bryson, Phillip J. and Gary C. Cornia (2003), "Moral Hazard in Property Tax Administration: A Comparative Analysis of the Czech and Slovak Republics," Forthcoming.

2 Bryson, Phillip J. (1984), *The Consumer Under Socialist Planning: The East German Case*. New York, Praeger.

The "Velvet Divorce" of 1993 set the new Czech and Slovak Republics on independent development paths. Their common origins make their post-separation development an excellent focus for a comparative study. The two countries began the new era on the basis of the same fiscal legislation and institutions, the same property tax base and rates, etc.,

The vital question of fiscal decentralization has been given little publicity in the transformation story, but it is vital for the democratic development of the former central planning countries. Since the downfall of communism, fiscal crises in the transitioning countries have been common and transfers of funds from the center to the subnational governments have generally been insufficient to cover the backlog of needs. The municipalities have not been able to function with anything approaching full effectiveness. But the problem has been more than having insufficient funds for public service provision. The municipalities have also been unable to enjoy genuine autonomy, especially because they have insufficient sources of independent revenue. In the Czech and Slovak Republics, one of the primary difficulties is that the property tax, the traditional western source of independent finance, has not been modernized. It is basically the same purely symbolic and ineffectual tax that it was under central planning regimes.

2.1 The Potential Role of the Property Tax in the Transition

The movement of the former central planning regimes to a more distinct market orientation parallels the less distinct movement of a number of developing countries away from an import-substitution model of economic development to a more open, market orientation. The general view that greater reliance should be placed on markets rather than any kind of statist activism is paralleled by the view that less power should remain in the hands of the federal government.3 But power devolution is not a part of the instincts of either central or municipal agents.

The advocates of strong central government see the municipalities of transition countries such as the Czech and Slovak Republics as being either incapable of fiscal autonomy, or as failing to demand or require it. They also argue that many of the municipalities and townships of the Czech and Slovak Republic are too small. Immediately after the Velvet Revolution of 1989, Czechoslovakia permitted villages and towns, many of which historically had been arbitrarily amalgamated, to declare their independence. This dramatically increased the numbers of independent municipalities (*obci*) in Slovakia, Moravia and Bohemia. It is assumed that many of these towns are too small to manage self-government, lacking in technical abilities and resources, lacking a viable fiscal base, and lacking scale economies in the provision of public goods and services.

But insufficient size is hardly the extent of the problems facing the many municipalities of the twin republics. Problems of both horizontal and fiscal imbalance confront subnational governments in countries undergoing public sector reform. Horizontal fiscal imbalance is the product of the unequal resources available to municipalities of disparate wealth. Vertical imbalance becomes apparent where central governments have already captured the lion's share of the taxable sources, leaving municipalities with insufficient potential for independent tax revenues. Both problems must be addressed in countries of the former Soviet Union and the Soviet bloc.

Another important problem in the ongoing transition is a lack of trust in government. The process and outcome of decentralization will enhance the efficiency of public services as government is brought closer to the people. The ideas supporting this view of decentralization have a long history in the public finance, public choice, and public management literatures.4 Decentralization makes the decisions of public servants more transparent and permits citizens to participate more effectively in government at low cost.5 But successful decentralization requires effective performance of a whole set of complex tasks, both by agents relinquishing and agents acquiring new tasks and prerogatives. The reassignment of personnel and responsibilities, often with a reduction in services, is not always easy for citizens to understand and support.6

3See Vito Tanzi, 1991, *Public Finance in Developing Countries,* Edward Elger Publishing Limited, Aldershot, England.

4 See for example Charles M. Tiebout, 1956. "A Pure Theory of Local Expenditures," *Journal of Political Economy*, Vol. 54, No. 5, pp. 416-424 and Robert L. Bish and Robert J. Kirk,1974, *Economic Principles and Urban Economics,* Englewood Cliffs, NJ, Prentice-Hall, Inc.

5 See Oates, Wallace E. 1998. "Introduction" in Wallace E. Oates, (ed*), The Economics of Fiscal Federalism and Local Finance*, (North Hampton, Mass.: Edward Elgar Publishing, Inc.), pp. xiii-xix.

6 See Amsden, Alice, Jacek Kochanowicz, and Lance Taylor, 1994. *The Market Meets Its Match. Restructuring the Economies of Eastern Europe.* Cambridge, Mass., Harvard University Press.

For fiscal decentralization to succeed, local governments must have access to an autonomous source of tax revenue, *i.e.,* they should not be dependent upon the center for all revenues7 Local activity increases the visibility of choices made by elected and appointed public officials, and accountability increases *pari passu* with visibility.8 The literature suggests that the property tax embodies the positive characteristics required of a local tax:

- The property tax is immobile (taxpayers can't evade it by engaging in transactions just beyond a relevant political border).
- The property tax is stable (it provides fairly constant revenues independent of the business cycle).
- It is potentially neutral (its imposition does not cause changes in the utilization of the services of taxed properties).
- The tax falls on taxpayers who presumably have the means and the ability to pay (they are home owners and property holders). Excise taxes, for example, can be regressive, representing a larger portion of lower than of higher incomes.
- As local public services improve and increase property values, the beneficiaries are required to pay for the increased value.
- as a direct tax, it is visible to taxpayers.9

Unfortunately, because visibility is not only an advantage, the design and implementation of an effective property tax is very challenging. Since it is direct and visible, it makes citizens and officials less comfortable than do indirect taxes such as the VAT.10 Both citizens and officials usually prefer the pursuit of revenue through the use of excise taxes and local fees on a variety of transactions.11 For local officials, the property tax too often generates political problems.12
There are also administrative and practical problems with property tax implementation.13 Examples of the latter include the difficulty of establishing market-oriented property values in the absence of a functioning real estate market14 and coping with the uneven distribution of the property tax base.15 As a consequence of political and practical issues, the property tax remains critically under-used,16 especially in the transition countries; this can be an impediment to successful decentralization and undermine the welfare gains expected from that process.

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7 See Richard M. Bird, Robert D. Ebel, and Christine I. Wallich, eds., 1995. *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies*. Washington, D.C.: World Bank

8 See Jennie I. Litvak, Richard M. Bird, and Junaid Ahmand, 1998. *Rethinking Decentralization in Developing Countries*. Washington, D.C.: World Bank.

9 See Richard A. Musgrave 1993. "Who Should Tax, Where, and What?", in Charles E. McLure, Jr. (ed.) *Tax Assignment in Federal Countries*, Canberra: Centre for Research on Federal Financial Relations, Australian National University, pp. 2-19 and Wallace E. Oates, 1996. "Taxation in a Federal System: The Tax-Assignment Problem," *Public Economics Review*, Vol. 1, No. 1, pp. 35-60.

10 See Joan M.Youngman and Jane H. Malme, 1994. *An International Survey of Taxes on Land and Buildings*, Kluwer Law and Taxation Publishers.

11 See Andrei Shleifer and Robert W. Vishny, 1998. *The Grabbing Hand: Government Pathologies and Their Cures*. Cambridge Massachusetts: Harvard University Press, 1998.

12 See Anne Paugam. 1999. "Ad Valorem Property Taxation and Transition Economies," *ECSIN, Infrastructure Unit Europe and Central Asia Region*, World Bank, Working Paper No. 9.

13 Roy Bahl, and Johannis Linn, 1992. *Urban Public Finance in Developing Countries*. New York: Oxford University Press.

14 See Alain Bertaud and Bertrand Renaud, 1994. *Cities Without Land Markets*. Washington, D.C.: World Bank.

15 Dick Netzer, 1966, *The Economics of the Property Tax,* The Brookings Institution, Washington, D.C.

16 See Jonathan Dunn and DeborahWetzel, 2000. *Fiscal Decentralization in Former Socialist Economies: Progress and Prospects*. Washington, D.C.: World Bank.

Many transitioning countries generate little property tax revenue, partly because inflation can erode assessments, which are not automatically linked to inflation or economic growth. Moreover, cadastral data are generally poor and collection and enforcement efforts are weak and inconsistent.

Local governments in transition countries have almost uniformly been under-funded and are overly transfer-dependent.17 The services they provide for fees generally secure trivial revenues in the face of significant resource needs; they are nuisance levies that may cost more to collect than they yield in revenues.

Fiscal decentralization can really succeed only if *inter alia* the following three conditions hold. First, there must be a correspondence between the expenditure responsibilities of local governments and the financial resources available. Second, the autonomy of subnational governments must be increased not merely by permitting, but by actually providing incentives for them to mobilize their potential resources. Third, the system for providing transfers to them must be transparent and based on objective and consistent criteria, rather than through negotiation and ad hoc bargaining.18

Chapter 3. Fiscal Decentralization in the Czech and Slovak Republics: The Record

3.1 Moral Hazard Problems in Property Tax Administration

Because there are marked divergences between the perspectives and incentives of central and sub-national governments, principal/agent conflicts are common in the fiscal regimes of the transition countries. In this arena, as elsewhere, agents have a proclivity to pursue their own interests rather than those of the principal; in part, doubtless, because agents tend to regard themselves as principals.

Local government musts generally be considered the principal, the central government the agent. The local government principal receives property tax revenue as a result of the agent's actions, but the agent central government will not generally share in the revenues, in spite of its superior resources and position. In the specific case of the Czech Republic, this is the situation, and as in many principle/agent relationships, moral hazard problems are the result.

The sub-national governments, desperately needing funds, can merely hope that the center will exert significant effort in administering the property tax, since they do not share in that responsibility. Nor are they in a position to monitor tax administration closely. From their perspective the outcome will be far from optimal, since the center has different incentives regarding property tax revenue and the exertion of effort and resources to generate it. Smaller property tax revenues can easily be offset by greater transfers from other taxes or revenue sources. To the extent that the center compensates for its lack of effect in property tax revenues, local governments are *financially* no worse off, but these alternative revenues rather consistently come with strings attached.

Clearly there is a role for central government in property tax policy design, but the Czech centralization of the tax's implementation creates the potential for incentive incompatibilities and the eventual failure of the property tax. Even attractive, smart policy and administrative designs cannot assure that a tax will succeed in the face of inept incentives.19

An additional potential for moral hazard problems emerges when the central government transfers revenue to local governments. Fiscal redistribution is justifiable if the distribution of resources is badly skewed across subnational governments, or if subsidies encourage local governments to pursue activities of high priority to the center.20 But if transfers from the center merely offset revenues that could have been raised locally, there is an additional twist on the moral hazard problems already described.

If the central government compensates the municipality for the property tax funds it has failed to collect, the compensating revenues will not be encumbered with dangerous political transparencies for local officials. With the more transparent property tax, local officials would run the risk of becoming the object of political opposition. This is particularly true for local governments in the transition countries where under central planning taxes were neither visible nor direct. In the transition period, such taxes are quite visible and direct; they certainly have the potential to impact local elections.

When the alternative transfers are provided by the center, municipalities may conveniently abdicate fiscal power, relinquishing their own autonomy for the convenience of revenue provision. Here, the local government as the

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17 See Bird *et al., op. cit.*

18 I*bid.* p. 59

19 See Vito Tanzi, 1991, *Public Finance in Developing Countries,* Edward Elger Publishing Limited, Aldershot, England.

20 Richard A. Musgrave, 1961, "Approaches to a Fiscal Theory of Political Federalism," in *Public Finance: Needs Sources and Utilization,* National Bureau of Economic Research, New York, and Princeton: Princeton University Press, pp. 97-122.

proximate agent of the citizens is in a situation fraught with moral hazard problems. It shares responsibility for the revenues foregone, as well as for the loss of local independence as central influence on local service provision will usually be attached to transfers of alternative funds. The consequence of these actions is that the importance and effect of the property tax are diminished, as is the potential for local fiscal autonomy.

3.2 Comparative Municipal Fiscal Performance.

We would like now to apply these theoretical considerations to the Czech and Slovak fiscal situations, asking which of the two governments has been most successful in terms of local finance, and why? The Slovak Republic has administered its property tax locally; the Czech Republic has administered it centrally. The Czechs have transferred considerable revenue to the local governments, while the Slovaks have been far less generous in providing transfers. The Czech Republic, having chosen a centralized approach to property tax administration, transfers substantial amounts of funds from the national to the local governments, while the Slovak central government has been far less generous.

The relative success enjoyed in fiscal decentralization will be reflected in public sector data. The macro situation and economic growth in the economy will impact both national and sub-national budgets. After taking account of price inflation, both the Czech and Slovak Republics have experienced growth permissive of expanding state and local budgets. Budget data are presented in Table 1.

Under central-planning, the Czechoslovak federation's local governments derived roughly 60% of their total receipts from subsidies from the late sixties on. From around 1984, they experienced a gradual decline in central government subsidies, a trend which extended beyond the opening to market economics and democracy. Although there was a brief expansion of transfers from 1990-1992, the decline continued. After the mid-nineties, subsidies represented no more than about twenty-five percent of the total receipts of Czech and Slovak municipalities.21

Table 1 shows the financial situation from the end of central planning through the year 2000. The data indicate that Slovakia's municipalities are substantially poorer than those of the Czech Republic. From 1993 on, after the Velvet Divorce, Czech municipal budgets were more than twice as large as those of Slovakia, even without taking into consideration the greater value of the Czech crown. The difference between the two is best illustrated by a *per capita* comparison of grants from the respective central governments. By the end of the period, per capita public services expenditures for Czech citizens were three times greater than those for their Slovak counterparts. Local budgets in Slovakia are only about fourteen percent of the total national budget. In the Czech Republic they are as high as from one quarter to just over one-third of the national budget.

A comparison of central government grants to municipalities reveals the reason for the relative poverty of Slovakian municipalities. Grants in Slovakia ranged from 1.5 billion SK in 1993 to

Table 1
National and Local Budgets: Czech and Slovak Republics

1.1 billion SK in 1994. The grants paid by the Czech central government to the municipalities ranged from just over 27 billion CK in 1993, to 59.5 billion CK in 1996. Interestingly, in the years just prior to Slovak independence (1991 and 1992), the government in Prague provided grants of 7.9 billion and 2.4 billion crowns respectively for Slovak municipalities. Independence from the Czechs turned out to be a shock for the municipalities of the Slovak Republic, for it separated them from the Czech central budget.

They soon discovered that the strange politics of the Mechiar era would also separate them from the Slovak central budget. Mechiar was interested in the "family privatization" of Slovak industry, but not in helping solve the problems of Slovak towns, cities, and regions. He let them know they would be forced to solve their own fiscal problems, for there would be no significant resource flow from the center to the subnational governments.

Chapter 4: The Czech System of Inter-governmental Grants.

In the Czech case, the central government's ongoing efforts to fund the cities and towns are expressed primarily through revenue sharing and financial grants. Table 2 provides data for an overview of these efforts. Note especially the tax revenues accruing to local governments as a percentage of the republic's consolidated budget totals. Local tax revenues were only 13.6% of total budgets at the beginning of the period in 1994. From 15% in 1995, the

21 See Jitka Pekovà, 1996 "Obce a dotace," *Obec & Finance,* Vol. 1, No. 1, pp. 28-31.

Table 2
Local and State Tax Revenue Sharing, Czech Republic

share then declined for three straight years, reaching a low for the period of 12.8% in 1997. Increasing over the next three years it reached an all-time high in 2000 of 15%.
In the early years the center transferred to the local governments a considerable share of the personal income tax revenues that it collected. In 1994 and 1995, municipal governments received 89% and 87.6% respectively of those revenues. In 1996 the share dropped to 63% and remained at that level. Corporate income tax followed a contrasting pattern, with the center initially transferring only a small portion to the municipalities. In 1994 only two tenths of one percent of corporate income tax revenues accrued to local budgets, increasing quickly to the level of over twenty percent. It increased only gradually up to 26% from 1996 to1999, reaching 31% in 2000.
Federal grants have been an important and increasing source of funding for Czech municipalities. They have represented roughly a quarter of the budgets of the local governments since 1994. They constituted 22% of total accessible funds in 1994 and 29.8% in 1997, declining to around a quarter of the total for the remainder of the decade, holding at 25.7% in 2000.
Over the past decade, the joint contribution of transfers and shared taxes has remained at roughly 70 percent of local government revenues, but it remained true that a "meaningful degree of tax autonomy for local authorities was still missing."22
As compared to most other European countries, including other transition countries, the Czech Republic is unique in that it offers no equalization grants to districts or municipalities. Nor did reforms in 20000 make any provision for such grants. There is instead a complex system of conditional grants or subsidies which transfers funds to promote central government policy objectives. Since they are targeted for specific purposes, local governments must follow directives and report on the specific uses for which the funds were spent.23 It should be noted, however, that the relative importance of earmarked subsidies is declining, providing only 24 percent of all sub-national government revenues in 1999.

4.1 Earmarked Grants
Earmarked grants of two types are in use currently. The first type, categorical grants, is for funding tasks delegated by the center to municipalities. They must be spent on specific, well-defined programs and require no matching funds from the municipalities. Distributed generally on a "per head" basis, they cover outlays for social assistance, early education, hospital and assistance institutions, fire brigades, and the execution of general government services including registration and permits. Categorical transfers are used by central governments *inter alia* for redistributing fiscal resources, countering externalities, adjusting for vertical imbalances, and promoting local government expenditures in support of national programs. If unconditional grants were used rather than categorical transfers, central authority would demonstrate greater respect for the decision-making autonomy of local government officials. The nearly exclusive use of earmarked grants suggests the central authorities' belief that they have identified all local level priorities and that they simply possess better information on needs than local officers do.
Capital transfers represent the second type of earmarked grant. They originate from the central government general budget and from the State Environmental Fund to accomplish a variety of purposes, including *inter alia* fire protection, natural gas distribution, schools, development of industrial zones, hospitals, water and sewerage treatment plants, and public transport. Matching funds are required of the municipalities for all centrally supported capital infrastructure projects, except for the building of new social care institutions.
Capital transfers from the State Environmental Fund are for environmental purposes, *e.g.,* to fund water supply systems or to introduce gas, flood control, and energy conservation measures. Matching funds of at least 20 percent are required of the subnational governments at rates set by the state agency. In 2001 the State Environmental Fund transferred a share of about 7 percent of the Republic total for that year.
Specific transfers have been funded in such a way as to supply a negative incentive for municipal revenue generation. The central government apparently reduces the level of discretionary transfers systematically as local governments increase their own revenues. The allocation of grants conditionally and at the discretion of central authorities tends to be less efficient and fair than through the use of objective formulas or well-publicized legislative procedures and criteria. Discretionary central systems can be distorted by pressures from lobbyists representing local governments or by parliamentary members defending or lobbying for local interests. Oliveira and Martinez-

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22 Joao do Carmo Oiliveira and Jorge Martinez-Vazquez (2001). *Czech Republic: Intergovernmental Fiscal Relations in the Transition*. Washington, D.C.: World Bank.
23 *Ibid.*, p. 48.

Vazquez suggest, as an alternative to project by project application processes, that local governments develop comprehensive expenditure plans for evaluation and funding to the extent of the center's budget possibilities. Clearly, budget transfers from the center give the Czech *obci* considerably more options than are available to those of Slovakia. Nevertheless, because such a large share of Czech municipal funding comes from the state, Czech municipalities enjoy less budget autonomy. Although local independence plunged Slovak municipalities into poverty, it also placed them under a hard budget constraint with a large measure of budget autonomy from the center. By forcing them to be more responsible for their own revenues, the Slovak Republic caused its municipalities desperately to pursue increased property tax yields for their revenue needs.

In contrast, the Czech Republic has tapped resources other than the property tax to generate municipal funds. More generous provision of fiscal grants and transfers to Czech municipalities appears to avoid the need to develop the property tax as a revenue source. But in the meantime, the Czech government has failed to provide any foundation for genuine local autonomy.

4.2 Grants and The Future

Over time, local governments in both republics will face increasing revenue needs for current operations as well as a heavy backlog of needed investments. To this point, local governments in both countries have sold off assets in the form of the public housing and commercial properties the central government transferred to them early in the transition. This has been the source of considerable revenue, but a disappearing one as assets capable of being privatized become more scarce. Even this source of funds has not permitted municipalities to avoid ongoing revenue shortfalls. The problem will continue to become more serious until the municipalities are vouchsafed more adequate sources of revenue.

Since the transition period began, both republics have struggled with periodical fiscal crises. A natural response has been to reduce revenues to the municipalities, while transferring additional service provision responsibilities to the local governments. Numerous unfunded federal mandates merely reflect this kind of transfer of responsibility from the center. In fairness, the Czechs have not been as guilty of that offense as most other transition countries. But even when the Czech government funds centrally mandated programs, it retains strong influence over the use of central funds, thus subverting the development of local autonomy.

In Slovakia, which has about exhausted the possibilities of the current property tax system, further fiscal development would require a more serious property tax. Transfers from the central government are unlikely to satisfy local financial requirements, since they have to this point represented no more than about a tenth of the local budgets. It is very important, therefore, that the Slovaks continue to develop local autonomy through the establishment of a more substantive property tax.

Given the relative largesse of the Czech Republic toward its subnational governments, one might view the lack of a serious property tax as being of no large consequence. The fiscal needs of the Czech regions, districts and municipalities could be amply covered through transfers from the central government and other revenue sources. Compared to a number of transition countries, the Czech Republic has in fact been fairly generous in supplying funds for this purpose. It appears that the European Union accepts this fact as evidence for the proposition that the Czech Republic is developing satisfactorily as a modern democracy and should ultimately be admitted as a full member.

In our view, this perception is too narrow. In the first place, the fiscal needs of the municipalities have not been properly taken care of, even though the needs are not as great as those of Slovakia and some other transition countries. And there are other significant problems in the fiscal decentralization process of the Czech Republic. The central government takes a paternalistic attitude toward the municipalities and agents probably feel they are securing financial security for the cities and towns. To the outsider, the perception is that the central government is prohibiting the independence of the municipalities and regions.24 The center has not gotten far beyond the tendency of the central planning era to rely only on local agents for state administration. The center generally establishes the policies, allocates the funds, and gives very specific directions on how local officers are to utilize the funds.

The spirit of intergovernmental relations can be observed from the administration of public housing. After the Velvet Revolution in 1989, the central government turned public housing over to the municipalities. The buildings were of notoriously poor quality and in need of major expenditures, but they were transferred without the funds to maintain or repair them. Housing units have been privatized to some extent, and that provides a supplementary revenue source for the municipalities, but housing rents and tariffs on such public utilities as water and gas are still regulated by the central government, and they are held at levels below full cost recovery. Likewise, the salaries of

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24 Bryson and Cornia, 2000. "Fiscal Decentralisation in Economic Transformation: The Czech and Slovak Cases, *Europe-Asia Studies*, Vol. 52, 3: 507-22.

local government employees are controlled by central government.25 So the policy preferences of central government can constrain the municipalities to operate in the red.
Under democratic governments, municipalities generally have the responsibility to develop their own capital infrastructure. In the Czech Republic, however, local governments remain fully dependent upon the central government to fund capital expenditures. Such funding takes the form of various grants and subsidized loans. Municipalities can often suggest projects they would like to see funded, but the center will determine which projects are selected and establish the terms and conditions upon which the funding is contingent. This, too, could be described as state administration.

4.3 The Advent of Regional Government

Recently, regional governments were established in the Czech Republic, which had actually been a two-level system of government previously. The *kraje* are now being phased in, and for a transition period will be funded by transfers from the state budget. The regions have not yet been assigned clear expenditure responsibilities, but it is intended that they will inherit some of the state's responsibilities, *e.g.*, secondary education, regional planning and inter-city transport.26 They will doubtless provide assistance to municipalities, especially small ones lacking in resources and administrative potential. One can be sure that this activity will be guided by centrally-provided directives and mandates. The functioning of the new *kraje* will likely become an important part of the activity of subnational governments, but that functioning will not necessarily enhance local autonomy.

4.4 Meeting Fiscal Requirements vs. Promoting Local Autonomy

These kinds of intergovernmental relations, and worse, have been the general experience of transitional countries; local governments have often been able to function only as administrative agents, too frequently with unfunded mandates burdening their activities. The assignment of responsibilities without the corresponding resources frustrates local governments, already dependent upon the state for financial transfers. In the years since the transition began, municipalities have become accustomed to having no independent operations based upon revenue sources that are significant and under their jurisdictional control. They have thus never broken free of their dependence on the state.
According to Oliveira and Martinez-Vazquez,27 this situation is mitigated to some extent because the Czech Republic has generally avoided the imposition of substantial unfunded mandates on local governments. Delegated functions usually obligate the Czech central government to guarantee full funding for any new expenditures. There have been exceptions to these rules, *e.g.,* when a recent transfer of the responsibility for issuing personal identification cards and passports was transferred to local governments without funds for the project. A more high-profile case was the transfer of public housing referred to above. Retention of control over the pricing of transferred service responsibilities is tantamount to another unfunded mandate, adding insult to injury. But the center's unwillingness in such cases to demand normally appropriate fiscal performance, when their own policies make such impossible, explains why soft budget constraints develop for local governments and why there is an occasional need for bailouts. Subnational governments cannot be expected to meet financial obligations if the financial requirements of tasks assigned to them exceed the available funds. The municipalities become hostage to their administrative directors in central government, but avoid full financial responsibility by partnering in their administrative practices.

Chapter 5: The EU and Ongoing Czech Centralization

The European Union could easily place pressure on the Czech Republic to provide genuine autonomy for local governments. We have seen that since the end of the central planning era the Czech system has retained its centralized character with local governments unable to function with the autonomy foreseen by fiscal decentralization. The level of funding has not been bountiful by western standards, but the Czechs are not unwilling to share the gains of economic growth with the localities. As a nascent democracy, the central government must respond to the elected leadership, so there is pressure from within the country to increase the level of local funding. The Czech government is also accustomed to responding to pressure from the European Union.
The EU is in a position to dictate reforms to countries aspiring to membership. Indeed, EU membership requires that a country achieve:

- stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and

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25 See Jorge Martinez-Vasques, Jorge, and Robert McNab, 1997. *Tax Systems in Transition Economies*, International Studies Program, Working Paper 1 - 97, Georgia State University School, of Policy Studies, January, 1997.
26 *Ibid.*, p. 6.
27 *Ibid.*, p. 26.

protection of minorities;

- a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;
- the ability to take on the obligations of membership and adhere to the aims of political, economic and monetary union.

Clearly, a guarantee of democracy's implicit demands for local autonomy would be an appropriate demand of the EU for prospective accession countries. To expect fiscal reforms on the transition countries seeking membership would be well within the rights of the EU, and the Czech Republic is one of the countries which could be expected to respond favorably to such demands, given its strong aspirations for membership.

Unfortunately, it cannot be said that the EU requires fiscal decentralization. In its initial country report, the Czech Republic was recommended for ultimate accession. The budgetary and finance systems were addressed, but questions about them were limited to the financial control system. Concern was expressed only about the Supreme Audit Office which the Czechs had created in 1993; it was observed that the system of internal financial control did not correspond to EC provisions for member states. When the Czech government expressed its intention to improve budgetary control, the EC declared itself satisfied.28

In the 2000 Regular Report29 by the Commission on the Czech Republic's Progress towards Accession, the Czech Republic is commended for strengthening VAT controls through additional IT equipment; is acknowledged for its *Act on Budgetary Rules*, June, 2000, which established the legal framework for the country's management of budgetary relations with the EC; is admonished to further efforts to strengthen its financial control functions at all levels; is berated for ongoing weaknesses in the Finance Ministry in the areas of tax collections, and analysis of capital investment programs, is faulted for poor management of EC pre-accession funds, having proved slow in formally requesting available funds and in the use of funds granted.

The more serious, long-term failure to enable or promote the development of local autonomy is not mentioned by the EU as a subject of concern. The problems of unfunded mandates, the nature of financial transfers from the center to local governments with extensive strings and controls attached, and disinterest in the property tax as a means of independent financial leverage are all testimony to the failure to take seriously the problem of local autonomy. On the basis of a continental tradition lacking in concern about hyper-centralization, the EU finds the Czech fiscal system adequate for membership. It elects to ignore the lack of local or regional autonomy and the failure of recent reforms to address the problem. The Czech tradition of fiscal centralization can now be celebrated as having a half-century tradition.

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28 See Agenda 2000 - Commission Opinion on the Czech Republic's Application for Membership of the European Union, (1997) DOC/97/17, Brussels, 15th July.

29 See EC 2000 Regular Report From the Commission on The Czech Republic's Progress towards Accession. Online at http://www.europa.eu.int/comm/enlargement/report_11_00/pdf/en/cz_en.pdf, accessed January, 2002.

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TABLE 1
National and Local Budgets: Czech and Slovak Republics

SLOVAK REPUBLIC

	1993	1994	1995	1996	1997	1998	1999	2000
Public Budget TR*	170	158	184	273	279	287	324	371
National Budget*	150.3	139.2	163.1	162.9	175.8	179	179	224
Local Budgets*	19.5	19	21	21.5	23.5	22.7	21.3	24.8
Local as % of National Budget	12.97	13.65	12.88	13.2	13.37	12.68	11.9	11.07
State Grants to Local Budgets*	1.5	1.1	1.2	1.3	1.8	2.08	2.24	2.77
Grants as % of Local Budgets	7.69	5.79	5.71	6.05	7.66	9.16	10.52	11.17
Total Local Revenues*	21	20.1	22.2	22.9	26.7	25.9	24.2	27.4
Local Budget Expenditures*	19.3	19.1	18.9	21.9	25.3	25.8	23.9	26.5
Real Estate Tax*	1.6	1.79	1.73	2.14	2.61	2.4	2.72	2.87
RE Tax as % of Local Revs (%)	7.62	8.91	7.79	9.34	9.78	9.27	11.24	10.47

CZECH REPUBLIC

	1993	1994	1995	1996	1997	1998	1999	2000
Public Budget TR*	422	472	536	585	562	595	626	651
National Budget*	358	390.5	440	482.8	479.6	509	538	557
Local Budgets*	91.1	111	129.1	161.72	145.3	157.2	187.7	181.8
Local as % of National Budget	25.45	28.43	29.34	33.5	30.3	30.8	30.9	32.6
State Grants to Local Budgets*	27.03	29.25	33.28	59.44	35.87	37.39	41.43	46.05
Grants as % of Local Budgets	29.67	26.35	25.77	36.75	24.68	23.79	22.07	25.33
Total Local Revenues*	101	111	129	162	147	162	188	181
Local Budget Expenditures*	90.1	112.1	132.3	171.1	150.5	158	173	190
Real Estate Tax*	3.021	3.808	3.799	4.018	3.943	4.108	4.248	4.437
RE Tax as % of Local Revs (%)	2.99	3.43	2.95	2.48	2.68	2.53	2.26	2.44

*Billions SK, CK
*Slovak State Grants in 1991: 7.961,
1992: 2385
Source: Federal Ministry of Finance, Czech and Slovak Republics, and own calculations

Table 2
Local and State Tax Revenue Sharing, Czech Republic
(Millions of Czech Crowns)

	1994	1995	1996	1997	1998	1999	2000
Tax Revenues, State	349,027	391,228	439,186	464,087	495,232	524,765	544,142
Tax Revenues, Local	54,428	68,167	70,000	76,091	83,319	87,011	95,807
Consolidated budgets, Total	401,503	457,022	506,202	592,474	575,836	608,585	636,618
Local Share in %	0.135561	0.149155	0.138285	0.128429	0.14469	0.142973	0.150494
Local PI Tax Revenues	48,716	60,096	50,818	54,503	58,581	60,078	63,501
National PI Tax Revenues	5,804	8,491	29,726	33,378	36,339	35,224	34,771
Total PI Tax Revenues	54,520	68,587	80,544	87,881	94,920	95,302	98,272
Local as % of Total	0.893544	0.876201	0.630935	0.620191	0.61716	0.630396	0.646176
Local CI Tax Revenues	128	3,145	14,139	13,361	16,232	18,773	23,470
State CI Tax Revenues	63,624	63,337	47,676	42,202	51,324	51,343	52,322
Total CI Tax Revenues	63,752	66,482	61,815	55,563	67,556	70,116	75,792
Local as % of Total	0.002008	0.047306	0.228731	0.240466	0.24027	0.267742	0.309663
National Government	30,980	34,803	61,504	35,839	37,355	41,374	45,939
Current	24,003	21,747	48,882	23,958	24,982	27,658	30,429
Capital	6,977	13,056	12,622	11,881	12,373	13,716	15,510
Local Rev & Grants Total	112,241	130,041	163,831	145,342	157,178	187,700	181,814
Consolidated Public	504,283	522,753	562,792	487,655	637,656	688,844	707,844
Local Share	0.222575	0.248762	0.291104	0.298043	0.24649	0.272485	0.256856

Source: *Government Financial Statistics: Fiscal Data for the Czech Republic.*
Ministry of Finance, Czech Republic, and authors' calculations.
See the web site, http://www.mfcr.cz/scripts/hpe/default.asp?VlfinSta.