Intergovernmental fiscal relations in the Baltic municipalities

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Abstract

During the last decade, Baltic countries have created new public institutions, democratized system of local governments and settled foundations for a pluralistic and democratic society. Nevertheless, there are still essential reforms are waiting for implementation. One of the main problems concerns the area of central and local government fiscal relations.

In all three Baltic countries municipalities' functions and their fiscal resources are often inadequate. Central authorities control most of sub-governments municipalities' revenues and municipalities' fiscal autonomy is still limited. Therefore, the most important goal of the fiscal reforms is to enhance the fiscal autonomy, increase the administrative capacity of different level of governments, balancing their budget level with municipalities' functions.

The main purpose of the article is to point out certain similarities and problems of Baltic municipalities' fiscal situation. Particularly are considered municipalities' revenue structures and possibilities to expand their tax autonomy.

Introduction

The Baltic countries[1]' local governments are functioning in a permanently changing environment. When they were part of former Soviet Union, local governments were subordinate to the centralized administrative and bureaucratic structure. Their role was to implement state plans for economic and social development on their territory. Though residents were formally elected to local councils, local governments in true sense of the term did not exist. After Baltic countries regained their independence, the local administrative units have followed path to democratization and became factual representatives of local residents.

After excessive centralization emerged clear need to decentralize and devolve a number of expenditure functions and revenue sources to lower levels of sub-government. The democratization process logically led to increase of sub-national governments role, in fiscal activities particularly. The delegation of fiscal responsibilities to sub-national levels of government is likely to increase amount and quality of service delivered, reduce costs associated with the provision of public goods and services and enlarge municipalities' fiscal autonomy.

Often the Scandinavian type of municipalities with their large variety of functions and wide fiscal autonomy is considered as an ideal model for the Baltic countries as well. In contrast to the Nordic countries, almost all revenue sources in the Baltic local governments are still controlled by the central governments. Most of authors consider that as a factor that limits municipalities' fiscal autonomy and financial capability (Chandler, Reiljan, Vanags). In addition, there is a concern that municipalities' fiscal capacity is not adequate to act in accordance with functions stipulated by laws. Often sub-governments' revenues from its own taxes and user-charges are insufficient to finance their expenditures on an efficient level.

In comparison with their European Union neighbors, the Baltic countries sub-national governments under-provide many public services. As soon-to-become members of European Union, the Baltic countries have to follow the ideas of European Charter of Local Self-Government. Its article 9 states clearly: "Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law" (European Charter of Self-Governments).

Baltic municipalities' fiscal capacity varies regionally very noticeably. Disparities in municipalities' fiscal situation are correlated with unbalanced regional growth, social degradation in the low-income regions and growing disparities on access to quality education and healthcare.

Considering the above-mentioned problems, this paper focuses on current situation description of local governments in Baltic countries. The main interest is to consider local municipalities' fiscal autonomy conditions.

1. Baltic States administrative division and size

During the period after regaining independence in early 90-es, main emphasizes in Estonia and Latvia was put on developing new administrative systems that would resemble the historical situation before the World War II. The mixture of nostalgia to the past and economic naïveté led to (re)establishment of numerous low populated and fiscally weak municipalities. Contrary to that, in Lithuania the number of municipalities remained limited and their role has been seen mainly as fulfilling administrative tasks given by the central government. Perhaps, local municipalities there are still too large by population, thereby limiting their functioning as democratic representatives of residents living on their territories.

The number of sub-governments changes periodically due to continuous administrative territorial reforms. In following Table 1, the Baltic countries administrative division in is given.

[1] Estonia, Latvia and Lithuania

Table 1. Administrative division of the Baltic countries

	Estonia (1.01.2002)	Latvia (31.03.2000)	Lithuania (1.01.2001)
Rural authorities	205	486	48
Towns	42	72*	12
Total number of local governments	247	558	60
Regional government (counties, rayons)	15	26	10

Source: Statistical Offices on Baltic Countries
* includes so-named amalgamated municipalities

As the table shows, there is much bigger number of municipalities in Estonia and Latvia compared to Lithuania. Estonia and Latvia, instead of using the old Soviet administrative system with big rayons and towns, quickly (re)established an impressive number of local municipalities. In Lithuania formation of new municipalities has been slower and the number of sub-governments is growing gradually.

Rural authorities and town governments in the Baltic countries are local administrative bodies to which residents elect representatives and fulfill the functions delegated to them by laws.

Regional (county) government representatives in Estonia and Lithuania are appointed by the central governments and approved by local municipalities' elected bodies within their jurisdictions. County governments carry out mainly general regional tasks and implement state policy in the spheres of social maintenance, education, culture and health. In Latvia, elected representatives of local authorities form regional governments and their functions are wider than in other Baltic countries.

In following Table 2 sub-national governments are distributed by their size and proportion of the whole population in municipalities within the population range.

Table 2. Baltic countries municipalities composition by population size

	Estonia (1.1.2002)		Latvia (31.03.2000)		Lithuania (1.1.2001)	
Number of inhabitants	Municipalities proportion by population size	Population proportion within population range	Municipalities proportion by population size	Population proportion within population range	Municipalities proportion by population size	Number of inhabitants
Less 999	13%	2%	33%	6%	0	0
1,000-1,999	41%	11%	39%	13%	0	0
2,000-4,999	32%	18%	19%	13%	2%	0.1%
5,000-9 999	9%	11%	4%	7%	2%	0.2%
10,000-49,999	4%	17%	3%	15%	63%	34%
50,000-99,999	0.4%	5%	1%	9%	25%	26%
More 100,000	1.2%	36%	0.4%	37%	8%	40%
Capital city and population	Tallinn (400,800)		Riga (764,300)		Vilnius (589,200)	
Total population	1,372,100		2,377,400		3,692,600	

Source: Statistical Offices in relevant countries and author's calculations

In Estonia and Latvia the majority of municipalities are relatively small by population, there 86% and 91% of municipalities respectively have less than 5,000 habitants. Lithuanian municipalities are clearly bigger. Thus, only 4% of communities have population less than 10 thousand inhabitants. In Lithuania the number of municipalities still remains limited and will grow up to 93 in 2003 (Fiscal Design Across Levels of Government: Lithuania). A bigger number of low population municipalities increases need for grant-in-aid from central government to keep up their revenue level. However, municipalities that are larger by population and territory, face the risk of discrepancy between interests of local population and elected sub-governments'.

Another apparent difference from Lithuania is that in Estonian and Latvian population is concentrated to big(capital) cities. During economic and social restructuring those large centers have developed faster than other regions. Bigger towns' habitants have higher incomes, which is basis for prosperous municipal economy. In addition, high incomes attract new settlers from poorer regions, which weakens the low-income areas even more. In the result, the disparities on revenue basis between capital areas and rest of country, particularly low-density rural municipalities, became extremely wide (Raus).

2. Local governments' fiscal situation in general

A decade of reforms in Baltic countries has changed local governments significantly. Municipalities became democratic and modern representatives of local interests. Nevertheless, fiscal relations between the central and local authorities are still far from optimal. General problems are not distinctive troubles only of the Baltic municipalities, but correspond with situation in many transition countries (Bird). Here we emphasize some general weaknesses of Baltic municipalities current fiscal situation.

First, there is often clear mismatch between municipalities' functions and their fiscal resources to meet those tasks. Central authorities tend to delegate more new functions on local governments. Even more, municipalities themselves are interested to have more functions because they are expecting increase of their role and autonomy in a whole government sector. However, very often increased number of tasks does not correspond with available fiscal resources for local governments. Therefore, delegation of functions to municipalities is not only a central governments willingness to enlarge municipalities' tasks and autonomy, but motivated often by decreasing their own responsibilities towards lower level of governments (Sootla). Many low populated municipalities' in Latvia and Estonia have inadequate tax base is to finance properly those new functions. As result, a number of functions executed by the local municipalities have increased in all three countries, but municipalities' fiscal situation became more unbalanced.

In Table 3 Baltic municipalities' expenditure level, structure and share in total consolidated budget is given. The budget structures in general indicate municipalities' tasks and obligations, located on them by law. The biggest expenditure in all three countries belongs to education, which covers from 42% in Latvia up to 57% in Lithuania municipalities' budgets' cost. All other expenditures, like social security or general public services, cover much smaller proportion in municipalities' total spending. Municipalities' educational expenditures in Estonia grew significantly in year 2001, when sums for schoolteacher's salaries were transferred from central budget to local ones. Baltic municipalities expenditures in 2001 were about one fifth of general governments' operating cost.

Table 3. Baltic countries local governments' (LG) expenditures (millions) and structure, 2001

	Estonia		Latvia		Lithuania (2000)	
	LG expenditure, EEK	LG expenditure structure	LG expenditure, LVL	LG expenditure structure	LG expenditure, LTL	LG expenditure structure
General public services	884	9%	55,312	11%	155,231	5%
Defense		-	115	0.0%		0.0%
Public order and safety	95	1%	6,231	1%	25,852	0.8%
Education	4,383	46%	222,039	42%	1,871,815	57%
Health	136	1%	7,073	1.3%	13,266	0.4%
Social security & welfare	895	9%	38,036	7%	478,300	15%
Housing		n/a	77,238	15%	231,892	7%
Recreational, cultural & religious affair	1,001	10%	35,980	7%	149,168	5%
Fuel &services		n/a	936	0.2%	80,614	3%
Agriculture and forestry		n/a	1,571	0.3%	49	0.0%
Mining, manufacturing & construction		-	86	0.0%		0.0%
Transportation		n/a	25,188	5%	74,341	2%
Other economic affairs	2,153	23%	14,597	3%	1,045	0.0%
Other functions	17	0.18%	43,083	8%	184,313	6%
Total	9,566	100%	527,485	100%	3,265,886	100.0%

Source: Estonian Ministry of Finance; Monthly Bulletin of Latvian Statistics, 2(93)/2001, p. 42-43; Lithuanian Ministry of Finance
* not included extra budgetary funds

General public services have bigger proportion in Estonia and Latvia than in Lithuania. The reason is that such expenditure includes also administrative cost, which is proportionally higher in smaller population sub-governments like in Estonia and Latvia. Therefore, decrease of expenditures for an administrative purpose is strong argument in those countries for municipalities' consolidation.

Second, municipalities are limited in their autonomy to raise taxes or other own revenues. Some authors consider the lack of tax autonomy most significant shortcoming of intergovernmental fiscal relations (Reiljan). Principally, the need to increase of Baltic municipalities' tax autonomy is adequate, but requires certain preconditions. Revenue base of many municipalities is often so limited, that even increase of tax autonomy does not allow them fulfill their statutory tasks. In addition, there is a risk that differences of municipalities' tax base will lead to increasing disparities among them in public goods provision.

Third, in the situation where local government's tasks and responsibilities are no very not clearly defined, municipalities' tasks vary on wide extent among them. Provision of public goods depends heavily on municipalities' fiscal abilities. In addition, the question "who should do what", generates permanent tension between local and central governments.

Fourth, sub-governments fiscal abilities differ very significantly. Usually such differences are seen as regional disparities. Disparities lead to municipalities' competition problem and cause Tiebout economy like movements. He argued that individuals choose to live in the local community where the provision of local public goods and tax levels best satisfies their preferences (Tiebout). In the Baltic countries this practice means discarded population flows with concentration of economic activities into capital city areas and continuous impoverishment of rural areas. Another aspect of fiscal differences is related to the abilities to execute statutory functions. Some of the municipalities are ready to carry on more functions and some are not able to cope with existing ones.

Fifth, sub-governments' financial decision-making processes are often not sufficiently transparent and understandable for local residents. Frequently unwanted outcomes are inefficient expenditure decisions or realization of minority group interests. In addition, municipalities' elected councils and their local administrators often do not have required skills and experience to manage fiscal issues in their jurisdiction. Limited fiscal administrative capacity results in taking unreasonable financial risks. In the situation of weak legal regulation, such decisions may cause a fiscal collapse of local economy or even serious problems to national economy in general.

However, there is wide consensus on the pressing need for improving municipalities' fiscal capacity and autonomy in all three Baltic States. Nevertheless, increase of fiscal autonomy requires certain conditions other than delegating municipalities more functions and enhancing their tax establishing rights. Unfortunately, limited progress has been made in all three Baltic countries on recent years implementing the local government reform agenda.

3. Municipalities revenue composition

In following Table 4, data of revenue level and composition of local municipalities in the Baltic countries is given. Separately are presented the central and local governments' data and share of local governments in total consolidated budgets[2].

[2] Consolidated budget includes different type of governments budgets and centrally established social funds

Table 4. Overview of Baltic municipalities'(LG) revenue level and structure (%), 2001

	Estonia			Latvia*			Lithuania		
	Revenues	Revenue composition	LG on consolidated budget	Revenues	Revenue composition	LG on consolidated budget	Revenues	Revenue composition	LG on consolidated budget
Tax revenue	**4,415**	49%	15%	**254**	55%	17%	**2,804**	87%	22%
Personal income tax	3,942	43%	56%	204	44%	72%	2,512	78%	100%
Property and land tax	435	5%	100%	46	10%	100%	284	9%	100%
Non-tax revenue	**777**	9%	23%	19	4%	11%	**117**	4%	11%
Grants and transfers	**3,363**	37%	99%	**159**	35%	n/a	**303**	9%	73%
Other revenue	**503**	6%	60%	**27**	6%	30%	**10**	0%	26%
Total revenue	**9,064**	100%	26%	**459**	100%	25%	**3,234**	100%	22%
GDP level	95,275			4,802			47,958		
LG revenue in GDP, %	9.4%			9.6%			6.7%		

Source: Estonian Ministry of Finance; Monthly Bulletin of Latvian Statistics, 2(93)/2001, p. 39; Lithuanian Ministry of Finance and authors calculations
*includes also regional level

Sub-national governments receive majority of revenues from different taxes, there revenue from the income tax is the biggest. In Lithuania the total tax revenue is as high as 87% of total revenues but in Estonia it is less than half and in Latvia 55% of total municipalities' incomes.

The main revenue of local governments in Latvia and Estonia is generated from the shared state taxes on personal income. In Latvia respectively 71.5% and in Estonia 56% of total collection of that tax is transferred to municipalities' budgets. In Lithuania the personal income tax is until 2002 collected by local municipalities, but will be also shared with central government thereafter.

Other main sources forming the revenue are property tax and land tax. Only land tax exists in Estonia, but other Baltic municipalities receive substantial part of their revenues also from property taxation. In Estonia local municipalities have rights to establish land tax rates within the limits, which are set by the central government. The tax is also administered by the central government. In Latvia the property tax rates are set by central authorities, but administered locally. Similarly, in Lithuania property and land tax rates are set by central authorities, but administered locally.

There are no local taxes established in Latvia. In Estonia, despite the 9 different local taxes, their sum in municipalities' total revenues is insignificant. In reality, such taxes do not play any noteworthy role in generating local income because municipalities express a little incentive to collect them. Often local tax basis is extremely limited, local taxes are difficult to administer, tax revenues are hard to forecast and imposing local taxes is unpopular.

Municipalities' non-tax revenues consist of incomes from their economic activities, fees, fines and user charges. Those incomes cover less than one tenth of all revenues in Estonia, but less than 5% in Latvia and Lithuania.

In Estonia and Latvia local municipalities receive substantial part of their incomes in form of grants from central government or special equalization funds. Share of transfers and grants from the central budget in local governments' total revenues often described also as a vertical imbalance or mismatch between municipalities own revenues and relevant expenditures. Such a vertical imbalance is highest in Estonia and relatively low in Lithuania. In the following years due to local budget reforms share of grants will considerably increase in Lithuanian municipalities' budgets as well.

Grants-in-aid serve to balance the per capita revenues among municipalities and maintain necessary expenditures, but it increases municipalities' fiscal and political dependency from central authorities. Similarly to world practice, the grant transfer scheme is criticized because equalization adversely affects localities' effort to collect own (tax)revenues. Limited tax base discourages municipalities' competition to raise their own revenues.

4. Grant transfers in the Baltic countries

In everyday practice most developed countries have implemented at least some supporting mechanisms for sub-national governments, mainly in form of grant-in aids. Intergovernmental grants are used by central government as a measure to expand services, to equalize municipalities' incomes and make greater use of central government tax base by the sub-national governments.

Theoretically, in a system of multi-level of government, budgetary balance is not required at each level or unit of government. Revenues at one level of government, for example, can fall short of spending, if the difference is covered with transfers from other level of governments. This provides underlying principle for central government to issue grants to local authorities with respect to such services.

Theoretical aspects of grant transfers are extensively provided in economic literature (Oates). The approach to grant transfers payments vary from "how much money is thrown for incapable municipalities to "unconditional support of every single community" (Gramlich).

In general, there are economic, political and institutional reasons for grants. One rationale for grant transfers justifies the benefit spillover aspect. The general idea is that not all of the benefits of a local expenditure are captured within the community and therefore central government acting as agent for other communities in carrying out specified tasks.

Another reason for grants considers in a simple way redistribution of wealth. Intergovernmental grants support low-income municipalities because their own revenue base is limited. Supporting low income communities allow provision of education, health, public safety and other services on the same level or cost as in richer communities. The European Charter of Local Self-Government supports that principle: 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 unequal distribution of potential sources of finance and of the financial burden they must support (European Charter of Self-Governments).

In the Baltic countries, despite positive impact of transfers to local economies, in many cases the objectives set for use of grant transfers are not giving expected results. The fiscal disparities among municipalities still remain high and grants are not motivating municipalities to increase their own revenues. Also, the total amount of grants is limited to guarantee municipalities adequate resources for fulfilling their functions. Therefore the grant systems are permanently under revision and governments introduce different supportive and equalization mechanisms for municipalities.

Often the regional income varieties equalization are considered narrowly as part of regional policy programs. In practice, as precisely mentioned by researchers, transfers to local municipalities are powerful instrument for motivating local economies (Mønnesland). For example, total grants size allocated to Estonian municipalities exceed significantly funds transferred to regions within regional policy.

5. Increase of fiscal autonomy

Increase of fiscal autonomy is seen as the ultimate goal of Baltic municipalities' fiscal development. Theoretically, larger fiscal autonomy of municipalities leads to a greater autonomy (ability) in spending, tax collection, debt management, budget execution and other fiscal activities. As a result, the task of providing public goods and services and other public sector functions can be shared efficiently across levels of government.

The municipalities' fiscal autonomy level indices also called decentralization level indicators. Share of local governments' tax revenues in their total revenues considered as tax autonomy level. Vertical imbalance measures percentage of transfers and grants from the central budget in local governments' total revenues. In other words, how large is municipalities' need for additional funding other than their own resources. In the Table 5 some decentralization indicators for Baltic municipalities are given.

Table 5. Decentralization indicators in the Baltic countries, 2001

	Estonia	Latvia	Lithuania
Local governments tax revenue as % of total tax revenue	15%	17%	22%
Tax autonomy	49%	55%	87%
Vertical imbalance	37%	35%	9%
Source: Sources: Ministry of Finance Internet websites respectively			

Local governments tax revenue in consolidated tax revenues varies among Baltic municipalities from 15% up to 22% Tax autonomy by the indicator is formally highest in Lithuania, mainly because where the personal income tax is totally collected by local municipalities. In the Nordic countries same ration is between 21% in Norway and 34% in Sweden (Söderström, p.5). However, in all three Baltic States most of taxes are centrally established and administered, despite some of the taxes allocated directly to local governments' budgets. Therefore the share of local taxes in total tax revenues and tax autonomy ratio indicate tax autonomy level only partially. In that sense, all Baltic countries municipalities still suffer from fiscal over-centralization.

The biggest tax revenue in Baltic countries comes from shared personal income tax. Municipalities in Estonia and Latvia are interested to receive a bigger percentage of that tax in favor of local governments. However, such a requirement ignores the situation, where income tax base differs drastically by municipalities. Enlargement of tax autonomy will significantly increase revenue disparities between municipalities (Trasberg, 2002).

In Lithuania the situation, where personal income tax was administered by the central government but transferred to local budgets, created problems for the efficient tax collection. The national government institutions have shown a weak initiative to improve the tax collecting because all received revenues are transferred to local governments. For this reason, in 2002 the state budget will receive approximately 40% of personal income tax revenue and increased respectively the categorical grants to municipalities. Those grants must compensate the decreased revenues from the personal income tax (Chandler).

Increase of fiscal autonomy requires certain conditions. First, municipalities' functions and sources for their financing should be clearly defined. Second, decisive aspect for larger fiscal autonomy is relevant tax base of the municipalities. In Estonia and Latvia that means proceeding with an administrative territorial reform with the main

aim to optimize municipalities' population size. Amalgamation of many smaller municipalities to bigger units will assure them with more solid tax base and therefore take advantage from large fiscal autonomy.

Conclusions

In Baltic countries a new administrative system is being developed to establish the foundations for pluralist and democratic society. The early phase of democratization process led to increased number of sub-national governments and widened rights to municipalities' decide over activities on their jurisdictions.

At the same time sub-governments activities are constrained with their limited budget resources. One of the sources for increase municipalities' budget capabilities is enlargement of their fiscal autonomy. Today almost all revenue sources for local government are controlled by the central government, which clearly weakens municipalities' fiscal autonomy. Therefore decrease of municipalities' dependency from the central authorities is under discussion in all three Baltic countries.

Increase of fiscal autonomy requires certain conditions. First, municipalities' functions and sources for their financing should be clearly defined. Second, local government tax base or more generally own revenue level must be adequate to implement the tasks in larger fiscal autonomy conditions. If municipalities' tax base is not sufficient for fulfilling statutory functions, then increase of fiscal autonomy might lead to unwanted increase in revenue disparities among municipalities. Therefore, it is necessary to proceed with reforming municipalities through specifying their functions and responsibilities optimize their size even through their amalgamation.

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