HIGH LEVEL OF CENTRALIZATION AND LOCAL DEBT IN SLOVENIA

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Abstract

As a new member of the European Union, Slovenia made several legislation changes during the accession process and as a small country could benefit a great deal from the large EU single market. Despite so many changes almost none were at the local level. Local government in Slovenia has to deal with a high level of centralization of public finance. Local expenditure represents only about 11% of total public expenditure in Slovenia. Local budgets therefore depend heavily on state transfers and financial equalization. A further issue that should be mentioned is that municipalities are very small and even decentralization would not help these micro-local governments to raise enough funds for delegated services. The lack of staff and funds would probably remain even if some steps towards decentralization were taken. In practical terms, local governments in Slovenia could not raise their own resources. They could introduce specific charges, but all taxes are determined by state. According to law, until 2005 local governments could borrow funds from different financial institutions while local debt should not exceed 10% of local revenues. Before borrowing, local governments need approval from the Ministry of Finance.

The main objective of this paper is to present financial centralization in Slovenia, and to analyze local borrowing and debt repayment. The main constraints on managing local debt are also presented. The ratio of local expenditure to total public expenditure and the ratio of local revenues to total public revenues are used to describe the level of fiscal decentralization. The results showed that both ratios are among the lowest in the European Union and far below the Europe average.

The analysis of local debt include several local borrowing and debt repayment ratios. The high level of centralization and borrowing control leads to the fact that less than 13% of local governments do not receive financial equalization from state budget, more than 60% of local governments did not borrow at all in the last five years and local debt on average reached only EUR 20 per capita. This situation leads to stagnation of local investments, especially if additional funds are not received from the state or EU, and to a lack of resources for professional and flexible public services. Most of the local debt is raised by borrowing from domestic banks. Some municipalities used other resources that were not regulated by the law. For these reasons the Government amended the Financing of Municipalities Act in 2005.

The main purposes of the amendments are: deregulation for local borrowing (quicker procedures, higher limits); additional local borrowing for investments granted from EU

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projects; additional funds to prepare projects to receive EU funds; repayment of some local administration costs to those municipalities that share administrative work and therefore rationalize staff costs and increase professionalism.

Chapter 1: Introduction

The financing of local communities and the issue of centralizing or decentralizing financing is an important fiscal policy issue for every country. There is considerable diversity in the levels of financial centralization from country to country, and the level of centralization usually depends on the tradition of a particular country. A number of research works have already been carried out to investigate the advantages and disadvantages of centralization or decentralization. The level of fiscal centralization is generally measured using the ratio of local revenue to total public revenue and/or the ratio of local expenditure to total public expenditure. Data indicates that developed countries have on average a higher level of decentralization than developing countries. Research into the relations between the level of decentralization and economic development (e.g. Oates 1993; Ebel and Yilmaz 2002) have indicated a positive correlation, as well as a trend towards increasing centralization in developing countries, particularly countries in transition. The research also raises the issue of local borrowing in relation to the level of centralization.

The article will first present some results from research into the advantages and disadvantages of fiscal decentralization, and the level of centralization in Slovenia since independence. Although the legislation on local financing changed in 1998, there were no significant changes to the level of decentralization and municipality borrowing. Te article also compares Slovenia's position to the level of centralization in other EU countries in 2001 and 2004, and the level of borrowing in those years.

Chapter 2: Advantages and Disadvantages of Fiscal Decentralization

As mentioned above a positive correlation was found between the level of decentralization and economic development. The average level of fiscal decentralization in developed countries is considerably higher than in developing countries. Economic development in countries in transition has been accompanied in most cases by an increase in the level of decentralization. In studying the relation between the level of fiscal decentralization and economic development, there remains the unresolved issue of which is the dependent variable, as data on the level of decentralization and economic development from the middle of the 20th century does not indicate a positive correlation. The thesis of a positive correlation between these phenomena has not therefore been fully attested (Blažić 2004).

Despite this, decentralization certainly offers a range of advantages. Fiscal decentralization should have a positive impact on improvements to public services, improving the coordination and supervision of designated use of funds, improving how local populations' requirements are met, and increasing their participation in managing finances. Greater decentralization should increase the responsibility of local authorities over development, stimulating competition between and ensuring greater fiscal stability for local communities.

Decentralization reduces public spending and hence contributes to reducing budget deficits (Mello and Barenstein 2001).

Nevertheless, alongside the advantages of greater decentralization, one must also mention some disadvantages. Greater decentralization can lead to poorer supervision over public finances, can restrict fiscal policy management, overloading local finances with liabilities delegated by the state, etc.

Local community borrowing is one possible source of local revenue, especially for financing investments. The transfer of debt arising from borrowing to future generations in such situations is justifiable, as current investments will have benefits for future generations. If local communities do not make investments their development may be harmed, so from that point of view borrowing is appropriate. In certain cases borrowing is also suitable for covering an imbalance between local community revenue and expenditure. In this case, borrowing can also be justified, as it is preferable to the negative effects of a deficit and cuts in public services. Despite the advantages of borrowing set out above, at the local level it must be regulated to avoid excessive and ungrounded borrowing by local communities. The regulations should set out the procedures, revenue levels, and capacity to pay off debt (Ebel and Yilmaz 2002).

Chapter 3: Fiscal Decentralization and Local Debt in Slovenia

The Slovenian state has only one level of local community organization, its municipalities. Although legislation sets out specific criteria for establishing a municipality, the number of municipalities has continually increased due to approvals being granted to various exceptions and above all for political reasons. At the end of 2005 Slovenia had 193 municipalities, with an average population of over 10 000 inhabitants. Excluding urban municipalities the average population is a little over 7 000. The municipalities are therefore rather small and cannot independently collect sufficient funds, and are operated by small municipal administrations that struggle to provide the necessary public services. Despite the fact that small municipalities are heavily dependent on financing from the state, in Slovenia the number of municipalities continues to increase. In March 2005 a further 12 new municipalities were established, and referendums will be held on the creation of eight new municipalities. Despite the relatively large number of municipalities with respect to Slovenia's size and population, the level of fiscal decentralization is quite low, and is below the EU average. Local governments in Slovenia are practically unable to raise their own resources. They can introduce some specific charges, but all taxes are determined by the state.

Table 1: Fiscal Decentralization in Slovenia from 1992-2004[2]

Year	Local revenue/total public revenue (%)	Local expenditure/total public expenditure (%)
1992	11.14	11.36
1993	10.83	10.98
1994	11.21	11.04
1995	10.82	10.44
1996	11.29	11.02
1997	11.60	10.80
1998	11.52	11.01
1999	11.52	11.21
2000	11.99	11.60
2001	11.75	11.49
2002	12.17	11.73
2003	11.69	11.38
2004	11.59	11.23

In 1998 the first large scale amendments were made to the legislation on the financing of municipalities. Table 1 indicates that this has not changed the level of fiscal decentralization. Slovenia's first Financing of Municipalities Act, which was in force until 1998, set limits on municipality borrowing, but did not set out detailed restrictions on obtaining funds from the national budget for investments and other inflows from the national budget. As a consequence, after independence municipalities began various forms of borrowing up to the legally defined limits. The amended Act which came into force in 1999 defined a different form of financial equalization for municipalities, a new distribution of income tax revenues between the state and municipal budgets, and changed the method of allocating funding for co-financing projects from the national budget. The borrowing limit for municipalities was also changed (Klun 2001).

Until amended, the Act envisaged that the guaranteed expenditure for a specific municipality was set on the basis of measures determined by the competent ministry. This did not clarify which measures were used and how they would change for the next year. The amended Financing of Municipalities Act, however, determines that "fixed expenditure per inhabitant is determined by the Slovenian parliament when adopting the national budget for each budget year. The fixed expenditure per inhabitant is determined as the average sum of funds per capita for the population of the Republic of Slovenia". The fixed expenditure per person is then determined for each municipality using a formula stated in the Act. The formula envisages that the fixed expenditure per capita for each municipality is corrected

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[2] Ministry of Finance of Republic of Slovenia, Bulletin for Public Finance, 1/06.

with factors such as area, length of roads, population under 15 years and population over 65 years as a ratio between the municipality and the whole country. Greatest emphasis is placed on the total population of each municipality and the number of inhabitants under 15 years. A greater emphasis is also placed on population in city municipalities. Financial equalisation is applied to municipalities whose own revenues cannot provide 90% of the centrally defined fixed expenditure, calculated according to the formula. This funding can reach up to 100% of assessed revenue. The large number of small municipalities means only a few municipalities are able to collect sufficient revenues to cover 90% of the calculated fixed expenditure. The average value of the financial equalization per inhabitant in 2004 was SIT 36 186 (c. EUR 150), with 48% of municipalities receiving a financial equalization higher than the average, and with 87.6% of municipalities receiving a financial equalization.

The distribution ratio for revenue collected from income tax was changed to the benefit of municipalities, from 30 to 35%. This gave municipalities a greater proportion of income tax revenue, but also led to a reduction in the funds available from financial equalizations and an increase in powers delegated to the municipalities. The Financing of Municipalities Act on obtaining funds from the national budget for various investments also introduced a scale for municipalities to obtain such funds. Wealthier municipalities (depending on the income tax collected per inhabitant) can obtain up to a maximum of 10% of an investment, while the least wealthy municipalities can obtain up to 70%.

An important amendment was connected to the limits on municipal borrowing, and stated that municipalities could only borrow up to a level that was 10% of realized revenue (this revenue does not include funds from the national budget to co-finance investments and grants). The procedure for obtaining consent form the Ministry of Finance was also made stricter. The legislation also permitted borrowing on the capital market, however the implementing regulation that would regulate this form of borrowing has yet to be passed. As a consequence since 1999 municipalities ended borrowing through the issue of bonds, and from 1999 their only borrowing has been via domestic commercial banks. Borrowing by means of issuing securities reached its highest proportion of total municipal borrowing in 1992, when it reached 71.5%. From that year on the proportion continually fell, down to 7.2% of total borrowing in 1992, and just 0.9% in 1998. Despite the reduction in borrowing through issuing securities, the ratio of borrowing to total municipal revenue did not fall, and ranged from 0.5% to 3% of average municipal revenue throughout the entire post-independence period (see Table 2).

Table 2: Ratio of Average Local Borrowing and Debt Repayment to Local Revenue (%) 1992-2004[3]

Year	Local borrowing/local revenue (%)	Debt repayment/local revenue (%)
1992	3. 77	1.98
1993	2.49	1.60
1994	1.35	1.11
1995	0.46	1.62
1996	0.73	1.34
1997	1.11	1.34
1998	1.35	1.43
1999	1.06	1.18
2000	0.83	0.91
2001	1.25	0.94
2002	2.98	0.85
2003	2.00	0.80
2004	2.64	1.06

In 2004, 19 municipalities exceeded the legal limit on borrowing, which defines the highest permitted amount of borrowing as 10% of realized revenue, and the number has risen year by year since 2000. Most municipalities in Slovenia do not borrow. From 2000 to 2004 the proportion of municipalities that did borrow was between 25% (in 2001) and 34% (2004). Just under a third of municipalities engage in borrowing, despite the fact that on average municipalities only recorded a surplus in 2000 and 2004. Before 2000 on average municipalities had a surplus of revenue over expenditure. In 2004, 56% of municipalities recorded a budget surplus, and average debt per person was SIT 5 015 (c. EUR 20.90). A detailed analysis of municipal borrowing and debt repayment is given in Table 3.

An additional restriction on borrowing is the amount of debt repayment, which cannot exceed 5% of realized revenue. Some municipalities have also exceeded this restriction, however, they are far fewer in number than those exceeding the limits relating to borrowing. In 2004 just 4% of municipalities exceeded the debt repayment limit. Despite this small number the average debt repayment amount per inhabitant is increasing consistently. In 2004 the average amount was SIT 1 761 (approximately EUR 7).

[3] Ministry of Finance of Republic of Slovenia, Bulletin of Public Finance, 1/06.

Table 3: Selected Local Borrowing and Debt Repayment Figures in Slovenian Municipalities 2000-2004[4]

(%)

	2000	2001	2002	2003	2004
Proportion of municipalities that have borrowed	25.9	25.4	33.2	21.2	33.2
Proportion of municipalities with borrowing:					
- below 2% of revenue	80.3	79.7	70.9	81.9	71.5
- below 5% of revenue	89.1	87.0	79.3	88.1	81.3
- below 10% of revenue	96.9	95.8	94.3	93.8	90.2
Proportion of municipalities making debt repayment	61.1	57.5	60.1	60.6	61.7
Proportion of municipalities with debt repayment:					
- below 1% of revenue	73.0	68.9	72.5	73.5	73.5
- below 3% of revenue	91.2	86.5	88.1	93.8	93.8
- below 5% of revenue	95.3	90.7	92.2	95.9	95.3

The data indicates that municipalities use most of their revenue for the provision of delegated public services. Not a great deal of funds remains for investment, so the investment trends remain the same, with the average proportion of funds for investment and investment transfers being around one third of expenditure, or just under 20% of revenue. The low level of borrowing is due in part to Slovenia's high level of centralization. Slovenian municipalities persist with a financing method that is largely dependent on funds obtained from the state budget. This means that municipalities place most of the burden for providing their public services on the state. On the other hand, smaller municipalities cannot manage large debt, given their small number of staff. Some smaller municipalities have fewer than five staff. Debt management at the municipal level is also restricted in another area. Municipalities only borrow on the domestic market, and do not have the possibility of borrowing on the capital market, so domestic financial institutions are their only option. As the financial market in Slovenia is an oligopolistic market, it does not offer much diversity and municipalities have very little choice in their borrowing. The largest proportion of municipal borrowing is from credits taken out at domestic commercial banks. This proportion ranged between 72% to 86% of total municipal borrowing in the period 2000 to 2004. Table 4 gives an analysis of municipal borrowing from 2000 to 2004. Municipal borrowing grew as a proportion of overall public sector borrowing throughout the studied period. The local debt also grew as a proportion of GDP.

[4] URL: http://www.fu.uni-lj.si/sib/vhod.asp

Table 4: Local Public Debt, 2000-2004[5]

Year	Budget surplus/deficit (SIT million)	Primary surplus/deficit (SIT million)	Current surplus/ deficit (SIT million)	Ratio of borrowing to total public borrowing (%)	Ratio of credit from commercial banks to overall borrowing (%)	Local borrowing as proportion of GDP (%)
2000	620	-930	18 987	1.0	71.9	0.04
2001	-1 897	-3 487	29 650	1.2	72.6	0.06
2002	-8 668	-10 063	34 535	2.7	86.0	0.15
2003	-1 114	-1 862	38 661	2.4	77.2	0.10
2004	138	-204	40 970	3.0	81.1	0.13

The audits performed by the Court of Auditors of the Republic of Slovenia from 2002 to 2004 also found that only a few municipalities exceed the legally defined upper limit on borrowing, and the Court did not find any other irregularities relating to borrowing. Based on its audits, in 2004 the Court informed the state that municipalities are increasingly turning to other methods of borrowing that legislation in force until the amendments in 2005 did not anticipate and did not therefore define limits for. Commercial borrowing is increasingly being used (e.g. commercial credit, leasing, etc.).

In 2005 a set of amendments were made to the Financing of Municipalities Act to enable the state to reduce municipalities' dependence on the state, offer them greater independence in obtaining funds, and redress some deficiencies related to borrowing. The main purpose of the amendments was to enable municipalities to perform their duties within regional development programs and to increase their capacity to draw on additional revenue from EU funds. Municipalities obtained the first transfers from EU funds in 2004, but the proportion was relatively low, with such transfers worth just 0.5% of overall municipal revenue on average.

Municipalities should be entitled to further special incentives for co-financing investments in the field of regional development programs within the structural and cohesion policies. According to the amended Act, municipalities still require the Minister of Finance's consent, but the procedures have been simplified. The threshold up to which municipalities can borrow was raised to 20% of realized revenue, while the restriction for debt repayment remained at 5% of realized revenue. Borrowing now includes all forms of debt, i.e. including commercial credits, leasing etc. In addition to these basic forms of borrowing, municipalities have the possibility of additional borrowing of up to 3% of anticipated revenue, if they are borrowing for investments co-financed by EU funds, and to finance

[5]Ministry of Finance of Republic of Slovenia, Bulletin of Public Finance, 1/06 and own calculations

investment in elementary school education and public infrastructure for waster water treatment.

In addition to the amendments relating to borrowing, the Act also anticipates additional revenue for municipalities that obtain funds to co-finance investment in development programs and structural and cohesion policies. These additional funds may not exceed 3% of a municipality's fixed expenditure. The Act also sets out a special incentive aimed at small municipalities that opt to jointly perform municipal administration tasks. As already mentioned, small municipalities are inefficient when performing various service provision tasks, and asset and debt management. Above all these administrations lack the professional staff to prepare programs to draw on EU funds. The state will return half the costs used for this purpose to municipalities that opt to provide services jointly.

There is also a special form of liquidity borrowing available to municipalities, which they do not however make use of. This is via the Treasury Single Account (TSA, Slovenian abbreviation: EZR) managed by the Public Payments Office. A TSA is a joint account for direct and indirect spending units that enable lower cost repayment of liabilities, while also enabling short-term placement of available funds and liquidity or non-current borrowing under more favorable conditions than those offered by commercial banks. Municipalities do not make use of this form of borrowing. For municipalities that have opened a TSA (there were 143 such municipalities at the end of 2004), the Public Payment Office includes available funds in the account, on a daily basis, in the form of night deposits in various commercial banks and controls deposits returned by banks. Each month interest is calculated for municipalities depending on the balance on their TSA accounts.

Chapter 4: Fiscal Decentralization and Local Debt in the European Union

In 2004, there were 90 500 local communities in the 25 EU Member States whose funds represented 12.7% of EU GDP. The level of decentralization has increased in most member states, as only six countries recorded a reduction in the ratio of local public expenditure to overall public expenditure, one of which was Slovenia. Comparing Slovenia to other EU countries indicates that Slovenia is one of the most centralized countries, as in 2001 it was ranked fourth in the EU-25 by ratio of local spending to total spending, and in third place in 2004. Slovenia is therefore behind the average level of decentralization of both the old (EU-15) and new EU member states. According to data (Ebel and Yilmaz 2002) on the ratio of local expenditure to total public expenditure around the world, the highest level of decentralization is found in the most developed OECD member states, where the ratio exceeds 30%. They are followed by European and Central Asian countries with a ratio of over 25%, while the lowest ratio is found in southern African states, where it is around 15%. In Slovenia the ratio is therefore lower than the average for all the various world regions. If we compare ratios of local revenue to total public revenue the situation is somewhat different, as the ratio is higher in Europe and Central Asia, where it reaches 20%, while the lowest is found in the Middle East and Africa, where the ratio is below 10%. In this case Slovenia’s ratio exceeds the average for those countries.

The finding from the preceding chapter that Slovenian municipalities practically do not engage in borrowing or that their borrowing is very low is clearly demonstrated by the comparison with other EU member states. Alongside Malta where there is no borrowing at the local level, Slovenia has the lowest local public debt as a proportion of GDP. With local debt at 0.1% of GDP, it is considerably below the EU average of 5.6% of GDP. The EU-15 average in 2004 was 5.8% of GDP, while the average for the 10 new states was lower at 2% of GDP.

Table 5: Local Public Expenditure and Local Debt in the European Union, in 2001 and 2004[6]

Country	Local expenditure as % of total public expenditure		Local public debt as % of GDP	
	2001	2004	2001	2004
Austria	15.8	15.9	2.5	2.4
Belgium	13.2	13.8	5.9	5.4
Cyprus	4.1	4.5	2.5	2.3
Czech Republic	20.8	28.5	2.3	2.8
Denmark	54.6	60.4	4.6	5.1
Estonia	24.4	24.8	2.1	2.5
Finland	37.9	38.5	2.8	3.9
France	18.9	20.3	7.2	6.8
Germany	15.2	15.4	4.8	5.2
Greece	5.5	6.0	0.6	0.8
Hungary	23.7	25.9	0.8	1.7
Ireland	39.9	42.4	1.8	2.3
Italy	30.0	32.5	3.4	5.6
Latvia	25.8	28.1	2.3	2.3
Lithuania	21.7	26.8	1.1	0.7
Luxembourg	14.8	13.0	2.4	2.3
Malta	1.7	1.5	0.0	0.0
Netherlands	36.7	35.1	9.8	8.9
Poland	22.2	30.3	1.7	2.1
Portugal	13.5	12.8	2.8	3.4
Slovakia	7.3	17.5	1.3	1.5
Slovenia	11.6	11.2	0.1	0.1
Spain	37.3	52.1	9.4	9.1
Sweden	44.3	44.3	5.2	9.1
United	23.2	29.0	5.4	4.4

[6] Local finance in the twenty five countries of the European Union. Dexia, 2004 and 2005; for Slovenia Bulletin of Public Finance, 1/06

Kingdom				
Total 25	**24.0**	**26.8**	**5.3**	**5.6**

Comparing the level of decentralization and municipal borrowing in individual states, one cannot conclude that having greater fiscal decentralization means higher local level borrowing. In 2004 Denmark, which has the highest level of decentralization, only ranked eighth in terms of local borrowing as a proportion of GDP. The main influence on the amount of borrowing therefore comes from the regulation of local borrowing by the state. By acceding to the EU's stability and growth pact most EU countries have introduced measures to reduce public debt at all levels, including the local. Despite this, the proportion of local debt in GDP increased over the period from 2001 to 2004 in half of EU member states, however, in most cases by less than one percentage point.

Chapter 5: Conclusion

Slovenia has one of the lowest levels of public debt as a proportion of GDP of the ten new EU member states, and its local debt is also among the lowest as a proportion of GDP. Compared to other EU member states, it has the lowest proportion of local borrowing in GDP, except for Malta which does not have local level borrowing. This situation is the result of the restrictions on local borrowing and the low possibility of other forms of borrowing. Slovenian municipalities can only borrow on the domestic financial market, where there is not a great deal of competition. Most municipalities do not exceed the legally defined limits. In recent years, in their search for additional funds municipalities have increasingly turned to commercial borrowing not regulated by law. In 2005, the state addressed this area and restricted all forms of borrowing to 20% of realized revenue. The low proportion of municipal borrowing and the actual size of municipalities means that in Slovenia one cannot practically speak of managing local debt, as it is almost all in just one form, i.e. credits from domestic commercial banks. The new legislation does open up more borrowing options to municipalities, but does not anticipate offering incentives for different forms of borrowing that could lead to a debt management policy at the local level. One important incentive included in the amended Act is the co-financing of costs for joint municipal administration, as in that way smaller municipalities could employ professional staff, which is essential in drawing on European funds.

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