LOCAL GOVERNMENT NON-TAX REVENUE SOURCES IN TRANSITION COUNTRIES: USER FEES AND CHARGES

Edited by Željko Šević

NISPAcee
THE NETWORK OF INSTITUTES AND SCHOOLS OF PUBLIC ADMINISTRATION IN CENTRAL AND EASTERN EUROPE
Local Government Non-tax Revenue Sources in Transition Countries: User Fees and Charges

Edited by
Željko Šević, University of Greenwich, United Kingdom

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Prologue: Taxing or Charging for Government Services? – A Panacea of Modern Government Finance

I

‘Charge whenever you can’ has become the motto for local and regional governments that provide a number of services to their citizens. Some would say that the rule will soon be ‘Charge as much as you can’, but it is most unlikely that this will happen. Charging for government services has traditionally been based along the lines of at least average costs, if marginal costing could not be applied.

The state, as the sovereign power, traditionally was entitled to impose taxes and other levies onto the citizens under its jurisdiction. Citizens more or less accepted the fiscal powers of the state and paid their dues with good grace. With the refocusing on transparency and more responsible models of governing, questions on the efficiency and effectiveness of public sector spending have once again been raised. The neo-classical economic concept tells us that all economic entities/agents should behave rationally and maximise their wealth (the profits and effects of their chosen activities). Markets provide a natural order that brings together market forces and provide the best regulatory framework through competition. While we may have a competition of ideas and concepts in the public sector theory, in practice there is very little market in the public sector service provision. Even in those countries with the most advanced markets for public sector-like services (Australia, New Zealand and the UK, etc.) markets by themselves have proven to be less effective than supporters of large scale privatisation and public-private partnership would like to see. In reality, a hierarchical structure exists between the government and other entities in the process of allocation and distribution of (scarce) resources. The government, as the sovereign power, has the authority to collect and force citizens to pay taxes and other levies on the one hand and to use the central bank to monetise debt on the other. An effective government has at its disposal, the instruments of both fiscal and monetary policy. The government has the power to enforce the law and to ensure that resources are allocated and distributed according to its stated priorities.

The modern state performs a wide range of duties, one of the most important being to ensure the welfare of its citizens (however this may be defined in a particular society), enforce law and order, respect an internationally endorsed code of conduct in international relations and support economic growth and development, etc. In a democratic setting, one may ask why the state has to provide services directly outside the market. Why are the markets replaced by usually ineffective hierarchical systems? Both the extensive regulation and the creation of public enterprises have been the usual response of governments to the (supposed) cases of market failure. Why then does the state itself have to be engaged
in the provision of services, either directly or via a separate legal entity – usually a fully or predominantly owned public (state) company? And, if the state is indeed involved in the provision of services, what should be the base for deciding on prices when there are no real market forces in action? Do we set the price arbitrarily, based on the data available from the past, or – do we have to look for another model for deciding on a price?

II

For those citizens who grew up in strong welfare states, or in a state where there was a high level of socialisation in public life, the very idea of charging for the provision of public services sounds, from the onset – unacceptable. Often the public may ridicule proposals for the introduction of user charges for some public services. Proposals to charge for services that have been traditionally provided free or to increase the charge for services that have been provided well below the cost, initiate a significant public outcry and this is usually perceived as dishonest behaviour on behalf of the government, which is seen to be in pursuit of ‘easy money’. This is especially problematic for sub-national governments which usually do not have wide enough revenue bases and often are prohibited from imposing original taxes. Therefore, the main argument for the introduction of charging for public services should be linked to economic efficiency and not to revenue. Well-defined charges should be a good interface for information, as these could provide information on the demand for services and the willingness of the users to pay. This should also ensure that there is some, if not full, cost recovery. One should be aware that the services that are provided (ostensibly) free of charge (in fact, at societal expense), may lead to over-consumption as the consumption may well be higher than society at large is ready to pay.

Usually, local governments are faced with the challenge of whether to charge and how much to charge. The problem with financing sub-national governments is not new. Normally, central government decentralises functions, but unfortunately it is not directly followed by or even better, accompanied by, fiscal decentralisation. Local governments then have two choices, either to use the maximum decentralised powers and try to impose local taxes, or to go for charging for services provided. Local taxes usually have to be approved by the central government body (often the Ministry of Finance), while there is more latitude when it comes to charges. Also, local tax systems are not easy to establish and maintain, especially those that can be classed as being good. Good local (sub-national) taxes are those that are (relatively) easy to administer; 2) that are imposed solely (or mainly) on local residents and 3) that do not raise problems of ‘harmonisation’ and ‘competition’ between various sub-national governments or between the sub-national national level governments and the central/national government (see: Musgrave, 1983; Oates, 1998; McLure, 1999, etc.). Often, only the property tax meets all the criteria and, to some extent, some secondary income taxation (Šević, 2006b). As an alternative, the sub-national
governments are encouraged to charge for their services and therefore, user charges and fees are theoretically a significant source of revenue, although in practice, fees and charges do not usually contribute to more than 5 per cent of aggregate revenues of sub-national governments.

Pure economic logic would require that the charge for the publicly provided service equates to the price that would be otherwise set in a perfectly competitive market. However, it is difficult, if not impossible to determine market prices for publicly provided services as there is no suitable referencing system. The main problem with publicly provided goods is that they often have far too many characteristics of classical ‘public goods’, so the prices of the products/services provided do not fully reflect all the external costs and benefits. Publicly provided goods are very specific, since often the openness of the process matters; excludability is not feasible; scale and sunk costs often lead to a monopolistic provision of goods; non-priced externalities are significant and cannot be neglected, or in fact distributional aspects of the provision play far too important a role to be ignored. Public services provision therefore faces the problems of monopoly, the mandatory nature of the services, the rigidity of demand, the clientele and the visibility of operations.

### III

The pricing for user charges and fees is similarly problematic. Often, the regulatory authority (the Government that has the full ownership of the public enterprise that provides a service) opts to impose the charges at marginal cost level. This generally has been accepted as a cross-national standard, but in fact, as an economic concept, it creates problems for accountants calculating the costs. From accounting, especially a financial accounting point of view, the cost is defined as a monetary outlay that was necessary to achieve a certain effect, i.e. to have services provided. The marginal cost is basically linked with the economic concept of the cost and therefore is linked with the concept of the opportunity costs, i.e. an opportunity foregone due to the particular choice made by the economic agent in the particular case. Proper, effective application of marginal pricing requires inclusion of a range of implicit societal costs (seen as opportunity costs). This is however somewhat cumbersome even in theory, let alone in practice. Marginal pricing can be defined as having two time spans to consider: short-term and long-term marginal costs. In the case of the short term calculation, only variable costs are taken into account, which can often lead to a situation where the government may think that the facility will last forever and at the time of replacement, insufficient resources will be available either for major repair or for the building of a new facility. However, in the case of long run marginal costs, fixed costs will be taken into account and the calculated price may look high to potential users, especially if the facility is overbuilt, bearing in mind the growth in the local population throughout the useful life of the facility.
This is especially the case with facilities that have very high set-up and sunk costs and high economies of scale. Often, the theory gives as examples, hydro-electric facilities, telecommunication networks and rail networks, etc. Basically, most large infrastructure projects will be classified in this group. Whatever the case may be with these major projects, the public will have to pick up the bill, as often additional funding will be required from the budget. Therefore, one alternative can be to set up the charges at average cost level. This theoretically should lead to the full recuperation of costs, but as the charges/prices will be higher, the interest and output should go down, which in turn may not be desirable from a larger society and/or political elite’s point of view. However, average cost pricing for public services has its own shortcomings. It is not easy to receive information on how unit costs will change as the number of users change, and how the users will be sensitive to price changes (elasticity of demand issues). Developments have included average incremental cost pricing, which many may see as the introduction of a marginal concept to average cost pricing. This may, in fact, be true, but in contrast to marginal cost price setting, average incremental pricing ensures full cost recovery and provides information to those making decisions on the level of service provision. Average incremental costs can be allocated to activities and classified based on other criteria, ensuring that users under different regimes are charged appropriately (i.e. differently). For instance, price discrimination based on the level of service demanded at a particular time of day, is usually practised, or the service is ‘sold’ in chunks (various block packages). For instance, the users of monthly or yearly transport passes normally pay less than those who purchase tickets on a daily basis. The price difference may be up to 20 per cent for those ‘loyal customers.’ (However, these ‘loyal customers’ may also be penalised at some other time).

Although the users may pay the ‘price’ for the service consumed, in practice, many of the publicly provided services impose some externalities. Similarly, external social benefits are difficult to measure and consequently, included in the price set down. One may agree that there are positive externalities of publicly provided services (not necessarily with pure public good characteristics) but empiria has failed to produce any conclusive evidence of this. Often, it is claimed that education benefits both the individual and society, but the societal link has often been hazy and remained largely in the speculative sphere. Therefore, the basic line of modern public policy in this domain is that the direct user should pay for the service rendered, unless there is a very convincing argument that society at large should pick up the bill, either in full (tax coverage) or in part (through, for instance, subsidies).

However, the problems with user charges are not merely limited to the process of setting the level of charges, but also in the way the charges are administered and how users can pay them. Often, users do not mind paying for a service, but the process to which they are exposed in paying the charge is somewhat tedious. For instance, it is difficult to pay for parking if the parking ticket machines are
out of order, or take only coins and do not accept other forms of payment, or if every time the payment is processed, the user is worried that something may go wrong and they will then be subject to different penalties. Often the advice includes the prerequisite of knowing both the product and the customers, including their changing nature. There is also a need to know the data, adjust them as and when required in order to set the price, and if necessary, justify any subsidy that is eventually paid. Monitoring of the scheme at regular intervals is a must and only if this is done properly, can the user charging system operate effectively and efficiently. In times of a constant search for the ‘best-value-for-money’ this is of the utmost importance for those involved in the public policy processes.

IV

The set of papers presented in this volume explores the issues of charging for government services in the broadest sense. The book consists of a series of national case studies that followed the same research protocol. Despite using the same template and employing the same methodology, they deal with particular issues that face each of the countries covered and try to provide an accurate picture of the institutional (legal) framework and positive practices in setting up and enforcing user charges and fees, especially for locally provided services and less often, products. Particular care has been taken to ensure that the papers correctly depict the current situation.

This book is the result of an ongoing individual and collective effort of the members of the NISPAcee Working Group on Public Sector Finance and Accounting. It is the third book in the series and following the success of the previous titles (Šević, 2005; Šević, 2006), the team hopes that this one will also be highly regarded by professionals and academics alike. Both the group convener (and also an editor of this volume) and each of the authors hope that the book will be used as teaching material for public finance courses, primarily in the target region. Far too often, a lack of policy orientated books has been witnessed in both the East and the West. The authors hope that this book will fill the gap with notable success.

The work presented in this volume should be exclusively contributed to the authors themselves and should not be attributed, under any circumstances, to the organisations for which they work. The editor obviously assumes overall responsibility for this volume and all eventual criticism should be addressed solely to him.

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Acknowledgements

This book has been a collective effort of the members of the NISPAcee Working Group on Public Sector Finance and Accounting. The Group was established at the NISPAcee Annual Conference held in Riga, 2001 and since then has chosen a number of important policy focused issues to explore on an annual basis. The work has traditionally been presented at the NISPAcee Annual Conferences.

This effort would not be possible without the now traditional and generous support given by the Local Government and Public Service Reform Initiative (LGI) at the Open Society Institute in Budapest. Programme Director Adrian Ionescu has shown understanding from the very beginning, while Programme Manager Viola Zentai has closely followed the work of the group and participated regularly in the meetings held at the NISPAcee annual conferences, contributing to ongoing debates and initiating new ones. Without the support of the LGI, many group members, residing primarily in Eastern Europe and Central Asia, would not be in a position to participate in the meetings and take an active part in the development of the project.

Since the majority of authors are not native English speakers, Jane Finlay (OECD) has done a superb job in improving not only the readability, but also the consistency of the papers. She often spotted inconsistencies that the editor missed. Jane often had to read two, or sometimes three, versions of papers before this text could be presented to the general public.

Elena Žáková is a Programme Manager in the NISPAcee Secretariat charged with supporting the Group. She has been very supportive both of the Group Convenor and the Group itself. Sometimes it was fairly tedious work, but Elena has heroically endured throughout. Ludmila Gajdošová, NISPAcee Executive Director, has shown a keen interest in the group from the outset. Both Elena and Ludmila deserve a special ‘thank you’ from the group members.

As we have already said, this is both an individual and a collective work. The editor would therefore like to thank all the authors for being so gracious in responding to queries from the editor, the referees and Jane. Although all the papers in this book have been cross-referenced at least twice in the process of its preparation and production, the entire book was read and commented on by Dr Gábor Péteri, former Research Director of LGI, now with an LGI consultancy branch – LGI Development. All those who know Gabor, are aware not only of his profound knowledge of local government finance in Central and Eastern Europe, but also his erudite general knowledge. Gabor’s comments were generally taken on board and fully addressed. Certainly, without his support, the quality of the work would not be at its current level.

With the sterling support provided, it should be very difficult to produce a work of less than excellent standard. However, if there are any shortcomings, these should be attributed exclusively to the editor himself, as stated in the prologue.
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1. Charging for Government Services: Exploring the Experience Of CEECs

Željko Šević

1.1 Introduction

With the fall of the Berlin Wall in 1989, the process, better known as ‘transition’, began. The focus was on restructuring the economy and establishing firm grounds for the development of a market economy; ensuring that property rights were guaranteed and that the markets’ operational and basic economic freedom and human rights were present. The focus was primarily on fast structural changes and the building of a legal framework, which was to support the development and operations of the markets (see: Šević, 1999). The focus later widened and the banking/financial sector reform was initiated, almost at the same time as the public administration (public sector) reform came into the spotlight of the ‘reformers’, or to be more precise, the foreign donor governments.

The predominant focus of the public administration reform was decentralisation. Initially, it was perceived as the main activity in dismantling the socialist state, which by definition was highly centralised and where a tradition of sub-national level government was literally non-existent. Eventually, some detached central bodies performed their activities locally, but in the main, that was really it. No genuine local (self-) government existed and the central government bodies performed most of the services for citizens. Even the enterprises that provided local services were formally owned by the central government, although this situation has gradually changed since the 1960s. In fact, many public enterprises were “owned” by local governments, which was especially the case in Hungary and Poland. The experience of the former Yugoslavia was that since the 1950s, economic decentralisation was in place, which reflected the fact that republican, regional and local (self-)government bodies owned public enterprises. In fact, there was a clear distinction between “state” and “public” enterprises. The former were formally owned by the state, whilst the latter were not only owned by the state, but also provided a public service.

In the classical blueprint communist/socialist model, local input was minimal, if existing at all. However, the early reform (in the 1960s and 1970s) that was initiated, together with the transition process, has changed this in a number of countries. Currently, in Eastern Europe only one country – Belarus – has preserved, to a large extent, a highly centralised model of government, where it seems the trends are reversed and centralisation is taking place, rather than decentralisation.

The financial model applied in the highly centralised states, was consistent with the high level of centralisation. The main source of revenue for the government was taxes. The number of taxes was large and often taxes were paid several
times on the same items. At the same time, in a failing economic system, where allocation of resources was a systemic failure, it is very difficult to talk about an efficient tax system. State-owned enterprises (SOEs) were allocated resources following the central plan and if necessary, additional resources were provided in order for an SOE to meet a physical production plan as set by the central planners. The main concern was motion and effort, rather than the outputs and final results. Under a ‘soft budget constraint’ it is impossible to make an enterprise successful and consequently, a significant contributor to fiscal revenues.

The failing enterprises were, in fact, beneficiaries of the budget, as large subsidies were paid to them either directly by the budget or via the central bank (in fact, the state bank) in the form of a production credit line (see: Šević, 1999). In a centrally planned economy and highly centralised state there was no culture of charging for government services and if any charging was done (in the case of local transport, for instance), the charge (price) was set well below the marginal or average cost and the service was openly subsidised by the government. Therefore, the contribution paid by the user was more of a symbolic nature than a recovery of at least part of the production/provision costs. Only with decentralisation and changing the government’s philosophy and range of services provided by the government, did room open up for the introduction of user charging for the provision of public and/or quasi-public goods.

1.2 Public Provision of Goods and User Charges

User charges are theoretically delineated as “prices determined through political rather than market interactions” (Hyman, 1999, p.391). This generally implies that there is a possibility of having prices determined by the market, which directly insinuates that the state may delegate the provision of those particular goods and services to a private sector organisation. It is then that the market can ensure efficiency, assuming that the market players are rational enough to keep prices steady for their own comfortable position in the market. This, however, raises the question of public goods (“social goods”, “collective goods”), and why the government should be involved in the production and distribution of products that do not demonstrate the characteristics of public goods.

Public goods were defined by Samuelson (1954, p. 387) as those that “all enjoy in common in the sense that each individual’s consumption of such a good leads to no subtraction from any other individual’s consumption of that good”. Later, the difference between public and private goods was made, where private goods “can be parcelled out among different individuals” (Samuelson, 1954, p. 387). In the case of private goods, the aggregate consumption will be equal to the overall consumption exhibited by all members of the group/society, while in the case of public goods; the consumption is not affected by the number of people involved in their consumption.
Public goods are non-rival in their consumption; or in other words the consumption exhibited by one individual will not preclude the other individual from enjoying the benefits of the public good. Public goods also demonstrate the characteristics of non-excludability, which means that consumers cannot be excluded from the consumption benefit, or at least easily excluded, without bearing the burden of prohibitive costs. In the case of private goods, markets may operate in such a way that consumption of the goods may be contingent upon payment of a defined price for them. In the case of private goods, the economic agent will be denied consumption unless he can establish property rights over the good. Usually the property rights of one economic agent over the particular private good will preclude others from enjoying the benefits of the particular good, whilst in the case of public goods, it is usually technically or legally impossible to preclude others from enjoying the benefits of the particular good. If non-excludability cannot be provided, then the phenomenon of a “free-rider” appears.

An individual may try to enjoy the benefits at no cost, hoping that others will pick up the bill. But, if everyone is hoping to be a successful free-rider, then the free-riding phenomenon will not be a problem, as there will be no provision of the particular good. As long as one group is prepared to bear the costs of provision, the free-riders can attempt to enjoy the benefits, hoping that they will not be discovered and forced to bear the costs of provision. In other words, if everyone tries to be a free-rider, then nothing will, in fact be provided and a free-ride will become literally impossible. If the defence is used as an example of a “pure public good”, then the concept of public good holds relatively well (see in Sandler, 1977 why even defence may not be a ‘perfect’ public good). But, if other services are used as an example, even those that can be viewed as similar to national defence, such as public security/safety, the problems with the concept of public goods emerge. Margolis (1955) argues that the concept of a public good is not so obvious in the “real world”.

For instance, the provision of lighthouse services, which was originally used by Samuelson (1954) as an example of a public good, appeared, according to other research, to be in fact provided (in the U.S.) by private companies (see: Coase, 1974; Peacock, 1979). Samuelson himself concurred with this and in 1969 delineated between “pure public goods” and “pure private goods” (see: Samuelson, 1969). Between the two extremes there will be a range of impure (public) goods that can be observed (and experienced), but there may be a problem to establish a taxonomy of such goods. With the moving boundaries of the public sector and the attempts to make cheaper governments, one may even question to what extent those taxonomies may remain valid (see: Šević, 2004). In order to solve this problem, one may focus on the characteristics of the very public goods i.e. on their characteristics of non-rivalry in consumption and non-excludability (see: Head, 1962; Peston, 1972).
The goods can fall into two categories – rival/non-rival consumption and excludable/non-excludable consumption. However, there are four possible classifications and the public good has to be non-excludable and non-rival in its consumption. However, common experience tells us that often one good can be classified differently if some marginal assumptions/conditions are changed. Buchanan (1965) dealt in an interesting manner with non-rival, but excludable goods, developing the theory of clubs. Namely, his clubs can limit membership (controlling the access and therefore exclude potential users), but there is no rivalry in the consumption, as long as the club remains below its maximum capacity membership. It is also possible to analyze each of the services and see to what extent they satisfy the ‘public good’ criteria. There is a particular problem with externalities, where one individual consumes a private good where there are public good externalities, or where the consumption of a public good has, in fact, a positive effect on both the individual and society (for instance, education, although the case of non-compulsory education may be a peculiar one).

Equally, the mode of finance can be a method for distinguishing between whether a good is in fact ‘public’ or ‘private’ (see: Weisbrod, 1988). The more public a certain good is, the less finance will come from the market realization of the good provided (sales), as it will be difficult to establish a clear property-rights link between the company (supplier) and the good itself. Organizations that provide “pure public goods” may, in fact, rely more on subsidies, transfers, gifts, donations and other forms of finance that come from the core public sector (the government/state) or operating non-profit organizations and charities. The provision of finance from “alternative” sources may, in fact, lead to a position where the organization may supply the “private good” at a subsidised price and then the delineation may become even more blurred. However, again this generally works in a world where individuals are law-abiding citizens who do not shirk or free-ride. Some empirical research shows that the vast majority of citizens are, in fact, risk-averse to free-riding, although this may be a very culturally biased conclusion (see: Marwell and Ames, 1981). To a large extent, citizens in developed countries are more likely to respect law and order and regard it as the very base of social cohesion, necessary for any successful society, whilst individuals in developing and transitional economies are more likely to have a negative attitude to the public sphere and the state in general, believing that the state is a classical Leviathan and that it is somehow their (natural) right to defraud it whenever the opportunity arises.

Again, free-riding can be a rationale for the very existence of the state (see: Schmidtz, 1991). The fact that individuals are better off if they choose to be coerced into paying taxes is an important conclusion for those who would permit an active role for the government. Public choice scholars, however, believe that this argument has been overplayed and that there is a rationale for limiting
government intervention. Namely, if individuals can create mechanisms that will provide public good, then what would be the purpose of the state (the government in Anglo-American political terminology)? If individuals see the need to have an external coercive force created, then the central issue will be how to limit (coercive) government. In fact, charging for impure public goods might be a solution to the free-rider problem but, then, some other issues arise.

Public goods can be publicly provided, or the provision can be ‘contracted out’ to other non-public providers. Private finance, through user charges, links directly to the discussion of the benefit principle, since the user will pay for the benefits that he or she enjoys, regardless of who the provider is. Where a good is excludable and rival, generating no Pareto-relevant marginal externalities, and the distribution of income is deemed fair, then such an approach is the one to follow, almost without exception. Public finance will be more significant where a good is non-rival and/or offering significant externalities, and where there is a case for redistributive action on behalf of the government. The engagement of public finance is related not only to the benefit principle, but also to the ability to pay principle. Most tax systems are based on the latter, largely independent of any consumption benefit from the goods and services provided. Public finance addresses, as a rule, the issues of equity and shared responsibility, rather than the issues of allocative efficiency per se.

Of course, modern governments in their continuous search for “efficiency gains” try to re-emphasise the issue of allocative efficiency in the public sector, but not necessarily in their own tax system. It would appear that many western public sector reform-prone governments (Australia, New Zealand, the U.K. and the USA etc.) have failed to capitalise on their tax cuts and attempts to create more efficient tax systems. Private production may be deemed ideal as both X and allocative efficiency will be generated by a profit-maximisation goal. This is the general belief, although with the introduction of social responsibility concepts in the corporate world, the story may have somewhat changed since the 1990s and especially during this century. In other words, as long as the price signal is correctly read, concern will be directed towards the external environment of a firm and a highly competitive firm will define its strategy to correspond to the perceived changing conditions in its immediate and wider business environment. However, the issue that remains is whether we can head towards a market failure situation if the market is the only regulatory force. A company may follow too closely the market’s signals and opt out of an industry where profits are falling and attempt to enter into new products and markets etc. This may lead to a situation whereby the provision of socially-desired goods may fall short. So, is there a case for a public provision of those goods?

The historical response was generally two-fold. In continental European countries the traditional response has been to organise public enterprises to
provide those goods and services, thereby ensuring that market failure, as such, would not happen. In Anglo-American countries the preferred response to this challenge has traditionally been the fairly robust regulation of private providers. Both approaches have their merits and their shortcomings. Regulation, at least in the leading country, the U.S., has been swinging back and forth between over-regulation to deregulation. At present, for instance, there is a wide attempt to stringently regulate the accounting/auditing profession and procedures as a robust response to company failures in the last few years (2001-2003). On the other hand, the failing continental European welfare state requests a serious look at public enterprises and the manner in which they operate and charge for their services etc. Certainly, public enterprises in the vast majority of continental European countries were used to bolster employment records during the run-up to general elections and these companies were, as a rule, labour-intensive, over-staffed, inefficient and difficult to manage because political preferences often influenced the internal decision-making processes.

Theory states that moral hazard (see: Baumol, 1984), transaction costs (see: Arrow, 1971), co-ordination and countervailing power (see: Culyer, 1983) and sunk capital costs and market contestability (see: Rashid, 1988) may be the reasons for supporting the case of public provision of goods. Psychological peace might be another reason why the public sector may be involved in the provision of goods. Namely, cognitive dissonance suggests that individuals need to feel that their words and actions are consistent or make sense, so that something has to change when the beliefs individuals hold and their actual behaviour are in contradiction (see: Akerlof and Dickens, 1982; see also Tullock, 1971). However, on the reverse side, one may find arguments against public production. These arguments might be, for instance, the inefficiency triggered by administrative intervention, regulation (or rather over-regulation) and subsidies. Administrative intervention per se may increase transaction costs and therefore trigger further inefficiencies. Regulation may prove counterproductive, especially if there is a rate-of-return regulation in place. Averch and Johnson (1962) demonstrated how this regulatory attempt may lead to too much capital being used in the production of a given level of output. Similarly, Peacock (1980) demonstrated how subsidies can, in fact, teach producers that inefficiency pays off, if subsidies are readily available. The theory of public goods has been further modified by discovering new forms of services with a mixed character. As Savas (1987; see also: 1993; 2000) has proved through various examples, non-rival consumption of public services can be made excludable for a certain group of customers (see toll roads) and rivalry rises in the case of some public goods, which are in shortage. Therefore, not only the free rider problem is behind the introduction of user charges, but the general transformation of public service provision has also raised the incentives for charging.
This is why economic incentives, impact on productivity and pricing methods are the real issues of user charges. It has become a trend and fashion that everything that can be moved out of the public sector should be privatised and de-publicised. The privatisation waves have been, to a large extent, felt in all countries. This is particularly true for the developing and transitional economies where international (financial) organisations prophesy privatisation as the main measure that will support structural changes, make public finance healthier (although one-off sales of family silver has not been proven a very wise move, at least in a historical perspective) and finally make the customers/end users better-off in the long run. However, experience with privatisation in the developed countries that downsized their public sectors in the 1980s and early 1990s proves that the problems are recurring. Experience in some developed countries has demonstrated that private operators could not maintain the infrastructure and the government (the public purse) is again required to finance redevelopment and maintenance of the infrastructure.

This has clearly been the case in the U.K., but it seems that it will be a shared experience of many other developed countries which have been at the forefront of the New Public Management (NPM) reform agenda (see: Šević, 2004). Privatisation emerges from the recommendations of those who are not only critical of big government, but are also inherently worried about possible government failure. So, can a solution to that be to charge for the services? One possible solution is to promote Public Private Partnership (PPP) as they, like some concession agreements, stipulate that maintenance is included in the main duties of the contractual party running the service. It seems to us that the problems have emerged only in the case of services that require large infrastructure to be run (railways, transport of varying kinds etc.).

1.3 Social Context of User Charges

The political science and public administration theories have always been intrigued by the nature of the state (the government in the Anglo-American political parlance, as we have already pointed out) and what may be the basis for the government. Marxian literature claimed that the state is a form of oppression of the ruling class over other classes, whilst the liberal democratic model claimed that the state (government) is based on a form of social contract where people voluntarily delegate some of their genuine powers to their representatives. To a large extent, the latter explanation has been widely endorsed in democratic countries and created a foundation of Western democracies. However, with the rise in a managerial state, quangos and the relative role of non-elected political advisers in the policy formulation process, it may merit a re-examination of the very foundations of today’s democracies of a Western provenance.

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1 The editor is very grateful to Dr Gábor Péteri (LGI Development) for pointing out this aspect of user charging within the context of the modern theory of public goods.
User fees are a form of charging for the provision of services by the government. It is usually perceived as a situation where the user of a particular government service is required to give up some amount of money as a direct consequence of the use of that service. Whilst taxes are charged generally and the amount paid by the individual taxpayer cannot be (easily) traced to a particular service (but rather is seen as a contribution to the pool), the user charges are seen as an exchange of money for a service rendered. The debate on user charges usually goes back to the issue of whether it is possible to determine the price to be charged and whether full economic costing is to be observed. Theory generally suggests that marginal, or sometimes average pricing, should be applied (see: Šević, 1997). The pricing mechanism used for determining user charges is derived from the pricing models for monopolies, especially those that have already attracted the attention of the regulators.

User charges are now used in many situations in which it is more or less possible to determine the benefit to the user. The services are provided by the government or quasi-government agencies. For instance, no-one complains today when asked to pay for a passport, driving licence or any other official document that commands a duty to be paid. Similarly, people do not object to paying for tickets to various public events etc. However, introducing user charges often requires a change in culture and public perception as to what is to be provided by the government at no cost. For instance, in the Australian state of South Australia, there was a public outcry when the state government attempted to charge a modest (or rather symbolic) parking fee in the public recreational parks. After a boycott by the citizens, the state government finally was forced to withdraw its proposal and to cease charging parking fees in national parks and recreational areas managed by the state government and its agencies. Quite simply the South Australian public believed that free public parking space is a public good that has to be provided to all, without additional charge and that the development of public parking should be financed from the general public coffers. This brings us to the usual problem with user charges versus general taxation. When comparisons are provided, one usually assumes the same level of revenue and fiscal burden for both taxes and user charges. Often this is not the case and while the beneficiary pays for the service received through the fee charged, when the general taxation is applied, not every tax-payer will benefit from the service.

Therefore, before attempting to introduce user charges, the government has to examine public opinion and see that the public shares the enthusiasm for charging for services, and that those services are not perceived as something that is generally to be provided anyway by the government, without additional earmarked financing. Often, the government may try to charge a symbolic fee, simply to examine public opinion and see what may be the elasticity of demand for a particular service. However, often the major issue to be considered is what
the nature of the service is and who should be providing the service. If service in its essence is a quasi-public service, then the charging will be easier, with a view that in the end, the provision can be transferred to the private sector, but under a well-defined regulatory regime.

### 1.4 Practicalities of User Charging

User charges are often placed in the same group as earmarked taxes, although there may be some differences. Whilst user charges have been defined as prices defined politically, earmarked taxes are special taxes designed and introduced to finance particular government expenditures. In both cases, it is possible to trace the finance to a particular service, but the method of collection and the logic of disbursement may be somewhat different. User charges are usually paid by the end-user for a particular service received and whilst the earmarked taxes are paid as general taxes, the tax-payer knows that some benefits may come his way. For instance, a charge can be paid for a particular service received from the Coast Guard, whilst the financing of the Coast Guard may be via the special tax paid by everyone living in the coastal area, regardless of whether or not they have a boat or how often they use the boat (professional or leisure use). In the former, the end-user who benefited from the service paid for it, whilst in the latter case, those who are obliged to pay may expect some service (or something) in return, but there is no link between the payment and the service/good received.

Hyman (1999) believes that user charges and earmarked taxes are very similar and offers an example of the levy on the consumption of gasoline in the U.S. However, the earmarked taxes do not have the same rationing function as user charges (high charge may deter someone from over-using the service) but they still may be attractive to the government since the tax-payers (voters) may be able to link the payment of an earmarked tax to a particular benefit, more easily than a benefit from paying general taxes finishing in one tax coffer. In a large number of cases, user charges are fixed at a level less than the average price of offering the service, so that the end-user is subsidised from the general tax pot, as tax revenues will be used to cover the difference between the average cost and charged sum. The charging for services can be extended, not only on classical infrastructure services, but also to the services rendered by the government. For instance, some administrative fees may be imposed when the government department is required to register something or approve some action.

The usual criticism of the user charges is that they act discriminatorily towards those who cannot afford to pay. So, the ability to pay principle may play a role here. But, then again, if the services are provided free of charge, subsidies will be paid not only to those who cannot afford, but also to those who are far better off and could contribute to the cost of the service. There is always an option to give discounts on user fees to those who can demonstrate the need and who are
known to be unable to afford to pay for a particular service that is perceived to be essential. Also, the government (or, in fact, local government) can target particular groups and support their needs more readily (elderly people, children, youths, etc.). As price discrimination can be applied by a private company, equally user fee discrimination can be implemented by government departments. If well-designed, the user charges can support the more efficient behaviour of both providers and end-users. Providers will have to ensure that charges are collected and that they cover the whole or part of the provision costs, while the end-users will be rational economic agents, in the sense that they will rationally use the services as they have to pay for them (based on the volume used).

As we have already pointed out, the problem that emerges is really how to charge when there is mixed private benefit (that can be defined) and the public benefit that is somewhat difficult to quantify, but it clearly exists. Usually, education and culture etc. are examples of mixed private benefits and positive externalities. Use of the user charges can also ensure that there is efficient behaviour if there is congestion and the danger of failure in the provision of the government service. For instance, if the public roads are congested, then the marginal costs of accommodating additional users fall to zero after the first user enters the road, but eventually becomes positive, as there is no purpose achieved (people are late for work resulting in lost labour hours). Therefore, imposing a congestion charge may not be welcomed by the drivers, but in a sense it can restore equilibrium behaviour and ensure that public roads are in public use.

The user charges are set externally and usually demonstrate the classical problems associated with monopolies. The government department (or public enterprises) are usually exclusive suppliers (providers) and it gives them far more power than would be the case if the competitive (contestable) market were in operation. However, due to the fact that in a number of cases the user charges are set below the real cost, the providers usually heavily rely on subsidy transfers from the budget rather than looking for ways to improve the effectiveness and efficiency, and address the often forgotten issue of productivity. So, even if the government decides to set the charge equal to marginal cost, the marginal cost of the public provision may, in fact, be higher than the marginal cost that would be experienced by a private company in the same situation and offering the same service. Nevertheless, it is common knowledge that the government should attempt to charge for their services at marginal cost level, although often, average or around average cost pricing has been in place. We have dealt with these issues in more depth elsewhere (see: Šević, 1997).

Usually, it is of the utmost importance to “buy-in” the end users, so that charging for public services is perceived as something necessary and, in fact, desirable. Often, the first step is to determine the public services that can be easily earmarked as those that an end-user has the direct benefit from and create a
political climate of contributing to the cost of the service. For instance, in almost every country around the world, governments charge for issuing passports, driving licences, identity cards, marriage certificates etc. The ultimate user does not have a problem paying for these services, as he or she will enjoy the direct benefit. The passport will be used to travel overseas on vacation and the driving licence will be used when driving a car.

Usually, no individual objects paying for these services. The usual evasion cases are associated with general taxation and it is often believed that an individual does avoid paying taxes, as he/she cannot see the immediate link between his/her contributions and the benefits enjoyed. The social solidarity principle may be appealing theoretically, but it is somewhat difficult to put into practice. User charges may have deterring effects on some parts of the population, but as we have exhibited above, it is necessary to ensure that there is user-charging discrimination in place to ensure that the poorest users are “protected”. To a large extent, this is especially important in the case of user charges for health services (see: Sepehri and Chernomas, 2001; Audibert and Mathonnat, 2000: Barber, Bonnet and Bekedam, 2004).

1.5 Conclusions

User charges have been very popular in Canada and the U.S., as their participation in especially sub-national budgets is increasing steadily (see: Anderson, 1991). Politicians are very supportive of this kind of charge, as it allows them to keep their pre-election pledges and, at the same time, secure additional revenues for present-day chronically deficit-budgets. Also, it seems that the end-users (voters) prefer these types of levies as they can somehow link the expense with the benefit received. Benefits from general taxation are usually remote and difficult to define, so voters have a negative regard for them. As Anderson (1991) reported, in 1988, some 66 per cent of CEOs in the U.S. preferred to have user charges/earmarked taxes imposed, rather than having an increase in general taxes. Initially, in the 1980s, the support for user charges may have been an ideological issue, as conservatives (neo-conservatives) were in favour of them, while today all political players, regardless of their political/ideological provenance are supportive of charging for publicly provided services.

However, one may find moves in other directions. For instance, the U.K. government decided in 2002 to abandon entrance fees for a number of major museums in the UK. Similar moves were undertaken by the Australian Commonwealth Government and some state governments in Australia. Some Australian state governments, notably the Government of South Australia, experienced a significant public outcry when trying to introduce symbolic parking charges for organised parking fields on the territory of the national parks and reserves. Namely, the public perceived free parking as one of their entitlements and could not see why the parking fees had to be charged “when there is so much abundant space”. So, the introduction of user fees and charges does not just have to comply with economic rationale, but
also to appeal to the generally accepted notion of the population. If something is seen as a normal entitlement, then it will be a politically risky undertaking to try to charge for those goods and services. Despite this unique backing down by the government, the overall trend internationally is to increase the charges for the provision of goods and services by the government and quasi-government departments.

User charges and fees have traditionally been more widely represented on the North-American continent than in Europe – both continental and in the British Isles. In continental Europe, notably The Netherlands, earmarked local taxes have been used to finance public and quasi-public services, which traditionally were to be provided by the local governments and it seems that this has been working relatively well (see Boorsma in this volume). User charging as a form of raising local (or even central) government revenue has been a novelty to the countries of Central and Eastern Europe. The decentralisation attempts, very strongly supported by the World Bank, led to new methods of financing newly granted authorities and traditional duties of local governments (see: Bird, Ebel and Wallich, 1995a; 1995b; Bird and Wallich, 1993).

However, the review of experiences given in this chapter clearly shows that there is still a long way to go before charging user fees gains the full citizenship rights in the European transitional economies (although many of them are now in a fairly advanced stage of transition) and currently represent more than 3 to 5 per cent of total fiscal revenues collected nationally. This will undoubtedly increase in the years to come, especially as there is strong international pressure to release the government budgets from unnecessary burdens and to shift as many direct costs to the end users as possible. Certainly, the governments over time will charge far more for their services than is the case today and many of those services that are now publicly perceived as inherent rights, will become those services that will be a significant source of revenue for the governments providing them. For instance, reclassification of some medical services from acute to chronic, may command a completely different charging model, or similarly reclassification of one medical service from primary to secondary health care may also be a justification for the levying of fees or flexible patient contributions to the costs of the service provided. In our view, the strengthening of NPM ideological predominance in transitional and developing countries (strangely, almost in parallel with constant criticism of NPM in developing countries – see: Šević, 2004), will certainly be marked with a strong push for charging for as many public or quasi-public services as possible. In fact, it seems that the expression “Charge whenever you can, and as much as you can” (see: Šević, 1997), will come fully into being when the budget planners and public sector strategists sit together to discuss new discourses in filling the public coffers in the years to come.
1.6 Organisation of the book

The book is organised into 11 chapters that explore the experiences with user charging, not only in central and eastern European countries (CEECs), but also in some Western countries. The work begins with an introductory chapter that sets the stage for the whole volume, followed by the second chapter, by Professor Amboński Ryerson University) that focuses on the Canadian experience with user charges and literally a replacement of local taxes with local charges (although this strong statement can be fiercely argued). A completely different experience is presented in chapter 3 by Professor Boorsma (University of Twente), as he focuses on the Dutch experience with local taxation and almost total neglect of user charging practices. To a large extent, the chapter is devoted to the Dutch experience and should be read as such. Many of the statements put forward are to be understood only in the Dutch context and not generalised. Professor Bryson (Brigham Young University) looks at the Czech and Slovak experience with user charges and fees. This is followed by a chapter on Poland by Professor Bury. This is the result of long-standing research by the author on non-tax revenue sources in the Polish context. Chapter 6, by Dr Chandler, (SSE in Riga) examines the Lithuanian experience with user charging. It is data-rich, although to a large extent, the collected data neither supports nor rejects many of the claims made in the paper. The Estonian experience is thoroughly examined by Dr Kritz (University of Nebraska) and his Estonian associates. The example of Ukraine is presented by Dr Slukhai and Dr Subbotovich (Taras Shevchenko National University – Kyiv), but the focus veers more towards general tax issues rather than looking carefully at the implications of user charging within the Ukrainian context.

This is followed by the chapter on Belarus by Pliskevich (Belarus Academy of Sciences and International Institute of Labour and Social Relations) which focuses on the overall analysis of the fiscal system, as it is clear that within the Belarus context, there is very little space for user charging, due to the high level of centralisation of the country. Chapter 10 by Dr. Sedmihradská focuses on the Czech experience and certainly gives a somewhat different outlook, compared to that of Professor Bryson. The volume concludes with a chapter again analysing the situation in Ukraine, in a broader context, by Dr. Fritz.

All the contributors in this volume followed the same research protocol, but certainly the format and style used in the respective chapters differ. Therefore, most of the conclusions should not be generalised too much and should be accepted with the premise that they may be primarily true for the countries for which the respective country studies have been produced. We have tried to provide a more common framework in the introductory chapter. To what extent we succeeded in that can be judged by our readers.
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2. Applications of Municipal User Charges in Canada: Experience and Implications for Other Jurisdictions

David Amborski

2.1 Introduction and Context

In the context of Canadian municipal public finance, user charges have, for a long time, been an important source of revenue. It is useful to provide a brief introduction to the context of local governments in Canada and the fashion in which local governments are financed. Understanding the financing of local government is important in terms of policy implementation, because in order for local governments to implement policies, programs and projects, they must make budgetary allocations in their budget process and in turn they must have appropriate revenue sources available in order to make the necessary allocations.

In addition to Canada’s central government, the country is divided into 10 separate Provinces. This division is important as first the British North America Act and later the Canadian Constitution reaffirmed that the responsibility for the creation and regulation of local governments is a provincial government responsibility. Consequently, each province has its enabling legislation in the form of a municipal or local government act as a central piece of legislation that is used in conjunction with other more specific types of legislation. As an illustration later in the paper references will be made to the Province of Ontario and its latest Municipal Act. Ontario is the Province with the largest population in which approximately one-third of Canada – approximately thirty million people – reside. It is also the Province in which the City of Toronto and the Greater Toronto Area, GTA, is located. The population of Toronto is approximately 2.3 million people, while the Greater Toronto Area has a population of approximately 4 million people.

There is some similarity in terms of the general approach to regulating local governments in Provincial legislation. The similarity also exists for the municipal revenue sources for municipalities in all of the Provinces across Canada. There are three generally accepted classifications that represent the sources of revenue for municipalities across the country. These categories include the property tax, transfers or grants from senior levels of government and what are referred to as “other revenues”. “Own source revenue” is considered to be the property tax and other revenues, as these are revenue sources over which the local governments have some jurisdiction, at least regarding the quantum that they wish to charge or collect. In 2000, 82.3 per cent of municipal revenue was “own source”, with

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1 F. Hoehn, Municipalities and Canadian Law: Defining the Authority of Local Governments, Purich, Sasakatoon, 1996.
53.3 per cent coming from the property tax and 21.3 per cent from user charges. It is also important to note that almost all of the revenue obtained from grants or transfers comes from Provincial governments, as in addition to the Provinces creating legislation, they are also responsible for providing transfer payments. In 2000, grant revue comprised 17.9 per cent of municipal government revenue of which 0.7 was from the Federal government. Some Federal government money flows to municipalities through federal provincial cost sharing agreements.\(^2\)

The major revenue source for most jurisdictions across Canada, including the Province of Ontario is the property tax (53.3 per cent in 2000). The application of the property tax has a long tradition in Canadian provinces. It is based again on legislation that is specific to each province. In general, however, it is structured such that a tax rate is applied annually to an assessment base that is calculated as the sum of the individual assessments of all properties in the jurisdiction. Assessment is either undertaken by the provincial government, or by an agency or local governments in accordance with provincially determined norms and regulations. Each local jurisdiction, i.e. elected council, however, would set the tax rate annually as part of its budget process.

Table 1
Percentage Distribution of Municipal Government Revenues, Selected Years, 1947 to 2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Property taxes</th>
<th>User fees</th>
<th>Other own-source revenues</th>
<th>Total own-source revenues</th>
<th>Provincial and federal transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947</td>
<td>51.5</td>
<td>-</td>
<td>-</td>
<td>82.8</td>
<td>71.2</td>
</tr>
<tr>
<td>1955</td>
<td>53.4</td>
<td>-</td>
<td>-</td>
<td>77.1</td>
<td>22.9</td>
</tr>
<tr>
<td>1965</td>
<td>49.4</td>
<td>6.5</td>
<td>5.4</td>
<td>61.3</td>
<td>38.7</td>
</tr>
<tr>
<td>1970</td>
<td>43.8</td>
<td>6.3</td>
<td>5.0</td>
<td>55.1</td>
<td>44.9</td>
</tr>
<tr>
<td>1975</td>
<td>36.7</td>
<td>6.9</td>
<td>5.4</td>
<td>49.0</td>
<td>51.0</td>
</tr>
<tr>
<td>1980</td>
<td>35.3</td>
<td>12.2</td>
<td>4.1</td>
<td>51.6</td>
<td>55.2</td>
</tr>
<tr>
<td>1985</td>
<td>35.3</td>
<td>10.8</td>
<td>5.8</td>
<td>51.9</td>
<td>48.1</td>
</tr>
<tr>
<td>1990</td>
<td>36.9</td>
<td>12.0</td>
<td>5.4</td>
<td>54.3</td>
<td>45.7</td>
</tr>
<tr>
<td>1994</td>
<td>48.5</td>
<td>18.8</td>
<td>7.3</td>
<td>74.6</td>
<td>25.4</td>
</tr>
<tr>
<td>2000</td>
<td>53.3</td>
<td>21.3</td>
<td>7.5</td>
<td>82.1</td>
<td>17.9</td>
</tr>
</tbody>
</table>

Note: Separate figures for user fees and other owner-source revenues are not available for 1947 and 1955.


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\(^2\) An example of this is the Federal-Provincial Infrastructure Grant where approved capital projects are funded 1/3 each by Federal, Provincial, and Local governments.
However, as municipalities do not like to continually raise property taxes especially during election years, increasing use has been made of user charges as an own source revenue. Table 1 shows how this revenue source been increasingly used by Canadian municipalities over the last forty years.

It is important to understand the policy context within which local governments and, particularly Ontario, have been operating over the past fifteen to twenty years. To understand this context, it is important to understand the large public finance picture in Canada. In the late 1980s the Federal government became very concerned with the very large National debt whereby approximately 1/3 of revenue collected was required to pay the interest on the national debt. In an effort to move towards balanced budgets and reducing the impact of debt, the Federal government moved towards reducing the transfer payments that it gave to the provinces. The provinces in turn, many of which also had significant accumulated debt and annual budget deficits, were now faced with declining transfers from the Federal Government. Their response in many cases was to reduce the transfers that they in turn gave to municipalities. This led to municipalities having to make up the revenue reduction to maintain the range and quality of services via “own source revenues”. Consequently, municipalities had pressures to increase property taxes, and/or increase the quantum and range of user charges. There was a tendency and, in many cases need, to undertake both changes.

In the Province in Ontario, the response of the Provincial government was to undertake a number of policy changes in 1998. The most significant change in this context was called ‘Local Services Realignment”. This policy essentially eliminated transfers to municipalities, as we knew them, in Ontario. In addition to eliminating the transfers, it also altered which level of government was financially responsible for the services that citizens received. It essentially redefined which level of government would be responsible for each service. The outcome is often referred to as downloading financial responsibility for a broader range of services on local governments in Ontario. In order to minimise the impact of this reform on the property tax rates imposed on municipalities, the Province decided to provide funding for 50 per cent of the residential component of education taxes. This provided “tax room” for municipalities to increase their component of the property tax without increasing the overall property tax burden of property owners.\(^3\)

The general and Ontario context is important to understand as it leads to a motivation for increasing the use of user charges by Canadian/Ontario municipalities. As they need to increase revenue from “own source revenues”, elected officials do not like increasing property taxes, especially during election years.

\(^3\) In the Ontario property tax system both local governments and School Boards determine tax rates that are applied to assessed values of properties to finance the services that they provide. The local municipality will collect all of the property tax and then distribute it to the appropriate public bodies.
Consequently, applying new or increased user fees are an alternative that may have less of a political impact than increasing property taxes.

In order to better understand the application of user charges, the next section of the paper will discuss the rationale and theory by which user charges may be applied. Comments will also be made on the impacts and potential limitations of applying user charges. The following section will describe the application of user charges in Canada and more specifically, in Ontario, as the Province in its recent new Municipal Act has created new regulations for the application of these charges. Finally, conclusions will be drawn about the Canadian/Ontario applications in the context of how user charges may by applied in the Central and Eastern European context.

2.2 Theory and Applying User Charges

With regard to economic principles, there are two approaches upon which taxes are charged or revenues are raised: the “ability to pay principle”, and the “benefit principle”. With the ability to pay principle, those who have greater ability or economic means should make greater contributions. Applying the benefit principle means that people should pay or contribute for a good or service, in accordance with the benefits that they receive. It is the latter of these two principals, the benefit principle, which is the basis upon which user charges are applied. This application in itself provides insight into the type of services for which the application of user charges may be appropriate. It is those government provided goods or services where the beneficiary can be identified and consequently charged. Where a good or service has “public good” characteristics, user charges may not be appropriate.

There are some generally accepted reasons for the application of user charges. First and foremost is that they promote economic efficiency in terms of the use of the good or service and allocation of public sector resources. This is important in local government as of the three economic functions of government, the efficient allocation of resources is the function that is central to local government. A second benefit is that it rations the use of the good or service. Rationing may take place by price or congestion. However, where price signals exist, it provides insight into the providing government regarding how much of the good or service to provide for its residents. Local government decision makers, in providing goods and services, have the annual problem when setting the budget of determining how much of a specific good or service to provide. The use of fees to replicate prices and the associated

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4 The theory and applications are discussed in detail in a number of sources. For example, see H. Kitchen, Municipal Revenue and Expenditure Issues in Canada, Canadian Tax Foundation, Toronto, 2002; and D. N. Dewees, “Pricing Municipal Services; The Economics of User Fees”, in the Canadian Tax Journal, Vol 50, No. 2. 2002.

5 The three economic functions of government are the efficient allocation of resources, the redistribution of income, and stabilization policy, i.e. prices, inflation, employment and economic growth.
demand provide some insight for the decision-makers at budget time regarding how much of a service to provide. This will help to promote the efficient allocation of resources. Finally, user charges generate revenue for the municipality. This is important, simply in terms of providing revenue to fund all or part of the provision of the service. In addition, the injections of this revenue may provide the government with the opportunity to either provide a higher level of service than what would be provided in the absence of the charge, or a broader range of services for its residents. This leads to an enhancement in the quality and/or quality of services for residents. An example of this in the North American context is the use of user fees for recreation services or programs. When some revenue is generated from these programs, a municipality will then have the ability to provide a broader range of programs and services to its residents.

Once the decision is made to apply a user charge for a service because the beneficiaries of the service are definable, there is also the need to make a decision on how to calculate the charge or fee. If we wish to revert to the economic efficiency argument of economic theory, the argument would be made that the charge should be based on the marginal cost of providing the good or service, where the cost includes both the operating and capital costs of providing the good or service. This ideal raises several questions with respect to determining the user charge. First, if it is possible, the charge should reflect the marginal cost. In theory this is an excellent ideal. However, in practice it is very difficult to determine true marginal costs for a variety of reasons. Consequently, the fallback position is to base the charge on a determination of average cost. This approach is easier to undertake from a practical perspective.

In attempting to apply either marginal or average cost pricing to the user charge, a decision has to be made regarding which costs to include in the calculation – capital costs, operating costs, or both. Obviously to apply full cost pricing, both or all costs should be used in the calculation. However, there may be circumstances when only one of the two cost components is appropriate to be used in the calculation for the user fee. For example, there could be a situation where the capital costs for transit are provided by a grant from senior levels of government. If the objective of a user charge transit fee is cost recovery for the charging government unit, then the charge would only reflect the operating costs. On the other hand, when municipalities impose charges for growth related capital costs, the quantum of the charge would only be based on capital costs, with the operating costs being borne via property tax revenues. There are also examples such as those often applied for the provision of water in which both the operating and capital costs may be used to calculate the charge. There may be situations or policy decisions where there is a desire to determine charges, not only for the purpose of revenue generation, but also to meet some additional policy objective. This may lead to variations on the pricing applications. These pricing applications
include peak load pricing, geographic variations, differentiation by user and the inclusion of externalities in the pricing.

Peak load or time-related pricing refers to varying the price charges in a temporal fashion. The idea is to charge a higher price when there is peak demand for the specific service. In this way, the higher price will lead to a reduction in demand for the peak period and people will be enticed to use the service during non-peak periods. The benefit from this approach is that the infrastructure or capital needs for the service will not have to provide as much capacity as would be required without this pricing approach. Consequently, less expenditure is required for capital/infrastructure expenditures. Furthermore, better use of the capital/infrastructure is encouraged when it would otherwise be underutilised.

Another variation in user charge pricing for some services is to vary the charge by geographic location. This can be the result of applying one of the earlier identified pricing rules, or be the result of a policy decision to try and alter the user fee by geographic location. In the first instance where costs of providing a service vary by location, one might expect charges to vary by location. For example, providing sewer and water services to a remote location will result in a higher charge than providing the same services contiguous to existing development where services are already being provided. An alternative approach would be to apply different charges in various locations in such a way not to accurately reflect the cost of service provision, but to achieve some additional policy agenda. Higher charges could by applied to certain areas to discourage development of low charges which may be used to encourage growth and activity in certain areas.

It is also possible to alter the application of the charges based on the type of user for a specific type of service. For example, it may be desirable to set lower charges on some fees for certain groups of users. Some recreation programs or athletic rental fees may be set lower for certain groups, such as children or youths as compared to adults. Adults who are income earners may be expected to pay higher rental fees for ice time in areas to play hockey, compared to youth groups. This reflects the groups’ ability to pay, or recognition of the need to provide athletic facilities to youths and children. Other variations in the application for different groups could relate to different charges being set for senior citizens or adult groups. There could also be differential charges applied to different members by obtaining and understanding the need to alter the charges for various income levels.

Another variation would be not only to include the actual private costs, however they are defined, but also include any social or external costs that are also present in the need and/or delivery of the good or service. This is a more theoretical approach that takes into account the economic concept of externali-
An example of these costs not being taken into account is the case when there was the need to rationalise user fees when the New City of Toronto was created from seven local government units. The new city undertook a study to determine the appropriate user charges that previously were set differently in each of the seven jurisdictions. One of the results was that some of the recreation user charges increased or were now imposed for certain programs and facilities. In the old City of Toronto many of these programs were previously free. With the new charges in the old city, there was a noticeable increase in mischief problems with teenagers in the inner city (old City of Toronto area). Critiques of the new charges indicated that with teenagers unable or unwilling to pay the new fees to participate in the old program, they were now imposing increased policing costs as they wandered the streets in groups. The argument could be made from an economic perspective, not that the user charge should be eliminated, but rather that it was set incorrectly, i.e. too high, as it did not take into account the external costs i.e. increased policing, resulting from the new charge.

A useful typology to user charges has been suggested by Richard Bird that may be useful in helping policy makers to categorise user charges and then ultimately set the charges at appropriate levels for their specific jurisdiction. He identifies three types of user charges; service fees, public prices and a special benefit charge. They refer to payments made for licences, permits and permissions that are already required by law. Examples include building permit fees, vendor’s permits, as well as marriage and dog licences. These tend to have the charges set on a cost recovery basis, depending on the cost of providing and/or administering the service. The point is that for items that fall into this category, municipalities should ensure that the charge that is being collected covers the cost of providing the service.

Public prices, on the other hand, refer to revenue generated from goods or services provided by the public sector and local governments that may also be provided by the private sector. The “prices” should be set at a competitive level and not include any special tax or subsidy level in them unless it is necessary to promote efficiency. Examples of public prices include public utility charges, admission charges to recreation facilities and transport charges.

The final category is special benefit charges. These reflect charges that are compulsory payments to support local revenue, whereas the previous categories tended to be voluntary. These charges support specific benefits that tend to support specific residents, often by bestowing benefits on the properties owned or occupied by these residents. Examples include special assessments or improve-

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ment taxes, assessments for business improvement areas and items that relate to
developer actions such as development charges (impact fees in the US). Most of
these charges are imposed or related to property and are determined based on
assessment or some measure of property characteristics.

With the increasing application of user fees in Canadian municipalities, local
government decision makers should be gaining a greater understanding in terms
of their applications. It is also important for them to understand the impacts and
limitations of their applications. Although user fees rate high in terms of efficiency,
there are questions on user charges regarding their impact on equity considerations.
The most important equity impact of user charges is the fact that they are regressive
in nature and consequently place greater burdens on lower income individuals and
households. For some types of user charges there have been attempts to minimise
the regressive nature of user charges, especially for those applied to recreation facili-
ties and programs. This has been achieved via providing vouchers for low-income
households for programs by applying differential fees for various groups. An exam-
ple is lower fees for renting ice time for youth groups compared to adults. There is
also an example in the area of transit fares where lower fares are set for students and
senior citizens.

It is important to ensure that in designing user charge systems or programs,
policy makers take into account the type of user charge. They need to undertake
an analysis of the cost or pricing rule to be applied to the type of charge and an
analysis of the impacts of the charges.

2.3 Application in Canadian Municipalities

This section will provide some examples of the applications that have taken place
in Canadian municipalities. They are organised using the typology suggested by
Bird, referred to earlier in this paper. This typology is helpful to municipalities in
considering how to approach the application of user charges when designing their
pricing approaches.

2.3.1 Service Fees

In explaining the Canadian applications, the focus will be the Province of Ontario
as an illustration. As mentioned previously, it is the largest province in terms of
population and also has the largest urban area, the Greater Toronto Area. It has
approaches that represent the current state of Canadian practice in the area of user
charge applications. As was previously indicated and shown in Table 1, the use of
municipal user charges has been increasing. In the Ontario context, user charge ap-
lications have been supported in terms of clarifying the rules for their application
by the Province’s most recent Municipal Act. This replaces an Act that has not been
revised in a comprehensive fashion since its inception. Some examples may also
be provided for urban type service charge applications that are not directly under
the jurisdiction of local government in Ontario. These examples are interesting applications that provide some interesting lessons or potential applications for other jurisdictions.

If we first consider the type of user charge applications that Bird refers to as service fees, we can see that Canadian municipalities have a long history of applying these types of user charges. This is especially true for the activities of planning and urban development. In the Canadian land use and building system permits, various types of permission are required to make changes in land use in the planning system. Each province has legislation that enables municipalities to control land use through the use of official or master plans, changes in zoning bylaws and permission to sub-divide or create new lots upon which building may occur. After ensuring that the appropriate land use provisions are met, property owners must obtain a building permit in order to construct their desired building. All of these activities, changes in land use designations, creation of new building lots and obtaining building permits, require the applicant to pay a user charge.

It would appear by examining the results of a survey of municipal user charges in the late 1990’s, and the author’s experience in research and consulting with local governments in Ontario, that there was not a uniform or always rationally calculated approach to determining the planning user charges applied by Ontario municipalities. It would appear however, that the larger, more growth-oriented municipalities that have more activity in this area, have higher charges that may reflect a more careful calculation of charges relating to the cost of the service undertaken by the fee. However, the survey results show a wide variation for the responding municipalities. For example, fees for applying for amendments to the Official (Master) plan ranged from $250 to $4,470 (all values are in Canadian dollars) with the median being $1000; zoning by-law amendments ranged from $200 to $1,750 with the median being $800 and subdivision applications ranged from $100 to $5000 with the median being $1,000.

This demonstrates a wide variation and a lack, in many cases, of any widely applied pricing rule to guide the calculation of the charge. However, ideally the charge should reflect the cost of the work by the municipality in processing the application. Although no comparable survey exists for user charges after the imposition of the new Municipal Act, there is some indication that the municipalities, especially in high growth areas, have undertaken some calculations regarding the cost of undertaking these planning functions to guide the current setting of their charges.

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8 Changes to the zoning by-law may include not only change in land use, but changes in density, the building envelope or other items controlled by zoning such as required, parking, building setbacks, or landscaped open space requirements.

Another example is with regard to building permits. In this case the cost to the municipality is not only the issuance of the permit, but also the cost of the building inspectors actually inspecting the construction to ensure that it is being undertaken in accordance with the Ontario Building code and local land use requirements. These fees are typically calculated, based on the estimated value of the building construction. This presumably reflects the time and complexity of the inspection requirements. An illustration of these fees is also provided by the 1997 survey. It found that the fees for a 1,500 square foot residential unit would range from $72 to $1,470, with the median being $734. Once again, this variation demonstrates a wide range of possible ways in which municipalities determine their fees. Some may have had the same fee for many years and have just kept it the same; others sometimes check what neighbouring municipalities are charging, and some may actually attempt to calculate the time and consequently cost of undertaking inspections. This last approach and analysis should be undertaken.

In addition to these types of planning/building-related service charge fees, many additional examples could be given. There are other examples in the Building and Planning Departments, such as demolition permits and other types of zoning by-law fees and there are numerous examples in other departments of Ontario municipalities. These include items such as business licences, peddler’s licences, taxi licences, marriage licences, amusement licences, plumbing permits, burning permits, parking permits, etc.

### 2.3.2 Public Prices

Applications of user charges to reflect public prices in the Canadian and Ontario context are best illustrated by charges for utilities, recreation fees, transit and potentially road pricing. The first of these categories is utility pricing, which in the local government context will generally include water and hydroelectric power, and in some municipalities includes gas as a utility provided for heating buildings.

If we examine pricing for water services in Canadian municipalities, there is a wide range of pricing approaches that are applied. However, it is desirable for municipalities or authorities that supply this service to set water rates that reflect the costs of the service provided and charge in such a way to achieve or promote economic efficiency. The first step in this process is for municipalities to ensure that the price that they set per litre or gallon reflects the full cost of providing the service. This requires including both the operating and capital costs. It is necessary to undertake full life cycle including replacement costing for facilities. This has not always been historically undertaken in Ontario or Canadian municipalities. However, in Ontario, in response to a major problem with water quality that resulted in severe illness and death in the Town of Walkerton, Provincial legislation has been passed that requires municipalities to set rates that reflect the full cost – operating and capital – of providing the water to its users. The objective is to ensure that
enough revenue is generated to ensure water quality via testing, treatment and appropriate infrastructure.

Once the municipalities or authorities take the full cost into account, the question of how to charge the users still exists. The ideal is to apply marginal cost pricing.\(^\text{10}\) To apply this approach it is necessary to have the water metered at each unit so that each unit will pay for the water that it actually uses. In the absence of metering, municipalities have used proxies such as the number of bathrooms in the house/building or the size of structures. There are also variations in residential and commercial rates. Commercial rates across Canada use a broad range of pricing approaches including constant unit rates, declining block rates, increasing block rates, humpback block rates, seasonal rates, excess use rates and mixtures of the various approaches.\(^\text{11}\) Whether applying the more complex commercial rates, or more straightforward residential rates, it is important to have the water metered so that people will pay the costs of what they actually use. This will encourage people to conserve water and promote efficiency. Unfortunately, metering of water is not undertaken in all jurisdictions across Canada. It was reported in 2002 that residential units were metered in only 43 per cent of all Canadian municipalities and commercial users in only 58 per cent. Despite the fact that most of the lack of metering tended to be in municipalities with populations under 50,000 people, there were also some large cities including Toronto, Calgary and Vancouver that lacked metering in some districts.\(^\text{12}\)

There is substantial evidence from Canadian applications that installing meters leads to a reduction in water consumption. Table 2 below shows the results of a number of studies that support this outcome. The results in the table show a consistent pattern that over a more than twenty-five year period and for a range of municipalities of various sizes, metering the use of water has led to a reduction in the volume used.

Similar applications and analysis apply to other utilities such as hydro and natural gas. These may be supplied via municipalities or public authorities, which are often controlled by a government body. An interesting potential hydro efficiency application has been suggested by the Premier of Ontario. He is advocating the use smart hydrometers that will differentiate prices via peak and off-peak consumption. This application has the potential to lead to efficiency and a reduction in consumption.

\(^\text{10}\)This approach is advocated by economists for efficiency. For example see Donald N. Dewees, “Pricing Municipal Services: The Economics of User Fees”, in Canadian Tax Journal, 2002, vol. 50. No 2.


\(^\text{12}\)H. Kitchen op cit page 138
<table>
<thead>
<tr>
<th>Municipality</th>
<th>Impact and special details</th>
<th>Date of study</th>
</tr>
</thead>
<tbody>
<tr>
<td>Etobicoke, Ontario</td>
<td>Water use was 45 per cent higher in unmetered areas than in metered areas of comparable assessment.</td>
<td>1972</td>
</tr>
<tr>
<td>St. Catherines, Ontario</td>
<td>Consumption dropped by 11 per cent following metering but rebounded because prices were kept low. Two years later, water usage was higher than before metering.</td>
<td>1967</td>
</tr>
<tr>
<td>Alberta</td>
<td>10 to 25 per cent drop in water use following meter installation</td>
<td>1984</td>
</tr>
<tr>
<td>Peterborough, Ontario</td>
<td>10 per cent reduction in water use predicted following meter installation.</td>
<td>1984</td>
</tr>
<tr>
<td>Calgary, Alberta</td>
<td>Unmetered water use was 46 per cent greater than in metered residence.</td>
<td>1984</td>
</tr>
<tr>
<td>Calgary, Alberta</td>
<td>Unmetered water use was 65 per cent greater than in metered residence.</td>
<td>1978</td>
</tr>
<tr>
<td>Canada, selected municipalities</td>
<td>Residential water consumption was twice as high in unmetered communities as in metered communities.</td>
<td>1975</td>
</tr>
<tr>
<td>Port Elgin</td>
<td>25 per cent reduction in overall demand after metering.</td>
<td>1991</td>
</tr>
<tr>
<td>Small municipalities in Ontario</td>
<td>The impact of metering is evident in the 1996 water municipal use data compiled by Environment Canada. Average per capita water demands for metered and un-metered communities indicate that metering leads to a 22 per cent reduction in average daily water flow per capita and a 27 per cent reduction in maximum daily water flow per capita. An analysis of the residential water use component of total demand, using the same 1996 database, indicated that metering causes residential demand to fall by about 30 per cent in small and medium sized municipalities and by 20 per cent in large municipalities.</td>
<td>2000</td>
</tr>
</tbody>
</table>

**Source:** Taken from Roger McNeill and Donald Tate, Guidelines for Municipal Water Pricing, (Ottawa: Environment Canada, Inland Waters Directorate, Water Planning and Management Branch, June 1990), 16-17; Harry Kitchen, A Statistical Estimation of a Demand Function for Residential Water, Social Science Series no. 11 (Ottawa: Environment Canada, Inland Waters Directorate, 1975), for selected municipalities in Canada; and K. Sharratt, “Do Water Meters Improve Water Efficiency?” (December 2000) Ontario Pipeline, for small municipalities in Canada.

Recreation user fees have a long-standing application in Canadian municipalities. These fees or charges range from programs such as swimming lessons, tennis and skating lessons, summer camp programs as well as renting facilities such as hockey arenas, swimming pools and athletic facilities. As many of these have private sector competitors, the pricing and quality of service may have an impact on demand. For these activities there have been some attempts to set the charges both to address efficiency and equity issues. However, these have been limited to a small range of charges. For example, the renting of ice time in municipal hockey arenas is often differentiated by higher rates for peak times relative to off-peak. Furthermore, often the rental rate is different for youth renters compared to adults. In some cases, vouchers or reduced rates for some programs are applied to lower income households or individuals. There also may be reduced rates for seniors or youths in some programs and rentals. This has been demonstrated in the Municipal Finance Officers of Ontario 1997 user charge survey. It indicated that the median adult ice
rental time was $97/hour for peak time compared to $70 per hour for off-peak. The median hourly rental rates for youths were $70 peak and $58 off-peak.\(^\text{13}\)

With respect to transit user charges, the relative rates in Canada tend to be higher in Canadian municipalities, as there is no general federal funding or subsidy for mass transit in Canada. There tend to be variations in prices for some users, such as students and seniors, an incentive for frequent users via monthly pass rates that provide a discount. However, there is not a tendency for Canadian systems to apply fair by distance pricing that would support pricing based on marginal cost pricing. There is however, multiple zone pricing in some jurisdictions that is a crude attempt at this pricing approach.

There are other transportation-related charges that might be considered in the context of user charges that may be used in conjunction with approaches to transit pricing to address some overall policy regarding transportation in urban areas. These are user charges that relate to private auto usage. For example, governments may apply user fees as a form of road pricing. The best-known recent example of this is the London 10 L charge for driving into the City. The recently elected mayor of the City of Toronto discussed imposing a similar charge in Toronto for cars driving on major expressways into the city. There is already a limited access highway, 407, at the northern edge of Toronto that is North America’s first electronic toll highway. The toll is charged by scanners recording the users’ licence plates. The owners are then sent a bill in the mail for their use of the highway. The amount charged is based on distance travelled and whether they used the highway at peak or off-peak times\(^\text{14}\). In addition to road pricing, municipalities may set parking charges for municipally-owned parking lots to reflect peak pricing approaches to discourage people from driving cars into the urban core.

In this section, some examples of the Canadian and Ontario applications of user charges as public prices have been provided. This has not been a comprehensive detailed list and discussion, but rather one to illustrate several applications and issues.

### 2.3.3 Special Benefit Charges

A good example of special benefit charges is the application of what are known in Ontario as Development Charges. Variations on this application also occur in two other Canadian provinces – British Columbia and Alberta. In U.S jurisdictions, they are what are typically referred to as “impact fees”. These are charges placed on new development to pay for the offsite growth related capital costs relating to the new development. They may be imposed for both residential and non-residential development. The premise is the benefit principle, in that growth should pay for

\begin{footnotesize}
\begin{enumerate}
\item Frequent users have the alternative have the option of purchasing a transponder which records the billing without scanning the licence plate which leads to a lower administrative charge being included in the billing.
\end{enumerate}
\end{footnotesize}
itself in terms of its requirements for capital facilities. Existing residents and businesses should not be required to subsidise the costs of growth.

Ontario has had various applications of development charge type fees going back as far as the 1960’s. However, the way that they were applied and calculated by municipalities in the years prior to the first enabling legislation was not based on any rational pricing rule. Consequently, there were many legal challenges to their application.\(^{15}\)

With the passing of the first legislation, The Development Charges Act 1990, there was not the legislative basis for defining the growth related capital costs that could be included in the charge and a defined method by which the calculation could be charged. The legislation permitted the inclusion of all growth-related capital costs based on an average cost calculation of projected population growth and its related development.

Later applications and revisions to the Act led to the use in some jurisdictions of “area specific development charges” which permitted variation in the charges, based on different costs of engineering/works related services in various geographic areas. This meant that the charges in these cases were attempting to move beyond average cost calculations to a variation of marginal cost pricing. From an efficiency perspective, this is considered to be advancement over the previous applications. However, the new legislation also limited that range of capital cost that could be included in the calculation, by reducing the range and/or discounting the amount of people or soft service capital costs that are included in the calculation. Although there is general agreement regarding the inclusion of property-related services in the cost calculation, there can be some debate amongst interested parties regarding which and how much of the people-related capital costs should be included.\(^{16}\)

It is important to note that much of Ontario has two tiers of local government. In addition to what we refer to as local municipalities, we also have regional governments or counties that provide a range of services. Under the development charge legislation, both levels of local governments can impose development charges for the services that they provide. In addition, School Boards may impose development charges for the capital costs of new schools required due to growth. Consequently, as an example, the combined charges that are imposed in some of the high growth jurisdictions in the greater Toronto area are in excess of $15,000 for a single-family residential unit.\(^{17}\)


\(^{16}\) The people related service include such facilities as libraries, sport facilities and areas fire stations, cultural facilities and expansions to municipal offices i.e. City Hall’s.

\(^{17}\) For example, half of the eight municipalities in York Region, the high growth area north of Toronto have single family detached charges greater than $15,000. See Urban Development Institute, “Government Charges that Drive Up Housing Costs: A Study of Taxes, Fees, & Charges in the GTA”, 2002.
This application meets the objective of providing necessary revenue to municipalities and not having the costs of growth imposed on existing taxpayers. The alternative to these charges is raising the property tax. The use of the charge will, however, promote economic efficiency. The charge approach is desirable, not only because it has moved beyond simple average cost pricing to a variation of marginal cost pricing in its application, but it also represents a form of multi-part pricing which is deemed to be very efficient. Its multi-part application consists of offsite capital costs that are paid for by development charges, sometimes based on a marginal cost variant, the connection fee to the services is borne by the developer as they are required as part of subdivision agreements to provide all services internal to the subdivision at existing municipal standards, and the operating costs for the services are paid for by the property taxes.

There are other applications of special benefit charges, such as the local improvement charges and special assessments for Business Improvement Areas, each of which has legislative basis for the application and use of the charge and its revenue. However, the development charge application was provided as an illustration, as it is the largest revenue source in this category and it provides an example of how the legislation was necessary to ensure the improved application of the use of this type of development charge. Furthermore, the legislation ensures accountability in the actual use of the revenue for the purposes for which it was collected.\(^\text{18}\)

### 2.4. Conclusion

Over time, Canadian and Ontario municipalities have made increasing use of user charges a source of revenue to finance municipal services. It is important to be aware that residents have demanded an increased range and quality of services. This, coupled with a reduction in transfers and expectations that municipalities finance a greater range of services, has provided the impetus for their increased use. Over time municipalities have also become more sophisticated and better in terms of making use of pricing rules and applications that enhance efficiency and address some of the equity issues associated with applying user charges.

A major part of the impetus for better and more efficient approaches to user charges may be attributed to Provincial legislation. In Ontario, this includes the new Municipal Act passed to become in force in January 2003. Although the old act made provisions for the application of user charges, the new Act has more specific regulations, including the requirement that a master list of fees be reviewed annually as part of the budget process. There is also legislation that requires municipalities to set sewer and water rates that reflect the full operating and capital cost of providing the service. Finally, earlier, i.e. in the 1990s, develop-

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\(^{18}\) The legislation requires that development charge revenue by placed in special “earmarked” funds and furthermore that annual reports by made to the Province regarding the use of these funds.
ment charge legislation and the revision to it clarified the way in which development charges were to be calculated according to the new provincials rules.

Therefore, a key component to improvement in the municipal user charge system was legislation that provided the framework for municipalities to design and apply a user charge system that is consistent and rational i.e. based on sound pricing applications.

As one of the main benefits in making more extensive use of user charges is economic efficiency, this has to be considered in the context of the equity impacts that potentially result in lower income households and individuals. Taking this into account, local government decision makers have to decide when and how, to apply user charges. As indicated above in the Canadian experience, enabling legislation with appropriate regulations and requirements is an important pre-condition for an effective and appropriate user charge system. This also requires knowledge and training for local officials regarding how to implement the legislation and design the charges.

The municipal finance situation in central and eastern European countries is different to Canada, where property tax revenues are the largest source of revenue. Here, decision makers have opted for the use of user charges to finance some local services, rather than increasing property taxes. This has proven to be more politically expedient than raising property taxes and has the “benefit principle” advantage of efficiency, if appropriately applied. In the central and eastern European context, rather than user charge revenues being a substitute for property tax revenues, user charge revenues serve as more of an expansion of local source revenues to enhance transfers from senior governments. Consequently, the Canadian benefit of user charges, i.e. mitigating property tax increases, is not as relevant in the European context.

Therefore the prime rationale for the application of user charges is the expansion of the range and perhaps quality of services, as well as the promotion of economic efficiency in service provision. Again, the charges must be applied with the equity impact trade-offs considered. This means either applying the charges for services that equity impacts are not a major consideration, or designing the charge to minimise the regressive impacts. Hopefully, the Canadian applications and impacts described in this paper are instructive in providing some insights into the approaches that have been successful as Canadian municipalities have expanded their use of user charges over the years.
Applications of Municipal User Charges in Canada: Experience and Implications for …

References:


3. Local Taxes: Why?

Peter B. Boorsma

Introduction

In the western world (and probably elsewhere too), regional and local governments are funded from three income sources: a general grant from central government; specific grants from central government and local income sources consisting of taxes, fees and income from property. The relative importance of these three sources differs greatly between countries, with the share of local tax revenues as a percentage of total local income, varying in 1987 from between 70 per cent and 30 per cent for federal countries and between 70 per cent and 4 per cent in unitary states (Owens and Norregaard, 1991). As a percentage of GDP, the local tax revenue varies (1995) from 1.1 per cent in The Netherlands to 15.5 per cent in Sweden and Denmark (Joumard & Kongsrud, 2003).

One might ask whether it may be more efficient to leave the power of taxation to the central authority and, at the same time, raising the general grant to the local authorities. One could argue that in this way, central government might better keep its macro objectives, related to stabilisation and economic growth, and equity. It could even be argued that local politicians might be better off, as long as no strings are attached to the general grant. In this case, local spending autonomy remains the same, but politicians do not have to impose unpopular taxes on citizens and the municipalities can therefore save on perception costs.

An example is given in The Netherlands, with its internationally very low relative share of local taxes. The main taxes there are the two property taxes: one on the owners of houses and industrial property, and one on the inhabitants (owners or tenants) of houses. The Cabinet has stated that it will change the law, in order to end the property tax on house inhabitants, since the tax is unpopular and also to economise on perception costs. This article will summarise some of the arguments, all or most of them time-honoured, in favour of a substantial weight of local (and regional) taxes.

There is a reason why we wish to discuss these arguments or functions. First, reconsidering the different functions may be useful if a public authority is reconsidering its tax policy and, of course, taxes exist since governments need money to pay for the provision of their non-market services. However, they also serve other functions and one kind of local tax may better serve a specific function than another. Second, in literature, more attention seems to be given to the criteria for a sound tax system, which criteria may be taken together (see Governing, The Magazine of States and Localities, Febr. 2003) as being adequacy of revenue,
fairness to taxpayers and management of the system. Chapter 3 will summarise these criteria for a sound local tax system.

Going through the literature, it would appear that sufficient attention has been paid to these principles, but a careful discussion of the reasons, i.e. the functions for a substantial local tax system, is lacking (see e.g. Owens and Panella, eds, 1991; Bingham et al., 1978; Netzer and Drennan, 1997). Only a few major functions are discussed. Rafuse (1991) while writing about “financing local government” mentions as the “essential functions of government” the well-known set of general functions of allocation, distribution and stabilisation, as formulated by Musgrave. But do these general principles for national government apply in the same way for local government? It is commonly accepted that local government cannot deal with stabilisation and should refrain from distribution. Later, when he deals with the “objectives of local finance”, mentioning accountability, equity, and efficiency (in this contribution, taken as being allocation), he is more succinct. In the same volume, Strachota (1991) mentions the objectives of local finance being accountability and control, effectiveness, efficiency and equity. In this paper, effectiveness is linked with efficiency in allocation. Raimondo (1992) mentions the two general principles – the benefit principle and the ability to pay principle, but these are not functions. Or one may find a function treated as a characteristic or criterion for a good tax. Take for instance, Panella, who mentions three “basic features” for a local tax: first “all citizens should participate in the financing of local public services”; second, “their taxable bases should be spread throughout the entire territory” (a criterion which seems to overlap the first one, P.B.B.), and third “they can eventually be used for equalisation purposes.” The first two are indeed criteria but the third does not say anything about the tax, but about the purpose and the use, and that is the function! This contribution will provide the evaluation.

This paper deals with local taxes and local authorities. Although the focus is on municipalities, the discussion runs more or less along the same lines for regional and provincial authorities. It will not deal with other sources of local income such as income from property or from fees, since such a discussion would follow rather different lines.

3.1 Local taxes: why?

3.1.1 Financing local expenditures

“Financing the local needs”, of course, is the first argument on why we need local taxes – the “mother of all arguments”. All too often it is not mentioned at all, since all local outlays can also be funded from grants. Once one begins to really discuss the argument, it overlaps with the allocation function.
3.1.2 Strengthening the autonomy of local authorities

“Raising the relative importance of local taxes will increase the autonomy of local authorities.” The autonomy (for a detailed discussion of several measures for autonomy, see Owens and Norregaard, 1991) means, in this context, the discretionary freedom of local authorities to weigh the burden it imposes on its citizens by imposing a tax or raising the tariffs in order to finance local needs. Normally it is understood that, at the same time, central government will step back by reducing the grants to local authorities and at the same time, reducing central taxation.

The argument can be discussed in several ways. First of all, discretionary power or autonomy may be restricted by central government in many ways. It may impose central rules on municipal spending, e.g. by prescribing certain types of expenditures. Thus, in The Netherlands, central government tells municipalities that they shall spend funds on the local fire department, according to the national risk classification. It is up to the municipality to decide if the expenditure is financed from the central grant or the local income. More relevant is the possibility that local income sources are regulated by central government, thus effectively restricting the autonomy of the municipality to raise income from fees or taxes. The Dutch government is proposing, for example, to set at maximum the rate of the remaining property tax. Another example is the regulation that a user fee, such as the garbage collection fee, shall not exceed the cost price. Thus, enlarging the local tax capacity will not automatically enhance local autonomy. However, given a certain amount of central government regulation of local taxes, an enlargement of local tax capacity will increase the local autonomy.

Second, The European Charter of Local Self-Government (1985) gives local authorities the right to raise their own taxes. Article 9 on “Financial resources of local authorities” states in article 9.1 that local authorities are entitled to adequate financial resources of their own, “of which they may dispose freely within the framework of their powers.” Thus autonomy is guaranteed, but this also applies to a general grant. Article 9.3 relates more to this point for this contribution: “Part, at least, of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.” A weak point in this Charter is, however, that it does not specify or quantify the “constitutional” municipal privilege. Are the municipalities entitled to a tax capacity of 5 per cent of their total income or 50 per cent? The Dutch government is familiar with the Charter and still proposes to reduce local tax capacity, although it is already almost the smallest in the world.

As to enlarging the local autonomy, at the beginning of the last century, all Scandinavian countries, including Finland and Iceland, decided that local authorities could raise local taxes in the form of surtax on central income taxes. “Without this allocation, the Scandinavian public sector would not have become as decentralised as is currently the case” writes Lotz (1997). Because of the afore-
Local Taxes: Why?

mentioned argument of central by-laws that may restrict the local tax autonomy, it should be noted that although the Scandinavian countries have a relatively large local tax capacity, the autonomy in raising the surtax is restricted. For this reason, it is common nowadays not to compare internationally the relative local tax capacity, but the relative local tax power. This tax power is calculated by multiplying the tax capacity with a variable, varying from 0 to 1, which expresses the relative discretionary freedom to impose and raise taxes.

3.1.3 Improving the allocation

“A strengthening of the local tax capacity will improve the allocation.”

In this context, it is useful to distinguish between several phases in the allocation. First of all, there is the national macro-allocation, which is the decision by central government on the national tax burden on the private sector, in order to finance national needs. After the national macro-allocation follows the phase of the national micro-allocation, meaning national decision-making about how much of the budget will be spent on this specific end and this specific activity etc. The national macro-allocation will often also include some decision on the municipal package of tasks and the relative size of the municipal tax capacity. Also at the local level, one may distinguish between the macro and the micro allocation. The macro allocation implies that the city will take a decision on raising a tax in order to finance the proposed budget. The micro-allocation will deal with deciding how much will be spent on a specific issue. In this stepwise allocation model, it is assumed that a tax will be raised to finance the total budget, which is common procedure. It might well be, however, that a tax proposal is directly related to a specific expenditure proposal. Although this procedure is less common, in practice, local politicians will defend a tax increase by referring to the extra provision involved. Such a procedure will make the allocation process even clearer for the taxpayer.

The argument means that increasing the local tax capacity and reducing the central regulation will improve the allocation, since the local politicians have a closer contact with the citizens than national politicians and for that reason, the local politicians know better the citizens’ preferences. Thus, by reducing national taxes in favour of local taxes to finance municipal needs, total welfare will increase.

In the Netherlands, the Union of Dutch Municipalities, which has published several studies on the item, wrote that the allocation theory can neither explain nor guide the reality of taxation. (VNG, 2002, p.21) The statement is hard to understand, since in reality, municipalities do weigh the burden of extra taxation against the benefits that can be realized with the extra means. Other authors argue that from the allocation point of view an increase in tax capacity is not needed, since the allocational weighing between extra tax burden and extra benefits is at the margin (Allers, 2002). The weighing is indeed at the margin, but if the tax capacity generates only a small part of the total budget, and if there is not
much room for manoeuvre, then a large increase in rates is needed to generate the amount required. As long as the existing tax capacity is small, the “leverage” of an increase with 1 percentage point is small. For that reason, the allocation argument remains a good argument for increasing local tax capacity, as long as this capacity finances a small portion of the budget.

3.1.4 Evening out the distribution of centrally provided means

“The local tax capacity is a medium to even out the inequalities in the distribution of nationally provided grants.” In most countries, as previously mentioned, local authorities will receive from central government various kinds of grants, normally a general grant and several specific grants. The grants system regularly has several flaws. The first one is that a specific grant is not enough to finance the full costs of whatever the grant is being given for. In that case, the receiving organisation has to finance part of the costs from other sources, such as taxes. A second flaw is related to the general grant. Central government distributes the general grant amongst the municipalities, according to several objective criteria, in order to treat the receiving municipalities equally. Unavoidably, one city will be better off than another and the city with objectively larger financial needs must find other ways to raise income, thus raise taxes.

If the central government in The Netherlands abolishes the municipal property tax on rented accommodation and compensates municipalities by increasing the general grant, then for that reason a city with a disadvantage in the distributive criteria can no longer compensate the inequality by raising the tax; it has to cut back its expenditures, which may result in reducing total welfare. There is a quote from Panella: “It is through local revenue that the flexibility of the budgets can be insured, whereas revenue transfers should mainly have the aim of equalisation…”(Panella, 1991, p.119) In this contribution, enhancing the flexibility of the budget is not taken as a separate function of the local tax, as it is included in the allocation function and the smoothing function.

3.1.5 Absorbing financial setbacks

“The local taxes are needed to finance unexpected financial setbacks in the exploitation of municipal companies and the implementation of the budget.” The city government may take a decision that proves to be completely wrong which means that the city then has to persuade the city council of the necessity of raising a tax to finance the setback. The increase in the tax rate is also a signal to the taxpayers that city government has made the wrong decision. Setting wrong decisions aside, a city is confronted with many risks. The city may cover the financial consequences of risks via a reserve or via insurance or other ways, but an unused tax capacity may be used as well, especially if those other instruments are inadequate.
3.1.6 Signal function

“The local tax may act as a signal to central government about local scarcity.” Central government provides a general grant, according to a set of objective criteria, trying to distribute the available funds as objectively as possible. In The Netherlands, where at present the most important taxes are based on real estate, one of the distribution criteria is the local tax capacity, based on an assessment of the value of real estate. The nationally estimated tax capacity is deducted from the calculated gross general grant. Here again comes the value of the former argument for local taxes, of evening out the inequalities in the nationally provided funds. The signal function means that a general rise in tax rates may serve as an indication that the municipalities are financially in dire straits.

3.1.7 Accountability

“Raising a tax increases the need for local politicians to account for their decisions.”

If a city receives its money from the central state, there is then the necessity to account for the receipt and for the responsible spending of the money, according to the goals set either by central government, in case of a specific grant, or by the local council in the case of a general grant. For local politicians, the cry for accountability (for a careful discussion of the concept see Owens and Norregaard, p.10) will be stronger if they raise taxes from their citizens.

The argument for the need for controllability and accountability has grown in importance over the last decades in western countries and even more so in the new democratic states such as the CEE countries. Smith says (1996, p. 277): “There is a growing recognition of the importance of local tax-raising powers in ensuring local accountability and budgetary control.” He even recognises the tendency in Europe to set lower limits on tax rates “to enforce at least a minimum degree of local fiscal accountability through taxation.” Normatively I do agree with him, although I doubt the empirical validity of the statement. One may wonder why the argument of accountability is used more with regard to taxes as a source of municipal income, than in the case of governmental grants. This has everything to do with a rather new theory of ‘mental accounting’ (Hines and Thaler, 1995, Allers, 2000), according to which, people spend money in different ways, according to the source of income. A person will show a strict spending behaviour when dealing with his monthly income, but will show other, say more loose behaviour in the case of a windfall, such as a lottery prize. Thus, for a city councillor, his spending of money received from general government will differ from spending money taken from his own citizens/taxpayers/voters. Money received from general government is “easy money” compared to money from local taxes. Based on this line of argument, not only the argument of accountability is strengthened,
but also the allocation argument: the local politician will spend the money from local taxes more carefully than money from general grants.

This last insight is also formulated but in a more rudimentary fashion by Owens and Norregaard (1991). They rightly state that the issues of local autonomy and local accountability are closely linked, since accountability “enables the local electorate to influence the mix of local taxes and services, thereby promoting a more efficient allocation of resources and encouraging cost containment at the local level.” (p.9)

### 3.1.8 Strengthening local democracy

“Local taxation as a municipal income source may strengthen local democracy.”

It is argued that financing municipal expenditures with local taxes, compared to financing from central government grants, may increase the involvement of municipal council members in the first place and citizens as tax payers and voters in the second place. Discussing this argument, one may dispute the point that the argument is an extension of the former argument of accountability and mental accounting. In this case, we are dealing with different aspects of the same phenomenon.

In discussing this argument, one can see that there are two steps in the budget allocation. First, there is the local allocation, made between the municipal political executives on the one hand and the city council on the other. Secondly, there is the allocational weighing by citizens, who assess the municipal services against the tax burden. Several authors doubt the line of reasoning in the weighing process. As to the first weighing, the city executives may adjust the tax rates to inflation, without invoking much discussion. If, however, a substantial tax increase is proposed above the inflation rate, the council will discuss the proposal, giving way to the old adagium that tax is at the heart of democracy. But, what about citizens’ involvement? Do citizens really assess the performance of municipal politicians against the tax burden paid? The hypothesis is that citizens will be more involved with city politics if a larger share of municipal services is paid for by local taxes. (Commission Boorsma, 2002).

Some authors (VNG, 1996, p.50) have argued that a “misunderstanding” is involved, since there is, in The Netherlands, no empirical relation between the share of local tax in total local revenue and the voter turnout for municipal elections. Allers (2000) also found no significant relation between voter turnout for local elections and local tax share. Denters (2003) did analyse the influence of political involvement via higher tax payments, as well as the influence of voters’ satisfaction of municipal performance on the one hand and on political involvement on the other, and found no relation whatsoever. But Denters remarks that the effect on political involvement might be restricted anyhow, because of the small variety in local taxes. Indeed, so long as local taxes form a small part of total revenues, a priori their influence on political involvement will remain small. One might think
of a kind of tax elasticity of political involvement. The hypothesis is that in a country with a relative high tax share this elasticity will show a high, positive value.

Although local taxes form just a small share in Dutch local revenues and although the above defined elasticity will be low for that reason, tax rate increases do receive quite a lot of attention, not only at the local level, but also at the national level. At the national level, the employers’ organisation will complain if the average increase of local taxes is high in a period where employers, wage unions and national government try to moderate inflation, wage and tax increases. Also the Consumers Union, the press and parliament will pay attention to these increases. An explanation is related to the character of the tax: since there is no automatic increase of tax revenues, such as with the income tax or sales tax, the city council has to explicitly deal with the rate each year and with the valuation of real estate every couple of years.

3.1.9 Political economy

It has been said that municipalities should receive a substantial share of their total revenues from local taxes. In the theory of political economy, admittedly a broad subject, also a couple of noteworthy remarks in the line of the foregoing have been made.

Hettich and Winer (1988, 1991) explain the development of tax structures in a country from the policy to restrict tax resistance. Indeed, the Dutch local property tax on house tenants used to be evaluated by rather critically by taxpayers, as is evidenced by the number of legal objections against the tax. In The Netherlands it is the conservative party VVD, however, which proposes to end this tax in favour of a higher general grant from central government. But, the argument can go two ways. The conservative party wishes to abolish this party to minimise taxpayers’ resistance. Will the end effect be higher total public spending, since the grants have to be financed from central taxes with lower tax resistance? Or will the end effect be lower total public spending since parliament can better control total spending than the different councils? It is actually not so clear what to do with the Hettich and Winer argument. A nice formulation is given by Fraschini and Osculati (1991), when they discuss the recent attempts in Italy to change the local tax system. They state: “The local governments have always been opposed to a more rapid and vaster creation of local taxes… This position, though it reduces local autonomy, is useful to the majorities in power at the local level, since it places the political costs of an increase in taxes on the central government.” (p.235)

Speaking about the relation between total spending and the tax system, one is confronted with the theory of fiscal illusions, first developed by Puviani (1960/1903). There are fiscal illusions if voters underestimate the benefits of public provisions and overestimate the tax burden, a phenomenon that received a lot of attention too in Public Choice Theory. Such a fiscal illusion can be caused if
public services are financed by a variety of taxes. Wagner (1976) indeed found a positive relation between the complexity of a tax structure and the size of government spending. Other parts of research do point however in another direction. (see Groenendijk, 1998). Another illusory effect, the fly paper effect, is mentioned by Oates (1988). This fly paper effect, formulated shortly as “money sticks where it hits”, argues that a revenue windfall will be spent publicly rather than returned to the citizens as a tax reduction. It implies also that for a local authority, it is easier to spend money from a grant than from a local tax. Thus, the propensity to spend from a grant will exceed the propensity to spend from a local tax. This theory has recently received more attention in the theory of mental accounting: the way people treat a sort of income will vary with its source and regularity. Thus, city managers and local voters will deal with central and specific grants received from central government differently as compared with revenues from local taxes – just as a citizen will apply other spending rules on his monthly labour income, compared with a windfall from the lottery. Silkman and Young wrote already in 1982 about this kind of fiscal illusion, created when a local provision is paid for by national taxes. Thus, we agree with the conclusion of Maré and Comandini (1991) who wrote: “the wider the role of local taxes, the lesser the scope for ‘fiscal illusion’”.

3.1.10 Regulation or “Other functions”

“A local tax may serve other functions, such as equity or environmental policy.”

The national budget will serve three goals – thus is the conventional wisdom, viz. macro-economic stability and economic growth, allocation and equity. The first is typically the goal for the national budget, as is the third goal. Normally it is maintained that income policy and, to that end, the policy aimed at equity and poverty reduction, belongs to the national playground. Decentralised government should not meddle with poverty problems in order not to interfere with national policy. Still, however, it may be observed that local governments will in some measure also try to improve equity. Its municipal taxes may contribute to that end, mainly via tax exemptions, maybe also by the choice of the tax source.

In the same way, environmental policy, as a part of allocation, is typically a national policy. At the national policy level in the EU there is a tendency to the “greening” of taxes, by putting more emphasis on some excises, on taxing the use of electricity, or taxing the use of automobiles, etc. Local government may try to contribute via its tax policies. To that end, a city might, for instance, raise a surtax on a national tax on electricity.

One may ask the question whether these “other” functions are on a level with the other functions. If a city chooses a certain kind of tax source, it should also weigh the suggestion against the criteria for a good tax system, such as stability of income, the perception costs, the nuisance caused by side-effects, etc.
One may argue that in discussing a possible new tax source in the light of these weighing criteria, one may also discuss the effects on income distribution, environmental policy, etc.

On the other side, however, a government may decide to levy a tax in order to regulate or influence the decisions of the economic actors. A “grass tax” on the sale of marihuana may be chosen in order to raise income, but also to raise the price and thus reduce consumption. At least, isn’t this the function of taxes on alcohol and cigarettes?

### 3.2 Characteristics or criteria for local taxes

Since the criteria for “good” local taxes have been widely discussed, this contribution will mainly give a summing up of these criteria in the next table. A very thorough, but also very incomplete, discussion of criteria is given by Oates (1972), who mentions the avoidance of an excess burden, the contribution to effective collective decision-making, an equitable pattern of incidence, and low costs of administration and compliance.

**Table 1:**

Criteria for “good” Local Taxes as mentioned by different Authors

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<tr>
<td>Economic efficiency: minimum influence on economic decisions</td>
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<td>X</td>
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<td>Tax base should not be mobile</td>
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<tr>
<td>Tax should be visible to enhance accountability / Perceptibility</td>
<td>X</td>
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<tr>
<td>Sufficient revenue/ Adequacy: productive in comparison to needs and costs of administration</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Buoyant yield over time/ income elasticity</td>
<td>X</td>
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<tr>
<td>No strong fluctuations over time / Revenue Stability = Income elasticity = 1</td>
<td>X</td>
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<tr>
<td>Difficult to shift to non-residents</td>
<td>X</td>
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<tr>
<td>Broad based/ all citizens pay</td>
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<td>X</td>
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<tr>
<td>Easy to administer/Administrative feasibility/ Low perception costs</td>
<td>X</td>
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<tr>
<td>Benefit principle: beneficiaries pay the burden / Link between spending and taxing</td>
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<tr>
<td>Fairness: everyone should pay his fair share</td>
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<tr>
<td>Avoid tax competition / EU tax harmonization</td>
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<td>Effective collective decision-making</td>
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Categorising the criteria for good local taxes, as mentioned by different authors, has a problem of slight differences in the wording. Is, for instance, the criterion “easy to administer” the same as “low perception costs”? One author will
explicitly argue about the perception costs for the administration, while another will also mention under the same heading, the costs for the tax payer, thus the compliance costs.

Although most criteria stand to reason, some criteria such as low perception costs being commonly accepted, there is discussion about certain criteria. Income elasticity is seen as a good criterion from the point of view of efficiency. If the tax revenue grows endogenously in an adequate way over time, there is no need for politicians to argue with voters about tax rate increases. It has been argued that this criterion is at odds with the criterion of democracy or accountability (Foster et al., 1980, here quoted from Tatsos). This argument was first brought forward by Buchanan (1967) in his Leviathan approach of government.

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4. User Fees in Local Finance: The Czech and Slovak Cases

Phillip J. Bryson

4.1 Introduction*

The revenues gained by the Czech and Slovak Republics from charges for public services are certainly not considerable and in fact, represent well under 10 per cent of the receipts of local budgets. In a transition state, trying to cope with a backlog of needs for local and national infrastructure and public service needs, one must ask the question whether such revenues could be increased. Underneath this is the more philosophical question of what the objective of user fees is or should be.

It is a common view that the acceptable rationale for public prices is cost recovery. Policy may justify charging less than full cost recovery for obvious public purposes, but it may also seek more than recovery of the full cost. In transition countries, user fees will frequently be administered in the hope of providing a contribution to general revenue and such is the case for the Czech and Slovak Republics.

Municipalities in the Czech Republic receive revenue for the provision of paid public services. Some public services are provided privately e.g. water and sewage, provision of electricity and heat, and the consumer/citizen pays the providing private firm directly. Other public services e.g. the use of public spaces for parking or other purposes or the permission to establish casinos or approved gambling, are provided to citizens with the payment of fees.

Public services provided privately are not the analytical focus of this paper, since in the Czech and Slovak Republics such services have been privatised. They are subject to industrial regulation through the Ministry for Industry and Trade, which addresses pricing practices and other regulatory issues.

On one occasion the Czech Republic’s Ministry of Finance proposed that user fees be classified as taxes. Parliament declined approval of the proposition, so the term “fees” (poplatky) still applies. Parliament does occasionally approve new fees (e.g. the fees on slot machines and casinos) and of fee increases as appropriate. Privately provided services have a prices character, while publicly provided services have a tax character.

It should be observed that a formally correct use of the term “fee” involves the provision of a public service (or good) for a price imposed upon the con-

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sumer/citizen. A tax is, in contrast, a surcharge on a privately provided service (or good), requiring a contribution to the public coffers by the private buyer who pays the tax. When one reviews the list of services for which Czech and Slovak citizens pay fees, *poplatky*, it is apparent that some of these services are really just being taxed. “Fees” paid for the use of private spas or recreational facilities would really just be taxes. A fee for a dog licence or a fee for a gambling machine might be viewed as an appropriate public charge on a private activity with potential external effects. But, once again, if the state supplies a vital public authorisation, public land upon which an activity (e.g. a circus) occurs, or something else of importance in the production of a service supplied with or without the participation of private parties, the term “fee” is appropriate.

This paper will review the current budgetary contribution of user fees (*poplatky*) and their potential revenue contributions for both the Czech and Slovak Republic. User fees were presented in the legislation of Czechoslovakia, both in Prague and Bratislava. This occurred in the latter capital on the 27th of November, 1990, which was before the Velvet Divorce and the establishment of two independent republics. That law remains the fundamental statement on user fees in Slovakia, as in the Czech Republic today, so the two countries departed from an identical initial situation. Since the division, they have continued to share many of the characteristics of transition states, struggling to develop the capacity to perform in market environments. They make an interesting comparative study now, especially as they gradually develop substantially different approaches to national and local finance. This has been partly due to divergent approaches to the major reforms of public administration both nations undertook in preparation for their accession to the European Union in 2004. The Slovak Republic has proposed a complete overhaul of public finance and a comprehensive tax reform, striving to move towards a single tax at the single rate of 19 per cent for the basic taxes: VAT, corporate and personal income.

Of particular relevance to this paper is that in Slovakia, local governments received the right on January 1, 2005 to set “tax rates” (a term applied, interestingly, not only to the real estate tax, but apparently also to the very limited number of user “fees,” *poplatky*, already extant) and to introduce new “taxes.” The municipalities received full discretion to adjust those old system rates and apply exemptions according to their own preferences. So the door has been opened, in Slovakia at least, to permit municipal governments ultimately to apply user fees much more independently.

This paper focuses on the need to do so, starting with the fiscal parameters prevailing during the transition period, prior to the adoption of reforms of public administration and the accession by the twin republics to the EU. In the Czech Republic, the situation regarding user fees remains unchanged, as described below. In
the Slovak Republic, little actual change has been introduced to this point, but the announced changes mentioned above have now made such change possible.

Section I will review the services for which fees are provided in the twin Republics, after which section II will review the revenue implications of such public services for local budgets. Section III will address the question of charging user fees, not as a means of cost recovery, but as a technique for providing budgetary relief for hard-pressed local authorities in transition countries. We will be interested here not only in the potential revenues provided by appropriately-named and designated user fees, but also the revenues potentially provided by some of the taxes the Czech and Slovaks list as “fees” and by other potential taxes that could also appropriately address the revenues shortfall faced by autonomous sub-national governments. The emphasis here is on increasing autonomous revenues for sub-national governments, rather than on user fees *per se*.

4.2 User Fees: Typology

There are nine general services for which user fees are levied in the Czech Republic. These are listed by Jiráskova and Šneberková (2002, p. 7) and include the following:

- Recreation and spa fees
- Fees on local housing accommodation
- Fees on the use of public properties for parking and other uses
- Permits to drive in the city centre
- Fees on admissions to ticketed entertainment
- Garbage collection
- Value added fees for lands where, for example, water and sewage have become available
- Dog licences
- Fees on casino gambling and slot machines.

Basically, the same list is provided by the Law of the Slovak National Council of the 29th April, 1992 on local fees.  

Let us review the Czech municipal fees stemming from 1990. The entire menu of Czech and Slovak user fees can and should be reviewed briefly, since under the fiscal system of the transition, the municipalities of these republics can charge only those fees permitted by their central governments. If one compares the menu of user fees applied, say, in the United States or in other capitalist countries, one becomes aware of the starkly restricted access the Czechs and Slovaks have to the use of fees that would help provide financial independence for

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2 See *Zakon Slovenskej národnej rady y 27. novembra 1990 o miestnych poplatkoch*, which presents essentially the same list in section 1 of the statute.
sub-national governments. The brevity of the list of fees permitted here is a commentary on the need for further fiscal decentralisation.

Although there have been a small number of changes in both the Czech and Slovak Republics, today they remain very similar. The right to apply user fees in both republics, since before their division, were granted by the national parliament through law. Each municipality has the right to decide whether or not it will apply any of the fees approved by the legislation. If they decide they will charge an approved fee, they decide what (approved) rate they will charge and then post a notice on the municipal bulletin board that a user fee will be charged.

**Fees for Dog Licences.** As one reviews the provisions pertaining to user fees, their intent becomes apparent. In the case of fees for dog licences, one intent is made explicit when the regulatory function of this fee is pointed out. When citizens have a dog in a large apartment building, the potential external effects of the pet are discouraged through the imposition of the fee. When, on the other hand, fees are exempt for specially trained dogs for the blind, helpless, or handicapped, other intent is apparent. Clearly, we are not talking here of price discrimination, since the elasticity of demand of handicapped individuals for canine assistance is low and the willingness to pay would be greater, were higher fees applied, than that of individuals for whom dog ownership is a form of consumption. The municipality can also extend the exemption for dogs to other payers, such as owners of dogs who passed exams showing some sort of special qualification, e.g. guard dogs or hunting dogs.

**Fees for visiting a spa or for a stay at a recreation facility** are neither paid by the blind, helpless, or handicapped, nor by any assisting person accompanying them. Nor is this fee paid by persons younger than 18 or older than 70; a child support recipient, or by soldiers on active duty. The tariff may not exceed 15 Kč per person per day of the stay so this fee is quite minimal. Rather than suspecting that the demographic groups selected for exemptions are akin to those who receive lower prices in price discrimination schemes, we recognise that this is simply exempting on the basis of avoiding the creation of hardship cases.

**Fee for the Use of a Public Area.** This fee is represented as having a “regulative and educative” function intended for maintaining public order. It is paid for private use of public space, particularly for placement of facilities offering services, of sales or advertisement facilities, for circuses, carnivals and other attractions, for cultural or sports activities, or for film or TV work. No fee is paid for activities that charge no entrance fee or for activities providing proceeds only for charities. Public space can be utilised, in other words, only for activities of social

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3 This will be done on the basis of explanation and commentary on the Czech law as provided by Jirásková and Šneberková, op. cit.
4 See Ibid., p. 21.
5 See *ibid.*, p. 29.
worth, and educational activities are especially favoured. If such activities are profit-making, the municipality may share the profits for sharing its desirable locations.

Unfortunately for the revenue-seeking municipality, the law stipulates that the fee for use of public space cannot exceed 10 Kč for each square metre of public area used per day,\(^6\) making it apparent that the legislators were not sympathetic toward revenue generation via this fee.

**Fees on Entrance Charges for Public Events.** The purpose of this fee is not only to apply a “tax” to admission charges for the purpose of generating revenues. It is also to give municipalities the opportunity to influence what cultural, sport and other ticketed activities are held within the municipal territory. According to the legislation, the municipality may apply these fees in a manner promoting its own interests and autonomy. As we saw earlier, the law intends that such fees should not be paid for admission to activities where the entire proceeds are for a charity or public service.\(^7\) When applied, the maximum fee can be up to 20 per cent of the total entrance charge, which would permit the municipality to enjoy a good share of the net revenues.

**Fees for lodging** are levied in spa towns or at facilities serving as temporary residences. The fee can also be collected from owners of family homes if even a part of the house is used for paid lodgings. The fee may not be levied on lodging for students and pupils.

**Motor Vehicle Fee for Restricted Areas.** Fees levied on vehicles entering into restricted places in the municipality are limited to 20 Kč per day, which can be paid in a lump sum if the municipality so chooses.\(^8\) The legislative purpose of this fee is to limit the movement of motor vehicles in certain locations, preserve the tranquillity of historical parts of towns, or to improve the environment in certain places. The fee is not paid by property owners or by persons businesses, having permanent residence in such areas. Nor is it to be paid by their close relatives or by handicapped persons.

**Fee for Slot Machines.** The municipality is not required to offer exemptions from this fee, which must be paid for each machine in use.\(^9\) The fee is paid by the machine’s permit holder, a Czech corporation without property participation of non-citizens.\(^10\) The tariff for each machine ranges from 1000 to 5000 Kč for a three month period; it can be set differentially, depending *inter alia* on the machine’s physical location.

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\(^6\) See ibid., p. 36.

\(^7\) See ibid., p. 38.

\(^8\) See ibid., p. 44.

\(^9\) See ibid., p. 45.

\(^10\) See ibid., p. 48.
Fee for Communal Waste. The fee for gathering, collection, transport, separation, or removal of communal waste is paid by any corporate body which has permanent residence in the municipality, or by a household’s owner or the owner’s agent.

Fee for Enhanced Construction Property. A municipal fee can be levied for the enhancement of construction property by connecting it to water and sewage. The purpose of this local fee is to permit the supplying municipality to recover at least a part of its cost. It is paid by the owner of the construction property and can be collected only for the first connection to water and sewage.

In Slovakia, the fees applied are quite similar, as was explained above. The following summary table will demonstrate the situation with regard to user fees in the Slovak Republic.

### Exhibit 1
Local fees in the Slovak Republic

<table>
<thead>
<tr>
<th>Fee</th>
<th>Subject of the fee</th>
<th>Maximum tariff permitted</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. For usage of public space</td>
<td>space</td>
<td>10 SK/m2</td>
</tr>
<tr>
<td>2. For usage of an apartment or a part of an apartment used for other purposes than living</td>
<td>rent</td>
<td>500%</td>
</tr>
<tr>
<td>3. For lodging capacity</td>
<td>Bed</td>
<td>2 SK/day</td>
</tr>
<tr>
<td>4. For say a spa town or a place of concentrated tourism</td>
<td>Person</td>
<td>15 SK/day</td>
</tr>
<tr>
<td>5. For a dog</td>
<td>Dog</td>
<td>1000 SK/year</td>
</tr>
<tr>
<td>6. From entrance fee</td>
<td>Entrance fee</td>
<td>20%</td>
</tr>
<tr>
<td>7. From sale of alcoholic beverages and tobacco goods</td>
<td>Retail value</td>
<td>10%</td>
</tr>
<tr>
<td>8. For entry of motor vehicle into historical parts of cities</td>
<td>Motor vehicle</td>
<td>10 SK/day</td>
</tr>
<tr>
<td>9. From advertising</td>
<td>Advertisement</td>
<td>5% from the price of the ad. 5 SK/m2</td>
</tr>
<tr>
<td>10. For entertainment machines</td>
<td>Entertainment Machine</td>
<td>20 000 SK/year</td>
</tr>
<tr>
<td>11. For placement of vending machines extra fee of 500% if the goods are alcohol or tobacco</td>
<td>Vending machine</td>
<td>1000 SK/year up to 10 kinds of merchandise</td>
</tr>
<tr>
<td>12. For placement of a nuclear facility</td>
<td>Nuclear facility</td>
<td>Mochovce 37.7 million Sk</td>
</tr>
<tr>
<td>13. For collection, transport and disablement of communal and small construction waste</td>
<td>Amount of waste</td>
<td>80-1200 SK/person/year</td>
</tr>
</tbody>
</table>


Local fees in Slovakia were established by the law 544/1990, which came into effect on January 1, 1991. Since that time, the law has been modified in more or less minor ways on ten different occasions. Exhibit 1 shows which users fees may

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11 See ibid, p. 61.
be levied by municipalities. Gains from these fees (not including revenues from the fee for collection of communal waste and the fee on placement of nuclear facilities) reached 940 million Sk in 2001.

**The fee for the sale of alcoholic beverages and tobacco goods** accounted for about 50 per cent of the total revenues derived from fees in Slovakia. Because they are in conflict with EU regulations, however, which allow alcohol and tobacco to bear only one tax burden, this fee will be repealed to avoid the double tax practice currently in effect.

**The fee for use of public space** yields the second largest share of total receipts, the top revenue gains being generated by the fee for collection of communal waste, which yields 20 per cent of total municipal revenues. **The fee on placement of entertainment machines** has had a strong tendency to yield declining revenues, largely because the municipalities are often unwilling to have them available. They are too often associated with vandalism. Some fees are perceived as being inequitable. The fee on lodging has the character of a property tax, for example, while restaurant capacity is, in contrast, not taxed.

The gain from the principal seven national taxes is 400 times larger than the gain from Slovakia’s ten local fees. Therefore there are those who question whether, from a strictly financial point of view, it would not be better to repeal those fees. The significance of local fees, however, lies in the fact that the municipality independently decides which it will impose and how the revenues derived therefrom will be utilised. They represent a small, but important part of the independence of Slovak local governments.

### 4.3 User Fees: Revenue Implications

It is difficult to find data on the subject, since municipal revenues derived from user fees are not reported at the Finance Ministry sites or online. The Finance Ministries are willing to talk about them in general terms and provide interesting perspectives as seen in section I, but they have not responded to requests from the author for numerical data.

**Slovakia.** In Bratislava an officer of the Finance Ministry suggested that user fees represented only approximately 10 per cent of the revenues of Slovak municipal budgets. She later updated that approximation with the estimate that local user fees represent only 5.6 per cent of the total tax revenues of the municipalities.

**Czech Republic.** As is apparent in Exhibit 2, in 2001 and 2002 revenues from user fees in the Czech Republic were actually larger than property tax receipts. That failed to indicate, unfortunately, that such fees represented a significant amount of revenue. Rather, it comments on the insignificant amount of property tax. Local

12 This occurred by email from Mrs. Krkanová on August 11, 2003.
fees for the years in question represented only 2.9 per cent and 3.8 per cent of total municipal receipts. We likewise observe in Exhibit 2 that property tax receipts for the two years, as a share of total receipts, amounted to only 2.5 and 2.2 per cent respectively. The combination of both local fees and property tax, which are appropriately considered together because they are normally both the primary sources of a municipality’s “own” revenues and represent a proxy measure of a municipality’s fiscal autonomy. The correct observation is that with respect to user fees, as is the case for property tax receipts in the Czech Republic, municipalities have a very unpronounced sense of fiscal autonomy. The process of fiscal decentralisation has not been successful;\textsuperscript{13} nor have users fees contributed significantly to fiscal autonomy.

\textbf{Exhibit 2}
Municipal Revenues, Czech Republic, 2001 and 2002 (Millions Kč)

<table>
<thead>
<tr>
<th>Revenue Source</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenues</td>
<td>88 838</td>
<td>99 549</td>
</tr>
<tr>
<td>User Fees</td>
<td>5 388</td>
<td>7 998</td>
</tr>
<tr>
<td>As per cent of Total revenues</td>
<td>2.9%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Property Tax</td>
<td>4 568</td>
<td>4 571</td>
</tr>
<tr>
<td>As per cent of Total Revenues</td>
<td>2.5%</td>
<td>2.2%</td>
</tr>
<tr>
<td>User Fees plus Property Tax as per cent of revenues</td>
<td>5.4%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Non-tax Revenue</td>
<td>23 016</td>
<td>23 809</td>
</tr>
<tr>
<td>Capital Revenues</td>
<td>10 583</td>
<td>11 588</td>
</tr>
<tr>
<td>Own Revenues</td>
<td>122 438</td>
<td>134 947</td>
</tr>
<tr>
<td>Grants</td>
<td>61 800</td>
<td>73 256</td>
</tr>
<tr>
<td>Current</td>
<td>47 198</td>
<td>55 844</td>
</tr>
<tr>
<td>Capital</td>
<td>14 602</td>
<td>17 412</td>
</tr>
<tr>
<td>Total Revenues</td>
<td>184 239</td>
<td>208 204</td>
</tr>
</tbody>
</table>


\subsection*{4.4 User Fees: Bases for Charging}
Although the first concern for public prices is cost recovery, policy and circumstances may also permit a municipality to charge less than the full cost of service provision or to seek the recovery of more than the full cost. It will be the assumption of this section that Czech, Slovak or other municipalities should at least consider

pricing that achieves the largest possible contribution to general revenues. There will be far too many instances, of course, where the national parliament and laws, or important political considerations will prohibit the municipality from implementing prices that, from its own perspective, are optimal in terms of receipt generation. In appropriate instances, such suggestions as offered below, certainly could and would be ignored by the municipal authority. But where appropriate, suggestions offered are intended to provoke thoughts on enhancing the receipts of the municipalities.

As the potential for revenue maximisation is reviewed, it should also be remembered that differing prices may be needed to reflect not only differing demand elasticities in separate markets, but may also have to reflect whether the service provided meets an essential human need and whether cost differentials in diverse market segments reflect choice responsive to higher incomes. Sometimes the affluent choose to live further from the city centre and should willingly pay the higher costs of that location. If, however, the poor choose to live further from the centre because such a place is the only one where they can afford land and shelter, most would not favour charging them the logically higher prices for services that would merely add to their financial burdens.14

Such issues are sometimes difficult to resolve and they confront the public housing authority in the establishment of rents, which can be expected to vary substantially where different generations of housing construction experienced divergent construction costs and market interest charges. Different market segments would require different treatment so that not only varying demand elasticities can be addressed to generate greater revenues through price discrimination. The varying costs must also be accounted for as suggested.

Reasonable pricing would suggest that prices should be responsive to the public’s willingness to purchase public goods or services and the full cost of production, just as they must be in the private sector. Too often, complete cost recovery is not really attempted in public service provision. Where the users are not impoverished, it is hardly appropriate to fix prices below full-cost level (not including the amortisation of capital assets at their current, not historic, value) so that they must be subsidised from general revenue. The price should be comparable to what it would be for a commercial operator using the same amount of capital, since this is the test of market viability. The test of comparability, moreover, can be fully met only if public service prices include the equivalent of the taxation faced by the private supplier.

There are instances, of course, where less than full cost recovery is appropriate. Where a public service is provided, the collective benefit would justify charging no price at all, but a positive price is suggested to impose discipline upon consumption. In that case, the price should be at a level that would deter waste, but permit the desired minimum level of consumption across all incomes. Another case is the one mentioned above: where a public good or service satisfies a basic human need for which the impoverished are not expected to pay a full, cost-recovery price. Finally, a service may be subsidised that primarily benefits the individual user, but the government wishes to encourage consumption to achieve some public benefit or saving. We observe this rather frequently where municipalities subsidise public transport to reduce traffic congestion, highway construction and repair costs, and to improve air quality.

As is well known, subsidies tend uniformly to generate inefficiencies. Sometimes they benefit all consumers, even those not in need of the subsidy. Sometimes they simply squander resources for a service that is not cost effective. Such waste can be minimised by reducing prices only for low income groups, senior citizens, children, etc. and by applying subsidies only to a minimum consumption level and market pricing beyond that. In Hong Kong and Tokyo, a minimum level of litres of water is supplied to all citizens at a nominal price. At higher levels, consumption is priced at the full marginal cost.

In some instances, pricing of public services may justifiably be based on more than full cost recovery, i.e. generating net revenues. Where prices are imposed with the intent to regulate consumption, where there is little direct cost involved, such as where municipalities derive revenues from licensing building or trading activities, levying parking charges or issuing liquor licenses. Prices may also be established at greater than cost-covering levels to enforce discipline in consumption. Telephone charges, where telecommunications have not been privatised, may be graduated at peak hours to reduce congestion. Parking fees may be established at prohibitive levels in large cities to reduce congestion in downtown areas. It should be remembered, however, that charging above cost for public services should consider, just as taxation would, the incidence and equity considerations that apply.

We turn now to a discussion of the kinds of techniques that should be applied as municipalities implement user fees, if they wish to do so with an eye toward revenue maximisation. There are two basic kinds of problem inherent in this tax. First, the municipality becomes a silent but important partner of private firms, which often provide lodging or entertainment and whose revenues the municipality will essentially tax through the user fee. Here the municipality attaches a fee to private sector activities. Examples are the recreation and spa fees utilised in the Czech and Slovak Republics, the fees on local housing accommo-
User Fees in Local Finance: The Czech and Slovak Cases

dation, fees on admissions to ticketed entertainment and those on gambling and slot machines.

In the other case, the municipality is in a position to provide a monopoly service and can price as a monopolist would, except in the numerous instances where for social and political considerations, it must provide a possibly essential service which must account for low income groups and sometimes even subsidise consumption. We will focus on the kinds of services that officials can dare to provide with revenue optimisation in mind. Fees (qua taxes) charged for dog licences, fees for garbage collection, parking fees and rents for public housing are examples where the municipality acts alone as a monopolistic provider of services and charges the whole price involved.

4.5 Fees Attached to Private Activities

When the municipality is not providing a service directly, it may still derive revenues from an activity by attaching a tax-like fee on the services of a private provider.

If in doing so a municipality establishes a unit or ad valorem fee that is too low, it will fall short of the revenues it could have obtained. If the fee is excessive, it could drive away the entertainment activity it would tax; if the municipality’s revenue yield is so great that it removes from the private activity the revenues that would have generated profit or even covered cost, the fee will prove destructive. Even if these kinds of fees are not extreme, they will distort resource allocation. The fee should optimally reflect the characteristics of a lump-sum tax. The firm providing gambling or slot machine revenues, or selling tickets to a concert or other form of entertainment, may be assumed to establish ticket prices so as to maximise net revenues. The municipality then simply lays claim to its share of the take without causing the firm to change its optimal price and quantity results. If the firm were to try to “pass the fee” on to the consumer, raising its price would merely reduce ticket sales and generate a smaller profit pool, from which the predetermined amount would still have to be turned over to the municipality.15

The municipality should determine or estimate the net revenues the project would generate on municipal property, deciding what share of the net revenues it would appropriate for public coffers as a lump-sum tax and levy the fee as a lump sum in the form of say, a licence to perform. If the municipality felt constrained to simulate the more traditional per-ticket fee, it should divide the total revenue anticipated by the number of tickets sold ex post and collect an average revenue

15 This is easily seen in the standard way. The firm’s demand function is the usual \( P = a + bQ \). Total Revenue, \( TR = P(Q) \), or \( TR = (a + bQ)Q = aQ + bQ^2 \). Marginal Revenue, \( MR = dTR/dQ = a + 2bQ \). On the cost side, Average Cost, \( AC = c + dQ \). Here we add the fee, \( J \), to the fixed cost, so \( AC = c + J + dQ \). Total cost, \( TC = AC(Q) = c + J + dQ \). Marginal Cost, \( MC = dTC/dQ = c + 2dQ \). Note that the differentiation yielding MC does not change by adding the fee. As a part of fixed cost, the fee cannot be passed on through a higher price and the optimal outcome cannot be reached by selling a different quantity.
per ticket. In any case, the private firm should know the revenue total that it will have to turn over from the ticket sales and not think of it as a “per ticket” amount that must be attached to each ticket sold.

If the fee is treated as an excise or unit tax, it would increase the price of each ticket, forcing the price higher and resulting in a sub-optimal quantity of ticket sales.

The closer the objective of such fees approximates this fee-maximisation approach, the closer behaviour should move to this pricing strategy. Figure 1 shows the net revenue (NR) associated with the maximum net revenue (NR) position at the optimal quantity of sales,

This diagram assumes that for a circus, there is only a fixed cost for the delivery of a single night’s performance. All of the normal “variable” costs for a given evening are determined by the cost of a single performance and so can be treated as fixed. If the principles explained above are applied, the municipal entertainment fee will simply take the revenues by shifting downward the net revenue function from NR to NRat, the net revenue after tax. If the fee is applied instead as a unit tax, that will have the effect of starting at the level of fixed cost, but causing the TC function after the tax, TCat to slope up to the right. The firm would then optimise its position by operating where MC = MR, where the slope of the TR curve is the same as the slope of the TCat curve, which of course slopes upward. This will entail the higher cost, the price after the unit tax is imposed, the reduced, sub-optimal number of tickets sold, Qs, smaller net revenues, smaller tax take, and smaller profits.

![Figure 1](image)

Figure 1
Optimal Fees on Private Activities

What is happening here may be clarified by the data of Exhibit 3. In the left column the circus sells 1,250 tickets for the performance of a single evening at 320 Ks per ticket. This is an optimal quantity and price resulting in TR of 400,000 Ks with net revenues of 80,000 after deducting the total cost of 320,000 to pay
the cast and expenses. The municipality takes the 50,000 it had targeted for its fee, leaving the circus 30,000 Ks. The right column demonstrates the inadequacy of using an excise tax type fee. The 40 Ks fee is attached to each ticket so that the total ticket price becomes 400 Kc, reducing ticket sales to 1,050 and yielding total revenues of 378,000 and NR = 58,000. But the circus must still pay 40 Ks (1,050) = 42,000 Ks to the municipality, leaving the post-fee take at 16,000 Ks for the circus. The higher ticket price (including the municipality’s fee cut) reduced ticket sales, fee revenues and the net revenues of the circus after imposition of the fee.

**Exhibit 3**

Entertainment Fee: Lump Sum vs Excise Tax

<table>
<thead>
<tr>
<th></th>
<th>Lump Sum</th>
<th>Excise Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Fixed) Total Cost</td>
<td>TC = 320,000 Ks</td>
<td>TC = 320,000 Ks</td>
</tr>
<tr>
<td>of Performance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of tickets</td>
<td>Q = 1250</td>
<td>Qat = 1050</td>
</tr>
<tr>
<td>sold</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price of ticket</td>
<td>P = 320 Ks</td>
<td>320 + 40 Ks</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>TR = 400,000</td>
<td>TR = 378,000</td>
</tr>
<tr>
<td>Net Revenue</td>
<td>NR = 80,000</td>
<td>NR = 58,000</td>
</tr>
<tr>
<td>Target 50,000 in</td>
<td>NRat 80,000 Ks</td>
<td>NRat = 16,000</td>
</tr>
<tr>
<td>municipal revenues,</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| or 40 Ks(1250) =    | = 50,000 Ks     | Actual fee receipts:
| 50,000 Ks           |                 |                   |
|                     | = 30,000 Ks     | 40Ks(1050) =      |
|                     |                 | 42,000 Ks         |

Fees Applied to Public Service Provision.

In the case where the municipality supplies a service or sells a licensing fee, it can act as a monopolist and maximise revenue. Assume a city wanted to charge for dog licences and legislation was passed to allow that city to establish its own price. The city would not forget, of course, that the licence has a regulatory function and that it is levied primarily against dog ownership as entertainment. As we saw above, dogs used to assist the handicapped or perform other professional functions are licensed at a reduced fee.

The municipality would maximise revenues by operating at the centre of its demand curve extended from axis to axis at the point where demand elasticity is unitary, since at that point $MC = MR = 0$ in an essentially no-cost activity for the municipality. It could attempt to determine its demand curve econometrically or through questionnaires to potential consumers, but if it had doubts whether it were enjoying maximal revenues, it would be easiest to experiment at the margin, observing whether price increases would reduce the quantity of licences demanded and cause net revenues to decline.

A somewhat more sophisticated revenue effort would obviously incorporate price discrimination, charging somewhat lesser fees for senior citizens, etc. Attention paid to demand elasticities would likely result in lower fees to rural citizens, where possession of animals is less an expression of demand for “entertainment.”
It is possible that where dogs in rural areas perform no work function, their maintenance for entertainment purposes might be in less demand than would be the case in urban settings. Here we would be concerned with third degree price discrimination, in which individual market segments would command their own individual licensing fee, roughly taken from demand curves directly above the point where MR curves intersect the quantity axis.

It is imperative, of course, that municipal officers (and the national officers and lawmakers who have usurped local governance in hyper-centralised transition economies and who control legislation constraining municipal prerogatives) take into account the social considerations that may take priority over the municipality’s revenue yields. Once that has been done, however, it is only reasonable that the municipalities of the Czech and Slovak Republics, not to mention other sub-national government sectors in transition economies similarly stressed financially, apply methodologies in the application of local user fees that will permit them to enjoy the greater revenues that are desperately needed.
5. Charges in Local Government Services and Budgets in Poland (The example of kindergartens and local transport in Lodz)

Piotr Bury

5.1 Introduction

Fees and charges make up numerous and diversified categories of budgets’ revenue. These two kinds of sources are commonly known in Poland as “public” or “private”. The latter is strongly connected to a public service (charges), while the former is connected loosely, or has no link at all (both are called fees; some of those being, in fact, hidden taxes which were discussed in the author’s paper written for the 2003 NISPAcee Conference).

Local governments have to run many different services for local societies. In Poland this especially refers to gminas, which are the basic units of local government. Their activity covers: physical planning, roads, water, sewage, waste collection, kindergartens, primary schools, social and health care and cemeteries etc.

Some public services are free, such as local roads or schools. Some have a payment charge calculated to cover a part, or the whole cost of the service, such as water or kindergartens. The level to which the total costs are to be shared by consumers depends on national and/or local government policies.

From a number of local public services, two were chosen to show the different solutions for their organisation and financing: pre-school care for children (kindergartens) and local public transport. Kindergartens may be financed from the local budgets, but usually their costs are shared by the local government and the beneficiaries. Local public transport, as in other countries, requires support from local budgets. When buying a ticket, a passenger covers only a part of the actual cost: how much depends on each local government decision.

The paper shows the tasks of the basic tier of the local government (Section 2), general types of financing local government services (Section 3), the different ways they are organised and their influence on local budgets (Section 4), with examples related to the social (kindergartens, Section 5) and technical (public transport, Section 6) infrastructure in the city of Lodz; the paper ends with some conclusions (Section 7).

5.2 Gminas and their Tasks

Local government in Poland has basic, sub-regional and regional units.

1 P. Bury – Tax-nature Fees in Local Government Budgets in Poland.
The units of the basic tier, *gminas*, are the most differentiated ones. As far as their status is concerned, there are three or even four types. One is a typical rural *gmina*, another is a separate town and the third is composed of rural areas and of usually, a small town. The fourth group is made up of large towns, which simultaneously are the units of the upper, sub-regional level.

Units of the sub-regional level (*powiats*) may be one of two types: one is composed of a town which is the *powiat’s* “capital” and a number of rural, mixed or urban *gminas* and the second is, as mentioned above, a separate large town. Such urban *powiats* have to fulfil tasks which are typical, both for the basic and sub-regional tiers of local government. Their budgets also use sources of income set down by the Law for each of these two local government levels.

Regional units (*wojewodztwos*) cover the area of several *powiats* and have the same territories as central administration regions.

Each of these tiers of local government has to fulfil its tasks set down by the national law. The most differentiated and important set of tasks to local communities is that for *gminas*, which for example are responsible for:

- physical planning and land-use management;
- environment and water protection;
- water supply and sewage treatment;
- electricity and gas supply;
- street cleaning, refuse collection and waste disposal;
- local public transport;
- street lighting;
- district central heating;
- maintenance and construction of local roads;
- health care;
- local market-places;
- maintenance of green areas;
- municipal cemeteries;
- municipal housing;
- provision of education services (kindergartens and primary schools);
- culture, including local libraries and leisure centres;
- social welfare services for elderly, handicapped and homeless people;
- pro-family policy and care of pregnant women;
- promotion of local governance and of the *gmina*;
- co-operation with NGOs and with local communities from other countries.

The list above shows the general areas of the *gmina’s* activity; concrete responsibilities are spread over many different acts. One can easily see that the indicated areas cover all those functions which are crucial for both the local communities and business. These areas may be aggregated into three general groups.
One is social services, covering, for instance, education, health and social care. Another group consists of technical services such as water, sewage and roads etc. (Some services, however, may be found in both groups; for example housing on the one hand is a typical technical maintenance activity, or even construction of residential houses, but on the other, it is a social function, not only because the right to have a place to live is at the top of the social needs' list, but also because municipal housing is generally of poor quality and among its residents it is the poor people who prevail). The third area of the gminas’ activity is promotion and co-operation with other territorial units.

So, while the tasks from the last group are directed towards the gmina itself, the other two groups are services directed towards the gmina’s inhabitants, visitors and business located on its territory.

5.3 Organisation of Local Public Services

Delivery of public services can be organised in several ways. First, each unit offering public services in Poland falls into one of two general sectors. One is the public finance sector and the other is the business sector.

Within the public finance sector, most services are rendered by units organised in one of several typical forms, regulated by national law (Act on Public Finance). In each case, the form of organisation is strongly connected with the financial clearings with the budget of the relevant local (or central) government.

The basic form is a budgetary entity, fully subordinated to the relevant government. Budgetary entities cannot earn money for themselves and all their expenditures are covered directly from the budget. The most common budgetary entities are, for instance, public schools, offices and hospitals. The financial regulations concerning this type of unit are both simple and restrictive, so that quite often, the real conditions exceed the limited framework. Therefore in some cases additional forms are taken to solve the problems. One such a form is the auxiliary unit, created when the budgetary entity has to run a quasi-economic activity and when direct use of the earned money would simplify the financial procedures. This would be the case for workshops at vocational schools or of a school canteen. Half of their profit goes to the income of the relevant local budget; from the same budget the auxiliary units receive grants, if necessary. Another form was special funds, created when a budgetary entity receives money from outside the relevant budget and has to spend it on a concrete, indicated purpose (e.g. a donation or an insurance payment)\(^2\).

The next form is a budgetary establishment. It is created when, as a rule, the type of service guarantees an income sufficient to cover its costs. Units of this type may also receive grants from the relevant budget and, on the other hand, a

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2 Was, because from April 2005 the special funds were eventually cancelled (and likewise the auxiliary units). Simultaneously the severe financial rules adopted for the budgetary entities were loosened.
possible surplus of that budget’s income. Common examples of budgetary establishments were, in the past, units responsible for water and sewage management; most of them, however, have been transformed into local government limited companies. Nowadays a typical example is still kindergartens, although the criterion of being self-financed is not achieved there, for social reasons (therefore more and more often they are being transformed into budget entities).

Yet another form is appropriate (or purpose) funds. Each of them has its own, separate income sources provided in the relevant Act, which also indicates what the money collected can be spent on. Purpose funds are no longer common at the local government level since 1990, but still exist at the national level, with the Social Insurance Fund being the largest.

The above forms are convenient in most, but not all cases. Therefore there are also units, the organisation of which is regulated in separate acts, issued especially for a type of service or even for a particular institution, such as for instance: universities, libraries, museums, Social Insurance Unit (ZUS) or the Fund for Farmers’ Social Insurance (KRUS).

Since 1999, the summary financial plans, including income and expenditures of all the units within the public finance sector, are discussed and voted, together with the “real” budget of the relevant local or central government.

Within the business sector there are a variety of private and state-owned firms in different forms, for example, enterprises of physical persons, joint-stock companies, one-man corporations of the State Treasury and limited liability companies. Their links with the central or local budgets are limited to taxes and dividend, on the one hand, and to the purchase and/or grants to some public services on the other.

5.4 Charges as Local Budget Income Sources

User charges for public services are used to cover a part or all of their costs. Thus, one specific function of charges is being automatically fulfilled. Another function – prohibitive – should also not be neglected. It seems that even a symbolic charge can prevent some potential users from an unnecessary use of the service. 3

Public services are financed from different sources, also in gminas. Most are offered free: to all consumers (e.g. primary education) or to some of them (e.g. free local transport for citizens over 65 in Lodz). What is more, some such services are, in fact, money granted to those who need it (e.g. housing allowances for poor residents). In such cases, the total cost of a service is covered by the local government from its budget.

3 This especially refers to regularly reappearing debates on the ambulatory health services. Some doctors (but not only doctors) are of the opinion that even a very low charge for a visit would prevent many people from treating the ambulatory as a social meeting club.
Consumers of other services are charged payments (charges). These are calculated, either so as to cover the total cost of the service or a large part of it; how big depends on the central and/or local government policies within the related area.

An example of a partial share in the service costs is, probably everywhere, local public transport. Delivery of water is, in turn, a common example (at least in Poland), where the charges are calculated at a level that ensures not only covering the total costs of the drawing out, purification and delivery, but also gives some surplus to the water management unit.

During the last decade, local governments, as well as organisations responsible for local public services delivery, have been gradually gaining larger and larger discretion over service charges. The present situation in the most important services may be summarised as follows 4:

- city transport – the local council decides on ticket prices for the services offered by the city transport unit or other firms under agreement; other private competitors are free to decide on their own tariffs;
- water and sewage – municipal entity (in most cases a company) proposes the tariff, which needs to be approved by the local council 5;
- central heating – the price is set by an entity delivering the service on the basis of general rules set by the central government; prices are controlled by the Office for Energy Regulation;
- waste collection and disposal – tariffs are negotiated between the provider and the client; the local council may (but until now this has happened infrequently) decide on a maximum price per unit;
- communal housing – local council decides on rents on the basis of general rules set down in the law; in practice, in most cases (for political reasons) the rents are fixed below the real cost of maintenance;
- most other services – prices are subject to negotiation between providers and clients.

User charges, such as for kindergartens, water provision, sewage, solid waste collection and public transport are usually collected by the servicing unit, with or without the mediation of the collector. Quite often, these revenues are not shown in the municipal budget, since they may be kept by some delivery units and used to cover the costs of service provision. In some cases, local government may subsidise these services, or local budget may receive the surplus, so what can be found in the budget is just a balance of charges collected and the amount spent on the actual de-

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5 Till the end of 2002 it was the local council that decided on prices under general rules set by the central government. These rules referred to the method of calculation, based on justifiable operational costs. For a long time, there has been a discussion on to what extent local companies and local governments should be allowed to include the cost of necessary investments into the tariff calculations.
livery. For some services (e.g. solid waste collection), the local government may also set maximum charge rates, which may be collected by the private provider.

Flows of money from charges when public services are rendered by three basic types of local government units (mentioned in Section 3) are shown on Figure 1.

**Figure 1**
Charges as Local Budget Income

<table>
<thead>
<tr>
<th>Charges</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Budgetary Entity</td>
<td>Budgetary Establishment</td>
</tr>
<tr>
<td>Total</td>
<td>Surplus</td>
</tr>
<tr>
<td>Local Budget</td>
<td></td>
</tr>
</tbody>
</table>

Similar flows of money as these shown above can also happen in the case of other servicing units. In general, there are three possibilities:

1. Charges as a whole are an income of the relevant budget (budgetary entities but also the case of the local transport company discussed in Section 6).
2. Charges are not shown as budget income, but are an income of the servicing unit (budgetary establishments when their costs are higher than charges, as in the case of public kindergartens discussed in Section 5).
3. A part of charges is shown as a local budget income (budgetary establishments when the charges exceed their running costs; similar to this type would be auxiliary units or local companies if they pay a dividend from their profit to the relevant local government).

What is really important: in each of the above possibilities, user charges increase the total sums of money used for financing public services. And in the cases of government units shown on Figure 1, these charges as totals are approved by local councils, together with the budget of each local government (or by Parliament in the case of the central government).
Different forms of the organisation of public services, together with specific rules on clearings with the relevant budgets, make any comparisons very difficult. This refers not only to the analyses made between local governments, but also to those made for the same government within a certain timeframe. In each case, a thorough analysis of the ways of rendering local public services has to precede the analysis concerning the local government budget itself.

5.5 Kindergartens

Kindergartens are used here as an example of a local government social service, run within the sector of education.

From 1996, primary education became an own, compulsory task of all gminas. Since that time, it covers two consequent schools: first (basic) for children of 7, with 6 classes, then the second (gymnasium), with 3 classes (secondary schools: general and vocational, are an obligatory task of the powiats).

Pre-school care also is a gminas’ task. Kindergartens themselves, as well as schools, may be public or private units. In Lodz, a significant decrease in the number of children in recent years, has led to a decrease in the number of kindergartens and classes in them. But this relation refers to the units managed by the City (public), while the others (private) do quite well (see Table 1).

Public kindergartens are organised as budgetary establishments. According to the law, such units should earn enough to cover their expenses. This is not the case, however, with kindergartens. Parents, of course, have to pay tuition for their children but it is not sufficient. In Lodz, tuition was fixed by the City Council at 14 per cent of the minimum wage. This rate is the same for everyone, despite the real per head income of the interested families. What is more, although the minimum wage has been raised annually, the tuition – due to social but also linguistic reasons – remained unchanged. Funds received from this source are, of course, insufficient to finance even the current expenses. Therefore a special grant from the local budget is necessary (see Table 2).

<table>
<thead>
<tr>
<th>Number of</th>
<th>2001/02</th>
<th>2002/03</th>
<th>2003/04</th>
</tr>
</thead>
</table>

Source: based on data of Lodz City Hall

6 In fact some of these, mainly run by nunneries, are officially called public, due to exactly the same grants received from the local budget as in the case of kindergartens managed by the City.

7 Due to different words meaning the same, i.e. minimum and the lowest, used in the national and local documents.
Table 2
Financing Public Kindergartens in Lodz, in 2001-2004

<table>
<thead>
<tr>
<th>Number of</th>
<th>2001/02</th>
<th></th>
<th>2002/03</th>
<th></th>
<th>2003/04</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>'000</td>
<td>Per cent</td>
<td>'000</td>
<td>Per cent</td>
<td>'000</td>
<td>Per cent</td>
</tr>
<tr>
<td>Tuition</td>
<td>18,172</td>
<td>19.6</td>
<td>18,360</td>
<td>20.4</td>
<td>17,749</td>
<td>19.2</td>
</tr>
<tr>
<td>Budget grant</td>
<td>74,202</td>
<td>79.9</td>
<td>70,651</td>
<td>78.7</td>
<td>73,710</td>
<td>79.8</td>
</tr>
<tr>
<td>Other sources</td>
<td>518</td>
<td>0.6</td>
<td>807</td>
<td>0.9</td>
<td>942</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>92,892</td>
<td>100.0</td>
<td>89,818</td>
<td>100.0</td>
<td>92,401</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: based on data of Lodz City Hall

Each kindergarten has to offer a minimum educational programme, set by the Minister of Education. This minimum service: a few hours of educational games and teaching, without meals, is provided free of charge. From September 2003 the so-called “0” class became obligatory for all six year old children, which means additional money to be spent by local governments.

Because the number of pupils taking advantage of these minimum and obligatory programmes varies among kindergartens and also during the school year, the grants from the city budget have to be calculated for each unit separately. The amount of grants to each City kindergarten is fixed every year so as to cover – together with its other income (tuition, but also some other sources such as renting the rooms) – all the running costs. The capital costs are financed through separate local grants. The running grant rate per pupil is then used to calculate the respective grants to a few private kindergartens with “public” status and – but in 75 per cent only – to other private units.

All grants to kindergartens are paid from the local budget; only for special kindergartens (or classes) for handicapped pupils do local governments receive support from the central budget within the educational part of general grant.

Because public kindergartens operate as budgetary establishments, the charges paid by parents go directly to the relevant kindergarten’s account, as shown in Figure 1. And, because the tuition is fixed at a very low level compared to the running costs, there is no surplus to be transferred from any kindergarten to the local budget.

Shares of grants transferred to the public kindergartens from the gmina’s part of Lodz’s budget have dropped from 6.5 per cent in 2002 to 6.1 per cent planned for 2004. Ratios expressing tuition to the total income of the same part of the budget would have been (if this could happen in reality) slowly declining as well: from 1.6 per cent in 2002 to 1.4 per cent expected for 2004.

8 See e.g. P. Bury, P. Swianiewicz (2003). “Grant Transfers and Financial Supervision over Local Governments in Poland”, Working Papers, No.37, Glasgow Caledonian University.
5.6 Local Public Transport

Local transport is another example of public services organised in Poland by gminas.

Local public transport may be organised in different ways; most often in the form of a budgetary establishment or of a local company with limited liability. Each solution results in different links with the local budget and different flows of the money. The former case would be exactly the same as for the previously discussed kindergartens, while the latter would refer to the other two types shown in Figure 1, i.e. to the budgetary entity or to the auxiliary unit.

It is very difficult to express the volume of city transport by the number of passengers. The easiest way seems to be by means of tickets sold. But first, in Lodz, there are many different tickets (however, not as many as in Warsaw): single travel, daily, weekly, monthly, for one school semester or even yearly. Second, there is a time system for single tickets: a ten-minute journey costs 1.70 zloty, but for 2.40 zloty one can travel (and change vehicles) for a half an hour, another 1.20 zloty ticket increases the time to one hour and yet another for two hours. Four basic tickets stamped at a time are valid for 24 hours. The volume of local city transport services in Lodz is roughly estimated as 234 million single journeys in 2003.

Local public transport in Lodz is organised by the Unit for Roads and Transport being a budgetary entity, which in July 2003 replaced a division within the City administration. Services are based on contracts signed in 1993 (nowadays an adjudication procedure would be necessary). There are four firms rendering public transport services within the borders of the town. They are three local companies: MPK (City Transport Company), TP (Suburban Tramways), MKT (Inter-municipal Tramway Transport) and a small private bus firm, KORO, operating just two buses and servicing one line. In addition to these, a local bus company from the neighbouring town of Zgierz runs one bus line connecting that town with the main railway station in Lodz. All services rendered by these firms are subject to the already mentioned contracts with the City.

Outside the local public transport system are many firms rendering similar services according to their needs and recognition of the market: regional bus companies of national monopolist PKS (State Transport Company), hypermarkets, private mini-buses etc. More than sixty such firms have signed agreements with the City and pay annual charges for using bus-stops which belong to and are maintained by the city.

Local public transport in Lodz is based on tramways and buses. They run an annual distance of almost 60 million kilometres; tramways run a little more than a half of that figure. The most important provider is, of course, the MPK, a limited liability company owned by the City of Lodz. Its 380 tramway wagons (usually 190 trains) and similar number of buses, drive 55 million kilometres per
year, servicing 15 tram-lines and almost 50 bus-lines. MPK also offers special mini-bus services for disabled persons.

Prices of tickets for local public transport are decided in Poland by local councils and are similar in different towns. As previously mentioned, the basic ticket for a half-hour trip costs in Lodz 2.40 zlotys, the same – for instance – in the capital city of Warsaw, whilst in the regional town of Kielce with over 200 thousand inhabitants – 1.90 zlotys (in these two towns, without changing vehicles).

In Lodz tickets are sold by the City Unit for Roads and Transport to eight distributors (the MPK being the most important) which then organise retail sales. All receipts for the tickets are an income of the Lodz budget. On the other hand, out of every year’s budget, a significant amount of money is devoted to paying for contracted transport services (including also the maintenance and repairs of tracks). Purchase of wagons and buses is the decision and financial responsibility of the MPK and other contractors.

Another solution has been adopted with ticket control and vindication of fines. This is a subject of another contract with four firms. Each of them operates in a different sector of the town, changing area every month. All receipts from the fines are the income of these firms.

A comparison of the amounts received from the sale of tickets with that paid for the local public transport services during the last three years is shown in Table 3.

Table 3
Local Public Transport in the Budget of Lodz, in 2002-2004 (in thousand zlotys)

<table>
<thead>
<tr>
<th>Amount of</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receipts for tickets</td>
<td>127,136</td>
<td>136,000</td>
<td>147,000</td>
</tr>
<tr>
<td>Purchase of services</td>
<td>275,151</td>
<td>271,834</td>
<td>275,688</td>
</tr>
<tr>
<td>Receipts / Purchase</td>
<td>46.2</td>
<td>50.0</td>
<td>53.3</td>
</tr>
</tbody>
</table>

Source: based on data of Lodz City Hall

The figures in the above table prove that the passengers’ share has been constantly growing. This was possibly due to various reasons. The most obvious was the consequent rise in ticket price: in the period surveyed, this happened in Janu-

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9 The longest tram line, connecting the town of Ozorkow covers a distance of 34 kilometres. A few years ago, the number of tram lines has been limited and the frequency of the reorganised lines raised; nowadays each line is being served on weekdays every 7-10 minutes during the day and 14-25 minutes early mornings and late evenings.

10 Local public transport is probably supported everywhere from the budget; it even happens that big cities charge nothing during for certain times, to encourage car users to exchange them for public transport.

11 There was also a controversial purchase by MPK of several high-standard trains “Cityrunner” from the Bombardier (due to their price, called by some local media “City-ruiners”).
Charges in Local Government Services and Budgets in Poland

ary 2002 (fragmentarily) and in August 2003 (totally); the recent one was in August 2005. Passengers, who used to pay for the service, would do so even if the tickets cost more. Another reason could be increased offers, including tickets for families or school-groups. Nowadays, tickets are sold not only in kiosks and small food shops, but also in automats and (a recent solution) – directly from the tram or bus driver. On the other hand, MPK also introduced some procedures directed towards cost-saving so that the service costs were lowered (2003 compared with 2002) or remained almost the same (2004 compared with 2002). In the budget of Lodz, both quotas shown in the table, i.e. receipts for tickets and the purchase of services are shown in full. So, although it is a case of a city limited liability company, its clearings are similar to those typical for the budgetary entity (see Figure 1).

Both amounts prove that local public transport holds a significant position in the city budget. Ratios of the receipts for tickets to the total budget income within the gmina’s part of the Lodz’s budget are stable and remain just below 12 per cent. Ratios expressing the purchase of transport services to the expenditures of the same part of the budget are slowly falling: from 24.0 per cent in 2002 to 22.9 per cent expected for 2004.

5.7 Conclusions

The above general considerations and examples of two local services allow us to formulate several conclusions:

1. User charges are commonly accepted, as they burden those who use public services. Even when the charge rate is symbolic, it plays its role of inhibition against over-use.

2. Charges play a significant role in delivering to public authorities, or directly to private servicing units, the money necessary for fulfilling their tasks. It is not necessary for charges, however, to be tightly connected to the relevant budget.

3. Whether the charges are shown in the local budget or not, depends on the form of servicing the unit adopted – voluntarily or under legal pressure – by the interested local government. Thus the lack of specific user charges in the local budget does not necessarily mean a lack of relevant public service. In any case, this enables any superficial comparison between local governments, as well as within the same local government in time.
6. User Charges and Fees: Financing Local Services in Lithuania

Mark Chandler

6.1 Introduction

This paper is an attempt to analyse the impact of user charges on the overall fiscal system of Lithuanian local governments. It will review the structure of Lithuanian local government and then proceed to introduce its financial basis. Having provided this background, the paper proceeds to examine the legal basis of user charges and the revenues generated by them, and to analyse their role in the overall system.

It should be noted that at the start of Lithuanian independence, there was enthusiasm for creating a truly autonomous system of local government. Breaking away from the USSR had been motivated in part by a desire to end decades of centralised control over many aspects of life and hence decentralisation and local control were popular concepts. In some ways, the story of the first years of development of Lithuanian local government appears as a gradual emasculation of these ideals, as they came into conflict with the terrible realities of creating a strong state in the face of the catastrophic economic conditions of the early transition.

6.2 Lithuanian Local Government at a Glance

Lithuania is a unitary state, with two elected levels of government. National government is primarily a parliamentary democracy. The directly elected president has a mainly advisory role, with most of the executive power in the hands of ministers chosen by the Prime Minister. The Lithuanian Constitutional Court decides on constitutional questions and there is a hierarchy of lower courts from the Supreme Court down to the courts of first instance to decide criminal, civil and administrative cases. Local councils are elected by proportional representation and the council then elects its leader, the mayor. There are currently 60 local authorities.

The Lithuanian Constitution provides the most fundamental legal basis for Lithuania’s local government. Chapter 10 of the constitution is devoted to local government. It gives few rights to them, however, providing for control by laws, thus giving effective control over all local government matters to the national parliament. The basic law on local government is the Law on Local Self-Government, passed in 1994 and amended 36 times by the beginning of 2004. This law establishes the municipal council as the basic representative institution and the Director of Administration as the institution responsible for implementation. The

1 I am grateful to Zeljko Sevic and an anonymous reviewer for their helpful comments. I remain responsible for all remaining errors.
Law on Municipal Council Elections was also passed in 1994 and was amended 19 times by 2004. It provides for municipal councils elected by a system of pure party list proportional representation for four-year terms. The number of council seats depends on the population and ranges from 21 for the smallest to 51 for local authorities with greater than half a million residents.  

From the beginning of 2004, the Law on Local Self-Government distinguishes two control institutions within local authorities. The first is the Controller and the Control Committee, which is responsible for overall monitoring of the legality and effectiveness of the municipality’s use of its property and budget. The second is the Internal Audit Committee, responsible for the audit of the municipality’s administration and public enterprises.

The Law divides local authority functions into four categories, according to how much formal independent decision-making power belongs to the municipality. The four categories are independent, assigned, state and agreed. Only the first of these gives local authorities potential decision-making power over an activity, otherwise it is mainly the implementer of national decisions. The law lists independent local government functions as the formation of local government budgets, pre-school education, extra-curricular education and professional training, adult education, school lunches, social services, support to local health care, training and public works, public order, development of sport, tourism and recreation, establishment of local nature reserves and protected cultural objects, and development of local business conditions. The Law also leaves open the possibility for local authorities to independently perform other functions that have not been assigned to state institutions.

The table in Appendix 1 contains the full list of services that are independent and assigned according to this law. The assigned activities, such as general education, are items which are implemented by the local government, but which are the primary responsibility of the state and must be carried out in accordance with the wishes of the national government. State functions designated to local authorities, by contrast, refer to the pure execution by local authorities of provisions of national law regarding such things as welfare payments or citizenship documents.

Municipalities may establish parish administrations within their boundaries to facilitate local operations. These parish administrations are headed by an administrator, selected by the director of administration of the local authority. The parishes are responsible for organising services such as the care of cemeteries and public works. The law also provides for election of a community representative for a living place or group of living places. This individual may represent the community at the parish level or in municipal institutions, if the need arises.

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2 Only the capital city, Vilnius, is so large.
With regard to the relationship between local governments and the national government, the law states that local authorities are not under the control of the national government. It names the Lithuanian Association of Local Authorities as the institution to represent municipalities. This may negotiate with the national government in a two-party commission. One of the rights given to local authorities by the law is the right to go to court to defend themselves from infringements. A government representative monitors how the local authority upholds the Constitution, national laws and government decisions.

6.3 Lithuanian Local Government Finance: An Overview

There is no comprehensive data set that allows us to evaluate what proportion of municipal budgets are divided between the different levels of local responsibility. However, below, I present an analysis of the budget for the Palanga local authority. The budget passed for 2003 approved total spending of 32,219.6 thsd LTL. From this amount, 38.5 per cent was either classified as state functions, or funded out of state grants, as shown in the table below.

<table>
<thead>
<tr>
<th>Total spending:</th>
<th>32,219.6</th>
</tr>
</thead>
<tbody>
<tr>
<td>State functions:</td>
<td>4,767.4</td>
</tr>
<tr>
<td>State budget special purposes:</td>
<td>1,632.8</td>
</tr>
<tr>
<td>Pupil basket:</td>
<td>5,509.1</td>
</tr>
<tr>
<td>Special programs:</td>
<td>504.1</td>
</tr>
<tr>
<td>Hence total from state funding:</td>
<td>12,413.4</td>
</tr>
</tbody>
</table>

From this, one may gain the impression that over 60 per cent of local authority spending was under municipal control. However, that would be misleading. There is no classification in the official budget of which expenditures were independent and which merely assigned functions. For example the budget includes 2,547.2 thsd LTL of municipal spending on general school education, which is clearly an assigned function under the control of the national government.

If we use a zero-base approach and try to identify which areas of the budget are clearly independent functions we get the following table.

<table>
<thead>
<tr>
<th>Pre-school education</th>
<th>3,589.7</th>
<th>11.1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public works</td>
<td>2,406.0</td>
<td>7.5%</td>
</tr>
<tr>
<td>Seaside tourism development</td>
<td>99.6</td>
<td>0.3%</td>
</tr>
<tr>
<td>Preparation for EU structural funds</td>
<td>100.0</td>
<td>0.3%</td>
</tr>
<tr>
<td>Tourism development fund</td>
<td>100.0</td>
<td>0.3%</td>
</tr>
<tr>
<td>Development of business</td>
<td>8.0</td>
<td>0.0%</td>
</tr>
<tr>
<td>Local public order</td>
<td>30.0</td>
<td>0.1%</td>
</tr>
<tr>
<td>Local projects</td>
<td>1186.4</td>
<td>3.7%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>7,519.7</strong></td>
<td><strong>23.3%</strong></td>
</tr>
</tbody>
</table>

Local projects include a variety of items from preparation of the local economic and social plan to grants to local NGOs.
Hence the truly independent spending of local authorities is dominated by pre-school education and public works projects. While the Education Ministry provides recommendations on means and pedagogy for pre-school education, these are of an advisory nature and local authorities have control over the level of services they provide. However, it should be borne in mind that since Lithuanian municipalities cannot control their revenue directly, they are not able to trade-off private income against pre-school services. Their effective trade-off is between different levels of local services, although this does include the possibility of funding increases in assigned functions by cutting spending on pre-school education or public works. Only in a few cases, where municipalities have made general abatements to one of the property taxes, can we conclude that they have increased private income at the expense of public expenditures.

Appendix 2 provides the data on local authority revenue for the last ten years.

Chapter 1 of the *Law on Tax Administration* states that only the Finance Ministry is responsible for implementing tax law; no other institution can be given this responsibility. The Finance Ministry department that implements tax administration is the State Tax Inspectorate; this is described further in chapter 3 of the law. It consists of both central and affiliated local territorial tax administrations. Hence, even local fees and charges are collected by the local affiliate of the State Tax Inspectorate and then transferred to the local authority.

Occasionally, municipalities have converted the property taxes into local taxes by offering general abatements, reducing the tax by a fixed proportion for all taxpayers. The tax then operates as a local tax, since at the margin it may be increased or reduced by the local authority, and the local budget receives the full impact of such changes. The most important by far of these property taxes is the real estate tax on enterprises. However, most abatement takes place in the land tax and the land rental tax. From 2003, local authorities were allowed to vary the land rental tax from 1.5 per cent to 4 per cent of the land value. Siauliai District Council, for example, converted the land rental tax to a local tax in 2003, by setting the rate at the minimum 1.5 per cent for a certain class of taxpayers and higher rates for other taxpayers. This meant that Siauliai District had the option to increase or decrease its revenue from this tax. However, land rental tax is not a large revenue source for municipalities. The planned land rental tax revenue was 0.7 per cent of total planned revenue in Siauliai District in 2003. In Lithuania as a whole, the tax provided 2.0 per cent of municipal revenue in 2002.

The importance of grants to Lithuanian local authorities increased dramatically following the 2001 reform to school finance. This reduced the funding to local authorities from the personal income tax and replaced it with a new grant, the pupil basket grant, based on the number of pupils in local schools. Hence from 2000 to 2002 grants went from 10 per cent of local government revenue to a planned 57 per cent.
6.4 The Legal Framework for User Charges and Fees Levied by Local Governments and its Implementation

The Law on Fees and Charges allows local authorities to impose fees on eight specific items. Six of these regard various licences or permissions for activities including area evacuations, trading in public places, outdoor advertising, organising commercial events in public spaces, bringing vehicles into protected areas and keeping animals in multi-occupancy residences. Local authorities may also establish parking fees on public streets and squares. Lastly, they may charge for rubbish collection. The revenue available from the first seven of these items clearly depends on the demand for them. The charge for rubbish collection appears to give municipalities an open ended opportunity to raise revenue, as Section 3 of the State Strategic Plan on Refuse Collection makes it compulsory for all residents and enterprises to participate in the municipal rubbish collection system. However, paragraph 20 of this section then expressly forbids local authorities from using revenue from this source to fund other policy areas and puts a limit of 1 per cent of family income on charges for municipal refuse collection. Hence the above instruments are demand-constrained charges for local activities. Most of them are not true taxes, since they do entail direct receipt of services in return for payment.

6.5 Revenues Generated By User Charges and Fees

Data on revenues generated by user fees has been made publicly available by the Finance Ministry starting with 2002. Overall local user charge revenue increased by 28 per cent from 37.4 mln LTL in 2002, to 47.2 mln LTL in 2003. The distribution across local authorities is summarised in the table below.

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country wide mean</td>
<td>2.3</td>
<td>2.8</td>
</tr>
<tr>
<td>Mean of LAs</td>
<td>2.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Median</td>
<td>1.6</td>
<td>2.2</td>
</tr>
<tr>
<td>1st Q</td>
<td>0.9</td>
<td>1</td>
</tr>
<tr>
<td>3rd Q</td>
<td>3.2</td>
<td>3.7</td>
</tr>
<tr>
<td>Min</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Max</td>
<td>7.3</td>
<td>8.9</td>
</tr>
</tbody>
</table>

Source: www.finmin.lt; own calculations.

The largest proportion of revenue from user charges was reported by Taurage in both years. The table below shows the top 5 LAs in terms of the proportion of their revenue from user charges.
Table 2
The Local Authorities with the Highest Proportion of Revenue from User Charges.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Local Authority</th>
<th>Fees as % of revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2003</td>
</tr>
<tr>
<td>1</td>
<td>Taurage District</td>
<td>8.9</td>
</tr>
<tr>
<td>2</td>
<td>Siauliai City</td>
<td>8.0</td>
</tr>
<tr>
<td>3</td>
<td>Svencioniai District</td>
<td>7.5</td>
</tr>
<tr>
<td>4</td>
<td>Anyksciai District</td>
<td>6.5</td>
</tr>
<tr>
<td>5</td>
<td>Kaunas City</td>
<td>6.2</td>
</tr>
</tbody>
</table>

The table below shows the 5 LAs with the least user charge revenue as a percentage of overall revenue.

Table 3
The Local Authorities with the Lowest Proportion of Revenue from User Charges.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Local Authority</th>
<th>Fees as % of revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2003</td>
</tr>
<tr>
<td>1</td>
<td>Salcininkai District</td>
<td>0.2</td>
</tr>
<tr>
<td>2</td>
<td>Panavezys District</td>
<td>0.3</td>
</tr>
<tr>
<td>3</td>
<td>Kaisiadoriai District</td>
<td>0.4</td>
</tr>
<tr>
<td>4</td>
<td>Prienai District</td>
<td>0.5</td>
</tr>
<tr>
<td>5</td>
<td>Lazdijai District</td>
<td>0.6</td>
</tr>
</tbody>
</table>

We might expect an LA's ability to impose user charges to be dependent on the economic vitality and population density in its jurisdiction. The correlation of 2001 population density with user charge revenue as a per cent of overall revenue is 0.29 for 2002 and 0.20 for 2003. These correlations have t-values of 2.31 and 1.55 respectively. Hence the correlation was significantly positive in 2002, at the 5 per cent significance level, but not in 2003. A scatter plot of this data is shown below. Some of the highest percentage shares are in less urban municipalities with low population density. Hence, there is no strong or robust evidence for the relationship between population density and user fee revenue in Lithuania.
6.6 Conclusion

User fees have been used to a rather limited extent in Lithuania. There is, however, sizeable variation across the local authorities in the proportion of their revenue derived from this source. There does not appear to be a simple explanation for this variability. Hence, further investigation is warranted in order to test hypotheses concerning its determinants.
### Appendix 1

<table>
<thead>
<tr>
<th>Government</th>
<th>Independent</th>
<th>Assigned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local budgeting</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Education</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-school</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Child, youth and adult general education</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Control of children’s school attendance</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>School transport for distant rural pupils</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Extra-curricular</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Adult special education</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>School lunches</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Welfare</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social services building maintenance</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Social services and assistance</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Public works</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Integration of disabled residents</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Management of social assistance for housing</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Health</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary health care</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Support to local services</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Implementation of a local health plan</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Enforcement of sanitation regulations</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Refuse collection and recycling</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Public Order</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local public order programmes</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Enforcement of alcohol and tobacco advertising prohibitions</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Enforcement of construction site regulations</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Social</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Establishment of cultural institutions</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Care of riverbanks and designated cultural areas</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Environmental protection</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Development of sport</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Development of tourism/recreation</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Establishment of local nature reserves</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Protection of local cultural heritage</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Care of cemeteries</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Economic</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Development of local business</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Territorial planning</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Planning for infrastructure, economic development etc.</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Designation of addresses</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Participation in regional development planning</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Management of local government land and other assets</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Organising heat and water supply</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Regulation of market and public sales places</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Issuing licenses</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Transport</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Care of local roads</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Organisation of local mass transport</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>
## Appendix 2

**Revenues 1994-2002 (thousand litas)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue</th>
<th>Tax Revenue</th>
<th>Personal Income</th>
<th>Corporate Income</th>
<th>Property taxes</th>
<th>Land</th>
<th>Land rent</th>
<th>Real estate</th>
<th>Estate, inheritance, and gift</th>
<th>Other</th>
<th>Stamp duty</th>
<th>Market place duty</th>
<th>Non-Tax Revenue</th>
<th>Grants, Loans and Transfers</th>
<th>Sales of fixed capital assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>1,927,461</td>
<td>1,301,313</td>
<td>626,550</td>
<td>2,133,660</td>
<td>38,220</td>
<td>6,786</td>
<td>31,344</td>
<td>46,356</td>
<td>-</td>
<td>-</td>
<td>106,861</td>
<td>3,269</td>
<td>77,602</td>
<td>547,928</td>
<td>6,18</td>
</tr>
<tr>
<td>1995</td>
<td>2,532,720</td>
<td>1,765,464</td>
<td>1,220,631</td>
<td>2,760,392</td>
<td>135,796</td>
<td>15,976</td>
<td>51,200</td>
<td>76,856</td>
<td>-</td>
<td>-</td>
<td>67,901</td>
<td>4,992</td>
<td>76,055</td>
<td>686,367</td>
<td>94</td>
</tr>
<tr>
<td>1996</td>
<td>2,883,534</td>
<td>1,998,864</td>
<td>1,547,418</td>
<td>2,167,483</td>
<td>126,941</td>
<td>15,302</td>
<td>53,120</td>
<td>85,763</td>
<td>-</td>
<td>-</td>
<td>85,763</td>
<td>4,432</td>
<td>852,055</td>
<td>498,068</td>
<td>94</td>
</tr>
<tr>
<td>1997</td>
<td>2,959,709</td>
<td>2,094,016</td>
<td>1,698,844</td>
<td>2,392,550</td>
<td>176,857</td>
<td>18,795</td>
<td>50,070</td>
<td>77,756</td>
<td>-</td>
<td>-</td>
<td>73,556</td>
<td>5,463</td>
<td>771,775</td>
<td>481,112</td>
<td>343</td>
</tr>
<tr>
<td>1998</td>
<td>3,719,954</td>
<td>2,704,550</td>
<td>2,021,738</td>
<td>2,576,994</td>
<td>246,066</td>
<td>18,795</td>
<td>47,452</td>
<td>74,436</td>
<td>-</td>
<td>-</td>
<td>60,031</td>
<td>6,787</td>
<td>125,660</td>
<td>650,167</td>
<td>781</td>
</tr>
<tr>
<td>1999</td>
<td>3,207,977</td>
<td>2,819,416</td>
<td>2,150,555</td>
<td>2,594,727</td>
<td>207,104</td>
<td>18,795</td>
<td>47,170</td>
<td>74,915</td>
<td>-</td>
<td>-</td>
<td>60,031</td>
<td>9,130</td>
<td>178,210</td>
<td>381,112</td>
<td>343</td>
</tr>
</tbody>
</table>

*Forecast*

7. Utility Pricing Policy and Local Budgets in Ukraine

Sergii Slukhai and Yulia Subbotovych

7.1 Introduction

In 1992, Ukraine began its existence as an independent state. The nation is now attempting to build a self-reliant economy and an effective state. Much has been done in the domain of the national economy: the privatisation of productive assets, the liberalisation of entrepreneurial activity, the introduction of market institutions, etc. But despite the progress in implementing market reforms, the state has been very slow in building modern institutions of governance. This relates not only to the central government, but especially to local governments.

The basic legislation on local government – The Law on Local Self-Government (1997) and The Law on Local State Administration (1999) – passed in the mid-1990s, after approval of the Constitution of Ukraine (1996), did not address all the necessary issues to create an adequate legal environment for the public administration of territorial units. As a result, the Ukrainian public sector is still highly centralised, offering only very limited discretion for local self-governing authorities in most of the areas in which they must function.

During the Soviet period, the local provision of public services was highly centralised. State enterprises bore significant responsibility for the provision of local social infrastructure, e.g. hospitals, recreation centres, sporting facilities etc. Being privatised and facing market competition, they could no longer afford such provision. The local service infrastructure was therefore transferred in some measure to local public authorities although central authority remained heavily involved.

One cannot ignore some ongoing positive changes in the fields of public finance and public service in Ukraine. Since the passage of a Budget Code (2001), some new possibilities for fostering local autonomy and responsiveness have arisen. But it will be some time before significant innovations are implemented and reform brings the real fruits of increasing efficiency to local government.

This study will present some local finance developments in Ukraine with particular emphasis on steps expected to enhance local fiscal autonomy and accountability through the increasing use of user charges and fees. Up until present, this issue has not received much attention from domestic observers for several reasons; one of the most important being the lack of comprehensive data on the issue.

7.2 Ukrainian Local Government Finance

Until recently, local governments in Ukraine have simply functioned as an agent of the central government. Most of their expenditure assignments have been regu-
lated and directly controlled by the centre, which created a situation in which the demand for local fiscal autonomy concerning revenues was highly limited. The local authorities were mostly accountable not to the citizens, but to the state. This system, inherited from the socialist past, retains those features even now, despite new legislation proclaiming the autonomy of local governments.

According to legislation, Ukraine has two types of local authority. First, there are local state administrations at the oblast (region) and rayon (county) levels. These bodies have a wide range of responsibilities ranging from the delivery of basic social services (such as primary and secondary education, health services etc.) to the implementation of oblast and rayon budgets. According to the Law on Local State Administrations, they carry a vast range of responsibilities from implementing programs of local social-economic development to composing and executing local budgets. They manage the education, health care and culture institutions in oblasts and rayons on a generalist principle. The functional departments of local state administrations are subordinated to the respective functional ministries. This suggests that the overall fiscal data on local governments’ involvement in economic activity (public service delivery) and revenue accumulation could be misleading (see Table 1 below). The real role of the sub-national governments (SNG) is actually less than implied by statistics because in many cases, the local budgets are only formal transit stations for funding local budgetary institutions (e.g. schools, hospitals, etc.). Such institutions are, in reality, administered by local state administrations at the rayon level.

### Table 1

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government expenditures</td>
<td>68.6</td>
<td>62.2</td>
<td>60.5</td>
<td>64.7</td>
<td>52.7</td>
<td>56.4</td>
<td>60.1</td>
<td>51.9</td>
<td>54.6</td>
<td>64.7</td>
<td>59.7</td>
<td>58.9</td>
</tr>
<tr>
<td>Sub-national government expenditures</td>
<td>31.4</td>
<td>37.8</td>
<td>39.5</td>
<td>35.3</td>
<td>47.3</td>
<td>43.6</td>
<td>39.9</td>
<td>48.1</td>
<td>45.4</td>
<td>35.3</td>
<td>40.3</td>
<td>41.1</td>
</tr>
<tr>
<td>Central government revenues</td>
<td>54.1</td>
<td>52.4</td>
<td>53.3</td>
<td>58.0</td>
<td>47.2</td>
<td>52.4</td>
<td>56.8</td>
<td>54.3</td>
<td>60.0</td>
<td>70.9</td>
<td>67.7</td>
<td>68.6</td>
</tr>
<tr>
<td>Sub-national government revenues</td>
<td>45.9</td>
<td>47.6</td>
<td>46.7</td>
<td>42.0</td>
<td>52.4</td>
<td>47.6</td>
<td>43.2</td>
<td>45.7</td>
<td>40.0</td>
<td>29.1</td>
<td>32.3</td>
<td>31.4</td>
</tr>
</tbody>
</table>

*Source: Ministry of Finance data and own calculations.*

These data show that up until 2001 there was no clear trend in expenditures or revenue assignments indicative of a decentralisation of public revenues and expenditures in Ukraine. It is apparent that no decentralisation policy was in effect. Only since 2001, when the first steps of budgetary reform were implemented, does the former vacillator
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pattern become a clearer path to decentralisation. Even with the decentralisation trend of the last few years, the overall situation demonstrates no significant growth in the sub-national government share of total national revenues and expenditures. This is in contrast to the situation in some other post-socialist countries.

The local governments in Ukraine play quite a significant role in public service delivery. Table 2 below demonstrates that they are especially important in the provision of social services, such as education and health care. It is significant that SNGs take responsibility for the primary functions of local governments – they are responsible for almost all expenditures on housing and amenities. Here, at least potentially, user charges could play some role, because the benefit principle between consumer and provider could be applied. The Ukrainian SNG as an agent of the central government is responsible for a rather small share of the expenditures that could be funded through user charges. The share of expenditures for this function is not very high – only 5.4 per cent in 2002; most of the SNG expenditure competences relate to delegated functions (especially social services) funded through ceded national taxes along with general and tied grants.

Table 2
Ukrainian Sub-national Expenditure Shares by Function, 2002, in per cent

<table>
<thead>
<tr>
<th>Sphere</th>
<th>Central government</th>
<th>SNGs</th>
<th>SNGs of oblast level</th>
<th>Rayon governments</th>
<th>Cities of oblast significance</th>
<th>Cities of rayon significance</th>
<th>Settlements</th>
<th>Villages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total expenditures</td>
<td>58.9</td>
<td>41.1</td>
<td>11.1</td>
<td>11.7</td>
<td>15.4</td>
<td>0.6</td>
<td>0.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Social protection</td>
<td>57.5</td>
<td>42.5</td>
<td>9.5</td>
<td>15.4</td>
<td>17.4</td>
<td>0.1</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Economy</td>
<td>77.5</td>
<td>22.5</td>
<td>12.9</td>
<td>1.1</td>
<td>7.2</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Housing and amenities</td>
<td>3.6</td>
<td>96.4</td>
<td>13.5</td>
<td>11.7</td>
<td>58.6</td>
<td>5.4</td>
<td>4.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Total social branch</td>
<td>32.9</td>
<td>67.1</td>
<td>17.0</td>
<td>21.6</td>
<td>23.6</td>
<td>1.0</td>
<td>1.1</td>
<td>2.8</td>
</tr>
<tr>
<td>Education</td>
<td>40.7</td>
<td>59.3</td>
<td>7.9</td>
<td>23.8</td>
<td>22.5</td>
<td>1.5</td>
<td>1.4</td>
<td>2.2</td>
</tr>
<tr>
<td>Health care</td>
<td>21.0</td>
<td>79.0</td>
<td>29.0</td>
<td>19.4</td>
<td>26.5</td>
<td>0.2</td>
<td>0.7</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance data and our own computations.

SNG finance in Ukraine reflects a heavy reliance on central government fiscal assistance. The structure of revenues of the sub-national levels is characterised by dominance of direct or indirect transfers. The tax share in SNG revenues is quite high – around 55-65 per cent; but almost all of these proceeds are national, ceded to the SNGs or shared with them. The portion of local taxes is insignificant (less than 3 per cent of total revenues). User charges are of importance, but they are not statistically assessed under current methodology; only subsidies covering the deficits of communal units (transportation, water treatment, sanitation etc.) are reflected in the budgets of the SNGs. The share of official transfers is quite high – about 1/3 of
the total revenue; they are disbursed mainly in the form of equalisation grants. The dominant number of rayon governments, not to mention small towns, townships and villages, cannot perform their functions without massive fiscal support from the state or higher level budgets.

The revenue patterns of Ukrainian SNGs were inherited from Soviet times when they were funded mainly though a system in which direct and indirect transfers were used as tools of fiscal equalisation.

SNG revenue sources in Ukraine consist of three traditional categories: (i) “own revenues” in the broad sense (local taxes and local non-tax revenues together with so-called ceded national taxes); (ii) regulating (shared) taxes; (iii) general and earmarked transfers.

When the Budget Code was approved in 2001, the category of shared taxes was abolished in intergovernmental relations, but it has not disappeared in sub-national fiscal relationships (personal income tax and land tax are shared due to their fixed rates). Thus, Ukraine has shifted from a system of shared taxes in intergovernmental finance to the more progressive system of ceded taxes.

### Table 3

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value added tax</td>
<td>D</td>
<td>D</td>
<td>20</td>
<td>D</td>
<td>D</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Excises on domestic goods</td>
<td>D</td>
<td>D</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>50</td>
<td>0</td>
<td>D</td>
<td>D</td>
<td>D</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>100</td>
<td>100</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>100</td>
<td>100</td>
<td>D</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Enterprise profit tax</td>
<td>D</td>
<td>D</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>100</td>
<td>100</td>
<td>D</td>
<td>D</td>
<td>D</td>
</tr>
</tbody>
</table>

Legend: D means that sharing rates are regionally differentiated.

- a AR Crimea and Sevastopol retain 100 per cent.
- b AR Crimea and Kyiv City retain 100%.
- c AR Crimea retains 50 per cent.
- d Kyiv City retains 50 per cent.
- e AR Crimea retains 100 per cent.
- * The regional governments received 1.5 per cent of enterprise profit tax proceeds for financing expenditures on house construction for military servants.

Source: respective annual Budget Laws.

Up until 2000, the calculation of local shares was based on the central assessment of local expenditures and regional and local funding followed through grants from selected national taxes; territories experiencing deficits received official transfers to cover the shortfall. This system was modified by the Law on Budget System (1995), which introduced marginal sharing. Its main features, however, did not change: selective tax sharing, annual corrections of sharing rates and revenue distribution, based on the origin principle, were all retained. One of the main prob-

1 The proceeds of ceded national taxes are fully attributed to sub-national budgets; on the sub-national level they could be shared.
lems with this system was its instability, caused by turbulence in the national fiscal system. As Table 3 shows, chaotic experiments with shared taxes and sharing rates seemed to come to an end by 2000, at which time the national taxes (first of all personal income tax) essentially became ceded taxes.

“Permanent turbulence” was characteristic of the assignment of national taxes to Ukrainian sub-national governments. This practice made local fiscal planning and sound fiscal management almost impossible and made local fiscal autonomy insignificant. Given the prevalence of national tasks in SNG activities, it is not surprising that local governments preferred to piggyback national revenue sources rather than generate their own revenues.

The other problematic issue in tax sharing was that the central administrative bodies retained the right “to regulate” the sub-national budgets. “Regulation” implied the right to select the differentiated sharing rates applied in the SNGs. As a result, instability at the national level was aggravated by instability and non-transparency at the regional level. The latter relations were characterised by even more unfairness and arbitrariness because there was no legal procedure to calculate the sharing rates at the regional level. This was especially true for the biggest donors of the Ukrainian budgetary system – cities of oblast significance, which suffered badly from the unfair distribution of funds. In many cases, the tax-sharing decisions of local administrations were not motivated economically (e.g. the choice of public facilities developed), but politically (Parhomenko, 1999). Such decisions were often used to pressure the city government to pursue a prescribed expenditure policy or to compromise local officials before the electorate.

The most serious disputes have been between oblast authorities (which were entitled by the state to perform the redistribution of regional public revenues) and cities of oblast significance: in many cases, cities originally enjoying a rather large revenue base were artificially placed in a budgetary deficit position.

This analysis might be concluded with the observation that the most compelling argument for the retention of this system over time has been the desire of the centre to retain strict control over intergovernmental fiscal flows. Doing so has had some high costs, including incentive incompatibilities in revenue collection, non-predictability and administrative arbitrariness. The negative impacts of this system on sub-national government finance, which reduced accountability and soundness of fiscal management, ultimately resulted in its abolition in 2001.

Since then, personal income tax has become a ceded tax that delivers the greater share of sub-national revenues. It has represented about half of the sub-national revenue yields. Nevertheless, due to the nature of this personal income tax, this change did not solve the problem of sustainable local revenues. It has also made sub-national budgets more vulnerable to downturns in the national economic performance due to the pro-cyclical tendencies of the revenue proceeds. On the other hand, the national government faces the temptation of using
this tax as a tool of macroeconomic regulation. Doing so would endanger local budgets and cause significant resistance to any change in the taxation of personal incomes. In the current situation, with the exhaustion of external sources of economic growth, the state could try to create more favourable conditions for internal investments by reducing current, relatively high tax rates. The personal income tax rate was, in fact, reduced in 2004 to a 13% flat rate. To compensate for the short-term drop in sub-national revenues proved difficult indeed.

The current composition of local revenues, seen in Table 4, shows not only a strong reliance of the SNGs upon transfers from the centre, but also the very minor role of user payments (partly hidden in non-tax revenues) in local revenues.

Table 4
Revenue composition of Ukrainian SNGs, 1999-2002.

<table>
<thead>
<tr>
<th>Revenue type</th>
<th>1999</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes on revenue, profit, market value increase</td>
<td>40.0</td>
<td>42.7</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>15.7</td>
<td>38.3</td>
</tr>
<tr>
<td>Enterprise profit tax</td>
<td>24.3</td>
<td>4.4</td>
</tr>
<tr>
<td><strong>Property taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motor vehicle tax</td>
<td>1.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Fees for special usage of natural resources</td>
<td>5.9</td>
<td>6.4</td>
</tr>
<tr>
<td>Land tax</td>
<td>5.5</td>
<td>6.4</td>
</tr>
<tr>
<td><strong>Internal taxation of goods and services total</strong></td>
<td>5.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Licenses for entrepreneurial and professional activity total</td>
<td>0.7</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>Other taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local taxes and duties</td>
<td>2.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Unified tax for small businesses</td>
<td>0.3</td>
<td>2.3</td>
</tr>
<tr>
<td><strong>Non-tax revenues</strong></td>
<td>2.8</td>
<td>7.3</td>
</tr>
<tr>
<td>Incomes from property and entrepreneurial activity</td>
<td>1.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Administrative duties and payments. incomes from non-commercial sales</td>
<td>0.7</td>
<td>1.0</td>
</tr>
<tr>
<td>Fiscal penalties</td>
<td>0.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Other non-tax revenues</td>
<td>0.5</td>
<td>6.0</td>
</tr>
<tr>
<td><strong>Capital revenues</strong></td>
<td>0.04</td>
<td>2.2</td>
</tr>
<tr>
<td>Earmarked funds</td>
<td>8.2</td>
<td>1.0</td>
</tr>
<tr>
<td>Road tax</td>
<td>7.7</td>
<td>0.0</td>
</tr>
<tr>
<td>Regional and local earmarked funds</td>
<td>0.2</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Revenues without transfers</strong></td>
<td>66.3</td>
<td>68.8</td>
</tr>
<tr>
<td>Official transfers</td>
<td>33.7</td>
<td>31.2</td>
</tr>
<tr>
<td>General donations from the state budget</td>
<td>10.23</td>
<td>16.5</td>
</tr>
<tr>
<td>Mutual settlements</td>
<td>4.01</td>
<td>0.0</td>
</tr>
<tr>
<td>Special subventions form the state budget</td>
<td>20.0</td>
<td>14.7</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

*Source: Ukrainian Ministry of Finance (2000, 2002).*
7.3 The Legal Framework for User Charges and Fees

To assure a stable financial system, improvement of market institutions and a better response to social welfare problems in this era of transformation to markets, it is essential that SNGs have greater power. Sub-national governments will need to establish their own tariff policy in the public utility sector, as they search for ways to increase local budget revenues. A first step towards the solution of this problem was taken in 1997, when the Ukrainian Law on Local Self-Government was adopted. Local executive bodies can substantially influence the provision of domestic, public, transport and other services supplied by public enterprises. Within limits defined by legislation, local bodies also have a right to coordinate these questions with private sector enterprises.

The legal base for local government fiscal policy remains incomplete, which renders independent policy in the field of user charges quite weak. The legislation still lacks some background pieces such as a law on municipal property, a law on local finance, a law on user charges, a law on local taxation, etc.

To this point, Ukrainian academic literature offers no deep and comprehensive insights into public enterprise funding and local government activities targeted at resolving emerging local socio-economic problems. It is necessary to learn how to efficiently use publicly-owned facilities in the market system in order to provide local citizenry with an appropriate volume and quality of utility sector services.

7.4 Revenues Generated by User Charges and Fees and Cost Recovery

General experience has demonstrated that communal property under any political regime can have considerable influence on local budgets’ proceeds. Charges for utility consumption could be a stable source of budget revenues. In the 1990s, 16% of local budget incomes in Germany, Spain, and Romania were derived from municipal payments. In Portugal they amounted to 19%, in Greece 22%, and in Luxemburg 29% (Kravchenko, 1999). It is impossible to say whether user charges form any significant part of local budgets in Ukraine, since they are not separately recorded in budget revenues. Some indication of the amounts received for services in local budgets could be listed under the too-general category “own receipts of budgetary entities.” According to data of the Ministry of Finance, these amounted to 1.7 million hryvnas in 2002, which consisted of about 8.7 per cent of non-transfer revenues.

As in many countries, Ukrainian user charges for services rendered do not cover, or only partially cover, the costs of services provided. The determination of charges for services provided by the communal enterprises is based primarily on social considerations, reflecting concern for the affordability of utilities to the ma-
jority of the population. Service costs are reflected both in the revenue and expendi-
ture parts of local budgets, but mainly as expenditures to cover communal negative balances.

In Ukraine, most public utility payments by users are not directly included
as incomes in the local budget. However, the fiscal results of communal enter-
prises do affect local government finance because they pay enterprise profit tax
to the local budgets; these proceeds are not taken into account in calculating
intergovernmental transfers (Article 69 of the Budget Code of Ukraine). Thus,
profit before taxation or the net profit of utility companies depends on both the
tariffs set by the state and those set by local governments (for example, in 2004, a
special increase in tariffs on electricity and heating is expected to increase local
incomes by 0.4 billions of hryvnas). The low income level and indebtedness of
the population results in increased local government expenditures in the form of
housing subsidies for lower incomes, as well as subsidies for the maintenance of
communal enterprises.

Decisions about tariff changes are taken by local authorities, especially by
urban and district councils and district administrations. As a result, utility tariffs
differ substantially across regions. Heating tariffs are an example of this, ranging
from 0.7 hryvna per square meter in Poltava, to 0.75 hryvna in Donetsk, to 1.46 in
Lugansk and Odessa, 1.51 in Dnepropetrovsk, and 1.70 in Simferopol. Consum-
ers are sometimes charged equal amounts each month throughout the year (as,
for example, in Kyiv), and sometimes with most of the charge paid in the heating
season and only fixed service payments in the remaining months.

An important feature of local government tariff policy in Ukraine is its dual-
ity: local governments have the possibility to set tariffs, both on units of pro-
duced and consumed services. In the first case, tariffs will be set lower than in the
second, because they take into account the actual cost of inputs with no regard
to losses on the way to final consumption. In the second case, a consumer pays a
tariff that includes loss (leakage) on the way services are delivered. For example,
in Kyiv, due to some estimates, only 80 per cent of the heating produced reaches
the population, but the lost 20 per cent is still included in the price. In order to
avoid excessive utility consumption charges, some owners of multi-storey build-
ings have already achieved substantial savings by installing a common meter,
which has saved them about 52 per cent of their former heating costs. Another
acute problem in Ukraine is overpayment for water by the 88 per cent of the
populace who do not have water meters. Calculation of the tariff for water is
based on the determination of actual consumption of cold water by one person
in a given facility during a certain period. For example, the average non-metered
consumer uses 3-3.5 cubic meters of water, but is billed for an additional 6-7 cubic
meters not consumed.
Under the current circumstances, service suppliers are not really interested in precise measurement of services actually consumed. At the current rates, that would mean bankruptcy. On the other hand, the populace often lacks the money to invest in a meter; some people merely reject their bills for communal services. That possibility will apparently be eliminated soon, since legislative changes appear inevitable. Since 2004, the gas delivery companies have been authorised to disconnect those who did not pay bills for an extended period.

The communal utility companies often exploit the limited awareness of mass consumers. Lack of information prevents the population of Ukraine from defending their rights. Few people know that billing rules for heating are fixed by Regulation # 1197 of the Ukrainian Cabinet of Ministers approving the “Public Provision Rules for Water, Heating and Sanitation.” According to this document, the standard temperature in an apartment should not be below 18°C; for each centigrade of temperature deviation from 18°C to 12°C, the heating charge should be decreased by 5 per cent for the entire heating period; for each centigrade of temperature deviation from 12°C to 5°C, the charge should be decreased by 10 per cent for the heating period and at temperature 5°C and below, no charges are to be collected.

In accordance with a draft of the new Housing Code of Ukraine, any enterprise violating the delivery conditions of signed contracts and failing to meet standards must decrease the charges for services provided. In the case of a temporary cessation of utility supply for a given period, a supplier is obliged to make an adjustment for each day the service is not provided.

The current tariff policy for the utility companies creates a specific structure of their accounts receivable: the amount of households’ outstanding bills exceeds that of legal entities (both private and public). It makes the utility companies’ fiscal situation very doubtful, for the local governments are not eager to compensate for this kind of loss. So, the city government of Kyiv does not immediately pay off the households’ debt; however it makes annual compensations to partially cover the increase of prices of exported resources.

Social justice in the field of housing and utility payments has not been attained for those citizens who conscientiously pay for these services. One of the current painful problems is privileges granted to certain segments of the populace. Several dozens of categories of citizens who have legal exemptions, or are charged at a reduced rate, create a heavy burden for local budgets. Although these privileges should be covered by the state, this in fact is done neither fully nor promptly. The state seems unable to manage this policy sensibly. The Law of State Budget of Ukraine (2004), for example, establishes new categories of citizens, e.g. judges in retirement and pensioners retired from the office of the public prosecutor, qualifying for utilities and other service privileges. Privileges foreseen by this Law will also be transferred to family members of these policy beneficiaries. This
privilege is quite generous – a 50 per cent discount on rent and utility supply (water, gas, electricity and heating).

Another example delivers public transportation privileges for specified groups. For example, current Ukrainian legislation provides for free public transportation for retired persons. The number of privileged, non-paying passengers on public transportation exceeds 30 per cent of the total passenger turnover. Since the maintenance of public transportation in districts and cities is mainly a municipal task, local governments bear the burden of these state obligations.

7.5 Summary and Policy Recommendations

Although user charges and fees are still a modest revenue source for local governments in Ukraine, they could potentially deliver a rather significant portion of budgetary proceeds. The existing approaches to tariff policy at the local level should be improved by replacing arbitrary privileges with cash subsidies or tax credits. Local governments should be granted more discretion in their management of local utilities. Under the current circumstances, the quasi-public utility companies have no interest in effective management, because local authorities simply allow them to increase their tariffs. The higher the tariffs, the more urgent the problem of payment collection is.

To make utility delivery more cost-efficient, market regulation should be introduced between provider and consumer. This should break the monopolistic position of the existing service providers. Taking a more market-like approach in some Ukrainian cities has pushed utility companies to be more active in seeking possible ways to reduce tariffs.

Steps taken by the central government in this field look quite promising. The government developed the “Program of Reforming and Developing Housing and Utility Delivery in 2004-2010”. In the first stage (2004-2005), legislation promoting the stabilisation of enterprise financial conditions in the housing and public services sectors is foreseen. In the second stage (2006-2010), a transition to full cost coverage for housing and utilities has been planned. Without institutional changes in the field, however, allowing consumers to have some influence on service providers, this kind of approach will ultimately merely result in increased tariffs.
References:


*Law on Local State Administrations* (1999), Kyiv.


8. Local Government Fees and User Charges in Estonia

Kenneth A. Kriz, Alari Paulus and Karsten Staehr

8.1 Introduction

Since regaining independence in 1991, Estonia has thoroughly reformed its economic and political system. Estonia’s membership of the EU, effective May 2004, shows that the main transition period is over and that the country is entering a new phase of fine-tuning and deeper structural reforms. An important area of these reforms is the organisation of the public sector, including inter-governmental relations and the fiscal relationship between the central government and local governments.

Local self-governance is essential if public services are to reflect local requirements and adjust to changing needs. The ability of local governments to provide local services is, however, crucially dependent on their ability to finance the costs. Possible revenue sources for local government include grants from the central government, shared taxes, local taxes and fees and user charges. Local taxes, fees and user charges comprise own-source revenue (revenue each local government can influence in substantial ways). Thus, fees and user charges are essential sources of own-source revenue enabling local governments to provide adequate levels of public services. They are also a potential way for local governments to reduce reliance on central governments for revenue. The study of fees and user charges is therefore of great importance for an overall assessment of the functioning of the local government sector.

Independent local governments were re-established in Estonia at the end of the Communist period, but most of the legislation, establishing and enabling local governments and their finances, were written during the 1993-95 period. The territorial organisation has remained essentially unchanged since Estonia regained independence, with the exception of a few municipalities merging. As of June 2004 there were 241 local government units in Estonia, 202 rural authorities and 39 towns. The size of the units varies widely, from approximately 70 inhabitants in the smallest, to approximately 400,000 inhabitants in the largest. The majority of Estonian municipalities are small, with 70 per cent of municipalities having less than 3,000 inhabitants.

The inter-governmental system confers substantial *de jure* autonomy to local governments but the autonomy is *de facto* restricted, partly because of financial and other constraints. Most local governments in Estonia remain heavily dependent on the central government for revenue (Hoag and Kasoff 1999:923). Fiscal relations were relatively stable during the second part of the 1990s, but since 2000
have been subject to a number of changes, \textit{inter alia} with respect to the financing of educational expenses.

Estonia has, for some years, experienced a lively debate on reforms of local government territorial structure. The topic is politically sensitive and decisions to change the administrative division have been delayed repeatedly. A widely stated objective is to give local government additional autonomy by reducing the number of local governments and ensuring that each local government has an adequate revenue base. In this view, greater access to own-source revenue would allow local governments to provide a more efficient mix of services and payments. The important point of how local governments can utilise fees and user charges more efficiently has only entered the discussion on the periphery.

To our knowledge, no studies have been published focusing on fees and user charges in Estonia. Ainsoo \textit{et al.} (2002) and Pedastsaar and Jaansoo (2002) discuss local government accounting and very briefly consider fees and user charges in this context. Other broader issues within local government finance issues have attracted considerable academic and political attention. The literature has concentrated on the overall development of local governments (Ulst 2002), their financial autonomy (Ulst 2000, Reiljan \textit{et al.} 2002, Trasberg 2003) and regional disparities (Raus and Trasberg 2003). A number of studies have considered major revenue sources such as personal income tax and transfers (Pedastsaar and Jaansoo 2002, Trasberg 2002), while non-tax revenue sources have generally not been explored. The analyses have generally been descriptive, while efficiency issues have received comparatively little attention.

The remainder of the paper is organised as follows: Section 2 reviews some facts about Estonia and its local governments, while section 3 gives an overview of the local public finance system in Estonia. Section 4 considers the legal basis for the use of fees and charges by local governments in Estonia. Section 5 provides a statistical account of local government fees and user charges, and provides estimates of the importance of this financing source for local governments. Section 6 sheds light on the implementation of fees and user charges by briefly reviewing case studies from three local governments. Finally, section 7 sums up the paper and analyses the use of fees and user charges by local governments in Estonia.

8.2 Estonia and its local governments at a glance

8.2.1 Demographic and economic background

Estonia is the smallest and northernmost of the three Baltic States. With 1.36 million inhabitants in 2004, the population has declined markedly since it reached a peak of 1.57 million in 1990.\footnote{Unless otherwise indicated, the background data on Estonia is from the Statistical Office of Estonia, Regional Development Database or Statistical Database.} The declining population is a result of emigration...
and a “natural decrease” of 5,000-8,000 persons per year. The population density is relatively low at 30 persons per square kilometre. The population is concentrated in a handful of cities, with nearly 50 per cent of the population living in the five largest cities (Tallinn, Tartu, Narva, Kohtla-Järve, and Pärnu).

Age composition varies substantially within Estonia. Harju county, comprising Tallinn and surroundings, has a relatively large fraction of its population in the working age group (70.3 per cent). Conversely, a number of counties in southern Estonia (inter alia Valga, Võru and Põlva counties) have relatively many children and elderly and relatively few of working age (63-64 per cent).

Estonia’s rapid and comprehensive economic reforms are considered by many observers to be a success (Shen 1994, Bronshtein 1995, Aslund 2002, Staehr 2004). After declining production in the early 1990s, GDP growth averaged 5.7 per cent in the period 1995-2003. Nonetheless, with its unfavourable starting point, income in Estonia is low compared to the level in Western Europe. In 2003, the Estonian purchasing power parity adjusted GDP per capita was approximately 44 per cent of the level in the EU-15 (Eurostat 2004).

There are considerable income differences within the country and the differences are growing over time (Table 1). The capital region in northern Estonia has a GDP per capita which is more than twice the level of any other region. The north-eastern region, which in Soviet times had much heavy industry, is emerging as the poorest region in the country.\(^2\)

Other indicators show a similar regional pattern. The registered unemployment rate is lowest in the capital region and highest in the north-east. The average income per household is highest in the north and lowest in the north-east. The income tax revenue transferred to the local municipalities is above the national average in the relatively prosperous area around the capital, while the north-eastern and southern parts of Estonia in this respect are also disadvantaged.

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</table>

*Source: Statistical Office of Estonia, Regional Development Database (Economy, Regional Gross Domestic Product). Own calculations.*

\(^2\) In spite of the overall low income levels in north-eastern Estonia, some local governments in the region have substantial revenues from user charges on mining.
This sketch of the demographic and economic background indicates that the challenges of the local governments vary greatly throughout Estonia. The regions with the highest income, in particular Tallinn, also have the highest percentage of their population in the working age. The de-industrialising areas in the north-east have depressed income levels and high unemployment but relatively favourable demographics. The rural areas in southern Estonia have relatively low income and a large fraction of the population outside the working age.

8.2.2 Local governments in Estonia

The creation of autonomous local governments in Estonia dates to its independence from the Soviet Union. During the drive for Estonian independence, local government re-establishment began with small steps. Laws and decrees passed by the Estonian Soviet Socialist Republic in 1989 and 1990 established the first truly local governments in Estonia during the Communist era. However, it was not until the passing in June 1993 of the fundamental enabling statute for local governments, the Local Government Organisation Act (LGOA), that local government development was fostered. LGOA delineated the basic functions, responsibilities and authority structures of local governments (RT I 1993, 37, 558 – Riigi Teataja (RT) is the “State Gazette” of Estonian laws).

The governmental structure established in the LGOA was nominally a three-tier system, with the central government deciding national issues, county governments handling regional issues and municipal governments administering programs to meet local needs. In practice, however, the system is a two-tier federal system, central and local with very limited autonomy for (the centrally appointed) county governments and relatively little autonomy for local governments.

Under the LGOA and the Estonian constitution (Chapter XIV), municipalities have only a small measure of autonomy in decisions about which functions they will execute on behalf of their citizens. There are certain general government functions which are prescribed in the LGOA, including social, welfare and education services; housing and utilities and planning and public transportation (Chapter 1, Section 6 (1) and (2)).

Independent representative councils are authorised to decide on issues for the jurisdiction, including the provision of services beyond those specifically assigned in the LGOA. There are also restrictions on unfunded mandates from the central level – the central government cannot impose (additional) functions on municipalities without funding them from the state budget.

The relationship between the central and local governments in Estonia is one of central pre-emption. Local governments have the authority to deal with local issues, but the central government exercises supervisory control over not only the legality, but also the purposefulness of the local government activities. Additionally, county governors exercise supervisory control over their local gov-
ernments (LGOA, Chapter 11, Sections 66 and 661). In the exercise of this control, the central government can peremptorily (LGOA, Chapter 11, Section 661(2)):

- Issue a precept for the elimination of deficiencies in a legal instrument or act.
- Suspend the performance of an act or the validity of a legal instrument.
- Invalidate a legal instrument.

The limited de facto autonomy is also suggested by Figure 1. Average local government spending amounts to 20-30 per cent of general governments spending and 7-11 per cent of the gross domestic product. The figure reveals that while government spending as a whole has decreased since the mid-1990s in terms of its size compared to the overall economy, local government spending has been increasing. This suggests a shift in spending from the central level to local governments and their increasing importance in service provision. However, with increasing use of conditional grants from the central government (e.g. educational costs), this might not necessarily reflect increasing financial autonomy.

8.3 Local Government Finance: An Overview

8.3.1 Local Government Finance in Transition

Estonia’s basic public finance systems were established during the early transition period. The general framework was set with the Rural Municipality and City Budgets Act (RT I 1993, 42, 615), passed in 1993. The Act gave authority and guid-
ance to local governments in budget and finance matters. It was amended a few times until 2002 and then extensively over the next two years, showing the start of a new phase of transition.

Another important statute, the Local Taxes Act (RT I 1994, 68, 1169), was passed in 1994 and remained largely unchanged until 2000. It underwent extensive amendments twice in 2000 and then twice in 2002. The Local Taxes Act established the authority and procedural requirements for local governments to impose and collect tax revenue. Specifically, local governments have the right to impose the following local taxes: sales tax, boat tax, advertising tax, road and street closure tax, motor vehicle tax, animal tax, entertainment tax and parking charges.\(^3\)

Table 2 shows the unconsolidated revenue side of the local government budget. The limited authority of local governments to raise revenue also appears in the Table. Local tax yields are relatively insignificant. Also, in larger cities, only the advertisement tax and motor vehicle tax are used, accounting for 80-90 per cent of all revenue from local taxes. Much higher significance can be contributed to shared central government taxes – personal income tax and land tax. These account roughly for half of all revenue. From 1990-2003 the sharing percentage of personal income tax was based on aggregate collections. This share has been changed several times. In 1990-93 local governments received all the personal income tax, 52 per cent in 1994-95 and 56 per cent in 1996-2003 (see also IMF 1998:10). In the income tax reform of 2003, new provisions for sharing of the personal income tax were created. The sharing percentage was no longer based on aggregate collections. Instead, the tax collected on 11.4 per cent of the taxable income of each resident is designated to be paid to the local government of the taxpayer’s residence. The central government receives the tax on the remaining 90.6 per cent of taxable income (The Income Tax Act, RT I 1999, 101, 903). The revenue from the taxation of land accrues wholly in local governments’ budgets; and local governments can also set the tax rate, although within given limits 0.1-2.5 per cent (The Land Tax Act, RT I 1993, 24, 428).

However, the primary revenue source for most local governments in Estonia remains central government transfers (cf. also Hoag and Kasoff 1999:923). According to the State Budget Act (RT I 1999, 55, 584), the expenditures related to duties the state has imposed by law on a local government are funded through appropriations from the state budget. These are either assigned for a specific purpose or allocated through the support fund. The purpose of the support fund is to supplement and equalise the revenues of local governments arising from the different revenue basis (Pedastsaar 2001:7). The act also states that the size and the distribution of the support fund are determined annually on the basis of an

\(^3\) The parking charge is classified as a local tax since 2003; previously it was included in operating revenues.
agreement between local governments, their associations and the central government. In 2004, the size and distribution of support depended on several demographic and economic indicators, e.g. the size of different population groups (children, pupils, workforce and elders), the length of streets and roads, and revenues from personal income tax, land tax and extraction of mineral resources (The State Budget Act of 2004, RT I 2004, 1, 1).

8.3.2 Development of Local Government Revenues

Table 2

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<td>57.0</td>
<td>43.5</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<td>(8) Total revenues b), billions EEK</td>
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<td>(9) Total revenues c), per cent of GDP</td>
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<td>9.5</td>
<td>9.4</td>
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</tbody>
</table>

a) Total local government revenues exclude loans, assigned revenues from previous years and “other transactions”.
* Preliminary data. New account methodology introduced from 2003.


Table 2 presents an overall breakdown of the revenues of the Estonian local government sector since 1993. The breakdown is relatively coarse as required to attain data comparability over the full sample.

Revenue from local taxes and from state fees allocated to the local governments (row 1) has contributed 1-2 per cent of the total revenues since the mid-1990s. Property income (row 2) comprises several revenue sources based on property owned by local governments, e.g. the sale or renting out of municipal property and the sale of shares in companies. Fees and user charges for

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5 The Estonian kroon, EEK, has from June 1992 been pegged to the German mark and from 1999 to the euro via a currency board arrangement. The exchange rate is 1 EUR = 15.6466 EEK.
services specifically related to the use of land or other natural resources are also included. The relatively large share of total revenues coming from property income during the period 2000-02 is mostly the result of large property sales by the two largest cities, Tartu and Tallinn. Operating income paid by the public for locally provided services such as kindergartens, health and culture increased at the end of the period considered (row 3). The receipts for these services paid by other local governments units (when the services are delivered to individuals living in these units) amount to 1.5-2.5 per cent of total revenues (row 4). The sum of the revenues in rows (1)-(4) is the local governments’ own-source revenue, i.e. revenues over which the local governments have a high degree of autonomy, which accounts for only 15-20 per cent of total revenues for local governments in Estonia.

Direct transfers from the central support fund for local governments amount to almost 40 per cent of total revenues in 2003. The rapid growth from 2000 to 2001 is the result of a political decision to start financing most of the local education costs (primarily teachers’ salaries) via earmarked funds from the central government. Finally, the local governments’ share of tax revenue from mainly the personal income tax and the land tax is depicted (row 6). The tax revenue transferred from the central government to local governments has attained relatively less importance since 2001 because of the higher grants from central government. These revenue sources, over which the local governments have essentially no autonomy, amounted to more than 80 per cent of the total budget revenues in 2003. Another interesting feature is the relatively large year-to-year changes in property and operating revenues. The developments in these and other entries capturing fees and user charges will be discussed in section 5.

8.3.3 Development of Local Government Expenditures

Table 3 shows the development since 1993 of the unconsolidated expenditures of local governments, grouped according to economic classification. Data until the mid-1990s is unreliable and varies between sources. Current operating expenditures have amounted to approximately 80 per cent of total expenditures since the mid-1990s. The higher share of total expenditures taken up by wages and salaries since 2001 is the result of a reclassification of teachers’ salaries. Capital expenditures have since the mid-1990s hovered around 20 per cent of total expenditures with no apparent trend. In sum, the distribution of local resources between current expenditures and investment projects appears to be relatively stable.
### Table 3
Local Government Expenditures by Economic Classification, per cent of Total except Where Noted

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<td>Other goods and services</td>
<td>Subsidies and transfers</td>
<td>Other</td>
<td>Capital expenditures</td>
<td>Total expenditures</td>
<td>Total expenditures, per cent of GDP</td>
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* – indicates missing value.

* Preliminary data. New account methodology introduced from 2003.


### Table 4
Local Government Expenditures by Sector, per cent of Total except Where Noted

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* – indicates missing value.

* Preliminary data. New account methodology introduced from 2003.

The expenditures classified according to sectoral use are shown in Table 4. Education expenditures dominate local government, accounting for 40-45 per cent of total expenditures (row 3). The next largest category is for the economy. This category covers expenses related to the maintenance of streets and roads, public transport and provision of utilities (row 8). Administrative expenditures for items such as general government organisation, account for another 10 per cent of total local government spending (row 1). The transfers among local governments relate mostly to the payment for services provided by other local governments (row 10) The expenditure distribution of Estonian municipalities has remained relatively stable since the mid-1990s. The exception, expenditures on education, is affected by a reclassification of expenses.

8.4 The Legal Basis for Fees and Charges

No unified framework for the application of fees and user charges exists in Estonia and this is reflected in the enabling legislation. The only law dealing explicitly – and exclusively – with the subject is the State Fees Act, giving a detailed legal framework for the collection of state fees. Almost all the revenue from these fees is assigned to the central government budget, but the state fees often affect local matters and the local governments act as the collection agency in many cases. The State Fees Act is discussed in subsection 4.1. The legislation for other fees and for user charges is fragmented, with authority and regulation spread throughout statutes and administrative rulings. Subsection 4.2 seeks to provide an overview of the legal foundations of local fees and user charges.

8.4.1 State Fees

The present State Fees Act took effect in 1998. It is a long and rather complex law, full of exemptions and prescriptive language for specific situations. This version of the Fees Act replaced the much shorter and less complex Fees Act passed during the transition in 1990. The original act was amended 29 times between 1990 and 1997, so the replacement seemed a near inevitability. However, the developing nature of administrative law in Estonia is evident in the fact that the new act has been amended almost 70 times in the 6 years since it was passed.

The Act is divided into three parts and four annexes. The first part, which comprises the first four chapters of the Act, defines fees and sets out approximately 40 general areas where fees would have to be paid. These include judicial acts, registration acts (as in registering a non-profit organisation), marital property register acts, building register acts, and fees that must be paid as the result of any number of other Acts, including the Feeding-Stuff Act, the Gambling Act and the Lottery Act. The State Fees Act then goes on to define who must pay the fee (virtually all natural and legal persons).
Section 5 of Chapter 1 of the Act defines who may collect fees. These groups include “a government or local government agency, a state agency administered by a government agency and an agency administered by a local government agency, another agency performing functions in public law, a court, or a rural municipality or city secretary who performs an act subject to a state fee.” (RT I 1997, 80, 1344 – hereafter State Fees Act). Estonian county governments are thus prohibited from receiving fees, though they can and sometimes do act as an agent in collecting fees and charges for the central government. This is somewhat natural because the county governments in Estonia are mostly administrative arms of the state. They provide very little services independent of the mandates and financing of the state.

Section 6 of Chapter 1 of the Act then defines the allocation of state fees. The basic allocation is that state fees are paid into the state (central government) budget. However if the state fees are for acts of attestation performed by rural municipality and city secretaries, then they are paid into the corresponding rural municipality or city budget. The language suggests the perception that fees are the natural province of the central government, with local governments only receiving revenues in specific circumstances.

The pre-eminence of the state is also shown in Chapter 2 of the Act. This chapter lays out administrative procedures for authorities collecting fees. There is very little discretion left for local governments. When this chapter mentions the word “discretion” it means of the central government. An example is when the Act delegates power for the establishment of the receipt of fees in cash, which discretion is given to “…the Government of the Republic or, with the authorisation of the Government of the Republic, by a regulation of the Minister of Finance” (State Fees Act, Chapter 2, Section 7(7)).

Section 10 of Chapter 2 further restricts local government discretion through prohibiting bodies charging state fees from charging additional fees for the performance of acts subject to state fees. Therefore, there is no discretion for local governments to set rates to assure cost recovery or capture of benefits. The bulk of Chapter 2 contains regulations regarding the refund of fees. Again, state government is given discretion where it is forthcoming. Chapter 3 of the Act delineates the exemptions to having to pay fees and Chapter 4 contains regulations for the supervision of fees and charges.

The second part of the Act delineates the fees that can be charged and their rates. The fees are primarily for specific services, such as issuance of permits or entries into various registers. The list of services is too exhaustive to present, taking up almost 100 pages of text. State fees can be broken down rather arbitrarily into three broad categories: court-related fees, fees for acts of registration, and fees for acts performed by administrative agencies. An example of a court-related fee is the fee paid for entering a statement of claim on assets which may be inci-
dent to a lawsuit or a divorce proceeding. There are many types of registrations for which fees must be paid, including entries in the land registry for buying and selling property, entries in the commercial register to register a business with the state, and entries in the ship registry. Acts performed by administrative agencies for which fees must be paid include the initial registration of a vehicle, the issuing of driver’s licences, marriage and divorce registrations, inspections of businesses manufacturing feeding-stuff (feed for farm animals), and registration of many types of businesses. The language in the second part is extremely prescriptive: “A state fee of 500 EEK shall be paid for the entry of a sole proprietor, general partnership or limited partnership in the commercial register” (Chapter 6, Division 1, Section 40(1)).

8.4.2 Local Fees and User Charges

As stated above, the authorisation and limitation of fees and user charges, except state fees, are spread over a very large number of laws. Among local fees, i.e. fees sets by local governments, one may distinguish between four types.\(^6\)

First, some fees are considered local taxes in the language of the law (The Local Taxes Act, RT I 1994, 68, 1169), e.g. parking fees and the roads and streets closing tax. The central government decides the permissible local taxes and to whom they apply. Local governments can implement local taxes and set the tax rates within the central government stipulations. In the case of the parking fee, the specific conditions are stated in the Traffic Act (RT I 2001, 3, 6).

Second, potentially significant revenue sources have attracted relatively more attention from the central government and, therefore are more constrained by legal rules, often to the extent of designating some of the revenues to the central budget. One example is the fee for extraction of water and minerals. The Underground Act (RT I 1994, 86/87, 1488) outlines that the fee is set by the central government and the revenue is divided with 30 per cent going to the central budget and 70 per cent to the local budget or 100 per cent to the local budget, depending on whether the deposit has national or local significance. The latter term is also defined by the central government. Local governments have complete discretion only in the case of earth materials being extracted from municipal land.

Third, there are fees specified in a lesser detail, presumably because these fees have only minor revenue-raising significance. Examples are fees for fishing and mining permits (previously also for hunting permits). The fees for fishing permits are set either by the State Government or the Minister of Environment and most of the revenue is collected for the central budget (The Fishing Act, RT I 1995, 80, 1384). The fee for issuance of a mining permit (only for earth materials and not for mineral resources) is set and collected by local government. Another

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\(^6\) Notice that local fees are often accompanied by state fees on related objects/activities e.g. for the issuance of extraction permit for mineral resources beside the extraction fee.
example concerns the payment for the right of building title on municipal land, which according to the Law of Property Act (RT I 1993, 39, 590), would be decided by the local government.

Fourth, some actually collected user fees and charges, although again with only a slight importance, are not given any legal guidance at all from the central level. This includes fees for local government clerk services, permits to use public facilities and business permits (except licences).

The legislation for *user charges* is again somewhat different. The determination of the user charge is decentralised to local governments, but in many cases within limits set by the central government. While an exhaustive list of areas where local governments can impose user charges is beyond the scope of this paper, below we discuss the legal foundations of user charges for the common functional areas where charges are levied.

**Education:** Education charges are established and constrained by two laws. The Pre-School Child Care Institutions Act (RT I 1999, 27, 387) establishes that local districts may decide on the proper rates to charge for the food and educational costs of children in kindergartens. However, it also allows the Ministry of Culture and Education (now the Ministry of Education and Research), in agreement with the Ministry of Social Affairs, to set limits for these charges. In 2004, the guidance from the Ministry of Education and Research is that food costs are to be covered through charges to parents and part of the cost of education is also to be covered by charges. The total charge cannot exceed 20 per cent of the minimum wage level, set by the central government.

The Basic Schools and Upper Secondary Schools Act (RT I 1993, 63, 892) provides a legal basis for the development of the primary and secondary education system. Most of the law is mute on the specifics of educational finance, but contains two important clauses. In Section 8 of Chapter I, the act states that “Attendance of state schools and general education schools of local governments is free of charge” (state schools are primary and secondary schools run by the Ministry of Education and Research). Also, Section 31, Subsection 4 of Chapter V holds that students have the right to “use the buildings, premises, library, teaching aids, sports equipment, technical means and other equipment of their school for extracurricular activities, free of charge”. These two sections effectively prohibit local governments from charging fees for basic education purposes. The financing of food costs is not addressed directly in this Act, except that the central government will cover the costs of school lunches for students in grades 1-4, and “if possible, for other students, except students of state schools whose catering costs are covered from the state budget” (Chapter V, Section 321, Subsection 1). Interestingly, though, the grant from the central budget to the local governments is based on the number of students and the calculated cost of a school lunch established by the central government.
Utilities: The Public Water Supply and Sewerage Act (RT I 1999, 25, 363) governs the establishment and operation of the public drinking water supply and wastewater removal systems. This Act authorises a two-part charge for service, consisting of a connection charge and a usage charge. The connection charge is required to be sufficient to cover capacity needs and system standards, as well as to ensure “justifiable profitability”, but local governments have the right to establish maximum connection charges. The usage charge is to be set by the rural municipality or city government with jurisdiction over the usage area and approved by the local government council. The usage charge should be adequate to cover production costs, comply with quality and safety requirements and environmental requirements, and ensure justified profitability.

The requirements for public heating systems are similar to those of water supply and wastewater removal. The District Heating Act (RT I 2003, 25, 154) also authorises a two-part tariff. The connection fee authorised in Chapter III, Section 12 is calculated by the public or private company supplying the service and is supposed to: cover investment needs; ensure compliance with environmental, quality, and safety requirements and assure justified profitability. The company supplying heating services also sets the price of the heating service. The maximum charge for the heating service must be published three months before the charge is to take effect, and is required to be calculated so that the necessary operating expenses, including the expenses incurred upon the production, distribution and sale of heat, are covered; necessary investments for the performance of operational and development obligations are made; environmental, quality, and safety requirements are met; and justified profitability is ensured (District Heating Act, Chapter II, Section 8). The maximum price of heating services must be approved by the Energy Market Inspectorate, an extra-judicial board, for large providers, or by a local government council for smaller providers (District Heating Act, Chapter II, Section 9).

Public Transport: Fares for local public transportation services are governed by the Public Transport Act (RT I 2000, 10, 58). Under this Act, service carriers are responsible for setting fares. However, the following local governments can set upper tariff rates per kilometre and maximum ticket prices in public regular services: county governors in the intra-county carriage of passengers; rural municipality and city councils or authorised agencies in the carriage of passengers within the rural municipality or city.

Social Welfare: Under the Social Welfare Act (RT I 1995, 21, 323), a fee may be collected from a person for social services provided to the person or his or her family. The fee is supposed to reflect the extent and cost of the service and the financial situation of the person and the family receiving the service. The institution which provides or pays for the service is to set the fee. However, the limits and procedure for the collection of fees collected for social services are to
Local Government Non-tax Revenue Sources in Transition Countries: User Fees and Charges

be established by the Ministry of Social Affairs (Social Welfare Act, Chapter VII, Section 45).

8.5 Revenues from fees and user charges

Accurate, relevant and disaggregated revenue data on Estonian fees and user charges is difficult to obtain. Revenue data at an appropriate level of disaggregation is available only for the period 1996-2003. Even then, the “extraction” of fees and user charges data from Estonian Ministry of Finance databases involves challenges and inherently difficult judgments.

First, it is often difficult to assess the underlying economic contents of a number of the database categories.\(^7\) For example, the entry “advertisement tax” (on billboard advertising) could be either a fee or a tax on advertising. Second, payments for closely related services enter the accounts in different places, for example the fee for the issuance of permits for mining activities and the fee paid for the extraction of mineral resources are listed as different entries under different headings. Third, relatively large amounts of revenues are collected in various non-specified entries, often labelled “Other”. It is difficult to establish to which extent the “Other” entries also comprise fees and user charges. Fourth, some clearly specified fees do not generate any noticeable revenue (for example below 1000 EEK in total). These microscopic entries are generally not reported. Fifth, the underlying measurement and reporting methodology was altered from 2002 to 2003. We have undertaken every effort to make the 2003 data comparable to previous years, but some discrepancies still likely remain.

Finally, the organisation of public services, as well as the ownership structure of operating companies, can impact statistics greatly. A number of public services – water and sewerage, waste disposal, and heating – can be provided by the local government itself, by a company fully or partially owned by the local government or by a privately owned company (cf. also section 4). If the local government operates the service itself, the revenues will be reported under “operating income” in the database. If the service is provided by a fully or partially government-owned enterprise, the revenue might or might not occur under “operating income”. If the service is privately provided, the revenue cannot usually be traced in the Ministry of Finance databases. It is impossible to distinguish between the different possibilities, as the Ministry of Finance databases do not contain information about the organisation and ownership of local government utility providers.

Keeping this long list of caveats in mind, Table 5 gives an overview of the local government revenue sources, which we assess to comprise fees and user charges.

\(^7\) We have received valuable suggestions regarding the classification from Sulev Liivik, Estonian Ministry of Finance and the interviewed persons in our case studies (see section 6).

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Table 5
Revenue from Local Government Fees and User Charges per cent of Total Revenue except where Noted

<table>
<thead>
<tr>
<th>Fee and user charge</th>
<th>1996</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003*</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) State fees</td>
<td>0.03</td>
<td>0.02</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.00</td>
<td>0.03</td>
<td>0.22</td>
</tr>
<tr>
<td>(2) Roads and streets closing tax</td>
<td>0.08</td>
<td>0.09</td>
<td>0.09</td>
<td>0.04</td>
<td>0.04</td>
<td>0.04</td>
<td>0.05</td>
<td>0.06</td>
</tr>
<tr>
<td>(3) Fees for miscellaneous clerk services</td>
<td>0.04</td>
<td>0.05</td>
<td>0.05</td>
<td>0.05</td>
<td>0.04</td>
<td>0.04</td>
<td>0.03</td>
<td>0.00</td>
</tr>
<tr>
<td>(4) Fees for extraction of water and minerals</td>
<td>0.83</td>
<td>1.19</td>
<td>1.05</td>
<td>0.97</td>
<td>1.04</td>
<td>0.84</td>
<td>0.88</td>
<td>0.95</td>
</tr>
<tr>
<td>(5) Fees for fishing and hunting permits</td>
<td>0.005</td>
<td>0.006</td>
<td>0.004</td>
<td>0.004</td>
<td>0.003</td>
<td>0.000</td>
<td>0.000</td>
<td>0.001</td>
</tr>
<tr>
<td>(6) Fees for acquiring building title</td>
<td>0.15</td>
<td>0.16</td>
<td>0.13</td>
<td>0.14</td>
<td>0.26</td>
<td>0.20</td>
<td>0.16</td>
<td>0.11</td>
</tr>
<tr>
<td>(7) Fees for permits to use public facilities</td>
<td>0.22</td>
<td>0.19</td>
<td>0.07</td>
<td>0.04</td>
<td>0.03</td>
<td>0.02</td>
<td>0.23</td>
<td>0.15</td>
</tr>
<tr>
<td>(8) Fees for business permits</td>
<td>0.10</td>
<td>0.25</td>
<td>0.18</td>
<td>0.16</td>
<td>0.16</td>
<td>0.10</td>
<td>0.02</td>
<td>0.01</td>
</tr>
<tr>
<td>(9) Fees for mining permits</td>
<td>0.001</td>
<td>0.000</td>
<td>0.008</td>
<td>0.014</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.018</td>
</tr>
<tr>
<td>(10) User charges for education, culture, etc.</td>
<td>4.39</td>
<td>4.24</td>
<td>3.95</td>
<td>4.17</td>
<td>4.37</td>
<td>3.45</td>
<td>4.22</td>
<td>5.61</td>
</tr>
<tr>
<td>(11) Miscellaneous user charges and operating income</td>
<td>0.91</td>
<td>1.04</td>
<td>1.58</td>
<td>1.46</td>
<td>1.49</td>
<td>1.13</td>
<td>3.34</td>
<td>3.40</td>
</tr>
<tr>
<td>(12) Total fees and user charges</td>
<td>6.7</td>
<td>7.2</td>
<td>7.1</td>
<td>7.1</td>
<td>7.5</td>
<td>5.8</td>
<td>9.0</td>
<td>10.5</td>
</tr>
<tr>
<td>(13) User charges paid by other local governments</td>
<td>-2.1</td>
<td>-1.8</td>
<td>-1.6</td>
<td>-1.8</td>
<td>-1.5</td>
<td>-1.5</td>
<td>-1.5</td>
<td>-2.2</td>
</tr>
<tr>
<td>(14) Total fees and user charges from residents</td>
<td>4.7</td>
<td>5.4</td>
<td>5.5</td>
<td>5.3</td>
<td>5.7</td>
<td>4.4</td>
<td>7.5</td>
<td>8.3</td>
</tr>
<tr>
<td>(15) Total revenues*, billions EEK</td>
<td>4.06</td>
<td>5.33</td>
<td>6.34</td>
<td>6.79</td>
<td>7.10</td>
<td>9.99</td>
<td>11.13</td>
<td>11.81</td>
</tr>
</tbody>
</table>

*a) Total local government revenues exclude loans, assigned revenues from previous years and “other transactions”.


**Sources:** Ministry of Finance (1996-2003). Own calculations.

Table 5 shows that local governments’ revenue from state fees was unsubstantial until 2003. This is not surprising, given the centralised nature of fee implementation in the country. In 2003, the local governments became entitled to retain the revenue from issuing building permits, which has increased rather dramatically in percentage terms the revenue flow from fees to local governments. Local governments can impose a number of local taxes, of which a few essentially are fees. For example, the roads and streets closing tax is a fee paid when construction companies and utilities need roads to be closed off for a period of time. An advertising tax on billboards represents a borderline case between a fee and a tax. We have chosen not to include the advertising tax in Table 5. Also not shown in Table 5 are parking fees, which from 2003, figure separately in the Ministry of Finance databases. In 2003 total parking fees were 32.2 million EEK, amounting to 0.3 per cent of total local government revenues (or 1.6 per cent of own-source revenues).

Among a number of other fees (rows 3-9), only the fees on extraction of water and mineral resources bring in substantial revenue to the local governments.
On average, approximately 1 per cent of all revenue and 6 per cent of own-source revenue pertains to the extraction fee. However, for some municipalities where extraction is a major economic activity, in particular the north-eastern part of the country, this fee is an important revenue source.

The sum of user charges for public services such as pre-schooling and education, culture and art, sports and recreation, health services, and social welfare institutions is shown in row (10). These user charges are partly paid by the residents, but also take the form of transfers from other municipalities whose residents make use of the services provided (row 13). The user charges for public services, amounting to 3.5-4.5 per cent of the total revenues of local governments in Estonia, will be analysed in more detail below.

Miscellaneous user charges and operating income include fees for services of municipalities’ departments of economy (excavations compensations, cemetery services), departments of architecture and construction (examination and expertise of construction projects, building permits, building registry services), and (before 2003) parking fees (row 11). It increased significantly from 2001 to 2002 and remained in 2003 at a level around 3 per cent of total local government revenues.

The total of the fees and user charges depicted in Table 5 amounts to approximately 6-10 per cent of total revenue when the inter-governmental transfers are included (row 12). Excluding these transfers, the total fees and user charges amount to approximately 5-8 per cent of total revenue (row 13). In each case, fees and user charges comprise a relatively stable share of local government revenue over time, albeit other financing sources are of much greater importance.

**Figure 2**
Fees and User Charges from Residents as Percent of Total Local Government Revenue, Own-Source Revenue and GDP, 1996-2003

Figure 2 shows some summary statistics for the importance of local fees and user charges in Estonia. Fees and charges paid by residents amount to only 0.4-0.8 per cent of GDP throughout the period considered. Still, fees and user charges constitute a much larger share of the local governments’ own-source revenues (net of intergovernmental transfers), approximately 20-50 per cent. The difference between the share of overall revenue and own-source revenue is reflective of the relatively low level of revenue autonomy in Estonian local governments, cf. also section 2.

User charges are a far more important revenue source than the fees. Table 6 gives a detailed breakdown of the user charges for education, culture, etc. provided by local governments (row 10 in Table 5). These services comprise kindergartens and education, culture and art, sports and recreation, health services and social welfare (including nursery homes). The user charges are split in the charges paid directly by the resident end-users and the charges paid by local governments when their residents make use of services provided by other municipalities.

It follows from Table 6 that only the user charges for pre-schooling and education generate substantial revenue. As outlined in section 4, these charges mostly come from kindergarten charges, in some cases payment for food at higher education levels and user charges for various other kinds of educational activities (for example evening and hobby classes). Approximately half of the education charges are paid by other local governments. User charges for culture and art, for sports and recreation and for social services increased substantially in 2003, but they still constitute an insignificant share of the total revenue.

**Table 6**

Revenue from Specific User Charges, per cent of Total Revenue

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Kindergartens and education</td>
<td>Public</td>
<td>1.94</td>
<td>1.82</td>
<td>1.73</td>
<td>1.76</td>
<td>1.82</td>
<td>1.38</td>
<td>1.92</td>
<td>2.07</td>
</tr>
<tr>
<td></td>
<td>Local governments</td>
<td>1.99</td>
<td>1.73</td>
<td>1.54</td>
<td>1.65</td>
<td>1.67</td>
<td>1.36</td>
<td>1.41</td>
<td>–</td>
</tr>
<tr>
<td>(2) Culture and art</td>
<td>Public</td>
<td>0.15</td>
<td>0.16</td>
<td>0.14</td>
<td>0.14</td>
<td>0.16</td>
<td>0.14</td>
<td>0.30</td>
<td>0.53</td>
</tr>
<tr>
<td></td>
<td>Local governments</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.00</td>
<td>0.01</td>
<td>–</td>
</tr>
<tr>
<td>(3) Sports and recreation</td>
<td>Public</td>
<td>0.07</td>
<td>0.08</td>
<td>0.09</td>
<td>0.08</td>
<td>0.09</td>
<td>0.09</td>
<td>0.10</td>
<td>0.30</td>
</tr>
<tr>
<td></td>
<td>Local governments</td>
<td>0.002</td>
<td>0.003</td>
<td>0.003</td>
<td>0.002</td>
<td>0.001</td>
<td>0.001</td>
<td>0.001</td>
<td>–</td>
</tr>
<tr>
<td>(4) Health services</td>
<td>Public</td>
<td>0.01</td>
<td>0.08</td>
<td>0.06</td>
<td>0.07</td>
<td>0.12</td>
<td>0.06</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td></td>
<td>Local governments</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>–</td>
</tr>
<tr>
<td>(5) Social welfare</td>
<td>Public</td>
<td>0.14</td>
<td>0.26</td>
<td>0.28</td>
<td>0.36</td>
<td>0.39</td>
<td>0.32</td>
<td>0.38</td>
<td>0.48</td>
</tr>
<tr>
<td></td>
<td>Local governments</td>
<td>0.07</td>
<td>0.07</td>
<td>0.09</td>
<td>0.09</td>
<td>0.11</td>
<td>0.09</td>
<td>0.08</td>
<td>–</td>
</tr>
<tr>
<td>(6) Total revenues a), billions EEK</td>
<td>4.06</td>
<td>5.33</td>
<td>6.34</td>
<td>6.79</td>
<td>7.10</td>
<td>9.99</td>
<td>11.13</td>
<td>11.81</td>
<td></td>
</tr>
</tbody>
</table>

* indicates missing value.

a) Total local government revenues exclude loans, assigned revenues from previous years and “other transactions”.

* Preliminary data. New account methodology introduced from 2003. Detailed specifications of transfers from other local governments for the use of services are not available for 2003.

Table 7 presents rough measures of cost recovery rates for the categories of locally provided government services shown in Table 6. The cost recovery rates are calculated as the user charge revenue paid by the residents, divided by the expenditures in the corresponding category. These cost recovery measures should be seen as rough approximations, as the revenue and the expenditure sides do not always correspond closely. For example, most of the user charges revenue for education derives from user charges for kindergartens and various non-traditional educational activities. At the same time, the bulk of expenditures are for primary and secondary education, which is essentially without user charges. This reduces the interpretability of the data; however, the general figures are illustrative of trends and proportions.

Table 7
Cost Recovery for Specific Local Government Services,
per cent of Expenditure within Category

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Kindergartens and education</td>
<td>4.2</td>
<td>4.5</td>
<td>4.3</td>
<td>4.4</td>
<td>4.8</td>
<td>3.2</td>
<td>4.3</td>
<td>4.6</td>
</tr>
<tr>
<td>Culture and art</td>
<td>1.9</td>
<td>2.2</td>
<td>1.7</td>
<td>1.7</td>
<td>2.1</td>
<td>2.1</td>
<td>4.3</td>
<td>6.1</td>
</tr>
<tr>
<td>Sports and recreation</td>
<td>3.6</td>
<td>5.0</td>
<td>4.3</td>
<td>3.0</td>
<td>2.6</td>
<td>2.4</td>
<td>2.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Health services</td>
<td>0.5</td>
<td>5.4</td>
<td>3.7</td>
<td>4.5</td>
<td>8.3</td>
<td>4.6</td>
<td>1.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Social welfare</td>
<td>2.9</td>
<td>2.4</td>
<td>2.4</td>
<td>3.3</td>
<td>3.8</td>
<td>3.6</td>
<td>4.3</td>
<td>5.3</td>
</tr>
</tbody>
</table>


For all categories, cost recovery rates are far below 10 per cent of incurred expenditures. The drop in the cost recovery for kindergartens and education in 2001 is associated with changes in the school financing system. The user charges for municipal health services vary markedly, partly reflecting repeated changes in the health financing system. It is obvious that full cost recovery is not a priority for any of the service categories listed in Table 7. These services are considered part of the Estonian social welfare system. As discussed in section 4, government laws and regulations put in a number of cases, strict limits on the size of the user charges.

8.6 Case Studies
The data in section 5, together with the background information contained earlier in the paper, present macro level data on fees and user charges in Estonia. Often, however, macro level data misses the essence of how finance is conducted. In order to ascertain the actual practice of rate determination and administration of charges and fees as well as to assess the administrative capacity in the use of charges and fees, we undertook case studies of local governments in Estonia. These case studies involved interviews of local government finance personnel and/or policymakers.
Local Government Fees and User Charges in Estonia
together with analysis of the city’s budget. This section presents an overview of
the case studies and brings selected findings from the case studies.

The three case studies were chosen on the basis of size and geographic location. The country’s largest municipality was chosen along with two smaller munici-
palities. Table 8 describes the case study governments, their population and
measures of their activities.

<table>
<thead>
<tr>
<th>Government</th>
<th>Location</th>
<th>Population</th>
<th>Total expenses, mln. EEK</th>
<th>Expenses per capita, EEK</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Viiratsi</td>
<td>South-Central</td>
<td>3,799</td>
<td>25.8</td>
<td>6,796</td>
</tr>
<tr>
<td>(2) Türi Town</td>
<td>Central</td>
<td>6,220</td>
<td>69.0</td>
<td>11,098</td>
</tr>
<tr>
<td>(3) Tallinn</td>
<td>Northwest</td>
<td>397,150</td>
<td>4,243.5</td>
<td>10,685</td>
</tr>
</tbody>
</table>

Source: Statistical Office of Estonia, Regional Development Database (Population, Population Figure and Composition), and Ministry of Finance (2003).

8.6.1 Viiratsi

Viiratsi is a small rural municipality with 3,800 inhabitants, of which approximately
1,300 live in the main settlement. A large share of the population works outside
the municipality. Reviews of the budget and interviews with municipality officials
revealed that Viiratsi’s budget exhibits a revenue structure broadly similar to the
average Estonian structure.

State fees collected are insignificant. The municipality recovers only a small
portion of the cost of education and social welfare services with its user charges.
Kindergartens are heavy subsidised. The Law on Pre-School Child Care Institu-
tions allows for charges up to 20 per cent of the legal minimum wage. In 2003, this
would indicate a maximum allowable user charge of 430 EEK/month, whereas
the charge was set at 330 EEK/month in Viiratsi. The officials indicated that this
was due to highly price flexible demand, resulting in part from inhabitants earn-
ing substantially below the national average (Interviews: Luik and Kannimäe).
Thus, distributional concerns appear to play a pivotal role in the setting of kin-
dergarten charges. However, the officials also added that they had not changed
the fee in the last four years. The municipality spends 2.8 million EEK per year on
recreational and cultural activities and receives income from sales of only 31,000
EEK per year. When asked about this, local officials would only say that they have
traditionally charged only symbolic charges for those activities.

In addition to the budgetary revenues, other activities funded by user charg-
es include heating, water, and sewer services. The heating service is privatised
in Viiratsi and charges are set in negotiation with the private provider. In the
interview, local officials said that this negotiation can be contentious and that
the existing heating contractor had threatened in the past to shut off the service
if rate increases were not granted. However, the officials also claimed that there were other providers available so that the citizens could be offered some guarantee of competitive rates. The water and sewer services are provided by a company wholly-owned by the local government. The system is in need of an upgrade and improvements. The rates are essentially set to recover short-term marginal costs. The municipality expects to attract European Union structural funds to pay for the necessary repair and improvements.

8.6.2 Türi Town

Türi Town is an urban municipality. State fees are relatively more important in Türi than in Viiratsi, probably due to the change in central government policy that allowed building permit revenue to be kept by municipal governments. Given its closer proximity to Tallinn, the area around Türi is experiencing faster growth.

Education and social services etc. are subsidised a great deal in Türi. However, the cost recovery for kindergartens appears to be higher in Türi than in Viiratsi: with a charge of around 440 EEK per month against a cost of 1,300 EEK, the cost recovery rate is 35 per cent (Interview: Milt). Cost recovery for recreation and cultural activities is also slightly higher in Türi than in Viiratsi, possibly due to the relatively higher incomes in Türi, allowing for higher charges. Türi recovers a very small portion of its costs of social protection.

Private companies with partial municipal government ownership provide heating, water and sewers, and garbage collection. Cost recovery is low in heating and water services, but still the companies have difficulty in collecting from customers. Transportation services are provided for schoolchildren, for pensioners and for disabled people. Local governments in the area collectively own and administer a transportation system; only three bus lines have full cost recovery.

8.6.3 Tallinn

Tallinn municipality has a dominating position in Estonia, reflecting its size and the fact that Tallinn is Estonia’s capital. The city and its surrounding area account for over 50 per cent of total economic activity in Estonia (Tallinn City Council, 2003). Tallinn municipality is less reliant on central government grants than the national average and both of the two smaller municipalities. Tallinn spends proportionately less on education and general government than the Estonia average; this may partly reflect economy of scale effects.

City finance officials provided information about cost recovery rates in interviews. In the kindergarten education area, for example, food costs are borne entirely by the parents of the child and fees cover 6 per cent of other costs of education. There

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8 Tallinn has for some years derived substantial revenue from municipal property, mostly from the sale of property. A dwindling stock of municipal property will increase the need for alternative revenue sources.
Local Government Fees and User Charges in Estonia

are waiting lists for kindergartens, but the rate has not been adjusted to “clear” the market.

Heating service is provided by a private company, which rents the infrastructure from the city, but it is unclear whether the company achieves full cost recovery. The setup is similar for water service. Charges are set by the board of the private company, on which the city has one representative. The government can set consumer rate caps, but these can be increased. Bus service is provided by a government-owned company, but cost recovery is not attained; the municipality directly subsidises the service (Interviews: Saat and Tammearu).

8.6.4 Overview of Case Study Findings

The three municipalities do not constitute a representative sample of local governments in Estonia. Still, the overall picture from each of the three studies is similar and also corresponds fully with the statistics in section 5. In general, fees and user charges contribute only little to the overall local budgets. The state fees and local fees are mostly unimportant in the sampled municipalities. Charges for example for kindergartens are of greater economic importance, while user charges for culture, sports and social services are modest. User charges generally cover only very little of the operating costs of these services. User charges for utilities appear to provide more or less full cost recovery, but it appears that the cost term employed – at least in some cases – takes into account only partially the depreciation of the capital stock and thus not fully reflect long-run marginal costs (cf. also Bailey 1994, Dewees 2002).

We asked explicitly about the rate setting methodology and generally received inconclusive answers. It appears for all three municipalities that no formal rate setting procedure existed and very little economic background information was provided to the policymakers. Cost recovery did not appear as a goal in the rate setting and played at least only an unimportant role. This could be the result of the policymakers weighing other objectives (for example, distribution or externalities) strongly (Bailey 1994, Fisher 1996). From our interviews, we could not fully ascertain whether this was indeed the case. However, it was telling that rates mostly stayed unchanged from year to year and that little information on costs and other important economic variables was furnished to the policy makers when deciding the budget. A tentative conclusion might thus be that the rate setting is only driven by economic considerations to a small extent, while inertia and perceived distributional concerns play important roles. This impression of inertia was emphasised by the fact that the municipalities overall showed little interest in generating additional revenue by developing and implementing new fees or user charges.
8.7 Analysis and Conclusions

This paper has provided an account of the legislation, the practices and the resulting outcome of the application of fees and user charges by local governments in Estonia. Estonia has nominally a three-tier government system, but in actual fact, only the central and the municipal levels can make independent decisions. The relationship between the government levels is one of central pre-emption with local governments having little *de facto* autonomy. The size distribution of the more than 240 local governments is uneven; most are very small, while Tallinn with more than 400,000 inhabitants, is in its own category.

Local governments account for a relatively small share of government spending in Estonia. The revenue side of local government budgets illustrates clearly their limited autonomy. More than 80 per cent of local governments’ revenue stems from shared tax revenue and grants from the central government. Own-source revenue, including fees and user charges, amounts to 15-20 per cent of total revenue.

The legislation governing fees and user charges is fragmented. State fees are clearly delineated, but only a very modest part of the state fee revenue is channelled to local governments. The legal framework for local fees and user charges is spread over laws within the different areas. Although these are decentralised to local governments, laws and regulations exist and in many cases restrict local autonomy, for example by limits on rates or cost recovery rates, and in some case by outlawing fees and user charges completely.

Local government’s share of state fees was insignificant until 2003. During the period 1996-2003 local fees have contributed 1-2 per cent of total local government revenue with the fees for extraction of water and minerals being most important. User charges for education, culture, health etc. amount to 3-5 per cent of total revenue, but approximately half of this amount stems from intergovernmental transfers. Other user charges and miscellaneous operating income have increased to 3-4 per cent of revenue in 2002-03. In aggregate, fees and user charges net of intergovernmental transfers have brought in 4-8 per cent of total local government revenue during the period 1996-2003. Still, fees and user charges amount to 20-50 per cent of own-source revenues; fees and user charges comprise an important part of the revenue which the local governments can directly influence. Cost recovery rates are difficult to estimate precisely, but are without a doubt low within areas such as education, culture, recreation, health and social services.

Our case studies revealed that decisions on local fees and user charges are generally not governed by stringent economic analysis. Centrally imposed regu-

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9 User charges for many locally provided services (e.g. public transportation) and utilities such as heating, water and sewerage are generally not included in these numbers.
lation imposes many restrictions in this area and thus limits local self-governance. When setting rates, distributional concerns appear to be important but frequently “custom” or inertia also seems to influence the decisions. Local authorities seem to pay relatively little attention to fees and user charges as a potential source of revenue generation with the result being that rate setting is given only little attention.

An interesting phenomenon that became apparent during interviews is that the local governments appear to abstain from utilising possible sources of fees and user charges. This is in some respects puzzling. Estonian local governments have very little autonomy and at the same time they do not appear to use fully the little autonomy they have. Policymakers and officials in local governments tend to focus on revenues going to the central government, instead of developing alternative revenue raising mechanisms such as fees and user charges. Whether this finding reflects that the municipalities have made a deliberate decision to refrain from increasing the use of fees and user charges, or whether it reflects inertia and tradition are questions which warrants further research.

In the end, a careful rebalancing of the Estonian fee and charge system would probably be beneficial. More local autonomy in the setting of fees and charges may be in order, but must be accompanied by training and monitoring necessary to ensure good decisions and efficient administration. Studies should be commissioned that capture the cost of services, together with careful modelling of the benefits from services. Larger municipalities can engage in these studies directly. Regional studies could be carried out to provide guidance for smaller municipalities with less administrative capacity. Finally, the notion of the application of efficient and effective fees and user charges policies should be discussed openly, together with candid assessments of administrative capacity. One can only hope that the continued debate on Estonia’s territorial structure will include the important point of how local governments can utilise fees, user charges and other own-source revenues in order to enhance the mix of payments and services provided.

References


Interviews:


Milt, T. Deputy Governor of Järva County and Head of Finance Department of Järva County Government. The former mayor of Türi town. Interviewed at Järva County Government Building. 4 February 2004.


Tammearu, V. Consultant of Budget Department, Financial Service, Tallinn City. Interviewed at Tallinn City Office. 6 February 2004.
9. Municipal Revenues and Local Fees in The Czech Republic

Lucie Sedmihradská

8.1 Introduction

Since 1990, municipalities in the Czech Republic have gained substantial independence in budgetary decision-making, especially concerning their expenditure priorities and the provision of public services. There is far less decision-making independence with respect to revenues. Local fees are the only tax revenue, where the municipalities have discretion over their levy, their base and rates. Their fiscal importance is, however, minimal. The revenues from local fees amount to a mere 1 per cent of total municipal revenues.

The purpose of this paper is to characterise the discretion which municipalities have over their revenues and to discuss local fees imposed by the municipalities.

After a brief description of the structure of Czech local governments, the main municipal revenue sources are characterised and quantified. Attention is paid to the development of the revenue-sharing system since its introduction in 1993. The last part of the paper focuses on local fees, their legal regulation, the development and characteristics of individual fees and the revenues they provide.

8.1.1 Local government structure

The Czech Republic is a unitary state. The Constitution of 1993 establishes two levels of local government: regions and municipalities. Municipalities are basic territorial, self-governing communities, i.e. public corporations with their own property, acting on their own behalf and managing responsibilities as agents of the national government. There are currently about 6,250 municipalities. The number has increased from 4,100 to 6,250 since 1990. The size of the municipalities varies from 4 (Březina in the Vyškov district) to 1,161,938 (Prague) inhabitants (see Table 1).

Municipalities are responsible for the delivery and implementation of the responsibilities for civil registry and enforcement of national regulations, pre-primary and basic 9-year schools, recreational activities, sport and park facilities, secondary hospitals and primary health care, local library services, pensioner residential homes, orphanages, homes for the mentally handicapped, nursing homes for the elderly, local roads, local transport, local police, collection and treatment of solid waste, street cleaning, sewage treatment plants and operation, water treatment and supply, natural gas supply, heating, maintenance of public housing and

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1 This project is supported by the Grant Agency of the Czech Republic, No. 402/03/P068.
buildings, city planning, local environmental issues and local tourism (see de Carmo Oliveira and Martinez-Vazquez 2001).

**Table 1**

<table>
<thead>
<tr>
<th>Population Group Ranges (1 January 2003)²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of inhabitants</td>
</tr>
<tr>
<td>------------------------</td>
</tr>
<tr>
<td>0-100</td>
</tr>
<tr>
<td>101-500</td>
</tr>
<tr>
<td>501-1000</td>
</tr>
<tr>
<td>1001-5000</td>
</tr>
<tr>
<td>5001-10000</td>
</tr>
<tr>
<td>10001-50000</td>
</tr>
<tr>
<td>50001-100000</td>
</tr>
<tr>
<td>more than 100000</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

The 14 regions were established in 1997 and the first regional representatives were elected in November 2000. The regional governments have been in operation since January 1, 2001. The region is a public corporation, acting legally on its own behalf and carrying the responsibility resulting from that action. It is responsible for the general development of its territory and the needs of its citizens, especially in the fields of social care, environmental protection, transportation, education, culture and security.

Until December 31, 2002 there were also 76 districts, i.e. de-concentrated branches of the national government in the Czech Republic. They oversaw the implementation of state policies at the local level, supervised the legal performance of local authorities in delegated functions, coordinated inter-municipal affairs and supported smaller municipalities in the discharge of their duties. The existence of the districts came to an end as part of the reform of public administration.

### 8.1.2 Municipal revenues

Municipal revenues are specified in two laws: the act on Budgetary Rules for Territorial Entities (Act # 250/2000 Coll.) lists all municipal revenues and the Law on Tax Assignment (Act # 243/2000 Coll.) specifies the revenue-sharing formula. Figure 1 shows the municipal revenue structure of 2002. This structure is quite stable over time (see Table 2) with only one exception, i.e. the increase in capital revenues over the period 1998 – 2000, peaking in 1999 when municipalities sold shares they had held in utility companies.

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² Czech Statistical Office
Using the OECD system of classification regarding own taxes of sub-national governments (OECD, 2001), 93.3 per cent of tax revenues fits into group d.3 (the revenue-split is fixed in legislation and may be changed unilaterally by the central government), 4.6 per cent into group b (for which the municipality sets only the tax rate) and only 2.1 per cent into group a (for which the municipality sets both the tax rate and the tax base).

For income taxes, revenue sharing was introduced in 1993 and has been changed twice since that time. Until 1996, municipalities received the entire proceeds from the personal income tax (PIT). Revenues from PIT levied on dependent incomes were distributed among the municipalities based on the place of work; the distribution of revenues from the PIT levied on the incomes of the self-employed was based on the residence criterion. This assignment had several weaknesses: it led to harmful competition as municipalities attempted to attract the self-employed, it created vertical fiscal imbalances and it was inefficient and unfair. This injustice is a result of the fact that people consume more services where they live than where they work (see de Carmo Oliveira and Martinez-Vazquez 2001).

The system was adjusted in 1996: 30 per cent (rather than 100 per cent) of PIT from dependent incomes and 20 per cent of the corporate income tax (CIT) was received by the municipalities. As CIT revenues declined, another change was instituted in 2000, when the value added tax (VAT) was committed to revenue sharing. Currently, municipalities receive 20.59 per cent of the revenues from these three taxes based on the number of inhabitants (with coefficients that
Municipal Revenues and Local Fees in the Czech Republic

favour the larger municipalities). There are, however, two “motivation enhancement” areas: 30 per cent of PIT receipts of municipalities from the incomes of the self-employed are based on the residence of the self-employed; 1.5 per cent of PIT receipts of municipalities from dependent incomes is based on the number of employees. Revenues from shared taxes (i.e., the CIT, PIT and VAT) represented 87 billion CZK (42.3 per cent of total municipal revenues) in the municipal budgets of 2002.

Table 2
Municipal revenues (1997 – 2002) (in millions of CZK and share of the total)\(^4\)

<table>
<thead>
<tr>
<th>Year</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax revenues</td>
<td>65,824,533</td>
<td>72,099,140</td>
<td>75,678,277</td>
<td>83,583,959</td>
<td>88,830,343</td>
<td>99,545,585</td>
</tr>
<tr>
<td></td>
<td>51.3%</td>
<td>52.5%</td>
<td>44.9%</td>
<td>51.7%</td>
<td>48.6%</td>
<td>48.3%</td>
</tr>
<tr>
<td>Non-tax revenues</td>
<td>21,110,191</td>
<td>22,878,701</td>
<td>23,921,017</td>
<td>24,368,296</td>
<td>22,649,942</td>
<td>23,448,127</td>
</tr>
<tr>
<td></td>
<td>16.4%</td>
<td>16.7%</td>
<td>14.2%</td>
<td>15.1%</td>
<td>12.4%</td>
<td>11.4%</td>
</tr>
<tr>
<td>Capital revenues</td>
<td>9,624,153</td>
<td>13,166,741</td>
<td>36,683,662</td>
<td>16,313,392</td>
<td>10,517,024</td>
<td>11,467,590</td>
</tr>
<tr>
<td></td>
<td>7.5%</td>
<td>9.6%</td>
<td>21.8%</td>
<td>10.1%</td>
<td>5.8%</td>
<td>5.6%</td>
</tr>
<tr>
<td>Transfers</td>
<td>31,812,391</td>
<td>29,150,568</td>
<td>32,328,773</td>
<td>37,289,080</td>
<td>60,747,275</td>
<td>71,615,475</td>
</tr>
<tr>
<td></td>
<td>24.8%</td>
<td>21.2%</td>
<td>19.2%</td>
<td>23.1%</td>
<td>33.2%</td>
<td>34.8%</td>
</tr>
<tr>
<td>Total</td>
<td>128,371,268</td>
<td>137,295,150</td>
<td>168,611,728</td>
<td>161,554,727</td>
<td>182,744,584</td>
<td>206,076,778</td>
</tr>
</tbody>
</table>

Since 1993, municipalities have received revenues from the real estate tax. The law on real property tax (Act # 338/1992 Coll.) provides only minimal decision-making power to the municipalities on the tax rate and none on the measurement of the tax base, i.e. municipalities, have no discretion over the tax on land, they can only select the coefficient (ranging from 0.3 per cent to 4.5 per cent, as specified by national law according to the size of the municipality) by which the tax rates on buildings are multiplied. Revenues from the real estate tax were 4.6 bill. CZK (2.2 per cent of total municipal revenues) in 2002.

The tax revenues also include various fees: local fees, environmental and administrative fees. Local fees are described in part 3. Municipalities share the revenues from payments for particular types of environmental pollution or damage:

1) The air pollution fee. Municipalities levy and collect fees on small polluters and set the rates within a given limit. The proceeds are earmarked for environmental purposes. Fees on large polluters accrue to the State Environmental Fund.

2) The levy on the withdrawal of land from agriculture and the levy on the withdrawal of land from forestry: the rates and base are set by the central government, which also collects the fee. The proceeds collected in the area of the municipality are distributed between that municipality (40 per cent) and the

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\(^4\) Ministry of Finance
State environmental fund (60 per cent). There is no specific earmarking of the revenues.

3) The charges for waste deposition in landfills: these consist of a basic charge, which is paid for every type of waste. It is a revenue of the municipal budget and a risk charge, which is paid only in the case of hazardous waste and is also a revenue of the State Environmental Fund. The charge is paid by the producer of the waste. The rates per ton of waste are specified by central law.

Administrative fees are regulated by the Act on Administrative Fees (Act # 368/1992 Coll.) and are paid by natural persons for various administrative services listed in the scale of fees, which is a part of the law. The municipality receives the fees for the services it administers. The fee rates are given either by a fixed amount or by a percentage of the fee base. Municipal revenues from the administrative fees amounted to 1.5 bill. CZK (0.7 per cent of the total municipal revenues) in 2002.

8.2 Local fees

The Law on Local Fees (Act # 565/1990 Coll.) authorises municipalities to impose local fees, which from the economics point of view, are taxes on goods and services. Municipalities have discretion over the fee base, and fee rate, which has to respect the upper limits set by the law. Local fees are collected by the municipalities.

The municipal council must approve the fees levied in the municipality by an ordinance. This ordinance contains the fees, their rates, due dates for payments, compulsory registration, the beginning and ending dates of the payment duty, and any exemptions or relief from the payment obligation. Local fees are administered by the municipality.

Table 3 summarises the main characteristics of the local fees, including the fee payer, the fee base, the highest fee rate and any exceptions. Currently there are nine local fees, six of which have been in force since 1990 and three were introduced since 1998 or 2002. Another three fees were abolished in 1993 and 1994.

The last amendment of the Law on Local Fees (Act # 229/2003 Coll.) modified five of the nine local fees on January 1, 2004. The most important changes concerned the dog fee. The fee payer has been modified from the dog owner to the dog holder, in order to avoid dog registration by relatives or friends in municipalities with a lower fee. Unfortunately, the dog holder is not specified in the law, so the aim of this modification will probably not be reached. At the same time, the upper fee rate was increased from 1,000,- CZK to 1,500 CZK and the fee is paid for dogs older than 3 months instead of 6 months.

The payers of the resort and recreations fees and the fee on recreational units must now keep a written record containing data on accommodation dates,
the name and surname of the visitor, his/her permanent address and the number of the ID-card or passport. In the case of the resort and recreations fees, the reason for the stay must also be recorded. Simultaneously, the maximum rate of the fee on recreational units was increased from 2 to 4 CZK/per occupied bed per day. The fee on entry tickets is newly imposed, also on advertised events.

Table 3
Local fees

<table>
<thead>
<tr>
<th>Fee</th>
<th>Fee payer</th>
<th>Base</th>
<th>Rate</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dog fee</td>
<td>The dog owner: a natural or legal person who is a resident of the municipality</td>
<td>A dog older than 6 months</td>
<td>up to CZK 1,000,- for a dog, up to CZK 200,- for a dog owned by a handicapped person increase up to 50 per cent for a second and any further dog</td>
<td>Dogs accompanying by handicapped individuals</td>
</tr>
<tr>
<td>amended 1/1/2004 by Act # 229/2003 Coll.</td>
<td>The dog holder: a natural or legal person who is a resident of the Czech Republic</td>
<td>A dog older than 3 months</td>
<td>up to CZK 1,500,- for a dog,</td>
<td>A person who is either handicapped, or who trains such dogs, who manages a municipal animal shelter or who is required to hold a dog by other law</td>
</tr>
<tr>
<td>Resort and Recreation Fees</td>
<td>Natural persons temporarily accommodated in the municipality</td>
<td>The number of day(s) of the stay</td>
<td>Up to CZK 15/day or year lump sum</td>
<td>Handicapped persons, younger than 18 and older than 70 years; other cases specified by other laws</td>
</tr>
<tr>
<td>Fee on the use of public space</td>
<td>Natural or legal persons who use public space</td>
<td>The use of public space for providing services, or the location of various events</td>
<td>Up to CZK 10/m² or a lump sum per week, month or year, in some cases it can be increased 10 times</td>
<td>Parking of handicapped</td>
</tr>
<tr>
<td>Fee on entry tickets</td>
<td>Natural or legal persons who organise specified events</td>
<td>Entry tickets on cultural, sport or sales events</td>
<td>Up to 30 per cent of the collected entrance fees or a lump sum per year</td>
<td></td>
</tr>
<tr>
<td>Fee on recreational units</td>
<td>Legal persons who own or manage facilities or natural persons as entrepreneurs</td>
<td>Accommodation capacity, regardless of actual usage</td>
<td>Up to CZK 2/bed/day</td>
<td>The accommodation capacity used for temporary lodgings of pupils or students, or for employees of the owner, or for accommodations used for social or charity purpose</td>
</tr>
<tr>
<td>amended 1/7/1994 by Act # 48/1994 Coll.</td>
<td>Accommodation capacity actually used</td>
<td>Up to CZK 2/bed/day or a lump sum per year</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

5 Source: Law on local fees (Act # 565/1990 Coll.) and its amendments

>>> continuing on next page

135
Local fees are a stable, if not substantial, revenue source for the municipalities. They amount to only about 1 per cent of total revenues (see Table 6). The two most important fees from the point of view of revenue generation are the fee on the use of public space and the fee on the operation of gambling machines; these two fees generate about 2/3rds of the total revenues from local fees.

<table>
<thead>
<tr>
<th>Fee</th>
<th>Fee payer</th>
<th>Base</th>
<th>Rate</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>amended 1/1/2004 by Act # 228/2003 Coll.</td>
<td></td>
<td>Up to CZK 4/bed/day or a yearly lump sum</td>
<td>A natural person, who lives, owns real estate or runs a business in selected areas, related persons and the handicapped.</td>
<td></td>
</tr>
<tr>
<td>Motor Vehicle Entry Fee</td>
<td>Natural or legal persons who have a permit to enter selected areas</td>
<td>The entrance permit</td>
<td>Up to CZK 20/day or a lump sum</td>
<td></td>
</tr>
<tr>
<td>Fee on Operating Gambling Machines</td>
<td>The provider of the gambling machine</td>
<td>The licensed gambling machine</td>
<td>CZK 5,000,- to 20,000/gambling machine/3 months</td>
<td></td>
</tr>
<tr>
<td>Fee on Standard Waste Collection and Treatment</td>
<td>A natural person who is either a resident of the municipality or who owns a recreation facility without residents</td>
<td>The resident or the recreational building</td>
<td>The rate is composed of two parts: 1) a lump sum of up to CZK 250./year/person 2) a sum based on real costs for the previous year up to CZK 250./year/person</td>
<td></td>
</tr>
<tr>
<td>Fee on Appreciation of Building Land by the Provision of Water and Sewage Connections</td>
<td>The owner of the land</td>
<td>Area of the land in m²</td>
<td>Up to the difference in the price of land with and without the possibility of water and sewage connection; the rate per m² is specified in an ordinance</td>
<td></td>
</tr>
<tr>
<td>Advertisement Fee</td>
<td>The natural or legal person utilising advertisement facilities</td>
<td>Specified advertisement facilities</td>
<td>Up to 5 per cent of the advertisement or usual price</td>
<td></td>
</tr>
<tr>
<td>Dislocation Fee</td>
<td>Legal or natural persons performing entrepreneurial functions</td>
<td>The location of offices, shops and warehouses</td>
<td>Up to 10 per cent of rent given by the municipality</td>
<td>Facilities for basic telecommunications activities and rail transportation facilities subject to the fee on the use of public space</td>
</tr>
<tr>
<td>Fee on the Sale of Alcoholic Beverages and Tobacco Products</td>
<td>legal or natural persons who sell alcoholic beverages and tobacco products</td>
<td>Up to 10 per cent of the price</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Local Government Non-tax Revenue Sources in Transition Countries: User Fees and Charges
## Table 4
Local fees revenues (1997 – 2002)\(^6\)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dog fee</td>
<td>160,905</td>
<td>170,191</td>
<td>181,883</td>
<td>190,607</td>
<td>197,014</td>
<td>205,392</td>
</tr>
<tr>
<td>Resort and recreations fees</td>
<td>190,878</td>
<td>202,905</td>
<td>211,034</td>
<td>232,076</td>
<td>250,549</td>
<td>238,296</td>
</tr>
<tr>
<td>Fee on the use of public space</td>
<td>805,486</td>
<td>738,457</td>
<td>715,918</td>
<td>645,243</td>
<td>616,232</td>
<td>614,240</td>
</tr>
<tr>
<td>Fee on entry tickets</td>
<td>66,232</td>
<td>64,926</td>
<td>69,691</td>
<td>65,458</td>
<td>66,369</td>
<td>62,239</td>
</tr>
<tr>
<td>Fee on recreational units, based on capacity</td>
<td>69,502</td>
<td>65,527</td>
<td>67,202</td>
<td>68,917</td>
<td>70,633</td>
<td>70,181</td>
</tr>
<tr>
<td>Motor vehicle entry fee</td>
<td>23,765</td>
<td>28,844</td>
<td>31,143</td>
<td>31,956</td>
<td>31,879</td>
<td>34,834</td>
</tr>
<tr>
<td>Fee on operating gambling machines</td>
<td>659,259</td>
<td>721,611</td>
<td>795,084</td>
<td>832,430</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cancelled local fees</td>
<td>43,368</td>
<td>759,690</td>
<td>77,207</td>
<td>306,401</td>
<td>104,785</td>
<td>162,947</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,360,136</strong></td>
<td><strong>2,030,541</strong></td>
<td><strong>2,013,338</strong></td>
<td><strong>2,262,267</strong></td>
<td><strong>2,132,545</strong></td>
<td><strong>2,220,559</strong></td>
</tr>
<tr>
<td>- share of total revenues</td>
<td>1.1%</td>
<td>1.5%</td>
<td>1.2%</td>
<td>1.4%</td>
<td>1.2%</td>
<td>1.1%</td>
</tr>
</tbody>
</table>

### 8.3 Conclusions

Municipalities in the Czech Republic are independent, self-governing entities whose powers and responsibilities are granted by laws of the national parliament. The extent of the powers and responsibilities varies greatly over the different areas of municipal activity. Municipal discretion regarding revenue sources is extremely limited. Municipalities have some discretion over their tax revenues for less than 7 per cent of the total tax revenues (*i.e.*, 3.2 per cent of total revenues).

Local fees are the only source of “tax revenue” which the municipality can use (within given limits) for its own purposes. The municipality can decide which fees it will levy, at what rates, and with what exemptions. Unfortunately, the collected revenues are very low. At the same time, local fees are visible to the taxpayer and therefore very unpopular, especially the dog fee. Therefore the municipalities levy only some fees and rarely apply all the maximum rates permitted.

### References


\(^6\) Ministry of Finance
Czech laws
Law on Administration Fees (Act # 368/1992 Coll.)
Law on Air Protection (Act # 86/2002 Coll.)
Law on Budgetary Rules for Territorial Entities (Act # 250/2000 Coll.)
Law on Budgetary Tax Assignment (Act # 243/2000 Coll)
Law on Forests (Act # 289/1995 Coll.)
Law on Local Fees (Act # 565/1990 Coll.)
Law on Municipal Establishment (Act # 128/2000 Coll.)
Law on the Protection of Agriculture Land (Act # 334/1992 Coll.)
Law on Tax Assignment (Act # 243/2000 Coll.)
Law on Waste (Act # 185/2001 Coll.)
10. Financing of Local Services, User Charges and Fees in the Republic of Byelorussia

*Leonida Pliskevich*

### 10.1 Introduction

Up until 1991, the budgetary process in the Byelorussian Soviet Socialist Republic was regulated by the legislation of the USSR. The state budget of the Byelorussian Soviet Socialist Republic was included in the State budget of the USSR.


The beginning of the next stage of the history of self-management began with the Decree of the President of Byelorussia, dated September 19, 1995 on Reforming the Bodies of Local Management and Self-management. Since 1996, the tendency to reduce the budgetary resources in the Republican budget was obvious. So, if the share of the Republican budget in the Consolidated budget of the Republic was 63.0 per cent, in the year 2001 it was 51.0 per cent and in 2002, 50.8 per cent (Table 1.1).

This trend is proven by an analysis of the data of local budgets after considering the transferring of grants and subventions from the Republican budget, i.e. after final regulation of the local budgets (Table 1.2).

In the budgetary policy of Byelorussia, some corrective amendments were outlined in 1996-2000. A concentration of budgetary resources at the local budget level was observed. Nevertheless, as is shown in the table, budgetary resources were mostly centralised in the republican budget – about 52 per cent.
Table 2

Distribution of Budgetary Resources between Levels of Budgets after transferring to local budgets (Including target budgetary funds), In per cent

<table>
<thead>
<tr>
<th>Year</th>
<th>The budget</th>
<th>1996</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Consolidated</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>Republican</td>
<td>48.3</td>
<td>50.0</td>
<td>44.6</td>
<td>43.3</td>
<td>43.2</td>
<td>41.6</td>
</tr>
<tr>
<td></td>
<td>Local</td>
<td>51.7</td>
<td>50.0</td>
<td>55.4</td>
<td>56.7</td>
<td>56.8</td>
<td>58.4</td>
</tr>
</tbody>
</table>

The necessity of maintaining or increasing indefinitely the expenditures under the conditions of a transformation economy has increased the stress on local budgets. Currently, local budgets finance a significant share of the state expenditure, including expenses on education, public health services and social security. The following expenditures that were previously financed from the republican budget have been transferred to local budgets:

- charges on construction of objects of municipal property;
- financing of work on liming sour soils;
- expenditures on the operation of land improvement of the economic network;
- expenditures on the purchase of equipment from domestic manufacturers for public health service establishments.

Simultaneously, the expenditures of local budgets were transferred to the Republican budget, for example, expenditures on defence and legal activities. Thus, in the Republic of Byelorussia, two tendencies are developing simultaneously:

1) the centralisation of public revenues at the level of the Republican budget and,
2) the decentralisation of the State expenditure by increasing the expenditures of local budgets.

It should be noted that in Byelorussia, the principles of distribution of revenues and expenditures between separate budgets were, for a long time, not reconsidered. For many years, the organisation of inter-budgetary relations had huge problems. Recognising this, in 1996, the Ministry of Finance, on behalf of the Cabinet of Ministers of the Republic of Byelorussia, began the development of the Concept of Formation of Local Budgets that was taken into account as the basis for the preparation of local budgets and the Minsk City budget for the year 1997. In order to strengthen the revenues of local budgets by reducing transfers to local budgets, the rights of Local Councils of Deputies regarding the establishment of local taxes and tax collections were expanded. To realise this particular aim, a document was developed and authorised concerning local taxes and tax collections in 1997, which allowed carrying out a uniform policy of taxation of local taxes in the territories of the Republic.
In 1998, there was the formation of a fund for financial support to administrative-territorial units. This fund was necessary, due to the deduction of value-added tax, profit tax and income tax, listed in the Republican budget. Specifications of the formation of the fund for financial support of administrative-territorial units and grants to local budgets were authorised by the Law of Byelorussia on the Budget of Byelorussia for 1998.

Simultaneously, a further reform of local budgets was carried out in 1999, in three ways:
1. improving the revenue base,
2. well-grounded expenditures,
3. restructuring inter-budgetary relations.

This methodology was used in the Republic in the preparation of local budgets for 1999 – 2001.

Thus, in Byelorussia, continuous work on the development and perfection of the formulation of local budgets was undertaken. Aspects of the concept focused on:
- strengthening the profitable base of local budgets,
- increasing the level of well-grounded expenditures,
- strengthening the interest of bodies of local management and self-management to increase the income of the budget,
- equalising expenditures between budgets,
- reduction of transfers to the local budgets.

The question of a degree of centralisation of budgetary resources in relation to the Republican budget is one of the most important inter-budgetary issues. Thus, the construction of a rational system of financial relations between various levels of authority is the central problem to be addressed in reforming the budgetary process in Byelorussia.

10.2 Local Government

The period of transition to a market economy is characterised by an economic crisis and increasing social problems that cause increases in budgetary expenditures on these particular aspects.

The tendency to increase expenditures on welfare is evident in the budgets at different levels until 1997-1998, at which point these began to decline in both the Republican and local budgets (Table 2.1).

For the period 1996-2000, expenditures of the Republican budget on welfare were reduced to 10.2 per cent and expenditures of local budgets to 6.9 per cent. The basic burden of financing welfare establishments is on local budgets.
Table 3  
Expenditures of the Republican and Local Budgets on Welfare  
Percentage to volume of expenditures of corresponding budgets,  
not taking into account target budgetary funds

<table>
<thead>
<tr>
<th>The index</th>
<th>Year</th>
<th></th>
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<tbody>
<tr>
<td>Republican</td>
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<td></td>
</tr>
<tr>
<td>budget</td>
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<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>13.2</td>
<td>13.9</td>
<td>16.3</td>
<td>23.3</td>
<td>24.7</td>
<td>23.0</td>
<td>21.7</td>
<td>18.5</td>
<td>14.5</td>
<td>23.7</td>
</tr>
<tr>
<td>Local</td>
<td>52.7</td>
<td>50.0</td>
<td>59.2</td>
<td>61.3</td>
<td>65.0</td>
<td>61.9</td>
<td>62.1</td>
<td>56.8</td>
<td>58.1</td>
<td>59.4</td>
</tr>
</tbody>
</table>

The degree of participation of the Republican and local budgets in financing expenditures on welfare expenditures during 1992-2001 was variable (see appendix 1).

In 1992, 76.4 per cent of these expenditures were financed from local budgets and only 23.6 per cent were financed from the Republican budget. In subsequent years, the financial burden was moved to the Republican budget. This restructuring of sources of financing during this period is the reason for increased economic instability, social problems and the deterioration in the standard of living of the population. However, the following year’s local budgets’ expenditures in the total amount of the State’s expenditures on welfare, increased in 1996 and in 2001 the figure was 72.7 per cent.

Thus, the basic burden of financing welfare establishments is borne by regional budgets.

There are currently 1,664 local budgets in Byelorussia, which are the financial base of the regions’ functions and include the financing of their social and economic development. The economic basis of local management and self-management is undertaken with local budgets. Local budgets include oblast budgets, regional budgets, city budgets, settlement budgets and budgets of the Village Soviets.

During the transition to a market economy, social guarantees are of great importance for the social security of the population. In this regard, the role of the local budget is important as the main tool in the decision-making process with regard to these problems. Forecasting expenditures in the formulation of local budgets includes the following components:

- capital investments for the development of an infrastructure in the regions;
- financing the various welfare branches;
- grants for the maintenance of apartment houses and public transport;
- social security for the population (grants for families in need, invalids, large families etc.);
- expenditures for maintenance of agrarian and industrial complexes;
- expenditures for financing small businesses.
The characteristic feature of local budgets is the high level of expenditures on welfare. About 70 per cent of all expenditures of the state, which are earmarked for this, pass through local budgets. The largest expenditures are on education and public health services, which have not only local, but also national importance. This is in addition to other expenditures transferred to the local budgets, which were financed from the Republican budget, including expenditures for the construction of objects of municipal property, on liming sour soils and on improvements.

It should be noted that part of the local budget expenditures is financed from the Republican budget. This includes expenditures on defence and safety and law-enforcement activities.

According to the Constitution (Article 117), there is a system of local management and self-management, consisting of four elements:
1) Local Councils of deputies;
2) Executive and administrative bodies;
3) Bodies of territorial public self-management;
4) Local referenda, assemblies and other forms of direct democracy.

Local Councils of Byelorussia possess the exclusive authority to undertake the following (according to Article 121 of the Constitution):
1) a statement of programs for economic and social development and local budgets’ performance;
2) the establishment of local taxes and tax collection according to the law;
3) the management of municipal property according to the law;
4) the undertaking of local referenda.

In the Law on Local Government and Self-Government, it is stated that regional (the City of Minsk) executive committees are under the control of the President of Byelorussia and the Council of Ministers of Byelorussia, regarding issues which are included in their competence.

The organisation of the budgetary process is now controlled by a number of acts, the most basic of which are the Constitution of the Republic of Byelorussia; the Laws of Byelorussia on the Budgetary System of Byelorussia and State Non-Budget Funds; on the Taxes and Tax Collections in the Budget of Byelorussia; on Local Management and Self-management in Byelorussia and on Budgetary Classification of Byelorussia.

10.3 Conclusions
Thus, the creation of a rational system of inter-budgetary relations requires budget reform which addresses the following issues:
1) To determine the degree of centralisation of the budgetary resources in the Republican budget and the appropriate proportion of the distribution between the
levels of the budgetary system, according to the general budgetary transitional policy;
2) To define the optimum distribution of taxes between the budgets of regions;
3) To achieve conformity of revenues to expenditures of regional budgets and on this basis, to achieve balanced budgets;
4) To strengthen the profitable base of local budgets by increasing the financial independence of regions through the expansion of the application of own and fixed revenues;
5) To establish limits to the size of local taxes and tax collections in the total amount of own revenues, with the purpose of the elimination of the distinction in the regional taxes. It will require local councils to pursue a policy of moderate taxation concerning local taxes and tax collections and also to raise other revenues;
6) To develop uniform approaches to the organisation of all types of financial transfers, to render the financial transfers to regions, to increase the interest of bodies of local authorities in the expansion of own profitable base, development of investment activity and the carrying out of structural transformations in regions' economies;
7) To provide a reduction in the level of grants in revenues of local budgets;
8) To establish limits to the amount of participation of the Republican budget in covering the deficits of regional budgets.

Undertaking the complex actions of reforming inter-budgetary relations will provide equality and stability of regional budgets, a levelling-off of budgetary security and the social and economic development of administrative and territorial units by rational redistribution of budgetary resources.

References
Борисевич В.И., Гейзлер П.С., Фатеев В.С. (2002), Экономика региона (учебное пособие) [Economy of the Regions], Минск: БГЭУ
### Participation of the Republican and Local Budgets in Financing Expenditures on Welfare

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Expenditures of the Republican budget on welfare:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>the sum, in million roubles per cent to expenditures of the Consolidated budget on social and cultural sphere</td>
<td>22.6</td>
<td>348.6</td>
<td>793.5</td>
<td>6,068.5</td>
<td>8,804.2</td>
<td>15,067.9</td>
<td>27,761.5</td>
<td>106,545.7</td>
<td>642,054.6</td>
</tr>
<tr>
<td>expenditures of the Consolidated budget on social and cultural sphere</td>
<td>23.6</td>
<td>27.6</td>
<td>31.0</td>
<td>36.7</td>
<td>34.0</td>
<td>29.0</td>
<td>29.2</td>
<td>26.9</td>
<td>27.3</td>
</tr>
<tr>
<td>Expenditures of the local budgets on welfare:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>the sum, in million roubles</td>
<td>73.1</td>
<td>914.0</td>
<td>1,762.6</td>
<td>10,513.9</td>
<td>17,120.4</td>
<td>36,802.5</td>
<td>67212.3</td>
<td>289,836.7</td>
<td>1709,414.1</td>
</tr>
<tr>
<td>per cent to expenditures of the Consolidated budget on social and cultural sphere</td>
<td>76.4</td>
<td>72.4</td>
<td>69.0</td>
<td>63.3</td>
<td>66.0</td>
<td>71.0</td>
<td>70.8</td>
<td>73.1</td>
<td>72.7</td>
</tr>
</tbody>
</table>
11. User Charges and Fees in the Armenian Local Government System

David Tumanyan

11.1 Introduction

User charges and fees have a significant role in the public services delivery issue. User charges allow governments to impose the cost of services on the citizens who demand those services. User fees, by assessing all or a portion of the cost of such services upon users, allow market forces to set an economically efficient level of services. User charges are an effective method of reducing consumption of scarce resources. For example, many community water systems have switched from an un-metered water service funded from general revenues, to metered services where customers are charged based on consumption. User fees provide strong incentives to conserve water, reduce wastewater discharge by industrial users and reduce the volume of solid waste that requires landfill disposal.

State and local governments set user charges and fees. One of the characteristics of democratic local governance is the right of local governments to impose user charges and fees. Though there are many similarities in this issue, it gives local governments the possibility to take into account peculiarities of certain communities and to act flexibly in price setting.

User charges and fees are one of the less studied themes in the field of local self-government in Armenia. Proceeding from this reality, special attention will be given to the following matters:

- Introduction of user charges and fees in the context of Armenian legislation.
- Local governments’ responsibilities related to service delivery and user charges and fees.
- Types of user charges and fees and the practice of Armenian local governments to levy them.
- Peculiarities of user charges and fees in communities of different sizes.
- User charges and fees as local budget revenue.
- Best practices of user charges and fees usage and the possibilities of their application in Armenia.

11.2 Introduction of User Charges and Fees in the Context of Armenian Legislation

In order to examine changes in local reliance on taxes, fees and other revenues, it is necessary to define these terms and identify the types of revenue sources they include. This sounds like an easy task, but in different countries and local government
systems, the distinction between taxes, user charges and other miscellaneous revenues can become blurred. Under the term of “User Charges and Fees” it is necessary to understand those payments, which are imposed for providing current services, or for the sale of products in connection with general government activities. User charges are paid for consumption of goods and services. As to the types and rates of the user charges and fees, governments vary widely in their choices.

From 1922 to 1991, Armenia was part of the Soviet Union and the Armenian model of User Charges and Fees functioned as a component of the higher centralised Soviet system. The types of user charges and fees were defined and their prices were levied by the central government. After Armenia’s independence, the country began its transition to a market economy and the formation of a new system of public service delivery, of which two of the components are user charges and fees.

The new public administration system of Armenia has functioned since 1996. It is divided into two tiers: central government and local self-government. Public services delivery and price setting responsibilities are divided between them. There are two types of official prices that are relevant from the point of view of local public utility. One is the official price, stated by the central government and/or in public proceedings according to the rules of administrative procedures. The other is based on local legal regulation of local governments.

As in many transition countries, prices of some user charges are approved and controlled by the national agency. The Natural Monopolies Regulatory Commission (NMRC) levies some of the user charges. It is “a so-called” independent state body, which has five members appointed by the President of Armenia, upon presentation of the Prime Minister. NMRC defines prices on electricity, gas and drinking water delivered by the pipeline network. Commission activity is regulated by the law on Energy and Water Code.

Local governments’ powers are divided into mandatory, voluntary and delegated by the State. Mandatory and delegated by the State powers must be implemented first of all. But local public services are based on the principals of mandatory and voluntary. The Law on Local Self-Government defines mandatory responsibilities of local governments in the field of public services as well as the possibility to implement any activity, including public services deliveries, which are not against the law.

Responsibilities of local governments in public service delivery are divided between community elders and the head of the community. Community elders define the tariffs for public services delivery, approve the community budget and monitor budget implementation. Therefore the community elders are a community policy-making body in general and in the field of public services in particular. The head of the community implements community policy with the help of his/her staff and community organisations.
It is necessary to mention that there are unclear statements in the legislation. The laws on Local Self-government and Budgetary system distinguish two groups of local fees as community budget revenue:

1. Local fees, which are defined by the Law on Local Duties and Fees; and
2. Other local fees, the types of which are not clarified.

The Law on Local Duties and Fees prescribes procedures for the implementation of and requirements for ten local duties and three local fees. Under the law, community elders have the right to fix the rates of local duties within the defined range and to fix the rates of local fees according to the minimal expenses for those activities. The range is wide, which suggests autonomy for local governments.

Local governments may charge the following fees:

- fee for local government services in preparing technical or financial documentation for the construction of new buildings, or renovation of building facades;
- participation fee for auctions and tenders organised by the local self-government, for covering expenses;
- fee for government services in surveying land and other necessary activities in allocating, reclaiming or renting local government property.

Community Elders levy the tariffs for the service delivery by the community according to the general statements of the Law on Local self-government. Official prices stated by communities in their local legal statutes in the following services are for:

- waste removal;
- drinking water for only own local water supply system, except Yerevan district communities;¹
- sewerage delivered by municipal water works, except Yerevan district communities;
- local public transport, except Yerevan district communities;
- public heating, except Yerevan district communities;
- parents’ fees for kindergartens, vocational schools, etc.;
- maintaining services in public cemeteries, except Yerevan district communities.

Public Utilities have an important place in the system of public services because customers are all citizens. Some descriptions of public utility reform are as follows.

¹ Those responsibilities, which are not implemented by Yerevan district communities, are implemented by Yerevan city hall, which has the status of region (marz).
11.2.1 Electricity

Is this a local public service or a national/central one?

Considerable progress has been made in reforming the energy sector since 1995 (accomplishments including: 24 hour supply; increased tariffs and reduced cross-subsidisation; improved payment discipline and transparency of financial flows; diminished accumulation of quasi-fiscal debts; adoption of the Energy Law and the establishment of the Energy Regulatory Commission (ERC)). On 1st January 1999, the increasing block tariff was eliminated in favour of a single price of 25 AMD per kw/h.

Despite this progress, however, Armenia’s energy sector is still characterised by its inefficient use patterns, significant losses and worsening infrastructure. Households’ responses to the increased electricity tariff was reduced electricity consumption records (drop on average 17 per cent) and an increased consumption of substitutes such as wood and natural gas, with the poor exhibiting this pattern more, compared to the non-poor, since the burden of energy expenditures is larger for them (16 per cent of monthly cash expenditures on electricity)\(^3\). An increase in the tariff in 1999 was accompanied by an expansion of the poor family benefits system (to soften the impact of the tariff increase) and, in addition, a direct income transfer to a portion of poor households.

Recently, the four electricity distribution networks were privatised. The UK based “Midland Resources” became an 80 per cent owner of the energy distribution network (with the remaining 20 per cent in GoA hands).

The role of local governments is minimal. This raises certain problems and it is necessary to increase their role in the energy system. In particular, it is necessary to give a coordinating function to local governments. They should coordinate all activities of electricity units in their communities. Local governments should be more involved in responding to the population’s complaints and supervising that they are resolved in a more promising manner, as well as supervision of the compliance with safety norms, both by service delivery companies and by residents.

11.2.2 Water Sector

Despite the significant progress achieved in water resource management (WRM) reform, it – both municipal and irrigation water – is still in crisis (due to economic hardship, heavy dependence on energy imports, failures to cover maintenance costs, etc), characterised by:

- financial/receivables crisis, with 20-50 per cent collection rates at 0.2 per cent of GDP and billing (cost-price) -0.9 per cent GDP\(^4\);

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2 ERC was renamed Natural Monopolies Regulatory Commission (NMRC) in 2001.
4 In Western Europe and best practice emerging countries, collections are about 0.7-0.8 percent GDP.
- poor reliability and quality of supply;
- degraded infrastructure with the cost of investment required estimated at 1 billion US dollars;
- heavy burden on the state budget of water subsidies- reaching 2 per cent of GDP, exceeding the annual planned revenues of the utility companies by 2.9 times, and the factual ones- 11.9 times.

The GoA WRM reform programme includes: achieving an integrated approach to WRM; transfer of the operation of the main water operators on a commercial basis; wide adoption of participatory water management practices; financial reform – gradual removal of state budget subsidies by 2007; continued capital investments in the infrastructure (mainly with long-term loans on favourable terms) to ensure sustainable operation of the system; a wide scale program on the sustainable use of water resources, including a water preservation program, introduction of tradability of water rights and water markets.

The State Committee of Water Resources (SCWR) took over the responsibilities for the financial and operational tasks related to the provision of commercially-oriented water services (e.g. bulk water supply, sanitation, irrigation, drainage), gradually devolving responsibilities for service delivery to water user groups, applying integrated planning to maximise the use of the resources at the macro (national perspective) and micro (sectoral perspective) levels. In addition to the agencies described, many other government bodies play a part in WRM-often with overlapping functions. In recent years, the setting of the water pricing responsibility was given to the NMRC. So local governments do not have any responsibility in water price setting. (joint or separate)

The GoA has taken a moderate view on the issue: it sees privatisation as a final solution, perhaps in ten years’ time. It sees the transformation of “Irrigation” JSC, Yerevan Water and Sewerage Company (YWSC) and Armenian Water and Sewerage Company (AWSC) into full commercial entities, to achieve cost-recovery at a minimum in the coming 3-5- years, with introducing management changes using management contracts, concessions, and so on. This is a positive sign – in line with the lessons learnt from the international experience.

11.2.2.1 Community Water Sector

Institutional responsibilities in this sector are as follows:

a) Yerevan Water and Sewerage Company (YWSC), currently operating under a management contract with Italian “Acer & Company Armenian Utility S.C.A.R.L” with IDA funding.

b) Armenian Water and Sewerage Company (AWSC), GoA is currently working on transforming its 46 branches into legally independent entities and seeking private sector participation for their (joint or separate) activities. The feasibility study is already ongoing.
c) A third operator, “Nor Akunq” (“New Source”) has recently been established (as a model experimental project, with funding from GTZ/KfW) in Armavir marz: a shareholding company owned by the GoA, cities and village councils. It delivers water directly to consumers.

Local governments are theoretically responsible for:

- Ensuring water supply in their communities- according to the Law on Local self-government.
- Provision of drinking water and wastewater services within their geographic boundaries. The internal water canals are their property. As of 1999 however, almost all of them have transferred their O&M to YWSC and AWSC (GoA decree NO. 149, 13/03/1999). This is supposed to last until the branches of AWSC are separated out as legally independent entities.
- Defining retail prices for municipal water and wastewater. Currently however, this is not the case in light of the contracts. AWSC and YWSC establish retail tariffs, but subject to approval by community elders. It is envisioned that this function will be transferred to building management, the role of which is supposed to strengthen significantly.
- Organising water users groups, mobilising building management. Currently however, this is also done mostly by AWSC and YWSC.

Recently the GoA gave new impetus to the reforms by initiating a few important measures.

The key problem, which is also behind the contracts mentioned above, is more fundamental and multifaceted.

- While (a) the Law on local self-government stipulates that ensuring the supply of the population's drinking water is the responsibility of local self-government bodies, and (b) the key GoA Decrees (No 92 and 440) underline the role of communities, in the light of the transfer of O&M of inter-community water supply networks to water operators, the latter are now (and not the local governments, as one would expect) actively involved in mobilising building management. Local governments are essentially left out of the picture: only when neither building management, nor other forms of management of multi-apartment buildings (licensed or entrusted management) are present in a given community, can they, as specified by the Law on the Management of Multi-Apartment Buildings, temporarily take over their functions, until the latter are organised.
- Building management (as well as licensed or entrusted management bodies of multi-apartment buildings) are in charge of collecting water user fees (and for the repair and maintenance of intra-building pipelines – see below), taking over the responsibility for managing the municipal water use within apartment buildings. And here an important problem rises. While the contracts be-

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5 'Building management', for the purpose of this paper, should be understood as a recognised body comprised of the dwellers residing in a particular building.
tween water operators and households specify that the operator is responsible for ensuring the agreed on amount to the household, currently, they (as a result of the management transfer contract between with local self-government bodies), have taken over the O&M of the internal pipelines up to the entry point into a building. The intra-building pipelines are, according to the Civil Code from 1999, under the shared ownership of the households. Thus, in case of a problem with intra-building pipelines, or when the water pressure is not sufficient or a motor has to be installed in a building, the households will face a problem, which is in legislative/regulatory flux. The water operators sign (or will sign) contracts with building management (or licensed or entrusted management). In fact there is a form of a contract developed between operators and building management which have been signed in a number of communities. This process is proceeding with difficulty, however, because it was largely recognised that the contracts were deficient, as a result of (mainly, but not only) the problems described above: the contracts specify that the building management is responsible for the maintenance of intra-building pipelines, while the financial and technical base for these are not clear. Again, no role is stipulated for the local government bodies.

The issue of building management requires special emphasis. They exist almost exclusively in Yerevan, and even until very recently, they were not involved in water provision or wastewater services. Moreover, established by the law of 1996 after the give-away privatisation of apartments to individual tenants and despite massive donor assistance, the experience with building management was not successful until now. Coverage of the privatised stock is estimated at around 40-45 per cent, with only about 5 per cent of the building management associations being deemed to be able to undertake major investments. Many objective (such as the inadequate legislative base) and subjective reasons are behind that. In any case, the role of local governments should not be marginalised and should be better defined – since they could provide the missing link in solving the existing problems. While the GoA has stated the goal of an increased involvement of and strengthened capacity for marz and community levels in formulating and implementation of WRM strategies in view of decentralisation and devolution of responsibilities, at the moment the local government bodies are left completely out of the picture and have almost no say in the regulatory, O&M framework of water (with the exception of the “Nor Akunq” scheme).

Together with a gradual approach to private sector participation in WRM, a gradual shift (within 8-10 years) to water-scheme based management is stated in the Program for Water Sector Reform through:

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6 According to GoA Decision No.55 24/01.2002 almost 247,000 customers in Yerevan are supposed to be serviced by the existing building managements
increased involvement of and strengthened capacity for marz and community levels in formulating and implementing WRM strategies in view of decentralisation and devolution of responsibilities;

- (a) separating the branches of “Irrigation” JSC and AWSC (Armenian Water and Sewerage Company) according to the water-basin principle; (b) developing (unions of) scheme-based Water User Federations – in order to give users greater responsibility in the management of the irrigation system below the primary outlet and to progressively commercialise the sector.

- establishing Local Water Authorities under the authority of the WRM Board charged with the operational management of primary water bodies. It is envisioned that they will co-operate closely with Water Users Federations and other stakeholders in a particular water-basin.

This statement raises, however, several questions and issues:

1) First of all it is not based on solid research into the feasibility and creditworthiness of such an option, and without any serious research into the alternatives. The questions that are unclear for municipal water include: (a) should the regulation of water supply and price setting be carried out through contracts (management or concession) or by a regulator (through a licence). These two options are not mutually exclusive and there might be other regulation components; (b) Should AWSC and YWSC be merged or not; (c) what would be the extent of the regulatory power delegated to local authorities, (c) should the regulation be conducted by a national regulatory agency, a central government body or by local governments.

2) Regulation by an independent national regulatory agency has the following advantages – independence and specialised knowledge; allowing for a national set of systematic standards or methods for pricing; benefits from economies of scale, and so on, so that its higher monitoring costs may be offset partially by relatively lower regulatory costs.

3) Regulation by local governments has the advantage of taking into account local knowledge and interests, but does not allow for a systemic set of national standards or methods for pricing; lack of specialised knowledge; dis-economy of scale possibly leading to higher regulatory costs. Plus, this option is less attractive for foreign investors (or otherwise they may require no local government control over prices or performance standards). Regulation by local governments is applicable when the contracting authority is the local government, but less applicable if Armenia wishes to introduce more uniform national standards for water operators.

Taking into account the factors mentioned below, the ECA Report (12/2001) “Armenia: Development of an institutional framework for regulation of public utilities” suggests a mixed strategy for Armenia:
• Water operating companies in Armenia are “contracted” by local authorities but there are two distinct types; (a) national (or regional) bodies such as the AWSC and (b) local operators such as Nor Akunq. Regulation of local schemes that are operated by AWSC, under contract to local governments, will have two elements (1) the cost of assets that are owned by the local government and “loaned” to AWSC and (2) AWSC’s own costs (e.g. staffing and etc): the first of these could be regulated by local governments but the second cannot and will require a national regulator – unless there is strong competition among the water operating companies offering to provide operating services to local governments (which is unlikely).

• Where however, national or regional water companies such as AWSC are involved in providing water-operating services to local government, then the prices charged by AWSC for its services to local governments should be regulated by a national regulator.

The recommended mixed strategy would entail:

• the establishment of an independent regulatory agency
• the existence of both local water companies and multi-area ones
• allowing local governments to contract with local water operators, with contracts specifying one of the following (a) no role for the national regulatory agency; (b) full regulation of prices and service standards; (c) regulation of prices but not service standards.
• a national regulator approving (a) all contracts between local governments and water operators – to help ensure that local government bodies are not exploited by private operators and (b) prices charged by large or multi-area utilities to local governments. Local governments may delegate full responsibility to AWSC or YWSC: this will require that W&S services in these areas be fully regulated by the national regulatory agency.
• allowing local governments to delegate full responsibility to AWSC or YWSC (for smaller municipalities – as an obligatory procedure). Where the regulatory agency is given responsibility for regulating water operators at the local level, the local government should be required to establish a customer complaints’ procedure to investigate initial complaints and subsequently channel complaints from local areas to the regulatory agency. Criteria recommended for deciding to regulate local water operators by the national regulatory agency might include:
  • Size (small municipalities should generally delegate to the national agency);
  • Expertise (a municipal authority that has in-house modern expertise in regulating water operators might continue doing so). For example, Nor Akunq staff are receiving training in price-setting;
  • Plans to introduce private sector participation (local governments that have plans to introduce private companies to private water services should generally be regulated by the national agency).
The above relates only to economic regulation: price and standards of performance. Other regulatory functions, relating to health, environment, and allocation of scarce water resources and policy, etc. should be the responsibility of other bodies. An economic regulator will be in charge of prices, quality and licensing (as a means of achieving the first two), but since in Armenia, the antitrust regulation is not well developed, it will also have to monitor abuse of market power – even where there is competition.

11.2.2.2 Irrigation Sector

There are two main irrigation organisations, namely “Irrigation” and “Drainage”. “Irrigation” is now in charge of the main reservoirs, as well as water trading and the delivery of water to the second and third-tier agricultural users. The latter, however, has apparently disappeared after water users groups were created (in 1996/97). The experience with these was rather mixed and the GoA recently initiated a reform, whereby all existing water user groups had to reregister, with an enlarged membership base and better legislative framework to support it (Water User Federations).

Not all natural monopoly infrastructure needs to be regulated by a national agency. The WUFs will need to be subject to regulations covering the environment, safety, water resource allocation and land-use but these are not the domain of an economic regulator – rather the domain of a public body such as the Ministry of Agriculture. The primary irrigation services provided through Irrigation and DIMA enterprises are monopolies that could be exploited by their owners/operators to raise prices or deliver poor quality. These services could then require regulation by an economic regulator if they are under private ownership or control. State-owned and operated infrastructure does not need an economic regulator. The primary and some secondary irrigation systems that are not operated by WUFs and which the private sector will be invited to manage and rehabilitate will need to be regulated. It is planned to involve the private sector in the provision of irrigation services, but their involvement will initially be as contractors for rehabilitation works and possibly, to provide management services under contract.

Armenia has adopted a volumetric pricing system in irrigation. There are two types of wholesale tariffs: for bulk water from the source, these are 0.7 AMD for self-flowing water and 1.2. AMD for water that is generated by mechanical pumping. Retail tariffs are defined by the water users’ groups (or in their absence the contracted local operator). They add 0.5 – 2.0 AMF for m³ to 4.2 AMD for m³ (0.7 US Cents/m³) – the price at which they buy from “Jrar”. Current tariffs are 30-40 per cent of the current production costs. Retail tariffs are therefore around 5-6 AMD for m³.

11.2.3 District Heating

Due to the economic crisis and the increased prices for the imported fuel, currently most of the population receives no central heating. The very low collection rates
compound the problem, since because of the financial crisis, virtually no repair and maintenance is carried out by heating networks. The GoA, after some years of small-scale efforts aimed at rehabilitating central heating, has very recently embarked on a comprehensive program for the rehabilitation of district heating in Armenia. As a first step, a Strategy for the rehabilitation of district heating was elaborated with GoA support.

The Heating Study, based on the assessment of the populations willingness and ability to pay for a “normative” supply (corresponding to Soviet norms) – less than 10 per cent of the population – concluded that a 3-stage rehabilitation program is the one which is feasible and advisable for Armenia:

- 1-2 years: survival stage – with minimum investment, maintain the current systems of central heating and undertake priority measures which will enable an economically affordable district system,
- 2-5 years: rehabilitation stage – development and implementation of sustainable systems of district heating,
- 5-25 years: attracting large-scale investment to implement a decentralised system of district heating

During the first years, central heating should be achieved using “flexible” technologies, allowing for reduced consumption (both in terms of the temperature and the space being heated) and commercialisation of the existing central heating systems, meaning:

- a shift to operation on the principles of full cost-recovery, elimination of state subsidies; involvement of private service delivery
- transformation of all state heating supply enterprises into private shareholding companies;
- the remaining heating supply networks will remain the property of the community O&M companies. They will need to have new types of contracts with consumers with a new set of rules. Most importantly, the tariff must consist of two parts – with the fixed part not less than 25 per cent of the overall tariff.

Individual and self-regulated systems of central heating (boilers connected to one or a number of buildings) need to be encouraged.

The regulatory function reserved for the ERC is for large (with monopolistic positioning) heating systems. Tariffs for these systems should consist of fixed (as described above) and variable parts.

The building management issue is an important one, so perhaps it might be summarised in a separate section (see also the paragraphs under section 1.3)

Thus, while the GoA has previously declared that local governments should take the responsibility for district heating by using, whenever necessary, funds from local budgets to ensure the provision of minimum utility services and sup-
port the newly formed building managements, the role of local governments is not clear. Questions for the investigation by the proposed project are:

- how feasible is the proposed enlargement of the property base of building managements by transferring yards on their balance?
- is there any role for communities in subsidising the poor? Currently Hrazdan community is assisting poor households by paying a part of their heating bills. It is proposed that the fixed part (covering not less than 25 per cent of the tariff) could possibly be subsidised for the poor. What could be the preferred mechanism for such subsidisation?
- Building managements – maintenance of gas pipelines requires expertise and compliance with stringent safety rules. Interviews held with professionals in this field suggest that allowing the maintenance of gas pipelines to building management could be dangerous. What are the feasible options between the operators and building management on one side and local governments on the other?

11.3 User charges and fees as local budget revenue

As can be seen, local governments have a few responsibilities connected to the user charges and fees. Some public services are provided by the organisations under the subordination of local governments. Waste removal, drinking water for own local water supply system, sewerage delivered by community water works, local public transport, kindergartens, vocational schools and maintaining services in public cemeteries are among them. These organisations collect charges themselves, which are not considered as local budget revenues. Tariff-setting of these fees is not regulated by any document or regulation. There is no methodology for this. User charges do not exist in many rural communities. There is no data on user charges. Only 3 local fees (see above) are defined clearly by the law and they are mentioned separately in the local budgets. They are about 1 per cent of the total budget of all communities. Their share is fairly high in the budget of urban communities because fees are mainly levied by urban communities.

11.4 Survey

Nowadays, public services are regulated and delivered by the state, local governments and private sector organisations. There are many problems in this field, which require implementation of appropriate reforms. What is the place of local governments in the reforms, in general, and in tariff setting in particular? There are different opinions related to this issue. A thorough approach is necessary for answering this question correctly. In this context, it is important to question the representatives of local governments. A questionnaire has been developed for this. It consists of 7 parts (central heating, local governments building managements relations, water supply, electricity, gas supply, social support, co-operation between local governments and the Natural Monopolies Regulation Commission) and includes 25 questions. The questions concern the situation in the field,
the reasons for these results, price setting and the role of local governments in the field etc. From 80 bigger communities, which have more than 5,000 inhabitants13 ones have filled it in. They represent 5 regions of the country from 11 ones. They are 7 urban and 6 rural communities. Some of the results, in the context of price setting, are as follows:

**Central heating.** Almost all replies mentioned the bad situation of the inventory of the communities heating systems. It has been evaluated as satisfactory in only two communities. There is one case where a community enterprise was declared bankrupt and sold and another where the enterprise is in the process of bankruptcy. This bad situation of the inventory is due to two main reasons: as a result of many years of inactivity, the inventory is physically depreciated and the lack of finance does not allow either restoring or exploiting it. Community elders define the fee.

**Water supply.** Local governments’ participation in the water supply system was considered positive by 77 per cent of respondents. Half of them considered that the water supply system management inside the community should be returned to local governments and the other half considered that stock companies should be founded. The main bulk of respondents (75 per cent) considered it necessary to set water supply prices jointly by local governments and NMRC. Only 17 per cent considered that it should be the responsibility of local governments.

**Electricity and gas supply.** More than half of the respondents considered that local governments should have the responsibility for electricity supply (61.5 per cent) and gas supply (69.2 per cent) issues.

**Co-operation between NMRC and local governments.** 77 per cent of respondents answered positively to co-operation and 90 per cent of them considered this a necessity for price setting jointly in the fields of central heating, water, electricity and gas supply (see figure 1).

Results of the survey in the questionnaire showed that most respondents considered it necessary to have the co-operation and participation of local governments in public utilities price setting, which are implemented by the Natural Monopolies Regulatory Commission. This will increase price setting justification and efficiency.
11.5 Public Utilities Regulation in European Countries

A study of public utilities in different countries shows that water supply and central heating services, as a rule, are provided by local governments and electricity and gas services by the central government. However, it has to be mentioned that a percentage of mixed management and the private sector is gradually increasing. In table 1, the note in the corresponding management form shows that the service is mainly delivered at that level.

Many organisational forms of public utilities delivering entities are known in all countries. Budgetary organisations, stock companies, limited-liability companies, etc. are among them. Owners of such organisations can only be local governments or different entities by different shares. In Hungary, for example, in the water supply sphere, mainly local government enterprises (44 per cent) and budgetary organisations (38 per cent) operate. In Latvia, the local government enterprises percentage is 52 per cent in this sphere.
There are different approaches related to the regulation, including the price setting of different spheres. For example, there are 3 models in the electricity sphere:

1. Centralised model. Central government body (Ministry of Economy in Slovakia) is responsible for the sphere regulation.
2. Regulation by a State independent body. Large powers are given to this body (Romania, Poland).
3. Decentralised model. Some powers are given to local governments (Latvia, Hungary).

The trend of public services delivery in these countries is privatisation of the enterprises and increasing the private sector role, as well as market mechanisms usage in the public sector, encouragement of competition and contract relationship development, etc.

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<th>Table 1</th>
<th>Local Governments Responsibilities in the Field of Public Utilities</th>
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11.6 Conclusion

The issue of user charges, fee-setting and regulation is less developed in the Armenian local self-government system. This latter has only seven years' experience and there are many problems. User charges and fees are among them.

- First, legislation has to be improved. It is necessary to include all user charges and fees in the law on Local Duties and Fees. It will allow clear definition of the list of fees, which should be defined by the community elders.
- The law on the Budgetary System has to define the cases where user charges and fees will be local budget revenue (e.g. when services are delivered by local governments).
- It is necessary to increase local governments’ powers in public services delivery matters and their participation in price setting (water supply, electricity, gas supply).
- All major elements of a new model of local public service management should be put in place. The roles and functions of public clients, service producers (contractors), and consumers should be established and clearly separated.
- Regulatory institutions should be developed and endowed with clear-cut functions and real autonomy from the central government.
- Price regulation methodologies should be developed for the calculation and design of tariffs.
- Transitional arrangements during which subsidies or cross-subsidies between consumer groups should be phased out and metering should be phased-in by the Central Government and local governments.
- Hands-on training on financial modelling for tariff-setting purposes should be provided.

It is necessary to have systematic and complex approaches to the local self-government system in general and local services delivery in particular for the implementation of the above mentioned matters.
References


12. Raising revenue in transition: the development of tax policy and a tax administration in Ukraine

Verena Fritz

12.1 Introduction

As in all transition countries, Ukraine’s fiscal system has undergone tremendous changes during transition, both on the revenue and on the expenditure side. This chapter focuses on the revenue side and more specifically on tax policy and tax administration. Tax policy often draws considerable attention, while the development of tax administration, much less so. However, both are important elements of the overall revenue system and for how well or poorly it functions and both will be discussed in this chapter.

The chapter has three sections. The first section provides an empirical overview of developments from the Soviet system of taxation to that which had developed in Ukraine by 2004. The second section outlines some of the deeper political economy drivers of the way tax policy and tax administration developed in Ukraine. In the third section I briefly consider where Ukraine stands today – relative to other post-Soviet countries, between an enlarging European Union and a more aggressively reforming Russia.

12.2 The development of tax policy and tax administration in Ukraine

In this section, I give an account of institutional development in Ukraine from the early 1990s to the early 2000s. Tax policy and tax administration are of particular interest since they are at the heart of the relationship between the citizens and the state. At least in non-resource rich countries, taxes provide most of the income of the state. In several ways, taxes have also been a fundamental part of the wider institutional change taking place during the transition. Communist states are owners of the means of production and, hence, they can rely on direct profit extraction from enterprises. In a capitalist economy – be it “casino capitalist”, liberal capitalist, or social market capitalist – the state has to tax its entrepreneurs and citizens in order to generate the resources for its own operation.

1 In countries which are resource-rich, the state may finance itself primarily from resource rents and has less need to tax its citizens. See Moore, Mick (2004), Revenues, State Formation, and the Quality of Governance in Developing Countries, International Political Science Review, 25 (3), 297-319.
Tax policy is crucial as the state tries to decide who will contribute how much to the public purse. Tax policy is, therefore, about fundamental distributional issues. Budget policy decides who gets what from the public purse and internal and external control should ensure that whatever is written into the official budget (i.e. what is declared as public policy) is actually enacted in the process of budget execution.

Tax policy is implemented through tax administration, which is one of the oldest forms of administration states have created historically. In many countries, tax administration is among the largest administrative bodies. It is the arm of the state which ensures its financing. However, in many countries, including Ukraine, problems with tax administration abound: the actual implementation of a state’s tax policy depends on the capacity and the biases of its tax administration; in many countries, tax administrations are rated among the most corrupt administrative units – often exceeded only by the second income generating unit, the customs administration.

12.2.1 The Soviet tax system
The Soviet tax system differed markedly from that in capitalist countries. The boundaries between the state and the economy were fuzzy since de facto the state owned the means of production. The formal budget made up about 50 per cent of the economy. Since the state shared profits and losses with enterprises, tax rates were not uniform, but varied for the two main taxes on turnover and on profit. This system is described in a UNECE study: “……Turnover tax rates were not ‘parametric’: there were generally thousands of separate rates of the turnover tax. There was also a considerable degree of policy discretion in taxing enterprise profits as it was normal practice for such taxes to be negotiated.”

Despite numerous exemptions, tax collection from enterprises was simple because there were few kinds of taxes and, more importantly, because all enterprises had to have accounts with state banks. Taxes were primarily collected

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2 The state tries to decide: it may not be able to implement the tax policy it would like to impose, since, for example, richer groups often find ways to evade or avoid taxes, so taxing the rich more than the poor may be a goal of the state but it is by no means certain that states will succeed in realizing such a policy. See: M. Gillis. “Towards a Taxonomy of Tax Reform,” in: M. Gillis (ed.), Tax Reform in Developing Countries, Durham: Duke University Press, 1989: 7-26.


4 In most countries, tax and customs administration are separate, while in some they have been joined together; both may be subordinated to the Ministry of Finance, or independent state agencies or even separate ministries.


from enterprises, rather than from the population at large. As Tanzi writes: “The average citizen was never confronted by the tax system or tax inspectors. He never had to file a return and, in most cases, was not even aware of the existence of taxes. For the average citizen of these countries, taxes are a negative externality brought in by the transition to a market economy.”

The Soviet system of extraction involved a degree of informality. Especially during its last decades, there was a substantial black market – i.e. pockets of the economy which were not subject to taxation. On the other hand, local holders of power could extract extra from the economy for their personal benefit. However, since taxing the formal economy was relatively easy, these elements of informality did not fundamentally undermine the state's capacity to extract.

With the loosening of the state's control over enterprises, the Soviet system of taxation ran into serious problems from the late 1980s. The crescendo occurred in 1990/1991 when a process of 'stealing the state', i.e. a process of spontaneous privatisation in which actors grabbed assets from the state, reached a massive scale. At the same time, the central government began to relax control over the republics, which went on a spending spree. While the Soviet budget had had a slight surplus in 1980, it showed a deficit of around 10 per cent of GDP in 1990.

12.2.2 Tax policy and tax administration during early independence

Ukraine's tax administration developed out of the financial departments, which had been operating as agencies of the Ministry of Finance in every rayon during Soviet times. In the early years of independence, the new Ukrainian state operated on the basis of an institutional patchwork. A Ukrainian tax service was created by two legal acts in 1990: the Resolution of the Council of Ministers of the USSR "On the creation of state tax service within the State tax inspection of the Finance Ministry of USSR and state tax inspections in regions, districts, cities and districts in cities" dating from April 15, 1990 and the Law of Ukraine "On the state tax service in

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12 Interview with Viktor Chepenko, Tax Policy Analyst, Barents Group and former employee of the STA (State Tax Administration), Kiev, November 1, 2000.
Ukraine” adopted on December 4, 1990. In the early years of independence, the Ukrainian tax administration was an arm of the Ministry of Finance. In this period, the tax administration was relatively ill-equipped to deal with the small businesses which sprang up. However, since Ukraine was slow to privatise its large companies, the extraction of revenues could rely on these.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Consolidated budget, 1993 to 2002 in per cent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>revenues</td>
<td>38.3</td>
</tr>
<tr>
<td>expenditures</td>
<td>54.5</td>
</tr>
<tr>
<td>deficit</td>
<td>-16.2</td>
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The first basic laws on the tax system, adopted in the winter of 1991/1992 and revised in February 1994, provided only an embryonic legal base, while actual tax rates and definitions of the tax base were subject to constant revisions. Dabrowski commented on this early period: “…the specific feature of the Ukraine’s tax system is its instability. It has become the object of permanent political struggle and lobbying both in the Parliament and in Government”. As competencies between the executive(s) and the legislature were not clearly defined, it was not clear which body would have the power to decide on rates and tax bases. Tax rates on personal income were changed several times: the marginal rate was even raised to 90 per cent (!) in 1993, but lowered again to 50 per cent in 1994. Rates of the sales tax (a form of VAT) were likewise changed repeatedly and even more so, the list of exempted goods. Rates and the base of enterprise taxation were subject to continuous debate. Some tax rates were clearly based on planned-economy models, such as the adoption of extremely high tax rates for trading and banking activities. As a result, formal rules remained fluid and often un-respected: it was estimated that in 1992 only 30 to 50 per cent of taxes formally due were actually paid. If this is true, tax rates were clearly set too high at this point, since even with such a collection rate, the state extracted 32.8 per cent of GDP in taxes in 1992. The combination of tax rates and the tax base (such as gross income rather than profit; high social security payments) tended to be crippling to enterprises which actually paid all levies due.

13 These first tax system laws have a volume of less than 10 pages, while the tax code drafts debated in the late 1990s/early 2000s have a volume of 200 to 300 pages.
Tax policy in this first period of independence was driven by ideological debates (e.g. how much profit making would be acceptable), by the state leadership’s grappling with the severe economic recession in its early stages, and by the desire to expand the social security net as well as to re-start the economy. These latter two actions were also viewed as measures to secure support for the newly independent state, but they also contributed to a sharply widened deficit.

Budget planning during these early years of independence was sketchy. Budgets were adopted after the start of the fiscal year and included extremely ambitious revenue targets (more than 50 per cent of GDP was to be collected in revenues in 1993). Both in 1992 and in 1993, revenues fell far short of what had been expected. In 1992, the newly introduced VAT (Value Added Tax) yielded only half of what had been planned. 17

During the period 1992 to 1994, the attempts by various individuals and groups within the Ukrainian elite to build a financial base for the new state by and large failed. In early 1994, then Finance Minister Pyatachenko acknowledged that “we have successfully ruined the old financial system without having created a new one.” 18 The attempts failed in several respects: Revenues continued to fall, production kept dwindling despite massive and costly subsidies, while corruption began to proliferate.

12.2.3 A period of incremental improvements

From the mid-1990s onwards, tax rates began to be lowered, although this was a rather gradual and extended process. At the same time, the power and the capacity of the tax administration were increased. The new government which came to power in late 1994, with the election of president Kuchma, broadly realised that Ukraine’s tax system was not working well. However, despite the fact that the debate about the need for comprehensive tax reform began in the mid-1990s, it has proceeded incrementally rather than comprehensively up to the present day.

In 1995, the VAT rate was lowered from 28 to 20 per cent. This is reflected in the drop of VAT revenues relative to GDP (see table) from 1994 to 1995. 19 At the same time, since 1993, the number of exemptions from the VAT multiplied, which further reduced revenue from that tax. The main beneficiaries from VAT exemptions have been the coal industry, the energy sector, agents engaged in hard currency transactions, and a range of services, particularly those provided to the disabled. Exemptions from the VAT caused the most significant losses to the budget, amounting to between 50 and 80 per cent of all revenue lost due to

tax privileges. The existence of numerous exemptions also fostered schemes through which those for whom exemptions were not intended are able to enjoy them (for example, by usurping tax privileges enjoyed by enterprises established by the All-Ukrainian Public Organisations for Disabled Persons). The first serious attempt to cancel VAT privileges was made in connection with the reforms suggested by Pynzenyk in 1996/1997.

In 1996, Vice Prime Minister Viktor Pynzenyk proposed a broad program of economic reform, called Economic Growth 1997. The envisaged reforms were sweeping: various taxes and payroll deductions were to be reduced significantly or abolished, in order to reduce the overall fiscal burden by about half. Budget expenditures were to be streamlined, and non-priority spending and spending on the national economy to be reduced significantly. Bureaucratic regulation (licensing, labour laws, etc.) was to be reduced and the pension system to be radically reformed, with an immediate move to a two-tiered system which would introduce individualised pension accounts. Furthermore, the banking system was to be reformed and cash privatisation in particular, to foreign investors, to be accelerated. However, the program developed with the help of foreign advisors, was only half-heartedly supported by the government as a whole and was rejected in parliament in the spring of 1997. Still, some elements of the package, such as a reform of the profit tax, were eventually adopted (see below).

While tax exemptions were a major cause of reduced VAT revenues, evasion or abuse of this consumption tax was also widespread. In particular, illegal claims for VAT refunds became a widespread problem after the passing of the new VAT law in October, 1997. As the State Tax Administration lacked capacity to check refund-claimers, vertical chains of companies were set up for short periods with a one-member firm engaging in exports; while the upstream firm would disappear before paying VAT, the down-stream exporting firm would later claim a refund of VAT paid to the disappearing firm. The majority of tax evaders who were brought to trial have engaged in such operations.

21 Thießen (1997), 400.
23 Interview with Chepenko.
A general approach to taxing income and profit, based on the Soviet system, was retained long into the independence period. Thus, exemptions were regarded as “the best way to promote production or consumption”, while production of ‘material values’ was considered superior to any trading activities which were therefore more highly taxed (at 45 rather than the standard 30 per cent). In most sectors, accounting continued to be done on a cash rather than an accrual basis (or mixed by activity), while amortisation allowances remained far more limited than in most capitalist economies – driving up the de facto tax liability irrespective of relatively moderate tax rates.  

During the transition from an administered to a market-based economy, the question of what to tax has created considerable confusion in the field of enterprise taxation. Thus, from 1988 to 1991 profits were taxed; in 1992 this was changed to taxing gross income, in early 1993 again profits, later in 1993 and until the end of 1994 gross income, and since 1995, profits again. 

In 1997, a new enterprise profit tax law was adopted as part of what remained from Pynzenyk’s Economic Growth package. The new law inter alia cancelled tax privileges for joint ventures, causing an outcry among foreign investors. While most observers judged the 1997 law as somewhat simpler than the previous one, it was still criticised as distorting allocative processes, being poorly formulated, and, by others, as still too intricate. In spite of remaining problems, the EPT was more efficient than other taxes in Ukraine and its standard rate of 30 per cent was in line with taxation in other Eastern European countries at that time.

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**Table 2**

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<tbody>
<tr>
<td>% of GDP</td>
<td>9.4</td>
<td>11.9</td>
<td>12.0</td>
<td>8.9</td>
<td>8.1</td>
<td>8.7</td>
<td>7.6</td>
<td>7.1</td>
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</tr>
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<td>29.8</td>
<td>24.4</td>
<td>22.2</td>
<td>21.0</td>
<td>20.5</td>
<td>19.1</td>
<td>19.2</td>
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**Table 3**

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<tr>
<td>% of GDP</td>
<td>5.4</td>
<td>10.1</td>
<td>13.2</td>
<td>9.5</td>
<td>7.0</td>
<td>6.5</td>
<td>6.7</td>
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<td>5.2</td>
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<tr>
<td>% of rev.</td>
<td>16.5</td>
<td>25.3</td>
<td>26.9</td>
<td>23.7</td>
<td>18.1</td>
<td>15.3</td>
<td>16.8</td>
<td>15.1</td>
<td>12.8</td>
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25 Teriokhin (2000): 147-149. See also Ukraine Gateway Project (Worldbank) at www.ukraine-gateway.org.ua (business and economy, taxation).
27 Ukraine Gateway; Luzik, 36.
The taxation of personal income was rather new to citizens of former socialist countries. Moreover, the tax rates specified in Ukraine were highly progressive, suggesting a link to the socialist notion of not letting anyone in society earn too much more than the very modest average. Thus, depending on the period and the exchange rate, monthly incomes of between $200 and $500 were already subject to the maximum PIT rate. Because tax brackets were not indexed against inflation, the tax pressure on the population increased over time, the result being that even incomes below the official poverty line (118.3 UAH or 24USD in 1999; 271.8 UAH or 50USD in 2000) were taxed at a rate of 10 to 15 percent.  

The Ukrainian social security system (pensions, unemployment benefits, and aid to Chernobyl victims) continued to be financed via taxes, i.e. deductions collected in funds without personalised accounts. Payroll taxes were almost entirely paid by employers (employees contribute 1.5 per cent). Until 1997, total payroll taxes amounted to 52 per cent of wages; thereafter, the most significant reduction occurred with the abolition of payments to the Chernobyl fund becoming effective in January 1999. In the wake of this reform, payroll taxes were reduced to 37.5 per cent of wages.

Since labour was – and even after the reductions still is – rather heavily taxed, many firms hid part of the wages they paid to employees and paid them out in cash. This compressed the official wage scale according to which the average monthly income in 1999 stood at 178 UAH (or ~ 35 USD).

### Table 4
Revenues from PIT, mandatory pension fund, and Chernobyl fund contributions

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<tbody>
<tr>
<td>PIT</td>
<td>2.7</td>
<td>2.0</td>
<td>3.1</td>
<td>3.1</td>
<td>3.4</td>
<td>3.8</td>
<td>3.8</td>
<td>3.7</td>
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<tr>
<td>Pension fund</td>
<td>9.2</td>
<td>5.9</td>
<td>8.5</td>
<td>8.2</td>
<td>8.9</td>
<td>11.2</td>
<td>9.8</td>
<td>9.6</td>
<td>10.2</td>
</tr>
<tr>
<td>Chernobyl fund</td>
<td>2.4</td>
<td>1.8</td>
<td>2.2</td>
<td>2.0</td>
<td>1.9</td>
<td>2.0</td>
<td>1.5</td>
<td>0.2</td>
<td>0.1</td>
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</thead>
<tbody>
<tr>
<td>PIT</td>
<td>8.2</td>
<td>5</td>
<td>6.3</td>
<td>7.7</td>
<td>8.8</td>
<td>9.0</td>
<td>9.5</td>
<td>10.0</td>
<td>9.9</td>
</tr>
<tr>
<td>Pension fund</td>
<td>28.0</td>
<td>14.8</td>
<td>17.3</td>
<td>20.4</td>
<td>23.1</td>
<td>26.4</td>
<td>24.6</td>
<td>25.9</td>
<td>25.2</td>
</tr>
<tr>
<td>Chernobyl fund</td>
<td>7.3</td>
<td>4.5</td>
<td>4.5</td>
<td>5.0</td>
<td>4.9</td>
<td>4.7</td>
<td>3.8</td>
<td>0.5</td>
<td>0.2</td>
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Source: UEPLAC (December 2000), 50.

While the income tax and social security deduction systems have several problematic aspects, neither these nor the tax system in general were part of in-

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29 Thießen (1997), 400.
tense public discussion. Income taxes were still a new, unfamiliar phenomenon; however, they were paid by employers, therefore tax-awareness remained low – or at best created collusion between employers and employees who paid and received a significant share of wages “under the table” in order to avoid higher PIT and social security payments. Officially, arrears of PIT were very low compared to other types of taxes, which is also due to the fact that this tax is largely paid directly by employers. Still, collection of this tax was rather poor given that firms hid considerable parts of their employees’ incomes.31

12.2.4 Tax administration

During this period of partial and incremental tax policy reform in the mid- to late 1990s, tax administration was considerably strengthened. In 1996, shortly after having achieved the adoption of the constitution, president Kuchma created an independent agency by decree („Creation of a State Tax Administration,” STA).32 Thus, the tax administration became independent of the Ministry of Finance, and it obtained a special department to pursue tax-evaders, the Tax Militia (Golovne upravlinnya podatkovoї militsii). This body had previously been under the Ministry of Internal Affairs. Also, the STA was fundamentally reorganised, it received additional funds for technical upgrading, and a special Academy of Tax Services of Ukraine was set up. Furthermore, in October 1996, Mykola Azarov, who to that point had been chairman of the parliamentary budget committee and a close associate of president Kuchma, became head of the STA.33 After being removed from the Ministry of Finance, the STA became an independent body with unclear lines of reporting to the Cabinet of Ministers and to the President (reflecting the ambiguous dual executive situation). While formally being controlled by the Cabinet, the STA was controlled de facto by the presidential administration.34

In a number of ways, the tax administration was still weak at this point. Thus, an IMF report commented in 1997: “… the STA lacks resources in almost all areas of tax administration; the legal system does not provide adequate support (i.e., the rights of taxpayers and the STA are not clearly defined in law); penalties

31 S. Johnson, John McMillan, Christopher Woodruff. “Entrepreneurs and the Ordering of Institutional Reform: Poland, Slovakia, Romania, Russia and Ukraine Compared.” Economics of Transition, vol. 8, no. 1 (2000): 23. According to their survey, Ukraine has the highest rate of non-reporting of salaries among the five post-communist countries (Poland, Slovakia, Romania, Russia, Ukraine) studied, reaching a level of almost 50 per cent in privatized (rather than new start-up) enterprises.

32 The Constitution was adopted on June 28, 1996.


34 Interview with Chepenko, Nov. 1, 2000. Towards the end of the period, in late 1999 – and at the push of international donor organizations – there are movements to reintegrate the STA into the ministry of finance. As a first step, a fiscal policy unit was moved back into the ministry of finance; however, this was not entirely successful. Presidential Decree No. 1081/99, August 26, 1999. Interview with Peter Luzik, Tax Reform Specialist, USAID, Oct. 10, 2000.
are too high; enforcement is weak as the court system is not capable of handling potential tax cases; and STA auditors lack proper skills.” An indicator of the relative weakness of Ukraine’s tax administration at this stage was the rapidly expanding shadow economy.

After it had been re-created in 1996, the Ukrainian tax administration was substantially restructured between 1997 and 1999. The organisation of the STA was streamlined and local inspectorates emerged, reducing their number from 796 to about 500. At the middle layer, 27 oblast tax administrations remained. The number of employees, however, continued to grow considerably. According to a Ukrainian think tank, “……in 1994-1999, the number of employed in financial and fiscal bodies increased by 20.4 thousand or 23 per cent, their share in the total number of executive branch employees reached almost one-half. During 1996-1999, budget allocations on maintenance financial and fiscal bodies rose 2.2 times”.

By late 2000, the STA had a staff of 56,500. Thus, despite of some streamlining, the STA evolved into the largest single administrative organisation of Ukraine. This growth in staff was similar to that occurring in Russia at about the same time. The growth of a private economy made taxation more complex and hence required growing staff numbers; the low level of computerisation also required large numbers of staff for simple computational tasks. As a result, Russia and Ukraine had about four times as many people in the tax administration per inhabitant as the US, despite the latter's vastly bigger economy.

However, this process of strengthening the tax administration was accompanied by an increasingly negative perception of this agency. The STA came to be regarded as a) overly bureaucratic and a major cause for the bad business climate in Ukraine, b) corrupt, c) a political tool used against independent media and enterprises which did not support the ruling elite.

The first element of its negative image was an attempt to tighten the screws on a transition economy with a growing informal sector. The representative of small-business organisations described this as follows: “Initially, there was a new freedom to do business. The tax inspectorate was by far not as powerful, there were fewer inspections, and tax inspectors would help to fill out forms. Later, they began to concentrate on fines. By now, the STA has

37 Declaration of the STA, No. 6696/6/33-0116/759, Dec. 4, 2000. Before the streamlining, there were about 70,000 employees in the STA. The Russian Federation, in comparison, had a Tax Service with a staff of 200,000 in the late 1990s – which seems comparable in size if we consider that Russia has approximately three times the population of Ukraine stretched over a considerably larger territory.
38 Biznes, March 6, 2000, 9. It is followed by the custom's administration with 18 200 employees.
developed into a monster. More and more businesses are leaving the official sector.’’

The second element, the strong perception of the STA as a corrupt agency probably had multiple sources. Firstly, Ukraine’s tax legislation contained numerous privileges and exemptions. While this created problems for the STA, it also created opportunities for the discretionary application of rules – which in turn created incentives for paying and accepting bribes. Secondly, public servants in Ukraine were poorly paid, which increased their willingness to accept bribes. In a “National Integrity Survey”, commissioned by the World Bank, the tax inspection came out as the third most corrupt agency after the office of social benefits and the customs service, and ahead of the road police.

The third element of this negative perception resulted from a deliberate policy of the President to form the tax administration into an instrument of personal power. In 1996, the STA had been created by presidential decree rather than by a law. In the summer of 2000, the president issued a further decree which brought the tax administration even tighter under his control. Thus, in 2000, the head of the tax administration received the right to dismiss any heads of the regional tax administration with the consent of the president. Previously, the consent of the Cabinet of Ministers had been required. Also, the head of the tax administration, as well as his deputies, are appointed and dismissed by the President.

In the ‘tape scandal’ which erupted in the winter of 2000/2001, it became apparent that the tax administration had been used by Kuchma in the 1999 presidential elections to pressure local leaders into delivering pro-presidential results. According to one of the taped conversations, Kuchma ordered the head of the tax administration, Azarov, to communicate to regional tax officials that they would be fired should they “lose” the elections in their territories. They should make it clear to any local power-holder that they had enough material (regarding tax evasion) on him to put him into jail.

39 Interview with Kseniya Lyapina, head of the Coordination-Analytical Center of Ukrainian Business Associations, Kyiv, September 26, 2000.
42 See www.pravda.com.ua/?10211-3-1, translation by Kyiv post staff.
Thus, while the tax administration had been a weak and technical tax collection arm of the Ministry of Finance in the early period of independence, it grew to be a powerful and politicised agency from the mid- to late 1990s. A tax policy (i.e. decisions regarding tax rates, the tax base and exemptions) which imposed an uneven and still high burden on taxpayers in a weak economy, also helped to worsen the image of the tax administration and with it, the general relationship between citizens and the state.

12.2.5 The politicisation of taxation and the failure of a tax code

In the late 1990s to the early 2000s, the dominant theme in the debate about tax reform was the introduction of a comprehensive tax code. The main advantages of a code (rather than the reform of individual parts of tax legislation) were seen in allowing the double change of broadening the tax base and lowering tax rates, creating a ‘fairer’ tax system while maintaining revenue levels. Also, a tax code would signal a one-time fundamental change followed by a period of stability and thus, would signal an end to the previous instability of the tax system, which had been widely perceived as a fundamental problem. De facto, tax codes have been adopted in many post-Soviet and other Eastern European countries, although they have brought less absolute stability than was often proclaimed.\(^{43}\)

In contrast to Russia, however, Ukraine failed to adopt a comprehensive code, although it eventually undertook some similar changes in its tax policy.\(^{44}\)

There were several problems: in Ukraine, the number of proposed tax codes proliferated from about 1999 onwards.\(^{45}\)

The proposed changes in the tax system were also rather contradictory. For example, some actors proposed a change back from VAT to a cascading sales tax, arguing that the VAT-tax regime was too complex for a transition economy like Ukraine’s.\(^{46}\)

At the same time, key economic actors were unwilling to agree on a decisive broadening of the tax base. The interests of a narrow tax base were well represented in the Verkhovna Rada, due to the high number of deputies with business interests.

The closest attempt to pass a tax code failed in 2000 in the Verkhovna Rada. After being adopted in a first reading in July, more than 5000 amendments were

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43 See for example: *RFE/RL NEWSLINE* Vol. 8, No. 54, Part I, 22 March 2004 on Kyrgyzstan; *RFE/RL NEWSLINE* Vol. 8, No. 32, Part I, 19 February 2004 on debates in Russia to raise its flat income tax rate.


suggested by deputies, which essentially stalled the final adoption of the Code.\textsuperscript{47} An attempt to revive this code was made by the Kinakh government in 2001, and Viktor Medvedchuk, leader of the Social Democratic Party (united) (SDPU (o)) and deputy speaker of parliament, styled himself as a key advocate of the reform. At the time, the Head of the Committee on Finance and Banking, Serhiy Alioshin, commented: “To adopt the Tax Code in parliament we need to form a majority, which agrees simultaneously to lower the tax burden and to cut tax privileges. I’m convinced that such a majority does not exist in the hall of the Verkhovna Rada.”\textsuperscript{48}

However, in mid-December, Medvedchuk was ousted by a right-left alliance from his post as deputy speaker in revenge for earlier political and policy actions; the long-term Finance Minister, Ihor Mityukov, was rather suddenly replaced by Ihor Yushko, a member of the Donetsk industrial network (or “clan”). Thus, the climate of constant political fragmentation, shifts and turns again prevented a more fundamental policy reform in Ukraine.

Eventually, in December 2002, it was decided to reduce corporate taxes from 30 to 25 per cent, in line with Russia’s (24 per cent),\textsuperscript{49} taking effect as of January, 2004. Furthermore, Ukraine followed Russia’s example and chose a flat rate personal income tax of 13 per cent in May 2003.\textsuperscript{50} These changes came into force from January 2004.

The tax administration meanwhile continued to play a highly politicised role in Ukraine in 2004, in the run-up to the decisive presidential elections at the end of the year. The tax administration was being used to undermine support for the political opposition, in particular the largest opposition block “Our Ukraine.”\textsuperscript{51} The head of the Lviv Tax Administration, i.e. in the regional heartland of “Our Ukraine” was headed by the brother of Viktor Medvedchuk, one of the biggest oligarchs and a key political player in Ukraine. There were calls for his dismissal by the Oblast council, accusing him of oppressing businesses whose owners were close to the opposition parties.\textsuperscript{52} Instead, in early 2004, he was promoted to the first Deputy Head of the tax administration at the national level.


\textsuperscript{48} Serhiy Alioshin, cited from ZN, December 15-21, 2001 (“Sleep quietly, tax code”).


\textsuperscript{50} The Russian Economy, May 27, 2003, “The Flat Tax Spreads to Ukraine”.


\textsuperscript{52} RFE/RL NEWSLINE Vol. 7, No. 184, Part II, 26 September 2003.
In February 2004, 10,000 people (a considerable number given the regional location) picketed the regional office of the State Tax Administration in Ternopil, protesting “tax repression” against businesses associated with lawmakers from the Our Ukraine opposition bloc. The tax administration also continued to be widely perceived as corrupt; although some providers of public services (e.g. hospitals and universities), as well as the police, were even more widely perceived to extract bribes than the tax administration (hospitals: 85, universities: 79, police: 83, tax administration: 66 per cent of respondents thought that corruption is very serious or somewhat serious in these institutions).

12.3 Political economy of tax policy and tax administration development

In the first section of this chapter, I explored the development of tax policy and tax administration in Ukraine over the past decade. In this part, I will embed this development into the broader story of the political economy of Ukraine during the ‘Kuchma era’ in Ukraine (1994 to 2004). This era was marked by a hybrid political regime which led to the development of a reasonably strong, but highly politicised tax administration. At the same time, tax policy suffered from the lack of stable political alliances. Together, instability and politicisation contributed to making the tax regime rather burdensome and ‘dysfunctional’ for taxpayers and in this way, also holding back economic recovery.

Evaluations of Ukraine during the ‘Kuchma era’ in the literature are strikingly diverse. They range from the recognition of considerable accomplishments in economic and political reforms (Pigenko, Wise and Brown) to the proclamation of complete failure and persistent neo-patrimonialism (Hans von Zon). These contradictory judgements are based on the fact that Ukraine was a hybrid case in several ways: on the one hand, it developed much less towards a democratic system than its Western neighbours (Poland, Slovakia, etc.), but on the other hand, there was neither an authoritarian consolidation, as in Belarus, nor a clear trend toward concentrating power as in Russia. Ukraine had an abysmal record on economic policies and economic outcomes for much of the 1990s, but as the development of taxation reflects, there were also incremental improvements. Ukraine was far from being a failed state, in the sense that it maintained a considerable revenue collection capacity throughout the transition period.

There are three defining features of the political economy of Ukraine: the first is a continuous, but not too deep, fragmentation of political forces and a continuous, though low-level struggle for power by various groups. The second feature during the decade from 1994 to 2004 was a president who was the relatively – but not absolutely – strongest political player. The third was a rather weak society, a considerable decoupling between elites and society, and a weak accountability link between society and elites. Let me turn to each of these three features.

Ukraine’s party system and parliament remained rather fragmented. While party systems have been and are still fluid to various degrees in many parts of Eastern Europe, Ukraine has had one of the lowest levels of consolidation if we consider the “survival rate” of parties (from one election to the next), the number of parties in parliament and the stability of parliamentary factions. The latter has been particularly weak, also due to the lack of institutional constraints on switching factions (no limit, no loss of parliamentary seat is involved).56

This kind of fragmentation brought about a continuous but low-level struggle for power. Ukraine has no hard and fast political blocks and alliances, but is rather marked by shifting coalitions. These are often negative: for example, an alliance of oligarchic and left-wing parties ousted the reform government of Viktor Yushchenko in April, 2001, while an alliance of democratic and left-wing members of parliament ousted the oligarch Viktor Medvedchuk in December, 2001. In such a situation, binding commitments by individuals or political blocks were nearly impossible to achieve, and the resulting problems of policy instability and inconsistency in taxation have been persistent. At the same time, fragmentation and shifting alliances mean that the depth of the political struggle is limited. The dominant mode of problem solving is incremental, as in the case of tax policy, and is not without reversals. This broad trend was disrupted by the ‘second transition’ in late 2004 when the political struggle reached a peak during the ‘Orange Revolution’. However, the trend of shifting alliances returned during subsequent months when the new president Viktor Yushchenko cut a deal with his key rival of the previous December, Viktor Yanukovych.

The second feature between 1994 and 2004 was the relative strength of the president, in spite of his inability to establish absolute control. Since the election of Leonid Kuchma to the office in 1994, the President was the single most powerful actor within the political system of Ukraine. Compared to other CIS countries, the de facto power of Ukraine’s president remained, nevertheless, limited. As Way has pointed out for the case of Moldova, the absence of authoritarianism was not due to a more “democratic” predisposition of Ukraine’s elite or its president, but rather to the inability of the president to impose absolute control.57

Through a referendum held in April 2000, Kuchma attempted to create a more purely presidential system (after his successful re-election in late 1999). However, while the referendum confirmed the constitutional changes he suggested, he eventually failed to push these changes through parliament. In August, 2002, he suddenly changed tactics and started to propose a more parliamentary constitutional system.\(^{58}\) This was widely perceived as a strategy to weaken presidential powers before a possible opponent would take over the reins in the next presidential elections. After two failed attempts at such constitutional reform in 2003 and 2004, Kuchma eventually managed to insert this change into the deal with his successor, in exchange for accepting a repetition of the presidential election.

The relative strength of the president contributed to the politicisation of the tax administration. The president and his administration, as a key organisational power base, used the tax administration to keep political opponents as well as other critical groups at bay. The political use of the tax administration \textit{per se} is not at all unique to Ukraine; it is observed in other CIS countries as well.\(^{59}\) However, the proportion of the practice and the degree of reliance on the tax administration for political manipulation were particularly pronounced in Ukraine; and it was related to the peculiarities of a hybrid political regime. For example, while the spring 2002 parliamentary elections were reasonably free and fair, the tax administration was used in the aftermath to pressure independent and “Our Ukraine” deputies – many of which had business interests – to join pro-presidential factions in parliament, thus shifting the weight of factions in disregard of the will of voters.\(^{60}\)

The third feature of the political economy of Ukraine was the relative weakness of society particularly during the depth of the transition crisis; followed by a rather unexpected wave of mobilisation in late 2004. As in most of Eastern Europe, the 1990s were not marked by mass strikes or other mass political action despite the tremendous hardship which transition brought about for a majority of the population. In the Donbas, where miners had been a considerable political force during the dissolution of the Soviet Union, the last major strike wave occurred in 1996. Even the widespread non-payment of wages and pensions during the years 1996 to 1999 failed to spark popular protest. Demonstrations in the wake of a major scandal in 2000 involving the president and other high-level political figures in the murder of a journalist, power abuse and corruption remained limited.


\(^{60}\) Taras Kuzio, Loser Takes All: Ukrainian President Co-opts Parliament, RFE/RL NEWSLINE Vol. 6, No. 100, Part II, 30 May 2002 (Endnote).
While the number of NGOs of various types (political, charitable, etc.) grew considerably, many depended on foreign financing rather than domestic donations, limiting their “rooted-ness” in society. Others are small think-tanks financed from the pockets of oligarchs. At the same time, popular distrust of politicians, parties, and state institutions is very high, even in comparison with neighbouring countries. While politicians of the new Ukrainian state started by promising a very high level of social security in 1992, these promises were routinely broken during the following years, when pensions for the majority were very low, if paid at all. Once independence was securely established, the period of enthusiasm and of a broader engagement between elites and society passed quickly.

Weak accountability to citizens contributed to an institutional system which was not weak, but in many ways dysfunctional. The relative weight of society then increased in 2004, the decisive election year. In the course of the ‘Orange Revolution’ mass demonstrations overcame attempts at political manipulation. The change in government brought a new tone into the fiscal system, and a new head of the tax administration was appointed. A number of tax loopholes were closed which led to a substantial increase in revenue collection in 2005. However, facing a number of political challenges the new government was rather slow in bringing about fundamental improvements in the tax regime.

12.4 Ukraine’s fiscal system today: between an enlarging EU and a ‘strong-hand’ reforming Russia

Ukraine has managed to build and stabilise a tax system which achieves a substantial level of extraction. The level of extraction is rather high for a country with Ukraine’s per capita GDP and also compared to the poorer and less developed parts of the former Soviet Union, i.e. the Caucasus and Central Asia (see table 5 below). However, emerging from a deep transition crisis, Ukraine has a structural level of development (levels of education, of urbanization, etc.) which is higher than its current GDP, and requires a substantial level of state activity to maintain. At the same time, this means that the tax burden on citizens and enterprises is substantial, which makes fairness and efficiency of the revenue collection particularly important – and it is important that the new Yushchenko government manages to overcome the distortions created during the Kuchma era.

62 See IMF Staff Country Report no. 05/415 (2005), 7.
Local Government Non-tax Revenue Sources in Transition Countries: User Fees and Charges

Table 5
General Government Revenues* in per cent of GDP 1993-2003

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* comprising central and local/regional level budgets and extra-budgetary funds.


Ukraine is caught in a challenging situation between Russia and the expanded European Union. In contrast to the Central European countries, Ukraine can move closer towards the EU, but accession remains an uncertain prospect. At the same time, Ukraine needs to maintain a good relationship with countries of the former Soviet Union, especially Russia and Turkmenistan, from where it imports most of its gas.

Since Vladimir Putin took over the presidency, Russia has undertaken some major economic reforms including tax reform. High revenue from natural resources has eased a decisive reduction in tax rates in Ukraine's Eastern neighbour. However, the strong reliance on natural resources also harbours risks for Russia's economy and governance. Other sectors of the economy are “crowded out”, there is a concentration of wealth in the hands of few and less of an incentive for business and political elites to seek a broader development of the economy. Furthermore, the Russian state faces security threats of considerable magnitude relating to North Caucasus which consumes political attention and resources.

On Ukraine's Western borders, a number of new EU member countries have lowered taxes in recent years in order to attract foreign investment and to stimulate job creation. Further afield, Ukraine's competitors are the large “emerging markets” such as Turkey, India, or Brazil – which face their own political economy challenges but which are also undergoing a period of reform and dynamic economic development.
If Ukraine wants to begin catching up with a European level of economic development, further improvements in its tax regime and overall governance are essential. Structural conditions are broadly propitious: the Ukrainian government has to rely on taxation as the main source of revenue and therefore faces an incentive to promote broader economic development. In contrast to Russia, Ukraine does not face acute security threats. There has been a strong concentration in the economy on metals processing, but volatile prices provide an incentive to diversify. In several ways, therefore, the opportunities for a modern, well governed state to emerge in Ukraine are greater than in Russia. Progress in developing such a state, and the tax regime to support it, has been slow, but it is accumulating over time.

In contrast to EU accession countries, Ukraine has enjoyed less external pressure and less external engagement in cleaning up its administration. However, the role of the EU as a “driver for change” in Ukraine is growing: enlargement has brought the large EU market closer to Ukraine, making it a more attractive location for FDI. At the EU-Ukraine summit in December 2005, the EU finally awarded Ukraine the status of a market economy, thus reducing the potential threat of anti-dumping measures. The Yushchenko government is strongly committed to moving Ukraine closer to ‘EU-Europe’ and is taking concrete steps in terms of institutional and legal development.

Apart from the EU, Ukraine aspires to join other key international clubs; most importantly in the context of fiscal reform, the WTO. Striving to join such clubs generates reforms and improvements to Ukraine’s state and economy. Ultimately, it will help to turn Ukraine from a buffer state between the enlarging EU and Russia into a successful economic bridge between the two.