LOCAL GOVERNMENT FINANCE IN TIMES OF CRISIS: AN EARLY ASSESSMENT

Edited by
Lucie Sedmihradská
Nadezhda Bobcheva
Mihály Lados

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Selected Case Studies from the New EU Member States, the Western Balkans
and the Former Soviet Union

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Preface

This book is the result of a joint activity between members of the NISPAcee Working Group on Public Sector Finance and Accounting. During our meeting in Budva in May 2009, we discussed what the topic would be for the following year – 2010 – and agreed on "The Economic Crisis and its Impacts". As the Working Group had focused, during its ten years of existence, on local government finance issues, we agreed on the topic "Local Government Finance in Times of Crisis: How to respond?"

We were conscious of the fact that only a short time had elapsed in which to evaluate the impacts and potential responses; however, it seemed feasible for us to assess the early impacts and approaches by governments. Now, one and a half years later, it is clear that our expectations were far short of the reality. The impact of the crisis on local governments has been gradual, as has the reaction to it. Much more time and analysis will be necessary to find out what has actually happened, or how local governments have responded to the crisis. So, instead of a book entitled "Local government finance in times of crisis: How to respond?", we are presenting a book entitled "Local government finance in times of crisis: An early assessment."

It is a collection of twelve country case studies and an introductory comparative paper. The authors of the case studies focus, after a general evaluation of the developments between 2008 and 2010, on various related topics such as budgeting, borrowing, the role that local governments play in the stabilisation policy and the relationship between central and local governments. The case studies cover ten countries: four new European Union member states from Central and Eastern Europe, two countries from the Western Balkans, three countries from the former Soviet Union and Canada. The Canadian case study is included because it serves as an interesting example of how to respond to fiscal pressures through the introduction of performance budgeting.

This book is the outcome of a mutual collaboration between all the authors, who also served as peer reviewers for the other chapters and who responded to most of the comments and suggestions of the editors in a very limited time. The comments of David Amborski, Ryerson University, Toronto, Canada, who served as a reviewer of the whole volume, were very beneficial and we thank him for his precise and quick work. Jana Lysáková, student assistant at the University of Economics, Prague, Czech Republic, meticulously carried out the unrewarding and time-consuming technical editing.

We appreciate NISPAcee secretariat's assistance regarding all technical aspects of the preparation of this book and thank Jane Finlay for the language editing which is, for most of our papers, still required. We are grateful to the Local Government and Public Service Initiative at the Open Society Institute in Budapest for its generous financial support, without which, most of the working group members would

not have been able to attend the 18th NISPAcee Annual Conference in Warsaw, Poland in May 2010.

1. Local Government Finance in the First Year of the Economic Crisis

Lucie Sedmihradská

The financial crisis began in mid-2007 in the United States as a result of the subprime mortgage-backed securities crisis which gradually spread to become a worldwide economic crisis which affected almost everyone. World output fell in 2009 by 0.6 %, while the decline in the advanced economies was 3.2 %; in Central and Eastern Europe (CEE) 3.6 % and in the Commonwealth of Independent States (CIS) 6.5 % (IMF 2010a).

National governments continue to respond to two main challenges: (1) to smooth away at least some of the impacts of the financial and economic crisis through a set of stabilisation measures, such as bank bailouts or car "scrappage" and (2) to re-balance their budgets which are suffering simultaneously from decreases in tax revenues caused by the economic decline, and growing expenditures to finance the anti-crisis measures and expenditures aimed at reducing the social impacts of the crisis. Public deficits and debts are growing in CEE countries. The average public debt increased from 27.6 % of GDP in 2008 to 39.2 % of GDP in 2010 (IMF 2010b).

The situation of local governments is quite different from that of central government for several reasons: (i) local governments rarely engage in a stabilisation policy; (ii) they have different revenue and expenditure structures; (iii) their fiscal autonomy is quite limited; and (iv) they are influenced by central government measures. These differences lead to the spreading of the impact of economic decline on local governments over a longer period. Therefore, local governments will be required to respond repeatedly to various impacts of the economic crisis.

The purpose of this chapter is to examine the effects of the actual worldwide financial and economic crisis on local government finance in the transition countries and to identify the first responses that have been undertaken. The geographical focus of the chapter is limited by the availability of comparable data and the country case studies presented in the following chapters. A maximum of twenty countries are covered, i.e. ten new EU member states, seven countries from the Western Balkans, and three CIS countries.

This introductory chapter is based on a literature review of available studies of the impact of the economic crisis on public or local government finance, prepared by various international organisations, such as the OECD (2010), OSI/LGI (2010) or United Cities and Local Governments (2009), the country case studies presented in the following chapters of this volume, and own analysis of relevant data on economic development and public finance provided by Eurostat, the OECD and the IMF.

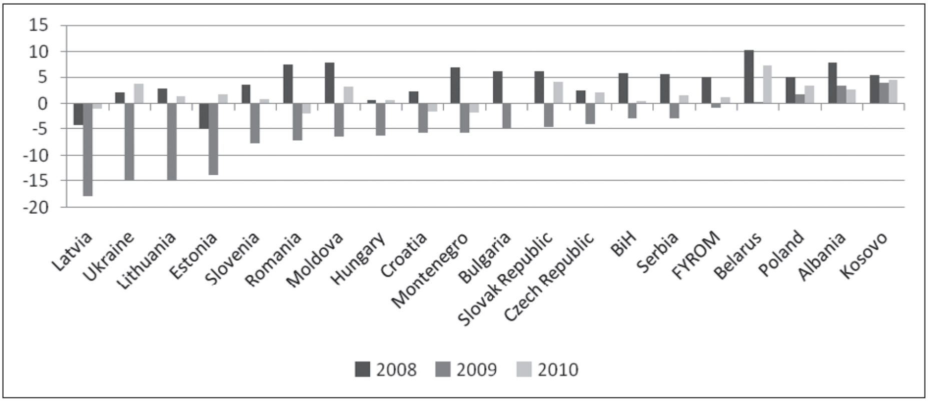
The chapter is structured as follows: First of all, the magnitude and beginning of the economic decline in the region is assessed, together with its impact on public and local government finance. Second, the differences in the impact between central and local governments are explored in detail. Third, the responses of local governments to fiscal pressures are discussed.

1.1 Economic crisis and public budgets

The course, magnitude and beginning of the economic crisis differ widely across individual countries and so do its impacts. Figure 1.1 shows the data for GDP growth between 2008 and 2010 in twenty transition countries. The countries are shown, based on the GDP growth rate in 2009.

Two countries (Latvia and Estonia) already experienced economic decline in 2008, and in four countries (Latvia, Romania, Croatia and Montenegro), GDP growth is not expected in 2010. The majority of countries observed a decline in GDP in 2009, whilst they enjoyed economic growth both prior to and after that year. Four countries (Belarus, Poland, Albania and Kosovo) did not see any economic decline and even in 2009, growth merely slowed down.

Figure 1.1
Gross domestic product, year-on-year changes in per cent,
constant prices (2008–2010)



Note: BiH = Bosnia and Herzegovina, FYROM = Former Yugoslav Republic of Macedonia, 2010 data are estimates only

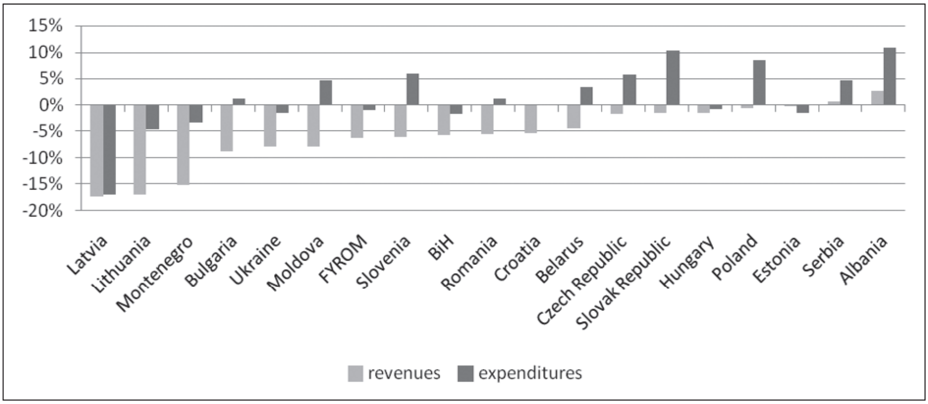
Source: IMF (2010b)

Economic decline adversely affected general government revenues. With only a few exceptions, the deeper the economic decline, the bigger the decrease in general government revenues. Despite an economic decline of 13.9 %, Estonia hardly saw any decline in government revenues, thanks, in particular, to the increased revenues from value added tax and excise taxes on fuel and natural gas, whose tax rates were increased in July 2009 and also capital revenues. On the other hand, the Former Yugoslav Republic of Macedonia observed a 6 % decline in government revenues while GDP had less than a 1 % decline.

Whilst only two countries observed a modest increase in revenues (Serbia and Albania), eleven countries observed an increase in government expenditures. In three countries – the Czech Republic, Slovenia and the Slovak Republic – general government expenditures grew by more than 5 %, even when their economy and government revenues declined. This counter-cyclical development was probably supported by sizeable EU funding. Figure 1.2 shows the change in general government revenues and expenditures between 2008 and 2009.

Figure 1.2

Percentage change in general government revenues and expenditures between 2008 and 2009 in current prices



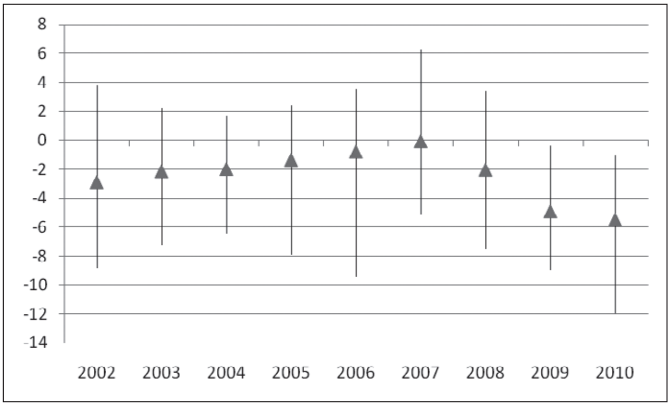
Source: IMF (2010b)

Public deficit and public debt have deteriorated in the region since 2007. (Figure 1.3) Whilst in 2007, seven out of twenty countries managed their public budgets with a surplus, in 2008 there were only three countries with a surplus (Belarus, Bulgaria and Montenegro), and in 2009 and 2010, none. Most of the countries managed to decrease the share of public debt in GDP between 2002 and 2007; in 2008 this share grew in eight out of 19 countries and in 2009 and 2010 in all countries.

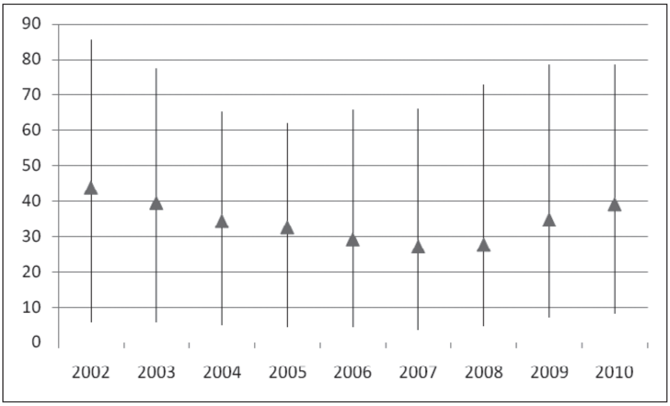
Figure 1.3

General government net lending/borrowing and general government gross debt as a % of GDP (2002–2010)*

General government net lending/borrowing



General government gross debt



Note: *minimum, maximum and average value, for up to twenty transition countries, data on public debt are not available for Kosovo, and for Belarus and Romania for 2002 and 2010; 2010 data are estimates only.

Source: IMF (2010b)

The impact of the economic decline on local government budgets is shown in Table 1.1 where the volume of the main budget categories in 2009 is compared to 2008. Whilst we can observe a decline in tax revenues in seven countries, total revenues and total expenditures fell in four of them. The data also show similarities between the three Baltic countries and the Visegrad countries and Slovenia, with the exception being Hungary.

Table 1.1
Change in main local governments' budget categories between 2008 and 2009 (2008 = 1.00)

	Total revenue	Taxes	Total expenditure	Intermediate consumption	Compensation of employees	Capital investments
Latvia	0.83	0.74	0.85	0.71	0.83	0.74
Estonia	0.91	0.87	0.89	0.89	0.95	0.69
Lithuania	0.94	0.84	0.93	0.90	1.03	0.69
Hungary	0.96	1.00	1.01	1.06	0.96	1.10
Bulgaria	1.00	0.82	1.08	0.95	1.09	1.10
Romania	1.02	1.02	0.99	1.00	1.06	0.87
Czech Republic	1.03	0.96	1.06	1.04	1.05	1.13
Poland	1.05	0.96	1.12	1.11	1.09	1.29
Slovenia	1.09	1.07	1.07	1.04	1.07	1.13
Slovakia	1.13	0.96	1.23	1.21	1.25	1.40

Source: Eurostat (2010)

1.2 Differences between central and local governments

Central governments can respond to the crisis in three ways: (1) cushion the impact of the crisis by increasing expenditures and lowering taxes, (2) take no policy action or (3) take actions to balance their budgets, such as decreasing expenditures and increasing taxes (see OECD 2010). Local governments have the same policy options as central governments. However, bearing in mind the differences between central and local governments discussed in this section of the chapter, it is obvious that local governments' possibilities to cushion the impacts of the crisis are very limited if one does not refuse this possibility at all. Even if a local government decides to take no action at the beginning of the crisis, sooner or later it will be required to take actions to balance its budgets. No action inevitably leads to a worsening financial situation of the local government.

1.2.1 Stabilisation policy

There is a broad consensus for centralising the governments' stabilisation function because of the "free rider" problem when neighbouring jurisdictions benefit from counter-cyclical measures that they did not finance (see Dafflon 2002). Despite this, local governments' actions can have counter-cyclical effects, such as the continuation of investments reported in many countries in the region (e.g. the Czech Republic, Hungary, Poland, Slovakia and Slovenia). Data on local government expenditures in Croatia show slightly counter-cyclical development, when subsidies to private enterprises remained unchanged and social benefits increased. At the same time, we can find examples of local governments' measures aiming to support local businesses, such as lowering rents in municipally-owned buildings in Prague, Czech Republic (see MF Dnes 2009).

Section 9.1 is devoted to a discussion of the role local governments might play regarding stabilisation policy.

1.2.2 Different revenue structure

Tax revenues are the major revenue sources for central governments. Data for the ten new EU countries (EU 10) show that taxes and social contributions formed, on average, in 2009, 78 % of central government revenues. Revenue sources of local governments are more diversified: Taxes form a minority portion of revenues and are accompanied by significant inter-governmental transfers and own and capital revenues. The proportions of these three revenue sources were, in the EU 10 countries, on average in 2009; 33 % taxes, 50 % inter-governmental transfers and 17 % own and capital revenues. This revenue diversification may or may not increase the stability of the revenue side of the budget, but in any case, the impact of the crisis varies on different revenue sources regarding both magnitude and time.

A sharp drop in tax revenues in 2009 in most of the CEE and CIS countries also inevitably led to a growing dependence on state grants. The development in the Czech Republic follows exactly the above general expectations. As the tax sharing mechanism ensures that all three governmental levels share equally either the tax windfalls or tax decreases, we can observe a decline in tax revenues in 2009, i.e. year one, when the share of tax revenues declined by 4.6 percentage points in municipalities and by 5.3 percentage points in regions, compared to 2008. In contrast, the share of inter-governmental transfers increased by 2.8 percentage points in municipalities, and by 5.6 percentage points in regions, because the majority of transfers to lower levels of government are entitlements (see also section 1.2.3). However, in 2010, i.e. year two, the grants received by regions are expected to fall by 9 % (see section 4.2.1).

Another example is from Ukraine, where the grant share increased and the grant structure has changed in favour of equalisation grants. At the same time, the distribution of these grants, based on a formula, was, to some extent, substituted by direct appropriations from the state budget (see section 12.2). However, in general, local government revenues were less elastic than expected, thus the actual decrease in 2009 was not consistent with the deep economic decline.

Table 1.2 shows that in the majority of countries, in the first year of the crisis, the impact was more unfavourable for central government. In future years, this situation will probably change, as the inter-governmental transfers react with a lag of one or two years to the cycle (see OECD 2010).

Table 1.2
Impact of the economic crisis on local and central government revenues

	Local government revenues between 2008 and 2009	
	Decrease	**Increase**
LG is better off than CG	Bulgaria Lithuania Latvia Croatia	Slovakia Czech Republic Slovenia Romania Poland Albania Moldavia
CG is better off than LG	Hungary Estonia	

Source: Eurostat (2010) for EU member states and for other countries, the authors of the individual case studies

1.2.3 Different expenditure structure

The expenditure structure of local governments and central governments also differs. A substantial part of central government budget is entitlements, i.e. the magnitude of these expenditures is determined by how many people or other subjects meet the eligibility requirements. These expenditures are open-ended, thus difficult to budget and difficult to cut. Local governments generally do not have entitlements (see Rubin 2000).

The data of the ten new EU countries show that entitlements (i.e. social benefits and interests) formed 22.2 % of central government expenditures and 5.8 % of local government expenditures in 2009. At the same time, a much larger share of local, rather than central government expenditures, forms investment. In the EU 10 countries these shares were 19.6 % and 7.1 %.

While capital expenditures appear to be easy to cut, at least in comparison to entitlements and other current expenditures, this expectation is not necessarily valid in the transition countries. The vast majority of local government investments are financed, at least partly, by grants received from the central government or EU funds. This may lead either to a decrease in capital expenditures, if the grantor does not provide a particular grant as a result of its restrictive policy, or to increase them if local government receives a grant which was approved earlier or is part of a multi-annual grant scheme. Thus, the magnitude of investments is determined by local governments only to a certain extent and need not comply with the actual financial situation of the particular local government.

1.2.4 Fiscal autonomy

Fiscal autonomy means access to the various fiscal resources that local governments have available. Tax autonomy is part of fiscal autonomy and encompasses the various aspects of freedom that local governments have over their own taxes (see Blöchliger and King 2006). Fiscal autonomy of local governments is much more limited than that of central governments. This is especially true in the CEE countries, which can influence their tax revenues only to a very limited extent. As a consequence of the economic crisis, several central governments increased local government rights or authority, so that local governments could contribute their own efforts to limit its impacts.

In Bulgaria, for example, the central government has increased the autonomy of local governments with regard to their revenues in two ways: local governments have gained full legal rights of execution (i.e. the possibility to better enforce unpaid taxes) and the maximum rates for property tax, and tax on movable and immovable property purchase were increased. In Albania, the poster tax and advertisement tax were increased and in the Czech Republic, the rate of real estate tax for most buildings was doubled.

Local government borrowing is, in all CEE countries, subject to central government regulations. This regulation can take the form of the determination of the purpose, limitation of total debt level, fulfilment of other conditions and supervision procedures or regulation of insolvency (see Swianiewicz 2004). In Poland, in order to avoid potential macroeconomic problems, local government borrowing is linked to the level of general government debt, therefore if the public debt exceeds 55 % of GDP, so-called prudential and improvement measures are taken, i.e. when public debt is higher than 55 % of GDP, local government units can plan for a deficit only for projects financed from EU grants. When public debt exceeds 60 % of GDP no deficit can be planned.

The case studies from Estonia and Croatia highlight the issue of local government contingent liabilities resulting from public private partnership (PPP) contracts. Whilst in Estonia these liabilities have been treated, since 2009, in the same manner as direct debt, in Croatia they form a kind of hidden debt, which escapes current regulation (see sections 6.3.3 and 9.2.2).

The economic crisis has influenced the opinion on local government borrowing in several of the countries analysed. We find examples of both relaxation and tightening of the conditions for local government borrowing. In Belarus, local executive and administrative bodies have acquired the right to issue bonds for the first time. These bonds are being bought by the State Bank (see section 10.1). Also, in Albania in 2009, a municipality borrowed for the first time.

In some countries with a long tradition of local government borrowing, we can observe a fear of the macroeconomic consequences of excessive public debt, which leads to a tightening of local government borrowing regulations. In Estonia, local governments are now required to consult on all new obligations with the Ministry of Finance. At the same time, all unconditional obligations to private partners of concession contracts for services have been accounted for as a loan burden of local governments since 2009, which, in practice, limits the amount local governments can borrow. In Poland, a new, stricter system will be applied at the beginning of 2014. In the Czech Republic, there is a new, more complex, local government debt monitoring process which began in 2009 (see Ministry of Finance 2008).

The case studies also show examples of changes in the magnitude of independence of local governments' financial management. Since January 2009, Ukraine local governments cannot deposit their temporarily free funds in commercial banks, and they are obliged to transfer their accounts to state-owned banks. This restriction was caused by a fear of commercial banks' insolvency, which could possibly harm local governments. However, it violated the budgetary legislation, which granted local governments the freedom to dispose of their funds as they so wished (i.e. against the law). (See section 12.1).

1.2.5 Impact of central government measures

Local governments are directly influenced by central government measures, i.e. measures aimed at achieving the objectives of central government in the area of stabilisation policy, or consolidation of state or public budgets, may adversely affect local governments.

For example, in Estonia, the system of sickness benefits was modified in early 2009, so that instead of sickness benefits being paid by the Estonian Health Insurance Fund from the second day of sickness, the employer now has to pay sickness benefits from the fourth to eight day and the Estonian Health Insurance Fund from the ninth day. This creates a new burden on local governments which have to pay sickness benefits for their employees. This new duty has not yet been compensated. In the Czech Republic, both the self-employed and small businesses were exempt from advance payment of the tax, which significantly influenced the cash flow of municipalities.

Whilst most central government measures have a specific aim, they often have negative impacts on local governments due to their side effects. The change in the rules for tax sharing of personal income tax in Estonia in the budget year 2009 was aimed directly at improving the central government's position regarding the costs of local governments. The tax share of local governments decreased from 11.93 % to 11.4 % (see section 6.3.3).

1.3 Coping with fiscal pressures

As a consequence of the economic crisis, the vast majority of local governments, if not all, will face fiscal pressures and will be required to respond to it. Table 1.3 summarises the main strategies for coping with the financial pressures identified by earlier research carried out in both the United States and other western countries.

Table 1.3

Strategies for coping with fiscal pressures

1. Expenditures strategies/reduce expenditures a. Reduce operating expenditures i. Reduce personnel costs 1. Lay off personnel 2. Reduce employee compensation 3. Freeze wages and salaries or reduce the rate of increase 4. Freeze hiring 5. Reduce workforce through attrition 6. Initiate early retirement 7. Reduce overtime ii. Reduce non-personnel operating costs 1. Defer payments to next year 2. Make cuts in all or in the least effective departments 3. Reduce administrative expenditures 4. Reduce expenditures for supplies, equipment and travel 5. Eliminate programmes (core services, optional services, social programmes) 6. Keep expenditure increases below inflation 7. Defer maintenance of capital stock b. Reduce capital expenditures i. Capital spending freeze for new capital projects ii. Deferral of non-essential capital projects iii. Transfer of costs to private capital c. Reduce participation in grant programmes requiring local matching contributions	2. Increasing revenues a. Increase tax revenues through increases in tax rates, tax base or change in tax structure b. Increase local fees, licences or user fees c. Sell assets d. Lower surpluses, use accumulated surpluses from previous years e. Borrow f. Add inter-governmental revenues 3. Management strategies/productivity increases a. Improve productivity through better management b. Improve productivity by labour-saving techniques 4. Delegating responsibilities through contracting out or co-operation a. Shift responsibilities to other units of government b. Contract out services to other units c. Contract out to the private sector d. Introduce purchasing agreements

Source: Walzer et al. (1991, Table 9.2, 143) and Wolman (1980, 232–233)

In the country case studies presented further on in the book, we find numerous examples of the application of listed strategies. However, similar to the conclusions of American researchers (see Wolman 1980), we can see that some of the strategies are being used earlier than others.

The first reaction is to ignore the problem and defer or use "buying time" strategies, such as the use of existing surpluses (e.g. Czech municipalities). Then follow strategies aimed at increasing revenues, and finally some expenditure cuts. At the same time, we find evidence of some strategies aimed at increasing productivity or delegating responsibilities.

Despite limited fiscal autonomy, which was discussed above, we find examples of increases in own local government revenues. For example, in Ukraine, local governments collected more revenues from land tax and land rent, incomes of budgetary institutions and environmental taxes and fees. Further increases in other local taxes, such as the unified small business tax for natural persons or local taxes and duties, are not possible because their rates in most local governments have already reached the caps set by law in the mid-1990s (see section 12.2).

In the Bulgarian municipality case we can see increases in the rates of municipal fees and increased efforts in the collection of tax arrears, which may also be due to the above mentioned new legal right of execution.

Borrowing or increased borrowing is another frequently used strategy. Local governments in the EU 10 countries borrow frequently: in 2007, only Czech and Polish local governments operated with a surplus and in 2009, none. Borrowing, as a share of total local governments' revenues, was higher in 2009 than in 2008 in Bulgaria, Slovakia, Poland, Hungary, the Czech Republic and Latvia (in order of the largest increase to the smallest). Borrowing as a fully new strategy for increasing revenues is reported in Belarus and Albania.

A slight contradiction can be found when comparing the case study of one Czech region presented in section 4.2.3 with the above listed sequence of steps. The vast majority of measures taken are on the expenditure side of the budget (across-the-board cuts in all departments, reduction in employee compensation, reduction in allowances to own budget organisations and the postponement of investment). On the revenue side we find transfers from regional funds (i.e. accumulated surplus from the previous year and funds originally earmarked for co-financing EU projects) and new loans. The region did not use its only revenue raising authority, i.e. sell property (Czech regions do not have any tax authority; all their tax revenues are taxes shared on a fixed formula).

The responses of Croatian local governments are similar to the Czech case: due to limited fiscal autonomy it is impossible to significantly modify the revenue side of the budget, thus the response is for local governments to cut expenditures, possibly reflecting the existing priorities and wages. They postponed the sale of property because of current low asset prices.

We also find examples of savings of current expenditures, such as in the area of public administration, street lighting or heating in Bulgaria or public administration or energy in the Czech Republic.

Country studies, which address the issue, e.g. the Czech Republic, Bulgaria, Croatia and Ukraine, report that local governments did not engage in a massive sale of their property. This may suggest that they behave in a rational and economic manner, because the possible revenues now would be lower than in the future due to the low prices caused by low demand. This finding is contrary to several examples of municipal asset management practices presented in Sedmihradská (2010), where local governments behave myopically and prefer immediate revenues. However, the reason may be that there was no-one who wanted to buy the property offered.

Next to the presented options, it seems that territorial reforms can be considered an interesting option as a response to financial pressures (see OSI/LGI 2010). Proposals for optimising municipal structure, i.e. attempts to force mergers of municipalities, as a tool for decreasing administrative expenditures, were discussed but rejected in Bulgaria and Estonia (see sections 2.2 and 6.3.2). In Belarus, in 2009, about 130 village councils (about 10 %) were integrated with other village councils (see section 10.1). In Croatia, the discussion of administrative-territorial reform began again in 2010 and an amalgamation of local governments may take place in the future (see section 9.2.1).

The authors of the country case studies do not report a systematic application of management strategies aiming to increase productivity or delegating responsibilities through contracting out or co-operation. The only exception is the final Canadian case study, which explores in great detail the application of performance budgeting at the municipal level.

1.4 Conclusions

The assessment of the impact of the financial and economic crisis on local government finance in the transition countries shows both differences and similarities among the individual countries. The crisis hit these countries with varying strength and the responses of the central governments also varied, i.e. their speed, type and magnitude, differ significantly. However, for local governments, the crisis does, after all, mean less revenues and growing pressure on the expenditure side of their budgets. Now we find numerous examples of local government strategies aiming to increase revenues (despite the very limited fiscal autonomy in basically all countries in the region), and cut expenditures (despite its political unpopularity and possible long-term adverse impacts). At the same time, there are no reported strategies aimed at increasing productivity, with the exception of a few minor examples from individual local governments. Only during a longer period of time will we see if these current fiscal pressures lead to a broader initialisation of new productivity-enhancing strategies. Only then will it be the right time to prepare a paper or book entitled "Local government finance in times of crisis: How to respond?"

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2. Local Government Finance in Times of Crisis: The Case of Bulgaria

Desislava Stoilova

Bulgaria is a unitary state with a 7.9 million population[1] and a territory of 111,000 km². The territorial structure of the country includes two regions on level NUTS I, 6 planning regions, defined as level NUTS II, 28 administrative districts corresponding to level NUTS III, and 264 municipalities, which represent the level LAU 1.[2] It is important to note that regions are not administrative, but only statistical units, created according to the Regional Development Act (2008, §4) and in compliance with the requirements of the European Union for the allocation of regional development funds. The districts are deconcentrated administrative units of the central government, which coordinate national and local interests, but they neither enjoy financial autonomy, nor provide public services to the population. According to the Constitution (§136), municipalities form the only tier of really autonomous subnational government in the country.

Municipalities are legal entities and have the right of ownership and adoption of an independent municipal budget, which must be used in the interests of the local population (see the Constitution of the Republic of Bulgaria, §140 and §141 and the Local Self-Governance and Local Administration Act, §14). The bodies of local government – Municipal Council and Mayor – are elected directly by the local population for a 4-year mandate with the purpose of making and carrying out local government decisions (see the Constitution of the Republic of Bulgaria, §138 and §139). Some of the most important pillars of the legal base of the local self-government are the Constitution of the Republic of Bulgaria (1991), the Local Self-Government and Local Administration Act (1991), the Act on Administrative and Territorial Structure of the Republic of Bulgaria (1995), the Local Elections Act (1995), the Municipal Property Act (1996), the Local Taxes and Fees Act (1997), the Municipal Budgets Act (1998), and the Municipal Debt Act (2005).

The process of gradual political, administrative, and financial decentralisation in the country began in 1991, at the same time as the transition from the centrally planned, socialist-type economy to a market-based economy. During the period 1991–2009, Bulgaria made remarkable progress in reforming and decentralising the public sector. First of all, the most important pillars of the legal base of local self-government were adopted, providing a stable background for financial decentralisation.

1 Last census on 1 March 2001, source: National Statistical Institute, at http://www.nsi.bg/Census/Census.htm

2 NUTS I, NUTS II and NUTS III are the abbreviations respectively of the level I, II and III of the Nomenclature of Territorial Statistical Units within the meaning of Regulation (EC) No 1059/2003 of the European Parliament and of the Council of 26 May 2003. LAU 1 is denotation for local administrative unit.

Second, the importance of local governments has significantly increased, as has their share in the gross domestic product and consolidated public budgets. Third, expenditure assignment and an inter-governmental transfer system have been placed on a clear and transparent basis. Fourth, local governments have been given full control over some of their own-source revenues (local fees, service prices and revenues from municipal asset management) and a limited control over the local tax levy. As a result, local governments became a powerful component of the public sector.

It is interesting to note that since 2003, the process of strengthening fiscal decentralisation has been accompanied and significantly influenced by an average annual economic growth of 5–6 %, increasing economic activity, low levels of unemployment (6–7 %), dynamically decreasing public debt, and consolidated budget surpluses equal to approximately 3 % of GDP. This process broke down in 2008, due to a new and deep worldwide financial and economic crisis. Decreasing economic activity strongly affects public finance by decreasing government revenues and increasing social expenditures, mainly due to the fast growing unemployment rate. At the local level, the economic crisis both sharply reduced local governments' own tax revenues and – via budget constraints at the central level – increased pressure on the grants system.

This chapter is intended to examine the influence of the current worldwide financial and economic crisis on local government finance in Bulgaria and identify the answers from central and local governments to the critical situation in the context of specific conditions of the national economy and the stage of financial decentralisation reform. It contains three sections. Section one describes the level of fiscal decentralisation at the beginning of the crisis and the general effects of the crisis in the country. Analysis is focused on the dynamics of the main macro economic indicators, such as GDP growth, inflation rate, unemployment rate, consolidated budget balance (deficit/surplus), consolidated public debt, and its impact on public finance. The assessment is based on factual figures for the period 1990–2009 and forecast for the period 2010–2011. A comparison is made between the loss of the Bulgarian economy at the beginning of transition (1991–1993), during the financial crisis in 1996–1997, caused by a credit crunch and a series of bank bankruptcies, and the current financial and economic crisis. Section two outlines the most important actions taken by the national government to consolidate the crisis and the respective effects on local finance. Section three concludes.

2.1 Impact of the crisis on the fiscal decentralisation process in Bulgaria

2.1.1 Development of the fiscal decentralisation process

The fiscal decentralisation process in Bulgaria comprises several distinct periods. At the beginning of transition (1991–1993), the highly centralised system was preserved and there was no sensible dialogue between local and central authorities. In 1993, the independence of municipal budgets within the consolidated state budget was acknowledged, meaning that the State abandoned the centralisation of local budget surpluses and the financing of local deficits. In addition, inter-governmental fiscal relations were organised on the basis of a newly introduced formula for the distribution of state subsidies to the municipal budgets. It is interesting to note that although adopted with the best of intentions, the allocation formula became exceptionally complicated and difficult to predict. Since its introduction, it has been changed every year, becoming more and more complex with each change. Moreover, the original legislative rationale for the general state subsidy, namely to meet differing expenditure needs based on objective criteria, has been gradually converted into a redistributive mandate, based largely on ad hoc decisions by central government (see Thcavdarova, Ivanov and Savov 2000).

Typical for the period 1994–2002 has been the process of a gradual building up of the capacities of local authorities. The National Association of Municipalities in the Republic of Bulgaria (NAMRB) and regional associations of municipalities emerged as the main champions of financial decentralisation. Several changes in inter-governmental relations have been provoked, gradually eliminating mandatory priorities in the allocation of municipal expenditures. However, up to the end of this period, inter-governmental fiscal relations remained centralised since the central government established a model of almost complete control over the municipal budgets.

The real fiscal decentralisation in Bulgaria began in 2003, based on the Co-operation Agreement, signed by the Council of Ministers and the NAMRB in 2002, whereby both parties agreed to decentralise local government and increase the financial independence of municipalities. The Fiscal Decentralisation Concept and the programme for its implementation were adopted. As a result, one of the main achievements in the scope of inter-governmental fiscal relations became a reality, namely the clear division between the local and central responsibilities for public services. Brought about for the first time by the annual State Budget Act for 2003 it was continued and improved during the following years. Additionally, this law provided a framework for regulating a new, simple and transparent model of assigning government subsidies. Now, subsidies' allocation is based on a formula, which takes into account the expenditure needs and revenue capacity of local governments.

A fundamental weakness of the revenue assignment system in Bulgaria during the transition period has been the lack of local tax autonomy. Prior to the Constitutional amendments at the beginning of 2007, Bulgarian municipalities were prohibited from setting either rates or bases of local taxes. Property tax, motor vehicle tax, inheritance tax, donation tax, and tax on real estate and movable property purchase, recognised as local taxes, were regulated entirely at the central government level. In terms of modern public finance, if local governments do not participate in the design of the local tax, it should be considered as a special transfer, based on the location of taxable property. Moreover, this regulation conflicted with article 9.3 of the European Chart of Local Self-Government, ratified by the Republic of Bulgaria in 1995.

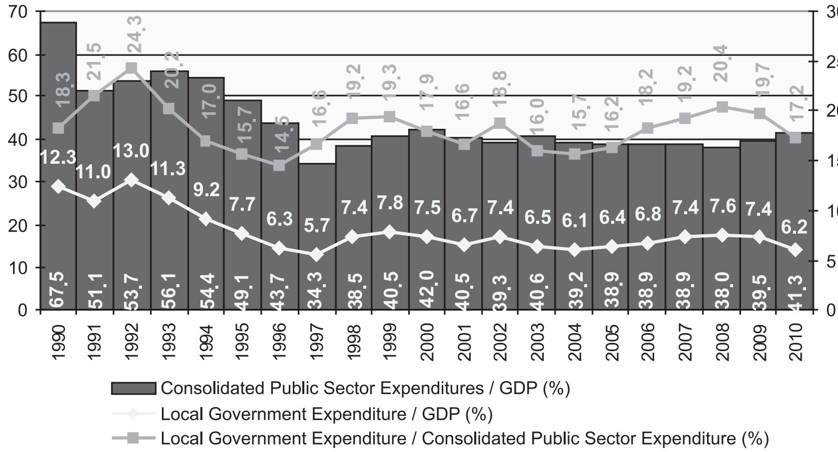
At the beginning of 2008, two important legislative changes considerably influenced local taxation. First, municipalities were given the authority to set local tax rates within certain legal limits. However, they are still not allowed to define the local tax base and provide additional (or remove the existing) legal alleviations for certain taxpayers. Second, the patent tax was reassigned as a local tax. Basically, the patent tax is a net annual income tax, which is collected from craftsmen and the owners of small enterprises, who offer hand-made products and a variety of services. The patent tax replaces the payment of personal income tax or corporate income tax, so it has the potential to become an important part of local revenues and a powerful instrument of the municipal tax policy.

2.1.2 Dynamics of the main budgetary indicators

In response to the fast-changing legal and financial environment during the transition period, public sector expenditures have been very dynamic. Due to economic stagnation, financial instability, and vertical imbalance in the last decade of the 20th century, the relative importance of local governments within the governmental system decreased. Moreover, regardless of the financial stabilisation and economic growth achieved during the first years of the new century, the downward tendency has proved its persistency. The relative share of local budgets in GDP decreased to 7.5 % in 2000 and 6.1 % in 2004 compared to 12.3 % in 1990. At the same time, local government expenditures, which accounted for 21.5 % of the consolidated state budget in 1991, were 17.9 % in 2000 and 15.7 % in 2004.

This negative trend was reversed in 2005, due to the ongoing process of fiscal decentralisation during the period 2003–2008, which has considerably influenced inter-governmental fiscal relations. As a result, the financial autonomy of the municipal level of government has increased. The positive dynamics were accelerated by the clear expenditure assignment, transparent inter-governmental transfer system, and local tax authority. In 2008, local governments appeared as an important part of the public sector in the country, accounting for 20.4 % of total government spending. At the same time, consolidated public sector expenditures have been constantly decreasing, representing 38 % of GDP in 2008, whilst local governments' share reached 7.6 % of GDP. In 2009 and 2010, as a result of the economic crisis, local government expenditures tended to decrease, in contrast to an increase in central government expenditures (Figure 2.1).

Figure 2.1
Public sector expenditures in Bulgaria (1990–2010)



Note: Data for 2010 are based on prognosis.

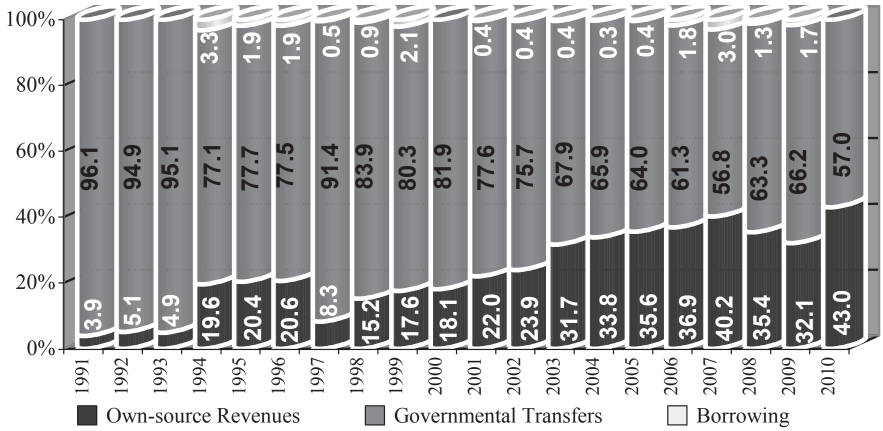
Source: Calculations based on the Ministry of Finance database

During the transition period, local governments have suffered more than central government from the decreased financial capacity of the public sector in the country. Because of the advantages of taxation at the central level and spending at the decentralised level, the public sector in Bulgaria has often ended up with a vertical and horizontal fiscal imbalance. Since 1991, the legislation in the scope of local finance has been subject to continuous changes, but the real decentralisation of local revenues proved to be a very long and difficult process. At the beginning of the transition period, several problems had a decisive influence over own-source local revenues, causing a significant decline in their relative share, especially during the 1990s.

First of all, there were the difficult inter-relations between local governments and the tax administration, which in 1991 became subordinated to the Ministry of Finance. As a result, the efforts of centrally dependent officers were aimed at collecting taxes from the larger taxpayers, causing delays in local taxes and fees' collection and even a waste of local revenues. In a dynamic inflationary environment, any postponement led to additional losses for the municipal budgets. Another serious problem was the outdated tax base for the property tax, which was also used for the calculation of inheritance tax, donation tax, and tax on property purchase. This was why, in the period 1991–1997, local taxes accounted for less than 3 % of local revenues. Especially low was the local tax revenue share in 1997 (0.45 %), due to hyperinflation, which additionally devaluated the local tax base. Moreover, it was beyond municipal competence to solve the problem. Although autonomous on paper, municipalities did not have the possibility to influence tax revenues. In addition, the inability of local governments to impose local fees and set their rates freely, particularly in the inflationary situation, resulted in a growing gap between local revenue potential and the actual costs of local service provision. This was the reason why in the 1990s, own-source revenues accounted, on average, for only 12.8 % of total local revenues (Figure 2.2).

Figure 2.2

Local governments' revenues structure (%)



Note: Data for 2010 are based on prognosis.

Source: Calculations based on the Ministry of Finance database

As a whole, during the period 2000–2007, local own-source revenues tended to increase gradually, from 18.1 % to 40.2 % of total municipal revenues, provoked by expanding financial decentralisation. Since 2003, local governments have been given full discretion over local fees and service prices, which have quadrupled their importance in real and relative terms. In 2006, municipalities began to collect local tax revenues. Especially high is the growth of local taxes in 2007 and the first half of 2008, due to the considerable revaluation of the property tax base, on the one hand, and the newly assigned tax competences on the other. At the same time, because of the expansion of own-source revenues, the inter-governmental transfer system has lost its dominant role in financing local governments in Bulgaria. However, bearing in mind the vast difference between the fiscal capacity in several of the richest municipalities and the remainder of local governments in the country, for the present, the strong inter-governmental transfer system still has no effective alternative.

It is important to note that since 2003 the process of strengthening fiscal decentralisation in Bulgaria has been accompanied and significantly influenced by constantly increasing economic activity, low levels of unemployment, dynamically decreasing public debt, and consolidated budget surpluses exceeding 3 % of GDP. This process was broken in the autumn of 2008, due to a new and deep worldwide financial and economic crisis. Because of the Currency Board, which preserved financial stability, Bulgaria faced the crisis later than most other countries in the world. However, in 2009, the crisis hit the Bulgarian economy with all its might. Decreasing economic activity strongly affected public finance by reducing government revenues and increasing social pressure, mainly due to the fast growing unemployment rate. At the local level, the economic crisis both sharply reduced local governments' own-source revenues and – via budget constraints at the central level – increased pressure on the grants system.

As a result, own-source revenues decreased to 35.4 % of total local revenues in 2008 and barely reached 32.1 % in 2009. Although calculated as 43.0 % of the total revenues in 2010, own-source revenues are expected to decrease dramatically. The Annual State Budget Act 2010 is based on a prognosis for own-source revenues equal to BGN 1,701.9 millions[3], which means 20 % less own revenues than expected in the previous year. Especially negative is the prognosis for the revenues from tax on movable and immovable property purchase, mainly because of the collapse of the real estate market, reduction in the construction sector, and decrease of motor vehicles purchases. The increased share of own-source revenue for 2010 is mainly due to the significant reduction of state transfers. Constrained by decreasing revenues in the consolidated budget, central government reduced inter-governmental transfers by 26 %, from BGN 3,049.3 millions in 2008 to BGN 2,256.7 millions in 2010.

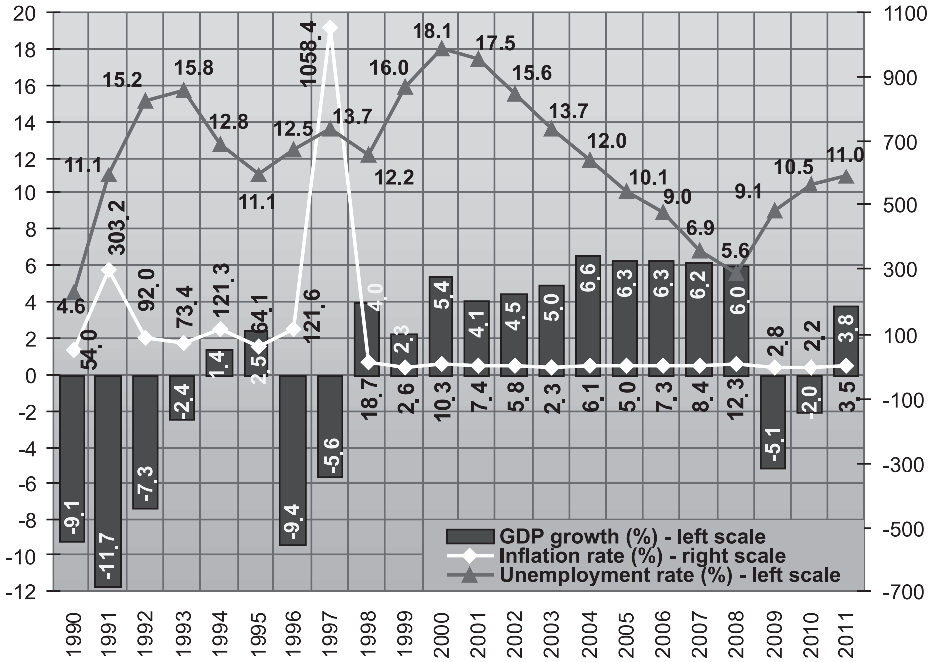
2.1.3 Impact of the world economic crisis on the Bulgarian economy and public finance

Although the 2008–2009 financial crisis is defined as the worst worldwide economic crisis since the Great Depression of 1929, it is not the most severe crisis faced by the Bulgarian economy during the last 20 years. Since the beginning of transition from a centralised to a market based economy, Bulgaria has survived two extremely difficult periods. (Figure 2.3) First of all, following the 1990 moratorium on external debt repayments, Bulgaria lost access to commercial external financing. During the period 1991–1993 the expansion of the private sector took place against a background of steep decline in production and high unemployment associated with the transition. The cumulative decline in real GDP during this period reached almost 25 %, mainly due to the drop in domestic demand and the loss of export markets. The restructuring of the economy resulted in an extremely high unem-

3 BGN is the abbreviation for the Bulgarian currency. According to the Currency Board provisions, 1 euro is equal to 1.95583 BGN.

ployment rate, which increased to 16 % of the labour force and stabilised around that level. Price liberalisation caused severe inflation in 1991 (303.2 %). After the initial price shock, the inflation rate steadily declined to 73.4 % in 1993. However, the sharp changes in relative prices and costs, and the drop in imports led to an additional decline in output. Reflecting the economic conjuncture during this period, the consolidated budgetary deficit reached 12.1 % of GDP and the public debt was calculated at 180 % of GDP.

Figure 2.3
Dynamics of GDP, inflation and unemployment rates (1990–2011)



Note: Data for 2010–2011 are based on prognosis.

Source: Ministry of Finance, Bulgarian National Bank, National Statistics Institute

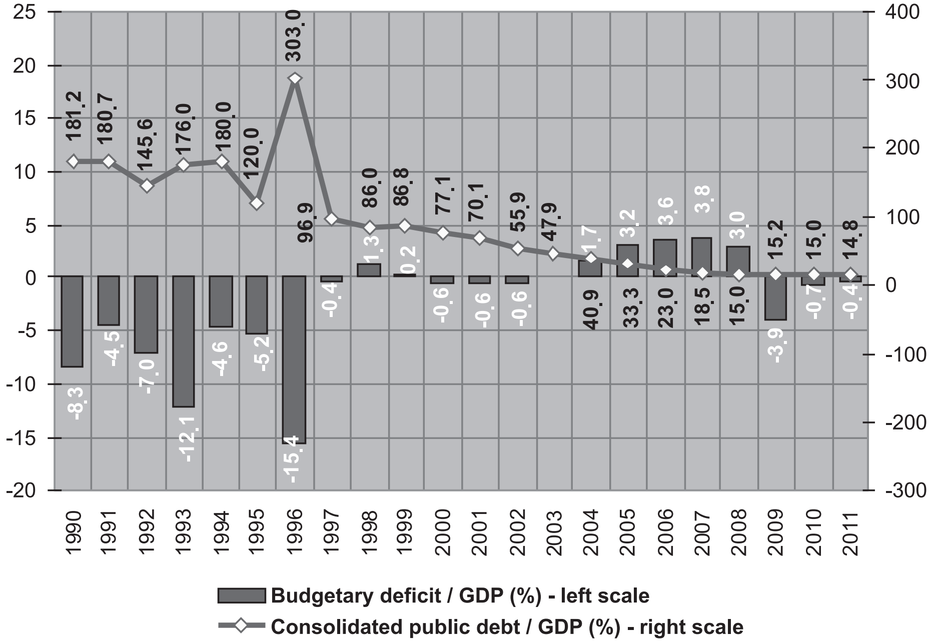
The second difficult period was the financial crisis of 1996–1997. The two factors, which provoked the crisis, were bad loans on commercial banks' balance sheets and large government deficits. Until 1996, commercial credit in Bulgaria was expanded to a degree that was unprecedented compared to any other European transition economy. Government attempts to recapitalise the banks failed. The government replaced bad loans to enterprises with government bonds. Banks then made additional loans, and their balance sheets did not improve. The credit crunch was followed by a series of bank bankruptcies. The economy slumped as a result of the collapse of the banking system. At the same time, government bonds increased the level of government debt (303 % of the GDP) and the interest obligations on this debt ballooned, creating an enormous government deficit (–15.4 % of the GDP). Hyperinflation of more than one thousand per cent was registered in 1997, which totally deformed all economic and financial relations.

As a last resort, the Currency Board was introduced on 1 July 1997, in order to restore confidence in the national currency and banking system, to impose financial discipline and stabilise the economy. Generally speaking, the Bulgarian Currency Board proved to be a great success. It established a fixed exchange rate and relied on automatic mechanisms to restore macroeconomic equilibrium, limiting severely the discretion of policymakers. From hyperinflationary levels during the first half of 1997, inflation fell to very low levels in the following years. The significant decrease of nominal interest rates made it possible for the government to reduce large government deficits. The economy began to grow, although more slowly than might be hoped during a recovery period.

In comparison with these economic fluctuations, the current crisis does not seem to be a significant threat to the Bulgarian economy. In 2009, GDP dropped by 5.1 %, but the banking system remained stable and financial stability was preserved. The inflation rate decreased to 2.8 %. The budgetary deficit did not exceed 0.8 % of GDP and consolidated public sector debt retained the moderate level of 15.5 % of GDP. (Figure 2.4) Because of the fiscal reserve accumulated during the growth period 2003–2008, Bulgaria did not apply for a loan, either from the International Monetary Fund, or from the European Union.

Bearing in mind the experience of Bulgaria and other countries all over the world, the core question is: How should the public sector respond to the current crisis? As a result of the previous significant worldwide crisis, namely the World Economic Crisis in 1929–1933 and the Oil Price Shock in the mid-1970s, the role of the state increased, in order to eliminate market failures. On the other hand, the last crisis within the region of Central and Eastern Europe in the 1990s was accompanied by a process of decentralisation of an entirely centralised political and economic system. In this context, it is interesting to study the reactions to the current crisis in individual countries: increasing concentration of power and fiscal capacity at the level of central government or increasing the role of decentralisation amongst government levels.

Figure 2.4
Budgetary deficits and consolidated public debt (1990–2011)



Note: Data for 2010–2011 are based on prognosis.

Source: Ministry of Finance and Bulgarian National Bank

2.2 The anti-crisis measures

The anti-crisis measures in Bulgaria were taken comparatively late – in the second half of 2009 – mainly due to the national elections in mid-July. The efforts of the newly-elected government were aimed at stabilising public finance and diminishing the budgetary deficit by the end of the year. The government actions were related both to the revenue and expenditure side of the state budget, mainly intended to increase efficiency in the public sector. First of all, the state administration was significantly reduced (by 15 %), and salaries in the public sector were frozen for an indefinite period. As part of the measures intended to optimise administrative expenses, the Parliamentary Commission of Regional Policy and Local Self-government discussed the possibility of merging municipalities with the fewest citizens. According to the legislation in force (Law on Administrative Territorial Structure of the Republic of Bulgaria, §8 (1) 1) municipalities must have a population of at least 6000 in order to be administrative centres. Although local government in Bulgaria is not very fragmented, bearing in mind that the average municipality has 30,000 citizens, such a measure would affect 53 municipalities with populations of between

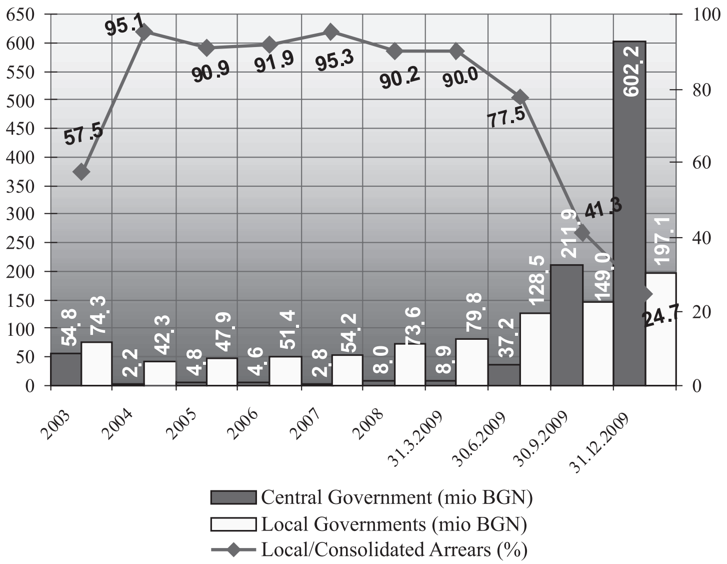
1,242 and 5,944. However, representatives of the central government declared that a merger of municipalities could become a reality only after a referendum.

Second, public sector investments were postponed until better times. The targeted capital investment subsidy, which was previously a significant source of financial resources for local governments, has been reduced by 43.1 %, from BGN 205.5 millions in 2009 to BGN 117 millions in 2010. Under these circumstances, most local governments rely on European funds for investment financing. Moreover, the central government assumed the responsibility of paying on behalf of the local governments, the required 5 % project co-financing, in order to support local investments.

Third, tax collection efforts were strengthened. Because Bulgaria applies the lowest tax rates of personal income tax and corporate income tax (both equal to 10 %) amongst EU countries, the most popular anti-crisis fiscal measures (decreasing income taxes) are not applicable (see European Commission 2009). Instead, the National Revenue Agency launched large-scale audits of legal entities and physical persons in order to improve tax collection. Moreover, local governments were given full legal rights of public executives, meaning in essence that they can levy restraints on the bank accounts, salaries, and properties of incorrect taxpayers. In order to expand local tax revenues, the maximum rates of the tax brackets were increased from 2‰ to 2.5‰ for the property tax and from 2.6 % to 3.0 % for the tax on movable and immovable property purchase. Despite these measures, public sector revenues dropped significantly, especially in the second half of 2009, mainly due to the decreasing economic activity.

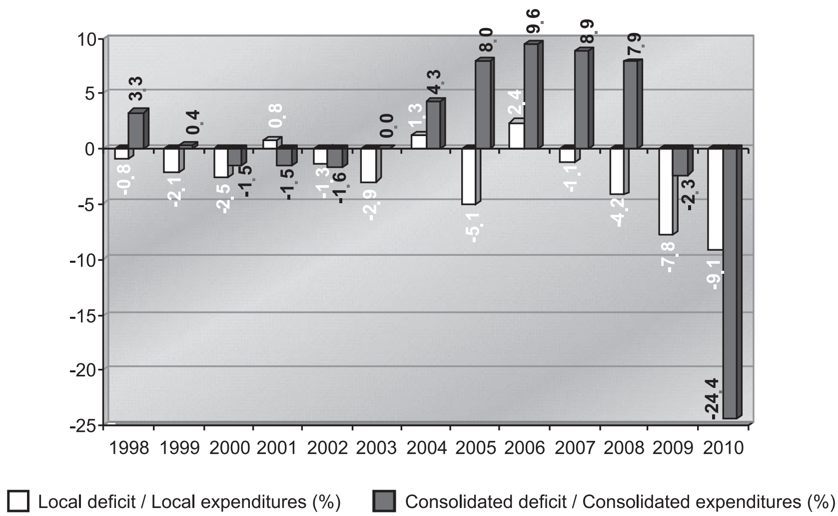
At the same time, consolidated public sector arrears (Figure 2.5) increased more than five-fold, from 81.6 million BGN at the end of 2008 to 360.8 million BGN in September and then 440.9 million BGN at the end of December 2009. Local government arrears reached almost 200 million BGN at the end of the year, which is the highest level since the beginning of fiscal decentralisation reform. It is interesting to note that central government arrears accumulate at a greater rate than local government arrears. During the period 2004–2008, local governments' arrears accounted for more than 90 % of total public sector arrears. At the end of 2009, they represented only 43.7 %. The increased amount of local arrears is due in part to low local revenues. In 2009, only 60.2 % of the expected local revenues were actually collected. On the other hand, pressured by the scarcity of financial resources, central government retained 10 % of state subsidies for the municipalities, which is in accordance with the regulations of the Annual State Budget Act 2009 (§17).

Figure 2.5
Public sector arrears (2003–2009)



Source: Ministry of Finance

Figure 2.6
Local and consolidated deficits (1998–2010)



Note: Data for 2010 are for Q1.

Source: Calculations based on the Ministry of Finance database

It is interesting to note that local governments in Bulgaria have not generally been sources of severe fiscal deficits in recent years, as a result of the adopted equalisation scheme. (Figure 2.6) According to the calculations, smaller municipalities register lower indebtedness. The equalisation scheme provides smaller local governments with more subsidies per capita and thus compensates them for the shortage of funds caused by low fiscal capacity. Because large and medium-sized municipalities traditionally rely more on own-source revenues than on government transfers, they have lost a significant part of their revenues due to the economic downturn. However, in 2009, the local deficit did not exceed 7.8 % of total municipal expenditures; therefore it still does not represent a significant burden on local budgets.

2.3 Conclusions

The current worldwide financial and economic crisis reached Bulgaria at a comparatively advanced stage of fiscal decentralisation reform. The basic achievements, strengthening local self-government, can be summarised as follows: first, the adoption of a stable legal base; second, the constantly increasing importance of local governments as a share of the gross domestic product and consolidated public sector of the country respectively; third, clear expenditure assignment; fourth, a transparent inter-governmental transfer system; and finally, full local control over some of the own-source revenues (local fees, service prices and revenues from municipal asset management) and limited control over the local tax levy. Although there has been remarkable progress in reforming the public sector, fiscal decentralisation proves to be a very long and difficult process. Moreover, bearing in mind the vast difference between fiscal capacity in several of the richest municipalities and the remainder of local governments in the country, for the present, the strong inter-governmental transfer system still has no effective alternative.

It is important to note that since 2003, the process of strengthening fiscal decentralisation in Bulgaria has been accompanied and significantly influenced by a constantly increasing economic activity, low levels of unemployment, dynamically decreasing public debt, and consolidated budget surpluses exceeding 3 % of GDP. This process was interrupted in the autumn of 2008, due to a new and deep worldwide financial and economic crisis. Due to the severe financial discipline provided by the Currency Board, Bulgaria faced the crisis consequences later and in a milder form than most countries worldwide. However, in 2009, the crisis hit the Bulgarian economy with all its might. Decreasing economic activity (GDP reduction of –5.1 %) strongly affected public finance by reducing budgetary revenues and increasing social pressure, mainly due to the fast growing unemployment rate. As a result, a budget deficit of 3.9 % of GDP was reported in 2009 and a deficit of 0.7 % is expected in 2010. Although completely different from the expected 3 % surplus, the Bulgarian budgetary deficit is amongst the lowest in the European Union. In addition, the banking system remained stable, the inflation rate decreased to 2.8 %, and public debt did not exceed 15.2 % of GDP.

A brief review of the country's economic development showed that the current downturn is not the most severe crisis faced by Bulgaria during the last 20 years, mainly due to the lessons in fiscal policy drawn from the previous crisis and the Currency Board, which preserved financial stability. However, local governments were affected more or less heavily by the decreased economic activity. Own-source revenues were sharply reduced and the pressure on the grants system was increased. In an attempt to consolidate the crisis, national government centralised public sector expenditures as the role of the state increased. In 2009 and 2010, local government expenditures tend to decrease, measured as a percentage of gross domestic product and consolidated public expenditures, in contrast to an increase in central government expenditures.

The anti-crisis measures in Bulgaria were taken comparatively late – in the second half of 2009 – mainly due to the national elections in mid-July. The efforts of the newly-elected government were aimed at stabilising public finance and diminishing the budgetary deficit by the end of the year. The government actions were related to both the revenue and expenditure sides of the state budget, mainly intended to increase efficiency in the public sector. First of all, state administration was significantly reduced (by 15 %), and salaries in the public sector were frozen for an indefinite period. Second, public sector investments were postponed until things improved. As a result, the targeted capital investment subsidy, which was previously a significant source of financial resources for local governments, was reduced to 43.1 % in 2010 compared to 2009. Third, tax collection efforts were strengthened. The National Revenue Agency launched large-scale audits of legal entities and physical persons in order to improve tax collection. Moreover, local governments were given full legal rights of execution, meaning, in essence, that they can levy restraints on bank accounts, salaries, and properties of incorrect taxpayers. Finally, in order to expand local tax revenues, the maximum rates of the most important local tax brackets were increased.

Despite these measures, public sector revenues dropped significantly, especially in the second half of 2009, mainly due to the decreasing economic activity. At the same time, consolidated public sector arrears increased more than five-fold, but they are more rapidly accelerated at the central, rather than the local, level. During the period 2004–2008 local governments' arrears accounted for more than 90 % of total public sector arrears. At the end of 2009, they represent only 24.7 %. According to calculations, smaller municipalities register lower indebtedness. The equalisation scheme provides smaller local governments with more subsidies per capita and thus compensates them for the shortage of funds caused by low fiscal capacity. Because large and medium-sized municipalities traditionally rely more on own-source revenues than on government transfers, they have lost a significant part of their revenues due to the economic downturn. However, the local deficit does not exceed 7.8 % of total municipal expenditures, so it still does not represent a significant burden on local budgets.

The key message of this chapter is that local governments in Bulgaria can do very little without active central government support and have no substitute for it with regard to basic anti-crisis measures to increase general demand. Local expenditures need to be rebalanced to meet the shifting needs within constrained levels of the overall activity. Local revenues can be increased, mainly by strengthening local tax collection. As a whole, the most appropriate role of local governments is to mitigate the crisis effects and relieve certain specific market or government failures. At the moment, the emphasis should be placed on short-term gains, rather than pursuing expensive and unrealistic development initiatives.

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3. Local Answers to the Crisis: The Case of the Bulgarian Municipality of Silistra

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The latest data available as of October 2007 (the data concerning the last local elections) confirms that there are 264 municipalities and 1,445 mayoralties in Bulgaria. According to the Constitution of the Republic of Bulgaria and other laws, the municipality is "*the basic administrative and territorial unit in which local self-governance is performed*". The municipal councils and mayors hold local self-governing power. However, at present, the local government has limited, especially in terms of financial opportunities, autonomy in managing revenues and expenditures.

At present, Bulgaria has a three-tier system of government as follows: central government, regional government(s) and local government(s). The territory of the country is divided into districts (*oblasti*) and municipalities (*obshtini*). Municipalities might be further sub-divided into mayoralties (*kmetstva*) and/or regions (*rayoni*).

The municipality is a legal entity and has its own property and sovereign budget. It is an independent sub-national government which is assigned the responsibility for the delivery of a set of public services, together with the authority to impose taxes and fees to finance those services. The district has purely administrative functions and does not consist of locally-elected officials. *The oblast* is a typical example of a deconcentrated unit of the state, i.e. a regional branch of the central government with some authority to take decisions.

3.1 Fiscal decentralisation in Bulgaria

Decentralisation is defined as a process of transferring powers and responsibilities and, related to them, resources for the performance of public functions from national to lower levels of government.

As a policy, decentralisation is not an end in itself. It is justified to such a level that it can serve as a mainstay for the balance between the centralised and decentralised provision of public services, which will lead to:

- Increasing the efficiency and effectiveness of public resources used;
- Broadening the scope and improving the quality of public services;
- Higher satisfaction of users of public services.

Table 3.1 presents the cornerstones of fiscal decentralisation in Bulgaria.

Table 3.1
Cornerstones of fiscal decentralisation in Bulgaria

Year	Action
2003	Official start of fiscal decentralisation in the country
2004	Municipalities were granted the right to determine the rate and base of local fees
2005	Municipalities were granted the right to collect local taxes and fees
2007	Municipalities were granted the right to determine tax rates within a certain margin
2009	Municipalities were granted the right to collect by force, due local taxes and fees

Source: the author

What has been achieved in Bulgaria during the 7 years of reforms to decentralise the government? Although partial, two government programmes have been implemented:

- The first was to execute the Concept for Fiscal Decentralisation for the period 2002–2005;
- The second was focused on executing the Strategy for Decentralisation of the State Government for the period 2006–2009.

As a result of a number of efforts, in 2008 compared to 2002, the position of municipalities in the public finance system has slightly changed for good. The share of municipal expenditure in the consolidated state budget reached 20.2 % (2008) compared to 18.8 % (2002). A significant improvement has been reported in the share of municipal public investment, which increased from 14.8 % (2002) to 36.6 % (2008).

Some positive changes in the internal structure of local government finance have also been observed. Indeed, the share of own revenues increased from 22.5 % (2002) to 32.4 % (2008) and the share of capital investment rocketed from 8.6 % (2002) to 28.6 % (2008). Local authorities have been granted the right to determine the rate of municipal fees and municipal taxes (within certain margins). The larger amount of state transfers became more transparent, more stable and more predictable.

At the same time, there are some alarming trends such as:

- The share of municipal revenues as part of GDP dropped from 7.7 % (2002) to 7.3 % (2008);
- For some years there has been a drop in the growth rate of municipal expenditure compared to the growth rate of public expenditure: 2006/2005 – 11.3 %, 2007/2006 – 6.8 %, 2008/2007 – 6.3 %.
- There has been an increase in the share of state transfers that are not channelled through municipal budgets and are allotted by non-transparent rules from the

various ministries. For example, the share of transfers stipulated in the State Budget Act compared to real transfers was 78 % (2005), dropping to 67 % (2006), 66 % (2007) and reaching 62 % in 2008. The share of capital investment subsidies that are subject to transparent regulations is much lower. Their share is as follows – 65 % (2005), 48 % (2006), 46 % (2007) and 64 % in 2008.

Determined by the national government, expenditure for financing state-delegated public services is lagging behind inflation. This forces municipalities to channel increasing amounts from their own revenues to co-finance those services. At the same time, there is a reduction in local government powers for managing those funds. In addition, the world economic crisis hit municipal budgets in 2008 and was more severe in 2009. As a result, municipal own revenues dropped from 35.8 % (2007) to 32.4 % (2008) and state transfers increased from 52.8 % (2007) to 56 % (2008).

3.2 Municipal finance

The share of municipal finance in public finance is presented in Table 3.2.

Table 3.2

Share of municipalities in public finance (BGN, million and %, current prices)

	2006	2007	2008	2009
GDP	46,704	56,520	66,728	66,256
Consolidated State Budget (CSB)	18,261	21,248	24,378	24,805
Municipal Expenditure (ME)	3,269	4,077	4,972	4,760
Share of CSB in GDP	39.1 %	39.1 %	36.5 %	37.4 %
Share of ME in GDP	7.0 %	7.2 %	7.5 %	7.2 %
Share of ME in CSB	17.9 %	19.2 %	20.4 %	19.2 %
Ratio increase of ME to increase of CSB	1.1132	1.0670	1.0684	0.9409

Source: Ministry of Finance

Data shows that by 2008, municipal expenditure increases at a higher rate than the increase in GDP and the consolidated state budget. As a result, the share of municipal expenditure has slightly increased to 7.5 % as part of GDP and 20.4 % of the Consolidated State Budget. Those figures are the highest since the beginning of the changes in 1990. However, in 2009, both indicators dropped to their 2007 level, indicating the impact of the world crisis on municipal finance. In the text below, both the revenue and expenditure sides of the municipal budget will be examined.

3.2.1 Revenue side of the municipal budget

The revenue side of the municipal budget consists of revenues from municipal sources, transfers from the state (transfers and shared taxes), and those attracted from external sourcing funds (incl. borrowing). Also, some municipalities have a so-called "transitional balance" which includes those funds which are not spent throughout the year and end up in municipal accounts.

In 2009, there is a nominal decrease in state transfers, own municipal revenues and transitional balance. The only increase is in attracted revenues. The share of state transfers in 2009 increased, compared to 2008. Table 3.3 presents municipal revenues.

Table 3.3
Municipal revenues

	Amount (BGN, million, current prices)				Ratio 2009 /2008	Share (in %)			
	2006	2007	2008	2009		2006	2007	2008	2009
State transfers	2,180.9	2,449.8	3,072.4	3,013.6	98.1%	59.4%	52.8%	56.0%	58.3%
Own revenues	1,232.1	1,664.0	1,781.3	1,517.3	85.2%	33.5%	35.8%	32.4%	29.3%
• Local taxes	365	513	648	540	83.3%	9.9%	11.0%	11.8%	10.4%
• Local fees	423	559	654	654	100.0%	11.5%	12.0%	11.9%	12.6%
• Other non-tax revenues	444	592	479	323	67.4%	12.1%	12.8%	8.7%	6.2%
Transitional balance	196.6	392.5	566.2	516.9	91.3%	5.4%	8.5%	10.3%	10.0%
Attracted revenues	64.5	137.0	70.7	126.2	178.5%	1.8%	3.0%	1.3%	2.4%
Total revenues	3,674.2	4,643.3	5,490.7	5,174.1	94.2%	100.0%	100.0%	100.0%	100.0%

Source: Ministry of Finance

However, the decrease in state transfers is insignificant – BGN 58.8 million or 1.1%. Such a decrease is observed in 135 municipalities, but in 50 municipalities the decrease is more than 20%. For the first time, in 2009, there is a nominal decrease in own revenues, compared to the previous year with BGN 264 million or 14.8%. Such a decrease is recorded in 183 municipalities, out of which 18 have more than 50%; in 68 municipalities the drop is in the range 20%–50%, and in 40 municipalities – from 10% to 20%.

3.2.2 Expenditure side of municipal budgets

For an improved and independent performance of any government, each level of government should have financial resources at its disposal; preferably "own" sources of revenue, in order to match its service cost. The expenditure assignment in Bulgaria echoes this statement by dividing public services into *state-funded* and *municipally-funded*. However, this division is conditional. It is subject to yearly negotiations between the Ministry of Finance and the National Association of Municipalities in the Republic of Bulgaria within the framework of the consultative process under Article 37 of the Municipal Budgets Act. Municipal services must be solely financed by local government, using its own sources. All state services delegated to the local government are funded by the state budget. In this case, municipalities act as "post office boxes". Importantly, municipalities may voluntarily allocate own funds to state services to increase their quality and/or to provide co-finance in the case of shortfalls, but the contrary is not legally permitted.

State administration, universities and research centres, justice and internal security, national defence, police and fire protection are the entire responsibility of the national government. These services are financed directly from the state budget. Defence is fully assumed by the central government. Local governments perform certain civil protection duties. Municipalities may introduce local police with limited powers – checking parking places, maintenance of public order, etc.

Municipalities have assumed full responsibility for public utilities. They are exclusively responsible for housing, water supply and sewerage, street lighting, operation and maintenance of public baths and laundries, public areas cleaning, solid waste collection, and parks and green areas' maintenance.

Education, social welfare, culture and health care are shared between the local and the national government. This group of public services is often "a point of discord" between the state and the local government and it is discussed and changed yearly. Generally, all services delegated by the state on the basis of approved standards to the municipalities are financed by the state budget. Those remaining are of municipal concern and are financed from the municipal budget.

Decentralisation has brought new and greater responsibilities to local governments. Municipalities are currently confronted with the challenge to meet the growing demand for public services, ranging from housing to culture and to kindergartens. The share of public services provided by local governments is estimated at 30 % but, undoubtedly, it will increase in the future.

In 2009, municipal expenditure is BGN 4,761 million which is BGN 211.8 million or 4.3 % less than in 2008. Table 3.4 depicts funding of expenditure assignment by municipal budgets.

Table 3.4
Funding of expenditure assignment by municipal budgets

	Amount (BGN, million, current prices)				Ratio 2009 /2008	Share (in %)			
	2006	2007	2008	2009		2006	2007	2008	2009
Total expenditure	3,283.3	4,077.1	4,972.6	4,760.8	95.7%	100.0%	100.0%	100.0%	100.0%
For state-funded (delegated) services	1,555.9	1,696.1	2,110.5	2,194.3	104.0%	47.4%	41.6%	42.4%	46.1%
Allocation of municipal funds to delegated services (co-financing)	47.3	111.9	142.6	120.0	84.2%	1.4%	2.7%	2.9%	2.5%
For munici-pally-funded (local) serv-ices	1,680.2	2,269.2	2,719.5	2,446.5	90.0%	51.2%	55.7%	54.7%	51.4%

Source: Ministry of Finance

Table 3.5
Municipal expenditures (Economic elements)

	Amount (BGN, million, current prices)				Ratio 2009 /2008	Share (in %)			
	2006	2007	2008	2009		2006	2007	2008	2009
Human resources	1,162	1,315	1,603.6	1,737.9	108.4%	35.4%	32.3%	32.2%	36.5%
Operational cost	1,433	1,657	1,948.6	1,532.9	78.7%	43.6%	40.6%	39.2%	32.2%
Investment	688.0	1,105	1,420.4	1,192.6	84.0%	21.0%	27.1%	28.6%	25.1%
Other				297.4					6.3%
Total expenditure	3,283	4,077	4,972.6	4,760.8	95.7%	100.0%	100.0%	100.0%	100%

Source: Ministry of Finance

For the first time, in 2009, municipal expenditure did drop, regardless of the fact that the drop is insignificant. Local governments are forced to reduce the amount spent on local services, meaning that less municipal public services were provided in 2009. Also, municipalities decreased the amount of funds that they allot to co-finance delegated services, meaning that there was an acute problem with funding them. Indeed, for co-funding of delegated services, local authorities spent BGN 22.6 million or 15.8 % less than in 2008, but almost all or 240 of them co-financed. Finally, there is an increase in the share of delegated services that were funded through municipal budgets. Table 3.5 shows municipal expenditures according to economic elements.

As a result of the drop in municipal revenues and the implementation of various anti-crisis measures in local governments across Bulgaria, an increase in expenditure on human resources is recorded. At the same time, there is a decrease in investments. Table 3.6 shows municipal expenditures according to functions.

Table 3.6
Municipal expenditures (Functions)

	Amount (BGN, million, current prices)				Ratio 2009 /2008	Share (in %)			
	2006	2007	2008	2009		2006	2007	2008	2009
General civil service	379.4	443.8	498.6	518.9	104.1 %	11.55 %	10.88 %	10.03 %	10.90 %
Defence & public order	103.8	87.3	134.9	117.2	86.9 %	3.16 %	2.14 %	2.71 %	2.46 %
Education	1,085.4	1,218.3	1,589.6	1,577.8	99.3 %	33.06 %	29.88 %	31.97 %	33.14 %
Healthcare	141.4	170.7	207.6	219.2	105.6 %	4.31 %	4.19 %	4.18 %	4.60 %
Social assistance	236.4	282.3	346.3	359.4	103.8 %	7.20 %	6.92 %	6.96 %	7.55 %
Housing & public utilities	793.5	1,055.1	1,120.9	1,211.1	108.1 %	24.17 %	25.88 %	22.54 %	25.44 %
Culture	158.7	226.8	248.3	238.4	96.0 %	4.83 %	5.56 %	4.99 %	5.01 %
Economic activities	375.3	580.2	809.6	499.4	61.7 %	11.43 %	14.23 %	16.28 %	10.49 %
Other expenditure	9.4	12.5	16.8	19.4	115.5 %	0.29 %	0.31 %	0.34 %	0.41 %
Total expenditure	3,283.3	4,077.1	4,972.6	4,760.8	95.7 %	100 %	100 %	100 %	100 %

Source: Ministry of Finance

Over the last few years, there has been a trend of optimising the municipal education system and many schools were closed. As a result, expenditure on education dropped by BGN 11.8 million in 2009 but, at the same time, their share in total expenditure increased. The most significant increase is recorded in the expenditure on housing and public utilities, both as an amount and as a share. There is a severe cut in municipal expenditure on economic activities, i.e. local governments cut many of the activities that they performed.

3.2.3 Municipal budgets balance

An interesting look at municipal budgets provides the so-called balance of municipal budgets. It incorporates both surpluses and deficits in budgets of all local governments in the country. It is shown in Table 3.7.

Table 3.7
Balance of municipal budgets (BGN, million, current prices)

	2006		2007		2008		2009	
	Deficit/ surplus	Number of LGs	Deficit/ surplus	Number of LGs	Deficit/ surplus	Number of LGs	Deficit/ surplus	Number of LGs
Net surplus	+395.0	264	+575.9	264	+505.9	264	+300.3	264
Incl. total surplus	+413.3	240	+596.8	237	+532.8	221	+357.8	204
total deficit	−18.3	24	−20.9	27	−26.9	43	−57.5	60

Source: Ministry of Finance

Over the period observed, the number of local governments with a deficit has dramatically increased from 24 in 2006 to 60 in 2009. The increase from 2008 to 2009 is the highest, meaning that in 2009, municipalities faced severe financial problems.

3.3 Brief overview of the crisis years (2008–2009)

In 2009, Bulgarian municipalities were confronted with a double challenge – a huge drop in own revenues and a 10 % cut in state transfers, both of them a result of the world crisis. The demands and pressures for social assistance have increased at the same time.

In order to correctly follow the impact of the crisis year (2009) it is appropriate to mention that municipal sources may be divided into the following categories:

- local taxes and other taxes imposed on behalf of the local government
- local fees charged for services
- proceeds from concessions and sales of municipal property
- rents paid for use of municipal property
- fines and pecuniary penalties imposed by a local administrative body
- other municipal revenues.

All local taxes are determined in the Local Taxes and Local Fees Act. As of 2010 they were: real estate tax, inheritance tax, tax on vehicles, tax on acquisition of properties and donations, patent tax (small business tax) and other local taxes levied by law. In the following, they are examined in detail.

3.3.1 Tax revenues

In 2009, the amount of revenues collected dropped by BGN 108.6 million or 16.8 % compared to 2008. In terms of taxes, the highest drop is that of tax on acquisition of properties.

In 2009, revenues collected from real estate tax increased by BGN 35.2 million or 25.7 % compared to 2008. Increases in revenues are reported by 202 municipalities. Relatively good revenues are due to the increase in property value, higher rates (in 176 municipalities the rate is above average and in 44, at the maximum rate), and the measures taken to increase tax collection.

In 2009, revenues from the tax on vehicles collected increased by BGN 28.8 million or 23 % compared to 2008 due to the increase in tax rates and the measures implemented to improve tax collection. Such an increase is reported by 219 local governments.

The revenues from the tax on the acquisition of properties and donations collected from tax on the acquisition of properties and donations, dropped severely in 2009 compared to 2008 by BGN 172.4 million or 47.5 %. Revenues collected dropped in 227 municipalities, out of which there were 31 with more than 70 %, in 97 within the range 50 %–70 %, and in 78 with less than 50 %.

Total revenues from the inheritance tax collected in 2009 amounted to BGN 76,000, meaning that this tax is not an important source of revenue. Revenues from inheritance tax were recorded in 14 municipalities only.

There was no great difference in revenues from the patent tax (small business tax) collected in 2008 and 2009. Considering that the amount collected is not high, this tax is not important to municipal budgets.

3.3.2 Local fees

The amount of revenues collected from local fees in 2008 is comparable to 2009; there is an increase of BGN 339,000 or 5 %. An increase can be seen in the revenues collected from fees charged for nurseries and kindergartens, markets, solid waste fee and tourist fees, etc.

A drop is recorded in revenues collected from fees charged for technical services in the amount of BGN 35 million (36.3 %) and for administrative services BGN 13.8 million (37.9 %). This is due to the impact of the crisis on the demand for technical services, mainly linked to construction, and the abolition of some administrative services.

3.3.3 Proceeds from the sale of municipal property

The crisis has severely influenced this revenue on the municipal budget. The revenues collected dropped significantly in 2009 compared to 2008 by BGN 174.2 million or 55.8 %. However, the reason for such a low revenue level is not only the crisis and the real estate market. The majority of local governments have already sold most of their attractive properties. Many small municipalities can only rely on accidental or one-time sales, coupled with the low value of municipal properties. Alarmingly, revenues collected from the sale of municipal property have been the major source for balancing municipal budgets in many local governments.

3.4 The case of the municipality of Silistra

The municipality of Silistra, which covers a territory of 516 sq. km, comprises the city of Silistra and 18 settlements. In terms of administrative organisation, the municipality is further sub-divided into mayoralties. The city of Silistra governs them but they have some limited powers regarding civil status. The city is regarded as medium-sized for Bulgaria and is a major city of the district, comprising 7 municipalities – Silistra, Alfatar, Sitovo, Kainardzha, Doulovo, Toutrakan and Glavinitsa. Silistra is one of the Bulgarian ports on the Danube River. It is situated on the Right Bank and borders Romania by land and water. Silistra has always been, and continues to be, an isolated community in the North-eastern region of Bulgaria. Historically, the city has relied on the food processing industry and, to a lesser extent, the wood industry to provide the basis for its economy.

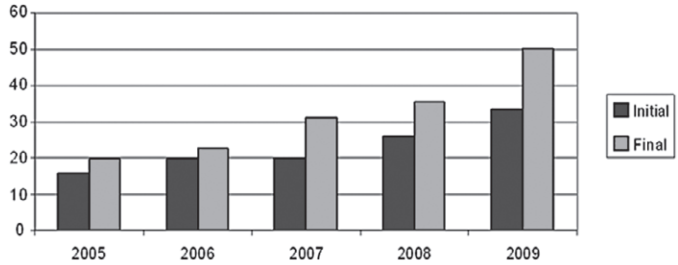
3.4.1 Budgetary process

The municipal budgeting process is executed as described in the Municipal Budget Act. The legislation requires a public hearing to present its budget to the local public.

Figure 3.1 depicts the initial and the final budget forecast for the year. The usual municipal practice is to adjust budget paragraphs for various reasons – letters from the Ministry of Finance, transfers between budget accounts and successful applications for EU funds, etc.

The percentage for increasing the amounts of the municipal budget is as follows: in 2005 – 26.25 %, in 2006 – 28.65 % in 2007 – 55.74 %, in 2008 –36.04 %, and in 2009 – 50.52 %. The graph depicts a case of conservative budgeting but it is due to the unknown amount of transfers from the state budget. This policy works – it assures higher revenues than planned – meaning that at the end of the year, there is more money to spend.

Figure 3.1
Initial and final municipal budget (BGN, million)

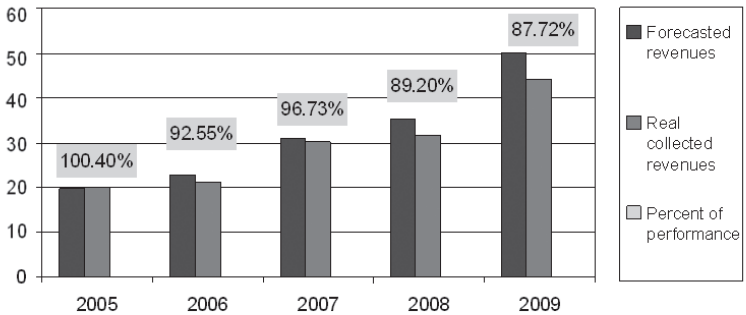


Source: Financial Department at the municipality of Silistra and own calculations

3.4.2 Collection of budget revenues

This indicator presents the match of forecasted and real numbers of municipal revenues (state transfers are excluded). Figure 3.2 illustrates this for the Municipality of Silistra.

Figure 3.2
Collection performance of budget revenues (BGN, million)



Source: Financial Department of the municipality of Silistra and own calculations

The trend observed indicated a constant drop in the collection of municipal revenues. At the beginning of the period in question, the forecast and the reality came together but, at the end of 2009, there is a gap of 12.28 %, meaning that BGN 6,164,265 were not collected by the municipality of Silistra. However, the gap began to widen in 2008 with the beginning of the crisis.

3.4.3 Revenue side of municipal budget

The period 2005–2009 is an important period in the process of fiscal decentralisation, an on-going process which follows state fiscal policy and the concept of the separation of public services into municipal and state. The budgets of the municipality of Silistra are prepared in compliance with the Municipal Budgets Act, the State Budget Act for the respective year, the municipal plan for development and the strategic goals and priorities of the municipality. The period studied was an important stage towards EU membership for Bulgaria. Table 3.8 presents the composition of revenues of the municipality of Silistra.

Table 3.8

Selected own revenues of the municipality of Silistra (BGN, current prices)

	2006	2007	2008	2009	Ratio 2009 /2008
1. Tax revenues					
Property tax	345,324	421,627	407,366	512,416	125.8%
Tax on vehicles	395,707	542,208	685,599	656,805	95.8%
Tax on acquisition of properties and donations	664,254	1,112,160	1,215,604	558,775	46.0%
Patent tax (small business tax)	n./a.	n./a.	101,327	88,530	87.4%
2. Non-tax revenues					
Solid waste fee	1,320,364	1,514,836	1,902,399	2,219,136	116.6%
Social service fee	85,335	87,190	114,966	132,007	114.8%
Market fee	137,345	154,936	163,134	155,409	95.3%
Other municipal fees	57,538	111,496	137,675	171,913	124.9%
Charges for technical services	50,811	81,344	68,494	47,383	69.2%
Charges for administrative services	174,362	249,675	219,708	101,672	46.3%
Other non-tax revenues	65,141	203,141	720,347	3,530,045	490.0%
3. Revenues from municipal property					
Revenues from rent of municipal property	590,017	596,774	647,749	651,742	100.6%
Revenues from sale of municipal property	1,729,464	4,835,435	1,208,212	699,991	57.9%
Total own revenues	6,059,508	10,138,590	11,417,070	10,899,619	95.5%

Source: Financial Department at the municipality of Silistra and own calculations

The most important element of the municipal budget is the tax on the acquisition of properties and donations. In 2007, its share reached 53.33 % of tax revenue and 10.97 % of all own revenues. In 2008, its share was still considerable, i.e. 50.29 % of collected tax revenues. In 2009, its share was only 30.70 %. In 2009, the revenues collected dropped by more than half compared to 2008 (by 54.03 %). At the same time, the drop in the revenues collected from the patent tax is 12.63 %. Both taxes are susceptible to the world crisis as they reflect the trends observed in the local economy.

Revenues from municipal property are also prone to the worldwide crisis. As far as rents are concerned, their amount is quite steady during the period covered. On the other hand, there are revenues from the sale of municipal property. In 2007 they peaked, tripling their amount in 2006. However, in 2008 the amount dropped four times compared to 2007, and in 2009 they again dropped by half, compared to 2009. In early 2010, "no light is seen", and by the end of the first quarter, there is no significant change. Indeed, revenues from municipal property float over the period examined.

A similar trend is observed with municipal charges for so-called administrative and technical services. In 2008, revenues from charges for administrative services dropped by 12 % compared to 2007 and revenues from charges for technical services dropped by 15.80 % compared to 2007. The drop in 2009 compared to 2008 was severe – 53.72 % and 30.82 % respectively. The data for the first quarter of 2010 indicates that this trend will continue.

In addition, 2009 was the first year for a period of more than 5 years in which the state budget transferred less than 100 % of the due grants, e.g. the municipal budget received only 90.52 % of the planned grants. Therefore, the municipality had to allot funds in order to perform state-delegated functions.

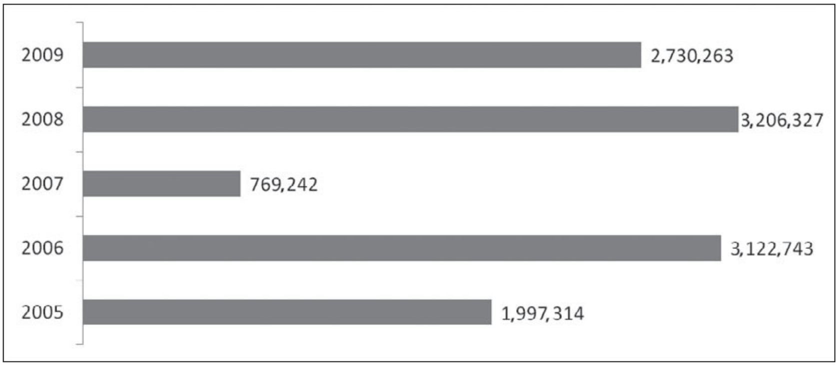
3.4.4 Expenditure side of the municipal budget

The highest percentage of expenditure is devoted to education. Its share is around half of the municipal budget – respectively 62 %, 58.11 %, 56.72 %, and 34.33 % in 2005, 2006, 2007, and 2008. The heading "education" incorporates a number of educational services: funding operations and activities of 13 schools, 13 kindergartens and 6 educational units and providing extra curricular education. Expenditures on housing and public works are stable during the period 2005–2009 with roughly 23 % every year. This heading combines expenditure on waste collection and disposal, environmental management and maintenance of public parks, etc. Social assistance and social care have the third most important share of municipal expenditure with 21 %. This reflects municipal efforts to provide social services. Almost every year, the municipality added a new social service. In 2005, it began with 5 and in 2009, it had 8.

3.4.5 Municipal arrears

In each year during the period 2005–2009, the municipality of Silistra ended in arrears, even in the most successful year, namely 2007. Figure 3.3 depicts this trend.

Figure 3.3
Municipal arrears as of 31 December (in BGN, current prices)



Source: Financial Department at the municipality of Silistra and own calculations

The percentage of municipal budget arrears is within the margin of 2.43 % (2007) to 14.82 % (2006). In the problem years – 2008 and 2009 – they are 10.15 % and 6.2 % respectively. The municipality put extensive efforts into decreasing the amount of arrears, especially in 2009. To some degree it was successful, meaning that it collected old debts from previous years.

3.4.6 Programmes for restricting the municipal deficit

The municipality of Silistra has prepared programmes for lowering the municipal deficit several times over the period examined. In 2007, it was successful in implementing such a programme, thus, the municipal arrears were significantly reduced –by more than 75 %. The worldwide crisis confronted the municipality with the challenge of overcoming its structural problems and, at the same time, facing a shrinking local economy and lower amount of revenues collected.

In April 2009, a municipal team was appointed to design and prepare the programme. It was adopted in July 2009. The horizon of the programme was short-term. All the measures were supposed to be performed by the end of 2009 and to collect some BGN 1,015,844. On the revenue side, two major groups of measures were foreseen: collection of arrears and setting new rates of municipal fees. Much effort was put into the collection of arrears; however, as of 31 December 2009 the arrears of due local taxes and fees increased significantly. On the other hand, setting new rates of municipal fees meant an increase, due to the decreased number of citizens using municipal services. The total amount collected as of 31 December 2009 was only BGN 483,599, meaning that the performance ratio is 47.6 %.

On the expenditure side, there were also two major groups of measures: restructuring municipal administration and restricting expenditure on street lighting and use of fuels for heating. Again, there was a huge gap between the expected and the final result. The planned amount to be saved was BGN 238,000 but the reality was BGN 134,585, i.e. 56.55 % performance. At the end of the year, the Ministry of Finance transferred BGN 363,440 to help out the local government.

The reasons for the lack of success are varied. In the first place, there is a lack of constant effort in adhering to the plan. Municipal actions were chaotic and erratic; on many occasions it was a "one-time effort" and facing the difficulties, municipal administrations gave up. Also, the effect of the Programmes was overestimated and over-planned. Many activities were not attainable at the very beginning but they were, however, included in the Programmes.

3.5 Conclusions

The crisis has worsened the fiscal position of Bulgarian municipalities. Since the beginning of the crisis the number of local governments with deficits in municipal budgets has almost tripled, meaning that about one quarter of municipalities face severe financial problems to provide public services.

Many municipalities have overlooked the influence that the crisis might have on their budgets and they budgeted so-called "empty revenues". The planned amounts of revenues were not collected and there was a need to undertake anti-crisis measures on both the revenue and expenditure sides and, correspondingly, to update their budgets. This fact additionally troubled local activities.

The reported results for own revenues confirm the conclusion of a low revenue base for Bulgarian local authorities and the trend to increase the deficit in local operations.

Finally, despite the measures taken to increase own revenues and to optimise expenditure, it seems that Bulgarian municipalities, and Silistra in particular, could not continue the provision of local public services in the years before the crisis. Local governments have either lowered the quality or ceased the provision of some services, shifting the effects of the crisis onto their citizens.

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4. Regional Budgets and Budgetary Process of Regions in Times of Crisis: The Czech Case.[1]

Robert Jahoda and Petra Dvořáková

The huge turbulence in the financial markets in 2008 was followed by the global economic crisis, which also affected the Czech Republic. Similar to other countries, its heavy impact is also evident in the Czech Republic public finance, which faces a substantial cyclic deficit. The decentralisation that has been carried out so far and the tax revenues sharing system, allow for the cyclic decline in public revenues to be distributed across individual components of the public budgets. The impacts of the cyclic component of public expenditures are, on the other hand, concentrated in the central budget and the sub-central units suffer to a lesser extent.

The main objective of this chapter is to evaluate the impact of the economic crisis on regional self-governmental units in the Czech Republic. The chapter focuses on whether and how the economic crisis affected the regional budgets, their size and structure and also on whether the budget process shows any traces of its impacts. Since the regions experienced no economic decline until 2008, it is assumed they might face some hardship drawing up and adjusting their budgets between 2008 and 2010. Attention is paid mainly to the regions which were able to quantify the slump in revenues in 2009 and how they devised the subsequent budgetary measures which were designed to counter this slump.

From a methodological point of view, the chapter is divided into two parts: a descriptive part which shows the impact the economic crisis had on the regional budgets, and an analytic part, which examines the quality of the budgetary process. The chapter concludes with recommendations formulated to achieve improvements in the quality of the regional budgetary process.

The chapter partly employs the results of a questionnaire survey carried out in September and October 2009 through the web portal Vyplnto.cz. Selected employees of the Regional Authorities of the Czech Republic, namely the executives of the Economic Departments and Departments of Finance of the Regional Authorities and their associates and delegates, were addressed as potential respondents. Thirty out of the 100 people who were approached participated in the survey. Despite the relatively low response rate (33 %), the findings which are based on the expertise and experience of the respondents do allow for interpreting the present situation.

Furthermore, a case study of the South Moravia Region, i.e. the third economically strongest region in the Czech Republic, was elaborated. The analysis of its economic situation and the study of its reactions to the economic slump at the

1 The chapter was elaborated with the support of the project of the Czech Science Foundation No. 402/08/1158.

end of 2008 and during 2009 were carried out, using publically available financial reports of the respective regions (Regional Budgets, Final Account of the Region, Regional Budget Outlook). However, it was the interview with the Head of the Regional Authority Economic Department which constituted the main method of data collection. The interview provided a more detailed insight into how the region has responded to the economic slump. It also revealed the anticipation of future development and increased the overall understanding of the regional budget processes.

As regards the structure of the chapter, the first part deals with a description of the level of fiscal decentralisation in the Czech Republic, also presented by the distribution of expenditures between the levels of government. It is followed by a general overview of the main macroeconomic indicators to show the general effect of the crisis. The second part of the chapter is connected to the economic development of the Czech regions during the crisis. First, regions, as higher self-governing units in the Czech Republic, are introduced and then their economic situation is described. Second, outcomes from the questionnaire survey are used to explain the opinions of regional representatives on the possible impacts of the crisis. Third, a case study of the South Moravian Region is presented. The chapter concludes with a brief summary of the main findings.

4.1 Nature of the crisis

4.1.1 Level of fiscal decentralisation in the Czech Republic

The Czech Republic is a Unitarian state, applying the so-called combined model of fiscal federalism. The Constitution specifies three levels of government in the Czech Republic with their own budgets. The top level is the Central Government; the fourteen higher self-administrating units are called Regional Governments, and the lowest level is represented by approximately six-and-a-half thousand Municipal Governments. Regions and municipalities are responsible for expenses within their "own" and "delegated" responsibility.

These three levels perform the basic functions of public finance, but it is only the allocation function of public finance which is largely decentralised. The current system has developed gradually since 1989, the decentralisation and de-concentration principles being applied mainly in connection with public administration reforms and the formation of democracy. The redistribution function of public finance is carried out at the lower governmental level only partially; mostly it is a matter of delegated power, funded from special-purpose subsidies from the national budget. The stabilisation function of public finance is usually up to the central level of the public budgets (Peková 2008).

Acts on Budgetary Rules (so-called "large ones" for the central level and "small ones" for local governments), the Act on Tax Revenue Assignment and also an Act on the State Budget for the relevant year can be considered the most important documents which define the arrangement of the individual levels of public budgets and their relations.

This chapter deals mainly with the regional level of Czech public budgets. Since these represent the most recent budget type in the Czech budget system, their development will be given more focus. The first draft on regions (1999) proposed nearly independent units. During the process of ratification, some essential changes were made. The first elections to regional self-governments took place in November 2000. Regional governments began to operate at the beginning of 2001. Their financial terms and discretion were provisional for the first two years, when they were supported mainly by central government grants calculated from the operating costs of transferred facilities (secondary schools, social care facilities, roads etc.) at the previous year's level. The law on regional self-government does not strictly define its responsibilities. The definition is broad – care of the territory as a whole, especially from the point of view of creating appropriate conditions for social care development, environmental protection, regional transport and communication, education and cultural activities, and public safety. Particular facilities for carrying out these tasks were transferred later on, either from the state or from district offices, which terminated at the end of 2002. In spite of being regarded as superior or higher levels of local government, regions and municipalities have to be treated as separate independent bodies. The hierarchy (with regions as the superior level) can only be applied in cases stipulated by law. Independent responsibilities have to be distinguished from transferred (or delegated) responsibilities. The central government is obliged to finance transferred responsibilities. For more details see OECD (2001).

The share of expenses in GDP of sub-national governments has recently stabilised around 11 %. (Table 4.1) The comparability of statistical data on local finances is partly biased due to the fact that the district office budgets are interpreted as a part of the state line of public administration of the Czech Republic. Prior to 2000, these budgets were not part of the state budget and were included in local finance alongside municipal budgets. Their budgets were part of the state budget until the closure of the district offices in 2001.

The impact of the crisis can be seen in the Public Sector's expenditures related to GDP. This share grew in the last two years thanks to the growth of state budgets expenditures, while the share of sub-national budgets remained almost unchanged.

Table 4.1
Distribution of expenditures between the levels of government

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
As a percentage of GDP												
Public sector	38.3	39.6	40.7	42.8	43.1	41.1	42.2	42.3	39.7	40.2	44.1	44.7
State budget	27.9	28.6	28.3	28.4	30.6	29.0	29.0	30.8	28.6	29.0	32.0	32.4
District offices	1.0	0.9										
Regional offices			0.6	1.5	3.7	3.5	3.8	3.9	3.5	3.6	3.9	3.6
Munici-palities	7.1	7.5	8.3	8.7	9.6	9.2	7.4	7.7	6.9	7.0	7.3	7.4
As a percentage of total public sector expenditure												
Public sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State budget	72.9	72.2	69.5	66.3	71.1	70.4	68.6	72.9	72.1	72.0	72.5	72.5
District offices	2.5	2.3										
Regional offices			1.5	3.4	8.5	8.6	8.9	9.1	8.9	9.0	8.9	8.2
Munici-palities	18.5	18.9	20.4	20.3	22.4	22.3	17.6	18.2	17.5	17.3	16.6	16.6

Note: Table includes only selected public budgets (state budget, regional offices, and municipalities). It does not cover extra-budgetary funds and funds of the public health care system. *2010 is approved budget

Source: Ministry of Finance. State Financial Statement for years 1999–2008; Draft of State Budget for year 2010.

4.1.2 General effect of the crisis

General information about the Czech Republic from the macroeconomic point of view is illustrated in Table 4.2. This is the first time that the regions have been exposed to an economic slump since their formation in 2000. The economic boost, accompanied by a decrease in unemployment, peaked in 2006 and 2007. Economic cooling occurred no sooner than in 2008, with a certain delay in the Czech Republic. The growing effect of the economic crisis began to become apparent mainly during the course of 2009.

Economic recession hit the Czech economy at the turn of 2008 and 2009. It resulted in an emergence of a so-called negative output gap, which peaked between –5 % and –4 % over the entire 2009. It may be considered as the lowest utilisation of economic potential in the post-transformation period (Ministry of Finance 2010).

Table 4.2
Development of key macroeconomic indicators in the Czech Republic

	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP (CZK bn., current p.)	2,352.2	2,464.4	2,577.1	2,814.8	2,983.9	3,222.4	3,535.5	3,689.0	3,625.9
GDP (PPS/capita, current p.)	13,892	14,421	15,215	16,261	17,058	18,217	19,948	20,145	18,960
GDP (%, y/y, real terms)	2.5	1.9	3.6	4.5	6.3	6.8	6.1	2.5	−4.1
GDP Output gap (% to the poten-tial output)	−0.1	−1.5	−1.6	−1.6	−0.6	1.3	3.7	2.5	−4.6
ILO general unemploy-ment rate (%, avg.)	8.1	7.3	7.8	8.3	7.9	7.1	5.3	4.4	6.7
CPI (%, y/y, avg.)	4.7	1.8	0.1	2.8	1.9	2.5	2.8	6.3	1.0
CZK/EUR (avg.)	34.083	30.812	31.844	31.904	29.784	28.343	27.762	24.942	26.445
CZK/USD (avg.)	38.038	32.736	28.227	25.701	23.947	22.609	20.308	17.035	19.057
Trade balance (CZK bn.)	−117.4	−70.8	−69.8	−26.4	38.6	39.8	87.9	67.2	152.0

Source: Czech Statistical Office. Czech Republic: key macroeconomic indicators [online]. 2010.

4.2 The regional budgets in the Czech Republic

4.2.1 The nature of the crisis at the regional level

The Czech Republic is structured into 14 self-governing regions, or, more precisely, 13 regions plus the capital city of Prague. An overview of the individual regions and their basic indicators, including economic, is shown in Table 4.3. The first row presents data for the Czech Republic as a whole for the sake of comparison. Table 4.3 shows that the regions differ in size (based on both geographical area and the number of inhabitants), economic performance and the number of municipalities.

Table 4.3
Selected indicators of the Czech Republic (by region, 2008)

Region	Extent (km²)	Number of municipalities	Inhabitants	GDP (CZK bn.)	GDP (PPS/capita)	Registered unemployment rate	Number of enterprises*
Czech Republic	78,865	6,249	10,467,542	3,689.0	20,145	5.96	8,899
Capital of Prague	496	1	1,233,211	934.1	43,301	2.14	857
South Bohemia	10,057	623	636,328	195.1	17,463	4.83	583
South Moravia	7,195	673	1,147,146	373.5	18,550	6.83	1,061
Karlovy Vary	3,314	132	308,403	78.4	14,425	7.62	276
Hradec Králové	4,759	448	554,520	162.7	16,697	4.81	520
Liberec	3,163	215	437,325	114.1	14,874	6.95	442
Moravian-Silesian	5,246	299	1,250,255	372.5	16,922	8.49	849
Olomouc	5,267	398	642,137	173.1	15,318	6.87	563
Pardubice	4,519	451	515,185	151.7	16,768	5.95	517
Plzeň	7,561	501	569,627	179.7	18,030	5.03	555
Central Bohemia	11,015	1,146	1,230,691	395.5	18,462	4.47	880
Ústí nad Labem	5,335	354	835,891	237.4	16,163	10.26	593
Vysočina	6,795	704	515,411	152.1	16,800	6.27	496
Zlín	3,964	304	591,412	169.2	16,254	6.13	706

Note: *Enterprises with 20+ employees and with their head offices in the region.

Source: Czech Statistical Office. 2009. Regional Analyses and Information Services Section Brno. Statistical Yearbook of the South Moravian Region.

Regional budgets appeared in the Czech system of public budgets for the first time in 2001[2]. They have represented the regional level of government since then – an intermediate level between the central budget and the local budgets. The regional budgets were funded mainly by grants assigned from central level budgets (the national budget and off-budget funds) at the beginning of their existence (Table 4.4). The grants covered approximately 80 % of total revenues of the regions. The own revenues of the regions were at a relatively low level at that time. Their volume was not enhanced until the 2005 amendment to the Act No. 243/2000 Coll. on Tax Revenue Assignment, which raised the shared tax revenues ratio in favour of the

2 Actually, regions were established in 1997 by the adoption of the Act No. 347/1997 Coll. The law entered into force on 1 January 2000. So officially, regions existed in 2000, but they had neither power nor revenues.

Table 4.4
Revenue and expenditure of regions, 2001–2010 (CZK, billions)

	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010***
I. Tax revenue	0.00	10.17	11.40	12.58	39.61	42.27	46.08	49.82	43.78	47.20
II. Non-tax revenue	0.07	0.72	1.42	3.18	2.81	2.94	3.48	3.87	3.96	4.00
III. Capital revenue	0.01	0.04	0.24	0.34	0.36	0.36	0.83	0.62	0.41	0.50
Own revenues	*0.08*	*10.93*	*13.06*	*16.10*	*42.78*	*45.57*	*50.39*	*54.30*	*48.14*	*51.70*
IV. Subsidies received	14.44	26.70	82.76	84.61	70.69	76.56	75.02	77.42	88.73	78.20
• non-investment subsidies	12.02	24.26	75.12	76.14	69.52	73.01	70.17	73.25	80.25	75.90
• investment subsidies	1.21	2.41	7.38	8.38	2.04	3.55	4.85	3.44	2.58	2.30
Total revenue	**14.52**	**37.63**	**95.82**	**100.71**	**113.47**	**122.13**	**125.41**	**131.73**	**136.87**	**129.90**
V. Current expenditure	13.22	32.07	84.96	88.39	100.59	108.49	107.68	112.55	120.91	112.30
VI. Capital expenditure	1.22	3.73	9.37	11.50	11.98	15.91	16.62	20.49	23.73	19.70
Total expenditure	**14.44**	**35.80**	**94.33**	**99.89**	**112.57**	**124.40**	**124.30**	**133.04**	**144.64**	**132.00**
Surplus (+)/Deficit (-)	**0.08**	**1.83**	**1.49**	**0.82**	**0.90**	**−2.27**	**1.11**	**−1.31**	**−7.77**	**−2.10**

Note: *2010 – approved budget.

Source: Ministry of Finance. State Financial Statements for years 2001–2009. Draft of the state budget for year 2010

regions (from 3.1 % to 8.9 %). Tax revenues are the top item among own revenues of the regions; the development of non-tax and capital revenues shows no clear trend. Total own revenues peaked in 2007 and 2008, before the impact of the economic recession became fully evident. The economic recession caused a slump in tax revenues in 2009 and 2010. The decline in non-tax and capital revenues is less evident considering their small relevance.

The main sources of revenues were transfers from the central level budgets during the entire period under discussion. It can be said that in the case of invariable grant funding, the revenue side of the regional budgets is less exposed to cyclical economic fluctuations. As Blöchliger et al. (2010) further show, eventual changes in the volume of inter-governmental transfers usually occur with a 2-year delay. The impacts of the drastic change in economic performance from growth to recession was thus followed at first by a decline in the ratio of subsidies to regional administration in 2007 and 2008 and then by its growth by almost 6 percentage points in 2009. This development is not surprising since transfers to lower governmental levels are among the mandatory expenditures of the national budget, while tax revenues are subject to cyclical economic development. The state budget for 2009 was originally constructed while expecting positive economic growth.

Within the scope of transfers, investment and non-investment components can be distinguished. Non-investment subsidies to regions showed an upward trend between 2001 and 2009, even though their share of the total revenues was slowly decreasing. The steep slump in subsidies allocated to regions in 2010 was largely a matter of the subsidy from the Ministry of Education, Youth and Sports.

Also, investment subsidies grew nominally at first, to stabilise at CZK 3–5 billions later. Their amount varied from year to year, probably accordingly to the amount of resources available in the individual chapters of the state budget.

In the case of non-investment subsidies, the effect of two government resolutions (from 25 April 2007, No. 436 and from 8 June 2009, No. 715), resulted in a reduction in the number of unoccupied function positions, including a corresponding amount of resources for salaries and a 4 % common reduction of salaries and other payments for delivered services. In this respect, it is not without interest that the real effect of this reduction in non-investment subsidies on the regions is, in fact, zero, as the regions do not dispose of these resources anyway, but only reallocate the funds to educational organisations, whose institutors the regions and municipalities are.

Looking at the expenditure of regions, the dominance of current expenditures over capital expenditure is rather obvious. However, the share of capital expenditures has doubled over the analysed period from 8.4 % in 2001 to 17.3 % in 2009. Following the approved budget, a change in this trend may be expected in 2010. The largest portion of the current expenditures comprises funds which the regions provide for their organisations within the scope of non-investment transfers. These organisations are mainly operating in education, social care, culture, and health care sectors. In some cases, the role of the regions is more or less that of a mediator distributing purpose-specific subsidies from the centre. Capital expenditures of the regions are mostly connected to investments – predominantly to projects co-funded from EU funds in recent years.

Putting together the processes described above, data on current expenditure and parallel on non-investment subsidies clearly show that the transfer of responsibilities to regional government terminated in 2003 and 2004. After that time there is a less rapid increase in current expenditure and non-investment subsidies than there was in the first years of this level of government. Tax revenue as a main own revenues source of regional government had its actual structure until 2005 and provided a significant growth over the next few years. In 2009, the year of the global financial crisis, tax revenue fell by –12.1 %. Central government intervention is possible with a one-year delay, so the non-investment transfers increased by 9.6 %.

Regarding investment, there has been a significant and continuous growth of this expenditure line since the beginning of regional governments. Parallel investment subsidies had a cyclical feature according to the actual national co-financing needs regarding EU funds. Because the co-financing arrives in the regional budget only after the implementation and pre-financing by the beneficiaries of each project item, there is a peak time for investment subsidies according to each EU-funded programme. This was the case in 2005 regarding Pre-accession Funds, and in 2007 and partially 2008 regarding the 2004–2006 Structural Funds period. Regional governments, like all other beneficiaries, are at the initial phase of the implementation of the 2007–2013 Structural Fund periods. This is why we experience growing capital expenditure on the side of regional government, but decreasing investment subsidy amounts compared to previous years.

The balance of growing current and capital costs on the expenditure side and increasing non-investment subsidies, but strongly decreasing revenues from tax income and investment subsidies, caused a deficit of CZK –7.7 billion for regional governments in 2009. This is close to 5 % of the total expenditure of the government level for this year. To stop this negative trend, the Central Government cut back non-investment subsidies by 5.4 % for 2010. Reacting to this situation, regional governments also cut back their current expenditures by –7.1 % and capital expenditures by –17.0 %. Thanks to the again increasing tax revenue, the imbalance of regional governments will decrease by 5.6 percentage points for 2010.

The development of indebtedness of the regions shows a clear upward trend. The predominant instruments are loans from the European Investment Bank or from local commercial banks (Table 4.5). At the same time, the Table presents the regions' balance of accounts, which also show a growing tendency. These resources are usually allocated in the monetary funds of the regions, part of which was created in advance in order to finance the aforementioned projects co-funded from EU funds.

Regions accumulated significant savings, i.e. the balance of accounts steadily grew between 2001 and 2008, while the difference between the debt and the savings was about the same since 2003 until 2009 when it fell significantly.

Table 4.5

Development of region's indebtedness and balance of accounts (CZK, billions)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Indebtedness	0.0	0.0	1.3	1.5	2.9	7.7	10.4	14.6	20.9
Balance of accounts	4.4	6.9	12.5	13.1	15.1	17.8	21.0	24.9	22.1
Difference	4.4	6.9	11.2	11.6	12.2	10.1	10.6	10.3	1.2

Source: Ministry of Finance. State Financial Statement for the year 2009

4.2.2 Local answers to the crisis: Results from a questionnaire survey

This section summarises the results of a questionnaire survey, which was carried out by a research team from the Faculty of Economics and Administration of the Masaryk University within the project "Implementation of New Tools for the Management of Public Expenditures at the Regional Level in the Czech Republic" in September and October 2009. It also dealt with the situation of the regional budgets during the crisis. One of the possible reactions to the tightening of the regional budget, when other than the expected development of revenues and expenditures occurs, is to implement budget measures. As stated in § 16 of Article 1 of Act No. 250/2000 Coll. on Budgetary Rules for Local Governments, the budget can be changed on the grounds of "*a change of objective factors affecting adherence to budgeted revenues and expenditures*". The potential impact of the economic cycle can be regarded as one of these objective factors. According to § 16 of Article 3 of the above-stated Act, the budgetary measures can be of the following types:

a) *"transfer of budget means where the individual revenues or expenditures are interlinked, without changing the total sum or the approved difference between total revenue and total expenditure,*
b) *utilisation of new revenues not envisioned in the budget to settle new expenditures not covered by the budget, thus increasing the total volume of the budget,*
c) *blocking budgetary expenditures in case their payment is threatened by a budget revenues failure; this measure decreases the total volume of the budget."*

Budget measures, as stated above, can be employed in reaction to adverse developments on the revenue and/or expenditure side of a budget. In one of the questions in the questionnaire, the individual respondents stated whether they expected the budget of the respective region to be affected or not by the economic crisis in 2009, and eventually in 2010. At the same time, they could further characterise the potential impacts or forthcoming actions. As the main findings for each region, the following can be stated:

- Prague: Respondents consistently reported their estimates of a revenue decline of CZK 5 billion in 2009 and a return to the 2006 level of tax revenues reached in 2010. Furthermore, they consistently reported that the solution might be to postpone the realisation of some investments and to look for savings, even though the expenses could be covered from funds saved in previous years.
- South Moravia Region: A respondent expected a decline in tax revenues of CZK 900 million compared to the approved 2009 budget. At the same time, he pointed out two amendments to the budget related to addressing the negative impact on the regional budget.
- Moravian-Silesian Region: One of the respondents reported he anticipated no significant impact from the economic recession on the regional budget in light of the fact that the region had a relatively realistic and achievable income target set for 2009. Another respondent expected a shortfall of CZK 600 to 800 million in tax revenues.
- Pardubice Region: Respondents expected a revenue decline of CZK 200 to 250 million, or 10 to 15 % of the budgetary revenues. Similarly, they expect a shortfall in tax revenues if another CZK 200 million in 2010. Accordingly, the budget expenditure in the region should also be proportionally decreased.
- Plzeň Region: A respondent foresaw a revenue slump of CZK 250 to 260 million to take place in 2009. Taking into account the anticipated decline in tax collection, his estimate of the revenue slump for 2010 was at least the same, or up to CZK 300 million.
- Central Bohemia Region: A respondent mentioned an expected revenue decline of approximately 5 % both in 2009 and 2010.
- Ústí nad Labem Region: Respondents also consistently expected a reduction in the approved budget by circa CZK 650 million, while they anticipated savings in expenses, including those on organisations. As far as 2010 is concerned, the respondents referred to the prediction of tax revenues issued by the Ministry of Finance, which expected the tax revenue in 2010 to be the same as in 2007. The region intends to adjust its expenses accordingly and also to obtain a loan of approximately CZK 350 million to cover its investments.
- Vysočina Region: A respondent was optimistic in his assessment of the regional budget for 2009, because the budget did anticipate a drop in tax revenue. Any shortfall would have been rather modest and could be covered from reserves or by implementing savings measures. The respondent expected a more difficult situation in 2010, but expressed the conviction that the region would maintain a balanced economy thanks to reserves from previous years.
- Zlín Region: A respondent expected lower revenues from shared taxes of CZK 250 million and the resulting restrictions on investments in the region.

Among the respondents who did not specify their affiliation to one of the regions, the majority expected a reduction in budget revenues and expenditures of 5 to 10 %. The respondents also expected a decrease in tax revenues for 2010, which might affect the planned investments and even projects co-financed from European funds.

To summarise the responses of the representatives of the regions, we can conclude that all representatives noted the negative impact of the economic crisis on the development of their income in 2009. However, most of them referred only to the decrease in tax revenues and that was why some considered the overall impact more or less negligible. The impact of the economic crisis on the regional budgets was relatively small, also due to the measures the regions adopted. Most respondents stated that the region would look for internal sources of savings, by which they meant, in particular, the involvement of monetary funds and reducing certain expenditures within the budget. Some representatives indicated that the decline in expenditures in 2009 would also affect investments, which may eventually be postponed, if that is at all possible. Only one respondent mentioned debt financing of the problems that arose, which corresponds to the majority opinion that the impact of the crisis on regional budgets will be relatively small in 2009. For 2010, the regions also expected reduced tax revenues, although the respondents' answers showed that they also expected tax revenues to have gained the previous growth momentum by then.

Interestingly, no-one expressed fear that the transfers from the central government may decrease in the coming years.

4.2.3 Local answers to the crisis: Case study of the South Moravia Region

The basic characteristics of the South Moravia Region have already been mentioned in section 4.1. The South Moravia Region ranks fourth among the regions of the Czech Republic with regard to its size and population. From the perspective of economic indicators, it ranks third by its volume of GDP (behind the Prague Region and the Central Bohemia Region), and second by GDP in PPS per capita. In the South Moravia Region, the purchasing power parity GDP per inhabitant amounted to 73.9 % of the EU average in 2008 (see the Statistical Yearbook of the South Moravia Region 2009). The unemployment rate is the sixth highest among the regions of the Czech Republic, but the number of businesses (with over 20 employees and headquarters within the region) is the highest in the country. Furthermore, the South Moravia Region ranks third by number of municipalities.

In nominal terms, the volume of revenue and expenditure of the South Moravia Region has steadily grown during the period 2005–2009. (Table 4.6) Despite the decline in tax revenues in 2009, the decline in total revenues and expenditures is first expected in 2010. At the same time, it is expected that the region will also operate with a surplus in the future.

Table 4.6
Revenue and expenditure of the South Moravia Region (CZK millions)

	2005	2006	2007	2008	2009	2010*	2011*	2012*
Revenue	12,656.5	13,377.9	13,848.3	14,902.4	15,539.5	14,918.8	15,114.9	15,048.5
from that: own resources	*4,156.5*	*4,428.4*	*5,120.7*	*5,390.4*	*4663.3*	*4,855.4*	*4,811.6*	*4,924.1*
own resources (%)	*32.8*	*33.1*	*37.0*	*36.2*	*30.0*	*32.5*	*31.8*	*32.7*
Expenditure	12,612.8	13,809.9	14,047.1	14,698.0	15,483.2	14,798.8	14,994.9	14,928.5
Balance	43.7	−432.0	−198.8	204.4	56.3	120.0	120.0	120.0

Note: *2010–2012 – Budgetary Outlook

Source: South Moravian Region. Regional Budgetary Outlook for the years 2010–2012; Regional Budget 2010

Ing. Hrachovinova, the Head of the Economic Department of the South Moravian Regional Authority, confirmed that 2009 was the first period in the region's history when the region experienced an economic decline which affected the regional budget. Since its establishment, the operation of the region experienced at first a slight, but later significant, economic growth; thus there was no need to address shortfalls in tax revenues. The year 2009 saw the first decline in tax revenues, and therefore it was necessary to adopt appropriate budgetary measures. These were mainly the savings carried out, according to Ing. Hrachovinová, in three phases, as the improved estimates of the Ministry of Finance on economic development were issued. It should be noted that the draft State Budget for 2009 and similarly, the draft budget of the South Moravia Region were based on the prediction of the Ministry of Finance of the Czech Republic, which allowed for up to 4.8 % economic growth in 2009. Subsequently, more accurate predictions were issued: a 2 % drop in GDP in March 2009 and later a 4.3 % decline in GDP in July 2009. (Table 5.2) Although the 2009 budget was prepared with caution and expected tax revenue growth 3 percentage points lower than the Ministry of Finance, the actual shortfall in tax revenues was circa 17 % compared to the approved budget.

Spending cuts have affected all the departments of the Regional Authority. In the first phase of savings, internal reserves were sought in the regional budget, and funds saved from previous years were used, as well as finance from the monetary funds set up by the Authority. In the second phase, the regional departments were ordered to save a certain share of their budgets. In this context, the departments' fields of interest were taken into account, since some of the departments were disbursing aid for entrepreneurs in the region as one of the anti-crisis measures. Further, the Authority proceeded to reduce funding of the operation of budget organisations established by the Authority and salaries of Regional Authority employees were reduced. In the final stage, the funds originally earmarked for co-financing

EU projects were used. "Fortunately" the implementation of these EU projects had been postponed; therefore it was possible to use the funds to cover other expenses. The problem is that these funds might be needed for their original purpose (EU projects) in the future.

The implementation of the austerity measures was approved by the Regional Authority management on the basis of the data provided by the Economic Department of the Regional Authority. In June 2009, the Regional Council approved the document "Addressing the Impact of the Economic Crisis on the South Moravia Region Economy – South Moravia Regional Budget Adjustment For 2009" and created a reserve of CZK 500 million in the budget to address the impacts of the economic crisis. In September 2009, the Regional Council discussed the 2nd adjustment to the regional budget for 2009 and it agreed to boost the reserve for addressing the impacts of the economic crisis by another CZK 398 million. The reserves thus amounted to CZK 898 million in total. According to the report on budget implementation in the 3rd quarter of 2009, this reserve comprised the following items:

- Savings in the budget expenditure of CZK 461.6 million;
- Reduced depreciation coverage for budget organisations and transfers of investment funds for budget organisations amounting to CZK 180.5 million;
- Submission of funds originally earmarked for financing EU projects worth CZK 100.5 million;
- Submission of available funds from previous years amounting to CZK 153.4 million;
- Submission of higher revenues from 2009 amounting to CZK 2 million.[3]

It is therefore possible to say that the South Moravia Region dealt with the impact of the economic decline mainly by fixing the expenditures side of its budget. There were no property sales or other exceptional revenue increases on the revenues side; only revenue estimates were specified. As Ing. Hrachovinová says, "thanks to these measures, the budget balance of the South Moravia Region at the end of 2009 was mildly positive, despite the economic situation". (Table 4.6) It nevertheless remains to be seen how the region will deal with its economic situation in 2010. The recession of tax revenues will continue to have an impact, while state budget subsidies may also drop since the state budget for 2010 is based on more realistic estimates of economic development than that of 2009 and will be adjusted to the current economic situation.

The economic situation of the region will depend not only on the balance of revenues and expenditures, but also on the development of the region's liabilities. As has been stated above, the majority of the region's expenditures are current expenses, whilst only about 15 % are capital expenditures. This is, of course, not suf-

3 For more information see South Moravian Region."Informace o vývoji rozpočtu za 1.–3. čtvrtletí 2009" (Information on the budget in the first three quarters of 2009) [online], 2010.

ficient to fund any large development projects, which is also why external resources are employed. Loans from the European Investment Bank seem to be the most suitable source as far as long-term costs are concerned. This is why the South Moravia Region signed a contract with the European Investment Bank in 2005 to fund its projects co-financed from EU structural funds and other projects. This enabled the region to make use of credit up to CZK 1.2 billion. In practice, the credit was drawn in 8 tranches from CZK 100 million to CZK 250 million. The loan rates were selected for individual tranches depending on current convenience. The finance was utilised to improve the region's traffic infrastructure, for reconstruction works and renovation in hospitals and in education. The payment of the principal was initiated in 6-month instalments after the credit utilisation was completed (in 2008). Each instalment amounted to 5 % of the loan, i.e. CZK 60 million, given the 10-year maturity. A listing of the instalments is shown in Table 4.7. In 2005, when the loan from the European Investment Bank was obtained; the region had to pay neither the principal nor the interest. The interest began to be paid off as late as in 2006 and the principal in mid-2008. In 2009–2017, two instalments, i.e. CZK 120 million per year will be paid. The last instalment will be paid in 2018.

Table 4.7
Overview of the loan repayments (South Moravia Region)

In millions CZK	2005	2006	2007	2008	2009	2010*	2011*	2012*
Payments of principal	0.0	0.0	0.0	60.0	120.0	120.0	120.0	120.0
Interests	0.0	9.1	26.9	44.6	43.0	25.0	29.0	25.0
Total	0.0	9.1	26.9	104.6	163.0	145.0	149.0	145.0

Note: *2010–2012 – Budgetary Outlook

Source: South Moravian Region. Regional Budgetary Outlook for years 2010–2012

In 2009, however, the South Moravia Region accepted another loan from the European Investment Bank, worth CZK 2 billion. The loan is without collateral and is to be made use of in 15 tranches in 2010–2015. As with the previous loan, the region can fix the interest rate for each tranche. The finance will be utilised for investments to be co-financed from EU funds, the region's budget or other sources. They include investments into road reconstruction, construction of retirement homes and further investments into schools and hospitals. The first instalment of the loan is due in 2017 at the latest. Since the region will be paying off the first loan until 2018, both loans will have to be paid from the region's budget during nearly two years. CZK 320 million and CZK 100 million respectively will go to pay off the principal and the interest. The instalments will then drop to CZK 200 million and CZK 70 million per year for the principal and the interest respectively in 2019. The maximum loan repayment period is thus 22 years and it may well be that the region will be able to get rid of its debt-paying obligation as late as 2039. All this, providing it is not going to accept any other liabilities, which is most unlikely given the nature of the region's activities and its economic situation.

The above-described European Investment Bank loans represent a long-term burden. Since no credit utilisation schedule has been established as yet, our assessment of the debt was based on the first loan only. The debt service ratio of the South Moravia Region (Table 4.8) is relatively low and does not exceed the set limit of 30 % (see Dvořáková 2007 and Jahoda 2007 for more details on local government debt regulation).

Table 4.8

Debt service ratio of the South Moravia Region (CZK, million)

	2005	2006	2007	2008	2009	2010*	2011*	2012*
Tax revenue	3,883.0	4,150.4	4,520.1	4,896.2	4,481.8	4,569.5	4,604.5	4,719.5
Non-tax revenue	231.4	248.2	461.2	374.8	273.8	137.9	187.1	189.4
Subsidies received	544.0	553.4	118.2	119.8	126.2	130.0	133.9	137.9
Debt basis	4,658.4	4,951.9	5,099.4	5,390.8	4,881.8	4,837.4	4,925.4	5,046.9
Interests	0.0	9.1	26.9	44.6	43.0	25.0	29.0	25.0
Payments of principals and bonds	0.0	0.0	0.0	60.0	120.0	120.0	120.0	120.0
Leasing payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt service	0.0	9.1	26.9	104.6	163.0	145.0	149.0	145.0
Debt service ratio	0.00 %	0.18 %	0.53 %	1.94 %	3.34 %	3.00 %	3.03 %	2.87 %

Note: *2010–2012 – Budgetary Outlook

Source: South Moravian Region. Regional Budgetary Outlook for years 2010–2012

The quality of the debt service ratio indicator is limited by two factors: first, regions have financial accounts to deposit their "surplus" funds (see Table 4.5), and, second liabilities of budget organisations instituted by the region are not considered.

As for the first factor, financial accounts of regional administration institutions are rather fragmented and depend on the ability of individual departments to create economic reserves. We believe centralised knowledge (among the Regional Board or the Board of Representatives) of the scope of this finance in individual regions is limited. This theory of ours is based on two hypotheses. First, this finance had already been assigned to budget items and ended up in reserve (or other) accounts of the given department. This is why other departments can no longer claim them. Considering the widespread war between individual departments, it is in the interest of the departments themselves to avoid drawing attention to these funds. Our second hypothesis, that the budget and finance department may view this finance as a reserve for potential crisis, is similar. This situation occurred in the South Moravia Region in 2009.

As for the second factor, it should be further noted that the region's debts include solely the obligations of the region, not of the organisations. These organisations are authorised to borrow funds (with the consent of the region) on its activities. The region, as the founder, is responsible for these liabilities, therefore it would be appropriate to show them as being, for example, in the form of their volume as so-called contingent liabilities of the region. However, in the case of the South Moravia Region, even after inclusion of these commitments (the outstanding loans and credits amounted CZK 777.2 million as of 30 June 2010)[4], the financial stability of the region is not significantly jeopardised.

4.3 Conclusions

Data on Czech public finances show that the economic slowdown has had a negative impact on public budgets. The impact has so far mainly concerned the central level, where the slump in tax revenues and the expenditures related to the growing unemployment rates have been causing growth in the cyclical element of the deficit. The regional level, however, has remained relatively spared of the negative influences. This was, amongst other factors, thanks to the fact that the tax revenue represents a relatively small part of their revenues (approximately 32 % of total revenues). Transfers from the national and supranational government levels are the major revenue source.

The development of the Czech regional budgets has therefore still been rather anti-cyclical, mainly thanks to the following two factors. First, the history of the current structure of regional public administration in the Czech Republic has been short and marked by the context of economic growth. Judicious management of the regions has led to a low utilisation of debt instruments; the regions tended to create high surpluses, which are intended to co-finance European projects in the future. The regions, therefore, have not been forced to restrict their investment activity to any extent yet.

The second factor causing the so far anti-cyclical behaviour of the regional budgets was the "slow" response of the central government, specifically the State Budget. The State Budget for 2009 was deliberately built on the premise of high economic growth. The subsidy expenditures in favour of the regional governments were not adversely affected by the impending economic crisis when the budget was drawn up. Unfortunately, it seems, the above-mentioned factor is likely to turn against the regions in 2010 and 2011. It will no longer be possible for the regions

4 South Moravian Region. "Informace o vývoji rozpočtu za 1. pololetí 2010" (Information on the budget in the first half of 2010) [online]. c2008

to rely on the state's previous generosity. The more or less anti-cyclical behaviour of the regions in the Czech Republic is in line with the finance development in the regional government levels of other OECD countries (see Blöchliger 2010). Blöchliger (2010) also points out that more protracted economic downturns eventually do lead to cuts in regional budgets. Such a situation mostly happens within a 1- or 2-year delay.

The relatively weak impact of the economic crisis on the regional budgets is therefore the likely reason why the regions have not been forced to significantly reassess their expenditure priorities. Their budget process and rules have not yet been subjected to any major test of their workability and flexibility. As mentioned previously, the low indebtedness of the regions allows for deficit financing in the coming years. It is evident that the volume of funds on the accounts grew faster than the volume of debt instruments. The existing resources therefore now support them, with the result that the existing indebtedness does not represent any serious threat to the regions.

On the other hand, the regions generated funds on their accounts for specific purposes (such as the need to co-finance European projects), which is why their current reallocation will remove the impact of the crisis on the regional budgets, while generating financing problems to be faced in the years to come. Moreover, it is not clear at present what development in tax and subsidy revenues is to be expected, as the present use of funds accumulated in the past removes incentives for a systemic treatment of the expenditure side of the budgets. The overall impact of the above described behaviour will be seen in years to come, when the regions will have adapted to the new situation. One might also speculate about the level of preparedness among the responsible staff to deal with potential enforced adjustments to the budgets. The case study undertaken in the South Moravia Region, however, tends to suggest that even though most of them have not yet had to cope with the impact of an economic decline, they have been managing well.

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5. Municipal Budgeting and Management in the Czech Republic: What Did the Year 2009 Change?[1]

Lucie Sedmihradská and Stanislav Klazar

Municipalities in the Czech Republic have observed, since 1990, a steady growth in their tax revenues. In 2009, for the first time, tax revenues were lower than in the previous year and it is expected that the 2008 level will be reached, at the earliest, in 2011. At the same time, this decrease was quite unexpected and the estimates of its magnitude deteriorated gradually during the course of the year. Total municipal revenues fell by 3 % and tax revenues by 11.5 % in 2009.

Our previous research (see Sedmihradská 2009) showed that most of the municipalities are very careful when forecasting their revenues and approving municipal budgets and that the approved (budgeted) tax revenues were, on average, 9.2 % lower than actual tax revenues between 1997 and 2007. This practice led to a moral hazard type of behaviour when municipalities relied on repeated experience that some additional revenues would arrive and thus their budget constraint was suppler and decreased the transparency of the budgetary process.

The objectives of this chapter are to explore in more detail municipal budgeting and management after the dramatic change in the environment. This includes an evaluation of the impact of economic decline on municipal revenues and expenditures in 2009 and on budget inaccuracy.

The chapter is based, first, on a detailed analysis of the aggregate data on municipal management provided by the Ministry of Finance and, second, on an inquiry into budget inaccuracy in 277 municipalities, i.e. a sample used in our previous research, see Klazar and Sedmihradská (2006) and Sedmihradská (2009).

The chapter is structured as follows: First, a short introduction of the Czech municipalities, their revenue sources and budgetary process is provided. Then we describe the economic development and its impact on municipal management in 2009. Finally, the budget inaccuracy of Czech municipalities in 2004 and 2009 is compared and evaluated.

5.1 Municipalities in the Czech Republic

This part aims to provide basic information on the Czech local government structure, municipal revenue sources and municipal budgetary process.

1 This project was supported by the Czech Science Foundation, No. 402/09/0283.

5.1.1 Basic characteristics

The Czech Republic is a unitary state with two tiers of local government – regions (14) and municipalities (6,250). Municipalities are basic territorial self-governing communities, i.e. public corporations with own property. Municipalities exercise simultaneously both own responsibility, which is exercised by the municipality and its bodies on its behalf, and delegated responsibility, which is performed on behalf of the state and the state is legally responsible for the performance of the delegated power.

The law on municipalities (128/2000 Coll.) recognises, with regard to the scope of the delegated power, three types of municipalities: municipalities with basic delegated powers (all municipalities – about 6,250), municipalities with authorised municipal offices (second-type municipalities – 388) and municipalities of extended scope (third type municipalities – 205). Municipalities belonging to the latter two groups are listed exhaustively in a special law (314/2002 Coll.). The type of delegated power determines a considerable part of both revenues and expenditures (see Hemmings 2006 for more detail).

Since 1990, decentralisation, and especially fiscal decentralisation, began in the Czech Republic. Although municipalities have promptly gained substantial power and independence in the decision-making on their expenditures, budget, property disposal and the way they deliver public services, the authority in the area of municipal revenues remains very low. Municipal revenue sources are described in detail in section 5.1.2.

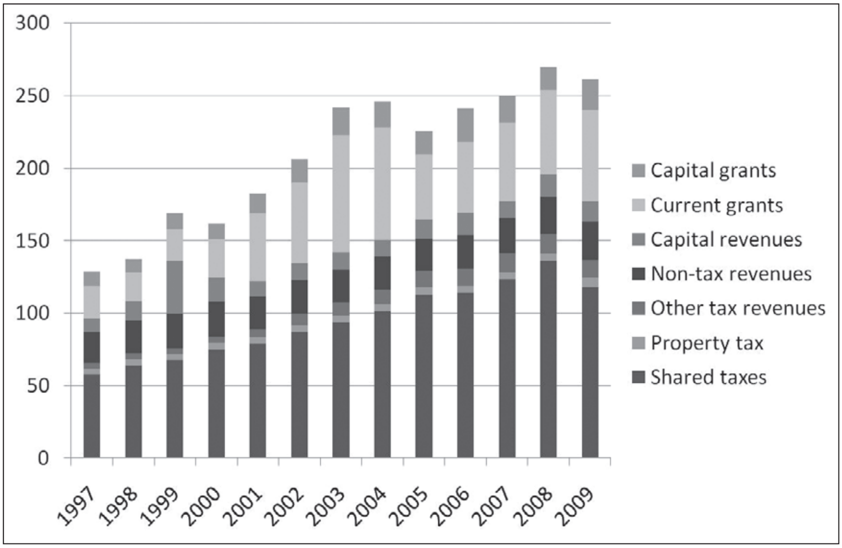
Current expenditures represent about 70 % of municipal expenditures and, to a great extent, have a form of entitlement: wages and salaries (14 % of total expenditures), transfers to own organisations, mostly elementary schools (17 %), social transfers paid on behalf of the central government (13 %) and allowing minimal discretion (purchase of energy or services). On the other hand, municipalities are much more independent in their decision-making on capital expenditures.

There is no direct borrowing limitation, thus a municipality can use deficit financing as long as it is able to obtain a loan from a commercial bank (due to the very small size of most of the municipalities, bond issue is a feasible option only for the largest municipalities). The Ministry of Finance merely monitors a set of debt-related indicators to identify in advance those municipalities which might have difficulties with their debt management. At the same time, municipalities can accumulate budget surpluses and use these funds at their discretion.

5.1.2 Municipal revenue sources

Municipal revenues are specified in two laws, the Law on Budgetary Rules for Territorial Entities (250/2000 Coll.), which lists all municipal revenues, and the Law on Tax Assignment (243/2000 Coll.), which specifies the revenue-sharing formula. We have observed stable nominal growth in total municipal revenues, with three exceptions, since 1997 (Figure 5.1). First, there was a one-time increase in 1999 when the 1998–2000 sales of shares held by municipalities in utility companies peaked. Second, there was a decline in revenues in 2005 when transfers from the Ministry of Education to individual schools began to pass through regional, rather than municipal, budgets. Third, in 2009 as a result of economic decline (see section 5.2).

Figure 5.1
Municipal revenue sources 1997–2009 (CZK, billions)



Source: ARIS, own presentation

Note: Borrowing is not included as it is not considered revenue in the Czech budget classification, which closely follows the IMF Government Finance Statistics. Following the Czech budget classification, the corporate income tax (CIT) receipts are reported together, thus the shared taxes in the figure also include the CIT paid by the municipalities.

Fiscal autonomy of the municipalities is very low; however, it is still much higher than the fiscal autonomy of the regions. The majority (95 %) of municipal tax revenues comes from shared taxes. Currently, the revenues emanating from income taxes (both personal income tax (PIT) and corporate income tax (CIT)) and value added tax (VAT), are shared amongst the three government levels. With some simplification, municipalities receive 21.4 %, regions 8.92 % and the state 69.68 % of the proceeds from these taxes. These revenues are distributed among the individual municipalities and regions based on a formula. For municipalities, the formula includes these characteristics: number of inhabitants, size group coefficient and land area. For the regions, the shares are fixed by the above mentioned law. For more information on the tax sharing system and its evolution, see de Carmo Oliveira and Martinez-Vazquez (2001), Hemmings (2006) and Sedmihradská (2008).

The remaining tax revenues come from property tax and local fees. Municipalities have some autonomy regarding the rate and base of both the property tax and local fees; however, the autonomy is quite limited itself and together with the volume of revenues coming from these two sources, it becomes almost insignificant. Using the OECD system of classification regarding own taxes of sub-national government (see OECD 2001), 93.6 % of tax revenues fit into group d.3 (the revenue-split is fixed in legislation and it may be unilaterally changed by the central government), 4.6 % into group b (municipality sets only the tax rate) and only 1.8 % into group a (municipality sets tax rate and tax base) in 2009.

5.1.3 Municipal budgetary process

The municipal budgetary process in the Czech Republic is mainly regulated by the Budgetary rules for territorial entities (250/2000 Coll.), which, next to the municipalities, also applies to the regions and voluntary municipal associations. The roles different subjects play in the budgetary process are specified in the Law on Municipal Establishment (128/2000 Coll.). Municipal management is also regulated by the Law on Audit of Local Government Units (420/2004 Coll.) and the Law on Financial Control in the Public Administration (320/2001 Coll.). The main elements of the regulation are presented in Table 5.1.

The central regulation leaves significant space for municipalities to choose how they will proceed with the preparation and debate of the draft budget. It only requires that the draft budget is available to the public for comments and that it is approved by the council.

Based on our previous research (see Klazar and Sedmihradská 2006), the first two phases (i.e. preparation, debate and approval) of the municipal budgetary process have the following main steps:

1. The budget officer sends instructions and tables to the department heads;
2. The budget officer prepares the revenue estimates;
3. The department heads submit their requests;
4. Property or investment departments prepare the capital budget;
5. The budget officer discusses the requests with the department heads and adjusts them;
6. The budget officer summarises the adjusted requests and prepares a draft budget and compiles summary tables;
7. The draft budget is discussed;
8. The draft budget is published;
9. The council debates and approves the budget.

Table 5.1
Municipal budget process regulation

Fiscal year The fiscal year is given by law and it is equal to the calendar year for all public budgets.
Budget Annual budget contains both current and capital operations.
Balanced budget requirement Budget should be prepared as balanced. Deficit is allowed only if it can be covered by either surplus from previous years or from repayable resources, guaranteed by contract, which will be repaid in the future.
Budget classification Uniform budget classification applies to all public budgets. Economic, functional and, optionally, organisational classifications are used in municipal budgets.
Accounting standard Cash accounting is used and the double entry system is required for all municipal governments.
Multi-annual outlook It contains basic summary data on revenues, expenditures, debts, financial resources and needs for a period of two to five years.
Budget preparation Preparation of the budget draft must reflect the relationship to other public budgets. The draft budget must be available to the public. Citizens can submit their comments in writing or orally at the council session.
Budget approval Budget is approved by the municipal council, i.e. the majority of all council members.
Amendments Amendments are obligatory in case of any changes in financial relations with other public budgets, at the legal level of control or in the case of danger of a deficit increase. Amendments include changes in revenues and expenditures, which do not lead to a change of the budget balance and blocking of budgetary funds.
Audit Audit of financial and legal compliance is obligatory for all municipal governments. It is provided by private firms or in the case of municipalities with less than 5,000 inhabitants by the regions.
Financial reporting Municipalities submit through the regions monthly reports in a uniform basis to the Ministry of Finance.

Source: Budgetary rules for territorial entities (250/2000 Coll.) and Law on Municipal Establishment (128/2000 Coll.)

The preparation, debate and approval of the municipal budget take several months. The preparation of the draft budget usually begins in September or October. In smaller municipalities, budget preparation begins later. According to the law, the municipal budget must reflect financial relations with the state and regional budget, therefore some, especially the smaller municipalities, begin budget preparation after the approval of these budgets and, for the first months of the year, have only a provisional budget. The other municipalities have to amend and approve their budgets as soon as financial relations with the other public budgets are approved.

In the course of the fiscal year, budget amendments are possible and in some cases even obligatory. In case the amendments affect the legal level of control, i.e. amounts approved in the budget, they must be approved by the municipal council. In case the legal level of control remains unchanged, or up to a certain amount, the municipal council can empower the municipal commission or the mayor to approve such amendments. In contrast to the standard budget process, the proposed amendments need not be published in advance, so that the possibility of the public entering the debate may be limited. Also, municipalities have to publish the approved budget on the internet. However, there is no legal requirement to publish the amendments or the amended budget there. This may decrease the transparency of the budgetary process.

5.2 Impact of the 2009 economic decline

Although the situation abroad suggested a worsening of the economic situation, the Czechs, including the Ministry of Finance, believed until the last moment, that the economic crisis would pass them by. The draft state budget of 2009 was compiled in compliance with these expectations. Although the municipal budgets and especially the municipal budgetary process are independent of the state budget, there are two important links:

1) Estimates of tax revenues and their growth, included in the draft state budget, serve or may serve as a basis for tax revenue forecasts in the individual municipalities.
2) In the state budget law the financial relations of the state budget and municipal budgets and the procedure for the calculation of transfers for financing of the delegated power in the individual municipalities are approved.

At the same time, the supporting documentation to the draft state budget includes a chapter which deals with municipalities.

The draft state budget was compiled based on the expected GDP growth of 4.8 % and the total municipal tax revenues were expected to be CZK 169.9 billion. Table 5.2 indicates how the expectations of GDP growth and the municipal tax revenues have changed since September 2008. The actual municipal tax revenues in 2009 were 19.6 % lower than those originally expected.

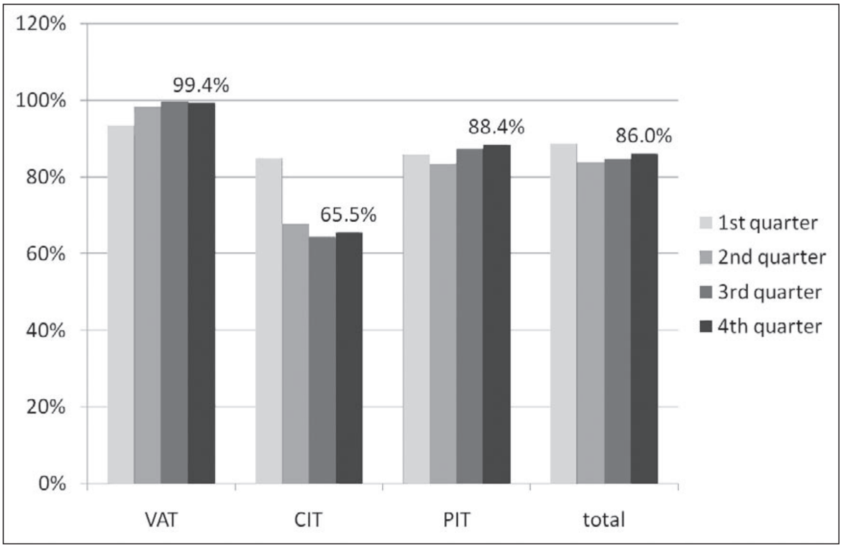
The discussion about the unrealistic estimates on which the draft state budget 2009 was based began as soon as the draft was discussed in the government in mid-September 2008 (see ČT24 2008). Therefore, the municipalities, which begin the preparation of their budgets around this time, were aware of the situation. However, as shown in Table 5.2, no-one expected such a deep decline.

Table 5.2
Improvement of GDP growth rate and municipal tax revenue forecasts

Time	Source	GDP growth	Tax revenues (CZK billion)
September 2008	Draft state budget 2009	4.8 %	169.9
January 2009	Governmental report – scenario C (see Government of the CR 2009)	1.0 %	155.6
September 2009	Draft state budget 2010	−4.3 %	139.2
Real figures	Czech statistical office and ARIS	−4.2 %	136.6

Comparing the three main tax sources of municipal revenues during the course of the year 2009 compared to 2008 (2008 = 100 %) we can state that the decline was more significant in the case of income taxes than VAT. (Figure 5.2) This was partly caused by a governmental anti-crisis measure, when the self-employed and small businesses were exempt from advance payment of the tax (see Ministry of Finance 2010). The revenues from personal income tax paid by people submitting their tax declaration (mainly the self-employed) dropped between 2008 and 2009 by 68.6 %.

Figure 5.2
Proceeds from shared taxes during the course of the year 2009
in comparison to 2008 (in %)



Source: Czech Tax Administration (http://cds.mfcr.cz/cps/rde/xchg/cds/xsl/dane_poplatky_10236.html?year=0), own presentation

Tables 5.3 and 5.4 provide a comparison of municipal management in 2008 and 2009: Revenues decreased by CZK 8 billion and expenditures increased by CZK 25.8 billion, 3 % and 10.1 % respectively. The resulting budget balance changed from a CZK 15.6 billion surplus in 2008 to a CZK 18.1 billion deficit in 2009.

The fall in revenues was mainly due to a decrease in shared taxes. The impact of the decrease of the other tax revenues, i.e. local, administrative and environmental fees, was due to their magnitude and was not so significant. At the same time, property tax revenues grew, thanks to the increased authority of municipalities, i.e. the possibility to introduce a local coefficient (see Sedmihradská 2010). Both current and capital transfers increased by more than CZK 5 billion.

Table 5.3
Municipal revenues (2008 and 2009, CZK, billions)

	2008	2009	Share in 2009	Change 2009 /2008	Change 2009–2008
Shared taxes	136.0	117.8	45.0 %	**−13.4 %**	**−18.2**
Property tax	5.1	6.3	2.4 %	24.0 %	1.2
Other tax revenues	13.3	12.4	4.8 %	**−6.8 %**	**−0.9**
Non-tax revenues	25.7	26.6	10.2 %	3.4 %	0.9
Capital revenues	15.5	13.9	5.3 %	**−10.1 %**	**−1.6**
Current grants	58.1	63.2	24.1 %	8.7 %	5.1
Capital grants	15.9	21.4	8.2 %	34.5 %	5.5
Total revenues	269.7	261.7	100.0 %	**−3.0 %**	**−8.0**

Source: ARIS, own calculations

Table 5.4 shows the expenditures divided, based on both the economic classification (current and capital expenditures) and functional classification (six sectors). In 2009, we observe only a negligible decrease in capital expenditures for social affairs and administration whilst all other expenditure lines grew.

The presented data show that municipalities were not able to quickly adjust the expenditures in line with the decreased revenues and they relied on the accumulated surpluses from the previous years. Based on the aggregate municipal balance sheet, the current account balance has decreased by CZK 16.3 billion during 2009.

Elaborated case studies show that municipalities, by the end of 2009, began to actively search for ways to decrease current expenditures, e.g. in Havlíčkův Brod there was a single tender held in the form of an auction for the purchase of electricity for the municipal office and all budget organisations with expected savings of CZK 2.3 million in 2010 (see Tecl 2010), and in a small village, Valy, all council members waived their remuneration in 2009 with a total saving of CZK 92 thousand (see

Aberlová 2010). This anecdotal evidence suggests that the impact of the 2009 tax revenues' decline on municipal expenditures will first take full effect in 2010.

Table 5.4
Municipal expenditures (2008 and 2009, CZK billions)

		2008	2009	Share in 2009	Change 2009 /2008	Change 2009–2008
Current expenditures	Agriculture, forestry and fishery	1.4	1.4	0.7 %	**−0.7 %**	0.0
	Industry	26.7	28.7	15.2 %	7.8 %	2.1
	Services for inhabitants	69.5	74.0	39.2 %	6.5 %	4.5
	Social affairs	28.2	29.1	15.4 %	3.2 %	0.9
	Public safety	5.8	6.6	3.5 %	12.8 %	0.7
	Administration	48.1	49.2	26.0 %	2.4 %	1.1
	Current expenditures – total	179.7	189.0	100.0 %	5.2 %	9.4
Capital expenditures	Agriculture, forestry and fishery	0.3	0.3	0.4 %	34.0 %	0.1
	Industry	32.7	40.0	44.1 %	22.2 %	7.3
	Services for inhabitants	33.7	42.9	47.3 %	27.5 %	9.3
	Social affairs	1.4	1.2	1.3 %	**−16.7 %**	**−0.2**
	Public safety	1.3	1.4	1.6 %	14.8 %	0.2
	Administration	5.0	4.9	5.4 %	**−3.2 %**	**−0.2**
	Capital expenditures – total	74.4	90.8	100.0 %	22.1 %	16.4
Total		254.0	279.8		10.1 %	25.8

Source: ARIS, own calculations

5.3 Budget inaccuracy

The municipal budget is, above all, a one-year financial plan of a municipality, which is prepared in advance and is based on a forecast of future development and is thus a subject of uncertainty. Therefore, the approved budget can be inaccurate to some extent.

Budget inaccuracy is the difference between the approved (budgeted, estimated) and actual (real) revenues or expenditures. In this chapter the following budget inaccuracy indicator is used:

$$BI_x = \frac{B_x - A_x}{A_x}, \text{ where} \tag{1}$$

x = analysed budget segment (revenues, expenditures or a line of them)

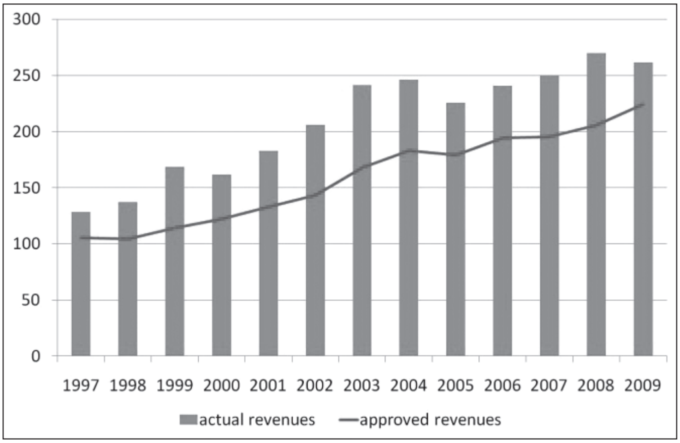
BI = budget inaccuracy in %

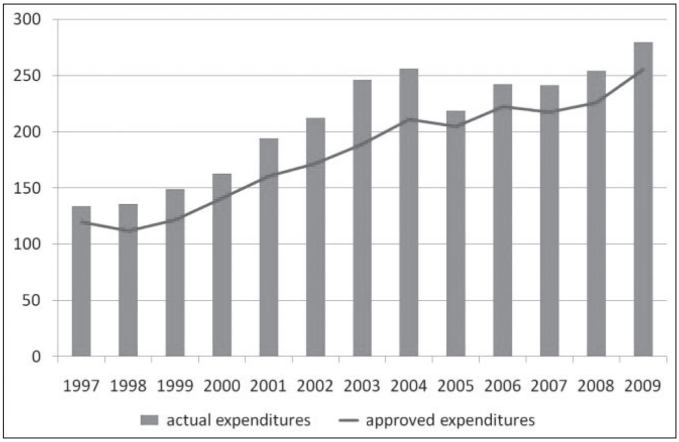
B = approved amount

A = actual amount

The inaccuracy can be either in the form of overestimation, i.e. the approved revenues (or expenditures) exceed actual revenues (or expenditures) and BIx> 0 or underestimation, i.e. estimated revenues (or expenditures) are lower than the actual expenditures and $BI_x<0$.

Figure 5.3
Approved and actual municipal revenues and expenditures
(1997–2009, CZK, billions)





Source: ARIS, own calculations

Table 5.5
Budget inaccuracy (1997–2009, in %)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	mean
Tax revenues	−1.1	−13.6	−8.6	−14.7	−8.7	−14.3	−11.8	−9.7	−14.4	−7.5	−8.9	−10.9	**8.9**	−8.9
Non-tax revenues	−30.8	−22.2	−23.8	−19.3	−21.6	−21.6	−20.2	−14.3	−17.0	−19.6	−10.0	−15.6	−14.5	−19.3
Capital revenues	−46.8	−57.0	−329.2	−90.3	−37.6	−23.5	−41.1	−22.5	−45.2	−43.5	−43.6	−37.9	−13.5	−64.0
Intergov. grants	−80.7	−113.7	−91.7	−83.1	−142.6	−161.4	−123.5	−98.6	−59.6	−68.2	−107.1	−124.1	−117.1	−105.5
Current exp.	−5.0	−8.2	−10.6	−11.0	−24.1	−19.5	−25.2	−17.1	−2.3	−4.6	−6.8	−11.6	−9.4	−11.9
Capital exp.	−25.8	−54.9	−54.8	−26.4	−15.2	−33.3	−45.3	−31.6	−18.2	−18.6	−22.7	−14.4	−10.4	−28.6

Source: ARIS, own calculations

The comparison of approved and actual revenues and expenditures between 1997 and 2009 shows that in the entire period, both the revenues and expenditures were underestimated on average by 32.2 % and 16.6 %, respectively. (Figure 5.3) The main reason for this systematic under-estimation is built into the budgetary process itself, i.e. ignorance of the volume of transfers at the time of municipal budget approval. However, Table 5.5 indicates that even the accuracy of the estimates of own revenue sources is quite low. With only one exception (tax revenues in 2009) we observe an under-estimation of all budget lines in the whole of the period examined.

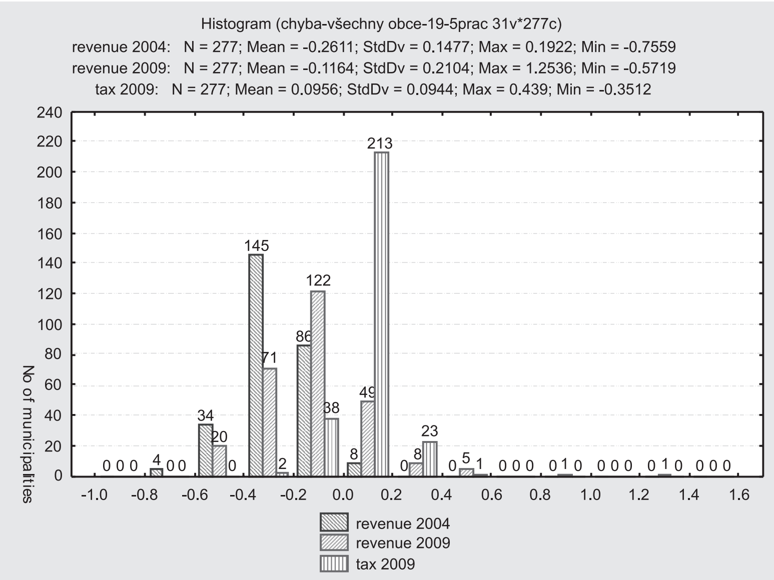
Next to the analysis of the nationwide data we also performed an analysis of individual municipalities. The sample of researched municipalities comes from our previous research (see Klazar and Sedmihradská 2006 and Sedmihradská 2009), i.e. 277 municipalities with an authorised municipal office which replied to our questionnaire in the Spring of 2004.

Figure 5.4 shows the frequency of budget inaccuracy in 2004 and 2009. Following our assumption, the combination of conservative estimations and subsequent decreases in actual revenues led to an improvement in budget accuracy. At the same time, the figure shows that the vast majority of municipalities (237, i.e. 86 %) overestimated tax revenues. In 2009, we also observe more extreme values, i.e. more cases of extreme inaccuracy.

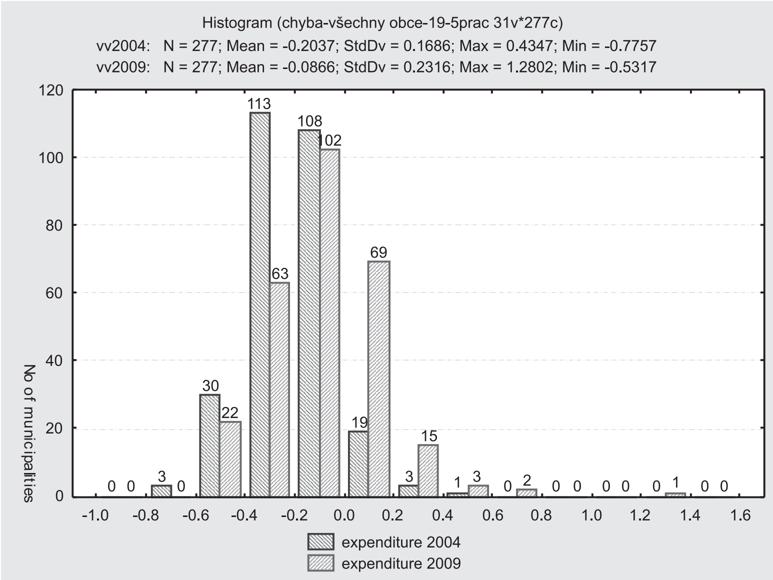
Figure 5.4

Frequency of budget inaccuracy

Revenues



Expenditures



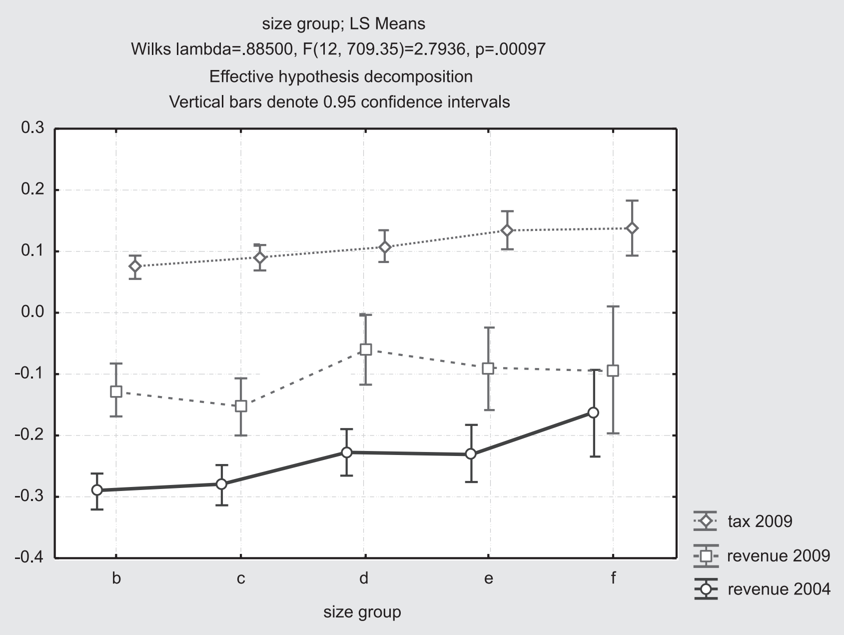
Source: ARIS, own calculations

A more detailed analysis of budget inaccuracy in different size groups showed that in 2004, both revenue and expenditure inaccuracy was significantly higher[2] in smaller municipalities (with less than 10 thousand inhabitants). In 2009, we observe a statistically significant difference, both for revenues and expenditures, between municipalities with 5 to 10 thousand inhabitants and municipalities with 10 to 50 thousand inhabitants only. (Figure 5.5) The budget inaccuracy of the tax revenues in 2009 was significantly different in municipalities with less than 6 and more than 10 thousand inhabitants. The expenditures generally have the same pattern as revenues and in order to keep figures 5.5 and 5.6 well-arranged, are not displayed.

2 Our commentary is based on the results of performed LSD (Least Significant Difference) test in the software Statistica. We worked at a 5 % significance level.

Figure 5.5

Conditional means of budget inaccuracy in different size groups



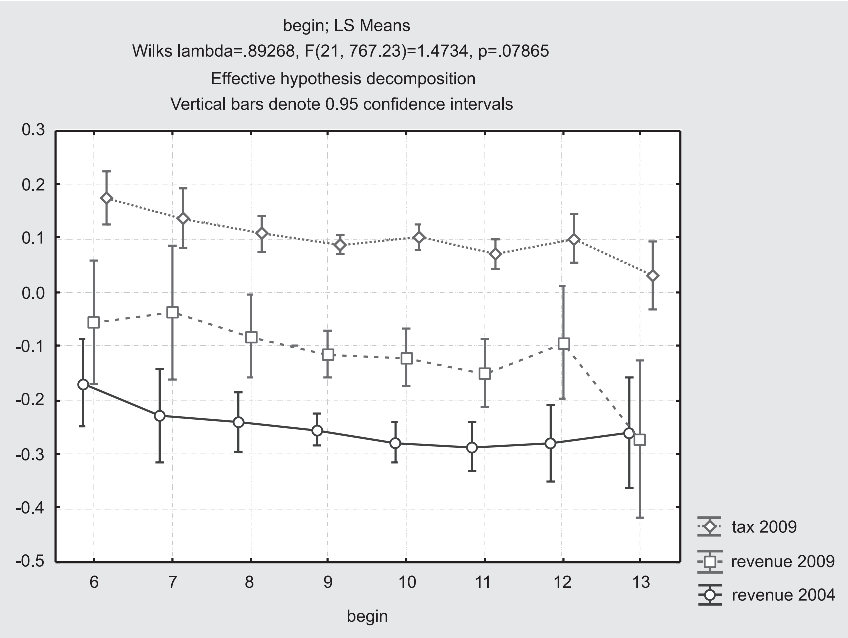
Source: ARIS, own calculations

Note: size groups: group b: less then 5,000 inhabitants, group c: 5,000–10,000 inhabitants, group d: 10,000–50,000, group e: 50,000–10,000 and group f: more than 100,000 inhabitants

Next to the decomposition of budget inaccuracy in different size groups, we did the same for the start of the budgetary process. In 2004, budget inaccuracy in municipalities which began their budget process in June was significantly different to municipalities which began between September and December for revenues and in October and November for expenditures. (Figure 5.6) There was no significant difference with municipalities which began in January. This is in contrast to 2009, when we could observe a statistically significant difference, in both revenue and expenditure inaccuracy, between municipalities which began their budget process in January and all other municipalities. Analysis of the tax revenues' inaccuracy in 2009 showed differences (1) between municipalities beginning their budgetary process in June and in all municipalities beginning after August and (2) between municipalities beginning their budgetary process in January and in all other municipalities. At the same time, the data suggest that municipalities, at least to some extent, took into account information on the deterioration of the revenue forecasts provided by the Ministry of Finance.

Figure 5.6

Conditional means of budget inaccuracy in relation to the start of the budgetary process



Note: *begin* shows the month when the budgetary process begins – 6 to 12 is for June to December (t–1) and 13 is for January (t)

Source: ARIS for calculation of budget inaccuracy and own questionnaire (see Klazar and Sedmihradská 2006)

5.4 Conclusions

Municipalities in the Czech Republic observed, for the first time since 1990, a decline in their tax revenues. The rapidity and magnitude of this decline was surprising, even for the Ministry of Finance, which only gradually modified its revenue forecasts. The data on municipal management in 2009 show that municipalities were able to adjust to the new environment only to a very limited extent: both current and capital expenditures grew. Decline in tax revenues was compensated by the use of accumulated surplus from the previous years. This development complies with the findings of Wolman (1980) who presents the sequence of measures (strategies) taken by local governments in case of fiscal pressure: “buying time” (e.g. borrowing or inter-fund transfers), increasing inter-governmental revenues, increasing own source revenue, expenditure reduction strategies and finally cutting of governmental services. The Czech municipalities relied mostly, so far, on inter-fund transfers.

Municipalities systematically underestimate their approved budgets, mainly because of the interconnection of different public budgets and ignorance of the exact figures at the time of approval of municipal budgets. The impact of the 2009 economic decline on budget inaccuracy was quite low. A comparison between 2004 and 2009 showed only moderate improvement, thanks to the combination of a conservative estimation and subsequent decrease in actual revenues. Budget inaccuracy is significantly lower in small municipalities and significantly higher in municipalities which begin their budgetary process in June (t–1). Data on tax revenues' inaccuracy in 2009 suggest that municipalities, at least to some extent, took into account the information on the deterioration of the revenue forecasts provided by the Ministry of Finance.

At the moment we can only give a very tentative answer to the question in the title of the chapter: The year 2009 did not bring a clear change in municipal budgeting and management; however, it could start a gradual modification of this. We need more time (and data) to be able to give a proper answer.

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6. Local Government Finance in Times of Crisis: Case Study of Estonia

Sander Põllumäe

Local finance is not a local matter (Bird, Ebel and Wallich 1995 and Leigh 2000). This is especially clear in times of economic shortage. The quarrel between the central government and local self-governments of Estonia is a prime example of conflict of interest inside the public sector and a lack of resources propounds the political, legal, and administrative force-lines. The main factor of the recent political, legal, and economic struggle for financing is the worldwide economic crisis, but the difficulties facing the public and private sectors of Estonia are intensified by the ongoing merge into the EU economical and financial system and national aim to join the euro-zone. These national objectives justify, both politically and legally, the increased intervention of central government into local government financial affairs.

The research question of this article is "how does the public sector respond to the economic crisis?" The author will first analyse the reaction of central government and then how local government units responded to both measures used by the state and changes in their own economic conditions. The objective of the article is to analyse the interaction between central and local government, dealing with problems arising from the decline in economic conditions, point out best practices and highlight the mistakes. The author has analysed financial data, legislative activities of parliament and related court decisions.

The chapter focuses on central-local financial relations in the context of the conflict of interests highlighted in the constraints of economic regression. As the main focus has been on the legal claims of local government to establish boards for its constitutional guarantees, a more thorough overview of the constitutional and legal framework is given in the first section. The second section analyses the legislative activities of central government that have influenced local government directly or indirectly and related legal suits.

The questions of whether central government supports or hinders local self-government units during periods of economic decline; what kind of counter-measures local self-government units can use against the hindering measures of central government and what the possible results are, are tackled in the third section.

6.1 Constitutional and legal framework

6.1.1 General historical overview

The Republic of Estonia regained its independence on 20 August 1991. The area of the republic is 45,227 km^2, with a population of 1,347,000 and a population density of 31.2 people per km^2. Estonia is a parliamentary democracy based on principles of unitary, legal, and social state. The territory of Estonia is divided into 15 state administration units (county) and local government units. There is a one-tier local government system that embraces 227 local government units (33 towns and 194 rural municipalities) in Estonia. The entire territory of Estonia is a region on NUTS 1 and NUTS 2 level and there are five statistical regions on NUTS 3 level (see European Parliament and the Council regulation No 1888/2005). The average population of a local government unit is about 6,000 inhabitants. The largest is the capital, Tallinn, with 401,380 inhabitants and the smallest is the rural municipality, Piirisaare, with 96 inhabitants. The currency, the kroon, (1 EEK = 0.0639 EUR) was introduced on 20 June 1992 and this will be replaced on 1 January 2011 by the euro[1].

The reform of local government in Estonia began at the end of 1989. Prior to that, the reforms of the fiscal system of the Soviet Socialist Republic of Estonia were highly centralised, with the sub-national level acting as an administrative unit or department of centre, with no independent fiscal or legislative responsibility (see also Bird, Ebel and Wallich 1995). On 23 November 1989 the Foundations of Local Government Act of Soviet Socialist Republic of Estonia (FLGA) came into force and on 1 January 1990 the Decree of the Presidium on Supreme Council on Foundation of Self-Government Administrative System came into force. According to § 2, § 4 and § 7 of the FLGA a two-tier local self-government system of self-government was founded, based on the principle of regional self-financing and with tasks to self-finance its activities by developing a social and productive infrastructure and municipal property. In the first case, the principle of collective ownership remains in effect. Municipal property was property owned by inhabitants of the administrative territory through the council of the municipality (§ 13 of the FLGA). A remarkable set of public tasks was transferred to local self-government units, together with the authority to invent and levy taxes and set burdens and charges (§ 8 of the FLGA). Estonia followed the trend that the total level of public sector activity had to be dramatically reduced, but at the same time, the new sub-national governments had to be allowed to build staff and institutional capacities in a manner that would make them accountable for their fiscal decisions (Bird, Ebel and Wallich 1995).

On 28 June 1992, the people of Estonia passed the Constitution of the Republic of Estonia. According to § 157(1) of the Constitution "a local government shall

1 In this chapter all figures are presented in euros, recalculated by the official exchange rate of the National Bank of Estonia 1 EUR = 15.64664 EEK.

have an independent budget for which the bases and procedure for drafting shall be provided by law." On 28 September 1994, the Parliament of Estonia ratified the European Charter of Local Self-Government. According to Art 9.3 of the Charter, at least part of the financial resources of local authorities shall be derived from local taxes and charges of which, within the limits of statute, they have the power to determine the rate. This means that a locally determined revenue base is a key guarantor of local self-government. Autonomy of local self-government is meaningless without a scope of discretion and the resources to benefit from it and therefore, an independent revenue base and the right to levy taxes are integral parts of local self-government (Lõhmus 2008).

An alternative view is provided by Peter Schöber, who finds that the true essence of local governments and their duty in respect to local people, is to take into account local geographical and historical specialities while fulfilling public tasks. Local governance is not linked to the right of taxation or the ability to levy local taxes, as it is an obligation of the state to provide sufficient funding. If the state fails to provide sufficient funding to fulfil tasks and provide services determined by law, then the state subverts the institution of local self-government (Schöber 2003). Richard M. Bird and others expected that central government would take steps to shift expenditure responsibilities onto sub-national governments or to redirect revenues from the sub-national level to central level (Bird, Ebel and Wallich 1995). The implementation of a theoretical base of local government financing is best tested in times of financial scarcity.

6.1.2 Arrangement of central and local government

Estonia is a unitary state, whose territory is divided into administrative-territorial units. The supreme power of state shall be exercised by the people through citizens with the right to vote: 1) by electing Parliament and 2) through a referendum. Central government consists of Parliament, the President of the Republic, the Government of the Republic, and courts, whose activities shall be organised on the principle of separation and balance of powers.

- The Parliament (Riigikogu). Legislative power is vested in the Riigikogu (§ 59 of the Constitution). Among others, the functions of Parliament are to pass laws and resolutions; to pass the state budget and approve the report on its implementation, and resolve other national issues which the Constitution does not vest in the President of the Republic, the Government of the Republic, other state bodies or local governments (§ 65 1, 6, and 16 of the Constitution[2])

2 In comparison with § 154 and § 157 of the Constitution, local governments pass regulations and make decisions on local issues; the local government budget is separate from the state budget and passed by the council of local government units, and local governments are authorised to resolve everything that the Constitution or the law of Parliament does not vest in other state bodies. The issue of the separation of national and local tasks and relevant financing of local government units has been one of the main issues raised due to the economic complexity of the last years (see below).

- The President of the Republic. The President of the Republic is the Head of the State of Estonia (§ 77 of the Constitution), whose main functions are to represent the Republic of Estonia in international relations, to appoint and recall diplomatic agents of the Republic of Estonia, to appoint or propose a candidate for the Prime Minister and other high state officials, to proclaim laws, and to issue decrees (§ 78 1, 2, 6, 7, 9, 10, 11, 13, and 14 of the Constitution). Further, the President of the Republic has summoned the President's Round Table for Local Government and Regional Development in an advisory authority to promote co-operation between the state and local government, ensuring the statehood, developing democracy and supporting civil society (order No 9 on 9 January 2007 of the President of the Republic "The Standing Order for President's Round Table for Local Government and Regional Development").
- The Government of the Republic. Executive power is vested in the Government of the Republic (§ 86 of the Constitution), whose functions embrace, amongst others, to execute domestic and foreign policies of the state, to direct and coordinate the activities of government agencies, to prepare the draft of the state budget and to issue regulations and orders on the basis of and for the implementation of the law (§ 87 1, 2, 5, and 6). The Government of the Republic comprises the Prime Minister and 12 ministers (§ 88 of the Constitution, § 3 (1) of the Government of the Republic Act). The Government of the Republic accomplishes its functions via agencies of executive power. Government agencies are ministries, the State Chancellery and county governments, as well as executive agencies and inspectorates, and their regional offices, with the authority to exercise executive powers and the Armed Forces of Estonia (§ 39 (3) of the Government of the Republic Act). Local government units (cities and rural municipalities) are not state agencies and are not subordinated to the Government of the Republic, but enjoy the status of an independent legal person in public law (§ 10 of the Local Government Organisation Act – LGOA). Central-local government issues are a matter of politics and justice.
- The Courts. Justice shall be administered solely by the courts (§ 146 of the Constitution). There are county courts and administrative courts in the first instance, circuit courts in the second instance and the Supreme Court. In addition to ordinary court procedures in the county or administrative court, a local government council, pursuant to § 7 of the Constitutional Review Court Procedure Act, may submit a request to the Supreme Court to declare an Act of Parliament or a regulation of the Government of the Republic or a minister to be in conflict with the Constitution or to repeal if it is in conflict with the constitutional guarantees of the local government. The right to settle a constitutional dispute in the Supreme Court is considered to be the true warranty of local government autonomy.

Local government is based on the administrative-territorial organisation of the territory of the state (§ 2^1 (1) of the Territory of Estonia Administrative Division Act). There is a one-tier local government system that embraces 227 local government units (33 cities and 194 rural municipalities) in Estonia. Cities and rural municipalities are based on the principle of decentralisation and are legal persons in public law (§ 10 of the LGOA). Cities and rural municipalities carry out local self-administration. At the same time, the territories of cities and rural municipalities are administrative-territorial units of the state.

Local self-government units join county and national associations of local government. There are two national associations of local government – the Association of Estonian Cities and the Association of Municipalities of Estonia – and fifteen county associations of local government (one in each county). Associations of local government are regulated by the Local Government Associations Act (LGAA) in the form of a non-profit association in private law (§ 1 s. 2 of the LGAA), but the association performs those functions of a local government, which the general meeting has decided should be performed jointly through the association (§ 9 s.1 of the LGAA). An association may enter into a contract with a governmental authority through which the association undertakes to perform a state function (§ 10 s. 3 of the LGAA).

State administration in counties is carried out by the county governors and government agencies (§ 2 (2) of the Territory of Estonia Administrative Division Act). There are 15 counties in Estonia. Many state agencies have their own local agencies of executive power (for example, the Police Board has four regional prefectures, the Rescue Board has four regional centres and the Tax and Customs Board has four regional service-agencies). County governments and local agencies of executive power are based on the principle of de-concentration and are subordinated parts of central government.

6.1.3 Central and local government fiscal relations

Local government units' budgets are separate from the state budget and relations between state and local governments' budgets are regulated by the Rural Municipality and City Budgets Act (RCBA). The state intervenes in local autonomy in matters of borrowing, budget classification and composition of the annual budget report. According to the economic content, the rural municipality and city budgets' revenue includes: 1) taxes; 2) sale of goods and services, including fees; 3) sale of tangible and intangible assets; 4) income on assets; 5) benefits, including foreign aid; 6) other income, including fines (§ 5 of the RCBA). Revenue, expenditure and financing transactions shall be classified pursuant to the budget classification, which is established by the Minister of Finance (§ 10 (1) of the RCBA). The government shall prepare an annual report and present it to the council for approval. An annual report shall include: 1) annual accounts, together with a report on the implementation of the budget; 2) a management report and an overview of the economic activities of companies in which the rural municipality or city has a majority holding and foundations and non-profit associations established by the rural municipality or city; 3) a report on the use of reserve capital; 4) an auditor's report and 5) other information prescribed by the council. The council shall approve the annual report no later than 30 June of the following year, after having heard the opinion of the audit committee. (§ 26 of the RCBA) A council shall report regularly to the Ministry of Finance and submit an approved annual report, together with the auditor's report to the county government of the location of the council (§ 27[1] and § 28 (1) of the RCBA).

6.2 Nature of the economic crisis in Estonia

Economic development in Estonia has grown rapidly. The growth was accelerated by Scandinavian banks entering the Estonian market of financial services after the crisis of the financial sector in 1997–1998. Easy access to loans and low interest rates, rising salaries and an optimistic financial perspective of the national economy encouraged people to take out loans for investment in real estate or for consumption. According to statistics of the Bank of Estonia, the total loans granted to individuals amounted to EUR 442.2 million in 2000 and the loan burden reached its peak in 2008 with EUR 7,735.7 million – the growth of loans granted to individuals had risen by 17.4 times in 8 years – decreasing to EUR 7,516.5 million in 2009. During the same period, loans granted to general government amounted to EUR 55.3 million in 2000 and EUR 387.5 million in 2009 – the growth of loans granted to general government had been increasing 6.9 times over nine years, forming 2.5 % of total loans granted in 2009. These types of changes were not followed by changes in the general domestic product or productivity.

The gross domestic product peaked in 2008 at EUR 16,073.3 million and has fallen in 2009 to EUR 13,730.0 million, which is slightly above the level in 2007. In a quarterly comparison of gross domestic product it can be seen that the greatest fall in GDP happened during the first quarter of 2009 and, after that, stabilisation can be seen at the level of the beginning of 2007.

The standard of living and earnings have changed considerably. From 2000, the medium net salary per month has increased from EUR 246 to EUR 672 in 2008, and, for the first time during the period from the restoration of independence till 2009, the medium net salary dropped to EUR 628, which is an average decline of 7 % per year. At the same time, the unemployment rate was at its lowest in 2007 at a level of 4.7 % and this has rapidly increased during 2009 to 13.8 %. Salaries and unemployment were the late indicators of economic recession. Although the changes in the real estate market were felt at the end of 2008, the statistics onreal estate sales show that there has been a decline in real estate sales since 2006. The real estate market was most active during 2006. Some fall in activity could already be seen in 2007 (that is, mostly the quantity of transactions), but when, at the end of 2007 and beginning of 2008, prices began to fall and banks did not give loans as cheaply and easily as they did previously, the activity of the real estate market reached the level of 2003. The changes in 2006 can also be explained by the end of the property and land reform (restoration of land and property, which was nationalised in the 1940s by the Soviet regime), which was often followed by the sale of restored property to new owners, and the end of national land transfers to private owners. Changes in 2008 further clearly indicate the effects of the economic recession in Estonia.

For the central government, the main problems arose from the decline in revenues from consumption taxes. For the local government, the problem was income taxes. According to data from the Ministry of Finance in 2009, 51 % of local government revenues were derived from personal income tax and 17 % block grants. Economic decline most influenced revenues from personal income tax, as many employers were forced to reduce salaries, use compulsory vacation or compulsory part-time work, dismiss employees or even close enterprises. At the same time, less consumption taxes were received by central government, which increased the need to cut down block grants to local governments. (Table 6.1)

6.3 Central-local relations in the management of the crisis

6.3.1 Central government budgetary activities

The Estonian economy has been increasing almost constantly, beginning with the restoration of the country's independence on 20 August 1991 and has survived, relatively well, the banking crisis of 1997. The economy began to change in 2006, when the average increase in real wages was 12.0 % and productivity 4.3 %, and in 2007, when the average increase in real wages was 10.5 % and productivity 6.1 %. According to data from EUROSTAT, productivity in Estonia was 62.8 % of the average productivity of other countries in the EU in 2008. It was already clear then that under conditions of low productivity, economic growth could not continue for long.

The changes in the world economy accelerated the procedure. At the end of 2008, the situation in the world and also the Estonian economy changed. In Estonia, the real wage declined in the 4th quarter of 2008 by 1.3 % and in the first quarter of 2009, by 4.5 %. However, smaller wages also meant less consumption. Consumer prices that had been rising since 2003, peaked with a rise of 10.4 % in 2008. In 2009, consumer prices fell for the first time by 0.1 % compared to prices for the same period in 2008. (Figure 6.1) Reducing consumer prices compensated consumers for the decline in income, but it also opened up some financial opportunities for the Government of the Republic.

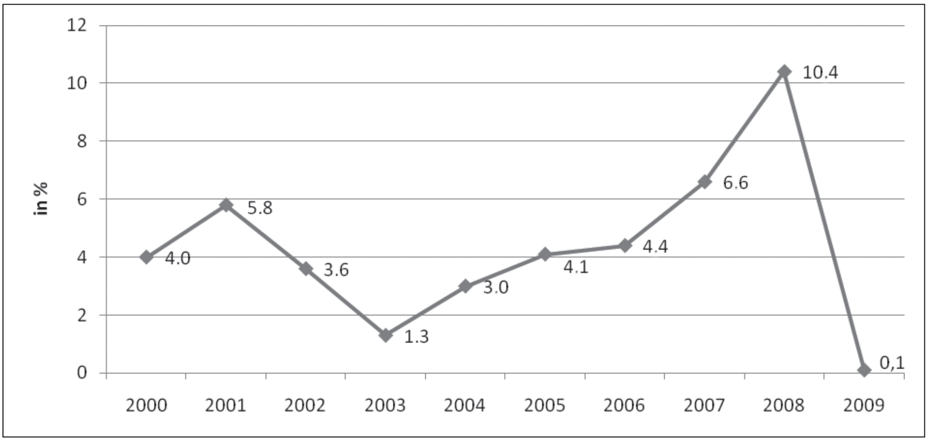
Table 6.1
Local governments' revenues and expenditures 2005–2010 (EUR, thousands)

	2005	2006	2007	2008	2009	2010*	Ratio 2008/2009
Revenues	**936,671**	**1,157,052**	**1,287,737**	**1,454,163**	**1,291,776**	**986,959**	88.8%
Local taxes	446,649	542,133	675,957	794,230	691,796	357,830	87.1%
• personal income tax (PIT)	406,792	500,635	629,764	734,173	634,095	310,789	86.4%
• land tax	32,324	33,064	35,307	48,259	48,249	25,829	100.0%
• other local taxes	7,532	8,434	10,885	11,797	9,452	21,211	80.1%
Income from economic activities	97,551	104,482	114,249	140,444	139,129	83,502	99.1%
Equalisation fund	60,715	73,103	91,636	91,806	71,601	41,033	78.0%
Block grants from the State Budget	186,497	197,683	207,759	239,863	219,683	82,717	91.6%
Earmarked grants from the State Budget	34,052	28,047	32,773	34,365	28,331	11,229	82.4%
Investment grants from the State Budget	27,098	48,972	61,003	65,623	16,638	41,611	25.4%
Transfers from foundations and NGOs	14,177	24,100	23,864	25,673	69,270	na	27.0%
Sale of property	45,237	99,041	36,860	13,735	11,484	7,471	83.6%
Other revenues	24,691	39,487	43,631	48,418	43,842	3,733	90.5%
Expenditures	**959,882**	**1,140,553**	**1,304,780**	**1,517,603**	**1,358,489**	**8,689,790**	89.5%
Allocations	99,786	112,346	115,444	141,525	171,505	87,927	121.2%
Staff costs	365,826	402,526	478,010	571,753	557,148	191,252	97.4%
Economic costs	314,318	363,661	407,434	474,442	389,112	170,595	82.0%
Investments	168,388	251,539	259,041	276,982	196,200	60,574	0.7%
Other expenses	11,562	10,478	44,848	52,899	44,523	45,027	84.2%

Note: 2010 data are estimates only

Source: Ministry of Finance

Figure 6.1
Consumer prices index in Estonia 2000–2009



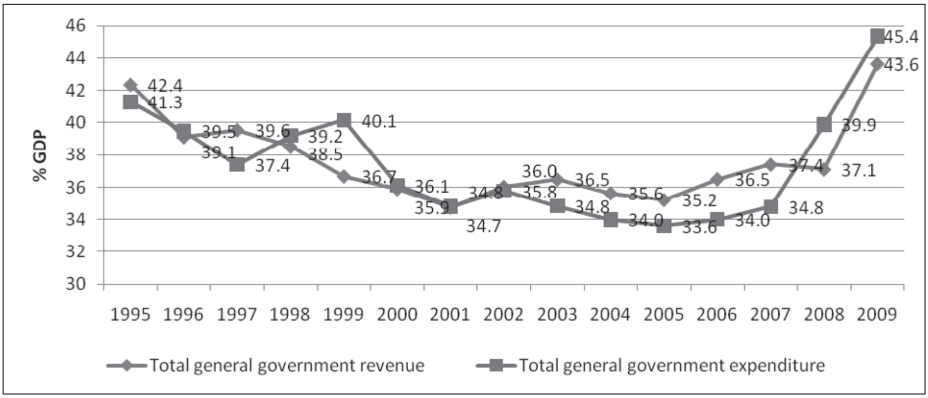
Source: Eurostat

Estonia joined the European Union on 1 May 2004. The decision to join the EU, which was approved with the referendum held in the Autumn of 2003, also came with support for accession to the euro zone. The practical preparations for adopting the euro already began prior to joining the European Union after the Government's Cabinet meeting on 15 January 2004, when the Government of the Republic of Estonia set the goal to be technically ready for adoption of the euro by mid-2006, in order to introduce the euro on 1 January 2007 (Bank of Estonia 2009). The increase in consumer prices has been considered to be the main obstacle to adopting the euro in Estonia. At the end of 2008, both the influence of fuel and food price pressures clearly started to abate, resulting in a rapid slowdown in price growth. The Bank of Estonia and the Ministry of Finance found that the inflation criterion would probably become feasible for Estonia at the end of 2009 and this would make it possible to adopt the euro on 1 January 2011.

Joining the euro zone became the main political and economical objective for central government and it devoted itself to meeting the other criteria for joining the euro zone (the general government budget deficit was lower than 3 % of GDP with a stable exchange rate of currency against the euro). As the rate of the Estonian kroon (EEK) against the euro was fixed, the only problem was to lower the general government budget deficit. Obvious measures were to cut expenditures, restrict borrowing and to increase revenues (without inducing inflation rates). The main objective was to get public expenditure under control. (Figure 6.2)

Figure 6.2

Total general government revenue and expenditure in Estonia 1995–2009



Source: Eurostat

Already in the Autumn of 2008, broad political co-operation was happening to reduce the state budget expenditure side and for the first time, the state budget for 2009 was smaller than in previous years. In the Spring of 2009, central government made large-scale state budget cuts, reduced wages and dismissed civil servants together with other unavoidable measures. Some of the measures were, for example:

- Central government stopped contributions into the II pillar of pension funds (saving about EUR 89.7 million). The Estonian pension system consists of three pillars: 1) the first pillar is a compulsory pension fund, gathered from compulsory payments from employees and employers; 2) the second pillar is a semi-compulsory fund (people were free to join, but cannot leave), gathered from payments from people and contributions from the state, and 3) the third pillar is a voluntary private pension insurance;
- Central government have cut the wages of all public servants in state agencies by 8 % since 1 July 2009 (saving EUR 39.3 million);
- Parliament (Riigikogu) reduced the allocations to the Health Insurance Fund by EUR 24.1 million and changed the Health Insurance Act so that during the first to fourth day, a person with a temporary incapacity does not receive any benefits and during the fifth to ninth day, the employer pays 80 % of the average wages and the remainder is paid by the Health Insurance Fund.

It remained obvious that only the cutting of expenditures would not be sufficient and additional revenues had to be collected. Central government made the following changes on the revenue side:

- Increase of value added tax from 18 % to 20 % since 1 July 2009;
- Increase of excise on fuel – about 10 % since 1 July 2009;
- Increase of excise on natural gas – 42.8 % since 1 July 2009;
- Increase of excise on tobacco – 5 % since 1 January 2010;
- Increase of environment charges since 1 January 2010.

6.3.2 Central government activities towards local government

The debate on local government arrangements have been ongoing since the movement for the restoration of the independence of the Republic of Estonia, beginning at the end of the 1980s. On 23 November 1989, the Foundations of Local Government Act of Soviet Socialist Republic of Estonia (FLGA) came into force and on 1 January1990, the Decree of Presidium on Supreme Council on Foundation of Self-Government Administrative System came into force. Both statutes provided a two-tier local government system and differentiated between tasks and authority depending on the size, type and population of municipal units.

On 28 June 1992, the people of Estonia passed the Constitution of the Republic of Estonia. In § 158(1) of the Constitution; only city and rural municipalities were mentioned as municipal units and other types of local government could be provided by statutes. On 2 June 2003, Parliament passed the Local Government Organisation Act (LGOA), which regulated only city and rural municipalities as local government units and provided a uniform regulation of tasks, arrangements, financing and supervision with no differentiation.

The local government units created were relatively small and lacked administrative capacity, which raised claims for the amalgamation of municipal units into bigger entities. In 2000, Tiina Randma and Taavi Annus warned that centralisation does not increase efficiency, if the functions of local government units are not changed (Randma and Annus 2000) and Wolfgang Drechler denied any relationship between the size and efficiency of local government (Drechler 2000). Still, the main debate of administrative-territorial reform has been the amalgamation of rural municipalities.

The economic decline motivated central government to raise two legislative initiatives, which would have had enormous influence on local self-governments in Estonia. Neither of these acts has passed, but they were the subject of many discussions and debates. However, they also caused confusion and uncertainty.

First, the consolidated debt of the public sector had increased from EUR 489.7 million in 2000 (5.62 % of GDP) to EUR 991.3 million in 2009 (7.15 % of GDP). In 2000, local government debt was EUR 216.7 million (loan burden 32 %) and this increased to EUR 583.1 million in 2009 (loan burden 50 %). It shows that the greatest accelerator of public debt was the borrowing by local government. On 9 October 2008 a meeting of the Government of the Republic approved a draft of the Financial Management of Local Government Unit Act and submitted it to Parliament. The aim of the draft was to limit a local government unit's ability to take out loans and other financial obligations and to preserve local government financial accountability. With special measures of local government financial accountability, every municipal unit that exceeded the net debt limit set by the draft had to compose a plan of implementation on measures of financial discipline. In the draft, if local government units were under severe financial threat, a special regulation was proposed.

The Commission of the Ministry of Finance had to compose a sanitation plan and all decisions with financial effects had to be considered by the committee. Local government units and associations opposed this draft and found it to be a breach of the financial and organisational autonomy of local government. The draft passed two readings in plenary sessions in Parliament and the second reading was suspended. Some of the more urgent enactments were passed as amendments of other legal acts (some of them in the Supplementary State Budget Act adopted on 20 February 2009, which will be discussed below).

Second, on 3 March 2009, the Ministry of Interior initiated a draft of the Reform of Administrative-Territorial Organisation Act. According to the draft, the minimum amount of residents had to be 25,000 for rural municipalities and 40,000 for cities. To guarantee access to services, sub-municipal level territorial offices were set up. These changes would have reduced the quantity of local government units approximately ten times. The Ministry of Interior planned to carry out the reform through the elections of the municipal council on 18 October 2009. The draft was published unofficially on the website http://haldusreform2009.wordpress.com and the initiative encountered intensive resistance from all local government units and organisations. Due to this resistance, the draft was never formally initiated and was discussed as if it were a smokescreen for the Supplementary State Budget Act adopted on 20 February 2009 (see below).

6.3.3 Changes in financing and accounting of local governments in 2009

Besides these general legislative initiatives, there have been three recent changes in financing and accounting which have had a vast impact on local government finance:

- The first change is related to the resounding public private partnership contracts in local government books and the influence the change had on the local government loan-burden.
- The second is an urgent enactment taken from the draft of the Financial Management of Local Government Unit Act and sets additional limits on local government borrowing.
- The third was the approval of the supplementary state budget of 2009, which amended the Road Act, the Income Tax Act and the Occupational Health and Safety Act.

First, many local government units had been optimising their loan burden by sharing loans with private partners. According to the § 8(1) Rural Municipality and City Budgets Act (RCBA) a rural municipality or city may take out loans or financial leases or issue securities which certify obligations and assume other debt obligations under the following conditions: The total amount of all outstanding loans, unpaid financial lease payments, issued debt instruments and other debt obligations, together with the loan or financial lease to be taken, the debt instruments to be issued and other financial obligations, shall not exceed 60 per cent of the proposed budget revenue for that budgetary year, from which allocations from the state budget, intended for a specific purpose, have been deducted. To avoid this restriction, local government units founded or participated in companies, non-profit unions or foundations in private law and provided services via established public-private partnership (PPP) relations. Prior to 2005, the Committee of Accounting of the Ministry of Finance of Estonia interpreted that a financial obligation belonged to the person who was legally obligated to fulfil the obligation.

According to the decision of 28 January 2005, "Instruction No RTJ 17" of the Committee of Accounting, the assets of PPP-projects was to be the responsibility of the person owning and using most of the building. Further changes were even less favourable to local government units. According to the decision of 1 January 2009, of the Committee of Accounting, the infrastructure was to be included in the balance of the public sector unit, a tangible basic asset. Clause 28 of the instruction was the most problematic, according to which, the public sector unit has to maintain its financial obligation to the private sector partner as a loan obligation. Therefore, all unconditional obligations to private partners of concession contracts of services were considered to be a loan burden of the local government unit.

The City of Tallinn submitted a constitutional complaint to the Supreme Court of Estonia. In the case 3-4-1-14-08, the city of Tallinn argued that the instruction of the Committee of Accounting, in interaction with § 32(1) of the Accounting Act and § 11(5) of the 11 December 2003 regulation No 105 of the Minister of Finance "State Accounting Rules", go against the constitution and violate the constitutional financial guaranty of local government. The City of Tallinn claimed that, according to § 154 and § 157(1) of the Constitution and Art 8 and Art 9(1) of the European Charter of Local Self-Government, local government units have the right to determine through their internal rules, how they engage in economic activities and set them out in their budget and financial accounting.

The Court found that the claim to nullify the instruction of the Committee of Accounting and § 32(1) of the Accounting Act was unallowable. The Court found that the obligation to follow the instructions of the Committee of Accounting could breach local government autonomy and was formally contrary to the Constitution. The Court decided to declare that § 11(5) of the 11 December 2003 regulation No 105 of the Minister of Finance "State Accounting Rules" violated the Constitution and in part, it obligated local government units to follow the instructions of the Committee of Accounting. The Court did not take a stand on the question, "how should local government resound concession contracts of services in their accounting?", or if § 8(1) of the RCBA violated local government financial autonomy. It can be concluded that local government units are still obligated to maintain all financial obligations derived from concession contracts of services and other PPP-projects as loan obligations in their accounts. This obligation has made § 8(1) of the RCBA limitations much more restrictive for local government units.

Second, until 1 March 2009, the restriction of § 8 (1) of the RCBA was the only restriction on borrowing for local governments. On 20 February 2009, Parliament passed the Supplementary State Budget of 2009 and Changing of Related Legislation Act. In the § 20 (3) of the Act, the RCBA was amended with § 8^1, which regulated additional limitations on local government borrowing. According to § 8^1 (1) of RCBA, local government units were allowed to take out loans only for projects co-financed by the European Union[3]. All financial obligations taken by local government units had to be consulted with the Ministry of Finance and in the case of any breach of this Act, the Ministry of Finance has the right to stop payments from the equalisation fund or transfer a share of personal income tax to the rural municipality or city breaching the Act. The regulation was of a temporary nature – the restriction is in force until the end of 2011 (§ 28^1 of the RCBA). The § 8^1 of the RCBA was implemented with regulation No 50 of the Government of the Republic, of 5 March 2009 "Particular Catalogue of Obligations of Local Government Units and Dependant Units, Provisions and Order of Application of Concerting the Obligations, and Provisions and Order of Asserting of the Application, and Rules of Reimbursement of Detained Resources."

The City of Tallinn (case No 3-4-8-09) and the city of Narva (case No 3-4-7-09) submitted two separate constitutional complaints to the Supreme Court of Estonia. The city of Tallinn and the city of Narva argued that § 8^1 of the RCBA was contrary to § 154 and § 157 (1) of the Constitution, § 38 (1) of the LGOA, and § 2 of the RCBA deriving local governments' rights for independent economic activities that are disproportionately restrictive. The City of Narva found that the aim to reduce the state budget deficit through this restriction was not in accordance with the constitutional principle of separation of central and local government. The City

3 § 8^1 (1) of RCBA: "*Only if the gross domestic product has declined during two quarters, can cities or rural municipalities or units under their direct or indirect influence in the meaning of the Accounting Act, whose income is composed of more than half from incomes from the rural municipality or city, state or other legal person in public law or foundation under the dominant influence of a prior entity, (henceforth city and rural municipalities and their dependant units) to assure macro-economic stability and to control governmental budget positions for three budget years, issue bonds, take out loans, rental or factoring obligations, obligations from service concession contracts, long-term obligations to purveyors, and other long-term monetary obligations, but subsidiaries received under the 2004–2006 Structural Fund Subsidiaries Act and 2007–2013 Structural Fund Subsidiaries Act or co-financing or own share for receiving structural subsidiaries or foreign aid under the international treaty of the Republic of Estonia or re-financing obligations taken before enforcement of this act*."

of Narva also argued that imposing such restrictions in the middle of a budget year and without due *vacatio legis* (the enactment was enforced from the day of publication) breached the principle of certainty of law.

The Court found, in both cases, that § 8[1] of the RCBA was in accordance with the Constitution and that the urgency of enforcement did not breach the principle of certainty of law. The Court found that the disputed enactment restrains local government's financial autonomy. Restraining local governments taking on financial obligations may limit or inhibit local government fulfilling some local tasks. Local government units' rights to take on financial obligations are not absolute and can be restricted in accordance with the rule of law and proportionality. Local government units execute the same public authority as the state and are acting in the same economic space and budgetary system with central government and their activity influences the economic position of the whole state.

The aim of the disputed restriction is to reduce the general government budget deficit and to match Maastricht criteria for financial stability for joining the euro zone. The national macro-economic stability and political objective of joining the euro zone were found by the Court to be sound aims and measures taken by § 81 of the RCBA, goal orientated and proportionate. The measure also prevents local governments from insolvency and excessive loan burdens. The Court also argued that the stability of the financial system of local government is not an object in itself, but has a dual effect on the impact on local government financial obligations. The Court found that § 81 of the RCBA neither shut off the possibilities for local government to fulfil their financial obligations already taken, nor totally exclude investments. Given the situation of economic decline and the long-lasting debate over the public sector loan burden, this did not breach the principle of certainty of law.

Third, the main financial tool to influence local government is the state budget and related statutory regulations. On 10 December 2008, Parliament passed the State Budget of 2009 Act and it was changed three times on 20 February 2009 with the Supplementary State Budget of 2009 and Changing of Related Legislation Act; on 16 June 2009, with the Second Supplementary State Budget of 2009 Act and on 26 November 2009 with the Supplementary State Budget of 2009 Act (RTI 2009, 58, 383). The most influential for local governments was the 20 February 2009 Supplementary State Budget of 2009 and Changing of Related Legislation Act.

On 10 December 2008, Parliament passed the State Budget 2009 Act. According to article 452.01 of the State Budget Act, EUR 331.3 million was assigned to local governments, including EUR 91.8 million from the equalisation fund. Passing the Supplementary State Budget of 2009 and Changing of Related Legislation Act, Parliament reduced the assignment to local governments by EUR 33.3 million and therein reduced the equalisation fund by EUR 21.2 million. However, at the same time, it increased earmarked grants for social benefits by EUR 6.4 million.

According to the explanatory letter of draft No 433 SE of the Supplementary State Budget of 2009 and Changing of Related Legislation Act, the initial state budget for 2009 was drafted, based on an economic prognosis by the Ministry of Finance published on 25 August 2008, and at the end of the year it was clear that the economic situation was worse than even the risk-scenario. The economic growth was −3.5 % and the deficit of the government sector was EUR 256.4 million, that is 1.5 % of GDP during the autumn of 2008. Therefore, already in January 2009, the Government of the Republic approved the supplementary state budget for 2009, reducing all expenditures based on the principle of joint responsibility of all sectors of governments.

These decisions were not challenged in court, but there was reluctance amongst local governments concerning these decisions. The mayor of Tallinn, the capital of Estonia, Mr Edgar Sarvisaar, said in his speech on 12 March 2009, at the conference "Forum of Local Government" the following: "Solidarity does not mean that all expenditures must be carried equally 50:50. Solidarity means that the stronger help the weaker. Unlike in Estonia, where weak municipalities must help, through the equalisation fund, the sinking Government of the Republic." (Savisaar 12 March 2009:6)

On 20 February 2009, Parliament passed the Supplementary State Budget of 2009 and Changing of Related Legislation Act. In the § 16, § 17, and § 19 of the Act, Parliament amended the Road Act, the Income Tax Act, and the Occupational Health and Safety Act. All these amendments were disputed by the City of Tallinn at the Supreme Court of Estonia in case 3-4-1-8-09. The Court rejected the claim and found that the City of Tallinn failed to prove that reductions of revenues actually inhibited the City of Tallinn from fulfilling its obligatory public tasks at the minimal required level or that the indirect impact of the measure was not a breach of local government financial autonomy. The following are the arguments in more detail:

Amendments to the Road Act

According to § 10 (4) of the Road Act, the owner of the road is required to maintain the road in a state that concurs with requirements (§ 25 (3) of the Road Act[4]). The owner of local roads is the city or rural municipality where the local road is situated. A local road is a local highway, street, footpath, cycle track and winter road prescribed for local traffic (§ 5^1 of the Road Act). The financing of maintenance of local roads is a matter for the local government budget, but pursuant to

4 Rural municipality and city governments shall organise the management of local roads and are required to create conditions for safe traffic on such roads (§ 25 (3) of the Road Act).

§ 16 (3) of the Road Act, at least 10 % of total road maintenance expenditure[5] of the state budget was to be assigned for maintenance of local roads. Passing the Supplementary State Budget of 2009 and Changing of Related Legislation Act, Parliament changed the § 16 (3) of the Road Act as follows: "The division of funds for the management of national roads and local roads shall be specified in the state budget for each budgetary year."

The City of Tallinn found that the enactment modifying § 16 (3) of the Road Act was contrary to § 154 of the Constitution, Art 9 (1) and (2) of the Charter and § 7 of the RCBA[6] because Parliament reduced the assignment of maintenance of local roads in the state budget to below the former 10 % of total road maintenance expenditure without reducing either the task of the maintenance of local roads or the standards of safety of roads.

The Court found that maintenance of local roads is purely a municipal task and has to be financed through the municipal budget. The local government's right to adequate financial resources for exercising municipal tasks anticipates financing by central government only, in as much as there is a lack of local government resources for the maintenance of roads and maintaining them in a sufficient condition without hindering the exercising of other municipal tasks at the minimal required level. The state is not obliged to provide additional funds for the maintenance of local roads as long as local government has sufficient resources for exercising municipal tasks at the minimal required level. The Court found that neither the sole reduction of the assignment for maintenance of local roads in the state budget, nor changes made in § 16 (3) of the Road Act that make this reduction of assignment legal, cannot breach the local governments' right for adequate financial resources.

Amendments to the Income Tax Act

Income tax is imposed on income on natural persons and on fringe benefits granted to a natural person (§ 1 (1) and (2) of the Income Tax Act). Income tax is a national tax and the rate of income tax is set in § 4 (1) and (2) of the Income Tax Act at a level of 21.0 % of taxable income. The revenues from income tax are divided between central and local government. Until 1 April 2009, 11.93 % of the taxable income of a resident natural person was received by the local government of the taxpayer's residence (§ 5 (1) 1) of the Income Tax Act) and the remainder of the taxable income from income tax was received by the state. Passing the Supplementary State Budget

5 The total amount of expenditure prescribed by the state budget for the financing of road management shall be equal to not less than 75 per cent of the proceeds planned from fuel excise duty, except excise duty on fuel marked with a fiscal marker and on natural gas, and 25 per cent of the proceeds planned from excise duty on fuel marked with a fiscal marker (§ 16 (2) of the Road Act).

6 Decreases in budget revenue and increases in budget expenditure on the basis of legislation enacted by Parliament or the Government of the Republic after the passing of the budget shall be covered from the state budget (§ 7 of the RCBA).

of 2009 and Changing of Related Legislation Act, Parliament changed the § 5 (1) 1) of the Income Tax Act and reduced the share of taxable income of local governments to 11.4 %. According to an explanatory letter concerning draft No 433 of the Second Supplementary State Budget of 2009 Act, during the period 2005–2007 the share of taxable income for local governments increased by 0.4 % without any additional obligations imposed on local governments.

The reduction in the share of taxable income of local governments by 0.56 % means a reduction in local government revenues of about EUR 19.2 million. In accordance with Art 9.2 of the Charter[7] and § 7 of the RCBA[8], Parliament changed the age of children for whom the local government unit had to guarantee a place in kindergarten from 1 year to 1 year and 6 months[9] and added to the Sport Act and Youth Work Act that local governments must support sports and youth organisations "if there appears to be the budgetary means."[10] These means were considered to be sufficient to compensate a reduction in local government revenues from income tax.

The City of Tallinn found that the enactment modifying § 5 1) of the Income Tax Act was contrary to the principles of legal certainty, stability of the financial system and guarantee of sufficient financial means. In the opinion of the City of Tallinn, the reductions of local government obligations under the § 10 (1) of the Pre-School Child Care Institution Act, the § 3 2) of the Sport Act and the § 6 (1) 2) of the Youth Work Act were illusionary. These changes could only reduce queues to kindergartens, as in practice, local governments were not able to follow the statutory obligations of guaranteeing a place in kindergarten anyway. Also, the changes made in the Sport Act and the Youth Work Act did not reduce the expenditure base of local government, since in practice, local governments were already supporting sport and youth activities on a discretionary basis. The City of Tallinn found that the state had shown no solidarity with local governments reducing the revenue base, as the economic decline influences local government revenues and expenditures more

7 Art 9.2 of the European Charter of Local Self-Government: "Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law."

8 Decreases in budget revenue and increases in budget expenditure on the basis of legislation enacted by parliament or the Government of the Republic after the passing of the budget shall be covered from the state budget (§ 7 of the Rural Municipality and City Budgets Act).

9 Prior to 1 April 2009, the § 10 of the Pre-School Child Care Institution Act provided that: "A rural municipality or city government shall provide all children from one to seven years of age whose residence is in the administrative territory of the given rural municipality or city and whose parents so wish to have the opportunity to attend a child care institution in the catchment area."

10 Prior to 1 April 2009 the § 3 2) of the Sport Act provided: "Rural municipalities and cities are required to: … 2) support the work of sports organisations located within their administrative territories; …" and the § 6 (1) 2) of the Youth Work Act provided: "Rural municipality and city councils shall: … 2) support youth programmes and youth projects of youth associations operating in the administrative territory of the given rural municipality or city, approve the conditions, procedure and application forms for supporting youth programmes and youth projects of youth associations from the rural or city municipality budget; …"

than the state and a reduction in the share of income tax diminishes accessibility to social services and lowers the quality of those services.

The Court found that reducing the local governments' share of revenues of income tax in the middle of a budgetary year might breach local governments' rights to adequate financial resources and the principle of legal certainty. The Court agreed with the City of Tallinn that the changes made in the Pre-School Child Care Institution Act, the Sport Act and the Youth Work Act provided only an illusionary reduction of expenditures and found that the application of such illusionary reductions to balance the reduction in local government revenues breaches the rule of law. The Court underlined that the breach of local governments' rights to adequate financial resources exists only if local governments' revenues in total are insufficient to exercise municipal tasks at the minimum required level.

The City of Tallinn had failed to prove that because of a reduction in the share of revenues of income tax they were not able to exercise all municipal tasks at the minimum required level. The Court reasoned that as long as the law does not make a strict and clear division between local and national tasks, the Court lacks the ability to control, if local government's revenues are adequate and commensurate with the local government's responsibilities. In the opinion of the Court, the sole fact that the impact of a reduction in the local governments' share of revenues of income tax to local governments' capability to exercise local tasks is not sufficient reason either to declare the changes made in § 5 (1) 1) of the Income Tax Act unconstitutional or void.

Amendments to the Health Insurance Act

According to § 56 (1) of the Health Insurance Act, every insured person had the right to receive sickness benefit as of the second day of release from the performance of duties as specified in the certificate of incapacity for work. The sickness benefit was paid by the Estonian Health Insurance Fund in the amount of 80 % of the person's average income. With the passing of the Supplementary State Budget of 2009 and Changing of Related Legislation Act, Parliament amended the Occupational Health and Safety Act with § 12^2 stating that the employer is obliged to pay sickness benefit to the employee from the fourth to eighth day of sickness in the amount of 80 % of the average income of the employee and changed the § 56 (1) of the Health Insurance Act granting the right to receive sickness benefit from the Health Insurance Fund from the ninth day. According to the explanatory letter of draft No 433 of the Second Supplementary State Budget of 2009 Act, the purpose of the change was to lift part of the responsibility for employees' health to the employer, thereby promoting the physical and mental well-being of the employees. The total economic burden was calculated to be EUR 32 million *per annum* for all employers.

The City of Tallinn found that the enactment amending the Occupational Health and Safety Act with § 12^2 being contrary to § 10, § 116 (2), and § 154 of the

Constitution, breached the local governments' activity as the changes increased the expenditures of the City of Tallinn in the middle of the budget year and the state had not provided additional funds to compensate local governments for such an increase in expenditures.

The Court found that § 12^2 of the Occupational Health and Safety Act cannot breach the local governments' financial autonomy, as it regulates the responsibilities of all employers uniformly, and therefore the City of Tallinn was not allowed to dispute the enactment in Court. Such a responsibility influences local governments' finances indirectly and has to be compensated through a general system of local government financing. If expenditures for exercising national tasks, imposed on local governments by law, increase, due to such additional duties, then local governments are entitled to compensation for such additional expenditures from the state.

According to § 154 of the Constitution[11], public tasks were to be divided into local and national tasks. The § 154 (2) required that all national tasks imposed on local governments by law were to be funded from the state budget. In general, local tasks are listed in § 6 (1) and (2) of the LGOA and include the organisation of social assistance and services, welfare services for the elderly, youth work, housing and utilities, the supply of water and sewerage, the provision of public services and amenities, waste management, physical planning, public transportation, and the maintenance of such facilities and local roads. In addition to local tasks, local governments fulfil state tasks, which are assigned to them by law or which arise from a contract between an authorised state body and a specific council (§ 6 (4) 1) and 2) of the LGOA). In addition to these enactments, there are specific statutes regulating the division of tasks between local and central government and providing different schemes of financing to exercise these tasks.

There is a general understanding that despite a historical and theoretical division of tasks, there are different sub-tasks and layers of the same task, which are fulfilled at different levels of government, but there is a lack of division of local and national tasks in general. On 19 April 2004, a decision in case No 3-3-1-46-03 in the Supreme Court of Estonia was concerned that in a situation where a division between substantially local tasks and substantially national tasks is unclear, the affording of block grants and earmarked assignments of the state budget to specific local government units on specific budgetary items were not sufficient to implement § 154 (2) of the Constitution. Still, at a time of economic growth, the assignments from block grants, earmark assignments, share of national income tax and the equalisation fund were broadly sufficient to cover most local government

11 § 154 of the Constitution of the Republic of Estonia: "(1) All local issues shall be resolved and managed by local governments, which shall operate independently pursuant to law. (2) Duties may be imposed on a local government only pursuant to law or by agreement with the local government. Expenditure related to duties of the state imposed by law on a local government shall be funded from the state budget."

expenditures. At a time of economic decline, when revenues from income tax were reduced without a reduction in the local governments' share of revenues of income tax, the question of division between local and national tasks and the financing required to exercise national tasks from the state budget again emerged.

On 16 April 2010, in a decision in case No 3-4-1-8-09, the Supreme Court of Estonia elaborated the former decision on local government financing[12]. The Court found that local governments' rights to adequate financial means to exercise local tasks requires that the state creates regulations which ensure that local governments have the money they require to exercise local tasks, at least the minimum amount. Hence, the level of local government revenues must conform to the amount of local tasks. In addition to exercising tasks imposed on local government by statutes, local government units must have funds to decide on and arrange important local matters not regulated by statutes. It is important that cities and rural municipalities could, besides deciding matters legally, also solve local matters in reality. Although the legislator, as the creator of economic and taxation policy, has great freedom of decision, he/she is not free to decide the amount given to local government financing.

The legislator cannot leave local government as an empty constitutional institution. The independence of local government as the decider and arranger of local maters means that financing of local tasks cannot be disproportionately dependant on financial assignments from the state, but must adequately reflect the general economic situation. The local tasks may be different in each local government unit, dependant on the special local needs and preferences of a local community. Changes in the social and economic situation may alter both the composition of local tasks and quality and quantity of exercising local tasks.

The crucial criteria for financing local tasks in a specific local government unit is that the level of public services provided in that local government unit would not decrease to a substantially lower level the public services in the country in general. The right to adequate financing of local tasks does not mean that the state could not reduce funding, if the reduction of funding does not cause an insufficiency of means for exercising local tasks at a minimum level. Hence, the violation of local governments' rights to adequate financial resources cannot be caused by any legal norm imposing additional tasks or expenditures on the local government or making any local task compulsory. There is no legal base to argue that an insufficiency of local governments' financial resources derives from any single or even the latest burden imposed on local government. The violation of local governments' rights to

12 In case No 3-4-1-8-09 the main issue was the constitutionality of specific enactments of the Second Supplementary State Budget 2009 Act and the Court was of the opinion that the division of local and national tasks and a scheme for local government financing was a general framework for the following decision. In the Estonian legal system a decision of the Supreme Court is not a precedent and is not legally binding in following legal cases. Hence, the argumentation of the Court was *obiter dictum* or *ratio decided* – is not relevant.

adequate financial resources can come only from a lack of or defect in the financial system itself.

These requirements, which the right to adequate financial resources poses on the financial system of funding and exercising local tasks, are not limited by the level of financing. To prevent the right to adequate financial resources becomes illusionary – and local government autonomy devaluates to a mere declaration – the state must create a financial system for funding and exercising local tasks, which permits assessing the sufficiency of financial resources in every specific case. It must enable local governments to defend their rights to adequate financial resources in court (Art 11 of the Charter) and allow a court to estimate the claim. This is only possible if the legislator has defined if a specific public task exercised by local government pursuant to the law is a local or national task and assigned funding for exercising national tasks by the local government. The Court also noted that according to the principle of universality and transparency of the state budget, deriving from § 115 (1) of the Constitution[13], the state budget must include all expenditures, including expenditures compensated to local governments for exercising national tasks imposed on them by the law. The Court concluded that leaving undetermined which tasks are local and which tasks are national, the state violated the Constitution and this violation has caused a breach of financial autonomy of local government.

6.4 Conclusions

The Estonian case shows that in times of economic crisis the central government tries to cover their own lack of revenues by taking away funds from local government. This is done by shifting tasks to local government units' own financing area and restructuring revenues of local government in favour of central government. The Estonian case is special because, in addition to the economic crisis, the state had the additional political objective of introducing the euro and, for that purpose, additional restrictions were implemented. Whilst for the central government the national policy was implemented successfully (Estonia joined the euro zone on 1 January 2011), the burden of economic decline was to be sustained by local government units. Local governments, as subordinated units of government, lack the possibility to gather additional funds. The only protection is that received from court. This chapter shows that in times of crisis, local governments are more eager to fight for their rights in court. There has been a very positive court practice in Estonia, which influences local government units' financial positions and will continue to do so, even after the crisis is over.

13 Parliament shall pass as a law the budget of all state revenues and expenditures for each year (§ 115 (1) of the Constitution of the Republic of Estonia).

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7. Local Government Debt Policy in Poland between 1999 and 2010, with Special Focus on the First Years of the Crisis

Agnieszka Kopańska

In 2004, the Local Finance Law provided Polish municipalities and cities with extended possibilities to finance their development. An important element of the new revenues was a higher (than in previous years) share of Personal Income Tax (PIT) and Corporate Income Tax (CIT); both of which are central government taxes. This higher share, accompanied by a higher value of taxes during the economic boom, made the financial situation of the "average" local unit very strong and pushed it to important investment activities. The situation seemed to be stable and even the lowering of PIT rates, established early in 2008 by parliament, did not scare local government officials. However, the world economic crisis, which came at the end of 2008, changed the situation dramatically. Despite lower incomes, local governments had to carry on with the planned investments funded from EU grants and particularly those which are obligatory because of accession protocols. That situation influenced local debt policy.

The aim of this chapter is to analyse the local government debt policy during the period 1999–2009 and during the first half of 2010, with special focus on the first years of the crisis. Statistical data related to debt and revenues and spending (especially investment) will be analysed throughout the years.

According to economic theory, an institutional framework is the most important tool which influences local spending and debt policy (Inman 2001). In the first section of this chapter, basic information on Polish local governments will be given. How and why its financial and legal situation changed in 1999–2009, and how the crisis influenced local government revenues will be presented. In the second section, the legal framework of local indebtedness in Poland will be covered. The final part studies the statistical data related to debt and its correlation with revenues and spending (especially investment). The factors, which are important for local debt policy, are: the financial situation and its perspectives, investments needs and EU grants and finally, the election cycle will be presented and analysed.

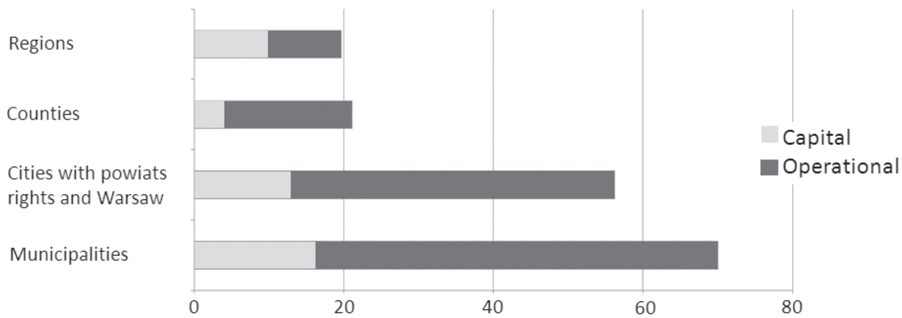
In this chapter, we focus especially on local units – municipalities (gminas) and cities with county's rights (66 cities which work as municipalities and counties – powiats).

7.1 Local governments' financial situation between 1999 and the first half of 2010

The present local government structure in Poland is a result of two phases of decentralisation reform. The first phase took place in 1990, when the local government system was introduced and about 2500 municipalities (*gmina*) were established. In 1999, the second stage of the reform introduced two new tiers of elected local governments, 315 counties (*powiats*) (plus 65 of the largest cities which work as powiats and gminas) and 16 regions (*województwo*) were created. The capital, Warsaw, operates under a separate legal act.

The responsibilities of gminas have been broadly defined as "all matters that are not reserved to other entities under existing laws", whilst the Gmina Local Government Act enumerates the most important tasks[1]. The powiat is responsible for public tasks of a supra-gmina nature. The primary responsibilities of województwo are aimed toward the region's development by defining measures and development goals in the so-called "wojewódzka development strategy". Furthermore, regions are responsible for public tasks of a regional nature that gminas or powiats are unable to fulfil.

Figure 7.1
Structure of capital and operational expenditures by levels of local government in 2009
(PLN, billion)



Source: Own calculation based on Ministry of Finance and GUS (Statistical Office) data

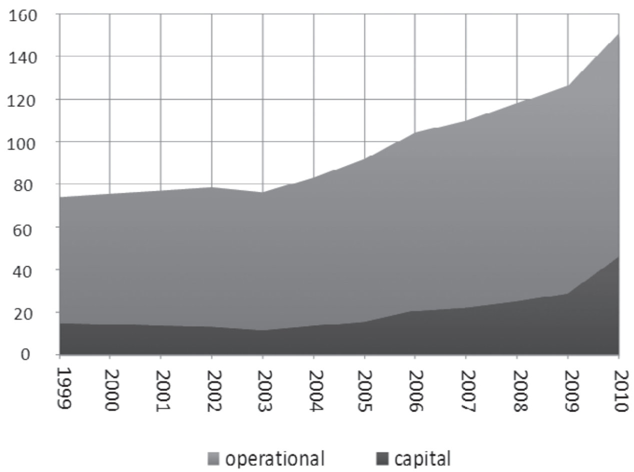
1 Such as spatial planning, health care, social care, primary education, municipal housing, culture, physical culture, construction and maintenance of local roads, streets, bridges, local public transport, planning for and financing of lighting in public areas, restoring good environmental conditions, creation and protection of parks and forests, protection against floods, solid waste management, maintenance of public areas, construction and maintenance of sanitary facilities, landfills, wastewater treatment plants, construction and operation of water supply and sewerage systems and the provision of power and heat supply.

Nowadays (2009 data), local governments are responsible for about 30 % of total general government expenditures (after consolidation) and about 12 % of GDP. Almost 76 % of local budgets are spent at a municipal level (including cities with powiat rights and Warsaw), 13 % by county level and 12 % by regional self-government. (Figure 7.1) More than a quarter of local expenditures are related to investments. Capital spending is very important at the regional level (where investments consist of more than half of the expenditures) but 67 % of whole local expenditures were carried out in 2009 by municipalities and the 66 largest cities.

Such a huge capital investment effort by municipalities and cities is associated with the serious under-development of the communal infrastructure inherited from the past. Due to the magnitude of existing needs, the amount allocated to capital projects is relatively stable; however, there are visible changes in those expenditures.[2] (Figure 7.2)

Figure 7.2

Amount and structure of local (municipalities+ the 66 largest cities) expenditures in 1999–2009 and planned for 2010 (PLN, billion, in prices as of 2009)



Note: 2010 – plan after amendments in June 2010
Source: Own calculation based on Ministry of Finance and GUS (Statistical Office) data

During 2000–2003, capital expenditures decreased (in 2003 they were 23 % lower – in real terms – than in 1999). This decrease can be explained by the worsen-

2 To avoid the problem of dramatic changes in capital spending and debt for new tiers of local governments, which are related to a close to zero amount in these categories in 1999; in this chapter we will mostly analyse local units which have operated since 1990 – gminas (municipalities) and cities with powiats' rights+ Warsaw (66 cities which work as gminas and powiats)

ing financial situation of local governments. The administrative reform from 1999 was only one of four major reforms in public finance which were organised in 1999 in Poland. The pension fund and health sector reforms heavily influenced public finance in 2001–2002 when there was a public finance crisis in Poland (Owsiak 2006). The idea of administrative reform was not to change the revenue situation of "old" local units, but the crisis mentioned was the reason why the Act on Local revenues, which was established for 1999–2003, did not fulfil that idea. Although local government revenues increased in real terms, at the same time their burden from new operational responsibilities (especially related to social spending) grew even faster. A prime example of problems which occurred in the public and local finance system after reforms in 1999 was a mistake in the calculation of the education subvention in 2000, which caused important problems for spending related to teachers' salaries. (RIO 2002)

In 2004, Poland gained accession to the European Union (EU), which entailed very important obligations for the communal infrastructure. For example, according to directive 91/271/EEC, adopted by Poland and concerning the treatment of communal sewage, such treatment is required for all types of sewage. As a consequence of this decision, during 2004–2015, approximately PLN 30 billion (app. EUR 8 billion) will have to be spent on water and sewage systems. Special EU grants were established to help Poland fulfil these obligations, but still local governments needed their own money to co-finance these grants. This forced important changes in Polish local government revenues. The financial situation of the sub-national government was radically modified in 2003 with the introduction of a new financing system (Act on Local Government Revenues) which came into force in 2004. (Figure 7.3)

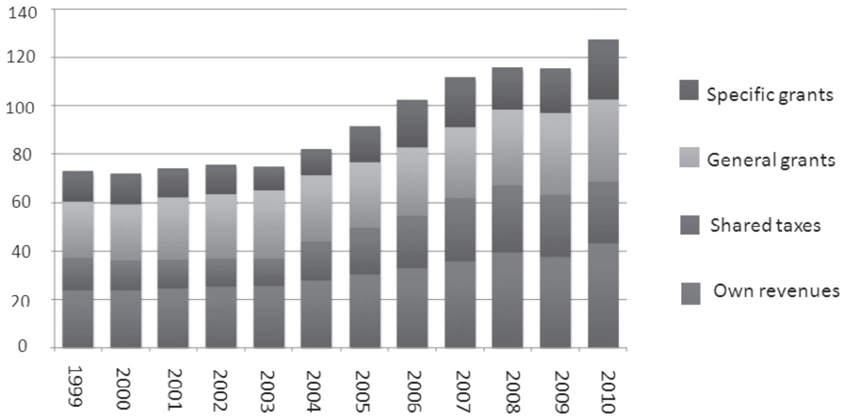
Local revenues may be divided into four major groups:

1. Revenues from own sources – such as local taxes, fees for services, revenues from local government property (selling, leasing).
2. Local government shares in revenues from central taxes (PIT and CIT), which are allocated due to revenues collected from a particular territory.
3. General purpose grants.
4. Specific grants coming mainly from the state budget, but also from special funds (such as environment protection), other local governments and from the EU.

The new Act on Local Government Revenues did not create any new sources of local revenues. In Poland, the only tier collecting own taxes is the municipality (and cities). Local property tax is the most important local tax (covering about 35–40 % of own local revenues). It is calculated based on area and category of the property, and thus revenues from that tax are not influenced by the economic situation. For cities, the important portion of own revenues comes from tax on civil law transactions, which is calculated (amongst others) based on the value of the transaction on the property market. In 2006–2007, revenues from that tax has grown rapidly and amounted to 7 % (in 2006) and 10 % (in 2007) of own revenues of cities, but, as seen in Figure 7.3, a decline in own sources in 2009 was caused by a decline in this tax (which decreased by approximately 25 % compared to 2008, and 40 % compared with 2007 when it was at its highest level). Also, in the first half of 2010, cities' revenues from that tax were about 4 % lower than in the same period of 2009.

Figure 7.3

Amount and structure of local (municipalities+ the 66 largest cities) revenues in 1999–2009 and planned for 2010 (PLN, billion, in prices as of 2009)



Note: 2010 – plan after amendments in June 2010
Source: Own calculation based on Ministry of Finance and GUS (Statistical Office) data

An important change in local revenues, established by law in 2003, was the increase of shares in central taxes. (Table 7.1)

Table 7.1

Local government shares in central taxes

	Personal income tax		Corporate income tax		
	1999–2003	Since 2004	1999–2003	2004–2007	2008–2009
Municipalities	27.6 %	Progressively increasing up to 39.34 %	5 %	6.71 %	6.71 %
Counties	1 %	10.25 %	0 %	1.4 %	1.4 %
Regions	1.5 %	1.6 %	0.5 %	15.9 %	14.0 %

Source: Ministry of Finance

This mostly affected the revenues of the largest cities, but also made their budget (and generally, their local budget) more vulnerable to the macroeconomic situation. That correlation is visible in 2009, when shared taxes decreased by 4% compared to 2008. What is interesting to note is that according to local governments plans for 2010, they expect an important increase in revenues from shared taxes (this can be seen in Figure 7.3), but the data from the first half of 2010 show that cities and municipalities received about 10% less from those taxes than in the first half of 2009. The planned budgets in Poland are usually over-optimistic. Due to budget procedures, it is easier "to cut budgets" during the budgetary year than to increase them. This attitude is illustrated by the fact that in 2009 there were 86,570 changes and amendments to sub-governments' budges (RIO 2010). This problem is outwith the scope of this chapter, but it definitely perturbs proper budget planning, especially in a difficult and unstable economic environment, which is ineffective and potentially dangerous.

The above changes in local revenues improved the economic condition of local governments in Poland. Beginning in 2004, capital spending was growing in some years even faster than operational expenditures, and covered, on average, about 20% of local budgets. (Figure 7.2) An important part of these expenditures is related to the obligations undertaken by the Polish government during the EU accession process. (Table 7.2) The amount of EU grants influenced local government spending. For example, due to the crisis, the EU agreed to prolong the consumption of grants from the 2004–2006 programmes until June 2009. Thanks to this, in 2009, local units had the possibility to use two sources of grants – those from the 2007–2013 programmes and earlier – this can be seen in Table 7.2.

As mentioned, Poland received grants to cover these expenditures, but grants could not exceed 75% of the project value. The "own sources" came from central budget grants, own local government budget and also local debt.

Table 7.2
Estimated share of EU investment programmes in local governments' capital spending (2005–2009)

	2005	2006	2007	2008	2009
Municipalities	18.0%	21.5%	14.8%	7.7%	15.0%
Cities (excluding Warsaw)	22.4%	38.0%	29.5%	19.5%	23.0%

Source: Own calculation based on RIO reports.

7.2 Legal framework of local government borrowing

An important method for regulating the indebtedness of local units is to set limits for the purpose of debt, the amount of indebtedness or method of borrowing. The most important limits for local borrowing are related to the purpose of the debt. In Poland, the Public Finance Law in 1999–2003 defined two types of debt that local government units are authorised to contract (see Levitas and Kopańska 2004). First, there is debt associated with a local budget deficit occurring during a year, which has to be repaid within the current year. Second, there is the debt contracted to cover the budget deficit of a local government unit that has to be specified in that unit's budget.

The laws differentiate between short-term current debt and long-term debt. It should be noted, however, that the aforementioned regulations do not provide limitations for the purpose of long-term debts. Both capital and current expenses are eligible under the existing legal framework. Polish regulation is not in line with the "golden rule" of local government finance. This rule says that borrowing is allowed for capital projects, but prohibited for current purposes (pay-as-you-use finance, in contrary to pay-as-you-go) (Musgrave and Musgrave 1989).

From 2003, a new type of debt was allowed – repayment of old debt. On the one hand, it gives local units the possibility to restructure old debts, but potentially it can also create the problem of accumulating debt.

In Poland, there are two limits for the amount of debt. The Law states that "Total amount of loan/credit instalments to be repaid in a particular budgetary year and potentially payable amounts under any collateral extended by a local government's unit, including interest on credits/loans, and the amount of local government securities with maturity falling in that year, may not exceed 15 % of the planned local government unit's revenues" (Art. 113 of Public Finance Act). Furthermore, total indebtedness as at the end of the budgetary year may not exceed 60 % of revenues in that particular budgetary year.

Since 2003, these limits do not cover debt related to EU grants. This is one of the effects mentioned above – investment commitments on accession to the EU – but also political (and social) pressure to consume "all the EU grants".

These statutory limits fail to be related to the real financial situation of local government units. For more affluent units, exceeding the statutory 60 % or 15 % limits is not a problem, but in others, even a small debt may seriously impair their solvency. The critics of these limits caused modifications, which were published in the new Public Finance Law in 2009. According to that law, the repayment of debt planned in a particular year as a percentage of planned revenues, cannot exceed the 3-year average of sources calculated as below:

$$\left(\frac{R+O}{D}\right)_n \le \frac{1}{3} * \left(\frac{Db_{n-1}+Sm_{n-1}-Wb_{n-1}}{D_{n-1}} + \frac{Db_{n-2}+Sm_{n-2}-Wb_{n-2}}{D_{n-2}} + \frac{Db_{n-3}+Sm_{n-3}-Wb_{n-3}}{D_{n-3}}\right), \quad (1)$$

where

R planned repayment of debt which needs to be paid in year n

O planned rates of debt + local governments' guarantees which need to be paid in year n,

D budgetary revenues,

Db current budgetary revenues,

Sm revenues from selling of local government activities,

Wb current expenditures,

n year for which the equation is calculated,

n–1; n–2; n–3 – year (2; 3 years) before the year for which the equation is calculated,

A discussion on the details of the above calculation of local creditworthiness is outwith the scope of this chapter. It should be stressed that new limits estimate the individual situation of local governments and for weaker local units it could limit their ability to borrow. That is why local units were against these changes in local debt limits and finally it was agreed that that limit would come into force from 2014.

Besides the above mentioned limits regarding the amount of indebtedness, under Polish law there are regulations which tie local debt to central debt. That regulation is intended to be a tool to avoid potential macroeconomic problems of local debt. The total amount of public debt is calculated as the nominal amount of liabilities other than mutual liabilities of public sector entities. The Minister of Finance is responsible for ensuring compliance with this calculated indebtedness level and, in the event that the amount of public debt exceeds 50 % of GDP, so-called prudential and improvement measures are enacted. Until 2009, the mechanism of these measures was that once the 50 % level is exceeded, the planned deficit amount (planned debt) of each local government unit may not be higher than the planned deficit of the State budget for that particular year. This seemed to be too restrictive and unfair to local governments' situations, when local government debt covered (in 2000–2008) about 4 % of the entire public debt. In 2009, a new Public Finance Law resigned from this obligation for local budgets when public debt is between 50 % and 55 % of GDP. But, according to the new law, when public debt is higher than 55 %, then every local unit is allowed to plan a deficit only for projects financed from EU grants. When public debt exceeds 60 %, then no public deficit can be planned.

The second group of limits are limits linked to the method of borrowing. As postulated by the European Charter of Local Self-government (Art. 9) "…local authorities shall have access to the national capital market within the limits of the law". Generally, this means that local units could borrow just like other entities – on commercial terms – contract credits in banks and issue bonds. In Poland all these methods are accessible to local units.

In most countries, specific regulations are related to foreign currency debt. In Poland, the Law says: the zloty-expressed debt value must be known on the day of transaction. Only loans extended by international financial institutions, of which Poland is a member or is a co-operation agreement signatory (e.g. the World Bank, EBRD), as well as by banks and other corporate entities extending loans from credit lines opened by such institutions, are exempt from these restrictions.

At the end of the discussion on local government debt limits in Poland, it is worth adding that according to Polish law, local units cannot go bankrupt. From 1999, according to the Public Finance Law, the state budget may provide a loan to local governments for a recovery programme. Every year there was PLN 30 million in the budget for this goal, but until 2004, in practice, this provision was never used. In 2004, for the first time, several local units received a loan to fulfil their liabilities – so bail-out problems are present in Poland

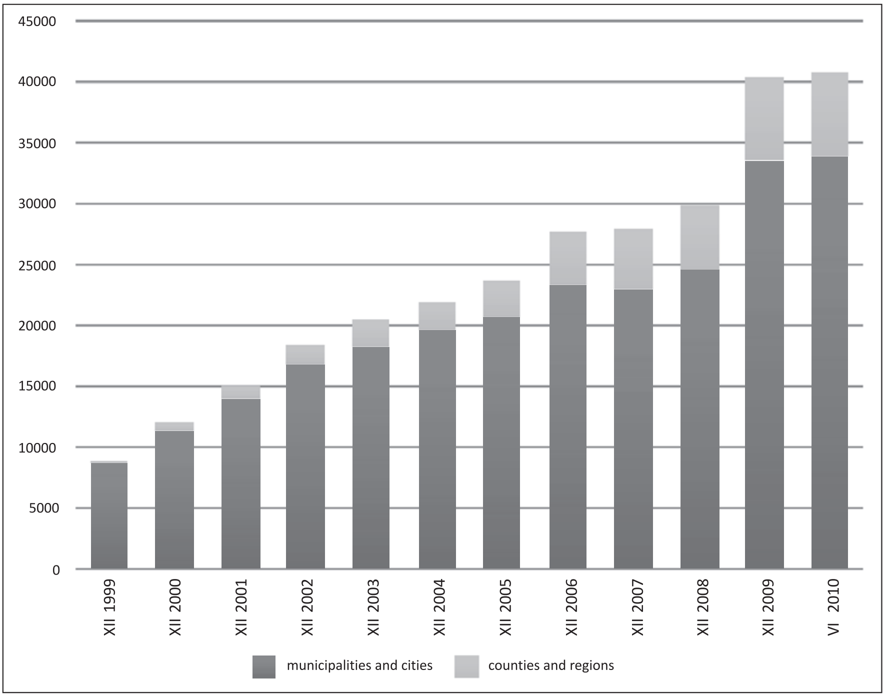
7.3 Local government borrowing in Poland in 1999–mid 2010

In the first half of the 1990s, local governments were very reluctant to borrow money, but later, many municipalities developed their activity on the capital market (see Kopańska 2005). During the years, local debt increased and in 2009 it was 4 times higher than in 1999.

The general level of indebtedness is far removed from the "60 %" debt limits (on average, in 2009, debt to revenues ratio was 26 % in all units, 37 % in cities and 22 % in municipalities). The most important "players" on capital market are the municipalities and cities. (Figure 7.4)

The amount of local debt is increasing, but this growth is not linear. During the years 2000–2002, 2006 and in 2009, growth was stronger, whilst in the years 2003–2005 and 2007–2008 it was weaker. (Table 7.3)

Figure 7.4
Outstanding debt of Poland's local governments (PLN million, prices as of 2009)



Note: data for 2010 are for the first six months only

Source: Own calculation based on Ministry of Finance reports

Non-linearity is also visible, when we analyse the deficit. Figure 7.5 presents a deficit to revenue ratio, and in 2000–2002, it was more than 4 % (in absolute values); in the following periods (2003–2005) this ratio was decreasing and was close to 0 % in 2005, increased in 2006 to 2 %, "back to" the decrease line in 2007, when local budgets had a surplus and increased in 2008–2009 to a very high level (almost 10 % in 2009). The planned deficit for 2010 (according to information about local governments' budgetary plans from June 2010) is even higher and is 18 % for municipalities and 17 % for cities.

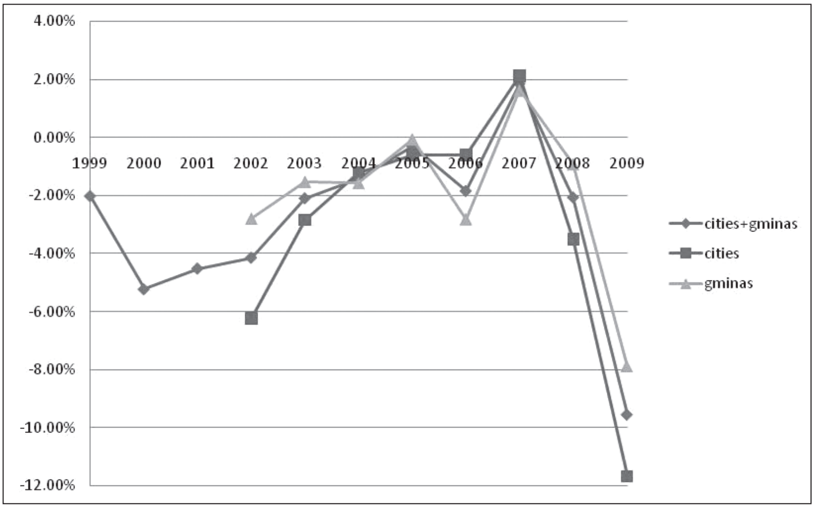
Table 7.3
Changes (year to year) in municipalities' and cities' indebtedness
(1999–June 2010) (in real terms)

	2000 /1999	**2001 /2000**	**2002 /2001***	**2003 /2002**	**2004 /2003**	**2005 /2004**	**2006 /2005***	**2007 /2006**	**2008 /2007**	**2009 /2008**	**6.2010 /2009**
cities + municipalities	20.1 %	15.7%	18.0%	8.1 %	3.4 %	3.9 %	10.8 %	−3.3 %	2.4 %	31.9 %	1.3 %
municipalities				7.8 %	6.5 %	2.5 %	16.5 %	−1.1 %	0.1 %	26.0 %	−0.1 %
cities				8.2 %	1.0 %	5.0 %	6.3 %	−5.1 %	4.5 %	36.9 %	2.4 %

*2002; 2006 – years of local election

Source: Own calculation based on Ministry of Finance reports

Figure 7.5
Deficit-to-revenues ratio in municipalities and cities (1999–2009)



Source: Own calculation based on Ministry of Finance reports

Comparing the above trends with information on local governments' financial situations presented in the first section, it can be seen that during years of prosperity, local units used less debt than in times of crisis, which could be explained by the necessity to fulfil obligations. It was especially visible in 2000–2002, when as was presented, local governments in Poland were in a bad financial situation and received new tasks without the appropriate revenues. The crisis, which began in 2008, also increased local debt and deficit. But, as can be seen from Figure 7.4, the changes were more dramatic than in 2000–2003. Below, we will try to find the answer.

7.4 Local government debt policy in times of crisis

Local revenues declined in 2009, but when we compare year-to-year changes in local revenues, this shift was less important than in 2000 and 2003. On the other hand, in previous crises, lower revenues caused less expenditures, especially capital. On the contrary, in 2009, despite lower revenues, capital spending increased by 14.6 %, and operational spending was higher at 4.6 %. (Table 7.4)

This means that an important element to understand the changes in local indebtedness in 2009 is to explain the increase in expenditures, especially capital. Part of the answer is related to the previously mentioned EU grants' policy. In 2009, local governments received more grants than in previous years. However, the question remains as to why local governments decide to take grants, higher deficits and probably future operational expenditures, even in times of crisis. There are some possible

Table 7.4

Changes (year to year) in municipalities' and cities' revenues and expenditures (1999–2009) (in real terms)

	2000 /1999	**2001 /2000**	**2002 /2001***	**2003 /2002**	**2004 /2003**	**2005 /2004**	**2006 /2005***	**2007 /2006**	**2008 /2007**	**2009 /2008**
Revenues	–1.08%	2.53%	2.34%	–0.95%	9.71%	11.56%	11.83%	9.31%	3.25%	–0.32%
Expenditures	2.01%	1.84%	1.96%	–2.89%	8.98%	10.34%	13.55%	5.35%	7.37%	6.90%
Capital expenditures	–4.22%	–5.21%	–3.92%	–11.87%	17.81%	14.49%	32.33%	7.10%	12.66%	14.60%
Operational expenditures	3.50%	3.41%	3.15%	–1.06%	6.86%	8.68%	8.77%	4.68%	5.67%	4.57%

Note: *2002 and 2006 – years of election

Source: Own calculation based on statistical data answers. The necessity to fulfil EU obligations related to communal infrastructure is obvious. If a municipality does not improve its water and sewage systems or waste treatment it would have to pay penalties. However, that mechanism does not work for sport or transport facilities (which were both co-financed by EU grants and special grants from the central budget – so-called "development grants").

The answer might be found in the local finance theory which suggests that grants destroy "optimal" budget choices. The so-called fly-paper effect presents higher income elasticity for grants than for own local government revenues – this means that in the presence of grants, there is "overspending" for granted projects compared to the same amount of own revenues (for example Fisher 1996). There are no studies about that effect in Poland, but public discussion about EU grants and the necessity to consume all of them is very strong. In newspapers and also in official documents, the most important question about EU grants is "did we use all that was available?" or "which local unit is more effective in the absorption of EU grants (consumed more)?" Central government and media pressure pushed local officials to new EU projects, even in times of crisis.

The projects from EU grants only partly explain the level of higher capital spending, public debt and deficit in 2009. Below, it can be seen that the increase in debt was related mostly to EU projects, but not only. (Table 7.5)

Table 7.5
Changes (year to year) in municipalities' and cities' new debt issuance (1999–2009)

	2006/2005	2007/2005	2008/2007	2009/2008
Municipalities				
new debt issuance related to EU projects	90.0%	–67.5%	–49.4%	83.8%
new debt issuance – other than relating to EU projects	13.8%	4.9%	18.0%	67.4%
Cities				
new debt issuance related to EU projects	247.1%	–24.6%	–63.6%	113.8%
new debt issuance – other than relating to EU projects	–33.2%	5.2%	76.3%	110.3%

Source: Own calculation based on Ministry of Finance data

A further local finance theory, which could be used to answer the question about higher capital spending (from EU grants, but not only) and also the higher deficit in 2009 is the idea of a political or electoral business cycle. That theory suggests that public authorities spend more on items visible to voters (and increase deficit and indebtedness) in the pre-election period and generally spend less after an election. (Nordhaus 1975; Rogoff 1987; analysis for the local level, was presented, for example, by Veiga and Veiga 2004; Pettersson 2003). The panel data study made in 2010 for Polish municipalities, proved that in election years, capital spending and deficits were higher than in others. (Rogala 2010)

It is difficult to observe this cycle with the general data presented in this chapter, especially when we take into account the changes in the economic situation and legal framework, but we still find some aspects of this trend. In Poland, local elections were held in 2002, 2006 and will be held in 2010. It can be seen that in the years after election (2003, 2007) the dynamics of capital spending and also the level of deficit were lower than in previous years. In election year 2002, capital spending was lower than in the previous year, and also, the deficit counted for municipalities and cities together was smaller compared to the previous year (which is contrary to the election cycle idea), but in 2006 it was higher. 2009 – the year before the election – is a good time to start investments, and the important shift in the level of planned investments for 2010 (visible in Figure 7.2) also suggest "election cycle" behaviour.

The other part of the answer to the question about important changes in local debt could be legal debt limits.

Table 7.6

Public debt to GDP according to "Public debt strategies" and real level of public debt in Poland in the years 2008–2009

	2008	2009	2010	2011	2012
2009–2011					
Public	44.2%	43.7%	42.9%	41.9%	
Central	42.3%	42.0%	41.1%	40.1%	
2010–2012					
Public		49.8%	54.7%	54.5%	54.8%
Central		47.2%	51.9%	51.9%	52.3%
2011–2013					
Public			53.2%	54.2%	54.3%
Central			50.0%	51.0%	51.4%
Real level					
Public	46.9%	49.9%			
Central	44.7%	47.0%			

Source: Public debt strategy for the years 2009–2011; 2010–2012; 2011–2013; Ministry of Finance

A potential problem for new borrowing by local units in the near future could be the level of public debt. As was mentioned, from 2009, the law states that when public debt reaches 55 % of GDP, then local governments can only plan a deficit for EU projects. The crisis, which cut public revenues and the dynamics of GDP, made that scenario more realistic. In the Ministry of Finance's "Public debt strategies" prior to the crisis (for 2009–2011 – published in September 2008) the level of public debt for 2009 was only 43.7 %. In reality, it was 49.9 %. In the latest strategy document, the level of public debt planned for 2011 is 54.2 % of GDP – ten points more than expected two years earlier. It is very close to the legal limit – 55 % of GDP. It is a "self-fulfilling prophecy" – local governments, to avoid future problems with new credits other than for EU projects, today take on more debt and thus they increase public debt closer to 55 % of GDP.

Finally, we can suspect that new limits for local debt, (published in 2009 and to come into force in 2014), which correlated the possibility of local debt with the real financial situation of local government units – pushed some local governments to more important debt issuance in 2009 and 2010. As was mentioned, the weaker units, according to the new limits, will need to resign from any new debt (and investments). Also, richer units could have problems, because new limits are calculated on historical data – this means that even after the crisis, the bad financial situation from previous years would influence the "legal creditworthiness". Calculations made by RIO (Regional Chamber Office) show that if the new limit is active in 2010 – for 82 % of counties, 25 % of cities and 37 % of municipalities – the amount of possible new debt is lower than according to the "old" rules. For several local governments, this is even more dramatic – 16 municipalities and 23 counties – according to the new limit – had no possibility to issue any new debt. (RIO 2010) Those local governments could decide to take on more debts under the "old" rules.

7.5 Conclusions

In 2009, Poland was the only country in Europe where GDP increased (1.7 %). However, this does not mean that the world economic crisis is not present here. In the public sector, the crisis cut tax revenues and imposed public deficit and debt. The most important changes are visible at the local level. In 2008, local debt was 4.7 % of total public debt and at the end of 2009, 5.9 %.

The aim of this chapter was to analyse local government debt policy during the period 1999–2009 and the first half of 2010 with special focus on the first years of the crisis. To understand local government debt policy in 2009 and 2010, we had to look back to previous years. In 2000–2003, at the time of the previous crisis, deficit and debt also increased. But, as was presented in the chapter, in 2009 local debt grew more drastically. Contrary to the former crisis, in 2009, local units did not cut capital expenditures. The important reason, analysed in this chapter was EU grants. Not only the EU, but also Polish government policy, pushed local governments to use more grants and realise larger investment programmes in 2009.

Although new debt, issued due to EU grants, grew more than others, it was not the only component of the entire new debt. Local governments in 2009 carried out more investments, not only for EU projects. The political business cycle could be another explanation. The analysis of local government spending and debt policy in 2003–2009 suggests that local politicians spent more on items visible to voters – investment projects (and increased deficit and indebtedness) in the pre-election period (2005, 2006 and 2009) and generally spent less after the election (2003, 2007).

In this chapter, other factors that influenced local government debt policy in 2009 were presented. The level of public debt, planned for 2010–2012 by the Ministry of Finance is very close to 55 %. According to Polish law, when that level is greater than 55 %, then local governments could plan a deficit, only when related to EU projects. It is a "self-fulfilling prophecy" – in order to avoid future problems, local governments borrow more new credits other than for EU projects and the result is higher public debt – close to 55 % of GDP. Finally, the new calculation of every local government's "legal creditworthiness", which is more preventive, pushed some local governors to take on more debt under the "old", less protective rules.

For years, local governments were more conservative in their debt policy than central government. Due to many actions taken by central government, the situation is changing today. Local authorities are forced to finance large investment needs arising from EU accession protocols. This is strengthened by the election cycle behaviour of local governors, but unfortunately, no serious discussion is being held regarding the future costs of such borrowing actions. At the moment, there is no clear vision of how such debt will be managed and how the investments will influence the future operating costs for local societies.

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8. Local Government Finance in Times of Crisis: The Case of Albania

Doriana Matraku (Dervishi) and Aida Gjika

The financial crisis has been, and still is, the main concern of every economy since 2007 (Bank of Albania 2010). However, in relation to the real economy, this problem has been deformed in many ways, as are the channels for transforming the world financial crisis into the real economy. The economic crisis impacts both the micro and macro levels to varying degrees in different countries (EuroStat 2010). In Albania, we are currently facing the problems of the impacts of the financial (economic) crisis and fiscal decentralisation. Both of these influence households and companies etc. Fiscal decentralisation means devolution of power and responsibilities from the national (central) government towards sub-national (local) governments (Oates 1972). This decentralisation policy has been introduced to offset the problems caused by dissatisfaction with the present centralised system of governance (see Dabla-Norris 2006).

This chapter deals with the effects of the financial crisis on local government in Albania. We focus on the years 2007–2009; however, in some cases, the review is extended to more than these three years for the purpose of development over time to find out if, as a variable, the trend of increasing or decreasing is a normal path or a result of the economic crisis.

In this chapter, the focus will be on the appraisal of the macro indicators of decentralisation in the framework of the economic crisis. Another aspect is the micro level of fiscal decentralisation, which we discuss, based on the index of perception and the quality of life from the point of view of individuals. So, to sum up, this chapter attempts to analyse and spot the problems of fiscal decentralisation in Albania in times of crisis. The focus is to differentiate between the problems arising from the financial crisis and those that are caused by the process of fiscal decentralisation.

The first part of this chapter deals with the financial and economic crisis in Albania and its impact on public budgets. The second part introduces the institutional framework of local government in Albania and discusses local governments' functions and revenues. The final two parts deal with the impact of the economic crisis on local governments – the first sub-section deals with the macro aspects, and the second deals with the micro aspects.

8.1 Presence of the economic crisis

Albania is one of the few countries which did not undergo the same financial crisis as other countries. Crucial for Albania was the transformation of the world financial crisis into an economic one due to the channels of transmission (see Bank of Albania 2010). It is obvious that a more stabilised financial and economic system can be more controlled and immune to the effects of the crisis in the real economy. According to the Bank of Albania (2010, 13), “The banking sector’s assets grew to ALL 886.3 billion, posting an annual nominal growth of 6.3 per cent or a real growth of 1.2 per cent relative to year-end 2008. The performance of the financial system’s financial resources, revenue and capital was affected by the international financial crisis and its impact on Albania’s real economy.”

The main effects of the financial crisis translated into the real economy are those of unemployment, the decrease in the demand, decrease in inflation, poverty and lower economic growth etc. (Dervishi-Matraku 2009). In 2009, we saw a decrease in economic growth. (Table 8.1) However, the recent quarterly data show that economic activity increased by 3.3 per cent compared to the second quarter of 2009, while it increased by 2.4 per cent compared with the first quarter of 2010.

Table 8.1
Main macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Annual real GDP growth, at constant prices versus 2008, in %	7.94	4.23	5.77	5.71	5.72	5.40	6.00	7.80*	3.30*
GDP per capita, in USD	1,323	1,437	1,831	2,336	2,597	2,854	3,394	4,073*	3,765
Unemployment rate	14.6	15.8	15	14.6	14.2	13.8	13.4	12.6	12.8**
Inflation rate (y-o-y)	3.5	1.7	3.3	2.2	2	2.5	2.9	3.4	3.5
External debt (in % of GDP)	25.8	23.5	20.6	18.0	17.5	17.2	14.4	18.3	23.1*
ALL/EUR average exchange rate	128.5	132.4	137.5	127.7	124.2	123.1	123.6	122.8	132.1

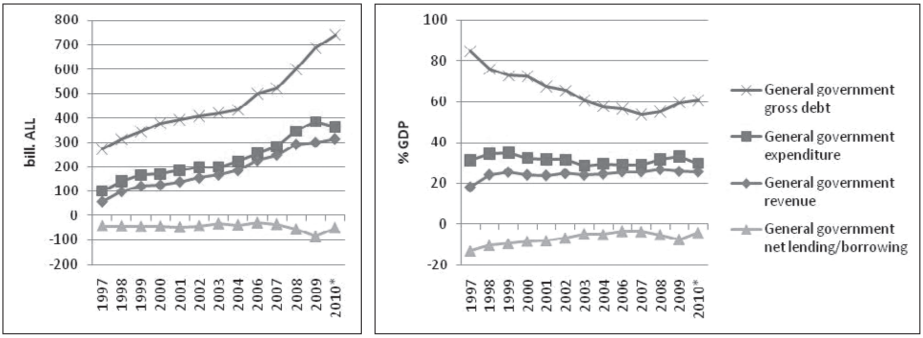
Note: * Preliminary estimates, ** As of the end of the third quarter.

Source: Bank of Albania (2010, 30).

The impact of the economic decline on public finances was quite modest. Both general government revenues and expenditures grew in nominal terms between 2008 and 2009 by 2.7 % and 11.0 % respectively. Whilst for revenues, growth is also expected for 2010, expenditures are expected to fall. Figures for the first nine months show an increase in revenues of 7.1 % and a decline in expenditures of 3.3 %, compared to the same period in 2009. The share of both general government revenues and expenditure in GDP is expected to decline between 2009 and 2010.

Despite high economic growth in the last decade, public budgets operate permanently in deficit. This is also the main reason for the steady growth of public debt in nominal terms. The ratio of public debt to GDP fell between 1997 and 2007 by 30 percentage points; however, since 2007 it has been growing.

Figure 8.1
Budget indicators



Note:* Estimates

Source: IMF 2010

Next to the evaluation of the impact of the economic crisis on general government, it is also important to evaluate the effects on sub-national budgets (see Sections 8.3 and 8.4).

8.2 The structure of local government

8.2.1 Institutional framework

First of all, it is useful to present the structure and the way local government works. In Albania, there are two tiers of local governments: 12 regions and 373 local government units. From these units, 65 are municipalities and 308 are communes in local areas.

Institutionally and legally, Albania has made immense progress. It signed the European Charter of Local Self-Government and approved laws in promoting local autonomy. It is important to emphasise that Albania has, since 2007, a Multi-Year Strategy for Local government units (Brahimi 2008).

The main deficiency at the moment is the unclear or lack of a well-defined position of the Council of Region (Brahimi 2008). These councils are not elected by the citizens in a democratic manner.

The legal framework should be seen in the context of giving local government the tools to postpone and maintain manoeuvres to minimise risks. These risks arise, not only from the fiscal pressures caused by the financial and economic crisis, but also from the political cycle (Gjika 2009).

8.2.2 Function and revenues of local governments

Also, in these contexts, it is useful to emphasise the function of local government, as it is one of the indicators that will be directly affected in times of crisis. According to Malaj (2009) the power of one local government is in the use of its functions and in the volume of what it does. In the presence of the economic crisis, the amount of money used for such functions will be reduced and therefore, even the effectiveness of such functions will be reduced. But for sure, these are connected directly to the kind of functions it takes into consideration and their importance. The Law on the Organisation and Functions of Local Government defines three types of functions for local government units (LGUs):

- Exclusive/Own functions: Local governments exercise full administrative service, investment and regulatory authority over these functions. These are basic public services (street lighting, green areas, street cleaning, garbage collection, cemeteries, etc.), road maintenance, maintenance of school buildings, primary health facilities, kindergarten, urban public transport, water supply, sewerage and urban planning. The latter three are not yet fully decentralised.
- Shared/Joint function: Local governments have a share of responsibility, clearly distinguishable from the share of responsibility granted to central government. It is exercised autonomously. Among the shared functions are: primary and secondary education and primary healthcare and social care; however, the decentralisation reform in these areas is not yet complete.
- Delegated functions are delegated by law or by a contractual agreement from central to local government. The manner and degree of performance is determined by the central government.

According to the Law on Local Government Organisation and Functions, local governments have rights of: governance, property, fiscal autonomy, economic development, rights as a juridical person, and others.

The Law on the Organisation and Operation of the Local Government (Law No. 8652, dated 2000) stipulates local government revenues. They are:

- Taxes, tariffs and other local revenues;
- Funds transferred from central government;

- Funds from the direct sharing of separate taxes and tariffs;
- Loans from the banking and financial market;
- Revenues from business activities, the sale and lease of properties, endowments, interests, fines, aids and donations.

The LGUs decide, at their own the level, the method of local tax collection and administration, in compliance with national general policies and principles.

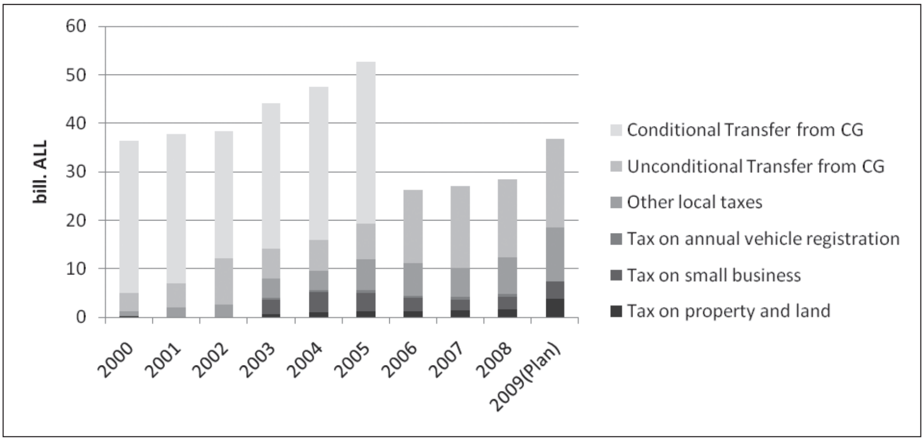
Further, the main local taxes in Albania according to LGPA (2009a) are:
- Small business tax
- Property tax
- Local taxes, which include:
  - Hotel tax
  - Tax on new buildings' impact on infrastructure
  - Taxes on the ownership title transfer on real estate
  - Tax on annual vehicle registration
  - Tax on the use of public spaces
  - Tax on posters and advertisements
  - Temporary taxes

Regarding these taxes, the Law on the Local Tax System provides their indicative level, while the local units are entitled to impose a tax under or above this level, within a defined interval, above the basic tax rate (in the case of the small business tax, property tax, etc.). For other temporary taxes, the local units are free to decide the type, tax base, and tax rate. At the moment, the largest source of local tax revenue is the small business tax. The second most important is the property tax (LGPAa 2009).

Tax revenues are not sufficient for the performance of the assigned tasks and are therefore accompanied by transfers from central government. (Figure 8.2) In 2009, own revenues were expected to form only about half of total municipal revenues.

The budget revenues of local government units have increased considerably, due to financial decentralisation. Until 2005, the conditional transfer for salaries in the education system passed through local government budgets and since then, this has been performed by the Education District Directorates, i.e. central government agencies. The total amount of the unconditional transfer is determined by the annual budget process and the distribution of that amount amongst individual local governments is based on a formula. The idea of this formula is to provide equity, according to some major indicators that distinguish the local units from each other. A very positive step in Albania is that it now takes into account the fiscal capacity of each municipality. The transfer is unconditional, i.e. without being asked and conditions posed for the use of this money. The current system has been in place since 2002 and is gradually evolving (see Schroeder 2007). However, despite small year-to-year differences it "is still not predictable and not entirely transparent" (see Ministry of Finance 2010, 48).

Figure 8.2
Municipal revenues



Source: LGPA (2009a, 2, 6)

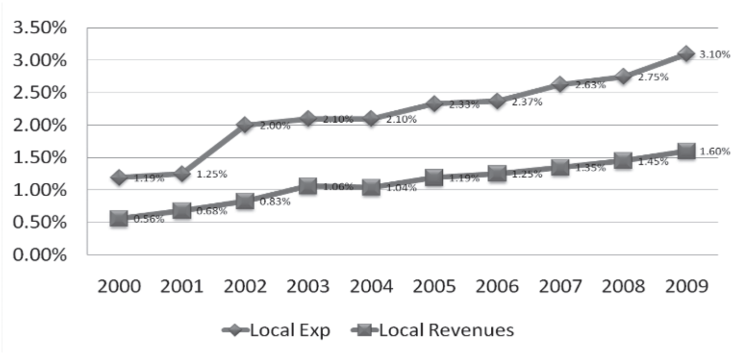
8.3 Evaluating fiscal decentralisation in the context of the economic crisis (Macro level)

8.3.1 Evaluation of fiscal decentralisation in terms of local expenditure and revenue

Local expenditures and revenues are the main indicators in the evaluation of fiscal decentralisation. The impact of the economic crisis differs across countries with different degrees of decentralisation. The more decentralised a country is, the more the effect of the economic crisis has to be dealt with at the local level. However, despite the gradual process of fiscal decentralisation in Albania, the country still belongs to the category of highly centralised countries.

Figure 8.3 shows the share of local government revenues and expenditures in GDP since 2000. While both indicators almost tripled during the decade, the share still remains quite low. The same holds for local governments' revenues compared to the total central government budget, which now amounts to about 5.5 %.

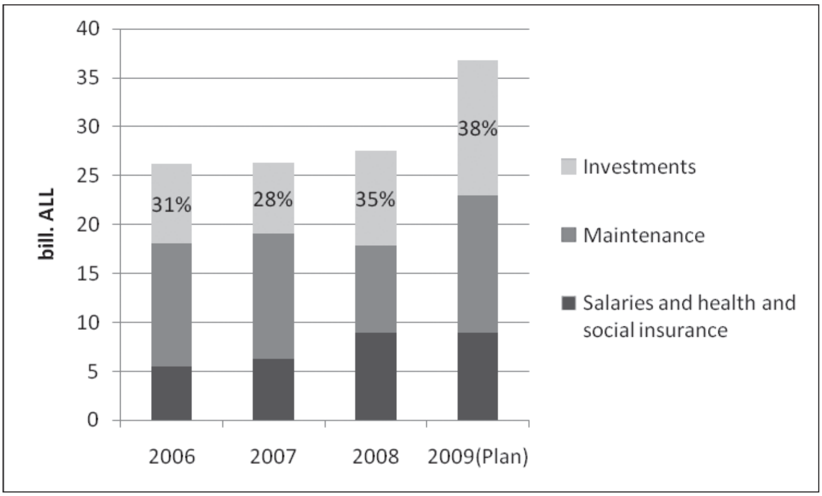
Figure 8.3
Own local government revenues and expenditures (% of GDP)



Source: Ministry of Finance (2010)

The main problem according to Gjika (2009) for local government with special reference to revenues is the total amount of tax revenues. Even the shift of tax to local government has not, so far, improved the amount of tax revenue. Also, if we look at Figure 8.3, we can see the difference between own local revenues and expenditure.

Figure 8.4
Municipal expenditures (ALL, billion)



Source: LGPA (2009a, 2)

Despite the fact that local expenditures as a percentage of GDP are in a positive trend, it is questionable if this can be judged as increasing local governments' autonomy due to the structure of the expenditures (or assigned functions) presented in section 8.2.2. This is because a significant part of municipal expenditures is spent on wages, as is shown in Figure 8.4, and this share has increased further in recent years.

When we talk about expenditure autonomy we should ask if a local unit has the right to spend money according to local needs and priorities. Due to the high share of wages, the remaining part of the money is not sufficient, as local expenditures cannot exceed the transfer from central government.

8.3.2 Evaluation of the impact of the economic crisis

The economic crisis has influenced both sides of municipal budgets. Table 8.2 shows a comparison of budgeted and actual data for 2008 and 2009 and for the first nine months of 2010. The data clearly show the main features of local government finance in times of economic crisis.

1) The assumptions on which local government budgets are based are far too optimistic; even in the pre-crisis year 2008, when the economy grew by more than 7 %, only 86.4 % of budgeted revenues were actually realised. The estimations for 2009 expected a growth in revenues of 40 % (!) compared to the 2008 budget. This was over-optimistic and the realisation of revenues in 2009 was only 66 %. While the estimations of consolidated government revenues were revised during 2009, i.e. lowered by 4.5 %, the estimates of local government revenues remained unchanged. This uncertainty complicates local government financial management.
2) Despite the economic slowdown in 2009, local government revenues grew in nominal terms by more than 7 %, thanks especially to local taxes. The revenues from property tax and small business tax fell by five and four per cent, respectively.
3) The data for the first nine months of 2010 suggest that the situation is the same as in 2009. Only 66 % of the estimated revenues are actually realised, even though the collection grows (by 7.5 % compared to the same period of the previous year).
4) The realisation of expenditures is also lower than expected in all three years analysed; however, as the actual revenues are far behind expectations, this needs to be evaluated as a very positive situation. We can observe a nominal decline of local government expenditures of 10 % in the first nine months of 2010. This suggests that local governments were able to react to the economic crisis, which manifested itself through lower than expected revenues, with a delay.

Table 8.2

Local government revenues and expenditures (2008–2010)

	2008			2009				2010			
	Budget	Actual	Actual/budget	Budget	Actual	Actual/budget	Actual 2009/2008	Budget	Forecast 9 m.	Actual 9 m.	Actual /forecast 9 m.
Local government revenues	13,082	11,307	86.4%	18,412	12,149	66.0%	107.4%	20,948	15,479	10,208	65.9%
Other Local Taxes	7,987	7,137	89.4%	11,114	8,454	76.1%	118.5%	12,452	10,350	6,446	62.3%
Property Tax	2,136	1,586	74.3%	3,734	1,509	40.4%	95.1%	4,383	1,895	1,491	78.7%
Small Business Tax	2,959	2,584	87.3%	3,564	2,486	69.8%	96.2%	4,113	3,234	2,271	70.2%
Local budget expenditures	29,146	27,079	92.9%	36,835	33,582	91.2%	124.0%	38,223	30,395	21,477	70.7%

Source: Ministry of Finance

Since 2007, the small business tax has been collected directly by the local government units. The intention of this change was to increase the autonomy of local governments and to increase efforts to collect this tax. Of course, problems resulted from the insufficient preparation of local governments for this task; however, an increase in revenues between 2007 and 2008 led to optimistic expectations for the future. An increase of 40 % was expected between 2008 and 2010, but it is lagging behind. Of course, it is impossible to distinguish which factors are due to the economic crisis and which are due to good or bad administration.

8.3.3 Evaluation of local borrowing

Albania has now had a Law on Borrowing for Local Governments (Law nr.9869 dated 4 February 2008) for more than two years. The intention of this law was to provide *de jure* and *de facto* financial autonomy for local governments. This law allows borrowing for cash flow and investment purposes, from the capital market (financial institutions and banks), and on the domestic and international markets. The loan maturity can be both short and long (more than one year).

The request for a short-term loan should first be sent to the Ministry of Finance. If the request is denied, the mayor may borrow directly from banks. The long-term debt is negotiated by the mayor but the final decision is made by the local council.

Short-term debt shall not, at any one time, exceed 10 per cent of total actual own revenues. The amount of debt service due in any year on all long-term debt shall not exceed 20 per cent of unconditional revenues (including own source revenue, shared taxes, and unconditional grants) in the previous three fiscal years and seventy-one per cent of operational surplus (surplus 1.4 times > debt service). Debt stock should not be higher than 130 per cent of unconditional revenues.

The first pioneer to use borrowing was the municipality of Fushë Kruja in June 2009. The purpose of the loan was to finance one segment of the northern ring road of Fushe Kruja city. The total amount borrowed was ALL 100 million; the maturity is 8 years and the interest rate is 6 months' treasury bills plus 3.08 % (USAID 2009).

No other cases of local government borrowing are reported so far. Therefore there is a lot to be done in this area. Local governments need to change the attitude to borrowing and there needs to be some technical assistance provided. Also, an oversight system needs to be set up.

8.4 Evaluating fiscal decentralisation in the context of the economic crisis (micro level)

This section is based on citizens' surveys carried out in the framework of the USAID Local Governance Programme in Albania (LGPA 2008 and 2009b). Table 8.3

shows the results of two indicators: quality of life and Public Services Residents' Satisfaction Index.

Most citizens evaluate the quality of life in their municipality as good or very good and there are very small differences between the various years and the two groups of municipalities. However, the increase of the indicator between 2008 and 2009 suggests that citizens did not observe any deterioration of the situation due to the economic crisis. The question is whether or not its impact will appear later.

The Public Services Residents' Satisfaction Index allows a complex evaluation of respondents' perceptions of the services of (i) maintenance of roads within municipality boundaries, (ii) drinking water supply, (iii) sewerage service, (iv) street lighting, (v) garbage collection and (vi) maintenance of pre-university buildings. The index ranges from 0 which means "Very dissatisfied" to 100 which means "Very satisfied".

The residents in eight out of ten target municipalities are, on average, more satisfied than dissatisfied with the services provided by their municipality. On average, residents in target municipalities are more satisfied with the quality of services than residents in control municipalities. Compared to 2008, there are no major shifts in the Public Services Residents' Satisfaction Index in most of the target municipalities. Thus, this measure does not suggest deterioration of the situation due to the economic crisis.

Table 8.3
Citizens' satisfaction

Quality of life in the city is "very good" or "good" (% of responses)						Public Services Residents' Satisfaction Index			
2005	2007	2008		2009		2008	2008	2009	2009
		CM	TM	CM	TM	CM	TM	CM	TM
68.3	72.0	64.1	70.1	68.7	75.5	52.2	54.2	57.7	52.2

Note: TM = 10 municipalities which are recipients of technical assistance from LGPA, CM = ten randomly selected cities that are not part of the LGPA programme

Source: LGPA (2008, 6, 2009b, 10, 18)

8.5 Conclusions

There is no unique evaluation of the problems of the financial and economic crisis with reference to fiscal decentralisation. We are not able to separate the reasons for the existing problems, i.e. what was caused by the economic crisis or downturn and what the reason is for the inefficiency of the fiscal decentralisation process.

Although Albania did not face any economic decline in 2009, the slowdown of the economy caused lower than expected growth of revenues of all government levels. Thus, local governments did not suffer any real decrease in revenues; however, due to the current revenue forecasting practice, they had to deal with lower than expected revenues. Whilst local government expenditures grew between 2008 and 2009, the data for the first nine months of 2010 show a modest decline. This suggests that there will be some lag in the impact of the economic crisis on local governments.

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9. Local Government Tools in Coping with the Crisis: The Case of Croatia

Saša Drezgić

The issue of the effects of economic crises on the local public sector presents one of the most important topics in the field of fiscal federalism at present. This is not surprising since the crisis is still an ongoing phenomenon and local governments worldwide are engaged in creating novel approaches to reduce the harmful impacts. Numerous questions arise. To what extent can local government provide support to citizens and local businesses? What are the repercussions of the crisis on the local budget? How can revenues be increased? Hard choices of cutting local government spending are also included. As in other countries, Croatia faces similar choices.

The main goal and purpose of this chapter is to determine the effects of the crisis on local government revenues and expenditures. It is still too early to trace these effects; however, some conclusions can be drawn, both from official statistics and data offered by local governments' statistics and from interviews with local government representatives. This chapter analytically examines these available resources in order to provide some potentially useful lessons for policy recommendations.

The first part of the chapter focuses on the position of the local government sector in terms of potential for conducting a counter-cyclical fiscal policy. However, it can be seen that such a policy is present in mainly developed decentralised economies. The second part deals with the position of local governments within the system of inter-governmental relations in Croatia. This position defines the potential for local governments to carry out proactive measures in mitigating the effects of economic crises. The end of this part enumerates the activities conducted across local governments in Croatia, based on interviews with local government officials and official documents of local governments. The conclusion contains a short summary of the research.

9.1 Fiscal policy and local governments in times of crisis

The usual framework of public finances considers the decentralisation process in terms of the allocation function. However, contemporary research devotes more and more attention to the issues of fiscal federalism and macroeconomic stability (see Shah 2008). The common notion that local governments do not have a role to play in the stabilisation policy is abandoned. This is particularly the case in the recent economic crisis, where local governments in many countries are no longer passive observers but, on the contrary, take proactive measures (see Clark 2009). Local government employment is, in itself, a stabiliser of the economic cycle. In times of crisis it is not easy to lay off government employees and some studies show that while employment in the private sector decreases sharply, employment in the state/local government even increases (see Boyd 2009).

However, such counter-cyclical activities are not a common feature of all countries. They usually occur in developed economies. Less developed economies, both at the central and regional/local level, engage in pro-cyclical behaviour. Pro-cyclical fiscal policy and its impact on macro-stabilisation and economic growth have been extensively studied. On the other hand, the effects of the imbalance between levels of government are much less studied. It is assumed that because there is a vertical imbalance in the federal system, local authorities have incentives to increase spending above the socially optimal level and have high deficits. This situation is definitely confirmed by the cases of Argentina and Brazil (see Struzennegger and Werneck 2008).

In federal countries, the regional and the local sector share responsibility for conducting fiscal policy and thus mitigate economic shocks. The allocation of responsibility focuses on the distribution of stable and cyclically less sensitive revenue sources and expenditure responsibilities for local authorities. This becomes a bit difficult for regions in the case where they have some responsibility that is cyclically sensitive, such as social assistance (see Shah 2008). In addition, it is still not clear whether the fiscal risks are greater in decentralised systems or not.

Both Keynesian and neoliberal theories agree on the fact that during recession, authorities need to use deficit financing and lower taxes, and during expansion, have budgetary surpluses and raise taxes. These same recommendations stem from different causes. Neoliberals argue that such an approach raises allocative efficiency, and Keynesians point out the positive effects of the short-term stabilisation of aggregate demand management policies (see Struzennegger and Werneck 2008).

Local governments in developed countries were strongly pressured towards fiscal consolidation efforts by imposing "hard" budget constraints and, at the same time, to additional efforts to increase the efficiency of their activities. It is believed that long-term fiscal sustainability is possible only in this way through the introduction of strict fiscal rules. More importantly, such efforts should reduce the negative effects of fiscal shocks (see Sutherland, Price and Joumard 2006). However, the fact is that pressures to reduce the expenditures of the local sector come more as a consequence of increased spending by the central government and extra-budgetary funds. This situation can also be attributed to Croatia, where social transfers, in fact, represent the largest category of expenditures, whilst the revenue of the local sector largely stagnated relative to GDP growth.

Regarding the effects of the economic crisis on local governments, there are several important issues that define the scope and extent of these effects and possible outcomes of local government responses for mitigating the crisis:

- fiscal rules that bind the autonomy of local government spending,

- level of local tax autonomy and structure of local government revenues, and
- institutional factor – fiscal transparency.

Fiscal rules should prevent the unsustainable growth of debt and spending at the local level. The most commonly used fiscal policy is a policy of balanced budgets. Apart from that, the usual tools are restrictions on borrowing and limits on tax rates. However, the general problem is that fiscal rules essentially do not succeed in restraining local spending. Local government spending is a result of numerous factors and politically sensitive programmes that are difficult to connect with the objectives of budgetary spending limits (see Sutherland, Price and Joumard 2006). This problem is even intensified in cases where there is insufficient awareness of the need for long-term planning of revenues and expenditures and programme spending.

Nevertheless, studies show that the rule of balanced budgets and borrowing constraints leads to long-term sustainability of local fiscal policy[1]. Local governments, under these rules, experience faster adjustment of fiscal shocks, especially by reducing expenditure. There are five criteria necessary for setting up the appropriate fiscal rules (see Sutherland, Price and Joumard 2006):

1. long-term fiscal sustainability,
2. short-term economic stability,
3. aggregate efficiency – in the sense of equalising marginal benefits from public spending to the damages caused by taxation,
4. allocative efficiency of public spending, which is manifested in matching the quantity and quality of public services with local preferences, and
5. possibility to maintain the redistributive elements within the system, should not come into question – the minimum standards should remain the same.

The level of tax autonomy is one of the crucial issues when analysing the possible effects of the economic crisis on local governments. Higher tax autonomy will place more power in the hands of local government in combating the effects of a crisis. This is especially the case in federal countries with a high level of fiscal transparency and high level of tax competition. In both cases, local governments will try to keep the taxes low. Also, the distribution of tax revenues, which exposes the local communities which are vulnerable to cyclical fluctuations, will reduce the tendency to conducting pro-cyclical fiscal policy (see Sutherland, Price and Joumard 2006). In any case, regardless of the method used to curb excessive spending and taxes at the local level, fiscal transparency helps the sustainability of the budgets of local governments.

1 However, the majority of research is related to the USA economy.

Many countries have developed procedures to ensure a budget balance in a range of consultations with central authorities in case of the realisation of a deficit or making consolidation plans. There are also more strict measures, such as drafting of a new budget. However, in the event of a crisis, rigid rules constitute an aggravating circumstance for counter-cyclical actions of local governments. In the majority of countries there are no measures envisaged in the case of a fiscal crisis caused by an economic shock. However, there are some exceptions. (Table 9.1)

Table 9.1

Coping with the cycle

Sub-central governments						
	Can draw on		Can cut man-dated expendi-tures	Revenues are adjusted to		Receive special financial support
	Rainy day or reserve funds	Off-budget funds		Projected cyclical fluctua-tions	Actual shocks	
Canada state	+	+		+		
Canada local	+					
Czech Republic		+				
Denmark				+		
Finland	+	+	+		+	+
France						+
Germany state			+			
Germany local					+	
Japan	+					
The Netherlands	+					

Source: Sutherland, Price, and Joumard 2006, 28, adapted by the author

An additional problem for less developed economies is that their local governments are prone to conducting pro-cyclical fiscal policy. A string of contemporary literature tries to provide an answer as to why that happens. There are several potential explanations. In addition to the argument of severe credit constraints in less developed economies during a crisis, some authors claim that the main reason for that is the so-called "voracity effect" proposed by Tornell and Lane (1999). They argue that during a boom period, some groups try to appropriate the surplus resources. The competition between groups is fiercer, the larger the amount of available resources. Because of that, the common pool problem is more intensified during expansion (see Struzennegger and Werneck 2008).

The more decentralised a country is, the harder it is to maintain counter-cyclical fiscal policy, particularly in the case where local authorities have a greater part of government spending in their jurisdictions. Since they have no responsibility for the stabilisation policy, there is an increased likelihood that in times of economic expansion, they will set off in pro-cyclical spending (Perry et al. 2008). For example, the case of Argentina provides an example of such pro-cyclical behaviour of local governments. It is interesting that smaller local governments conducted a more pro-cyclical policy. Furthermore, it was shown that tax revenues (particularly local sales taxes) are more pro-cyclical than transfers from central government.

Finally, the effects of the financial markets are not irrelevant. It is well-known that in times of crisis, the cost of financing in developed countries fell, whilst in Eastern Europe it significantly increased. Moreover, banks were not willing to finance the local community in order to ensure their own credibility and to isolate themselves in case of potential new financial shocks. Thus, the possibilities of refinancing of obligations are reduced and together with the additional pressure for the reduction of transfers from central government, it became difficult to service the commitments from previous periods. Therefore, local governments are unable to conduct counter-cyclical policies within their jurisdiction. Even if the local government has a flawless history in terms of fiscal credibility, they might have problems with financing the provision of goods and services. In times of crisis interest rates rise and banks refrain from lending, which has a pro-cyclical effect.

It has to be stated that the existing fiscal rules are still far from perfect, especially in the context of mitigating the effects of the economic crisis. These rules depend on the objectives of the fiscal policy of local governments, which can be directed towards debt sustainability and short-term stabilisation, reducing inequality, etc. There is certainly a great need to establish better rules which would contain elements of the stabilisation policy. Two important features of these rules that one should consider are: counter-cyclical transfers from the central government to ensure the smooth functioning of local authorities and the use of stabilisation funds (rainy-day funds).

9.2 Effects of the crisis and response of local governments

9.2.1 Brief overview of the inter-governmental system in Croatia

The reform of the territorial and administrative organisation of the public sector in Croatia began in 1994. By the Constitution, Croatia was proclaimed a federal state (however, this concept remained only on the formal level and has never been manifested in practice) consisting of three tiers of government – central government; regional government – 20 counties plus the special area of the City of Zagreb (which has the status of both a city and a county) and the local government sector (which consists of cities and municipalities). Such a concept of territorial division was intended to set up counties as classical regions with the function of a middle-tier of government. It is very important to address this spatial setup at the beginning, because it had a crucial impact on the results of the decentralisation process.

Territorial reform resulted in too large a number of counties, cities and municipalities. It was clear from the outset that the decentralisation process under circumstances of such fragmentation of governmental space could not be sustainable. However, despite this, from 1994, the number of cities and municipalities increased. At the moment, there are 570 sub-national governments – 21 counties, 128 cities and 421 municipalities. That is the reason why a substantial number of Croatian local governments and cities are quite small. This resulted in the fact that many Croatian local governments do not have the appropriate financial, administrative, technical and personnel resources to carry out the basic functions of local governments.

Until 2001, counties had dual functions and were primarily responsible for performing delegated tasks from the central government level. Their role of self-government, acting in accomplishing goals of regional provision of public goods and services, was seriously neglected. That situation resulted in an unclear division of responsibilities. In 2001, a new Law on Local and Regional Self-Government was adopted. By this Law, counties are defined as units of regional self-government.

From 2001, the responsibilities of counties, cities and municipalities are more clearly defined. Counties are responsible for activities of regional importance, such as education, health care, urban planning, economic development, traffic, and transport infrastructure, and for establishing a network of educational, health, social, and cultural institutions. Cities and municipalities are responsible for local activities whose purpose is to accommodate the immediate needs of citizens in their geographical area. These activities involve housing and community amenities, urban planning, municipal services, child and social care, primary health care, childcare and primary education, culture, physical education, sports, consumer protection, protection and promotion of the natural environment, fire fighting and civilian protection. Distribution of responsibilities according to the level of government is provided in Table 9.2.

Croatia began an ambitious policy of decentralisation in 2001. Through this decentralisation programme, sub-national governments obtained new assignments in the area of elementary and secondary education, health care, welfare and fire fighting. Local governments had the responsibility of financing a part of the costs of health care and education (material costs and expenditures for the procurement of non-financial assets) and of total costs of financing welfare and fire departments. However, delivery of these decentralised functions has only been taken by those local governments which had the highest level of fiscal capacity. Out of their total number, only 53 assumed the obligation of financing these functions. In addition, from 2002, financing of the fire departments was taken on by 83 local government units (municipalities and cities). The uneven financial capacity is clearly visible from the fact that the total budget of the 53 local government units that took over the financing of the decentralised functions constitutes about 70 % of the consolidated budget of all local government units (see Bajo and Bronić 2005).

Table 9.2
Distribution of responsibilities according to the level of government in Croatia

	Central government	Counties	Cities	Municipalities
General public services	x	x	x	x
Defence	x			
Public order and security	x		x	x
Education	x	x	x	x
• *pre-school*			x	x
• *elementary*	x	x	x	x
• *secondary*	x	x		
• *tertiary*	x			
Health care	x	x		
Social security and welfare	x	x	x	x
Housing and communal economic matters and services			x	x
Recreation, culture and religion			x	x
Agriculture, forestry, hunting, fishing	x	x		
Mining, industry, construction	x	x	x	x
Traffic communications	x	x	x	x
• *Road transport*	x	x	x	x
• *Rail transport*	x			
• *Air transport*	x			
Other economic matters and services	x	x	x	x

Source: Bajo and Bronić (2005, 5–6)

Legislative changes in 2005 established the concept of "large cities". Thirty-two cities have that status and they are allowed to take over the functions of counties if they are financially and technically capable. Fifty-three local units (20 counties, the city of Zagreb and 32 other cities) accepted the obligation to finance the aforementioned decentralised functions (elementary and secondary education, health care, welfare and fire fighting). An additional share in personal income tax and equalisation grants funds the new responsibilities of these units. The introduction of the large cities can be rationalised as an attempt to give more autonomy to the cities which have more capacity to provide a higher level of local public service. Until these amendments to the legislation were introduced, small and large cities had the same responsibilities, which created strong inefficiencies. Small cities were unable to deliver the responsibilities given and large cities had an excess of capacity due to the lack of responsibilities delegated to them.

Nevertheless, the decentralisation process in Croatia is still in the early stages. Since the reform in 2001 and the introduction of large cities in 2005, there have been no substantial changes in terms of further decentralisation. The Central government does not have confidence in the local sector. One of the main reasons for this is the territorial-administrative public sector organisation. This situation presents problems for the further delegation of the public function to lower levels of government.

Despite the formal efforts towards a higher level of decentralisation, sub-national government budgets (570 regional and local government units) still amount to around 15 % of the total consolidated government revenues. Nevertheless, sub-national governments finance a larger share of government investments. In addition to this, there are great divergences in the fiscal capacity of counties, cities and municipalities. The role of the cities is dominant. The problem is that delegated functions and responsibilities do not follow on from financial capabilities. Counties have a wide responsibility, but their fiscal capacity is often much smaller than the capacity of cities within their borders. In addition, about 30 % of the budgets of cities and municipalities go to public investment projects. In the case of counties, only 17 % of the budget is directed towards investment expenditures.

All municipalities and cities may also carry out matters from the self-government jurisdiction of the county in their own area, if they provide funds to finance them. Although the responsibilities and jurisdictions of local government units are laid down, nevertheless, local government units do not have total fiscal autonomy in the financing of all their expenditures because revenue sharing and central government grants are earmarked for financing decentralised functions and capital investment. Local government units finance a significant part of their expenditures in collaboration with central government, which provides grants from the central government (national) budget via the Ministry of Finance or the competent ministries. Greater local government unit autonomy can be found in connection with the performance of communal economy activity, pre-school education and cultural, sporting and religious activities (Bajo and Bronić 2005).

In Table 9.3, tax assignment in Croatia is presented. Own taxes given to the county level are, by their very nature, of minor significance. In terms of overall revenue collection, there are three major tax sources. That is Value added tax (VAT), Corporate income tax (CIT) and Personal income tax (PIT). The main source of revenue for the sub-national government level is PIT, which is distributed by the sharing mechanism (for more details on the sharing mechanism see Bronic 2007). However, counties receive only 15 % of the total PIT distributed. Despite that minor share, revenues from PIT take 93 % of the total tax revenues and 80 % of the total revenues of the county budgets. PIT is also the main source of revenue for cities. Due to the fact that this tax is not directly related to local government expenditures, there is a clear issue of a lack of accountability in terms of local spending. Citizens do not perceive the relationship between revenue collection and local spending and therefore there is no pressure on increasing local government's accountability.

The only real and significant local tax is the surtax on income tax which is piggybacked on the personal income tax. However, it is collected by the central Tax administration office and local governments do not have control over the collection and distribution of this revenue. In addition, it is clear that local governments do not want to raise this surtax, due to the assumption that such an action would be perceived very negatively by citizens. Instead, they are more prone to increase non-tax revenues (i.e. communal fees and contributions) which are a sort of quasi-tax revenue source. The problem is that these fees are non-transparent, both by their mechanism of collection and the ways in which they are utilised. The establishment of property tax would provide grounds for the improvement of local government responsibility and accountability; however, there is still strong resistance towards its introduction.

Table 9.3

Tax assignment in Croatia

Jurisdiction	Tax assignment
Central government level	• Value added tax • Corporate income tax • Special taxes (excises) on cars, motor vehicles, vessels and aircraft; mineral oil, alcohol, beer, non-alcoholic beverages, tobacco, coffee, luxury products, liability and comprehensive road vehicle insurance. • Levy on the organisation of games of chance
Regional (county) level	• Taxes on inheritance and gifts • Motor vehicle licences • Taxes on other vessels • Levy on coin operated machines for amusement
Cities and municipalities	• Consumption tax • Taxes on holiday houses • Trade name • Surtax on income tax • Taxes on the use of public land
Shared taxes	• Personal income tax • Real estate transfer tax

Source: Ministry of Finance – Tax Administration, 2010 (http://www.porezna-uprava.hr/en)

Despite numerous obstacles, it appears that the situation is improving; however, at a slow pace. Positive changes are particularly visible in general budget related concerns (regarding classification, consolidation, accounting, and the national treasury system), and also, to a somewhat lesser degree, with respect to expenditure side problems (regarding long-term capital project planning, controlling borrowing, and recording liabilities). Almost no improvements were observed in mitigating problems related to the number and size of local government units or the budgetary process (internal controls, audits, and guidelines of the Ministry of Finance) (Ott and Bajo 2003).

The main problem which curbs the decentralisation process in Croatia is territorial and administrative organisation. So far, it has been considered that reforms towards a better setup are not possible, due to the lack of political power to pursue such radical changes. However, the economic crisis inspired wide public debate on the necessity of such a reform, which would reduce the increased costs of government bureaucracy and improve the efficiency of the local sector. This fragmentation was the main justification for the central government to stop further delegation of responsibilities to local governments. During 2010, the Croatian government set up an inception phase of the reforms of administrative-territorial government. A working group was established, with the objective of defining the criteria for local government amalgamation and to develop an action plan of implementation at a later date.

However, there are additional issues that burden local government efficiency and there was no progress in these areas. Ott and Bajo (2003) mention some of these: public investment planning, revenue structure, insufficient shared taxation, position of utility companies, evaluations and rewards for the work of employees, internal controls, audits of joint stock companies owned by local units etc. However, there were improvements in the following areas: division of functions and responsibilities, budget classification, financial equalisation and allocation of grants, consolidation of local government units' budgets, accounting, plans and estimates of the budget, and financial control of the local government units' borrowing. Nevertheless, it can be concluded that the decentralisation process in Croatia has stopped and there are no significant improvements except the natural developments up the learning curve of local governments. A higher level of decentralisation and a step towards increased accountability is possible only after a forthcoming territorial-administrative reform.

9.2.2 Effects of the crisis

As was previously stated, local governments in Croatia have little autonomy. It is usually considered that greater autonomy of local governments in terms of revenue collection leads to the realisation of smaller deficits, particularly in cases where there is high tax competition. However, these authorities are more sensitive to cyclical movements. Tax reform in 2007, when corporate income tax became a central government own tax and a higher share of personal income tax was given to local

Table 9.4

Local government revenues 2002–2010 (HRK, millions)

	2002	2003	2004	2005	2006	2007	2008	2009	2010*	Ratio 2009/2008	Ratio 2010*/2009
Revenues	9,097.6	10,074.6	10,828.9	12,162.4	13,560.2	15,502.6	16,825.6	16,062.9	14,865.2	95.5%	92.5%
Taxes	5,494.3	5,922.5	6,592.1	7,072.4	8,299.2	9,157.9	10,097.2	9,891.9	8,872.6	98.0%	89.7%
Taxes on income and capital	4,918.4	5,327.4	5,901.0	6,339.8	7,456.7	8,173.4	9,074.2	8,961.5	8,080.9	98.8%	90.2%
Personal income tax	3,863.4	4,083.3	4,636.3	4,718.2	5,353.2	8,165.3	9,074.2	8,961.5	8,080.9	98.8%	90.2%
Corporate income tax	1,055.0	1,244.0	1,264.7	1,621.6	2,103.5	8.1	0.0	0.0	0.0		
Property taxes	329.4	315.9	375.1	388.1	479.5	576.6	595.0	512.7	424.4	86.2%	82.8%
Taxes on goods and services	228.4	264.9	301.9	330.0	348.3	391.5	413.2	406.7	356.1	98.4%	87.6%
Grants	1,266.8	1,546.8	1,425.1	1,704.6	1,664.7	2,137.6	2,085.6	2,034.5	2,199.8	97.5%	108.1%
Property income	616.1	627.6	685.4	760.2	794.4	844.3	966.0	983.9	929.7	101.9%	94.5%
Other non-tax revenue	1,720.4	1,977.7	2,126.3	2,625.2	2,801.9	3,362.8	3,676.8	3,152.6	2,863.0	85.7%	90.8%

Note: *Estimated on the basis of data up until September 2010

Source: Ministry of Finance, http://www.mfin.hr//

government, decreased the likelihood for a pro-cyclical effect of corporate income tax. However, in a period of expansion, revenues from corporate income tax increased much more, compared to personal income tax. In a period of crisis, the trend is the opposite and revenues from corporate income tax fell much more and revenues from personal income tax remained stable, which relaxed the financial position of local governments. The rate of surtax imposed on personal income tax is potentially the most significant tool for influencing the level of local revenues on the side of local government. However, local authorities are very sensitive to the possibility of raising that surtax in case of financial problems. The main reason for that is that this tax is highly visible and local governments are more prone to using different non-tax sources of financing. Table 9.4 presents the dynamics of local government revenues.

The data in Table 9.4 show that until 2009, revenues steadily increased. In 2009, most of the revenue sources decreased. Surprisingly, income from rents of local government property was the only item that increased in 2009. However, a significant reduction in revenues came in 2010, despite a much sharper fall in GDP during 2009. Total local government revenues fell by more than 7 %. All sources of revenues are reduced with the exception of grants, which come mainly from the central government level.

However, despite the fact that data show only a linear decrease in revenues, there are potential problems that come from borrowing and the models of the private-public partnerships (PPPs) used in some local units in the recent period. Even although fiscal rules in Croatia imposed hard budget constraints by using PPP models, there are additional burdens on the side of the current budget. An additional problem is that these fiscal rules are not good enough because they are primarily focused on static indicators. For example, the maximum amount of indebtedness of local governments is often determined by budgetary provisions which define the maximum debt ceiling – in Croatia this amounts to 20 % of operating revenues. However, the problem occurs because in periods of economic expansion, there is a possibility to increase the total amount of debt by following the growth of revenues. During the crisis, the amount of the repayments from the previous period remains, and falling revenues might cause liquidity problems. In this case, the limit of 20 % can be easily breached. When fees based on PPP contracts are added, the financial position is even more fragile. The problem is that obligations made by borrowing and PPP fees were not treated similarly by the fiscal rules framework, even although in an economic sense there is no difference. Finally, some local governments engaged in borrowing through their communal enterprises, which presents a kind of hidden debt.

Table 9.5 presents the dynamics of local government expenditures. It can be seen that subsidies to public corporations for local enterprises increased significantly during the recent period. At the same time, subsidies for private enterprises

Table 9.5
Local government expenditures 2002–2010 (HRK, million)

	2002	2003	2004	2005	2006	2007	2008	2009	2010*	Ratio 2009/2008	Ratio 2010*/2009
Total Expenditures	8,272.3	9,795.6	10,887.6	12,242.8	13,603.6	15,072.2	16,813.1	16,715.1	14,410.2	99.4%	86.2%
Current Expenditures	7,136.4	8,127.2	8,766.2	9,882.5	10,629.3	11,868.2	13,697.1	1,3959.0	12,379.6	101.9%	88.7%
Compensation of employees	1,893.8	1,997.0	2,239.5	2,379.6	2,695.3	2,957.7	3,390.3	3,665.3	3,511.3	108.1%	95.8%
Wages	1,639.8	1,732.9	1,972.8	2,065.6	2,335.9	2,572.6	2,946.4	3,175.2	3,042.7	107.8%	95.8%
Social contributions	254.1	264.1	266.7	314.0	359.3	385.2	443.8	490.0	468.6	110.4%	95.6%
Use of goods and services	2,902.4	3,202.5	3,351.6	3,775.9	4,108.9	4,678.9	5,079.1	5,167.3	4,665.6	101.7%	90.3%
Subsidies	582.5	623.1	726.4	746.1	877.4	993.8	1,231.5	1,275.5	1,227.3	103.6%	96.2%
Subsidies to public corporations	534.3	570.7	637.2	648.7	714.3	778.0	1,005.0	1,078.0	1,039.7	107.3%	96.4%
Subsidies to private enterprises	48.2	52.4	89.2	97.4	163.1	215.8	226.5	197.5	187.6	87.2%	95.0%
Grants	142.2	366.7	267.1	289.6	286.2	334.7	362.2	328.6	228.9	90.7%	69.7%
Social benefits	289.8	314.9	376.0	538.7	635.2	554.2	688.2	779.2	615.5	113.2%	79.0%
Other expense	1,210.6	1,539.7	1,726.2	2,054.6	1,954.9	2,255.7	2,812.3	2,627.6	2,026.4	93.4%	77.1%
Capital expenditures	1,135.9	1,668.4	2,121.4	2,360.3	2,974.3	3,204.0	3,116.0	2,756.1	2,030.5	88.4%	73.7%

Note: *estimated on the basis of data up until September 2010

Source: Ministry of Finance. http://www.mfin.hr//

remained at a similar level. Social benefits were also increased. It seems that local governments acted slightly counter-cyclically, primarily towards citizens, in preventing the fall of living standards either through subsidising local communal enterprises or directly through increased social benefits. However, in 2010, all of the expenditure categories fall dramatically. A particularly significant reduction can be observed in the item of capital expenditures and grants where the decrease amounted to about 30 %. This seems logical, due to the fact that capital investments are the easiest category to reduce from a political perspective. Reduction in grants is related to obvious consolidation of central government finance at the expense of local government.

When analysing the functional classification of expenditures (Table 9.6), it can be concluded that there are no significant shifts between spending categories. Certain decreases in local government economic affairs in 2008 can be noted, which might denote a decreased level of investment activity, which implies a potential pro-cyclical policy in this case.

Table 9.6

Local government expenditures 2002–2008, functional classification (in per cent)

	2002	2003	2004	2005	2006	2007	2008
General public services	20.13	18.22	16.99	17.23	18.67	16.93	21.00
Defence	0.01	0.01	0.01	0.01	0.01	0.01	0.02
Public order and safety	2.89	3.36	2.85	2.80	2.85	2.88	2.77
Economic affairs	16.46	16.10	17.33	16.46	15.11	16.18	13.56
Environmental protection	3.77	3.86	4.08	3.93	4.30	4.29	4.14
Housing and community amenities	19.08	21.39	21.02	20.58	19.77	22.73	21.22
Health	4.23	3.95	3.34	3.41	3.51	3.21	2.89
Recreation. culture and religion	11.28	11.01	12.36	12.40	12.57	12.15	12.02
Education	17.26	17.50	17.09	17.06	16.92	15.93	16.95
Social protection	4.88	4.61	4.94	6.11	6.28	5.70	5.43
Total outlays	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Ministry of Finance. http://www.mfin.hr//

The question is also to what extent rigid budgetary constraints limit the possibilities of local government units to undertake fiscally unsustainable activities. In this sense, the effects will depend on the structure of revenues. The possibilities for borrowing (as well as creative accounting) and budget spending are largely defined by obligations from the previous years.

The problem imposed by the balanced budget rule is that the greater the fiscal risks are, the shorter the time for budget planning has to be. Such preoccupation with the economic cycle makes budget control and monitoring much harder. Usually, measures to reduce costs have been focused on investments which are easiest to launch in a shorter period. In this way, allocative efficiency is reduced. A similar tendency occurs in Croatian local governments. During the boom period and high revenues, numerous investments were financed either from current revenues or by using short-term debt financing. Such a practice created problems for some governments which were already in a period of expansion. Nowadays, problems are intensified because investment activity is minimised and obligations from the previous period remain and are harder to service. An additional problem is related to the issues of allocative efficiency. In recent times, significant investments were devoted to sports facilities without appropriate planning, which created cases of overcapacity of sports facilities. These objects were financed mainly by borrowing or by using models of PPPs, presenting significant financial burden for numerous local governments in the future.

9.2.3 Responses of local governments

As already noted, the possibility of local government units in proactive behaviour towards mitigating the effects of the economic crisis depend largely on the given tax autonomy. Since the tax autonomy of local governments in Croatia is very limited, one cannot expect significant measures conducted by the local sector. The only form of taxation, which may have an important effect, is the change in the rate of local surtax on PIT. Other possible sources are communal fees. Therefore, the majority of measures that can be conducted fall in the area of local government spending.

Regarding local government spending, the majority of governments did not conduct any proactive measures in combating the economic cycle. However, some measures of limited scope and extent can be listed[2]:

- Some units adopted measures to reduce expenditures. Guidelines were sent to budget users to save up to 20 % of revenues, based on clearly-defined priorities of financing. These savings were partly related to the expected effects of the fall in revenues and budget deficits caused by excessive spending in the previous period (mainly by financing of infrastructures from current revenues);
- Some units decreased and others increased communal fees;
- In many local governments, tax revenues did not fall significantly. However, some units postponed planned sales of property due to lower prices of assets, which decreased total revenues;

2 This part is based on interviews with local government officials and official documents of local governments.

- Some units experience a high level of repayments for the infrastructure financed in recent times and are forced to cut other expenditures. In many cases, these objects exert high costs of maintenance;
- Certain local taxes are reduced. However, due to low rates, this effect is negligible in terms of decreasing the tax burden for local businesses;
- Numerous local governments conduct minor spending cuts more oriented towards showing fiscal discipline to citizens (i.e. cutting the spending of city departments). However, these spending cuts are also negligible in terms of their economic effects;
- In some cases, the wages of local government employees are decreased;
- Grants and subsidies are increased to a lesser extent.

The effects of the economic crisis on local governments in Croatia can be observed through the fall in revenues and expenditures. In that sense, the local public sector simply follows the economic shock and does not have any significant counter-cyclical potential. There is no systematic behaviour. Some measures are conducted in certain jurisdictions and motivated by gaining political points. It seems that the overall effect of local government is pro-cyclical but it cannot have significant effects on macroeconomic stability due to the low level of decentralisation and limited tax and expenditure autonomy of the local sector.

9.3 Conclusions

In this chapter, the effects of the economic crisis on local governments in Croatia have been analysed. Even although the theoretical framework shows possible significant responses in the hands of local governments, none of these were used across the Croatian local public sector. So far, the effects of the crisis have not been sufficient to jeopardise the activities of the local sector. It is clear that local governments follow the cycle and adapt to a lower level of revenues by cutting spending. However, there are no significant proactive measures. Potential problems might occur in the case of a prolonged crisis by repayments of obligations, mainly from financing of investments by borrowing or models of PPP.

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10. Anti-Crisis Measures in Belarus Local Financial Management: Tools and Methods

Yuri Krivorotko

This chapter is about the tools and methods of local financial administration in Belarus in times of the global financial crisis. It is important to note that the financial crisis has not by-passed Belarus. The situation is identical to many other countries whose budgetary systems have been affected. Tax shortages, both in the central and local budgets, are the main result of the influence of the crisis on the budgetary system. Local budgetary policy responded to this situation by selective funding of public expenditures, expansions of municipal borrowing, and increases in non-tax revenues.

How has the financial crisis affected the structure of public expenses? What policy in the sphere of local budget administration has been selected by local governments? What tools and methods of anti-recessionary management is it necessary to implement in order to resist the crisis? These questions will be answered in this chapter.

10.1 Belarus local budgets' position under conditions of the global financial crisis

In Belarus, according to national legislation, there are two levels of government: the central or national government and the sub-national (local) government. The local level consists of the oblasts (regions), the rayons (counties), cities with oblast status, cities with rayon status, urban settlements, urban districts, rural settlements and villages. Oblasts, rayons and cities with oblast status represent a higher level of local government and they have separate fiscal relations to the state government. Other units represent lower levels of local government and their financial relations are subordinated to higher-level units. However, they do not have their own local budgets and function on the basis of cost-estimated financial plans [smet]. Their economic functions are virtually ignored. The practice of Belarus sub-national governments shows that the lower levels of local government cannot execute their full budgetary rights and depend on the budgetary decisions of the central government (as well as those of the oblast or rayon). In fact, public administration in Belarus has a four-level structure where the first level belongs to central government and the other three levels belong to the sub-national government (Šević 2008).

The sub-national level includes six oblast governments (Brestskay, Vitebskaya, Gomelskaya, Grodnenskaya, Minskaya, and Mogilevskaya) and the city government of Minsk (capital of Belarus) (Table 10.1), 117 rayons and 18 cities with oblast status and finally 1,469 units, including cities with rayon status, as well as urban and rural settlements. Each territorial unit is granted budgetary independence, although the

Article of the Belarus Constitution concerning this is not effectively implemented. The rights of territorial governments at the oblast and rayon levels to execute independent fiscal power is very limited, as the executive power of locally elected bodies is increasingly delegated to local state administrations of oblast and rayon levels.

Table 10.1

Number of local budgets of sub-national level (as of 1 January 2006).

Administrative-territorial items of the first level	Local budgets of sub-national level			
	Number of oblast budgets	Number of rayon budgets and city budgets with oblast status	Number of rural, urban budgets and budgets of cities with rayon status	Total budgets of sub-national level
Brestskay oblast	1	19	237	257
Vitebskay oblast	1	25	215	241
Gomelskay oblast	1	23	289	313
Grodnenskay oblast	1	19	205	225
Minskay oblast	1	26	326	353
Mogilevskay oblast	1	23	197	221
Minsk city (capital of Belarus)	1	–	–	1
Total	7	135	1,469	1,611

Source: Sidorchuk 2007, 238

In Belarus, the differentiation of expenditure assignments is similar to the practice of differentiation in developed countries. The administrative expenditures of the central authorities, national defence, and environmental expenditures are financed from the Central (Republican) budget. Hospital maintenance, garbage collection and other functions provided by the local level are funded from local budgets. Formally, the oblasts and rayons provide fixed subsidies to public utilities and to transport organisation for the maintenance of roads with regional status. They share the responsibilities for the funding of rather amorphous joint expenditures with the centre, including those for education, public health services, social policy, and grants to the economy (Šević 2008).

Table 10.2

Revenues and expenditures of the Belarus sub-national budgets, 2000–2009 (BYR[1], billion)

Revenues	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Own and ceded taxes	759.8	1,432.5	2,166.1	3,405.6	5,532.5	6,547.8	6,048.5	7,509.7	10,520.3	10,129.1
Shared taxes	485.7	871.5	1,217.1	1,680.4	2,286.6	2,983.8	3,676.2	4,304.3	6,201.1	5,859.8
Transfers and grants from the central budget	273.9	560.9	654.7	1,101.8	1,562.3	2,517.7	4,178.9	6,175.3	7,459.6	5,999.3
Targeted budget funds and non-budget funds	288.1	492.0	728.6	1,105.1	*0.0*	0.0	0.0	0.0	0.0	0.0
Total revenues	*1,807.5*	*3,356.9*	*4,766.5*	*7,292.9*	*9,381.4*	*12,049.3*	*13,903.6*	*17,989.3*	*24,181.0*	*21,988.2*
Expenditures										
State and local administration	178.7	325.6	552.2	845.5	1,175.5	1,665.6	2,138.5	3,172.7	4,637.9	5,019.6
National defence	0.8	1.5	2.9	3.9	5.4	12.8	15.2	17.2	4.7	18.2
Judicial authority, law-enforcement activity and safety	26.5	97.9	132.2	173.1	164.0	209.6	253.8	308.8	135.1	362.2
National economy	175.7	292.8	368.0	695.6	1,317.2	1,801.4	1,657.0	2,148.7	3,192.6	2,884.4
Environment protection	0.04	0.0	0.0	0.0	235.6	263.8	0. 5	0.6	300.6	136.2
Housing and communal services and housing construction	248.2	449.3	611.1	944.7	1,393.3	1,665.3	1,950.1	2,577.3	3,940.0	3,018.4
Education	460.0	907.9	1,444.6	1,959.5	2,420.2	3,206.9	3,804.0	4,470.0	5,384.7	5,494.4

Revenues	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Fitness, sport, culture, cinematography and mass media	54.2	104.8	149.8	236.4	322.1	439.0	551.7	704.4	933.1	891.9
Health care	329.8	635.2	938.6	1,360.2	1,785.0	2,335.8	2,752.7	3,387.2	4,010.7	4,189.8
Social policy	30.4	61.4	79.4	108.4	335.4	663.1	815.6	1,039.0	1,330.5	1,431.3
Expenditures of targeted budget funds and non-budget budget funds	282.6	474.5	668.8	1,004.4	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditures	*1,786.94*	*3,350.9*	*4,947.6*	*7,331.7*	*9,153.7*	*12,263.3*	*13,938.6*	*17,825.9*	*23,869.9*	*23,446.4*
Surplus(+), deficit (-)	+20.6	+6.0	−181.1	−38.8	+227.7	−214.0	−35.0	+163.4	+311.1	−1,458.2

Source: Author's own calculations based on the Ministry of Finance of the Republic of Belarus reports.

1 For the analysed period (2004–2009) the Belarus national currency (Belorussian ruble, BYR) is characterised by the relative stability. Mid-annual growth rate of the BYR against the USD during 2004–2009 is 104.9% and against the Euro during 2004–2009 is 106.7%. The average refinancing rate during 2004–2009 was 12.25%.

The favourable general economic conjuncture over the last years has caused considerable growth of incomes of the sub-national budgets in Belarus. According to financial reports of the Ministry of Finance of the Republic of Belarus, during 2000–2008 growth rates have been 35.2 per cent per year, and all revenues of sub-national budgets have increased during the specified period 13.4 times. Expenditures for this period increased by the same growth rates – on average, 35.3 per cent per year. Since 2009, however, there has been a considerable reduction in the principal types of tax and non-tax revenues on the revenue side of the sub-national budgets. A similar situation occurred with total sub-national budget expenditures. (Table 10.2)

The global financial crisis, which reached Belarus at the beginning of 2009, has had a major impact on local finance in the country. First of all, this influence has been noticed in the falling growth of local budget revenue. In 2009, compared to 2008, growth of the Belarus sub-national budgets was 90.2 per cent, whilst in pre-crisis 2007 and 2006, growth was respectively 134.4 per cent and 129.4 per cent. (Table 10.3) Shortages in direct taxes (profit tax, property taxes and other direct taxes and charges) have occurred. In these conditions, the basic emphasis has been on the gathering of indirect taxes (value added tax, excise, sales tax, tax on services) with which it has been possible to receive and top up both central and local budgets.

Table 10.3

Growth rate of sub-national local budget sources in Belarus (in percentages)

Articles of local budget revenues	Changes (100=previous year)		
	2007/2006	2008/2007	2009/2008
Total revenues	129.4	134.4	90.9
From this:			
• Tax revenues	120.0	139.1	95.4
From this:			
• Profit and income taxes	121.2	147.4	86.9
• Property taxes	119.8	132.0	82.6
• Taxes on commodities and services (value added tax, excise, sales tax, tax on services)	122.4	130.4	112.4
• Other taxes, charges, duties and obligatory payments	81.8	155.0	93.6
• Non tax revenues	154.9	185.0	98.7

Source: Author's own calculations based on of Ministry of Finance of the Republic of Belarus reports.

One of the features of the financial crisis' influence on local budgets has become the change in local budget revenue structure in favour of non-tax revenues. It is necessary to note that non-tax revenues during 2005–2009 have grown twice as fast as tax revenues. Tax revenues for the period analysed have increased 1.6 times and non-tax revenues 3.5 times (Table 10.4). Such changes in the sub-national budgets' structure are partly explained by the tax revenue shortages in 2009.

Table 10.4

Dynamics and composition of tax and non-tax revenues in Belarus sub-national budgets (in percentages)

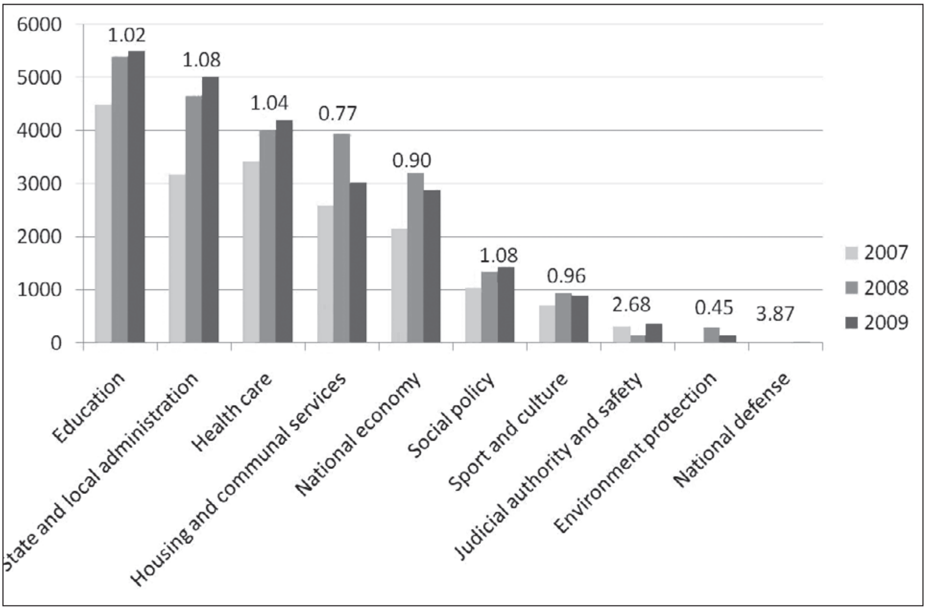
	Share					Change 2009/2005
	2005	2006	2007	2008	2009	
Tax revenues	96.69	95.8	94.65	93.0	92.8	161.2
Non-tax revenues	3.31	4.2	5.5	7.0	7.2	350.9
Total	100.0	100.0	100.0	100.0	100.0	167.5

Source: Author's own calculations based on of Ministry of Finance of the Republic of Belarus reports.

An active search for new non-tax revenue sources to fill the local treasury has been caused by the reaction of local authorities to tax source shortages. The share of non-tax revenues in local budgets (especially in rural budgets) is significant. The share of non-tax revenues in settlements' budgets of the Minsk oblast in 2008 was 27.3 per cent, in rural budgets 24.1 per cent, and in budgets of cities of rayon status, 20.6 per cent. Considerable influence on these processes has brought about the adoption of new Acts in the field of land tenure. Since 2007, according to the Decree of the President of the Republic of Belarus No 667, local authorities (rayon, rural and settlements) have the right to sell lands considered to be private property to the population and sell rent rights on the land for legal bodies on an auction basis (*Ob iz'itii i predostavlenii zemelnyh uchastkov, 2007)*. Proceeds from land tenure operations, including land rent, began to arrive directly to those local budgets where land operations were carried out.

The decrease in local budget revenues in 2009, compared to 2008, was caused by shortages in tax revenues and meant a selective approach to cut budget expenses. The expenditures in the three main spending categories (i.e. education, state and local administration and health care) saw a modest growth. The severest cuts took place in the area of housing and communal services, national economy and sport, and culture and the mass media. (Figure 10.1)

Figure 10.1
Sub-national budget expenditures in Belarus (BYR, billion)



Source: Author's own calculations based on reports of the Ministry of Finance of the Republic of Belarus.

Organisational measures on the integration of local governments at the primary territorial level – village councils [*selskie sovety*] – have become one of the anti-crisis methods of budgetary expenditures' administration. By own calculations, in 2009, more than 130 village councils or about 10 % of all local governments at the primary territorial level have been integrated into other village councils. The integration process will provide an economy on budgetary expenditures in the area of municipal administration and expenditures on the services of municipal organisations.

The financial crisis has forced local governments to look for new ways of attracting funds. One of these is municipal borrowing. Since July 2009, local executive and administrative bodies were granted the right to issue bonds (*O vnesenii dopolnenii, 2009).* At present, some local executive bodies and administrative bodies have already taken advantage of this tool and already issued bonds. (Table 10.5) The State bank of SB "Belarusbank" has become a buyer of these bonds. Local executive committees were authorised to issue their bonds without security, as in this case, the borrower was the State. Bond issues by both local executive and administrative bodies were carried out within the amount of debt defined in the local budgets for the following fiscal year. Thus, in order to increase the attractiveness of these bonds, the income received upon bond repayment of the local authorities was exempt from profit tax. From data from the beginning of August 2009, a portfolio of redeemed SB "Belarusbank" bonds of legal bodies attained BYR 327 billion, 90 % of which (for sums exceeding BYR 290 billion) belonged to the local authority securities (*Belarusbank pomog mestnym vlastjm dengami)*.

Table 10.5

Bond issuing by Belarus local authorities in 2009 (in Belarus currency)

Name of local authorities	Volume of emission (BYR, billion)	Number of emissions	Terms of bond circulation
Baranovichi city executive committee	10	1	11 months
Baranovichi rayon executive committee	60	2	12 months
Berezovski rayon executive committee	1.75	1	12 months
Brest city executive committee	69.0	9	from 11 to 17 months
Brest rayon executive committee	3.2	1	16 months
Drogichinski rayon executive committee	5.0	1	12 months
Ivatsevichski rayon executive committee	4.6	1	10 months
Kamenetski rayon executive committee	1.6	1	12 months
Kobrinski rayon executive committee	67.0	3	12 months
Liahovichski rayon executive committee	1.1	1	12 months
Luninetski rayon executive committee	45.0	1	11 months
Minsk oblast executive committee	200.0	1	16 month
Minsk oblast executive committee	323.7	8	from 11 months to 15 years and 5 months
Pinski city executive committee	21.5	2	11 months
Pruzhanski rayon executive committee	14.5	3	12 months
Zhabinkovski rayon executive committee	2.5	2	from 11 to 12 months

Source: Edited by the author, based on reports of the Minsk oblast financial departments and Brest oblast financial department.

The first local authorities to issue bonds were the Brest and Minsk oblast executive committees, Pruzhansky and Kamenetsky rayon executive committees and the Brest city executive committee. By this time, the local authorities listed above had been issued their own bonds by closed sale to the SB “Belarusbank”.

The further development of municipal borrowing will require working out the rules for its regulation, which should be embodied in the Municipal Credit Law and should be reflected in the Budget Code. At present, in Belarus, such legislation is missing. The legislative base of municipal borrowing should include procedures for permission to borrow, a procedure for the registration of loans in the Ministry of Finance, a system of specifications of restrictions on the loans, the authorised institutions to regulate loans, rules for the access of local authorities to the monetary and financial markets, and rules for municipal debt management.

10.2 Ways to improve municipal finance administration under crisis conditions

In Belarus, the basic ways to improve local financial administration in times of crisis are:

- improvement of the debt policy of sub-national governments;
- optimisation of local expenditures;
- transformation of municipal organisations providing public services to non-state and non-municipal organisations;
- outsourcing separate functions of municipal authorities[2].

10.2.1 Improvement of debt policy of sub-national governments

One of the possibilities for regulating local government debt is the use of local government debt capacity indicators (Krivorotko 2007). The debt capacity of a budget can be defined as an excess of revenues over its operational expenditures, without the expenses for servicing existing *direct and indirect* obligations[3] during each period of the chosen period of time. The time interval cannot be shorter than the duration of the prospective financial plan, and the period of time cannot surpass the fiscal year. The debt capacity indicator is used for both the already accepted and future planned acceptance obligations. It is characterised by the following formula:

$$DV = \sum_{i=1}^{N} \left(R_i - CE_i\right), \text{ where} \qquad (1)$$

DV – debt capacity of the budget for a period of time equal to N periods;

2 This paragraph is based on the results of an inspection of local budgets of the Minsk oblast, polls of experts of the Ministry of Finance of Belarus and the Minsk oblast finance department by issues of budgetary management in times of crisis and author’s own research.

3 In practice, direct obligation means principal debt and indirect obligation means guarantees issued by the local authority.

Ri – budget revenues in the i-th period;

CEi – budget operational expenditures without expenses for servicing the existing direct and indirect obligations made in the i-th period.

N – number of periods in the range of calculation.

The debt capacity of the budget for a period of time equals the sum of debt capacity in the individual years:

$$DV = \sum_{i=1}^{N} DV_i \tag{2}$$

The summary schedule of service and repayment of debt and expected payments is given by the following formula:

$$SGi = \sum_{j=1}^{J} (P_i^j + I_i^j) + \sum_{k=1}^{K} EP_i^k \text{, where} \tag{3}$$

SGi – summary schedule of service and repayment of a debt and expected payments on execution of indirect obligations;

j – type of direct obligations, j=1…J;

k – type of indirect obligations, k=1…K;

P_i^j – expenses on repayment of direct obligation j in *i*-th period;

I_i^j – expenses on service of direct obligation *j* in *i*-th period;

EP_i^k – expected payment on the k-th indirect obligation в *i*-th period.

The accessible debt capacity of a budget can be defined as the difference between the debt capacity of the budget and size of repayment and service of already available debt and indirect obligations:

$$ADV = \sum_{i=1}^{N} ADV_i = \sum_{i=1}^{N} \left(DV_i - SG_i\right) \text{, where} \tag{4}$$

ADV – accessible debt capacity for new loans for the whole period

ADVi – accessible debt capacity for new loans for each year, ADVi = DVi – SGi, for each i = 1,…N;

DVi – debt capacity in the i-th period;

SGi – payments on execution of already accepted debt and indirect obligations;

i – period of calculation;

N – number of calculation periods in the range of planning.

If the accessible debt capacity for new loans is positive in each period of the interval of planning, i.e. also ADV>0, then the attraction of new loans is assumed. If the accessible debt capacity for new loans is negative in any period during the interval of planning, but the total accessible debt capacity for new loans is positive, there is a budget cash gap. In this case, the budget cash gap can be eliminated by means of refinancing or partial pre-scheduled repayment of available obligations, or is funded by means of attraction in the corresponding year of a short-term loan to cover the cash gap. Attraction of new loans increasing expenses for repayment and service of obligations in the chosen year is assumed. If the accessible debt capacity for new loans is negative for the interval of planning, then the attraction of new borrowing is not assumed.

Practical use of the municipal borrowing regulation as an indicator of debt capacity creates convenient flexibility in the debt administration process. Interaction of debt capacity with legislative restrictions on the size of the debts means the budgeted deficit size allows better regulatation of municipal borrowing, with the purpose of decreasing the liquidity risk.

10.2.2 Optimisation of local expenditures

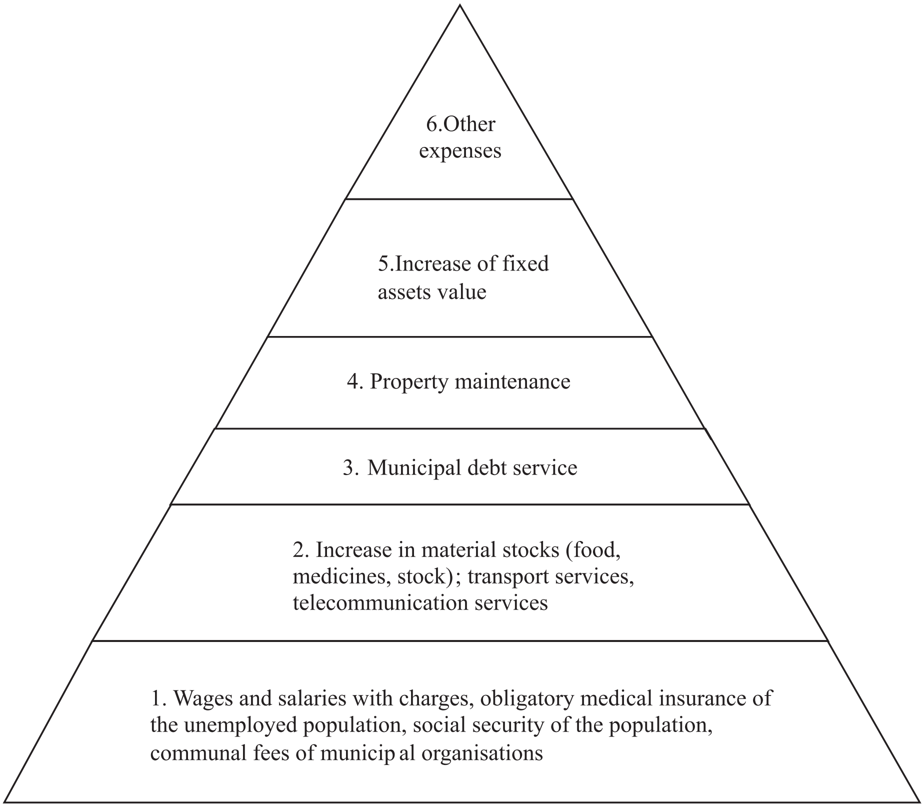
One of the approaches to optimise sub-national budgets in times of crisis is based on the grouping of expenditures under articles of economic classification. It assumes a defined priority for separate groups of expenses. The approach to optimisation of budget expenditures consists of the necessity to fund those expenses which are of an obligatory and urgent character and to transfer, for subsequent periods, those expenses which are not vital for the municipality in the crisis period. Our inspection of the economic structure of the majority of rayon local budgets of the Minsk oblast have shown that in crisis conditions, municipalities placed their priorities in an expenditure of budgetary funds[4]. In 18 out of 25 municipalities of the Minsk oblast, the following were the priorities. (Figure 10.2).

The first priority group of expenses is wages and salaries (with charges), social payments, obligatory medical insurance of the unemployed population, and communal fees for municipal organisations. This group consists of socially significant expenses. The following group includes expenses on the increase in material stocks (food, medicines, and so on), expenses on transport services, and telecommunication services. The third group is service of a municipal debt. All three groups together are “prime” expenses.

4 In January 2010 an investigation concerning the rational use of budgetary funds on the majority of rayon budgets of the Minsk oblast was carried out.

Figure 10.2

Priorities of local budget expenses (by economic classification[5]).



Source: Edited by the author, based on data from the Minsk oblast's local budgets.

Expenses on the maintenance of property, as an option for optimisation, are limited because they are hardly likely to be carried out and separately allocated. But, without these expenses, the provision of municipal services is impossible. Obviously, the focus of optimisation is on the fifth and sixth groups of expenses – an increase in the value of fixed assets and miscellaneous expenses. The case of the Minsk oblast shows that municipalities tried to keep the level and structure of current expenditure and, at the same time, cut back their capital construction expenditure to keep the budget balanced. (Table 10.6) The decreased level of the capital budget itself reduced the need for granting credits and loans.

5 Economic classification of local budgets represents the economic structure of budgets and includes expenditures on wages and salaries, purchases of materials, service fees (transport, communications, and communal services), transfers, capital expenditures, land acquisition and granting of credits and loans.

Table 10.6
Expenditures of local budgets of the Minsk oblast
(in BYR, billion and in percentages)

	2008	Share (per cent)	2009	Share (per cent)	2009 /2008
Current expenditures	2,502.1	69.2	2,483.2	74.1	99.2
of which:					
• Purchases of goods, wages and salaries, service payments and fees	1,876.2	51.9	1,829.6	54.6	97.5
of which:					
• *purchases of goods and materials*	*173.3*	*9.2*	*185.5*	*10.1*	*107.0*
• *wages and salaries*	*830.4*	*44.3*	*881.5*	*48.2*	*106.2*
• *charges on salary*	*265.5*	*14.2*	*280.9*	*15.4*	*105.8*
• *payments for communal services, transport services, communication services*	*197.5*	*10.5*	*229.6*	*12.5*	*116.3*
• *other current purchases*	*409.5*	*21.8*	*252.1*	*13.8*	*61.6*
• Current budget transfers	602.2	24.1	627.5	25.3	104.2
• Interests (pay-off)	23.7	0.9	26.1	1.1	110.1
Granting credits and loans	497.5	13.8	328.3	9.8	66.0
Capital construction expenditures	618.0	17.1	540.3	16.1	87.4
Total economic expenditures	*3,617.6*	*100.0*	*3,351.8*	*100.0*	*92.7*

Source: Author's own calculations based on the reports of the Minsk oblast financial department

The second approach consists of an estimation of the efficiency of the expenses of sub-national budgets. The main task of the optimisation of budget expenditures is to balance budget revenues and expenditures. However, optimisation should not mean solely the determination of the minimum volume of expenditures and looking for articles which can be reduced, but it must also take into account the efficiency achieved by the different expenditures. It is necessary to analyse whether there is a necessity to finance municipal services in a particular volume if the qualitative parameters of these services do not correspond to the expected level.

The third approach is connected to the improvement of conditions and forms for granting local budget funds. A prospective direction to improve local budget expenditures may be a changing approach to the definition of the target use of budgetary funds.

An important role in expenditure optimisation should be the specifications of funding. In this case, the volume of expenses is defined by the quantity indicators established in the municipal order and in the budgetary specification. After formation of the order for granting municipal service, local authorities do not have the opportunity to cover all expenses, but only that part which is connected to the granting of municipal services within the limits of the municipal order. Therefore, municipalities will receive a certain stimulus to improve the technology for the granting of municipal services and reduction of costs.

Using budgetary specifications for the definition of needs for local budget funds allows providing, as much as possible, an objective distribution of local budget funds between beneficiaries; reorienting funding of expenses for the final results of a municipal activity and placing volumes of funding depending on the quantity and quality of the public services provided (Begchin 2009).

10.2.3 Transformation of municipal organisations, providing public services to non-state and non-municipal organisations

The purpose of the transformation of municipal organisations, providing public services to non-state and non-municipal organisations, is to improve the quality of public services, to optimise budgetary expenses for their provision, to create competition within the services market, to decrease municipal costs, and to create flexible mechanisms to react to changes in consumer inquiries on public services. With the involvement of non-municipal and independent organisations, which have a more flexible control system and financial policy in providing services, the specified purposes are attained.

The basic advantages of transferring a part of municipal functions and services to non-municipal or independent organisations are (Morgunova and Chankina 2009):

- Setting up a priority for end results for providing public services over the traditional system of service provision carried out by municipal organisations;
- Strengthening the responsibility and interest of providers of public services;
- Reducing the risk of the occurrence of negative financial consequences to the local budget due to administrative mistakes and the inefficient use of resources because of the absence of orientation of municipal organisations to the final results of the services provided;
- possibility of a timely reaction to change in consumer inquiries from outside independent organisations;
- possibility to use a wider set of forms and methods for a better organisation of public services provision (number and qualifications of employees, occupied buildings, terms of payments to suppliers, conditions of payments to cover expenses and so on).

The basic directions to achieve the specified purposes are:

- transformation of a municipal organisation into new organisational and legal forms (independent non-commercial organisations, independent establishments, etc.);
- attraction of external organisations on a contract basis (outsourcing procedures), aimed at competition which will enhance the performance of separate functions and tasks in education, funded by the local budget.

In order to make the transformation of a municipal organisation successful, the following points should be solved:

a) definition of branches and specific kinds of public services that can be outsourced to non-municipal and independent organisations;
b) development of transparent procedures and the use of decision-making on the transformation of the provision of services to external organisations;
c) development and approbation of a model of local government co-operation with non-municipal and independent organisations providing public services;
d) development of effective mechanisms for placing and realising the municipal order for providing public services, including regulation for public and transparent competitive procedures, working out of usual forms of contracts with organisations that will provide the public services.

For decision-making on the transformation of municipal organisations providing public services to non-state and non-municipal organisations, the preconditions summarised in Table 10.7 should be considered.

Non-municipal and independent organisations may perform the following public services:

1. Extra-curricular education of children:
   a) educational services for enhancing children's creativity in the directions of: culture and art, art creativity and national crafts;
   b) services related to physical training and sports activities;
   c) extra-curricular educational services for deepening children's understanding of the sphere of management and economic knowledge.
2. Mass sports actions and activities of an entertaining nature.
3. Fitness services.
4. Organisation of concert programmes, including the realisation of cultural-entertainment actions.
5. Organisation of leisure and rest time for children during holidays.
6. Transport.

Table 10.7

Preconditions for decision-making on the transformation of municipal organisations into non-state and non-municipal organisations

Type of precondition	Essence of precondition
Financial	Excessive expenses on maintenance of municipal organisations, other circumstances testifying to the inefficiency of its work.
	Presence of the potential possibility of a non-municipal organisation to receive off-budget revenues that will be sufficient to perform a comprehensible level of efficiency.
Economic	Low degree of risk of positive consequences from the transformation of a municipal organisation for employees of a given establishment (their labour and social rights) and the presence of possibilities to neutralise these consequences.
	Insufficient demand for public services provided by a municipal organisation by citizens.
	Presence of competition and the possibility to create competition in the market of public services.
Organisational	Readiness of public service consumers to co-operate with non-municipal organisations and maintenance of prospects to receive public services from the organisations which are in the municipal property.
	Sufficiency of a property complex (infrastructure) of the municipal organisation which creates, for non-municipal organisations, the possibility of independent provision of qualitative public services.
	Degree of professional and socially-psychological preparation of Heads and staff of the municipal organisation, allowing for the carrying out of actions for the transformation to non-state and non-municipal organisations and to provide effectiveness under new conditions.

Source: Edited by the author, based on experience from studying the Minsk oblast Executive Committee.

10.2.4 Outsourcing the separate functions of municipal authorities

One of the possible solutions for improving the management of local expenditure in times of crisis is outsourcing of municipal functions.

It is possible to imagine outsourcing as a form of mutual economic relations in which the customer concentrates on the principal activities and transfers minor, but functionally necessary, functions and responsibility for their performance to professional companies. In times of crisis, outsourcing can save a considerable amount of the local budget and allows achieving better results. World experience shows that outsourcing allows raising efficiency in performing administrative processes, a more effective supervision of activity costs, focusing attention on the state and municipal administration, all of which will lead to an improvement in the quality of public services provided to citizens.

To prevent the negative consequences of outsourcing, municipal organisations must develop a transfer technology of municipal services to external firms in a competent manner and in detail, which include: (Morgunova and Chankina 2009)

- to develop a system of standard-legal base;
- to legally fix technology of services transferred to outsourcing;
- to define and accurately formulate the scope of services to be outsourced;
- to regulate the selection procedure of companies, possessing sufficient qualifications and resources;
- to define typical agreements among participants in the public service process (for example, agreement on the service level on the basis of quality assurance of services according to service standards);
- to define a process of municipal service provision by the outsourcing organisation.

The outsourcing system assumes the presence of following consecutive technological procedures (Morgunova and Chankina 2009):

A substantiation for transferring functions to outsourcers (analysis of the actual state of a municipal organisation, detailed analysis of the outsourcing services market, an estimation of the influence of transition to outsourcing on the efficiency of a municipal organisation's activity);

1. Transfer of a municipal service from a municipal organisation to outsourcers (working out of the description of quantitative and qualitative requirements for the public services; working out of requirements to outsourcer; providing competition to select the outsourcer; working out the organisational and administrative decisions connected with a transfer to the outsourcer);
2. Introduction of a monitoring system and quality assurance for the services transferred to outsourcers.
3. The first stage is the starting point in the decision-making process on outsourcing. This stage consists of the following steps:
   a) analysis of the actual state of a municipal organisation;
   b) detailed analysis of the outsourcing services market;
   c) estimations of the influence of introducing outsourcing on a municipal organisation's efficiency.

This means making a decision on the action: Is it worth undertaking outsourcing or not? From here, it is necessary to make a SWOT analysis of the municipal organisation (Table 10.8). It is necessary to represent accurately all of the opportunities and threats of outsourcing using a given sphere.

Table 10.8
A SWOT analysis example of a municipal organisation

Strong sides of municipal organisation	**Weak sides of municipal organisation**
1 Presence of the special areas and premises; 2 Professional staff structure; 3 Service is free of charge, that means full availability; 4 Municipal organisation knows in detail and clearly all features and subtleties as a supplier of public services.	1 Weak material and technical base; 2 Incomplete number of staff; 3 Insufficient financial possibilities; 4 Insufficient motivation of personnel; 5 Inconvenient schedule to provide services; 6 Compensation of missing services by means of users' own incomes.
Opportunities of outsourcing	**Threats of outsourcing**
1 Allows to improve service quality; 2 Allows reducing the costs of the municipal organisation; 3 Allows the municipal organisation to "be focused" on the main points of activity and to channel its freed-up resources; 4 Allows the municipal organisation to effectively use the equipment, buildings and technologies of the outsourcer; 5 Helps to free fixed capital of the municipal organisation; 6 Promotes sharing the risks.	1 Unsuccessful realisation of outsourcing projects is a possible result: 1.1 absence of trustworthy information about possible service providers; 1.2 organisational complexities between municipal organisations and outsourcer; 1.3 indistinct definitions of outsourcing purposes; 1.4 bad management of projects from the side of the service provider; 1.5 insufficient qualifications of service provider; 1.6 absence of a reliable and economically well-founded mechanism of outsourcing introduction in municipal organisations; 2 The overestimated cost of outsourcing which economically is not favourable to municipal organisations; 3 Refusal of service suppliers in municipal organisations in connection with the underestimated cost of outsourcing a project.

Source: An example, SWOT, is based on materials of inspection of the Minsk oblast municipal budgets and the technique of transfer of municipal services to outsourcing (Morgunova and Chankina 2009)

Thus, decision-making to use outsourcing requires a weighted and well-founded approach which could increase the quality of the service delivered. The following functions of municipal organisations that can be outsourced are:

- provision of food for patients in hospitals,
- provision of food for pupils and students in schools,
- management of transport services for pupils and students,
- some administrative services, such as informational and analytical maintenance of monitoring and control over the execution of the commission of local authority bodies.

The real possibility for transferring public services to outsourcers depends on the financial base of the municipal organisation. For this purpose, a preliminary economic analysis of the outsourcing project should be performed. Alternative costs, which represent the expenses connected to providing services by municipal organisations with its resources should be considered. Also, it is necessary to define if additional expenses by transferring services to an outsourcer will occur for the municipal organisation. Where the cost of outsourcing services offered on the market is less than the calculated cost price of services provided by municipal organisations, such services can be potentially outsourced.

Thus, the transfer of functions from municipal organisations to outsourcers is one method of expenditure management. By using outsourcing in crisis conditions, local authorities may not only save local budget funds, but also enable them to concentrate their efforts on the basic direction of their activities.

10.3 Conclusions

The global financial crisis has seriously affected Belarus, as well as all European countries, and has made a serious impact on their local finance. The basic negative influence of the crisis on local finance was the shortage of taxes in local budgets, which has essentially cut budgetary expenses. In turn, it has brought about a negative impact on the quantity and quality of public services provided to the population.

The main measures undertaken by local governments to diminish the crisis' influence on local finance has become municipal loans for the cash gaps in local budgets, the selective policy of local governments in the sphere of budget expenditures and a measure on the integration and consolidation of smaller municipalities, which has led to a relative reduction in local budgets' expenditures.

The basic directions in the field of anti-recessionary management of Belarus local finance can be measured by the municipal debt management of the local governments and measures on expenditure management of local budgets.

Among the measures related to the adjustment of municipal borrowing, it is worth putting into practice an indicator for local budgets' debt capacity. This indicator, together with limits of debt and debt service, allows defining the sufficiency of the local budget's capacity for maintaining municipal debt. Use of an adjustment practice of a debt capacity indicator creates convenient flexibility in the process of debt management. Interaction of debt capacity with legislative restrictions on the size of debts, means the budgeted deficit size allows adjusting borrowing better with a view to decreasing liquidity risk.

The important directions for the development of anti-recessionary management in Belarus are the measures of budgetary expenditures' management. Among these are the improvement of the debt policy of sub-national governments; optimisation of local expenditures; transformation of municipal organisations providing public services into non-state and non-municipal organisations and the outsourcing of various functions of municipal authorities.

The introduction of these measures in local government management can save considerable budget expenses, raise the quality of public services, optimise expenses for carrying them out, develop competition in the public services market and create mechanisms of flexible reactions to the change in requirements of public services' consumers.

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11. Impacts of the Economic and Financial Crisis on Local Governments' Budgets in Moldova

Eugenia Busmachiu

The current economic situation of local governments in Moldova is the result of both internal and external factors. Among the internal causes is the inefficient mix of macroeconomic policies implemented during the last years. In the past, a number of legislative changes were carried out to improve the financial situation in local governments. These reforms focused on allocation issues, local autonomy of local public authorities and fiscal decentralisation, borrowing capacity and taxation etc. So far, municipalities have been unable to exploit resources, such as economic assets, buildings or land, which could generate important long-term revenues that could be used in community development programmes. At the moment, Moldova's governments at both central and local levels appear to be, more than ever, committed to change (see Government of Moldova 2010). The external factors are related to the worldwide financial and economic crisis, which, in Moldova, led first of all to a sharp decrease in remittances and subsequently, to the deterioration of all economic indicators.

The purpose of this chapter is to assess the impact of the economic crisis on local government finance in Moldova. Following on from this, the course and magnitude of the economic downturn in 2009 and the level of fiscal decentralisation are discussed. The first part of the chapter deals with a description of the current economic situation in Moldova; the second part discusses the level of fiscal decentralisation and the third part focuses on local government revenues and expenditures and their development in recent years.

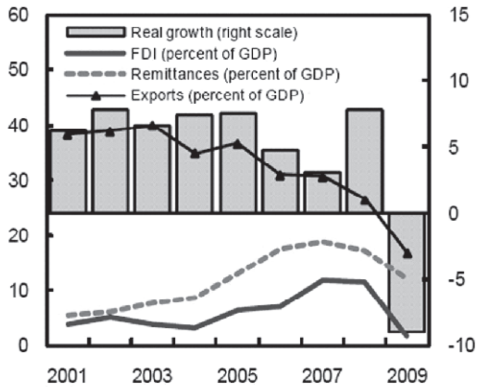
11.1 Nature of the crisis

Moldova was hit hard by the Russian financial crisis of 1998, with the poverty rate doubling to 70 per cent in 1999 and outward emigration. Nevertheless, between 2001 and 2008, we observed sound economic growth, exceeding 6% in most the years. The growth was mostly driven by foreign direct investment (12 per cent of GDP in 2007, up from 7 per cent in 2006) and large remittances from workers abroad (30 per cent of GDP in 2007).

The global financial crisis of 2009 has had a massive effect on the Moldovan economy (Figure 11.1). A steep fall in household consumption was driven by a large drop in remittance inflows, as a result of the main work destinations of Moldovan migrants. Higher domestic unemployment further constrained household consumption (Figure 11.2). Investment fell substantially, due to more difficult borrowing conditions and weak business confidence. With all Moldova's export markets entering recession in 2009, foreign sales dropped significantly (see Kraan 2010).

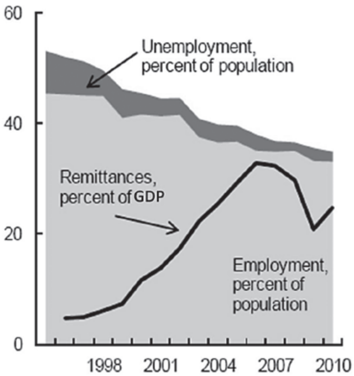
Exacerbating the effects of the crisis, the fiscal policy fell prey to the electoral cycle, while the monetary policy remained too tight, defending the exchange rate, despite some relaxation since May 2009.

Figure 11.1
Main economic indicators
(in per cent of GDP
and in per cent)



Source: IMF (2010a, 17)

Figure 11.2
Rate of employment and
unemployment and share of
remittances in GDP (in per cent)



Source: IMF (2010b, 61)

From the point of view of direct impacts, the banking system and capital market were little affected, the first one due to the prudent policies adopted by the National Bank of Moldova, whilst the capital market is only in its 16th year of activity, being at the incipient phase of development.

Indirectly, the international financial crisis affected, first of all, the amount of remittances, which decreased considerably in the last two years and reduced the volume of savings, consumption and investments. A decline in the exchange rate impoverished transport enterprises; some of them even faced bankruptcy. The reductions in the increase of exports and prices continue to determine the deepening poverty and increase in unemployment. As a result of decreasing remittances, with about 32 % in nine months of the year 2009, the final consumption of households decreased by 9.2 % in real terms compared to the same period of the previous year. The investments of enterprises and organisations in fixed capital decreased by about 42.5 % compared to January-September 2008. The lowest level of investments was registered in the area of construction-assembly, the level of which reduced by 37.8 % compared to January-September 2008. The personal resources of local businesses and of the population (58 %) remained the main financing means for investments, decreasing by 37.1 % compared to the same period in the previous year. Foreign investments also decreased by 42.5 % (they constitute 19 % of the total financing of fixed capital).

The increase in bank interest rates limited enterprises' access to external resources, and as a consequence, it reduced the amount of industrial production of all types of property by 22.2 % in 2009 compared to 2008, the highest decline being registered in the processing industry of 24.3 %. Overcoming the global crisis, let's face it, is outwith our capacities. As George Soros mentioned, "a global crisis needs global solutions". Although attempts to find adjustment solutions are necessary, we consider the following to be the most relevant: restoring trust in the functionality of the financial market, including the banking system, and facilitating the flux of loans to the real economy.

It is possible that our country will feel the global crisis real effects later, compared to the countries where the crisis originated or the countries with developed financial markets, taking into consideration that the reduction in consumption and in the amounts of credits to industrial enterprises could lead to bankruptcy among them. To avoid these situations, it is necessary to develop industrial policies aimed at increasing production competitiveness. At the international level, Moldova should opt for a more consistent external assistance, directed towards anti-crisis measures, according to the agreements reached by the G20 in London.

The economic crisis affected both central and local governments and their revenues through: 1) lower corporate income taxes because of a decrease in private economic activity, as well as lower personal income tax and value added tax revenues; 2) lower royalties and mining taxes brought about by decreases in commodity export volumes and values; 3) lower import taxes and 4) lower capital income (see Roitman 2009).

In the first half of 2009, the falling demand in trading partners led to a severe downturn in exports and remittances. While GDP dropped by nearly 8 per cent over the same period, domestic demand declined even faster, and the current account deficit contracted to about 11 per cent of the period. Growth is projected to reach 1½ per cent, with evenly balanced risks, on the back of a gradual recovery in external and domestic demand and improved business environment. (see IMF 2010a and IMF 2010b). Despite the large output gap, inflation is projected to reach 5 per cent by the end of 2010, pushed mainly by higher international energy prices. The current account deficit would widen modestly to 10¼ per cent of GDP from about 8 per cent in 2009, reflecting higher prices of imported energy and a recovery in investment. Over the medium-term, the economy should return to its potential, whilst inflation remains low and stable. Growth is expected to reach 5 per cent by 2012, led by a rebound in investment and exports, with remittances gradually recovering to their 2008 level.

Table 11.1
Medium-term outlook, 2007–2014

	2007	2008	2009*	2010*	2011*	2012*	2013*	2014*
Percentage change								
Real GDP %	3.0	7.8	−9.0	1.5	3.0	5.0	5.0	5.0
Inflation end of period	13.1	7.4	2.5	5.0	5.0	5.0	4.0	4.0
Percentage of GDP								
Current account balance	−16.6	17.3	−8.0	−10.2	−11.2	−10.2	−8.0	−8.4
Private investments	26.6	27	16.7	18.6	19.6	20.2	20.8	21.2
Fiscal balance	−0.2	−1.0	−9.0	−7.0	−5.0	−3.0	1.6	−0.9
External debt stock	64.2	55.9	66.0	78.6	83.6	85.7	84.3	82.2

Note: *Forecasted data

Source: IMF 2010a, 8

In the economic programme, supported by an arrangement with the IMF, the fiscal-budgetary policy has failed to build sufficient reserves to meet the fiscal budget's growing macroeconomic imbalances. The world economic crisis also led to a sudden re-balancing of the economy, putting considerable pressure on society. The crisis and unexpected increases in pre-election spending, generated a large deficit and the situation is aggravated by the economic crisis. The local governments' deficit increased considerably in 2009 and amounted to MDL 303 million. The local deficit was covered, for the most part, by sources from the privatisation of public goods. The impact of the crisis has been compounded by apprehensions in implementing market reforms and the introduction of targeted social assistance programmes for the poor. In October 2009, the new government launched its "Economic Stabilisation and Recovery Plan for 2009–2011".

The plan includes a sequence of measures which aim to cut inefficient, low-priority public spending, help businesses to withstand the economic slow-down and protect vulnerable households from a drop in consumption, due to the recession and fiscal contraction. A number of sectors of the national economy were excessively regulated; there are barriers to market entry and low competition. Consequently, domestic prices for consumer goods significantly exceeded international prices. Also, in early 2010, there was a growing chain in both utilities and prices for consumer goods. Since the beginning of March 2010, compared with December 2009, prices rose by 5.5 per cent. Having registered 5.6 per cent in real GDP growth in the first half of 2010, Moldova's economy is gradually recovering from the recession.

11.2 The level of fiscal decentralisation

Theoretically, the governmental systems should be more or less decentralised. According to the well-known "decentralisation theorem", decentralising public functions could contribute to social welfare in the case of the population's different preferences concerning locally provided public goods. Oates (1972) also deals with other outcomes of fiscal decentralisation, such as greater experimentation and innovation in the production of public goods and efficient levels of public output, due to the close relationship between expenditure decisions and real cost of resources.

Over the last few years, there have been a number of legislative changes and reforms concerning local public administration, regional development concepts, fiscal decentralisation and capacity building. An important aspect of the reform process relates to the aim of the Government to align the policies of Moldova with the policies of the European Union member states. For example, the Activity Programme European Integration: Freedom, Democracy, Welfare 2009–2013, aims to contribute to better coherence. It stipulates, amongst other points, that decentralisation and ensuring local autonomy is one of the priorities of the government. Local autonomy, in fact, means that local government authorities have the right to regulate and manage their own responsibilities and accountability in the interests of community citizens. Through fiscal decentralisation, local government authorities have the right to establish and operate local taxes, to ensure required financial resources and to cover the expenditure of local budgets. The reforms from recent years are focused on decentralisation by transferring administrative and financial powers and responsibilities from the central public administration authorities to local authorities. In fact, local authorities cannot realise major plans without a record of fiscal decentralisation. Unfortunately, municipalities have also received a number of tasks without giving them the opportunity to realise them.

The legal framework concerning decentralisation issues implies certain principles regarding regulation and allocation of financial resources, either in terms of expenditure and revenue repartition and sharing between central and local authorities or supplementary local revenue creation. According to the new Law on Administrative Decentralisation (435-XVI from 28 December 2006), the rules, principles of decentralisation and its own competences have been defined and established to the levels of budgets. To achieve objectives and realise competences, administrative decentralisation ensures equal opportunities for all local authorities.

The institutional dialogue, which involves informing and consultation by the government of local authorities in the process of financial planning and related decision-making, is an evolving process and a necessary condition for a balanced decentralisation. The partnership between local governments, the private sector, civil society and central government is advantaged by real opportunities for co-operation, as a result of administrative decentralisation. Providing public utility services, according to the qualified standards established by law, relies on the local authorities' responsibility. Initiation, development and implementation of this process belongs to the government in accordance with the Law on Administrative Decentralisation (435-XVI of 28 December 2006), the main task being assigned to a Specialised Commission for administrative decentralisation. Taking into account the principles of decentralisation approved by this law, the new law on local public administration was also reviewed and approved and the law on local public finances remained intact, practically unharmonised with the new principles of decentralisation. An important aspect in achieving effective fiscal decentralisation consists of the local government's fiscal framework. The legislation provides a high level of taxes and, in this case, the public authority has no right to raise certain taxes pertaining to the peculiarities of each district.

In this case, districts play an administrative and regulatory role in the financial relations between the state budget and local councils. Their main functions include distributing transfers from the state budget to local budgets, executing certain local authorities' functions at the district level, aggregating local councils' budget execution data reported to them by the local councils and reporting these aggregated data to the Ministry of Finance. Despite the last years' rhetoric about the need to increase their administrative and financial independence, in reality, the district authorities have little autonomy in fiscal policy decision-making and they end up executing central authorities' orders. The accountability continues to remain hierarchical and vertical, rather than to the local constituency.

The inter-governmental budget relations represent a mechanism for achieving the main functions of public finance. The allocation function of financial resources is fulfilled to realise the decentralisation of public services, provisions and to finance the community. Intervention of the government through transfers can guarantee a minimum level of public services.

The process of delimitation of competences between all levels of public administration is not clearly defined. Delimitation of competences represents the redistribution of financial resources and the determination of transfers from central budget. The local public finance law governs transfers of special funds for ensuring territories financial support to offset expenditure responsibilities under a single principle the national average cost per capita. Allocation of transfers under the provisions of that law causes unfair situations, putting the difference between needs and possibilities of administrative territorial units (revenue) to them. This leads to local governments tending to underestimate their own income. Existing formula for allocating transfers is general and does not give clarity as regards the correction factor of average expenditure per capita, what expenses can be classified as specific and discreet, as is their degree of adjustment. Depending on how decentralisation is undertaken, it is possible that this might contribute to the financial crisis. Rodríguez-Pose and Gil (2005) argue that, in the few instances where there are no strict regulations for local government borrowing, a separation between fiscal freedom and responsibilities can cause agency problems leading to financial disarray. Donors and researchers have highlighted that the financial crisis can serve as an opportunity for reform and set up social safety nets. (IMF 2010a)

The stabilisation policy can be implemented nationwide. Even if economic imbalances affect different districts of the country, it is impossible to apply a stabilisation policy at the regional level. Transfers and government allocations from the state revenues are the main instruments to fulfil financial interdependence needs. Improved communication between central and local governments can prevent the principal-agent problem highlighted in the previous section (Rodríguez-Pose and Gill 2005). Streamlined communication will: 1) allow both central and local governments to set priorities more accurately; 2) permit early identification of local consequences from the global financial crisis; 3) support joint programming of counter-cyclical spending; 4) gain local support for strategies to address the crisis. (OSI/LGI 2010)

The global financial crisis poses a risk of inter-governmental fiscal transfers from budget cuts as governments use the crisis as an excuse for political cuts. Stakeholders need to address this through evidence-based advocacy to ensure the maintenance of government investments for long-term growth. The current system of calculating inter-governmental transfers discourages local governments from increasing the share of the revenues. The methodology for calculating per capita expenditure norms for different groups of expenditures is not transparent; there are no clear normative base costs. As a result, local government does not have sufficient resources to meet and achieve its mission during the budget year. The Ist level local public authority is forced to negotiate the percentage of state budget revenues to be shared with the IInd level local government. Proposals expressed by the local authorities' representatives and some experts in the field have to be taken into consideration in order to enhance financial autonomy. The main proposals are as follows:

1. Improving the revenues of local budgets by delimiting through legislation their proper and shared revenues for Ist level local governments;
2. Promoting a mechanism for stimulating the collection of local governments' shared revenues;
3. Excluding the maximum established level of local taxes approved by law;
4. Reducing the dependence of local government's transfers from the state budget;
5. Improving procedures for an objective assessment of the tax base of territorial administrative units and elimination of all subjectivities.

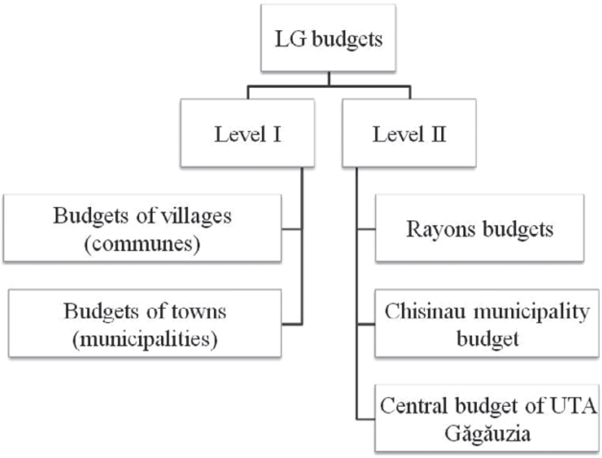
The national strategic plans are often not integrated with local strategic plans and management of resources is not relied upon as a result. The gap between strategic plans and financial relations for covering community needs is why local governments do not fulfil the needs of local society completely. Not all politicians share the same opinion regarding the types of taxes which should be oriented to public administration at a certain level.

11.3 Local budget revenues and expenditures

11.3.1 Levels of local budgets

The structure of local budgets in Moldova is complex. There are two major tiers of local budgets – Level I and Level II. Level I corresponds to the lowest level of local government – villages (communes) and towns (municipalities). Level II budgets are linked to larger territorial units – these are the budgets of rayons, the budget of the municipality of Chisinau and the central budget of the autonomous region of Găgăuzia. The structure is presented in Figure 11.3 and summarises it.

Figure 11.3
Levels of local budget



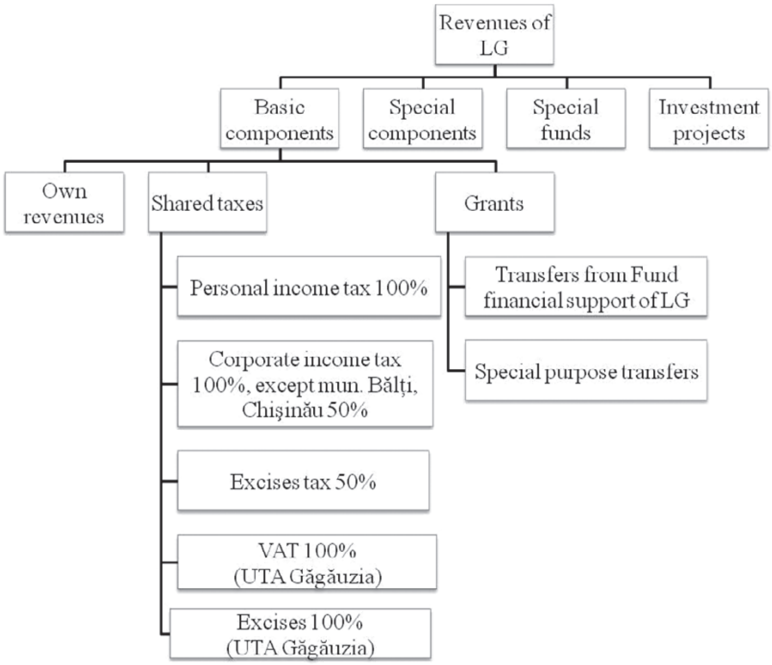
Source: Edited by the author

11.3.2 Structure of local government revenues

Local government revenues in Moldova are divided into: basic components (own revenues, shared taxes and grants); special components; special funds; investment projects; and revenues from business activities, the sale and lease of properties, endowments, interests, fines, aids and donations.

Further, the basic components are sub-divided into: own revenues, shared taxes and grants. Regarding the shared taxes, local governments receive 100 % of tax revenues from personal income tax, 100 % of corporate income tax with the exception of the municipalities of Bălți and Chişinău which receive 50 % and 50 % of excise tax. The UTA Găgăuzia is a special case and it is allowed to collect value added tax and excise duties at the level of 100 %. There are two types of grants: special purpose transfers and transfers from the Fund for financial support of local governments. Figure 11.4 presents the structure of local government revenues.

Figure 11.4
Structure of local government revenues



Source: Edited by the author

11.3.3 Dynamics of local public revenues

The impact of the crisis on local government current revenues depends on: the severity of the downturn, the parallel fortunes and responses of national government, the nature of the revenue base and its vulnerability to economic change (see OSI/LGI 2010).

At present, the Republic of Moldova is facing a difficult economic situation, which is reflected in local public finance through the accumulation of low-revenues in the budgets of local governments and financial dependence of local budgets on the central budget. The economic and financial crisis not only affects households and businesses but also governments. Local authorities are not spared. The crisis has weakened the financial situation of many municipalities. The recession is weighing heavily on public finances. Poor market conditions adversely affect income tax (lower income households and businesses) and push some spending upwards (especially spending on unemployment). The fiscal base of local governments is the sum of its revenue that remains directly and completely in local budgets, including state revenues collected in that territory.

Table 11.2
Local fiscal revenues

	2006	2007	2008	2009	2010	2011*	2012*	2013*
Local fiscal revenues/GDP (%)	6.0	5.69	4.57	4.51	4.41	4.41	4.3	4.75
Local fiscal revenues/Total National Budget Revenues (%)	11.95	12.5	9.4	8.8	8.2	8. 4	8.6	9.7

Source: Author's calculations based on the National Bureau of Statistics and MTEF

The degree of local economic development is low and the financing capacity of local authorities' level I and II is falling. The low level of local fiscal revenues in the total tax revenues is the result of the current tax sharing system described above.

Analysing the 2009 data, we can see that the total amount is about MDL 6,286 million, from which MDL 3,616 million (57, 5 %) are transfers (Table 11.3). During 2009, revenues have been accumulated by the local budgets (excluding transfers from the state budget) at the level of 97.2 %, compared to forecasted figures. In comparison with the previous year, the budgets of administrative territorial units showed a decrease of approximately 21.2 %. The lowest level of collection is from self-revenues which consist of 33 % from total revenues in 2009.

Optimising local taxes imposes new rules on the decisions issued by the Local Governments. Local taxes and fees must be approved as a result of consultations and public hearings. Analysing the situation of local budgets in territorial profile, we see that 57 % of territorial administrative units of the IInd level did not achieve the revenue part of their budgets in accordance with projected data for 2009. Thus, among them, the lowest level of enforcement is found in 12 administrative territorial units in which the level of execution is 63–88 %. Budget allocations from the local budgets of the IInd level decreased by 11 % compared to the forecasted figures, which suggests that access to resources from the central budget is limited.

The highest level of local governments' proper revenues is registered in the Chisinau municipality – 50.40 % in 2007 and 78.60 % in 2008, Balti – 49.92 % in 2007 and 36.38 % in 2008, the district Riscani – 24.24 % in 2007 and 19.96 % in 2008 Drochia district – 25.95 % in 2007 and 22.39 % in 2008. The national average proper revenues represent 31.67 % in 2007 and 36.38 % in 2008. Insufficient financial resources had a negative influence on the development potential of administrative-

Table 11.3
Local governments' revenues

	Revenues (MDL, million, current prices)					Share in %			Ratio	
	2006	2007	2008	2009	2010*.	2008	2009	2010	2009 /2008	2010 /2009
Own revenues	2,651.9	3,036.7	2,874.5	2,670.1	2,594.3	46.9%	42.5%	37.1%	0.929	0.972
Corporate income tax	660.7	832.1	414.3	259.7	120.5	6.8%	4.1%	1.7%	0.627	0.464
Personal income tax	1,123.2	1,322.5	1,479.6	1,464.9	1,493.0	24.1%	23.3%	21.3%	0.990	1.019
Land and property tax	232.7	226.3	262.0	252.7	271.9	4.3%	4.0%	3.9%	0.965	1.076
Indirect taxes	42.1	47.6	45.4	63.4	47.1	0.7%	1.0%	0.7%	1.396	0.743
Other revenues	396.3	415.9	410.9	414.7	463.2	6.7%	6.6%	6.6%	1.009	1.117
Funds and Special funds	196.9	192.3	262.3	214.7	198.6	4.3%	3.4%	2.8%	0.819	0.925
Transfers	2,143.5	2,609.9	3,254.3	3,615.8	4,404.0	53.1%	57.5%	62.9%	1.111	1.218
Total	4,796.0	5,648.4	6,128.9	6,285.9	6,998.3				1.026	1.113

Note: * Budget

Source: Author's calculations based on statistics of the Ministry of Finance of the Republic of Moldova territorial units and, in most territories, decreased the standard of living (UNDP 2009).

To alleviate the crisis some measures were taken at central and local levels and different policies were established. For example, fiscal policy provides direct and indirect tax increases, and re-establishes 10 % income tax from 2012, which will contribute to increasing tax revenues at the central and local levels. For medium- and long-term development, the national government has to establish a clear policy framework for increasing local revenues in a sustainable and efficient way. Local governments should focus on those sources of revenue, which provide significant potential and a reasonable cost-benefit ratio. They require focusing on real property tax, market fees and taxes via involvement of private providers. Stimulation of economic activity can be carried out by encouraging investment and development in the area of small business, by introducing new technologies and providing tax revenues to taxpayers and by raising fiscal discipline. It is important to establish a strategic plan for local development that defines the necessary short- and long-term actions to make the municipality attractive and competitive for new business activity, job creation and expansion of the municipal tax base.

11.3.4 Local public expenditures

Local government expenditures have a similar economic content to the rest of the central government public expenditure, expressing the socio-economic relationship in monetary form between local authorities, individuals and juridical persons, as effective tools used in the process of distribution of local governments' financial resources. Local governments can also redistribute expenditures amongst different budget items (education, healthcare) during the course of the fiscal year, but only within the limits set by the Ministry of Finance. However, they do not have any discretion over the salaries of public institutions' employees (including teachers and medical workers), which represent a major portion of local expenditures (about 60 %) and are determined by central government.

Local governments are obliged to provide many services according to their competences. Not all local governments' competences are financially covered. Some of those services are directly required by law, such as the list of responsibilities in the Law on Local Public Finance and in the Law on Local Public Administration. According to the information presented below, we can conclude that the expenditures portion was limited during the few last years.

In 2009, local governments' expenditure budgets were executed at 66.6 % compared to the previous year. Local governments are not uniform in regard to territorial size. The lowest execution costs are recorded in the following districts: Hincesti, Straseni and Ialoveni of approximately 50–54 %. The government's indication of cutting expenditures was not greeted with any joy by local governments. Most of the important investment projects cannot be realised because of the lack of financial and skilled human resources and this will have a negative impact on the economic development of the communities.

Table 11.4

Local governments' expenditures, %

	2007	2008	2009
General purposes government expenditures	6.76	6.77	6.78
National defence	0.13	0.11	0.10
Maintaining public order and national security	3.65	3.62	3.70
Education	49.74	59.33	59.89
Culture, arts, sports and youth activities	4.79	4.91	4.80
Health care	1.64	1.16	1.12
Insurance and social assistance	8.33	8.04	8.12
Agriculture, forestry, fishing and water management	1.38	0.22	0.21
Environmental protection and hydrometeorology	0.01	0.00	0.00
Industry and construction	0.20	0.20	0.20
Transport, roads, communications and computers	3.86	3.25	3.30
Household and municipal housing operating fund	11.35	7.79	7.44
Fuel and energy complex	5.04	1.44	1.44
Other services related to economic activity	0.08	0.14	0.12
Activities and services attributed to other major groups	3.03	3.01	2.76
Total local governments expenditures	100.00	100.00	100.00

Source: Elaborated by the author based on statistics of the Ministry of Finance of the Republic of Moldova

11.4 Conclusions

The economic crisis had a measurable impact on the development of local governments in Moldova. During the past years, revenues from business activities at the local level have been reduced considerably. There is a lack of investment capacity by local governments. Local public authorities are dependent on transfers from the central budget and lack any ownership of policy implementation at the local level. Zero income tax reduced the level of local public finances over the past few years. The mechanism for budgetary transfers from central to local governments provided political conflicts, penalising local governments whose mayors were in opposition.

Summarising the different comments on reducing the effects of the crisis we would point out that local governments' situations could be improved by:

- Harmonisation and implementation of the strategy on decentralisation;
- Increasing institutional budgetary capacities and expanding municipal level public private partnerships in setting and maintaining public services and adjusting the existing framework to current opportunities at the local and sub-national level;
- Improving the quality of local government agencies and institutions and enhancing local capacities;
- Improving the current equalisation policies of resources and grant allocation, at the national and regional level;
- Carrying out an inventory and evaluation of real municipal property assets such as land, buildings and other physical infrastructures that can support business activities and generate tax revenues.
- Creating a clear mechanism of regional development and involving government representatives at the local and rayon levels in the process of integrated strategic planning and regional economic development.
- Analysing regional financial capacities and priorities for strategic development.
- Developing social and communal services (water and sanitation, roads, solid waste management, gas supply etc.) which contribute to the attractiveness of the community to investors.

Concerning the new perspective "Rethinking Moldova", it is assumed that the implementation of the decentralisation process will increase the fiscal and institutional capacity of local governments via process learning and pilot projects, the introduction of monitoring systems, and introducing quality standards in the delivery of local public services. These realisations will motivate local government authorities to expand the tax base, avoid negotiations between local and central levels in the allocation of funds to exercise their powers and allow increased independence and responsibility of local authorities in developing and managing independently their own resources.

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Law on Local Public Administration no. 436-XV, Republic of Moldova, 28 December 2006.

Law on Local Public Finance no. 397-XV, Republic of Moldova, 16 October 2003.

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12. Ukrainian Local Finance under Pressure: Central and Local Governments Respond

Sergii Slukhai and Ihor Tsekhanovskiy

The global economic downturn hit public finance around the world. Due to conventional wisdom, under such circumstances, local governments could find themselves in a more problematic fiscal situation compared to the national government, since it is the national government that possesses the most important types of revenues and has more discretion towards most revenue sources. This could be a special issue for transition economies where local governments are newly created and usually do not have sufficient revenue sources and expenditure discretion compared to developed nations.

As a recent study by OSI/LGI (2010) shows, these expectations, concerning Europe, have so far turned out to be false: only three countries demonstrated a larger reduction in local budgets in comparison with national budgets; Twelve countries saw a decline in local government revenues in comparison to the previous fiscal year and the others experienced a slower growth. However, local governments in transition countries experienced a greater shock compared to developed countries; out of those twelve, only two are developed countries (Spain and Germany).

Ukraine belongs to those unfortunate transition countries where local governments experienced one of the hardest fiscal shocks, which resulted in downsizing local government revenues by more than 10 per cent in real terms in 2009. Such a situation, of course, must be related to the overall performance of the Ukrainian economy and national government's rate of success in counteracting a severe recession. But, on the other hand, we need to consider whether such outcomes could also be explained by the current composition of revenues and expenditures and the rate at which local authorities could alter them in order to adapt to hard times.

With the above mentioned in mind, we can formulate the corresponding goals for this chapter, of which there are two: (a) to analyse the national government's course of actions directed at helping local governments to overcome fiscal shortages associated with the financial and economic crisis; (b) to find out what measures are being taken by local governments in order to generate more revenues and optimise expenditures.

In order to achieve these goals, an analysis of the recent trends in Ukraine's economic performance and respective trends in public revenues and expenditures was undertaken. Their findings were expanded through the analysis of regional patterns of budget execution through the Vinnytsia region case study. This region is located in Right Bank Ukraine and its population is 1.9 million. It is characterised by prevailing agricultural economic activities. This fact might give us some clues to the situation whereby some regions are less affected by the crisis than others.

The chapter is structured as follows. First, we show the scale of the economic downturn in Ukraine and its consequences for the public finance system. Second, we present actions undertaken by the national government in order to prevent the collapse of public finance. Third, we analyse how local governments generally react to the challenges of turbulent times, through adjusting their revenue and expenditure policies. A case study of the Vinnytsia region gives us a deeper insight into what is going on in different localities, depending on their size and economic specialisation. Fourth, the analysis is followed by speculations concerning what could be done in order to avoid the current situation. The chapter ends with the conclusions.

12.1 Trends in the composition of the public sector due to the economic downturn: The national government responds

Ukraine is one of the post-socialist countries which has experienced the deepest recession in 2008–2009. (Table 12.1) In 2008, the reported GDP increase, in comparison to the previous year, was 2.3 per cent, but in 2009 it changed to a downturn of −15 per cent. The manufacturing sector shrunk respectively by 3.1 per cent and 21.9 per cent compared to the 10.2 per cent increase in 2007. According to official statistical data, the unemployment rate (as measured according to ILO methodology) increased by half and had reached 9.4 per cent by the end of 2009. The current balance of payments deficit in 2009 significantly improved, showing a value of USD 2.7 billion (2.4 per cent to GDP), compared to USD 12.9 billion (7.1 per cent) in 2008 and USD 5.3 billion (3.7 per cent) in 2007. The share of loss-making enterprises drastically increased from 32.5 per cent in 2007 to 37.2 per cent in 2008 and up to approximately 50 per cent in 2009.

As the data above shows, despite the drastic economic recession, the consolidated general government share, measured both by expenditures and revenues, soared. This fact should be considered to be as a result of the national government policies aimed at securing the highest possible level of social security in view of the approaching presidential elections, which took place in February 2010 and resulted in a change of President, Prime Minister and Cabinet.

Problems with the economy's performance created severe troubles for public finance. Despite the government's optimistic (due to the approaching presidential elections, where the managing Prime Minister was one of the candidates) reports concerning state budget execution, there are many serious problems. Of course, it was important that public servants' salaries and of those employed in central level public institutions, that pensions and social benefits were paid out on a timely basis and in full. In order to bridge the current fiscal gaps, the government pursued an aggressive borrowing policy, which resulted in the total public debt (direct and guaranteed by the state) reaching more than UAH 300 billion (about 1/3 of GDP), which exceeded the planned values by 1.6 times. By March 2010, the deficit in the State Pension Fund reached an approximate figure of UAH 30 billion. According to the Accounting Chamber of Ukraine, the actual state budget execution rate for 2009 was 88.2 per cent for revenues and 85.2 for expenditures. These results were due to the broadly spread enterprise profit tax advance payments, delays with value added tax reimbursement and, rapidly growing external and internal public borrowing.

Table 12.1

Basic macroeconomic and public sector indicators of Ukraine

	2007	2008	2009
Nominal GDP, UAH billion	720.7	948.1	912.6
Real GDP growth rate	7.9	2.3	–17.3
Industrial production, UAH billion	599.1	779.1	664.8
Growth rate to the level of the previous year	10.2	–3.1	–21.9
Current balance of payments balance, USD billion	–5.3	–12.9	–2.7
As percentage of GDP	3.7	7.1	1.5
Official unemployment rate, per cent	6.9 (2.4*)	6.9 (2.1*)	9.4
Inflation rate, per cent	16.6	22.3	12.3
UAH/USD exchange rate by the end of the year	5.05	7.58	7.98
Aggregate general government expenditures, UAH billion	226.1	309.2	312.2
As a percentage of GDP	31.4	32.6	34.2
Aggregate general government revenues (transfers excluded), UAH billion	219.9	297.9	288.6
As percentage of GDP	30.5	31.4	31.6

Note: * According to national methodology.

Source: ІБСЕР 2010; Міністерство фінансів України 2009; Рахункова палата України 2010.

Overcoming the public finance crisis encountered serious problems. First, the former President, who was also seeking re-election, did all within his power to ban government initiatives to generate more fiscal flows (stopping privatisation of some valuable state enterprises and vetoing the fiscal initiatives included in amendments to the Budget Code etc.). This was due to the fact that, from his point of view, the less success the Prime Minister achieved in the financial sector, the higher his chances of being re-elected were. Second, the political forces opposing the existing (up to March 2010) ruling political coalition, especially the largest parliamentary political actor, the Party of Regions, which controls more than 1/3 of the legislators and also had a candidate for the presidency, was motivated to make things worse in order to make the Prime Minister accountable. That is why it blocked regular sittings of Parliament for six months, making it impossible to adopt an anti-crisis legislation, and prevented the rotation of Cabinet members, whereby several key ministerial seats became vacant for about a year – Minister of Economy, Minister of Finance, Minister of Defence, and Minister of Transportation. Instead of helping the national government to cut inefficient expenditures, this party insisted on raising social standards just then, which, of course, could only worsen the overall economic and financial situation and distort the current shaky societal quasi-balance.

The economic and fiscal shortages, caused to some extent by actions of the parliamentary opposition and the ex-President during the election campaign, contributed to the failure of the "orange" coalition. As a result, Viktor Yanukovych was elected President. He immediately began to create a pro-presidential coalition and succeeded in dismissing Prime Minister Yulia Tymoshenko.

Fiscal shortages triggered some changes in the composition of public finance. As Table 12.2 demonstrates, during the course of the recession, the decentralisation process which seemed to begin in 2007 when we achieved some growth in the decentralisation rate for the first time since 2004, and which was expected to progress with the new Budget Code adoption, actually reversed, especially with regard to revenues. In 2010, as some experts report, a much larger part of fiscal resources will be centralised; subsequently, local governments will find themselves in an even tighter fiscal situation compared to 2009.

Table 12.2

Composition of general government expenditures and revenues (per cent)

	Government tier	2007	2008	2009
Total expenditures	Central government	57.3	59.0	58.6
	Local governments	42.7	41.0	41.4
Total revenues	Central government	73.5	75.2	75.4
	Local governments	26.5	24.8	24.6

Source: ІБСЕР 2010; Міністерство фінансів України 2009.

Another observable result was a drastic cut in public capital expenditures – the share of current expenditures reached 95 per cent of the total and the secured state budget expenditures were executed at only 94 per cent.

In order to prevent possible losses of local budgets, due to the insolvency of some commercial banking institutions, in January 2009, the Cabinet of Ministers issued a regulation which prohibited local governments from keeping their temporarily free funds in commercial banks, thus pushing them to transfer their accounts to state-owned banking institutions such as Oschadbank and Eximbank. With this regulation, the national government violated the budgetary legislation, which basically allows local governments to keep their free money wherever they wish to do so. Numerous protests by city mayors had no effect.

12.2 Fiscal troubles of local governments

As a cross-country analysis of fiscal consequences of the economic downturn for local revenues performed by OSI/LGI (2010) shows, there are several factors at play here. Concerning current revenues, we need to take into account the severity of the economy's downturn, the pertinence and adequacy of the central government's response to fiscal problems, the nature of the revenue base and its vulnerability to stress factors, the time lags of the taxation system and the rate at which the intergovernmental transfers could be cut down or used to offset the losses in local tax revenues (depending on national legislation). Regarding expenditures, most problems could be associated with the increasing cost of servicing debts and a possible increase in social payments and salaries of public servants due to higher inflation rates, as well as an increase in delayed payments for utilities. Concerning the capital budget, it drastically shrank in most countries because of the depreciation of municipal assets, a lower current budget surplus, and a falling demand for municipal securities. Some of these factors are also at play in Ukraine.

However, the high dependence of local governments on central government and the low elasticity of most types of revenues assigned to them, resulted in a smaller decline in revenues compared to expectations concerning the national economy's downturn.

The recession's consequences for Ukrainian local finance are depicted in Tables 12.3 and 12.4. A 2009 decrease in total revenues amounted to –3.8 per cent of the level of the previous year (minus UAH 2.8 billion). The budget execution rate for total revenues in 2009 was 90.9 per cent in comparison to 97.8 per cent in 2008. The negative signs in local revenue execution appeared in the first half of 2009: it was minus 7 per cent behind the plan of the first half-year. Especially affected were the proceeds from capital (–55 per cent), land sales (–58 per cent), targeted funds (–70 per cent) and personal income tax (–2.2 per cent). To overcome fiscal shortages, local governments tried to compensate by boosting the collection of land tax and land rent (+29 per cent), incomes of budgetary institutions (+16 per cent) and environmental taxes and fees (+80 per cent). It transpired that land payments constituted the most important revenue source, compensating for losses in grants and taxes (it brought about UAH 880 million extra revenues). In a situation where significant arrears in local revenue collection emerged and negatively affected the base for equalisation grant calculation, short-term loans from the national government were involved in funding delegated expenditures. The state gave away about UAH 1.7 billion in short-term interest-free budgetary loans (which is 22 times more than in 2008) in order to bridge cash gaps in local budgets; this generated local government debts towards the state budget by the end of the year.

Concerning revenue composition at the end of 2009, we can observe an increase in land payments' share and a significant drop in targeted funds and in capital revenue share. The first trend can be explained by the fact that land payments (especially land rents) are highly dependent on local government fiscal policy. It could be assumed that local governments tried to use the fiscal instruments at their disposal more effectively by setting higher rates for property use, which we mentioned in our study of municipal property in Ukraine (see Slukhai, Bovsunivskla and Sokrovolska. 2010). Concerning capital revenues, the drop here was caused by a drastically diminishing demand for non-agricultural land and other municipal capital assets.

This situation highlights the fact that not all local government fiscal instruments are sufficiently elastic to compensate for a drop in such ceded state tax proceeds as personal income tax, which comprised about 2/3 of total local revenues. For example, the unified small business tax rate for natural persons in most localities reached the highest possible level allowed by legislation (UAH 200 a month, set in 1998); the same is true for local taxes and duties whose rate caps were set in 1994.

Table 12.3

Composition of local government revenues, transfers excluded (per cent)

Type of revenue	2007	2008	2009
PIT	59.6	62.1	62.6
Land payments	6.7	9.1	11.8
Unified small business tax	2.7	2.5	2.5
Local taxes and duties	1.3	1.1	1.1
Other taxes	6.2	5.5	5.3
Targeted funds	4.6	3.1	2.1
Capital revenues	7.9	6.2	3.7
Other non-tax revenues	11.0	10.4	10.9

Source: ІБСЕР 2010.

The tight fiscal situation of local governments resulted in a growing dependence on state grants: the grant share exceeded 44 per cent in 2009. But the state grant appropriations were not carried out in full, so local budgets missed about 3.7 per cent of their expected grant revenues in 2009.

Changes in the revenue position caused stagnation in local expenditures and some re-shifting of outlays. The nominal total amount of local government expenditures in 2009 was almost the same as in 2008, but the actual execution of local budgets was significantly lower (92.0 per cent in 2009 versus 94.3 per cent in 2008).

As presented in Table 12.4, the share of expenditures dedicated to social and cultural issues (education, health care, social security etc.) reached about 77 per cent, which is significantly higher compared with 2008 (+7.5 per cent points). This means that local governments were determined to support local budgetary institutions so as not to trigger social tensions. Interestingly, administrative expenditures did not experience any significant cuts; they even grew relatively faster than any other type of expenditure – by more than 1/3. This fact signifies that local governments at large are experiencing a bureaucratic bias where the administrators are keen to cut any expenditures, except for those dedicated to their well-being.

Table 12.4

Composition of local government expenditures, per cent

Functional expenditure type	2007	2008	2009
Public administration	4.4	4.5	6.1
Health care	19.0	18.7	21.5
Education	26.6	27.1	31.8
Culture and sports	4.3	4.4	3.8
Social protection	17.1	15.8	20.2
Economy	12.8	9.7	4.8
Housing, utilities, and amenities	4.7	6.1	5.3
Transfers to the state budget	4.1	5.6	5.8
Other	7.0	8.1	0.7

Source: ІБСЕР 2010; Міністерство фінансів України 2009.

The most significant drop is observed in local expenditures on the economy (almost by half in 2009 compared to 2008 and almost by 2/3 compared to 2007) and housing. By the end of 2009, significant problems with local budget execution had arisen, the cause being the permanent delays in payments to local governments by the State Treasury in order to economise on some outlays, which almost paralysed local government functioning and called for some immediate actions from the President.

Concerning state transfers (Table 12.5), we observe a significant relative growth in 2008 and 2009 in comparison to 2007, causing a growing dependence of local budgets on the central budget. The grant share reached about one-half of total local revenues. In 2009, the total execution of grant appropriations reached 97.8 per cent including equalisation grants 100 per cent and subventions 95 per cent. The proportion between general and earmarked grants remarkably shifted towards equalisation grants. In 2009, acute problems with collecting revenue from sources employed for equalisation grant calculation were, to a great extent, secured through direct appropriations from the state budget, instead of sharing proceeds according to predefined rates on a daily basis. In this way, about 33 per cent of equalisation grant sums were transferred (in 2008 only 4.5 per cent).

Table 12.5
Transfers to local budgets (UAH million)

	2007	2008	2009
Equalisation transfers	18,582	28,810	33,356
Transfers for social benefits and social programmes	15,241	18,280	22,793
Other transfers	10,834	12,023	6,031
Transfer share in total local revenues	43.4%	44.5%	46.7%

Source: ІБСЕР 2010; Міністерство фінансів України 2009.

To summarise, the developments in 2008–2009 demonstrate that local governments are not in a position to cope with fiscal shortages caused by the recession and have to rely more and more on appropriations from the central government. But, the fall in revenues and, respectively, expenditures was not as large as expected. There is only the question of whether this situation of a shaky balance will also continue in 2010, when the national government encounters greater challenges in the fiscal area, associated with external debt repayments.

12.3 What really happens at the local level?: A case study of the Vinnytsia region

In the Vinnytsia region, a stable trend towards increasing local revenues was characteristic for the period 2006–2008. In 2009, however, the nominal amount of revenues (transfers excluded) actually remained at the 2008 level (UAH 1,500 billion in 2008 and UAH 1,490 billion in 2009). This is rather different from the overall picture outlined above. The reason lies in the regional economy, which relies mainly on agriculture – a branch that did not experience any drop in 2008–2009, but went through a revival.

The most significant drop in proceeds was observed from communal property sales (–61.2 per cent), land sales (–39.3 per cent), and transfers from the current budget to the development budget (–66.0 per cent). Personal income tax was collected in 2009 at the same level as in 2008 (–0.9 per cent). Our analysis showed that in small communities (with populations below 4,000), an increase in salaries and respectively PIT proceeds was observed; in larger urban communities, on the other hand, some cutbacks occurred. Such trends could be attributed to the fact that in small communities, part-time employment prevails, with salaries set at the minimum level. So, an increase in the minimum pay level to UAH 744 in 2009 led to an immediate increase in salaries and respective tax payments. In urban communities, where the pay level was significantly higher, a rise in the minimum pay level had no positive effect on total revenues; on the contrary, a cut in staff and wages occurred, which negatively influenced urban budgets.

A significant increase in the amount of land payments collected (+23.7 per cent) could be basically attributed to an increase in rent payments due to the renewed land lease contracts and higher rent rates. Curiously, the variation coefficient for rent rates in small communities (they comprise 94 per cent of the total) demonstrated a higher value in comparison to 2008, which could signify deeper heterogeneity in local governments' fiscal policy in combating budgetary shortages.

Concerning the unified small business tax for natural persons, in 2009, an increase of about 4 per cent was achieved – virtually all local governments increased rates up to the allowed maximum of UAH 200 a month. Without changes in the structure of this tax, the potential for using it to balance local budgets will be lost. This must be the case in 2010.

The most important source of own revenue – local taxes and duties – demonstrated a drop of 6.5 per cent against 2008. Almost all of the 15 local taxes and duties, except for the parking fee, showed a downward trend. Most severely affected were duties closely connected to commercial activity, such as the communal tax (it is a payroll tax fixed as UAH 1.7 per hired employee per month), market duty, and advertisement tax.

As the fiscal crisis affected the urban and rural locations differently, it was interesting to look for regional peculiarities which could be attributed to differing patterns of locally-based economic activities. As Table 12.6 demonstrates, there is a significant difference between urban and rural governments. Generally speaking, rural communities did not lose any revenues in 2009 – they even increased their revenues by almost 5 per cent in comparison to urban communities, which lost about 15 per cent. They have also had a much better budget execution rate: 101.3 per cent in comparison to 93.8 per cent in urban areas. Virtually all revenue sources of rural communities were managed better in comparison to urban communities. Table 12.6 shows revenues and their execution rate in urban and rural communities in the Vinnytsia region and aggregated data for the two types of local governments are shown.

The trends in the fiscal situation in urban and rural communities could be highlighted by the use of disaggregated data. For this purpose, we chose one urban community of about 14,000 (Hnivan) and one rural community with about a 2,500 population (Selysche).

Table 12.6

Revenues and their execution rate for some revenues in Vinnytsia region

	Total for cities of district significance				Total for villages			
	2008		2009		2008		2009	
	UAH thousand	Execution rate, per cent	UAH thousand	Execution rate, per cent	UAH thousand	Execution rate, per cent	UAH thousand	Execution rate, per cent
Total revenues	108,106	97.8	92,804	93.8	398,949	102.2	415,340	101.3
General fund	83,817	102.1	75,571	102.4	360,857	103.0	389,269	102.8
PIT	32,422	98.2	32,046	105.9	54,376	109.6	57,717	110.7
Land payments	9,431	110.9	10,569	103.1	25,396	112.9	33,995	110.5
Unified small business tax	8,279	107.1	8,114	100.1	8,448	106.8	8,754	109.2
Special fund	24,489	85.2	17,233	68.5	38,092	96.3	26,071	83.1
Land sales	6,937	94.3	5,750	74.8	5,459	123.5	7,671	123.6

Source: Authors' own calculation.

Table 12.7 below gives some insights into how the revenues of an urban community have changed through time. As seen here, the negative trends unfolded in 2009, when the total revenues were down by 12 per cent, in contrast to 2008, when they soared by 14 per cent. In 2009; the city's budget lost about 1/3 of its tax and non-tax revenues (an especially large reduction was observed for own revenues), which were partly replaced by different grants, especially equalisation transfers. Respectively, the composition of revenues also changed: the transfers now occupy more than 30 per cent of the total, in comparison to 12 per cent in 2008.

Table 12.7

Change in revenue composition in Hnivan

Year	Measure unit	Total revenues	Equalisation grant	Other donations	Subventions	Ceded revenues	Own revenues
2006	UAH	3,135,615	−105,834	0	158,722	1,423,081	1,553,811
	Per cent	100.0	−3.4	0.0	5.1	45.4	50.0
2007	UAH	4,250,695	503,422	165,796	159,985	2,282,257	1,139,234
	Per cent	100.0	11.8	3.9	3.8	53.7	26.8
2008	UAH	5,791,056	579,628	30,724	78,200	2,933,030	2,169,474
	Per cent	100.0	10.0	0.5	1.4	50.6	37.5
2009	UAH	5,107,168	1,278,094	101,072	207,793	2,167,183	1,353,025
	Per cent	100.0	25.0	2.0	4.1	42.4	26.5

Source: Authors' own calculation.

Concerning expenditures (Table 12.8), the lack of fiscal resources mentioned above, caused a cut in total expenditures by 13 per cent compared to 2008. Most affected were capital expenditures, which decreased by 88 per cent in 2009 in comparison to 2008. Respectively, their share in total expenditures became an insignificant 1.6 per cent. The expenditures related to labour increased to about 70 per cent of the total, versus 54 per cent in 2008.

If we consider the fiscal situation in the village, Selysche, it is obvious that it had not deteriorated at all in comparison to the city, as far as revenues are concerned (Table 12.9). First, a growth in total revenues (about +10 per cent) in 2009 versus 2008 is observed. Second, the high dependence on state grants (about 70 per cent) had not changed. The village has increased own revenues and ceded revenues diminished, but not as significantly as in a city. This results from the fact that agriculture was not affected by the economic downturn.

Table 12.8

Change in expenditure composition in Hnivan, UAH

Year	Measure unit	Total expenditures	Salaries and wages	Accruals to salaries and wages	Expenditures on energy consumption	Capital expenditures	Other expenditures
2006	UAH	3,155,352	1,221,525	453,351	213,927	282,343	984,206
	Per cent	100.0	38.7	14.4	6.8	8.9	31.2
2007	UAH	4,116,121	1,650,624	600,024	335,250	436,275	1,093,948
	Per cent	100.0	40.1	15.6	8.1	10.6	26.6
2008	UAH	5,774,704	2,317,126	830,042	499,695	650,655	1,477,186
	Per cent	100.0	40.1	14.4	8.7	11.3	25.6
2009	UAH	5,120,759	2,597,549	923,374	693,412	82,170	824,254
	Per cent	100.0	50.7	18.0	13.5	1.6	16.1

Source: Authors' own calculation.

Table 12.9

Change in revenue composition in Selysche, UAH

Year	Measure unit	Total revenues	Equalisation grant	Other donations	Subventions	Ceded revenues	Own revenues
2006	UAH	425,104	269,365	16,706	48,887	69,886	20,259
	Per cent	100.0	63.4	3.9	11.5	16.4	4.8
2007	UAH	603,704	356,441	50,226	52,673	104,737	39,626
	Per cent	100.0	59.0	8.3	8.7	17.3	6.6
2008	UAH	908,621	547,464	4,835	81,305	203,634	71,383
	Per cent	100.0	60.3	0.5	8.9	22.4	7.9
2009	UAH	1,026,576	596,727	54,455	107,902	186,842	80,649
	Per cent	100.0	58.1	5.3	10.5	18.2	7.9

Source: Authors' own calculation.

The mere existence of bulging revenues means that expenditures will also not shrink. As Table 12.10 demonstrates, the village has about a 10 per cent increase in expenditures. All components of expenditures (except for capital outlays) grew in nominal values.

Table 12.10
Change in expenditure composition in Selysche, UAH

Year	Measure unit	Total expendi-tures	Sala-ries and wages	Accruals to sala-ries and wages	Expen-ditures on en-ergy con-sumption	Capital expendi-tures	Other expendi-tures
2006	UAH	423,117	210,127	73,761	23,386	4,880	110,963
	Per cent	100.0	49.7	17.4	5.5	1.2	26.2
2007	UAH	586,191	283,612	99,323	46,004	21,961	135,291
	Per cent	100.0	48.4	16.9	7.8	3.7	23.1
2008	UAH	892,277	445,928	158,692	66,618	67,921	153,118
	Per cent	100.0	50.0	17.8	7.5	7.6	17.2
2009	UAH	1,054,941	531,961	190,106	120,757	5,250	206,867
	Per cent	100.0	50.4	18.0	11.5	0.5	19.6

Source: Authors' own calculation.

The expenditures for labour did not really change. It can be argued that in this specific case, rural public finance demonstrates a lower vulnerability in comparison to urban public finance. Of course, there are also risks, such as a high dependence on state transfers. If national government experiences severe fiscal shortages, it could cut the amount of transfers, and rural local governments will find themselves in a very difficult situation. That is why it is important to consider raising cost-efficiency and introducing elements of performance-based management.

12.4 Conclusions

In the past two years, local governments in Ukraine, in the area of local budget execution, became victims of the central government policy of centralisation and control. This happened because they have virtually no instruments to pursue their own fiscal policy and compensate for shrinking proceeds from ceded state taxes (personal income tax in the first line). This situation calls for securing additional revenue sources, such as property tax, and eliminating or adjusting the caps on some local taxes which were imposed in the 1990s.

The chapter showed that local governments try to adapt to the fiscal shortage period by a more intensive exploitation of the revenue sources for which they have significant discretion. On the other hand, the sources which are especially vulnerable to economic under-performance dry out very quickly, and the losses could not be offset by the aggressive local revenue policy under the current legislation.

Due to differences in the structure of local economic activities, we can observe varying approaches of local governments for combating current fiscal shortages. It appears that under the given rigid local revenue composition, the urban communities became much more vulnerable in comparison to the rural communities.

It is obvious that the current shortages of Ukrainian local governments could exacerbate in the current year because of a non-existent national policy of overcoming the economic downturn and a rise in the national government's external fiscal obligations. So the way out lies in changing public policy towards revenue and task assignment. The question is what to do: to decentralise or centralise the public sector?

We think that centralisation of public finance, which prevails at the moment, is not the answer to the current challenge. The fiscal shortages of local governments would be offset if a new Budget Code adopted in 2009 and vetoed by the President was introduced. This legal act would enact re-shifting public revenues between central and local governments in favour of the latter and introduce the local property tax. Proceeds from this tax would help cushion the drop in local revenues caused by the economic downturn, especially in cities. Of course, in countries with local property taxation, these proceeds were badly affected by the downturn, but in our specific case of tax introduction, it would positively influence local revenues.

Important for the expenditure side is raising efficiency in managing communal property. Cuts in some expenditures, especially capital, could occur, but they should not be the only measure undertaken. Many public facilities are used with no regard to the costs of maintenance. This would especially be the case for such locally provided public services as secondary education, as shown by us previously (see Slukhai 2006). The problem is that local governments fund the budgetary institutions, but not the functions, trying to save infrastructures inherited from the past.

The recent developments cast into stark relief the institutional weaknesses of Ukrainian local finance. Most of them are derived from incomplete administrative and territorial reforms which have been debated since the early 2000s. The composition of the local government sector is ineffective and stimulates non-productive usage of scarce public resources. So, if the public sector units became larger, fiscal severity would be less harsh.

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13. Municipal Responses to the Fiscal Downturn in Canada: Performance Budgeting

David Amborski

The worldwide fiscal crisis has impacted the Canadian economy, as it has in other major countries around the world. In the North American context, the impact on Canada has not been as severe as in the US, due to the fact that the lending practices of Canadian Banks for residential mortgages are more restrictive than the banks in the US. However, there have been job losses in a number of sectors that have affected employment and economic activity in most Canadian cities. This, in turn, has led to decreases in revenues in cities and an increased demand for a number of services, especially social services.

The Federal government's response to the fiscal crisis is similar to many other countries around the world in that they have provided stimulus funding via its "Action Plan" to lower tier governments. This is especially significant in terms of federal government grants to local governments, as the practice in Canada has been for very few federal grants/transfers to be provided to local governments. Municipalities, according to the British North America Act, are "creatures of the Provincial governments" and whatever activities local governments undertake are based on Provincial enabling legislation. Consequently, the majority of transfer funds come from Provincial governments, and in some cases, there are Federal-Provincial matching funds that are distributed based on some joint funding agreement negotiated between the Provinces and the Federal government.

As the rationale of the Economic Action Plan was to provide funding for "shovel ready" capital projects that will create jobs and have a multiplier effect, municipalities and universities were asked to submit projects to be funded under established guidelines. In addition to the employment impacts, investments in Universities are desirable because it provides longer run impacts by investing in human capital.

As local governments face declines in local revenues, and increased demand for social programmes, they may also be facing increased operating costs for infrastructure in the near future. With increased capital spending on new infrastructure, they will have additional infrastructure to operate and maintain. Furthermore, the increased or accelerated capital transfer payments from senior governments may impact on the deficits and debts of these governments. For example, the Province of Ontario has a $24.7 billion deficit, resulting from its contribution for stimulus spending. This suggests that local governments cannot count on increases in local government transfers for operating costs in the near future.

The municipal financial situation includes a decline in local tax revenue, increased cost for social programmes, and additional operating costs for new capital. Given provincial government deficits, there may also be less provincial transfers in the future once stimulus funding disappears. Municipalities will be expected to do more with less.

One municipal response that is being advocated by Provincial governments, such as Ontario, is to apply performance budgeting techniques. This represents an attempt to make more efficient use of the existing revenue and expenditures.

The purpose of this chapter is to first provide an overview on the use of performance budgeting, and secondly to provide case studies of three jurisdictions where performance budgeting has been applied with some degree of success. It will demonstrate how performance budgeting may be undertaken within the municipal context and that performance budgeting may be applied with a number of variations. It is the responsibility of each jurisdiction to develop an approach that is consistent with the culture and needs relative to their organisation.

13.1 Background to performance budgeting

Performance budgeting has been embraced widely by a number of public organisations including local governments, as it represents an enhancement over traditional line item budgeting approaches that have been used historically. Line item budgeting was simple and convenient as it tends to follow the basic accounting practices and formats that are used for local governments. However, despite its simplicity and understanding, especially by those with accounting backgrounds, it had limited usefulness in terms of modern decision-making requirements for local government staff and politicians.

Line item budgeting only focuses on inputs or the amount of money allocated to each line item for the various departments. It does not provide any information regarding the outputs or outcomes of expenditures, nor does it lend itself to understanding the nature of the programmes for which the expenditures are being made. It creates a tendency for decision makers to make across-the-board cutbacks when there is the need to reduce expenditures. This approach is undertaken with little understanding of the impact of expenditures on various programmes including those that may be a priority of the current government.

In response to the need for better budgeting systems or practices, innovations were developed in which budgeting systems or approaches would also look at the outputs and/or outcomes. One of these responses was the development of performance budgeting. Performance budgeting may be defined in a number of ways and may include both performance measurement as part of the process and performance management in a broader context. The two definitions below will clarify the way these terms have been defined for the purpose of the discussion in this chapter.

"***Performance measurement*** *… provides the foundation for performance management by collecting the necessary performance data and producing the necessary indicators or benchmarks to assess if priorities are objectives are met.*"

"***Performance management*** *… is defined as the organisational approach to define, assess, implement, and continuously refine organisational strategy. It encompasses methodologies, frameworks and indicators that help in the formulation of strategy and enable staff to challenge strategic assumptions, refine thinking, and inform strategic decision making and learning.*"

Given an understanding of the above two performance items, it is possible to define performance budgeting:

"***Performance Budgeting*** *… is not a technique or format…rather it integrates operational accountability into the process, because it unifies the function of management including priority setting and evaluation into a budget process.*" (see Kelly and Rivenbark 2003, 7)

As will be discussed later, the budget document in performance budgeting must link priority setting and evaluation. The intent is to use the management functions as best as possible to improve service performance. This is in part achieved by giving managers the tools and system to be better managers.

13.2 Current practice

The cases described in the next section provide examples where municipalities have successfully undertaken approaches that are considered to include performance budgeting, but they also include components of performance measurement and performance management. In examining the literature on the topic, much of the literature is relatively recent. One of the best comprehensive treatments of the topic is "Performance Budgeting for State and Local Government". It not only explains the evolution of performance budgeting, but also how to plan for and evaluate performance, as well as undertaking benchmarking (see Kelly and Rivenbark 2003).

There has been some evaluation of the application of performance measurement in a number of countries. This includes summary articles of the application in Australia and the Republic of Ireland. In the State of Victoria, Australia, where there is 30 years of experience with performance budgeting, the results have been somewhat mixed in terms of the success of the application (see Kluvers 2002).

In addition to the selected cases that are described in this chapter, there have been several broader initiatives in Ontario on the development of municipal performance measures and/or benchmarks that can provide useful applications or examples for municipalities that desire to undertake a performance budgeting approach to financial management in their jurisdiction.

The first is the Municipal Performance Measurement Programme (MPMP), which was developed by the provincial government. After significant development of this system, all municipalities in the province are now required to report a standard set of performance measures for 12 core municipal service areas. In addition to reporting to the Province, they are also required to report these results to the public, by posting the information about the measures via local newspapers and their municipal websites.

In addition to providing a set of performance measures that municipalities may compare with other municipalities, the development and municipal use of these measures may also have the effect of encouraging municipalities to develop performance measures for high cost or priority services within their municipality that may not be addressed by the Provincially required measures. (For details, see the Ontario Ministry of Municipal Affairs and Housing, "Municipal Performance Measurement Program Guidebook" 2007)

The Republic of Ireland has developed a performance measurement system in which there is a legislative requirement to report performance indicators. This mandatory approach is similar to the Province's requirements for MPMP. However, in Ontario, the use of more comprehensive performance budgeting applications is voluntary (see Wall and Borland 2005).

Several positive approaches or best practices of performance measurement and budgeting can be reviewed. Several US case studies have been written up as ICMA best practices or Westminster, Colorado and under research funded by the Sloan Foundation for the City of Austin. Both of these cases provide some useful lessons for municipalities which are trying to understand how to apply performance budgeting (see Epstein and Campbell 2002 and Hix et al. 2005))

In Ontario, there was some earlier consideration in using performance budgeting. Interest in measuring the performance of municipal services regained interest in Ontario during the late 1990s. One of the outcomes of this interest was the creation of the Ontario Municipal Benchmarking Initiative, OMBI. In 2000–2001, the founding municipalities began reviewing benchmarking initiatives across North America. This review was used to identify best practices and develop OMBI's benchmarking model to identify reliable information about local government service delivery. This led to the establishment of an OMBI project charter and office in 2001. The Charter facilitated communication and the sharing of information. Ultimately, this led to the Chief Administrative Officer (CAO) and city managers of the participating municipalities agreeing on a set of objectives for OMBI. This initiative has grown in both status and importance since its inception. Today, it is viewed as being an important initiative in terms of setting an example for Ontario municipalities in terms of municipal benchmarks.

By 2007 the "Performance and Benchmarking Report" was expanded to focus on 22 services with measurement definitions developed for 38 services/programme areas. The organisation represents a collaboration of 15 Ontario municipalities, i.e. over 9.3 million people and 73.5 % of the population of Ontario. (see Ontario Municipal Benchmarking Initiative, 2007, "Performance Benchmarking Report")

13.3 Elements of a performance budgeting system

To be classified as a good performance budget system, there are three elements which must be present. These include a set of priorities for the municipality, a budget structure in which these priorities are linked, as well as funded, and finally an evaluation framework for the priorities that are implemented via the budget. The mere existence of these three elements is necessary, but not a sufficient condition for a successful and effective performance budgeting programme. In order for a programme to work effectively, these three components must both be carefully developed and well integrated. There is not one single tool or approach for each of these steps, but rather a variety of approaches have been used by various jurisdictions.

Priorities may be set via a strategic planning process for the municipality, which in turn, may be undertaken in a variety of ways. The approaches include community based plans with broad public input, or plans developed primarily with staff and politicians. Alternatively, some form of business plans may be undertaken by the departments in a municipality which, in turn, may have an annual or multi-year time horizon. It is also possible to have departmental business plans developed and used by departments in conjunction with strategic plans or some priority setting initiative. In terms of the budget, it is necessary to focus on outputs as well as inputs (dollar allocations). However, there are a wide variety of formats that may be used, including those that organise the expenditures in a programme format. With regard to the evaluation of the outcomes, there may also be a variety of approaches used, including the use of benchmarks such as those developed from OMBI, the use of specific performance measures, or the undertaking of citizen surveys. The above examples are not exhaustive, but rather provide some prime examples of how performance budgeting may be applied or used.

13.3.1 Setting priorities

When it comes to setting the priorities for a municipality, the questions are – Who determines the priorities? How will they be determined? And how often will they be reviewed or revised? With respect to who sets the priorities for a municipality, it would be generally agreed that these priorities should reflect the public interest. Consequently, they should be determined by the public or community via some form of broad consultation. One popular tool for priority setting is the use of strategic planning. However, it is important to recognise that this tool can be applied in a variety of ways. It may be undertaken by municipal staff or a hired consultant. In some cases, it is undertaken with the primary input being given by members of council and staff. In other cases, especially where it is identified as community based strategic planning, the public will be consulted and will play a significant role in setting priorities.

The public consultation may also vary, depending on the process used. In a minimal fashion the public may be only consulted to comment on a draft strategic plan once it is completed. At the other extreme, the public can be involved in a broad set of steps in the strategic planning process beginning with developing a vision, identifying items to be in included in the SWOT analysis, identifying and prioritising the issues to be addressed, and in some cases even assist with the implementation of the action plans flowing from the strategic planning document. After implementation, citizens should also be involved in the evaluations to assess whether the action plans have been successful in meeting the priorities. An item to keep in mind, regarding the participation of citizens in the strategic planning process, is that the larger the jurisdiction and the more abstract the issues, the more difficult it is to engage people in the process. Typically, people become more engaged when issues are more tangible and are perceived to impact on their immediate environment. For this reason, regional government units have been less successful than local governments in having meaningful public consultation when preparing their strategic plans.

13.3.2 Budget format

In order to have a programme budget that will focus on both inputs, dollars allocated to various expenditures, and outputs, what the result of the expenditure has been, it is necessary to have a budget format that goes beyond the line-item format. Municipalities which attempt to apply some aspect of performance budgeting use a variety of formats that best suit their needs. The important component of this approach is information that includes the objectives of either a service or a programme. It provides an objective against which service or outcomes can be measured. Ideally, the budget will include a description of the service or the programme.

Where a programme format is used, the description will be of the programme. It is important to ensure that all the political decision makers understand the service or programme for which they are allocating funds. Secondly, there should be a statement of the objective or service level to be achieved. In the case of a programme format, it will be the objective of the programme. This information will be developed by the department head or manager who is responsible for the delivery of the service or programme. This statement or objective may also be approved, perhaps in a previous year, by council, a budget committee, or a standing committee responsible for this service area.

As the use of performance or programme budgets usually reflects a philosophy of providing better and more detailed information for decision makers in order to make more informed management decisions, these budget approaches typically include more narrative and detailed information to assist better decision making. This may include separate budget estimates to meet demand related to growth, or enhanced service levels.

The final component of the format in the performance or programme budget is the evaluation measures that are part of the formal budget format. This may take a variety of formats, depending on what type and range of performance measures are used and developed. More detail about the range of approaches and options are discussed in the next session.

13.3.3 Evaluation approaches

The evaluation may take several forms. It may be undertaken by staff alone, or it may involve public feedback that may be undertaken via surveys. In addition, the evaluation may be undertaken for specific items such as programmes or services in the budget, or it may be generally applied to priorities that are expressed via a strategic or corporate plan.

The most traditional approach would be to use performance measures that are part of the budget process. In this application, measures may be developed by staff, either each department head or performance measurement team, to reflect measures such as efficiency and effectiveness. To be effective, the application requires training in the development of performance measures to ensure that staff has the ability to develop useful measures. It may also require trial and error to develop measures that are most useful to both managers and politicians in making budgeting and programme delivery decisions. It could be argued that the Provincial Performance Measurement System provides a demonstration and enticement for municipal staff and politicians to see the potential benefits from the use of performance measures. It also gives some guidance and learning about performance measures and how they might be developed. The measures may also be used in conjunction with some established benchmarks where they exist for some or all of the services or programmes which are measured. The example in Ontario is the use of performance measures that are consistent with the services which have been included in OMBI.

In some cases, the performance measures are also developed in conjunction with a programme budget format. In this case, the expenditures and service delivery are organised around specific programmes that are delivered. This again could include measures of efficiency, effectiveness and other relevant measures. Generally when tied directly to the budget format, the measures will be determined internally to reflect the use of data that is readily available within the municipal management system, or data that is relatively easy to collect. This internally available data will not tend to draw on feedback from the service users, i.e. public, unless it is already collected in some format.

In addition to the general approaches that may be used for the key three components of a performance budgeting or management system – setting priories, using an appropriate budgeting format, and undertaking appropriate evaluations – there are several more formal tools that may be used. These include strategic planning, the balanced score card, and the triple bottom line as some of the current popular tools.

13.4 Case studies

This section provides case studies selected to represent three jurisdictions that have demonstrated successful applications of Performance Budgeting. The approaches undertaken are different in each of the jurisdictions which demonstrate that a number of variations can all lead to successful outcomes. Two of the cases selected are from Ontario: Burlington has a long history of applying performance budgeting tools and methods while the City of Barrie has only been using this type of approach over the past few years. The final case is Maple Ridge, British Columbia, which gives a perspective from another province for a municipality that has a long history of applying Performance Budgeting.

13.4.1 Burlington

The City of Burlington has one of the longest and most enduring systems in place in terms of priority setting, with it currently using the 7th edition of its strategic plan, “Future Focus VII”. The first plan was prepared in 1988. By establishing strategic priorities, a framework against which performance may be evaluated, was created. Over time, Burlington has improved and enhanced its tools used for measuring performance. This is typical of municipalities which have some success with performance budgeting. In the case outlined below, the tools that Burlington use, in addition to strategic planning, include report cards on the strategic plan, quality of service surveys, and performance measures. There have been continuous measures to enhance and improve the system.

Burlington is located in Halton Region on the shore of Lake Ontario. It is west of Toronto in the Greater Golden Horseshoe and has a population of 164,465 (2006 census). (see the City of Burlington website: www.burlington.ca)

Motivation for change and policy environment

The City of Burlington was one of the first Ontario municipalities to apply Strategic Planning that was undertaken on both a comprehensive, i.e. including all municipal functions, and a citizen-based approach. This approach was, in the early 1990s, encouraged also by the Provincial Government. Strategic planning has been undertaken each time a new council has been elected. The strategic plan has been redone or revised to serve as the document that will guide the priorities for the term of the new council.

The existence of a strategic plan alone does not ensure that a municipality will have a system of performance budgeting. However, the existence of strategic priorities and action plans does provide measures against which performance and expenditures can be measured.

Since the first strategic plan, the strategic priorities were reflected in the budget. However, it was not until the third or fourth version of the strategic plan that the performance measures began to be used in Burlington. The evolution of performance measures indicates that the politicians and staff found the guidance of the strategic priorities useful and they desired additional information regarding the performance of service delivery in the municipality. The use of the Strategic Plan has been in place for over 20 years and the use of performance measures has been in place for approximately half of the time period. The approach to priority setting and performance evaluations has been embedded in the government operations and budget process in Burlington. However, as will be discussed below, there is always room for enhancing or tweaking the process to improve it, or make it more responsive to current needs. Like most performance systems, it is a "work in progress" reflecting changing management, political needs, and expectations.

Description and analysis of the application

As with many of the performance budgeting approaches used in municipalities, there is not one simple term or method to describe what they are undertaking. In the Burlington case, it began with community based strategic planning that was initially used to set priorities for the municipality. The early approach did not consider the priorities as part of the budget process. It was only in the third or fourth iteration that the use of performance measures became part of the process.

In all of the innovations that took place, it appeared to be the CAO who took the initiative for the reform. It began in 1988 with Michael Fenn. A later CAO initiated the use of performance measures, and now the current CAO has an initiative to streamline the budget format.

The process has now evolved into one in which at the beginning of the new term of each council, a new strategic plan is developed to reflect the priorities of council for that term. Two members of staff are identified as the key people to facilitate this process. The first several strategic plans enlisted the support of an outside consultant. Now, in-house expertise has been developed and is used on an ongoing basis. The process does entail more than simply adjusting the previous document, but rather developing an entire new plan, if necessary. Part of the role of the internal staff is to consult with the various stakeholders. The stakeholders include various agencies, boards and commissions, as well as NGO's in the community, and other resident and community organisations. The intent is to be as comprehensive as possible in terms of input. Once the new plan is prepared, open houses are held in order to obtain public feedback before the plan is finalised and approved by council.

At the end of the term of council, the municipality has traditionally undertaken a "Quality of Services" survey of local residents. This survey is a telephone survey that is administered to 800 residents of Burlington. It addresses the broad range of services that are delivered by Burlington and provides responses to questions that are comparable over time. As the length of the term of office of councillors has increased, Burlington is committed to undertaking this survey on a two-year cycle in order to receive more regular feedback. When the survey is administered at the end of the term of council, it is used to inform the priorities that are determined in the new strategic plan prepared at the beginning of the term for the new council. The survey is also used to inform the budget process by the City Manager's office and Finance Department.

In addition, there is a specific periodic review of the performance of the strategic plan. Twice a year there is a report card to council. In this way council is able to monitor the performance of the plan that they have created. It also provides them guidance as they move into the annual budget cycle.

Finally, Burlington also has a system of performance measures and performance indicators that are undertaken by each department as part of the annual budget process. These are developed and determined by each department head for his own department. Whereas the performance measures are more a measure of service level, the performance indicators are more indicators of workload. The workload or performance indicators provide the information that lies behind the performance measures. In terms of the use of these two items, it is the performance measures that are presented to council as part of the budget process, while the performance indicators are useful as tools and feedback for the managers. Neither the performance measures nor indicators are developed according to any of the standard categorisations or typologies of measures or indicators. In the most recent budget process, attempts are being made to streamline the budget documentation that is presented to council in an effort to encourage them to focus on key performance measures rather than too much on the details. Consequently, the budget document format has a new look for the current budget year.

As can be seen above, there have been a series of CAO's who have taken a leadership role in the evolution of the system. Staff had to be trained to undertake a number of functions including preparing the report cards, and selecting staff to take on the facilitation role in preparing the strategic plans.

As the system has been well established and implemented for a long period of time, there does not seem to be a great deal of resource cost to using the tools that are part of their performance system. It would appear that staff accepts the development of these components as part of the normal management process. Council also appears to accept the system and the information that it provides. However, the CAO is trying to provide streamlined information for council in an attempt to keep them focused on the key variables and issues. It appears to be the opinion of senior management that the current approach works and is useful, but there is still a need for improvement and enhancements.

What are the benefits?

The benefits have been that priorities have been met because the strategic plan always reflects the priorities of the council of the day. As Council feels committed to meeting the priorities that they have helped to identify, they are also very interested in obtaining report cards and performance measures that provide them feedback regarding their priorities.

On the operational level, managers benefit from the use of performance indicators and at the political level councillors receive feedback on the strategic plan priorities via the semi-annual report card, and in terms of budget allocations via the performance measures during the budget process.

At one point, several years ago, Burlington initiated a Results Based Business Planning approach for which they hired a consulting firm to undertake the process. They apparently implemented it in several departments, but the programme lost momentum and was never fully implemented across the municipality.

Overall assessment/analysis of the approach

This approach, in terms of priority setting via strategic planning, has been used for more than 20 years. It has been considered to be very successful in terms of a process and widely accepted by all parties within the municipality. The weakest link in the system appears to be the current use and development of performance indicators and measures as the managers have been given very little guidance or training regarding the development of performance measures and indicators. There has not been any differentiation by type of indicator even in terms of measures of efficiency and effectiveness. Consequently, there are a large number of measures and indicators, all of which may not be meaningful. Furthermore, there could be the development of performance measures that are consistent with or support the items that are to be addressed in the semi-annual report card to make these two documents integrated and compatible.

13.4.2 City of Barrie

The application of performance budgeting is relatively new, as the champion, the General Manager of Corporate Services in Barrie, had only worked there during the past two budget cycles. Consequently, the system is still evolving and not fully embedded in the culture of the budgeting process of the City. However, it would appear that great strides have been made and that it has been generally accepted by both politicians and senior managers.

Barrie is a separate city, located approximately 50 km north of Toronto. It has a population of 136,000 (35th largest city in Canada), with many residents commuting to jobs in or near Toronto either by driving on Highway 400 or by Go Train. The city has experienced rapid growth and has annexed land from surrounding municipalities. (See the City of Barrie website, www.barrie.ca).

Motivation for change and policy environment

As Barrie is a fast growth municipality, with significant pressures on service delivery, there is a need to improve and reform the current financial management and budget system. They hired a General Manager of Corporate Services, who had significant experience with performance measures, including the Ontario Municipal Benchmarking Initiative (OMBI). In addition, the City has a Chief Administrative Officer with a significant private sector background, who desired to enhance the financial management system.

In 2008, they hired a new staff member, Ed Archer, who is responsible for moving the city beyond its traditional line-item budgeting approach. Consequently, he has initiated a new management approach that includes performance budgeting. The current system was initiated in the 2008 budget process and in 2009 and 2010 more substantial changes have been made in the format and the entire system.

One of the benefits of the change was to have politicians focus on service levels and programme delivery in the budget debates, rather than simply focusing on the percentage increase in taxes or the tax rate. This is viewed as a preferable and more productive focus as the role of local government is to provide a range of services for its residents that they both require and expect. The objective is that once citizens have expressed their priorities and desired service levels, the role of government is to provide these services in a cost efficient fashion.

In the most recent budget debates it was reported that 9 of the 11 members of council focused on service levels rather than tax increases. Only two of the members seemed to be stuck on discussing property tax increases. It appears that the members of council embrace the principle of focusing on service levels but at some points they revert to their traditional concerns about increases in the tax rate.

It is also reported that senior staff has accepted the performance budgeting principles and they are now requesting better information in order to address the priorities and assess their budget allocations. It would appear that the performance system is becoming embedded as it is the third budget cycle that it is being applied. The champion is still employed by the city and the system appears to be improved and enhanced on an annual basis. The city has also joined the OMBI. There has been significant training undertaken for all employees involved in the budget process to ensure common knowledge and approaches to the system.

Description and analysis of the application

The central document is the Departmental Performance Plan. Each department is required to prepare this plan each year. However, this is not a "stand alone" document in the performance management system. It relates to a number of other documents including the municipal strategic plan, the departmental work plan, and ultimately the City's Business Plan and Budget. It also relates to the CAO's report to council which relies on quarterly, and for internal purposes, monthly reports on monitoring by each department.

The departmental Performance Plan includes three standard elements:

1) Performance Summary: It includes a description of the department's products and services as well as key performance indicators used to assess the results. It includes the following components: departmental functions, key departmental objectives, major initiatives and key performance indicators.
2) Budget and Forecast Report: It shows the operating budget request in the context of historical budget requests and expenditures, as well as forecasts for future needs and requests for various services.
3) Base Budget Change Report: It is used to highlight significant changes between prior financial results and current period requested amounts, including explanations for changes greater than 3 %. Within this plan there are stated the key departmental objectives, which relate to either Council's Strategic Priorities that are consistent with the strategic plan, or other programme deliverables. It is important to have these objectives in order to develop useful performance indicators that will measure whether and to what degree these objectives have been met. The performance measures are developed for the key departmental objectives by the department heads, and they are then reviewed by the senior management team. As Barrie is part of the OMBI, if any of the performance indicators are close or similar to those used by OMBI, they will use the OMBI indicator. The benefit of using OMBI indicators is having a clear comparison to other municipalities which are part of the OMBI.

At the broadest policy level are the Strategic Plan/Priorities and the Corporate Sustaining Services. The service levels are set by council in the political arena. As the politicians are elected to represent the interests of the citizens, it is expected that both the strategic plan and related priorities reflect the interests, needs and demands of the citizens of Barrie. These are the policies and programmes that need to be addressed in the City's Business Plan and Budget. In order to develop the Business Plan and Budget to reflect council's policies and programmes, each department must prepare its Annual Performance Plan that was described above. Underlying the performance plans are the annual work plans that are prepared by the staff in each department as well as the balanced scorecards prepared for each department. The Work plans reflect more of a staff tool, while the performance plans are more a public document, viewed by council and used by the CAO to prepare his quarterly report to council. Although the CAO only makes quarterly reports to Council, each department prepares a monthly report for evaluation which is submitted to the CAO and Executive Team. The Executive team includes the three senior managers, the CAO, and Ed Archer, General Manager of Corporate Services.

The broad budget team includes approximately 100 people who "touch the budget" in the various departments. It is this group that must be brought on board to believe in the benefits of the system and who also must be trained to ensure the new system works smoothly and efficiently.

Despite its formative timeframe – third year – the programme is considered to be successful. Evidence of this is from the council debate on the last budget cycle where the majority of the council members focused their discussion on services and service levels.

What are the benefits?

The benefits are a more efficient and better data driven reporting system whereby budgetary decisions will begin to focus on service levels. It has also led to a system where mangers desire better data systems to better understand their service delivery more quickly. This will lead to meeting expenditures on priority items being undertaken in a cost efficient fashion. Staff will be better trained and informed and council members will make more informed budgetary decisions to reflect the needs and desires of the public.

Overall assessment/analysis of the approach

The application of performance budgeting is still evolving as it is only going through its third budget cycle since its introduction. However, it does appear to be a very strong and useful approach of implementing performance budgeting. It has strong support from not only the champion who instituted the system, but also the CAO who has a private sector background. It enjoys strong support from both the political regime and senior management in the city.

The uncertainty lies in whether or not the public is aware and understands the system. This is not to suggest that they need to know the technical aspects of the system, but rather the fact that their needs and priorities are articulated to council in order to feed into the process and budget cycle. Staff and Council need to ensure that an appropriate strategic planning or priority setting exercise with public input is an integral part of the system.

13.4.3 Maple Ridge

This municipal performance budgeting system has been in place for fifteen years and has evolved and developed to meet the needs of the municipality. It began with a CAO champion and it has continued to evolve, presumably because staff and council benefited from its use. It has all of the key elements required for a successful performance system, and looks at priorities and performance in a multi-year time frame. The municipality is proud of the fact that they have developed their system without outside consultants and now has a computer aided system that allows council, staff and the public to view the elements of the current system. This last component however, appears to be assisted by technical consultants for the computer application. This allows all parties access to the same information about the performance management system.

Maple Ridge lies in British Columbia and is part of the Metro Vancouver Region. Its population is 75,783. (see District of Maple Ridge website, www.mapleridge.ca)

Motivation for change and policy environment

The move toward performance measures and performance budgeting began approximately fifteen years ago. It was precipitated by a number of factors, including a reduction in provincial grants that led to fiscal stress for the municipality and the presence of an initial champion in the form of the CAO. The CAO at that time was completing his PhD and was studying how to measure performance and quality management in local government.

The anticipated benefits were to make more efficient use of funds in the situation with less fiscal resources and ensure that the services were still delivered at reasonable quality. Due to the fiscal situation and the leadership by the CAO, there was acceptance by politicians and staff. The early applications were very basic and the system has continued to improve and evolve over the past 15 years. Currently, the system is embedded in the budget and financial management process.

Description and analysis of the application

In terms of the approach that is used, the highest order objectives are based on the Vision and a strategic plan that is articulated by Council. There is currently a document called Vision 2025 which was last reviewed by council in 2007. In the plan, there are nine focus areas, each of which has a set of key strategies associated with it. These are the key strategies that are to be addressed in the council strategic plan and the departmental business plans. They are the focus of the budget activities.

Figure 13.1
District of Maple Ridge performance budget system

Source: District of Maple Ridge Five-Year Financial Plan 2009–2013

Maple Ridge has a business Planning Cycle that is based on a citizen-based performance reporting system. It begins with a Citizen Satisfaction survey that is undertaken on a three-year cycle following the municipal election. This survey, which is also used to assess the priorities that need to be addressed in the strategic plan, represents the primary community input into the process. From this point, in the Spring, Council will prepare a strategic plan that will set priorities and determine the strategic focus. This activity is undertaken at a council meeting in order to be open and transparent. It will identify what the priority areas are for this year that reflect the key strategies, based on the citizen survey as a form of feedback or evaluation, and the evaluation of the priorities from the previous year.

Based on the focus areas and priority areas identified in the strategic plan, the steering committee will set the guidelines and templates to be used by the departments for the business and financial plans. A Business Planning Steering Committee is established to ensure that the budgets expressed via the business and financial plans develop a link to Council's vision for the community, and to ensure a consistent strategic direction. Committee members include elected officials, senior management, union officials, and front-line employees.

Service areas or departments develop five-year operating plans and budgets which directly support the Corporate Strategic Plan. These plans include both a business plan, which relates to the activities and services that it must undertake to address the priorities of the focus areas, and strategies that have been identified as priorities for the current budget year. It will also include any adjustments to the other four years that comprise part of the business plan. The financial plan, on the other hand, shows what expenditures are required to implement the business plan for not only the first year, but the five additional years of the plan. The budget reflects the five-year budget forecast. Both the business and financial plans for the current year are based on those articulated in the previous year's departmental documents. However, they are adjusted to reflect the strategic focus and priority areas that are articulated by Council strategic planning activities that take place in the spring of the current year. These documents are basically brought into alignment with the priorities of that session. This reflects the fact that all of the key strategies in the nine focus areas of the Strategic Plan cannot necessarily be addressed or are a top priority in every budget year. Also, some of the key strategies may have been addressed adequately in previous budget years.

As part of this process, council requires that scenarios include business evaluations with a 10 % funding reduction scenario, forcing departments to look at new ways to deliver services. The plans are presented in open sessions and public participation is encouraged.

Once these plans are reviewed, the financial plan essentially forms the budget for the municipality. A Financial Plan Bylaw is drafted and passed by council, which constitutes the formal approval of the budget by council.

Once the Financial Plan is approved, employees prepare individual performance plans linking their work plans to the department's objectives. This is required of most employees, certainly down to manager level, but does not include those employees who directly deliver operational services.

The budget document itself does not include the evaluation or any performance measures. This is undertaken via separate documents. These evaluations are used by both politicians and staff as part of their process in firstly, the development of the current years strategic focus, and priority areas in the council session held in the spring, and secondly, in the departments development of their business and financial plans.

The cascading effect through all levels of the organisation provides the strategic alignment critical to achieving the community vision in the most effective and efficient manner. This is reflected in service delivery via the resources allocated through the budget process.

The business planning process in place today is the result of a decade of in-house development, feedback, refinement, augmentation, and improvement. The programme's longevity is a testament to its continued ability to provide value to citizens, customers, Council, and staff.

In terms of the performance measures that are used with respect to the priority areas and key strategies, each department develops their own score cards to address their components of the budget or expenditures. There may be two or three measures for each strategy. These have also been evolving over time to address the needs and understanding required for council and staff to make better decisions. There is also a quarterly reporting of these performance measures to provide feedback on performance.

In addition to the original CAO who was the initial champion of the performance budgeting process 15 years ago, there is currently a member of council who was also a provincial legislator and has a keen interest in performance budgeting and management for local government. There is a broad base of politicians involved in all stages of the process. Consequently, there is broad based knowledge about the process, as well as the focus areas and strategies, which helps to ensure that there is broad understanding of the priority areas and objectives. This understanding will enhance the focus when addressing these issues.

Overall assessment/analysis of the approach

The programme appears to be a very sound and workable approach that has evolved over the years to meet the needs of council and staff. The municipality is quite proud of the fact that the application has been developed and undertaken without the aid of outside consultants. Due to the internal development of the approach, the municipality has avoided the "flavour of the day" management tools that are sometimes recommended by consultants. This sometimes leads to situations where applications are not used or followed up once the consultant is no longer working for the municipality. With the current approach, staff and council are invested in the system that they have helped to redevelop and evolve, to meet the needs of council and staff. They have developed a new electronic web-based tool to review and assess the performance measures related to the nine focus areas and key strategies. This approach is very innovative and impressive in terms of providing access to the evaluation information for politicians, staff, and citizens.

13.5 Conclusions

Having defined the concepts of Performance Measurement and Performance Budgeting in the early sections of this chapter, it was possible to identify the three elements that are necessary to successfully apply the concept. This includes the setting/identifying of priorities and objectives that reflect the needs of the residents, having a budgeting system that can link the priorities to the actual funding of them in the annual budget process, and finally, having an evaluation system that actually provides feedback on the degree to which the priorities are being addressed by the municipality. The mere existence of these elements does not ensure that there is an effective and efficient performance management system in a municipality, as there are a number of approaches and variables in the way in which these elements may be undertaken by local governments.

In an effort to illustrate these points, three case studies were presented to illustrate current practice in performance management. These case studies were selected based on a review of mid-sized cities that were identified and considered to have good performance management systems. Table 13.1 below provides a summary of some key aspects of the four case studies.

Table 13.1
Summary of cases

Munici-pality	Popula-tion	Began	Champion	Tools	Strengths	Weak-nesses
Burlington	164,465	1988	CAO	Strat Plan, citizen survey	Strat Plan, continuity	Performance measures
Barrie	136,000	2008	Gen Mgr of Corp Services	Bus Plan, Performance Summary, Balanced Scorecard	Council focus, Staff Training, internal performance measures	Public strat plan/priority setting
Maple Ridge	75,783	1994	CAO	Strat plan, Bus Plan, Fin Plan, community surveys, score cards	Multi-year budget, well integrated	Need for more public input in strat plan

Source: Edited by the author

In examining these cases, it is clear that the jurisdictions used a number of different tools and approaches. The one item in common was that a champion initiated the approach. In cases where the approaches have been used for a significant period of time, the performance system has evolved and been improved throughout its history. To some degree, each approach has responded to the local culture and needs of the jurisdiction with the emphasis being on different elements of the system. In each case, there are elements that are very strong, as the cases were selected based on their reputation, but in each case, there is an element that is either out of date, or could benefit from some improvement. As each complete system is complex, significant training is required to ensure that staff and council are able to apply and use the system effectively. Despite the complexity and training needs, those using the systems feel that there have been significant benefits from the application of the systems.

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List of Acronyms and Abbreviations

CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CIT	Corporate income tax
CPI	Consumer Price Index
CSB	Consolidated State Budget
EBRD	European Bank for Reconstruction and Development
EU	European Union
GDP	Gross Domestic Product
ICMA	International City/County Management Association in the USA
ILO	International Labour Organization
IMF	International Monetary Fund
ME	Municipal Expenditure
NGO	Non-governmental organization
NUTS and LAU	Nomenclature of Territorial Statistical Units and Local administrative unit within the meaning of Regulation (EC) No 1059/2003 of the European Parliament and of the Council of 26 May 2003.
OECD	Organisation for Economic Cooperation and Development
OSI/LGI	Open Society Institute/Local Government and Public Service Reform Initiative
PIT	Personal income tax
PPP	Public-private partnership
PPS	Purchasing Power Standard
SSR	Socialist Soviet Republic
SWOT	abbreviation for SWOT Analysis – Strengths, Weaknesses, Opportunities and Threats
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VAT	Value Added Tax

ALL	abbreviation for the Albanian currency – Albanian lek
BGN	abbreviation for the Bulgarian currency – Bulgarian lev
BYR	abbreviation for the Belorussian currency – Belorussian ruble
CZK	abbreviation for the Czech currency – Czech koruna
EEK	abbreviation for the former Estonian currency – Estonian kroon
EUR	abbreviation for the Euro

HRK abbreviation for the Croatian currency – Croatian kuna
MDL abbreviation for the Moldovan currency – Moldovan leu
PLN abbreviation for the Polish currency – Polish zloty
UAH abbreviation for the Ukrainian currency – Ukrainian hryvnia
USD abbreviation for the United States Dollar

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