

FISCAL DECENTRALIZATION IN ESTONIA

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INTRODUCTION TO THE SERIES

The development of democratic and effective government at subnational levels remains one of the central tasks of transition in Central and Eastern Europe and the former Soviet Union. The sharing of expertise between countries can contribute significantly to the reform process in the region. Pursuing this goal, the Local Government and Public Service Reform Initiative (LGI) has launched a series of discussion papers, which will be distributed widely throughout Central and Eastern Europe.

The series will report the findings of projects supported by LGI and will include papers written by authors who are not LGI grant recipients. LGI offers assistance for the translation of the papers into the national languages of the region. The opinions presented in the papers are those of the authors and do not necessarily represent the views of the Local Government and Public Service Reform Initiative.

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Introduction

Fiscal decentralization, which may be defined as the transfer of some revenue-raising and expenditure authority from the central to a lower level of government, is certainly one of the most crucial parts of the overall administrative reform which the transition countries of Central and Eastern Europe and the former Soviet Union (CEE/fSU) had to carry out after gaining or regaining their independence. By now, the first and principal changes in the reform processes have taken place, so that one could call the current process a “refining” one; however, this period might form the most complex part of the reform and thus needs very careful consideration.

This paper presents an overview of the process of fiscal decentralization in Estonia. Two basic problems will be dealt with in detail: the multiplicity of small local governments and the lack of financial independence on the local level. There are many other relevant topics relating to fiscal decentralization, such as the optimal division of tasks between different administrative levels, which one could consider as well. As Estonia intends to join the European Union (EU), the requirements of the EU regarding local finance will also be taken into account.

The problems analyzed in this paper are particularly visible and pressing in the former Central and Eastern European countries; however, they usually pertain to “Western” countries as well. Over the past few decades, a clear trend has emerged towards the devolving of spending and, to a lesser extent, revenue-raising responsibilities to subnational levels of government. This trend can be observed in developing as well as industrial countries (Ter-Minassian 1997, 36).

The main problem which I encountered writing this paper was the lack of useable statistical data. I have used what was possible to gather, but the reader should be aware that some of my findings might suffer from this deficiency.

During the Soviet period in Estonia, there were officially three levels of government: central, regional and local. In reality, there was only a strongly centralized administrative and fiscal system. The governments on the lowest level were quite unimportant as the revenue and expenditure of their budgets constituted about 1–2% (Ulst 1996, 128) or even less than 0.5% of the total (Nuu 1996, 2). The system was very hierarchical; the units of lower government were subordinated to the central government and were financially dependent.

After regaining independence there was a need for a new decentralized system in Estonia due to the country's reorganization according to the principles of democracy: local governments are an important and perhaps indispensable contribution to this (see Schöber 1999). In addition, there had been a strong system of local governments in the Republic of Estonia before the Soviet occupation (see Reimets 1998, 12–16; Maasik and Peterson 1993, 7–9; Mäeltsemees 1996, 22–25). It is interesting that the issues discussed in this paper were also of concern in Estonia during that time. In 1939 during the territorial reform, the number of rural municipalities was reduced from 365 to 248 (Reimets 1998, 14; Mäeltsemees 1995, 126). Nevertheless, the current reform has not caused a restoration of the old system, but rather a creation of a new one.

The Process of Decentralization in Estonia

The process of decentralization in Estonia can be divided into two stages. The first period includes the changes from the beginning of the reform of local governments in 1989 until the adoption of the Constitution in 1992. The second stage comprises the period from 1992 until now.

The First Stage of Decentralization

The reform of local government began in 1989 with the passing of the Law of the Foundations of Local Government (Mäeltsemees 1994, 77; Mäeltsemees 1996, 25; Nuu 1996, 1).¹ Local government was established on two levels. The primary administrative level was formed by municipalities, boroughs and cities; the secondary level was formed by 15 counties and 6 independent cities (Kenapea 1996, 290; Mäeltsemees 1995, 129). In December 1989, the first local elections took place. The main goal of the first changes was to decentralize the state power to the lower levels of administration. However, the local governments were not ready to fulfill so many tasks because there was a lack of administrative apparatus and experience. In order to receive the status of a local government, they had to present their plans for socio-economic development and their statutes to the central government. These documents were to be reviewed by an expert commission on administrative reform. (Reimets 1998, 19; Mäeltsemees 1995, 129). Thus receiving the status of a local government depended largely on how well one could justify oneself as being eligible (Almann 1995, 448–449).

The most important achievement during the first stage of the reform was the creation of the structure of local governments. However, during the first stage of fiscal and administrative decentralization, the central budgetary system was maintained—the governments at the lower level had to prove their expenditures to the central government in order to receive their respective funds (Nuu 1996, 2).

The Second Stage of Decentralization

On June 28, 1992, the Estonian Constitution was adopted. In the Constitution, the legal basis for the functioning of local government is given. Article 154, Section 1 states that all local issues will be resolved and regulat-

ed by local governments, which shall operate independently in accordance with the law. Further, Article 155, Section 1, which was of great importance for local government reform, states that the units of local government shall be rural municipalities and towns. It implies a one-level Estonian local government system. However, Article 155, Section 2 states that other units of local government may be formed in accordance with the bases and procedures established by law.² Until now this possibility has not been used and currently the Estonian local government system has one level.

On June 2, 1993, the Estonian Parliament passed the Law on Local Government Arrangement. The Law on Local Government Arrangement is “the Constitution” of local governments in Estonia. With this law, the previous two-level local government system was replaced by a one-tier system, according to the Constitution, in which only rural municipalities and towns are mentioned as the local government units.

The unit of the state administration on the regional level is the county governor.³ There are 15 county administrations covering the territory of Estonia. County governors are described as the extension of the state government; they are state government institutions which are financed by the state budget and subordinated to the state government. County governors have supervisory and advisory functions concerning local governments (MIA 1995, 2; Law of the Government of the Republic, cf § 84).⁴ Another function of county governments is to distribute the investment and subsidy fund resources to local governments.

In the beginning of 1994, the system of the budgets of local governments was rearranged as well. The system based on “bargaining” (e.g., lobbying in the state government) was replaced by a system in which the appropriations are given according to criteria characteristic to all local governments such as number of residents, earning of revenue per capita and so forth (Nuu 1996, 6).

Currently there are 253 local governments in Estonia. Local governments compose their budgets independently. The body of representatives

of the local government is entitled to impose taxes and obligations⁵ according to the Law on Local Government Arrangement and special laws regulating it (e.g., the Law of Local Taxes). The budget is confirmed by the body of representatives elected by local residents.⁶ Accepted budgets will be presented to the Ministry of Finance.⁷ However, the central government does not have any right to intervene in the process of composing and accepting local budgets.

The expenditures made by local governments constituted 10.8% of GDP in 1993, 7.1% of GDP in 1994, 8.0% of GDP in 1995 and 9.1% of GDP in 1996.⁸ Estonia was, according to the comparative data from 1994 with its 7.1%, on the average level of transition economies (according to the data in Horvath 1997, 104).

Problems and Suggested Solutions

There are several problems concerning local governments in Estonia. In this paper two of them pertaining to fiscal issues are considered: the multiplicity of small local governments which have difficulties fulfilling their tasks, and the lack of local governments' own revenue.

Multiplicity of Small Local Governments

The federal structure of the public sector opens a whole set of important and fascinating issues for public finance: the proper allocation of fiscal functions among the different levels of government, the most effective assignment of revenue responsibilities and specific tax instruments to the various levels, the role of intergovernmental financial transfers between levels of government and the vertical assignment of regulatory responsibilities (Oates 1994, 126). But the context in which these intergovernmental fiscal decisions are made depends on one's idea of what the local

government is, and on what one believes are the functions or purposes of the subnational units (Horvath 1997, 99).

First, there are two central facts about local government: it is a provider of services to a local community and an instrument of democratic and humane self-government, not a mere agent of the national state.⁹ The need to sustain a viable system of local democracy is at least equal to the importance of securing efficiency in the provision of public services.¹⁰ Such a definition of local government may perhaps seem too trivial to comprehend the essence of this rather complex and cultural-historical phenomenon, but it is sufficient to our discussion.¹¹ It enables us to understand that there is a controversy between local governments being efficient and, at the same time, responding to local needs and providing humane local government (Scholler 1990, 46–47).

Estonian politicians often argue that many local governments in Estonia are too small to fulfill their functions properly (see Figure 1). However, the proper size of local government cannot be determined without further consideration. In determining local governments size one should certainly take into account its functions, the roles it should perform and circumstances within which it operates (Drechsler 1997, 9).

Figure 1: Local Government Units by Population Size in Estonia (as of January 1, 1996).

Number of residents	Number of local governments	Percentage
more than 100,000	2	0.8%
50,000 – 100,000	3	1.2%
10,000 – 50,000	11	4.3%
5,000 – 10,000	22	8.7%
3,000 – 5,000	36	14.2%
1,000 – 3,000	156	61.4%
less than 1,000	24	9.4%
Total	254	100%

Source: Ministry of Finance (Kirss and Tammearu 1997, 1).

Neither in theory nor in practice is there unanimous consent about which functions should be fulfilled by the state and which by the local governments. Localities should definitely fulfill tasks that are local in their essence.¹² The tasks of local governments in Estonia are determined in the Law on Local Government Arrangement and in a number of special laws (e.g., the Elementary and High School Law).

Figure 2: Local Governments' Tasks in Estonia.

Education	construction, operation and maintenance of primary and secondary schools, kindergartens and art schools, sport facilities, houses of culture and community centers; vocational, hobby and sports schools
Health	capital investment and maintenance for municipal hospitals and polyclinics
Roads	maintenance of local networks and town streets
Public transportation	local public transport
Fire protection	fire protection and emergency services
Libraries, museums	local libraries, cultural centers and museums
Water and sewage	operation and capital expenditures
Sanitation	garbage collection and street cleaning
Housing	housing maintenance and communal services
Public utilities	district heating
Social welfare	care for the elderly, home visits and other social services
Environment	local environmental issues

Source: MIA, 1995, 3–4.

In Estonia local governments have to fulfill a large array of tasks and some of them, like education, are very costly. The costs of tasks which are imposed on local governments by the state via laws are covered from the state budget. State government institutions have the right to make contracts with local government councils regarding the transformation of their responsibilities to localities. In this case the state covers all respective costs (Law on Local Government Arrangement, cf. § 6, Section 4, 5).

In addition to the tasks of local governments assigned to them by law (obligatory tasks), they have the right to fulfill other responsibilities that have not been assigned by law to any other party (voluntary tasks) (Law on Local Government Arrangement, cf. § 6, Section 3, No. 2). The possibility to fulfill voluntary tasks considering local needs is one of the most important constituents of the idea of local government. It is possible only if there are enough financial resources available, first to fulfill the tasks assigned by law and, additionally, the voluntary functions according to local needs and interests. If local governments do not possess the means to fulfill voluntary tasks they consider necessary, then they are essentially agencies of the central government on the local level.

Different suggestions have been made concerning the appropriate number of localities. For example, according to one schemata (in RMRK 1993, 21) regarding economic and geographical conditions, transportation, etc. the appropriate number should be 122. But the scholarly quality of such statements is highly dubious, since they have a conception of a locality as a mere provider of public services as their basis, or, in other words—a pure administration (see Laux 1984, 9–10). But as already noted, local governments are far more than simply providers of public goods. Even considering solely efficiency, it is not appropriate to assign uniform standards because some small localities might fulfill their tasks as well as the larger ones.

Here a glance at the situation in the European Union might be useful. The number of local authorities' inhabitants varies considerably in the EU. In both France and Spain, a major portion of the municipalities has fewer than 1,000 inhabitants, whereas 100,000 inhabitants is almost the minimum size of English municipalities, and many have populations of more than 500,000 (COR 1996, 19).¹³ It is also clear that the role, functions and financial capacity of the local authorities vary with the size of local units, and therefore, in many member states (e.g., Belgium, Finland, Italy, the Netherlands, Portugal and Spain) a range of other types of local govern-

ment entities exist, where typically smaller local units cooperate in the provision of certain public services (COR 1996, 19). Stein rightly points out the comparability of policies and units of analysis as one of the most difficult problems in comparative public policy (1992, 10).

As a part of the process of decentralization, some countries have merged smaller municipalities to establish local government entities with the minimum of staffing and financial capacity supposedly necessary to provide the needed public services in the local communities (e.g., the Netherlands) (COR 1996, 20). The main impetus for this reduction was the belief that by consolidating these units greater economy and efficiency could be achieved in the delivery of services (Horvath 1997, 112).

From 1968 to 1978 such reform was also proceeded with in Germany (*die kommunale Gebietsreform*). As a result of this process the number of localities was decreased from 24,282 (in 1968) to 8,518 (in 1978).¹⁴ The goal of these reforms was to achieve an organizational structure which would ensure uniform living conditions throughout the state (Seewald 1984, 38; Vogelsang 1997, 259). However, some states (*Länder*) also opted for cooperation and coordination instead of amalgamating administrative units which enabled small municipalities to stay “alive” (v. Mutius 1996, 172).

Economics of scale in the provision of public goods is quite frequently mentioned in the literature as a disadvantage of a decentralized finance system (Brown and Jackson 1994, 263; Rosen 1995, 517). For certain public services, it may be that the more people use them, the lower the cost per person. Other disadvantages of a decentralized system are associated with externalities, inefficiency of local tax systems on the national level, scale economics in tax collection and equity issues (Rosen 1995, 516–519).

Nuu also mentions the lack of qualified civil servants as one of the problems with too many small localities in Estonia, particularly in the outlying districts (1996, 9). Concerning this issue it should be mentioned that the idea of local *self*-government includes the fulfilling of tasks by local

residents whose interests are concerned. It is perceived as administration by local residents as opposed to professional civil servants, “bureaucrats,” working in state institutions (Maurer 1997, 541–542; Schöber 1999). This does not exclude professional civil servants, but the main point is that the emphasis is on local matters being arranged by volunteer residents of the community. There should be a symbiosis of professional and lay administration (Zielinski 1997, 164).

Efficiency gains may be associated with an increased number of local governments, as smaller localities can better respond to their residents’ needs and are more representative from the point of view of democracy. It is in tailoring outputs of local public goods to the particular tastes and circumstances of different jurisdictions that the real gains from decentralization are to be realized. This takes its sharpest form in the Tiebout model of local finance, where individuals “shop” among jurisdictions offering alternative levels of outputs of local public goods (Oates 1994, 129–130). Other advantages of a decentralized system include fostering intergovernmental competition, experimentation and innovation in locally provided goods and services (see Cullis and Jones 1992, 295–297; Rosen 1995, 519–521). Musgrave concludes that the determinants in the dilemma of spatial economies of scale regarding the regional structuring of public services are twofold (1969, 298). Not only should the supply of particular services be organized in such a way that costs are allocated to and policy determination is made by those residing within the benefit region, but the size of the benefit region should also be determined so as to comply with lowest cost considerations. Thus, to a certain extent, a decentralized fiscal system is to be preferred.

The advantage of many rather than few local governments concerning the variety of services offered is also recognized in Article 4 of the European Charter of Local Self-Government (ratified by the Estonian Parliament on September 28, 1994), which suggests that local authorities should, insofar as it is possible, be allowed discretion in adapting the exercise of

their powers to local conditions (CEM 1996, 9). Here, implementation of the subsidiarity principle is necessary.

Moreover, it seems relevant to mention that one should not consider democracy on the local level as it is conceived on the national level.¹⁵ The tasks and essence of local self-government are qualitatively different from the tasks of state government. Local government is characterized by the direct influence on interests of local residents regarding their daily life. Besides, all the rights of local governments are in their essence derivative from the state as sovereign. Thus the representative body of local government is not “a parliament.” The inhabitant’s citizenship is to be considered irrelevant concerning local self-government (Schöber 1999; see also v. Mutius 1996, 30). Consider that Estonia has adopted active voting rights in the local government election for noncitizens after five years of residency in the respective local government.¹⁶

The following possibilities could be considered to increase the capacity of local governments as providers of public goods.

Coordination of Services

Scholler rightly says that localities are no longer isolated units (1990, 55). There also must be a certain coordination of the use of respective services between local governments. Because of economies of scale, residents of participating localities would be better off, and each person would need to pay less for the service. Cooperation and coordination would leave the existent local authorities still in charge, and thereby avoid any arbitrary changes which would lead to the undermining of the principles of democracy on the local level. Coordination is also preferred considering benefit spillovers, since such spillovers lead to an inadequate allocation of resources in public services unless cooperation between governmental units is provided for (Musgrave 1969, 301). Thus cooperation is a necessary condition of an efficient fiscal system. Blankart admits that the the size of the smallest

local government units is not directly determined by decreasing average costs but primarily by the possibilities to contract with third parties (e.g., neighbouring localities and private firms) regarding the provision of the respective services (1994, 510).

This option has different explanations:

Common provision of services. Local governments in Estonia have the right to establish unions and joint institutions to fulfill common tasks. This right is given to the local authorities by the Constitution and the Law on Local Government Arrangement. However, special laws regulating possible ways to cooperate are missing. A legal framework should be established to enable local governments to choose between more or less organized or independent institutions for cooperation.¹⁷ The second step should be to encourage the municipalities to use these possibilities because the ability to achieve coordination is rather complicated when experiences in this field are limited.¹⁸

Buying services from other local governments. This option could be used in education. When the children from one local government attend the school of another local government, then the costs of the service are billed to the local government where the person resides. This is another quite useful option for very small local governments which have, in this respect, the advantage of having larger localities as their neighbors. Concerning this, there is another problem in Estonia to be solved: the lack of clear rules for intermunicipal payments (PDP 1996, 5).

Contracting out service delivery. Transforming services to the private sector has already increased competition and decreased administrative costs in the practice of Estonian local governments (WB 1995, 9). If the service would be of the same or better quality and cheaper if provided by private firms, then the provision of the service should be given to the private firm (horizontal application of the subsidiarity principle).

On the other hand, regarding certain services, sometimes there are problems with the horizontal application of the subsidiarity principle. Blankart notes two difficulties (1994, 510–512). The first case occurs when

there are no appropriate benchmarks to measure the quality of certain public services, and thus to demand a certain level of quality from the private firm providing it (e.g., police protection). Secondly, the problem of sunk costs may arise. This means that a certain private firm may acquire a monopolistic status regarding certain public services. This might be the case regarding services with considerable entrance costs like water supply firms. Consequently the private firm currently providing the service might take advantage of this position and, for example, bargain for better conditions for itself. A scenario such as this can perhaps be avoided when appropriate contractual quarantees are introduced.

Unionizing Local Governments

Whereas the former option is the preferred one, the second, less desirable, but also quite widespread solution used in practice is the voluntary unionizing of small local governments. This possibility is the most preferred among Estonian politicians and is currently the official policy of the government.

According to the analysis of the World Bank, the cooperation of local governments might not succeed because the administrative costs associated with it would exclude smaller and poorer local authorities which are more isolated, even though these local authorities are usually the most needy. Given this, an amalgamation of localities is proposed (WB 1995, 9). However, considering the results of similar reforms oriented to the amalgamation of different administrative units in Europe, most costs were not decreased. In fact, at times, they have even increased (Drechsler 1997, 9). The relationship between the cost of providing certain services and the size of a locality might not be causal (Mäeltsemees 1997, 6). By creating larger administrative units, the need for cooperation is not eliminated (Scholler 1990, 56). At any rate, cooperation of services is to be preferred, both in terms of democracy and in terms of efficiency.

Estonia has approximately 35 so-called circle municipalities, in the center of which another local government unit is located. In this case their unification is easier, with two local government units being located close to each other. Concurrent with the elections of 1996, such an amalgamation occurred when a circle municipality joined another municipality in its center and formed a joint structural unit—the amalgamation of the Halinga and Pärnu-Jaagupi municipalities (JTI 1998, 91).

Amalgamation of Local Governments

The third but most unfavorable way remains. It is the amalgamation of local governments (more exactly, nonvoluntary amalgamation). In fact, such a possibility is foreseen in the conception and draft of Estonian public administration reform. It gives to local governments the ability to amalgamate voluntarily until 2002, after which time state intervention is planned (Ammas 1998a, 4; Ammas 1998b, 3; Männik 1998, 5).

Article 154, Section 1 of the the Constitution of Estonia includes the institutional guarantee of local government (Anton 1998, 306). The constitution of Estonia only guarantees that there are local governments which decide and arrange local matters in Estonia (institutional guarantee), but it does not give to every locality a constitutional right to resist administrative changes by the state, which also includes nonvoluntary amalgamation of localities.¹⁹ Article 158 of the Estonian Constitution further states that the borders of local governments are not allowed to be changed without hearing the opinions of the respective local governments. But local governments do not have a veto right concerning this. This is also by no means in the arbitrary discretion of the central government. Rather, in order to conform with the Constitution, the changes should be justified within the public interest and in accordance with the principles of the Constitution.

Thus, it is theoretically possible to implement this alternative because such action by the state government is neither against the Constitution,

assuming that certain conditions are met, nor against any other legal act of Estonia. Despite this, the abovementioned solution should be avoided because it collides with the principle of democracy and with the fundamental right of local governments to self-determination.

Lack of Financial Independence

It is generally recognized that both distributional and, especially, macroeconomic management considerations argue against arrangements that would assign all or most taxing powers to subnational governments. Neither is another extreme preferred where all or most taxing powers are assigned to the central government. The alternative favored in the literature and most frequently observed in countries around the world is one that provides for the assignment of revenue sources to each level of government, according to their own incomes, in combination with various types of intergovernmental transfers to bridge any resulting gap between revenue and expenditure assignments (Ter-Minassian 1997, 37). There also exists a certain consensus on which tax instruments are better suited to respective government levels.

The process of fiscal decentralization is immanently connected to the transfer of political power to local authorities, which proceeds from the idea that localities have a right to self-determination, and thus to responsible self-administration (Laux 1984, 27).

The responsible fulfilling of tasks by lower administration levels also implies that they have some degree of fiscal autonomy. This means that local authorities should be able to raise revenue to finance the costs for a proposed service from the beneficiaries of the respective service—“People get what they pay for and pay for what they get” (Stern 1990, 6). On the other hand, this genuine connection between beneficiaries and taxpayers is also relevant from the public finance perspective. Public services should be decided upon and their cost should be defrayed by the beneficiary group.

The ideal tax pattern, insofar as the allocation function is concerned, is conceived of in the spirit of benefit taxation (Musgrave 1969, 294; see also Brown and Jackson 1994, 278). Further, from these considerations also proceeds the general rule of thumb in local public finance that the charges for services have to be used wherever possible (Bird et al. 1995, 32).

According to Article 9, No. 1 of the European Charter of Local Self-Governments, local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.

The revenue sources of local governments could be divided as follows: own income (taxes, fees and revenue from municipal assets); appropriations from state taxes (shared taxes); state budgetary appropriations and loans.

Figure 3: Local Governments' Revenue 1993 – 1997 (in million kroons).

	1993	1994	1995	1996	1997 ^a
Corporate Income Tax	4.9	0.0	0.0	0.0	0.0
Personal Income Tax	1,832.3	1,197.8	1,865.1	2,404.1	2,825.1
Natural Resources Tax	16.8	94.2	10.3	33.6	39.4
Land Tax	0.0	0.0	104.5	211.0	222.1
Revenue from State and Municipal Property	11.2	44.2	96.3	148.5	238.3
State Tax	63.8	13.2	1.6	1.1	0.9
Other Revenue	96.3	107.4	156.9	270.1	328.1
Loans	6.6	39.6	267.0	791.2	177.2
Subsidies from State Budget	643.4	683.3	759.1	910.6	886.9
Total	2,675.3	2,179.7	3,260.8	4,770.2	4,718.0
Residue to cover the expenses	103.4	174.7	175.1	151.8	250.2
Total Costs	2,778.7	2,354.4	3,435.9	4,922.0	4,968.2

Source: Ministry of Finance.

^a For the year 1997 preliminary data has been used.

Own Income

To enable a more resident-oriented local public administration which would better respond to public interest, the responsibility of local governments should be increased. This is better achieved in a situation where most costs are covered by revenue that comes from local taxes (WB 1995, 1). It is also argued that local politicians, bureaucrats and voters might take more care with money that is raised locally than with money that has been given to them (CEM 1996, 28). Considering this, Article 9, No. 3 of the European Charter of Local Self-Governments states that at least part of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of the statute, they have the power to determine the rate.

While there is no perfect local tax, there is a fair consensus in Europe about which local taxes are most satisfactory. The most common local taxes among Council of Europe members are property, income and sales taxes. Whether and why these taxes are suitable to use on the local level is discussed later. Few countries, either in Europe or elsewhere, have implemented large revenue-raising local taxes other than these (CEM 1996, 34). The Law of Local Taxes which regulates the order of imposing local taxes and requirements for local taxes in Estonia enacts nine different taxes that local authorities have a right to levy on the residents of their territory (see Figure 4). Local taxes can be imposed by the local government council. The most common taxes used by local authorities are the advertising and billboard tax, the road and street closing tax, and local sales tax (MIA 1995, 5).

Figure 4: Local Taxes in Estonia.

Tax	Tax base	Tex rate
Poll	Parish or town residents, age18-65	Rate or differentiated rates to be enacted by council
Local income	Income taxable according to corporate income tax law, less state income	As decided by council: up to 2 percent of taxable income; for insurance companies up to 0.4 percent of insurance and reinsurance payments received (except those from mandatory motorist's insurance)
Sales	Taxable portion of the sales price of goods and services to end users	As decided by council: up to 1 percent of the costs of goods and services
Boat	Boats, yachts and speedboats up to 12 m long, subject to technical inspection	Rate or differentiated rates to be enacted by council
Advertising and billboards	Ads and billboards placed on local government territory	Rate or differentiated rates to be enacted by council
Road and street closing	Paid on closing a road, street, square, park, rest area or part of it	Rate or differentiated rates to be enacted by council
Motor vehicle	Motor vehicles registered by the state	Rates to be enacted by council
Animal	Animals specified by council	Rates to be enacted by council
Entertainment	Tickets sold at places and events of entertainment	Rates to be enacted by council

Source: Law of Local Taxes.

Local taxes are enacted only by few local governments and the earnings from these are quite an unimportant part of the revenue of local authorities since they constitute less than 1% of the total revenue of local authorities (Nuu 1996, 10). There are very few states in Europe where this feature is the same or smaller (CEM 1996, 17). Uustal suggests that current local taxes should primarily be used to encourage or discourage certain activities and are not meant to raise revenue (1996, 49). For exam-

ple, the tax for closing roads and streets could be used to encourage the completion of renovations, so that streets could be opened for traffic as soon as possible.

Indeed, as already pointed out, certain taxes, like some pertaining to entertainment, are enacted to discourage or encourage specific activities (Ehrhart et al. 1995, 52). However, generally the primary purpose of imposing local taxes should remain the desire to raise revenue to enable local authorities to act responsibly when they provide services to local inhabitants.

Currently not enough revenue for the tax autonomy of local governments is guaranteed because current local taxes do not provide more than 15% of the current size of local budgets (WB 1995, 13). Some of these taxes are so-called “nuisance taxes”—the administrative costs of the taxes are higher than revenue received from these taxes (e.g., the tax on domestic animals). Which taxes then should be used as local taxes? The criteria according to which a tax is considered as a good local tax are the following (cf. CEM 1996, 36–40; Cullis and Jones 1992, 303–304).

Low administration and compliance costs. Local taxes should not have unreasonable administrative costs. Sales taxes are generally the best taxes on this criterion.

Low distortions. Ideally, local taxes should not distort people’s behavior, especially when tax rates in different areas are different. In particular, it is important to avoid giving people incentives to shift the tax base from one area to another. Tax-base migration can be especially serious with sales taxes and local corporate income taxes because people have an incentive to live in areas with high tax rates and good services, but then shop in areas with low tax rates. A local corporate income tax would create tax competition, distort a firm’s location decisions and may be unsuitable because of administrative complexity. It is suggested that under this criterion property taxes are suitable because locally provided services increase property values and the beneficiaries are made to pay (Bird et al. 1995, 33).

High yield and fair distribution of the yield. Under this criterion, a personal income tax and perhaps a property tax are both suitable. Nevertheless, it should be mentioned that the yield on property as tax will not stay in line with price and income increases (i.e., property taxes are not buoyant) (see also Redcliffe-Maud and Wood 1975, 113).

Promote efficient spending levels. Ideally, local taxes should help produce a situation where local authorities spend at the correct levels: that is, they should spend more so long as the benefits of extra spending exceed the cost. Efficient spending levels are not achieved when invisible taxes (voters do not know how much they are paying and consequently may not vote for the correct level of local spending) or tax-exporting occur.

Local incidence of tax. Tax burden spillover should be avoided. Local corporate income enables localities to “export” taxes (i.e., the burden of a tax falls partly on nonresidents) and thus creates a tax-burden spillover. The rationale of regional finance breaks down when local public services are financed by taxes whose burden is shifted to another region (Musgrave 1969, 306). Thus local corporate income tax is also in this respect not recommended. It is worth noting that some exporting is acceptable because some of the benefits of local services will also be exported, but it would be unwise to rely to a great extent on taxes where exporting is substantial.

Also, the revenue raised from providing services by local governments is considered as its own revenue. Regarding local governments’ role as providers of public services, they should not view profit as the goal of providing these services. Rather, the goal should be good and economic administration within the framework of a reasonable division of tasks. Generally, localities should not intervene when there is no need to provide the good publicly and private firms can provide it as well as or even more efficiently.²⁰

In Estonia the revenue raised from publicly provided goods by local authorities (e.g., public transportation, utility payments, kindergarten fees) is quite inconsiderable if it bears the costs of providing the goods at all.

As a rule this income goes to cover the expenses of the government agency providing the service and is not reflected in the local government budget. Increases in service fees (rent and public transportation tickets) by local governments constitute a major cause for increases in the consumer price index. Considering price increases for other items, it is difficult for local governments not to raise their service fees (Kirss and Tammearu 1997, 7). On the other hand, it is politically difficult for local councils to raise user charges (Bird et al. 1995, 32; Redcliffe-Maud and Wood 1975, 104).

The importance of fees and charges should increase because using them is actually the best way to enable responsible local administration. In the case of fees and charges the most direct connection between revenue-raising and spending is established. In the context of the Tiebout model of local finance, for instance, such revenue promotes efficient decisions by mobile consumers who give the right cost signals to residents for the determination of levels of local services (Oates 1994, 131). It is, however, impossible to introduce user charges for all services. Implementing user charges requires that the service charged should have a measureable output, and there must be a possibility to exclude individuals from receiving the service because persons who do not contribute should, in the case of user charges, be excluded from enjoying its benefits (Horvath 1997, 110).

Shared Taxes (Appropriations from State Taxes)

Tax sharing means allowing subcentral authorities the right to a share of the yields of certain national taxes. The main advantage of a shared tax is that it is a relatively inexpensive and simple way of securing tax revenues for lower-tier authorities with some guarantee of certainty. Its main disadvantage compared with local taxes is that local authorities cannot determine their own tax rates (CEM 1996, 34). Tax sharing also increases inequality among regions, in that more revenues go to areas with larger tax bases, exacerbating the emerging differentials on the expenditure side in

the provision of services (Bird et al. 1995, 33). Nevertheless, there is still a crucial connection between revenue-raising and spending, because the respective revenue comes from the pockets of local residents.

Figure 5: Shared Taxes in Estonia (in percent of total revenues).

Tax	Central Government	Local Government
Personal Income	44	56
Land	–	100
Natural Resources:		
Oil shale	50	50
Construction materials	30	70
Water supply	80	20

Source: MIA 1995, 7.

The most important of shared taxes is currently 56 percent of personal income tax, which is transferred to the budget of a certain local government according to the residence of the taxpayer. The revenue from personal income tax constituted in 1997 about 60 percent of the total income of local budgets (see Figure 3). There are two more shared taxes which raise the revenue of local authorities: the land tax and payment for the use-rights of certain natural resources.

Since the beginning of 1995, local income has also included a land tax, enforced by the local government council at a rate ranging from 0.3 to 0.7 percent of the land's assessed value. From 1996 on the land tax was channelled to local budgets only, while local governments could enact taxation at a rate ranging from 0.8 to 2.0 percent of the land's value.

Increasing the local budget share of personal income tax has been discussed (up to a full 100 percent allocation to local budgets) (Nuu 1996, 11–12). Implementing this idea, at the expense of reducing the portion of state budget allocations, would also contribute to the increase of inequities among local governments, because dues from individual income taxes are relatively greater in more affluent local communities (MIA 1995, 6). This

is perhaps not the most crucial problem here because respective mechanisms could be worked out to redistribute this revenue.

Another far more considerable problem is that the central government would lose one of the most flexible revenue sources and a very important macroeconomic tool regarding the allocation of resources and economic stability (WB 1995, 15). There exists a broad consensus among economists that taxing and spending decisions pertaining to macroeconomic management (e.g., having direct influence on unemployment and inflation) and related to the fiscal functions of distribution and stabilization should be made by the central government (for example, see Brown and Jackson 1994, 256–257; Musgrave 1969, 293–294; Oates 1994, 128–130; Rosen 1995, 516). In many market economies, the central government controls those taxes considered to be the most redistributive or those with a cyclical revenue flow, leaving subnational governments with more stable sources of revenue (Bird et al. 1995, 33). Ter-Minassian points out that, in general, the central government should be assigned taxes that are levied on the more mobile tax bases, are more sensitive to changes in income—that is, having higher income elasticity—and are levied on tax bases that are distributed very unevenly across regions (1997, 37).

Another way to increase the budget autonomy of local governments would be to create a separate local income tax out of the individual income tax portion channelled to local budgets in which the local governments would have discretion between a minimum and maximum rate. Along with the local tax, the income tax raised by the state would be retained (WB 1995, 15).

State Budgetary Appropriations (Grants)

The central financial authority must enter the process and treat equals unequally in order to offset the divergencies in the income and wealth levels of subordinate units (Buchanan 1965, 101). Other reasons also justi-

fy the grants system: grants are used as a direct financial support for the provision of certain services, and they are used to reduce the burden of regional and local taxation by transferring part of the national revenues to regional and local authorities (COR 1996, 24). The most important difference between grants and shared taxes is that, in the case of grants, there are no linkages between the source of the revenue and the expenditure.

Grants fall into two main groups: specific or conditional grants and general or unconditional grants. Specific grants are grants which the recipient local authority must spend on a particular service. General grants are grants which may be spent by the recipient local authority on any service it chooses and is legally allowed to perform.

General-purpose grants. Unconditional grants are used by the state mainly to reduce the differences between local governments regarding financial resources available to them because that enables smaller local governments to function properly. There remains the question: How much equalization should be implemented?

Regarding this point, we have to deal with what is just. Buchanan suggests that the policy objective of intergovernmental transfers is, reduced to individual terms, “equal treatment for equals” (1969, 101). However, this general classical formula of justice needs to be achieved with special terms according to which equality should be assessed. Thus deciding how much equalization is appropriate certainly contains a political value judgement. Only a certain or perhaps a minimum standard should be secured, unless local governments do not have any further incentive to “compete” and their initiatives in this respect would thus become obsolete. The national government should assure each citizen that, no matter under which local government he resides, he will be provided with a minimum level of certain essential public services such as safety, health, welfare and education. (Brown and Jackson 1994, 279; see also Musgrave 1969, 309). Persons earning the same income and possessing the same amount of property should not be subjected to different fiscal pressure in different localities.

Buchanan considers that the ideal of “equal treatment of individuals” is even superior to that of equalization among organic state units (1969, 101).

In Estonia, these grants are closed-ended lump sum transfers, i.e., the central government transfers a fixed amount of money to a local government without restrictions on its use or any change in the relative prices of the local public goods. They are appropriated to local governments through a subsidy fund. The size of the subsidy fund in the state budget bill, and its distribution among local governments will be determined by an agreement among authorized representatives of local governments, their alliances and the central government.²¹ If no agreement is reached, the size of the subsidy fund in the state budget bill and its distribution will be determined by the government (MIA 1995, 7). Until now the agreement has been reached every year. Proceeding from this agreement, the final sum of the subsidy fund and the principles of its distribution will be fixed by the Parliament of Estonia in the current state budget law.

The amount of the grant can be calculated by total reimbursement of costs or an agreed percentage, a predetermined fixed sum, a formula based on regional and local financial capacity (e.g., considering the individual revenues available from regional and local taxation compared with the average regional and local tax revenue), a formula to measure spending needs (e.g., based on criteria such as population size, length of roads, number of single-parent families, unemployment, etc.), or by any combination of these methods (COR 1996, 24). In Estonia a formula based mainly on financial capacity is used.

In Estonia the amount of the appropriation from the support fund shall be determined by the distribution equation as follows (Nuu 1996, 13; cf. 1999 State Budget Law, § 2):

$$T_n = (m * ak - an) 0.9 * cn$$

where:

- T_n – subsidy being appointed to local government;
- m – subsidy level co-efficient;
- ak – average level of appropriations and receipts to the budgets of local government units in Estonia allotted out of state taxes in the budget year (currently in 1999) in kroons per capita;
- an – level of appropriations and receipts to the budget of a local government unit allotted out of state taxes in the budget year (currently in 1999) in kroons per capita;
- cn – population of local government unit;
- 0.9 – shows that the revenues are supplemented at the amount of 90 percent.

State taxes in this formula include individual income tax, land tax and gambling tax. In practice, the formula makes no allowance for gambling tax. Gambling receipts from it only amount to a few million kroons and that primarily in Tallinn, the capital of Estonia, which does not receive support from the subsidy fund because of its larger income.

The subsidy level coefficient “m” is derived from the size of the subsidy fund and indicates how much per capita income from state taxes can be channelled to a local government budget, compared to Estonia’s average, to provide resources from the subsidy fund.

The first problem of the current state budgetary appropriations system is that the principles and characteristics, according to which the fund is distributed, change every year and the local governments cannot rely on an appropriate level of stability to plan their long-term activities (Nuu

1996, 14). The principles formulated in the respective laws are too general to provide at least the minimum level of security in this respect. The formulae of equalization are also very dependent on the size of the general grants (PDP 1998, 6). It is, however, impossible to set one absolute and final regulation for every year, since such a system would not provide the flexibility needed to consider the changing circumstances of a modern society. Ter-Minassian rightly points out that revenue-sharing arrangements with co-efficients set in law or in the Constitution give some predictability to revenues, which is important for budget planning. However, they would also impart considerable rigidity to the central government budget, substantially diluting the impact of fiscal belt-tightening (Ter-Minassian 1997, 37–38). These considerations are also relevant concerning an appropriate grants system as both the need for stability and flexibility should be considered.

There are also many other problems with the current state grants system. To mention only some of them: the present system does not consider the differences in expenditure needs across local authorities; still significant differences exist (sometimes more than 100 percent) in the revenue capacity per inhabitant across local authorities after the state grants have been transferred; the current state grants system reduces the interest of some local authorities in developing businesses within their own territory; and, in addition to revenues, the levelling formula should also consider the costs of local governments incurred due to differences in functions, demographic features, service costs and social needs (PDP 1998, 5–8).

Considering these problems in Estonia, there is an obvious need for a new state grants system, ideally a model which enables local governments to provide approximately the same level of service to their residents at an even level of local taxation. At the same time, the system shall ensure the local government's initiatives to strengthen economic development inside its territory and ensure a high level of local autonomy. It is also important to keep the model simple and transparent (PDP 1998, 9–10).

Earmarked or Specific Grants. The size and purpose of targeted subsidies is determined in the state budget. As specific grants restrict local authority's freedom more than general grants, they should be paid only when there is a good case for using them in preference to general grants. Theoretically, three main occasions justify the use of specific grants: (1) to finance services which local authorities provide as agents of central governments; (2) to encourage local authorities to provide services that generate benefits for nonresidents (externalities); and (3) to support local authorities if they provide services in accordance with some minimum standards laid down by the central government (i.e., primary education, health care, pollution control) (CEM 1996, 43; see also Atkinson and Stiglitz 1980, 552; Bird et al. 1995, 34; Cullis and Jones 1992, 312–314; Blankart 1994, 513–514).

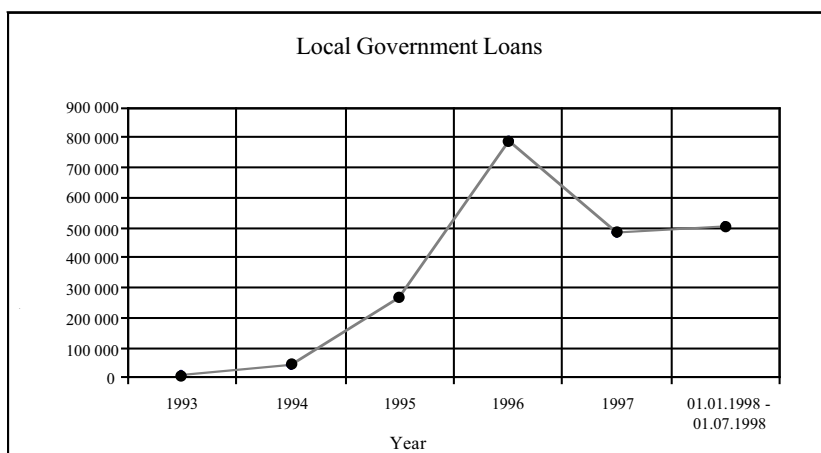
In Estonia, specific grants are mainly used to finance capital investments of local governments. Targeted subsidies are appropriated by the Government of the Republic according to its political priorities. Usually the targeted subsidies are used to renovate the infrastructure or to finance projects already started by poorer local governments (Nuu 1996, 14). Oates (in 1994, 138) rightly admits that intergovernmental grant systems do seem to have a considerable political dimension in the practice.

Loans

Local governments can also use loans to finance their projects. They are allowed to take domestic as well as foreign loans. The latter option has been used only in Tallinn, the capital (Kirss and Tammearu 1996, 7). Localities can take loans only if certain conditions are met. They can take loans strictly on the condition that the total amount of loans and other factors with loan associated costs (interest, etc.) do not exceed 75 percent of the last budget's revenue excluding loans and block grants from the state budget, and if the sums for paying back loans and loan interest in all financial

years do not exceed 20 percent of the revenue of the last accepted budget, loans excluded (cf. Law of Parish and City Budget, § 8, Section 1). There are exceptions when the state guarantees the loan. Moreover, loans taken by a parish or city cannot be backed by municipally owned property. As a rule local governments are not allowed to extend or to back loans. It is not clear, however, whether local governments have been living up to these terms (see Figure 6).

Figure 6: Local Government Loans in Estonia 1993-1998.



Source: *Estonian Statistics Monthly* No. 1 1994, No. 1 1995, No. 1 1996, No 1 1997, No 1 1998. Information for 1998 according to the data of the Ministry of Finance

The principles concerning the finance of capital and current spending stem from a value judgement that inhabitants should pay for local authority's spending on things they enjoy, but not pay for local authority's spending on things they do not enjoy (CEM 1996, 20). This inevitable relationship between revenue-raising and spending must exist in order to enable accountable local administration.

A loan is a quite useful instrument available to local government to finance certain costs. Loans are primarily meant to finance capital investments to renew the infrastructure. This is because capital spending benefits people for years to come and the repayments and the interest on the loans will be paid from taxes raised in years to come. Loans are inappropriate for a local authority's current spending because using them for current spending would enable the present citizens to shift the cost of the current spending which benefits them to future citizens who will receive no benefit. There could be an excessive amount of spending as citizens would be tempted to vote for high levels of spending for which they would not pay. Nevertheless, there are some exceptions to these guidelines. For example, occasionally a local authority will find the need to undertake a current expenditure that was not foreseen such as those associated with natural disasters. In this case there may be little alternative for them to borrow to meet these unexpected needs (CEM 1996, 20; see also Blankart 1994, 516; Redcliffe-Maud and Wood 1975, 104).

Estonian legislation allows local authorities to finance current costs only with short-term loans which should be paid back by the end of the budget year (cf. Law of Parish and City Budgets, § 8, Section 2). The general principle is that loans should be used to finance investments forecast in a municipality's development plan.

When taking loans careful considerations should certainly include calculations using modern planning and budgeting systems in preparing for and evaluating projects.²² It is suggested to implement such methods as a capital improvement program for 5 years that includes establishing a separate four-year capital expenditure budget which contains the capital investment of local governments (Francis and April 1996, 11).

For certain macroeconomic reasons and in ensuring that localities do not borrow more than they can reasonably afford to repay, appropriate mechanisms should be available for controlling the borrowing activities and for solving the problems associated with paying back the loans. In a

number of countries, the central government has direct administrative control over borrowing by subnational governments (Ter-Minassian 1997, 39). In Estonia localities should present the copy of the local government council decision on taking a loan to the county governor in three days after its taking effect and a copy of the loan contract to the Ministry of Finance in 30 days after the contract has been concluded (cf. Law of Parish and City Budget, § 8, Section 5, 6).

Control may take a variety of forms depending on the circumstances. The goal should be to proceed with more transparent mechanisms and to enable more information about local governments' financial status. But first of all, local governments should be careful when taking loans and exercise self-control.²³

Conclusion

Since the beginning of local government reform in Estonia in 1989, much has been done and many principal decisions have been made, but there still remain many complex problems to be solved now and in the future. This paper deals with only two selected issues relating to fiscal decentralization with an emphasis on public finance. Regarding the preceding considerations the following general conclusions can be drawn.

Instead of local governments voluntary or nonvoluntary amalgamating, first the coordination and cooperation of the provision of public services should be considered. Using this option, local government would retain its quality as an instrument of democratic and humane self-government. There is no need for amalgamating two administrative units if the same results could be achieved with less losses. Cooperation and coordination are a better solution from the long-run perspective because a system of public goods provision based on this is more flexible. Moreover, it is not even that

clear whether the expected saving resulting from amalgamating two administrative units can be realized. Thus cooperation and coordination are preferred.

Considering the lack of financial independence of local governments in Estonia, different solutions have been offered to solve this problem as well. Priority should be given to the working out of new local taxes. It is justified to characterize the current local taxes as symbolic because they have almost no relevance as revenue sources. New local taxes should be worked out considering the criteria of an appropriate local tax. While the need for political decisions and compromises with the central government is particularly visible in this case, it is relevant for all issues discussed in this paper. The solutions should be looked for in the increase of these categories of local income which really have potential and which promote better local cost-benefit relationships. Also, modifications in the current grant system are necessary.

Fiscal decentralization is a process which requires much consideration before implementation. It must be done step-by-step and if mistakes occur, the devices must be available to reduce or eliminate these mistakes. As long as options are kept open, the system will remain flexible, and it will be possible to introduce changes to improve the situation.

Notes

1. For an overview of the first stage of reform of local government and particularly the legislation concerning local governments adopted during the first stage, see Olle 1996, 24–28.

2. According to the Commission on Juridical Expertise of the Constitution, Article 155, Section 2 also enables the establishment of levels of government other than primary level local government units. For a different view, see Merusk and Narits (1998, 154). Merusk and Narits argue that the legislator meant under Article 155, Section 2 only the possibility to establish further units of primary local government level, and thus the creation of two-level local government would not be in accordance with the Constitution.

3. According to the Law of the Government of the Republic, the county governor is a state government institution. The county government could be described simply as the chancellery of the county governor.

4. Concerning their functions county governors are similar to prefects in the French system where the prefect (*prefet*) is constitutionally responsible for coordinating the activities of state officials, the representation of national interests and the administrative supervision of local authorities (cf. NEB 1991, 675). An official (prefect) appointed by, and representing, central government subnationally also exists in most OECD member states (OECD, 1997, 8, 30–31).

5. Obligations are imposed on physical and juridical persons by the local council to fulfill obligatory tasks concerning the land they use or own to ensure the general wealth of the territory bordering it (cf. Law on Local Government Arrangement, § 36, Sec. 2, 3).

6. All permanent residents in the area who have reached the age of 18 have the right to vote in local elections. Citizens of foreign countries and people without citizenship are also entitled to vote provided they have lived on the territory of the local government body for at least five years and have a valid residence permit (cf. Law on Local Government Council Election, § 3, Sec. 2).

7. Local governments have to present their budgets to the respective county government within two weeks after the budget has been accepted. County governments present the budgets to the Ministry of Finance within one month after receiving the budgets from local governments (cf. Law on Parish and City Budgets, § 13; Regulation of the Government of the Republic No. 3, February 2, 1996,

The Presenting of Accepted Budgets of Rural Municipalities and Towns and Their Fulfillment Reports to the State Institutions).

8. Government Finance Statistics of Estonia 1993; Government Finance 1994, 1995, 1996. Until the end of 1993 county government budgets were considered as local budgets. The new one-tier local government system is the main reason for the decrease of local government budgets' percentage of GDP in 1994.

9. Redcliffe-Maud and Wood referring to the Herbert Commission (1975, 10). If the local government were only a mere agent of the state, then the term local administration should be used (for the distinction between local government and local administration, see Redcliffe-Maud and Wood 1975, 19).

10. Redcliffe-Maud and Wood referring to the report of the Redcliffe-Maud Commission (1975, 31). Similar ideas were expressed by the Federal Constitutional Court of Germany in the famous Rastede Case. It argued that economic reasons do not justify the transforming of tasks from local governments to other administrative units; it is justified only when the further fulfilling of a certain task by local government would be unreasonably expensive. The simple argument that other administrative units could fulfill the given task more effectively does not justify the transforming of the task to another unit (BVerfGE 79, 127).

11. There are many different views about what the local government really is (Brause 1900, 26). Also, the historical context is very important in describing the idea of local government. In the 19th century the idea of local government was primarily understood in the context of localities striving for more independence from the state; nowadays, localities are generally treated as an integral part of the vertically organized state (Zielinski 1997, 7).

12. Several definitions may be thought of considering local tasks. One possibility is that local tasks are those "rooting" in the local community or having special implications on it—the definition of local tasks given by the Federal Constitutional Court of Germany in the famous Rastede Case (BVerfGE 79, 127).

13. However, in England the subdivisions are quite independent and usually play a considerable role in providing public services.

14. These reforms were often encountered with resistance by local residents because too little attention was paid to criteria other than efficiency (Drechsler 1997, 9; Zielinski 1997, 19).

15. Another question is whether and to what extent democracy should be implemented on the local level because the idea of local government does not necessarily include the idea of democracy (Schöber 1999).

16. Concerning the local council elections, Article 8b of the Treaty Establishing the European Communities in connection with the Directive of the Council 94/80/EC from December 19, 1994 introduces the active and passive right to vote in municipal elections for the citizens of the Union residing in a member state of which they are not nationals (see also Schütz 1999). The legislation of the European Union has a considerable impact on the local governments of member states. The influence occurs in almost all fields of local government activity (Vogelsang 1997, 277). See also note No. 6.

17. Here, the German legislation concerning different ways for local governments to cooperate can be taken as an example. In Germany both cooperation under private and public law is possible. In the form of private law only cooperation in the form of limited liability is allowed. Under public law, different, more independent institutions with their own organs (e.g., *der kommunale Zweckverband*) and less independent institutions with weak structures (e.g., *die öffentlich-rechtliche Vereinbarung*) are allowed (see, for example, Scholler 1990, 56–65; Vogelsang 1997, 259–277).

18. The problem in Central European states is not the lack of forms of cooperation but rather that these forms and legal institutions are not sufficiently popular (Horvath 1997, 117).

19. Institutional guarantee of local governments also exists in the Constitution of the Federal Republic of Germany (see, for example, Maurer 1997, 544–545; Schmidt-Aâmann 1992, 14–16). The state has the right to abolish local governments, but local government as such should be there. All the actions the state takes in this respect should be consistent with certain constitutional principles and cannot be arbitrary.

20. Municipal trading has also been an especially controversial issue concerning local government in England. Parliament has over the years implemented the following principles to determine whether local government should provide the service or not: (a) the undertaker requires special powers to override private interest, or (b) its provision is closely bound with other municipal activities, or (c) it can only be run as a monopoly, or (d) private enterprise was not interested because it could not make a profit (Redcliffe-Maud and Wood 1975, 14).

21. There are three national local governments' unions in Estonia. Regional associations of local authorities have been formed in all fifteen Estonian counties. The regional associations form the Union of Estonian Associations of Local Authorities. The second and oldest national association of Estonian local authorities is

the Association of Estonian Cities which was established in 1920 (ELL, EHI 1995, 12). The third organization on the national level is the Estonian Association of Rural Municipalities. In 1994 these three associations agreed to establish a Cooperation Assembly (MIA 1995, 9). The main objective of the activities of the Cooperation Assembly is the organization of cooperation and the coordination of joint activities in order to solve the problems local governments are facing today (ELL,EHI 1995, Appendix 56). The Cooperation Assembly performs as a party to the agreement with the Government of the Republic concerning the size of the subsidy fund.

22. The trend towards the modernization of administration can be described by different concepts like privatization, marketing, controlling, lean administration and public private partnership (Vogelsang 1997, 289).

23. Laux also suggests using methods which are appropriate regarding political planning and control as well as promoting cost-awareness (1997, 174).

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