Local Government
and Public Service
Reform Initiative

Providing More Services with Less Money?

Intergovernmental Finance Reforms in Central Europe

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PART I. ·· INTRODUCTION

Intergovernmental Finance Reforms in Central Europe

Intergovernmental Finance Reforms in Central Europe

Introduction

1. OBJECTIVES OF THIS PUBLICATION

Intergovernmental fiscal relations are always at the heart of political debate and policy dialog in countries facing public sector reform. It is an especially important issue in the transitional countries of Central and Southern Europe, because autonomous local governments have to be established in a rapidly changing political environment. In the wake of constitutional and administrative transformation, the complex task of local government fiscal reform often gets delayed.

This publication attempts to summarize the major characteristics of the intergovernmental fiscal systems of six countries: Bulgaria, the Czech Republic, Hungary, Poland, Serbia, and Slovenia. We have selected these different countries in the interests of presenting the diversity of models that have developed during a decade-long process of trial-and-error. We hope that this summary, and the case studies that follow, will assist policymakers, both in this region and in other countries also, in facing the complex challenges of fiscal decentralization.

The specific goal of this project was not only to generate comparative country studies, but also to provide professional support for Serbia's decentralization efforts. LGI, in cooperation with the "Serbia Local Government Reform Program" (SLGRP) and the PALGO Center, commissioned the papers contained in this volume as part of a wider technical assistance program. Through this, we hope to support the ultimate beneficiaries of the program, the Standing Conference of Towns and Municipalities in Yugoslavia, and the Ministry of Finance. Consequently, these studies shall be published in both Serbian and English.

We are very grateful for the professional input of the authors of the country reports, who have shared their views at a policy design workshop in Serbia. The project implementing unit was the Public Administration and Local Government (PALGO) Center in Belgrade, which also helped in the dissemination of these findings.

2. WHY INTERGOVERNMENTAL FISCAL RELATIONS MATTER

Public sector reforms are usually aimed at transforming the way public services are provided and funded. Public sector reforms are necessary because the demand for public services changes as societies face new internal and external challenges. Intergovernmental fiscal relations are critical components of these reform efforts, because they determine whether the raising, allocation, and management of public resources actually facilitates newer and more effective ways of providing public services.

However, intergovernmental fiscal relations are not purely technical issues. They are very much influenced by the institutional context and traditions of particular countries. They are also highly politicized, because ultimately they express the relative distribution of power between national and local governments.

One of the main forces driving public administration reforms in post-communist Europe has been the desire to decentralize control of public services. In theory, the purpose of decentralization is to shift responsibility for the financing and managing of particular public services to the lowest level of democratically elected government capable of effectively and efficiently providing the service. This is called the *subsidiarity principle*, a principle that constitutes the cornerstone of European Union policy regarding local governments. In practice, this means re-writing the rules governing which public services are provided by different levels of government, and then working out how to provide each level of government with the public revenue (and tax powers) necessary for them to effectively and efficiently provide the services they have been assigned.

Shifting responsibility for the management and provision of public services from national government to local government obviously entails altering the balance of power between them. But the real shift in power, and the real stamp of decentralization, is when control over the money necessary to pay for these services is also transferred to local governments.

As the essays in the volume show, most of the countries in the region have made considerable progress in transferring responsibilities from national government to local government. With some notable exceptions however, they have done considerably less well in transferring to local governments control over the financial resources necessary to actually carry out the functions they have been assigned.

The reasons for this are both political and economic. In many of the new, often fragile states in the region, policymakers have been reluctant to transfer responsibility from national government to local government simply because they do not want to give up state powers that were only recently won. This reluctance has been particularly strong in the states arising out of the former Yugoslav Federation, where new national governments actually re-nationalized, at least initially, not only many of the powers that local governments possessed under the old regime, but all of the property as well.

This trend towards re-nationalization was also strengthened by war, and the fact that in many ways the decentralized nature of the former Yugoslav Federation made it dysfunctional, not to mention its distortion by the Communist Party's monopoly on power. Not only did the Federation's intergovernmental finance system lack stable rules for fiscal equalization, but also the Communist Party often allocated additional resources as it saw fit.

The post-Yugoslav experience of re-nationalization offers a stark contrast to what happened in post-Soviet Europe during the 1990s. Here, reformers moved faster to decentralize more centralized regimes, because by and large they did not have to worry about external challenges to their sovereignty.[1] Indeed, reformers here saw decentralization as a tool with which to dismantle the remains of the communist apparatus.

Not surprisingly however, in all countries the powers that national policymakers have been most reluctant to hand over to local governments are related to public revenue. In part, this reluctance can be explained by the fiscal crises that all transitional countries have experienced in the period between the collapse of their socialist economies, and the (often weak) emergence of their new free-market systems. In short, ministries of finance throughout the region have resisted transferring significant financial powers to local government, so long as the fiscal position of the central government has remained weak. Nonetheless, in some countries, most notably Hungary, reformers used the initial fiscal crises as a justification for decentralization, arguing that only by increasing the efficiency and effectiveness of public services could the national government's fiscal position be improved.

Meanwhile in other countries, fiscal crisis has prompted national policymakers to off-load service responsibilities to local governments, while failing to give them the revenue or tax powers necessary to actually provide the services, a reaction that has unfortunately been more typical. Moreover, there is little evidence that economic growth, and a reduction of the fiscal pressure on central governments, has been accompanied by any greater willingness on the part of national governments to transfer revenue or revenue-raising powers to local governments.

Throughout the region, most decentralization projects have been based on the idea of separating local government responsibilities into two basic categories: "own" functions, and functions "delegated" to them by the national government. Typically, reformers have conceived of "own" functions rather narrowly, limiting them to basic urban housekeeping and infrastructure responsibilities performed in cities around the world. Meanwhile, their conception of delegated functions has generally been rather broad, taking in all services they have considered to be of national interest, and which

[1] It is worth noting that decentralization efforts in post-Ssoviet reform were most delayed in Slovakia, which was also forming into a sovereign state for (more or less) the first time.

they have felt should be provided equally to all citizens. Generally, this has included all larger public services, such as education, health, and social welfare.

This classification scheme has reflected a general fear among national policymakers concerning the management capacities of newly elected and inexperienced local governments. It has also re-expressed many of the heavy, centralist traditions of most of the states in the region. Equally importantly, it has been accompanied by a very simple vision of how the intergovernmental finance system should work. On the one hand, local governments should be able to use "own" revenue for their own functions; on the other hand, they should receive grants and transfers for their delegated responsibilities. This vision has generally resulted in a low level of municipal own-source revenue throughout the region. But it has also created, or been accompanied by, other problems.

Firstly, as we have already noted, national governments have often delegated important social-sector functions to local governments without supplying them with sufficient resources to actually provide them. Secondly, and equally importantly, national governments have typically made local governments responsible for the provision of these services, while maintaining archaic national service standards and expenditure norms that leave local governments little room to actually improve the way these service are provided. Thirdly, the provision of these services by the national governments before their delegation to local governments has tended to be extremely uneven, both in terms of finance and infrastructure. As a result, it is not clear how the national governments should allocate revenue, or for that matter, tax powers, to local governments for these delegated functions. If existing allocation patterns are preserved, then historically disadvantaged jurisdictions will remain disadvantaged. If however, allocation patterns are shifted, then either historically privileged areas will receive less funding than before, or the national government must add resources to the pot.

In many countries, these pressures have produced extremely complicated and unstable grant and revenue distribution systems. Indeed, in much of the region national governments have tried to fund "delegated" functions by assigning, on an annual basis, individual local governments different shares of specific taxes, on the basis of how much it thinks these services should cost in each jurisdiction.

Intergovernmental finances are critical components of political and administrative reform programs. Public finance theory provides some general guidance about how such systems should be constructed.

1. The first and most important principle is that local governments should finance as much of their responsibilities as possible through *local own-source revenue* (taxes and user charges) the rates, bases, and administration which are truly under their control. Under these conditions, locally elected officials feel responsible not only for how they spend their money, but also for how this money is raised, as the two types of decision are linked. Thereby, what the literature calls "fiscal illusion" (whereby public authorities spend more on services than what

citizens can afford, or are willing to pay, in taxes) is reduced. So the basic goal is that a significant percentage of local government revenue should come from locally collected taxes, fees, and charges, the rates and bases for which are also set locally.

2. The second general principle is that the transfer system should be *clear, transparent,* and *predictable*. This means that it should be based as much as possible on formulae, should not change radically from year to year, and should not be subject to political bargaining.
3. Transfer systems, almost always required to overcome vertical and horizontal imbalances, should be clear and transparent. *Vertically balanced* intergovernmental finance systems should provide sufficient funding for functions assigned to each and every particular type of sub-national government. This means that every mandate at local level is funded, and local governments with differing competencies (e.g., regions, large cities, towns, and villages) are eligible for differing levels of grants. *Horizontal imbalances* in the local government system should also be corrected. Regional differences in accessing public services are addressed by the means of various forms of intergovernmental transfer.
4. In practice, a variety of different types of transfer have to be used by governments in order to overcome such imbalances. Methods and techniques for vertical and horizontal equalization are rather diverse. Typically, categorical grants for specific functions or purposes are used to correct both vertical and horizontal imbalances in current and capital budgets. General or block grants, with higher local autonomy in spending, are used to decrease vertical imbalances in current budgets. Revenue distribution mechanisms also assist in the correction of vertical imbalances. Equalization grants, aimed at reducing differences in both the cost of services and in revenue capacity, are typically used to iron out horizontal imbalances. Matching grants (when national government provides additional funds to local governments, in proportion to local own contribution) encourage specific spending programs, or the establishment of revenue-raising incentives.

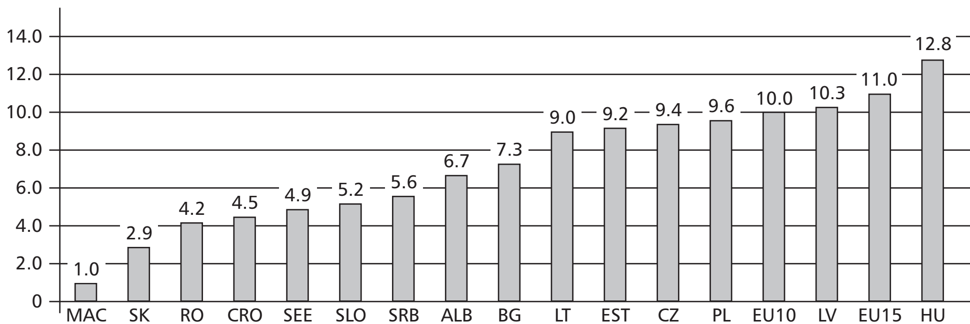
In the following sections we shall discuss these basic principles, and related policy issues in greater detail.

3. POLICY ISSUES

3.1 Local Functions and Competencies

The *quantity* of local government revenue, and type of appropriate intergovernmental transfer, are very much influenced by the scale and type of *public service assigned* to sub-national governments. The more services provided at local level, the larger the share of public revenue is that has to be assigned to local governments. Countries in Central Europe have been made formally responsible for a rather broad range of services over the last decade, which has been reflected in the level of local expenditure, taken as a proportion of the gross domestic product. In Hungary local spending is 11 percent of GDP, and in the Czech Republic 9 percent. This means that a quarter of general government expenditure is accounted for by local authorities. In other countries presented in this volume, local budgets account for a lower share, being only 5 percent of GDP in Bulgaria and Slovenia.

Figure 1.
Local Expenditure as a Percentage of GDP (2001)[2]



The *type of local service* also influences intergovernmental finances. Where municipalities are responsible only for basic urban and utility services, their own-source revenue often constitutes a larger share of their budgets, because these infrastructure services can usually be financed primarily by direct charges to the end user. Thus, the

2 Dexia. 2003. *Local Finance in the Ten Countries Joining the European Union in 2004; Local Finance in the Fifteen Countries of the European Union (Second Edition)*. Paris: Dexia: various country sources for Southern Eastern Europe.

quality of these services is typically tied to the revenue-raising capacity of localities, with transfers being used by the national government only in order to help the funding of capital investment.

This, however, is not usually possible with human services such as public education, welfare, and health care, for at least two reasons. Firstly, the ongoing costs of providing such services are extremely high, and in most cases exceed the revenue that most local governments would be able to earn from local taxes. Secondly, because many of these services are guaranteed to be public, the national government must be sure that all citizens have reasonably equal access to them, including citizens in poorer jurisdictions. As a result, grants and transfers tend to be the primary source of funding for major social sector services.

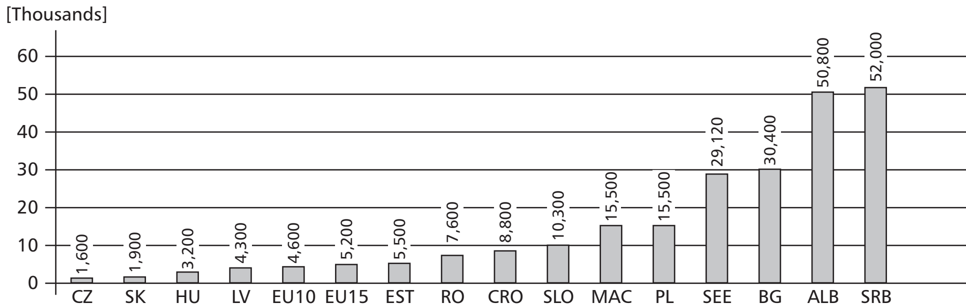
This separation among the major groups of local services is reflected also in the techniques of intergovernmental transfers. For example, in the case of Bulgaria, separation of "obligatory expenditure" (wages, social benefits, etc.) from other optional local functions affects the transfer system. The mandatory functions are financed by earmarked grants, using input-based calculations to determine the amount of the transfers. The optional services are financed through a different grant scheme.

The role and function of the *intermediary tier of government* also influence revenue assignment. In many transitional countries, regions and counties have maintained their role as "transmission belts"connecting the national government and local governments. As such, these intermediary levels not only retain strong supervisory powers with respect to the running of local governments, but are also often responsible for allocating national government revenue between them. This leaves local government budgets and policy decisions vulnerable to continual interference from above.

Regional units of national government may also influence local fiscal decisions. When service standards are monitored by these supervisory agencies, and the school staff and headmaster are hired or paid for by the ministry, then local funding practices will be more centralized. Other components of expenditure assignment also have an impact on the transfer system (e.g., subsidies to locally set user charges of urban services) .

The type and function of intermediary local governments are influenced by the *size of municipalities*. In countries with fragmented municipal governments, there is a greater need for regional governments than in countries with large municipal units. Moreover, many countries have found the rational decentralization of tax powers and public finances extremely difficult, because it has resulted in extremely small, fiscally weak local governments.

Figure 2.
Size of Local Governments in Eastern Europe[3]



In other countries, municipal budgets are in fact independent of county or regional budgets, but *functions are still not clearly separated*. Moreover, the voluntary transfer of services between levels may be permitted. For example in Hungary, both county and urban local governments are authorized to run secondary schools, and regional services might be taken over by cities. This obviously makes the intergovernmental transfer system more complicated, because it has to follow the very specific, almost individual needs of cities, whether they have secondary schools or not, providing equalization grants to counties lacking any major own-source revenue.

Intergovernmental finance models not only differ according to country, but they also *change over time*. As the local government systems of the countries of Central and Eastern Europe have evolved, their intergovernmental finance mechanisms have also changed. The re-assignment of service responsibilities has had to be followed up with the provision of new, local own-source revenue (e.g., business tax, property tax, and motor vehicle tax) and improved revenue distribution mechanisms (e.g., tax distribution according to location, equalization mechanisms). For example, in some countries, the transfer of education services to local governments has been accompanied by a change in the way grants are calculated. The general tendency has been a move away from allocating money to schools on the basis of per class norms, towards the allocation of money on the basis of (weighted) per pupil formulae. So the system of intergovernmental finances is more or less constantly being adjusted to fit these changing responsibilities.

[3] Dexia. 2003. *Local Finance in the Ten Countries Joining the European Union in 2004; Local Finance in the Fifteen Countries of the European Union (Second Edition)*. Paris: Dexia: various country sources for Southern Eastern Europe.

3.2 Own-Source Revenue

3.2.1 Own-Source Revenue in General

There are two basic types of own-source local government revenue, fiscal and non-fiscal.[4] Own-source fiscal revenue comes from taxes controlled by local governments, while own-source non-fiscal revenue comes from either user fees and charges controlled by local governments, or from the rental or sale of municipal property.

There are a large number of different types of non-fiscal revenue. These include charges for the use of public space (e.g., for markets, signs, kiosks, and special events) and fees for fines, licenses, permits, inspections, and administrative services (e.g., parking fees and fines, restaurant licenses, building permits and inspections, vehicle registration, land development, and environmental usage fees). The income generated by particular non-fiscal revenue is usually small, and much of it is often presented in municipal budgets under the heading of "Other Revenue." Indeed, much non-fiscal revenue is not directly recorded in local government budgets at all. Instead, it is retained by the quasi-budgetary or off-budgetary agencies that actually provide the services associated with particular fees and charges.[5]

Table 1.
A Typology of Revenue at Local Government Level

Type of Institutions	Local Revenue	
	Tax Revenue	Non-Tax Revenue
Budget (fiscal)	Local business tax, communal tax, land tax, building tax	Fees, building fines, school revenue from meals, rental and sale of municipal property
Off-budget (non-fiscal)	Earmarked tax revenue dedicated to local funds	Rental of municipal property, user charges, revenue from asset sales

4 Income from borrowing is neither a transfer from the central government, nor strictly speaking an "own" income of local governments. Here, it is dealt with only in passing.

5 It is also worth adding that people often use the terms fees, charges, and taxes to describe the same revenue, and in practice there is often little difference between what could be considered a fee, and what could be considered a tax.

As a result, it is often difficult to determine the share of non-fiscal revenue from local government finances, to say nothing of comparing this share nationally. Nonetheless, it is probably fair to say that non-fiscal revenue, including income from the sale and rental of municipal property, typically constitutes somewhere between *7 and 20 percent* of local government finances in OECD countries.

The quantity of real local government taxes is much smaller. These include taxes on agricultural land, on commercial and residential property, on businesses, and on gambling, as well as local surcharges imposed on personal income tax. In countries in which local governments draw a particularly large share of their income from own revenue, property taxes and/or local surcharges on income tax usually constitute the greater part of it, as shall be illustrated shortly.

A "pure" local government own-revenue is a tax, user fee, or charge, the *rate, base*, and *administration* (registration, collection, and enforcement) for which is entirely controlled by democratically elected local officials. In practice, however, the degree of local government control over both fiscal and non-fiscal revenue tends to be limited, to a greater or lesser degree, by the national government. In unitary states, for example, the right to "establish" or "create" taxes is normally reserved for parliament. In some countries, this has been interpreted to mean that local governments should have no tax powers. More frequently, unitary states allow local governments to set rates for a small group of taxes specifically assigned to them, and even then only within limits set by the national government.[6]

Many federal states also define which type of taxes local governments can impose on their citizens, and even the most liberal ones often restrict the ability of local governments to exercise their tax powers. In Canada, for example, local governments are entirely responsible for collecting and administering the property tax, and are free to impose whatever rates they see fit. But valuation procedures (determining the tax base) are either shared or closely monitored by provincial authorities in order to ensure intra- and inter-jurisdictional equity, and to calibrate the equalization system.[7]

Meanwhile in other countries, local governments may have quite extensive tax powers, but little responsibility for tax collection or administration. In France, for example, local governments are free to set property tax rates, and even determine property values, but the national government remains fully responsible for tax administration and collection. This is in opposition to the opinion of most tax theorists, who think that

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6 Sometimes the limits are so narrow or so low that they effectively eliminate local government rate setting powers.

7 We shall discuss the relationship between own-¬revenue powers and equalization systems in the next section.

local governments are better positioned to administer and collect property taxes than the national government. Similarly, other countries give local governments the right to impose local surcharges on personal income tax, a right that can radically increase the revenue-raising powers of local authorities (e.g., Scandinavian countries). At the same time, however, the determination of the base of the tax, and its administration and collection, always remain in the hands of the national government for reasons of both efficiency and equity.

In addition, national governments often define the types of non-fiscal revenue that local governments may impose on their citizens, and may also limit the size of the fees and charges local governments can set. For example, some national governments determine the maximum value of vehicle registration and administrative service fees, building permits, and environmental usage charges. In fact, some may even require local governments to get prior approval for the rental or sale of municipal property, such as schools or hospitals.[8]

Thus, in practice, local governments often have relatively few "pure" fiscal or non-fiscal own-revenues. Indeed, because there is so much variation in the rules governing the imposition of local taxes, fees, and user charges, as well as in administrative arrangements, there is often confusion about what should or should not be considered a local government own-revenue. Even worse, there is no fail-safe litmus test of what is and is not an own-revenue. Nonetheless, the single most important characteristic of an own-revenue is relatively easy to define: a tax, fee, or local government user charge should be considered an own-revenue if, and only if, local governments are responsible for *setting the rate* of the tax, or the level of the fee or charge. Or, to put it another way, the distinguishing feature of an own-revenue is that local officials have the right to determine how much their citizens/voters shall pay for a particular tax, fee, or user charge, and shall bear the political responsibility for such decisions.[9]

It is precisely the discretionary powers and political responsibilities of local government officials over own-taxes that make them so important to the overall operation of intergovernmental finance systems. There are three basic reasons for this: Firstly, if local government officials have the right to set important user fees, charges, and tax rates, they will then have the power to raise or lower local government revenue/expenditure in

8 In many transitional countries, nationally imposed limitations on water supply, sewage, and solid waste charges have significantly reduced the ability of local governments and their utilities to move closer to full recovery pricing. This revenue, however, tends not to be the direct budgetary revenue of the local government.

9 In many transitional countries there has been a tendency to regard shared taxes whose rates are specified in law as local government own-revenues. This is misleading and dangerous, because the national government still controls the rate and bases of these taxes, and is free to change them at will, and such changes can have dramatic consequences for local government revenue.

line with the preferences of their electorates. Moreover, they can do so independently of the national government's policies. As a result, real own revenue increases the financial and political autonomy of local governments, *vis-à-vis* the national government, while giving citizens a greater sense of local democracy.

Secondly, if local governments draw a significant share of their revenue from own-taxes, then the link between spending more on public services and imposing higher taxes is clearly felt, both by local residents and the elected officials who set the rates. Nationally set local revenue will not make locally elected councilors and mayors accountable to citizens. This is important, because if the vast majority of local government revenue comes from transfers and/or shared taxes, then both local government officials and citizens tend to see all local problems as resulting primarily from the national government's "failure" to provide sufficient funds. Of course, more often than not this is true. Nonetheless, many problems arise not because of the ill will of the national government, but because people's expectations for improved services exceed what they are willing or able to pay for in taxes, a reality that should be faced by local governments, and not just reserved for the national government.

Thirdly, if local governments have significant own-revenue, then it is much easier for them to access debt capital for investment purposes, because they can effectively adjust their tax policies (and revenue) to meet their debt service obligations. Indeed, the power to increase revenue by raising taxes is particularly important for municipal borrowing, because unlike enterprises, local governments should not be allowed to utilize property used for essential public services as collateral on a loan.[10]

Despite the critical importance of own-revenue for local democracy, the sound operation of intergovernmental finance systems, and the ability of local governments to access debt capital, there are substantial differences across countries in the percentage of income that local governments draw from own fiscal and non-fiscal revenue. This variation can be seen in the 15 members of the European Union before the recent enlargement, as shown in Table 2. In four countries more than 40 percent of revenue is drawn from locally controlled taxes, while in four others this figure is less than 10 percent. The municipal governments of the former group possess a high degree of fiscal autonomy, while those in the latter group are heavily dependent on the policies of other levels of government (mostly the national government) for their revenue.

[10] What local governments typically offer lenders as security is their "full faith and credit," meaning in the last instance their readiness to raise taxes in order to meet their obligations if other things go bad.

Table 2.
Percentage of Revenue Drawn from Locally Controlled Taxes

Sweden	60
France	54
Denmark	49
Finland	43
Belgium	35
Luxembourg	32
Spain	30
Germany	20
Italy	20
Ireland	16
United Kingdom	14
Netherlands	8
Portugal	7
Austria municipal	5
Greece	0

Source: Marie-Alice Lalllemand Flucher (ed.). 1997. *Local Government Revenue in the Fifteen Countries of the European Union*. Dexia: Paris. pp. 48–57.

Of the countries that draw more than 30 percent of their revenue from locally controlled taxes, the Scandinavian countries (including Norway, which is not represented in the table because it is not a member of the EU) draw the vast majority of them from a local surcharge on personal income tax. In France, the revenue comes mostly from a combination of local property taxes and a business tax. The situation is similar in Luxembourg, while in Belgium, a local surcharge on personal income tax is used in conjunction with both a property tax and a business tax.

In short, local governments that draw high proportions of their income from local taxes in Europe do so because they have been given the right to set the rates for a surcharge on personal income tax, property taxes, and/or a tax on local businesses. Despite its fairly frequent use however, most public finance experts think that allowing local governments to tax businesses is not a good idea, because it invites tax competition between jurisdictions. It also weakens the direct connection between taxation, service provision, and citizen preferences, because firms do not vote.

3.2.2 Own-Source Revenue in Transition Countries

With a few notable exceptions, the local governments of most transitional countries draw less than 20 percent of their income from own fiscal and non-fiscal revenue.[11] As a result, the level of financial autonomy of local governments in the region is generally low, and their financial dependence on the policies of the national government high, often exceptionally so. There are both political and technical reasons for this tendency.

Table 3.
Own-Source Revenue as a Percentage of Total Revenue in 2000–1

Country	Own-Source Revenue as a Percentage of Total Revenue in 2000–1
Hungary	32%
Poland	33%
Slovenia	34%
Serbia	20%*
Czech Republic	17%
Latvia	c. 7%
Bulgaria	c. 5%
Lithuania	<5%
Macedonia	<5%

* Data come from the studies in this volume. The figure calculated for Serbia does not include revenue from the wage fund tax, the rate for which local governments only have the right to lower.

Politically, the most important reason for the low tax powers of local governments in transitional countries is that the vast majority of these countries are trying to leave socialism behind at precisely the same moment they are trying to establish themselves as sovereign nation-states, often for the first time. In this context, newly elected nation-builders have proved reluctant to weaken the instruments of their still fragile states by giving tax (and other) powers to local governments, a tendency which is as understandable as it is regrettable. Indeed, it seems that only in countries where the question of statehood

[11] Marie-Alice Lallemand Flucher (ed.). 2000. *Les Finances Locales dans onze pays d'Europe Centrale, Orientale et Balte.* Dexia, Paris.

had already been more or less fully resolved *and* where the opponents of communism saw the rapid creation of strong local governments as essential to the dismantling of the *old regime* (e.g., Poland and Hungary) have policymakers been bold enough to give local governments tax powers.

Even worse, in many countries the creation of sovereign nation states has been taking place against a background of centrifugal ethnic conflict. Not surprisingly in such cases, "decentralization" projects have often been seen as a step towards further national fragmentation.[12] These forces have been most obvious in the states arising out of the former Yugoslav Federation, where the state-builders of the 1990s immediately centralized the fiscal structures of their new nation-states, almost totally erasing the decentralized (though poorly regulated) local governments of the former Federation. But the centralizing forces generated by new-nation insecurity have also been clearly visible in Ukraine, Slovakia, Latvia, and Lithuania.

The reluctance of state builders to assign local governments significant tax powers has been further reinforced by the fiscal distress that has accompanied the collapse of socialism in virtually all transitional countries. In short, for finance ministries trying to deal with profound budget crises, the only thing more troubling to contemplate than handing over tax revenue to local governments, is giving up tax powers. Moreover, their reluctance to seriously consider this possibility has often been amplified by the structural adjustment programs required of them by the International Monetary Fund. These programs often focus so narrowly on reducing public expenditure and increasing national budget revenue, that other strategic policy questions can not be raised.

But the problem is not just at the national level. Throughout the region, local governments themselves have not made particularly vigorous or sustained demands for greater tax powers. Instead, they have preferred to leave the political and administrative burden of imposing and collecting taxes on the national government, while simply demanding a larger share of the fiscal pie in the form of grants or shared taxes. This is understandable given the fact that for virtually all politicians the one thing worse than actually paying taxes is imposing them. Nonetheless, it is regrettable because it not only perpetuates the financial dependence of local governments on the national government, but also strengthens the arguments of those who oppose decentralization on the grounds that local governments want money without responsibility.

Efforts to give local governments greater tax powers have also been impeded by both policy confusion and serious technical difficulties. In many countries, policymakers have spent much energy searching for taxes that might be given to local governments,

12 Ironically, the creation of strong local governments (as opposed to, say, regional entities) is probably the best way to satisfy ethnic demands for greater self-governance AND decrease ethnic pressure for the further re-drawing of international borders.

without really facing up to the fact that there are only a limited number of instruments that will actually substantially increase their revenue-raising capacity. In fact, there are really only three: local property taxes, local surcharges on personal income tax, and local business taxes.

As we have already indicated, the last of these is, in theory, not considered a "good" local tax. Its imposition can seriously weaken economic growth by increasing the already high tax burden that most transitional countries impose on firms. In addition, it can encourage tax competition, and the business tax runs against local accountability, because "firms do not vote." However, when local governments have demanded an increase in their revenue-raising capacities, they have typically focused on local business tax.

From the technical point of view, the easiest way to significantly increase the own-revenue-raising capacity of local governments is, without question, to give them the right to impose a local surcharge on *personal income tax*, though there can be problems if the tax is paid according to place of work, rather than place of residence. This is because once the national government has set up a personal income tax, it is relatively simple to allow local governments to determine an annual surcharge rate that citizens pay together with their national taxes, and which is then transferred to the appropriate local government. Despite the simplicity and transparency of the mechanism however, the only transitional country that has begun to make use of it is Croatia. Hopefully, the example will be followed by other nations.

The technical difficulties with market based *property taxes* are more profound because they require specialized skills and sophisticated administrative systems for billing, collection, appeals, and above all, valuation. With the notable exception of the post-Yugoslavian states, none of the transitional countries has had any experience with such systems, and building them from scratch is obviously both costly and difficult. Moreover, introducing such systems sometimes raises difficult constitutional questions about whether local governments should be able to determine the base of the tax. If they are not, is the national government ready to perform the valuation function itself? Similarly, there are always complicated institutional questions about who should maintain local cadastres, and how they should or should not be integrated into other existing cadastres kept by the national government.

Despite these difficulties however, it should be noted that some transitional countries have succeeded in increasing the tax powers of local governments through property. In Poland, for example, local governments draw more than 11 percent of their total revenue from a quasi-market-based property tax, in which local governments set rates for residential and commercial property according to their area in square meters. These rates are set within national government limitations, and according to property tax zones defined by local government. Meanwhile, Macedonia is in the process of returning both rate control and administrative responsibilities (including valuation) for a market-based

property tax to local governments. This is taking place ten years after the government nationalized the tax, and subsequently more or less ran it into the ground.

3.3 Shared Revenue, Grants, and Transfers

3.3.1 Intergovernmental Transfers in General

As we have indicated above, virtually all public finance theorists agree that a substantial amount of local government revenue should come from own-taxes, fees, and user charges. At the same time however, no intergovernmental finance system relies entirely on own-revenue to fund local governments, and in many countries the share of own-revenue as a proportion of the total local government revenue does not exceed 25 percent. Indeed, there are good reasons why even highly decentralized systems make continued use of intergovernmental transfers, be they in the form of grants or shared taxes.

The first reason for this is quite simple. The taxes with the highest potential yields (personal and corporate taxes, value added taxes, and import and export duties) are more effectively administered by national government. As a result, the amount of revenue that local governments can generate through local taxes is in some ways *objectively limited* by the generally low-yield nature of most "good" local own-source revenue. Consequently, there is often a gap between the revenue local governments can reasonably be expected to raise through own-source revenue, and the costs of the service responsibilities they have been assigned. Indeed, this gap tends to be quite significant if local governments have been made responsible for important health, education, or social welfare services. This gap is referred to in the literature as a *vertical imbalance*, and is typically "filled" by financial transfers from the central government in the form of either grants or shared taxes.

The second reason for the use of transfers is that, even if most local governments could cover the costs of their services responsibilities entirely through the use of own revenue, there will be some local governments whose local *tax bases are too weak* to allow them to do this. In other words, these less well-endowed jurisdictions would have to tax their (poorer) citizens at extremely high rates to be able to meet their service responsibilities, rates which would in fact only compound their economic disadvantage. To fill the gap between what poorer jurisdictions can be expected to earn from own-source revenue (at reasonable tax rates) and the costs of the services that their local governments have been assigned, national governments typically provide them with equalization grants or payments. These sorts of gaps are referred to in the literature as *horizontal imbalances*.

Here it should be noted that if local governments are assigned significant social-sector responsibilities, it is almost inevitable that the national government will have to provide local governments with grants and transfers to make up both vertical and horizontal

imbalances. For example, if local governments are fully responsible financially for primary and secondary education, then it is likely that not only will the national government have to provide all local governments with additional finance to support schools, but that also significantly more money will have to be provided to poorer jurisdictions, because they cannot reasonably be expected to make the same sorts of own-revenue contributions to their education systems as their richer counterparts.

Even worse, it is often the case that the cost or workload involved in social-sector responsibilities is actually higher for poorer jurisdictions than for the richer ones. For example, poorer jurisdictions usually have greater problems with unemployment than richer ones, while the per-pupil costs of educating children in (poorer) rural areas tend to be higher than in their (richer) urban counterparts because of small school and class sizes. As a result of this kind of problem, it is often difficult in practice to draw a clear distinction between vertical imbalances (the gap between the cost of meeting service responsibilities, and standard tax rates in a jurisdiction of average fiscal capacity), and horizontal imbalances (the gap between what a poor jurisdiction needs to meet their service responsibilities, and what they can earn in own revenue by applying standard tax rates).

The two types of transfer instruments that national governments can use to correct vertical and horizontal imbalances are shared taxes and grants, each of which comes in a variety of forms. Taxes can be shared either on a location basis, meaning local governments get a percentage of the yield (as generated *in their jurisdiction)* from a particular national government tax, or on a national basis, meaning local governments are collectively entitled to a percentage of the total yield of a particular national tax. In this case, the share of this total that any individual local government receives is dependent, not on how much of the total yield was generated by its own jurisdiction, but on an alternative allocation mechanism. As a result, nationally shared taxes are, in fact, grants under another name.

Many countries use location-based tax sharing to increase the revenue of local governments, thereby correcting vertical imbalances. In fact, the location-based sharing of personal income taxes is particularly popular in the post-communist world. The reasons for this popularity are not difficult to ascertain. For one, the often extremely politicized allocation of grants by the national government has, not surprisingly, resulted in many local government officials disliking them on principle. Furthermore, many local government officials, like politicians of all kinds, are reluctant to assume political responsibility for raising taxes. As a result, location-based tax sharing appears to be the perfect instrument to instantly increase local government revenue, whilst at the same time leaving the national government responsible for the setting and collecting of taxes.

As it happens, the use of location-based shared taxes can be, and indeed has been, extremely problematic across much of the region for a number of reasons. Firstly, while location-based tax sharing can be of use in resolving vertical imbalances in intergovern-

mental finance systems, they, like own-taxes, tend to compound horizontal imbalances, precisely because the funding any particular local government receives through this instrument is determined by its relative wealth.

Thus, the use of location-based personal income taxes to supply local governments with the additional revenue they need to fund costly functions such as health, education, or social welfare, has proved to be a very dangerous game: If rates are set high enough to give poorer local governments the revenue they need to support these functions, then richer ones line their pockets at the expense of the central government. If, on the other hand, rates are set in such a way that richer or average jurisdictions have just enough to fund these functions, then other mechanisms must be developed to provide additional resources for poorer ones, something that does not often happen.

The second problem with a location-based shared tax is that, while it may look and feel like an own revenue to local government officials, it actually is not, for the simple reason that the national government retains control over the rate and bases. Indeed, in many countries, local governments have fought hard to introduce location-based shared taxes into the intergovernmental finance system, only to find that their gains have disappeared when the national government lowers tax rates, or changes the base in an effort to reduce the overall tax burden on citizens.

Because location-based shared taxes tend to blur responsibility for tax policy, and cannot be effectively used to resolve problems of horizontal imbalances, most public finance experts would prefer them not be used at all, and that local government revenue systems be constructed solely around the twin pillars of grants and own-revenue. That said, however, it is extremely important that grant systems be well-defined, and as far as possible, protected from political intervention.

3.3.2 Grants in General

Countries use grants for a wide variety of different purposes. Earmarked or categorical grants can only be used for a specific purpose, such as the construction of a particular type of infrastructure, the execution of a specific program, or the payment of a specific benefit. *Categorical grants* are often abused by national officials who do not want to give local governments spending authority. As a result, instead of giving local governments significant own revenue, or freely disposable general grants, they provide them with a plethora of different categorical grants that effectively dictate the structure of local government budgets.

Despite the frequent overuse of categorical grants, however, they do have a legitimate role in intergovernmental finance systems. They can be used very effectively, especially when matching local government resources are required to promote certain national government policies at the local level. For instance, categorical grants for school transport

can be used to promote the rationalization of school networks, while categorical grants for after-school programs can be used to encourage local governments to develop more comprehensive youth policies. These grants can be designed to cover some, or all of the expected costs of the desired program. They are usually allocated according to the number of end-users actually served by the program at local level.

Categorical grants are also typically used to help at least some local governments construct infrastructure that they cannot reasonably be expected to fund on their own. Here, however, grants are usually allocated on the basis of application procedures, and in accordance with strict eligibility requirements. This is because the investments are large, one-off expenditures, and providing a little money to a lot of eligible local governments is not usually an effective way to ensure that the facilities actually get built.

Non-categorical grants are typically called *block or general grants*. These tend to be freely disposable, though sometimes local governments are given block grants for particular functions, such as education or health. What this means is that they are free to spend the money as they see fit within a particular broad sector, but not outside of it. As such, this type of sectoral block grant represents a certain sort of compromise between a pure, general grant, and a narrowly defined categorical grant.

General grants are often used to correct both vertical and horizontal imbalances in an intergovernmental finance system. This is typically done by determining how much additional per capita revenue a jurisdiction of average fiscal capacity, taxing at a standard rate, would need to meet its services responsibilities, and then providing poor jurisdictions with a larger amount of per capita support. Similarly, block grants for functions such as primary and secondary education can be similarly constructed to adjust for significant differences in the relative costs of providing similar services in different jurisdictions. For example, education grants can be based on the number of pupils going to school in different jurisdictions, but the weights of children in rural areas, or children from disadvantaged backgrounds, can be increased to cover the higher costs of educating these children.

As intergovernmental fiscal reforms have to deal with a great variety of problems, the methods of revenue allocation and transfer systems are correspondingly complex. There is no single right way or technique to deal with these issues. The table below specifies the objectives of intergovernmental fiscal transfers adjusted to general principles of intergovernmental fiscal reforms (Table 4).

As specified in the first column, transfers should provide incentives for local governments to raise local own-source revenue. This principle is especially important concerning countries in Central and Eastern Europe, where grants are often used to bring total municipal revenue in line with centrally determined, or negotiated expenditure norms. This bargaining over transfers is still often carried-out individually for each local government, destroying any incentives for the levying and collecting of own-revenue, or for the efficient running of local services.

Table 4.
Objectives of Intergovernmental Fiscal Transfers

General Fiscal Goals	Objectives of Intergovernmental Fiscal Transfers According to the	
	Expenditure	Revenue
	Side of the Local Budget	
1. Providing local incentives	Incentives for reduction and efficiency in local service provision	Incentives for own-source revenue raising
2. Guaranteed minimum level of services (for *different* types of local governments)	Contribution a) to different functions and b) as a result of varying unit costs	Grants for equalizing differences in local revenue-raising potential
3. Horizontal equalization (between local governments of *similar* type)	Grants for decreasing differences in unit costs of services	Grants for equalizing differences in revenue-raising capacity

The guaranteed minimum service standards for local governments with different mandates can be achieved by providing transfers to both sides of the local budget. On the expenditure side, grants are needed to contribute to municipal budgets running special services for a larger jurisdiction. Local governments, typically larger cities, have to be compensated for these external costs (spillovers). There may also be differences in the unit cost of services across local governments of differing size and type, which are also subject to compensation (e.g., large cities with external environmental costs, and municipalities in sparsely populated regions).

Fiscal mechanisms for horizontal equalization are required in order to ensure that jurisdictions with weak fiscal bases, or extremely high service costs resulting from objective geographic, demographic, or environmental conditions, can provide services at a reasonable standard. Equalizing mechanisms designed to compensate poorer jurisdictions for their weak fiscal bases usually provide them with a grant that raises their per capita income to a certain percentage (e.g., 90 percent) of the average per capita income of all local governments at standard tax rates. (A standard tax rate is the average tax rate set by local governments) This means a poor local government receives additional finance, equal only to the difference between what it would get if it applied the standard tax rate, and the average per capita revenue the equalization system has been set against.

3.3.3 Intergovernmental Transfer Systems in Post-Communist Europe

There are three basic models for allocating transfers from national to local government budgets (Table 5). These methods generate different types of incentives for local governments.

Table 5.
Methods of Grant Allocation

Types of Transfers	Expenditure	Revenue	Transfers
1. Earmarked, centralized	Individual decision on appropriations ($EI_{estimate}$)	Individual revenue assessment ($RI_{planned}$)	Individual bargaining ($EI_{estimate} - RI_{planned}$)
2. General grants	Local decision on expenditure levels (E=R + G)	Local authority to generate revenue (R)	General grants (G)
3. Standardized expenditure and revenue capacity	Accepted expenditure levels ($E_{accepted}$)	Required revenue ($R_{required}$)	Calculated grant ($G_{calculated} = E_{accepted} - R_{required}$)

The first one is the *most centralized* form of grant allocation, where both municipal budget expenditure for particular services, and total local government revenue, including own-source revenue, are estimated for each local government. Transfers are then calculated as the difference between these individual levels of municipal expenditure, and total anticipated revenue. This method was typically used under the preceding communist rule and command economy. It allows the national government to control total public expenditure while also dictating to local governments budget expenditure for individual public services. Moreover, there are no own-source revenue raising incentives, because any surplus above the planned own revenue appropriations automatically decreases the amount of transfers.

As most of the CEE countries have tried to move away from this method of grant allocation, it is rarely used nowadays. However, some countries studied in this volume have made attempts to refine these basic structures. Bulgaria and Slovenia have *standardized* the *expenditure* side of the formula. In *Bulgaria,* the allocation method is a mixture of individual assessments of labor costs and welfare payments, and in addition some transfers are allocated through the following formula:

> *Grant=(gross salary + welfare payments) + formula based transfers + specific capital investment grants–(planned tax revenue + 50% of non-tax revenue in non-regional centers).*

The salaries and welfare payments are negotiated with each local government, similarly to the capital investment grants. There are 15 indicators built into the formula: population number has the highest weight (33 percent), and the rest are simple capacity indicators of service organizations.

In Slovenia the method of grant allocation sends a similar message to municipalities, whereby the expenditure estimates are standardized. The level of local government expenditure is calculated by a complex formula, so at least this component of the model is transparent and objective. Factors taken into account in calculating the individual expenditure level are population, length of local roads, area of the municipality, school age, and elderly population. These factors are built into the formula by comparing the per capita ratio with national averages, and by giving weights to each factor (e.g., the population number has the highest weight, at 70 percent).

Expenditure appropriation in a municipality = (0.70)

+0.05(ratio of national average and local road length per capita)

+0.16(ratio of national average and local population below age 15 per capita)

+0.04(ratio of national average and local population above age 65 per capita)

* *national appropriation per capita * number of permanent residents in the municipality.*

In Hungary one of the minor equalization components of the complex grant allocation method is calculated on the basis of the difference between expected expenditure and estimated revenue. This equalization grant constitutes only 1.5 percent of total national grants, but more than one-third of the municipalities apply for it.

The second model, used for calculating the *general grants*, provides greater autonomy in deciding municipal expenditure, and creates incentives for local own-source revenue raising. Under this model, the national budget grants are calculated by formulae, and are used without any limitations from local governments. Methods used for calculating the general grants are various: e.g., population number, users of municipal services (pupils, hospital beds, etc.).

This method is widely used in the Czech Republic, Hungary, and Poland. The difference between countries mostly lies in the complexity of the allocation formula. In Hungary, there are approximately 90 different basic indicators with different weights. Some of these grants are earmarked, both in the Czech Republic and in Hungary. In Poland, the general grant consists of two basic components. One component takes a fixed percentage of the national budget and divides it among local governments, based on the number of primary and secondary school pupils attending schools under their jurisdiction. The per pupil amounts, however, are weighted according to school type (rural, urban, primary, secondary, and vocational) and certain pupil characteristics

(special needs, foreign mother tongue) to account for the differing unit costs of providing education under different jurisdictions. The other component is designed to equalize the revenue-raising capacities of local governments.

Finally, the most complex model for grant allocation is built on the *difference* between expenditure *needs* and own-source revenue *capacity*. This method calculates the local expenditure through formulae, and at the same time takes into account a standardized quantity of municipal revenue. Consequently, methods of transfer serve equalization purposes (municipalities with low revenue receive higher grants), without destroying local incentives for own-source revenue increase (local governments get no compensation for uncollected revenue below the average level, and the surplus in own revenue does not automatically decrease the transfers).

Amongst the countries in CEE, only Hungary and Poland have tried to standardize the *revenue* side of the grant allocation formula. In both countries a grant is targeted at revenue equalization. In Poland, the so-called "basic part" of the general purpose grant has an equalization element, which is calculated at the maximum rate of local taxes and fees, and compared to national averages. Local governments below 85 percent of the average receive partial compensation. Hungary has further refined this method by using averages of PIT and business tax for municipalities of differing size, instead of national averages. However, this formula introduced a disincentive as well, because revenue from municipalities with tax revenue highly above the averages are "taken" by the national budget (in the form of the total amount of general grants not being allocated).

4. MANAGEMENT OF INTERGOVERNMENTAL FISCAL REFORMS

Changes in intergovernmental fiscal relations are usually driven by political transformations and efforts to reform the public sector. In Central and Eastern European countries, the basic shift from workplace-based, communist rule, towards a residency-based, multi-party political system, has created a new political environment for local governments. Decentralization, as a primary political goal of transition, usually began with the establishment of autonomous municipalities and the restructuring of the former local governments.

In some Central European countries this led to *fragmented* jurisdictions, with many municipalities of smaller than average size (Czech Republic, Hungary, Slovakia, and Croatia); while in others the former *amalgamated* models survived (Bulgaria and Poland). In South-Eastern Europe only Croatia, Macedonia, and Slovenia broke up the old, large-sized, "opstina" systems. In the countries that emerged out of the former Soviet Union, the large middle-level governments (oblasts) remained the key political players, generally blocking efforts to decentralize to democratically elected

local governments, and leaving the intergovernmental finance system centralized at the oblast level.

Public perception of decentralization is diverse, but shows elected local governments to be in a rather stable position regarding public trust, when compared to various political institutions. Due to economic crises and political scandals, public trust in most institutions (parliaments, political parties, etc.) has declined, but the position of local governments has remained relatively stable. For example, in Central Europe, throughout the previous decade, turnout at elections decreased by 10–20 percent. However, the difference between turnout rates for parliamentary and municipal elections reduced (between 1990 and 1998 in the Czech Republic and Hungary, the difference was only 10–15 percent; while in Poland the turnout was higher for local elections in 1994[13]).

The restructuring of public services is driven by *economic* transformation and public administration reform. Key components of this process are privatization, combined with other forms of public sector involvement in service provision, and the development of the government's new regulatory functions. These reforms are implemented through various changes in the sectoral legislation of various services, parallel to the establishment of the decentralization framework.

The starting point for many reforms was the demolition of the system of "dual subordination" of local government *administration*. This means cutting the direct linkages between the sectoral ministries and the local units of administration, and increasing the management autonomy of democratically elected local bodies. Territorial reorganization and free elections do not automatically diminish the independence of local governments. A favorable legal, regulatory, and financial environment should be established, where the competing goals of efficient and equitable public services can be achieved.

This process has been undertaken at very different speeds in the countries of CEE. Some countries had a quick start (e.g., Hungary and Poland), followed by a long process of complex reform. Constitutional and political changes during the first year of transition were followed by a decade-long transformation of public service management, financing, and in the case of Poland, even further territorial reforms. Those countries unable to lay down the basic institutions necessary for the establishment of democratic and modern states lost momentum. Several years were "lost" because of political fights (e.g., Bulgaria), or as a result of war and centralized, autocratic systems (Croatia). Some countries started the reforms from the top, by attempting to change the public administration without establishing real local governments (e.g., Latvia before 1997, Slovakia until the post-Meciar reforms started in 1998[14]).

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13 Swianiewicz, P. (ed.). 2001. *Public Perception of Local Governments*. Budapest: OSI/LGI.

14 Péteri, G. (ed.). 2002*: Mastering Decentralization and Public Administration Reforms in Central and Eastern Europe.* Budapest: OSI/LGI.

Decentralization of functions and competencies does not automatically mean the reform of intergovernmental finances. Beyond the declaration of local fiscal autonomy, and the legislation of a limited number of own-source revenue, municipal finances have changed slowly. Restrictive national fiscal policies have automatically supported centralization trends in public finances, in accordance with the assumption that general government budget deficits can best be controlled centrally. Arguments against increasing regional disparities, and warnings of uncontrolled social deprivation and poverty, always made centralization more acceptable to the general public.

However, when all the political, administrative, fiscal, and managerial conditions necessary for decentralization have been provided at an acceptable level, the decentralized public sector has been able to cope with economic crises more efficiently. Local government budgets are usually balanced, so they do not contribute to national deficit; municipalities can respond to local social problems more effectively if they are not controlled by central policies; and local government innovations in service provision make more efficient use of public assets.

In the interests of making these goals achievable, and obtaining all the benefits of decentralization, several conditions have to be met. In the area of intergovernmental fiscal relations the most critical components of successful reforms have already been discussed above. But these important "technical" details have to be accompanied by other reforms of municipal finances and financial management.

Firstly, *sectoral legislation* should provide a favorable regulatory environment. This means the establishment of new functions for national governments in the area of human and urban (e.g., utility, infrastructure) services. In public education and social services, the most critical elements are the supervision of local service management, autonomy of service organizations, special funding regulations (e.g., salaries, capital investments), development planning rules, and relationships with non-governmental service entities. For infrastructure services, the practices of state property devolution, legal forms of entrepreneurial activities, price-setting autonomy, tendering regulations, consumer protection, and other conditions of financing (management of arrears, capital investment schemes, etc.) are the critical conditions.

Secondly, as local governments still remain part of the general government finance system, *accounting* and *budgeting* practices have to be adjusted to decentralization. Public sector accounting has to ensure sufficient flexibility for local governments to develop their own charts of accounts, which also support local fiscal information systems and controls. General rules on budgeting have to guarantee an iterative process for fiscal planning, autonomy in managing local funds, and also a transparent process for allocating intergovernmental transfers.

The position of local governments in the financial disbursement or *treasury* system is also a critical condition for successful decentralization. As the former local units of governments were heavily dependent on the daily financial management decisions of

central agencies, the move towards greater funding autonomy has to modify these relations. However, as local governments are still heavily dependent on national budget transfers, the treasury functions are often mixed. There are reform experiments to create mixed systems of national and local treasuries, as in the case of Hungary, where municipalities establish their own micro-treasuries, but at the same time grants and shared revenue are transferred through the state treasury offices.

Under higher local fiscal autonomy, new external *audit* organizations and internal audit practices should replace the direct control of municipal expenditure and revenue. In CEE countries, the independent national audit offices usually lack the capacity of municipal auditing in the traditional sense. So local government auditing is regulated indirectly, through the support of internal auditing practices, and the setting of standards. For example, in Hungary, local governments above a certain amount of budget or value capital grants are forced by law to hire an independent auditor, who has to certify the municipal accounts every year. This is an important control mechanism, which enables the elected local councils to ensure the legality and accuracy of municipal financial management.

Finally, the establishment of new regulations for the *relationship with the private sector* is another important condition for successful fiscal decentralization. Better municipal services, reduced costs, and other gains in efficiency resulting from increased fiscal autonomy can only be achieved if local governments are free to decide on the forms of service provision. In a market economy, this means cooperation with the private sector, primarily in the public utility sector. Local regulatory practices also require sufficient professional capacity, which should be established jointly by national and local governments.

Bulgaria
Czech Republic
Hungary
Poland
Serbia
Slovenia

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