

**Financing Local Self Government**  
**Case-Studies from Germany, Slovenia and Croatia**

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## Foreword

The publication on financing local government is the result of a workshop in Zagreb end of June 2001, organised by the Zagreb office of Friedrich Ebert Stiftung in the frame of its regional project «Local Self-Government and Decentralisation in South-East Europe». In the context of the Stability Pact for South-East Europe and in co-operation with national institutions the Friedrich Ebert Stiftung has initiated a regional project to analyse the situation and the reforms of self-government and decentralization in the countries of the region, covering Albania, Bosnia and Hercegovina, Bulgaria, Macedonia, Croatia, Serbia, Slovenia, Romania, and Hungary. Based on the analysis and the discussion of experts on the different experiences in implementing reform steps, and the preparation and distribution of publications resulting from different workshops, the project aims at the stimulation of public discussion with policy makers, researchers, and experts at national and local level.

A first regional workshop with experts on local self-government and decentralisation was organized in Zagreb in April 2001. Friedrich Ebert Stiftung Zagreb has published the results of this workshop, including ten country studies\*. The discussion during the workshop had identified a number of most important problem areas of local self-government and several proposals concerning topics of future workshops were formulated. The majority of the participants concluded that in all the countries in the region there is a need to analyse more detailed questions of the financial structures at the level of local governments and proposed to organise in this context a follow-up activity on financial issues.

The Friedrich Ebert Stiftung Zagreb took up this proposal and organised a second workshop with international experts. Unlike the first workshop, where all the experts from South-East European countries were asked to present country reports for discussion, this workshop focused on case studies from Slovenia, Germany, and Croatia giving an in-depth overview of the financial system in these countries, thus stimulating an intensive discussion among the participants on the basis of experiences in their own countries. During the workshop the discussion concentrated on three main questions: the position of local self-government in the system of public financing, the real and possible financial

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\* *Local Self Government and Decentralization in South-East Europe. Proceedings of the Workshop held in Zagreb, 6<sup>th</sup> April 2001, Friedrich Ebert Stiftung, Zagreb 2001*

resources of local communities, and the mechanisms of financial equalisation between the different levels of the financial structure.

Zagreb, October 2001

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## Local Finance in Germany: Basic Information

Local Finance embraces basically four distinguishable issues:

- Tasks
- Public expenditure
- Revenues
- Equalisation

### *Tasks*

In Germany local governments are entities of **self government**. All affairs of local concern are under their jurisdiction. Within the limits of federal and Land law they regulate local affairs under their own responsibility.

The "own" tasks local governments (cities, municipalities, counties) are obliged to fulfil, are either voluntary or obligatory ones. Among the latter we find welfare (Sozialhilfe), provisions of and for schools (except teachers), kindergartens, planning of local building sites and local construction, public transport, cemeteries, garbage collection, public security and order, fire defence, ambulances, emergencies, etc. The voluntary tasks vary widely: museums, sport facilities, culture, music, theatre, etc. are among them. A wide range of these tasks (kindergartens, local transport, garbage collection, cemeteries) can be handed over to private enterprises or organizations, especially when the costs are covered by fees.

Furthermore local governments have to accomplish certain mandated tasks, funded and unfunded. Among these are issues of civil defence, the administration of inhabitants registers and of passports and identity cards, car registration, administration and maintenance of federal highways etc. In these areas the local governments act as agents on order of the Land government (or the federal government) without discretion of their own.

The room for discretion of local governments varies. Obligatory tasks allow more local decision than mandated tasks, however less than "voluntary" ones. Regulations differ from Land to Land since laws concerning local governments are under the control of the Land parliaments. However, there are some common features which apply to all Länder except the three city states.

## **Public Expenditure**

According to the constitution (Art. 104a para. 1 Basic Law) the responsibility for expenditure is related to the part of government which administers a certain public task (however not, which caused an expenditure). This rule which regulates the relations between the federal and the Länder is also applied to the relations between Land governments and local governments. Generally the local governments have to pay for their "own" tasks, even in case of obligatory ones. Exceptions from this general rule are applied when the local governments act as agents of the Land (or the federation). In those cases the Land takes over the expenditure. Additionally we have co-financed tasks. The latter are primarily public investments sponsored by the Land government for which the Local governments have to provide matching funds.

## **Revenues**

The Länder governments are obliged to provide sufficient financial means for "their" local governments in order to enable them to accomplish their tasks. How do they do that? Here we have to look at the German fiscal equalisation scheme.

1. The German financial system is highly integrated. The taxes are legislated nearly exclusively at federal level. The Länder governments have no tax legislation of their own. However, the local governments have the right to set rates of certain local taxes like property tax (Grundsteuer), business tax (Gewerbsteuer), and a number of minor taxes like dog taxes, tax on public houses, hunting tax etc.
2. The distribution of tax revenues is separated from legislation. The revenues of certain taxes are received by the federal government, some go to the Länder and local governments. The most important taxes, however, the income and corporation taxes, as well as the sales taxes (VAT) accrue jointly to the federation, the Länder and local governments (joint taxes). The local governments receive currently 15 pc of the local revenues of the income tax due to federal regulation, plus additionally a certain percentage set by Land law. On top they get a (small) share of the Value Added Tax.

The local governments participate at the VAT because the business tax on capital was abolished and the rates of the business tax on income heavily reduced. Currently we have a discussion about the total abolition of the business tax. As compensation the local governments should get the permission to raise local surcharges (tax on tax) on the income taxes.

3. Taxes regulated by local governments themselves play a minor role as far as the income of local governments is concerned.
4. More important are the revenues local governments receive out of the local equalisation scheme. Since the population structure differs from Land to Land Germany counts altogether 13 different models. Subsidies for local investments are paid via various ways. The degree of "localization" of tasks vary from Land to Land. All have in common, though, that they try to achieve a distribution of revenues which reflects need as well as local fiscal strength.
5. Finally the local governments are the only level of government which finances larger parts of their services by fees. The citizens have to pay for birth certificates, passports and IDs, vehicle registrations, marriage certificates, public transport, and - at last - for the services rendered by the cemeteries.

## **Fiscal Equalisation at Local Level**

The fiscal equalisation system has - as it says - the aim to "equalise" the revenues received by the local governments within one Land. The equalisation system provides for two different kinds of relations: a vertical relation between the Land and the municipalities and a horizontal relation among the local governments. Technically the vertical relation is the important one; the one which organizes the payments from the Land to the local governments. Effectively, however, it tries to balance the revenues among the local governments according to need. "Need" takes into account the different tasks a municipality has to deliver: A larger city, for instance, will provide more services than other areas. Schools for special purposes, sport facilities, culture, public transport etc. will be provided by the towns, to a lesser degree by smaller communities. These differences in public services are taken into account. The Länder follow different approaches: Especially the bigger Länder accept a larger need per capita for the larger cities. So do North Rhine-Westphalia, Bavaria and Lower Saxony. Other, especially smaller Länder, have chosen another way. They provide moneys for towns delivering task of "centrality".

Additionally the "own" revenues of the local governments are taken into account. Poor municipalities will get more support than rich ones, however it is not a levelling towards a common standard.

## **Instruments of fiscal equalisation**

### **Tax sharing**

As mentioned above the local governments receive shares of the personal income tax of their citizens as well as parts of the VAT on a per capita rate. On top

of this federally regulated participation the local governments get parts of the taxes received by the Land due to Land legislation (which is different from Land to Land). The general equalisation is part of the participation at Land taxes.

### Grants

Additionally to general revenue sharing the local governments receive general grants and specific grant. Here again we have to take in account that the regulations differ from Land to Land.

i. **General grants** are paid on a per capita base according to certain "keys". The most general key is the size of a municipality. It is accepted that the need per capita increases with the number of inhabitants. In North Rhine-Westphalia the need per capita is calculated in a range from 100 pc to 145 pc., Baden-Württemberg ranks its biggest cities with 186 pc of the average. These grant are paid without any specific purposes. Additionally the Länder apply keys for spas, the number of pupils and students (school expenditures), old aged people, unemployed and a number of other needs.

ii. **Specific grants** are paid for specific purposes. The local governments are not free in spending these grants but have to spend them for certain tasks. Among these grants there are compensation payments for mandated tasks which are executed by the local governments on order. More important are grant for investments. Again, there are general grants and specific grants. General grants for investments are paid on a per capita rate or according to certain needs. Mostly the local governments have to provide matching funds. Specific grants are handed out for specific purposes like new pavement, parking lots, parks etc. These grants have criticized for a long time because they allow the Land government to control local policies by a "golden reign".

### Summary

These brief outlines demonstrate the complexity of the local fiscal equalisation system. It is partly regulated by federal, partly by Land law. The latter differs from Land to Land and, therefore, generalizations are difficult.

However, there are a few general tendencies:

- The whole system is tailored to meet the needs of mid-sized towns which are not situated in the vicinity of larger cities, and which do not carry special burdens.
- Big cities suffer from a shortage of revenues. Despite the fact that they generate high tax incomes, and that a larger need is accepted they are still overburdened especially by social welfare payments.

- On the other hand independent suburbs are rather affluent. They also generate high tax incomes, however, they usually have small burdens to carry. This system has created a structure of suffering big cities and affluent suburbs surrounding the cities. From my point of view the whole German financial equalisation system suffers from a neglect of unequal burdens. The system was fundamentally reformed in the late 1960's when this problem has not existed like today. Today we need an adaptation of the system to changed problems, which is, however, politically very difficult.

## **The Dispute on the Financial Equalisation The Financial Constitution as Problem of the Federal State**

### ***The Partition of State Functions Has the Consequence of Distribution of Charges***

The Federal Republic of Germany is a federal state (article 20, paragraph 1 of Basic Law). Federal states consist of the member states (in Germany, these are called "Länder" = states), which constitute the Federal Republic and share with the Federal State the state functions of responsibility, which they realize on their own, that means also on their own financial account. The constitutions of the federal states expound which state level - Federal State or Federal Länder - is in charge of which function. As a rule, it is presumed that the responsibility is with the states - Länder (for example in article 30 of Basic Law); the responsibilities of the Federal Authorities are "itemized" in detail. Furthermore it is determined in which way the member states participate in the policy of the Federal State (article 50 ff. of Basic Law).

Observing state functions - being the legislation or the execution of laws - costs a lot of money and burdens the responsible territorial corporation with financial charges. The partition of state functions to the Federal State and its members would therefore be incomplete if the partition of the state charges were not settled at the same time. The function of the financial condition here is not only to settle the partition of charges (article 104a of Basic Law) but particularly also to ensure the distribution of tax sources and tax revenues (article 105 - 107 of Basic Law). It is an ideal case if distribution of charges and finances correspond to each other: each territorial corporation participates in tax revenues in such way, that they are independently able to equalise incomes and expenditure.

### ***The Distribution of Revenues is understandably full of conflict***

In the Federal Republic of Germany, it is very difficult to achieve a concordance of tax income and public charges. The rule is that differences concerning distribution of state incomes between the Federal State and the Länder are full of conflict and lengthy. This is being testified by the latest lawsuits brought before the Federal Constitutional Court by the States of Baden-Württemberg, Bavaria and Hessen. The intensity, which characterizes the conflict may be explained by the fact that due to the "functional partition of tasks" and the "policy interlacement" which arises from that, the Federal State and the Länder are no longer able or just in a restricted way in the position to fix their incomes and spending for each of them. Due to low funds and stagnating tax increases, which actually do not allow a settlement of conflicts by increases, the distribution of tax revenues is like a "zero-sum-play": the figures that one territorial corporation gains, are being lost by the other. As the short resource "money" is decisive for the possibilities of political creation, the territorial corporation, which has the money in its cashier, can act with it politically; the one, which does not have it, does not have that opportunity. This is the reason why financial equalisation actually deals with distribution of the decisive resource of policy, of opportunities for political action.

### ***The "Functional Distribution of Tasks" Is Typical for the Federal Republic of Germany***

"Functional distribution of tasks" definitely means that legislation and execution in broad fields of domestic and financial policy are not divided into political fields or domains of tasks as for example in social or research policy, but into functions. The Federal State is to a very large extent in charge of legislation, the states are to a considerable degree responsible of execution of the Federal laws: the responsibilities and actions of the regional administration (administration of the states) are thus to a great part determined by the decisions of the Federal legislator.

### ***Dispute on Financial Equalisation***

Since 1949, the Federal State has always consistently increased and extensively exhausted its traditionally broad responsibilities in the field of competing

legislation and framework legislation (article 74 - 75, 105 of Basic Law) - partly not before being urged but always with consent of the states. The legislation, which remained with the states, is restricted to a few domains. For these fields, at least if it is about compulsory tasks (for example broad fields of education policy and inner security) they agreed - partly with participation of the Federal State - to apply unique standards, for example concerning the school-leaving certificate (A-levels examination = Abitur).

The execution of Federal laws is matter of the states (concerning financial administration please refer to article 108 of Basic Law), apart from certain exceptions (article 86 ff. of Basic Law), as either "own matter" (article 83 f. of Basic Law) or as Federal Assignment Administration (article 85 of Basic Law). With the responsibility of the execution of Federal laws, the states also normally (article 104 a of Basic Law, exceptions article 104 a, paragraph 2-4 of Basic Law) have the financial responsibility. Thus the financial responsibility follows in the Federal Republic not the "law" but the "execution causality". An example: due to the Federal Law in Germany, each three-years old child has a legal right to attend a nursery school. Nursery school places, however, are not provided by the Federal State but are created and maintained by the local authorities (which are part of the states). Thus the financing of that task is with the local authorities (and thus indirectly with the states); the Federal State, which had given rise to the costs, has no share in them.

Due to Federal Legislation, actions and spending of the states are to a broad extent determined on a federal legislation level, their tax incomes are due to the here given monopoly of legislation decided by the Federal State (article 105 of Basic Law). Given equality before the law (article 3, paragraph 1 of Basic Law) and the welfare state rule (article 20, paragraph 1 of Basic Law) federal laws have to be applied in the same way towards all citizens. The broad equalisation of the living conditions in the different parts of the (old) Federal Republic is therefore neither the result of the often discussed constitutional sentences, which demand the "creation of equal living conditions" (article 72, paragraph 2 of Basic Law) or the maintenance of "equality of living conditions in the Federal Republic" (article 106, paragraph 3, 2nd subparagraph of Basic Law), nor the consequence of conscious political decisions, but the outcome of a functional division of tasks: the more detailed the living conditions are regulated by the Federal State, the more homogenous they become.

### ***Financial Equalisation as Necessary Consequence***

From this form of federal division of tasks there arises the necessity to financially enable the states to efficiently fulfill their tasks of which they are in charge. The

constitutional rule, to adjust the financial power of the states in a proper way (article 107, paragraph 2 of Basic Law) arises from the functional division of tasks and usefully has to be interpreted with respect to the charges of the states. It is the central duty of the financial constitution and the financial equalisation to put both the Federal State and the Länder - each of them individually - in the position to fulfill their tasks efficiently. As the original distribution of taxes among the states varies strongly, is unequal and does not come up to the tasks, a financial equalisation becomes necessary, which enables the states, independently from their original financial power, to meet their constitutional tasks sufficiently. The presently practiced and often criticized procedure of financial equalisation with a high equalisation of the financial power of the states arises from the rule that the states equally have to fulfill their tasks.

In the Federal Republic of Germany, the creation of federal financial relationships were and still are very difficult, full of conflicts and lengthy. Almost every regulation of the federal legislation, which has effects on the distribution of charges and taxes between the Federal State and the Länder, is *subject to consent* by the Bundesrat (Federal Council) and therefore it can only be regulated by accordance between Federal State and the states. It is indispensable that laws interfering in the administration of the states (article 84, paragraph 1 and 2 of Basic Law) or their finances (please refer concerning that to the special provisions in article 91 a, 104 a ff. of Basic Law) are subject to consent. Without them, the Federal State would not be hampered to put through its political interests and objects without respect to the efficiency and interests of the states. The states would become mere execution organs of the Federal State without having an own federal life.

Just the interference between the state levels and their dependence on each other is to a considerable part already an explanation for the intensity of the conflict concerning this topic.

### ***The Dynamic of the Federal State Is Requiring New Adaptations***

Almost all the laws negotiated within the mediation committee thus have to do in one way or another with the distribution of charges and finances between the levels. It appears seldom that "it is used for party political purposes". But there are a number of laws, with which the Federal State follows its (party) political objectives, for which the states, however, have to carry the charges. The willing of the single Länder Governments in these cases to accept charges also depends on the party political agreement with the Federal Government.



The conflicts are exacerbated by the dynamic, which is inside the Federal State: the burdens of the single state levels are changing partly by external incidents, partly by politically chosen developments in the course of time. An exemplary case for this is the development since 1989. Due to the breakdown of the Communist ruling system and the situation of security policy, which has changed due to that, in the last decade the defense spending (federal spending) could be really and nominally reduced for the first time in history of the Federal Republic of Germany. On the other side as a result of open borders and the immigration to the Federal Republic of Germany, the states and local authorities were additionally burdened by dramatically increased social aid costs, for example for asylum seekers. That was topped by immense expenditure for the reconstruction of the new states. Due to these circumstances, but also for the extreme financial exhaustion of the new states the existing defense rules had to be adapted to the changed conditions. - That dynamic of the Federal State, being externally or internally caused, needs from time to time adaptations in the balance between Federal Authorities and the Länder, so that the single State levels can still come up to their obligations. It is especially under these conditions of short cashiers, that the adaptation processes are very difficult and full of conflicts.

### ***Installment of "Cooperative Federalism" by Financial Reform of 1969***

The "functional" division of tasks, as it is familiar to us today, essentially got its present shape in the 50s and 60s.

The problems of the financial order of the Federal Republic of the late 50s and early 60s resulted in the objectives of the financial reform of 1969. It was necessary

- to remedy the problematic financing of the Länder functions by the Federal State and to replace them by thoroughly regulated and clear common tasks and financial participation of the Federal State in certain functions of the States,
- to create tax development within the Federal State and the Länder through a "big tax association" in a more equal way,
- and finally to secure better efficiency of the financially weak Länder by an intensive financial equalisation and to make the system easier.

Under the headword "cooperative federalism" the reform aimed to realize an enforced joint action of the Federal State and the Länder when taking out their functions. That actually meant that if there was an interest of the Federal State in

the even realization and if these were too much for the states themselves, then they would have to be planned and financed commonly in the future. The realization was left with the states. The objectives were both a more efficient realization of the state functions and an interregional equalisation in favor of the weaker states apart from the financial equalisation of the states.

Federal State and the Länder agreed in building new and rebuilding the existing universities including the university hospitals, improving the regional economic structure as well as the agrarian structure and the coast protection commonly and according to certain rules (article 91 a of Basic Law). Apart from that, the common planning and promotion of scientific research institutions and research plans of supra-regional importance were given a constitutional basis (article 91 b of Basic Law).

*The financial participation of the Federal State* in further tasks of the Länder - here without participation in the planning of these tasks - was apart from that lead out from the gray-area and put on a constitutional basis. It was determined that *laws on payment* of the Federal State, which were effected by the Länder, can be financed wholly or partly by the Federal State (article 104 a, paragraph 3 of Basic Law). Furthermore, the possibility was created that the Federal State may under certain - actually very broadly defined conditions - participate in important *investments of the states and local authorities* (for example hospitals, public transportation system etc. - article 104 a, paragraph 4 of Basic Law). It was both efficiency and equalisation thoughts, which were also here considered in the foreground of the plans. With the laws on payment (article 104 a, paragraph 3 of Basic Law), which were in many cases motivated by social policy, it was essential to release them from the negative burden of charges by participation of the Federal State. It is a rule that social spending is higher in economically weak states than in the stronger ones, which makes inter regional downward trends even stronger. The investment aids made by the Federal State (article 104 a, paragraph 4 of Basic Law) should serve to provide overall economic balance and to promote economic growth, actually to effect control of cyclical movements as well as the equalisation of different economic forces among the regions. The States and local authorities, which are responsible the far greatest part of the public investments, were, especially during recession, hardly able to take out the anti-cyclic finance and budget policy aimed at that time. Therefore, fiscal Federal responsibility seemed necessary in order to allow to the financially weak states a participation in a "concerted" budget and financial policy, namely a policy, which is agreed upon between the Federal State and the Länder. In the sense of the *equalisation idea*, it should be allowed to the Federal State to particularly support structurally weak and other problematic regions, for example such with a high unemployment rate or economic growth below average.

In the field of vertical tax distribution, there was created the great tax union. The income and corporation tax - which since the previous financial reform has already been a compound tax - as well as the value-added tax, became common taxes to which both the Federal State and the Länder had a right, unless they were assigned to the local authorities. For the other taxes, the divided system was kept, which was used so far. On the basis of the Basic Law (article 106, paragraph 3 of Basic Law) the income and corporation tax is shared to a half each by the Federal State and the Länder - after deduction of the local authorities' part in the income tax, presently amounts to 15 % of the complete tax revenue. The value-added tax became the variable element in the framework of tax distribution. The distribution was made according to the following principles: equal cover of the necessary spending of the Federal State and the Länder, an appropriate equalisation, avoidance to overburden the taxpayers and by respecting the homogeneity of the living conditions in the whole Federal Republic (article 106, paragraph 3 of Basic Law). The Federal State received until the integration of the new Länder into the financial equalisation system of the Basic Law in 1995, approximately two thirds of the whole amount of value-added tax, while the states received one third. Due to the special financial weakness of the Eastern German states and a change of the procedure in child benefit payments, since 1996, the Länder share has been amounting to almost the half (49,5 %) of the value-added tax on the whole.

Apart from that, in the financial equalisation system of the Federal Republic, the trade tax (real tax) is treated similarly to a community tax. In the framework of a community financial reform in 1969, the Federal State and the Länder received shares of the whole trade tax in order to stabilize and adjust the community tax revenues; the local authorities received as an equalisation the mentioned 15 % share in income and corporation tax.

The great tax union - the community taxes are up to about 75 % of the whole tax revenues - aimed at realizing an equal tax development with the Federal State and the Länder, by participation of both state levels in the two important taxes, which however react in different manners on the economic development. At the same time, the inclusion of the value-added tax into the tax union, the assignment of up to one quarter of the Länder share to particularly financially weak states (article 107, paragraph 1, 4<sup>th</sup> sentence 4, semi-section of Basic Law) and the distribution of the rest of the Länder share according to the number of inhabitants in the framework of vertical tax distribution was to promote the equalisation among the states.

With the tax distribution among the states - except the mentioned Länder share in the value-added tax - there was used the principle - applied so far - of the local revenue, which means: the states receive the revenue in the Länder taxes and the Länder share of the income and corporation tax, which is collected by the respective financial authorities. In order to correct distortion, which may arise in the procedure of imposing taxes, there was introduced a *tax disassembly*. The Länder share in the wage tax is generally assigned to the state where the taxpayer has his place of living. This provision becomes relevant in the case of employees who work in a different state than they live (commuters), as well as in cases where the wages and wage taxes are centrally calculated and paid, which is the case with big companies and authorities. The Länder share of the corporation tax of big companies, which have establishments in several countries, is likewise disassembled. The tax disassembly is thus not a measure, which modifies the tax distribution according to local payments but only a measure that corrects mistaken assignments due to false levy of such taxes.

The wage tax is part of the income tax; the employer pays it to the Financial Authority in charge. The employee whose tax obligation arises at his place of living is obliged to pay the wage tax. That is why it has to be provided that the Länder share in the wage tax is paid to the state, where the employee has his place of living, the municipal share has to be paid to his city of living. That is done by lump-sum calculations between the financial administrations.

This provision is not unproblematic: the income tax of persons, who work in one State and use its public institutions but live in another State, is paid almost exclusively to the State, where the employee has his place of living. This problem is of special importance for the city-states.

Big companies, which have branches in many States, like the big banks, automobile producers or chemical groups, but also public institutions like the Bundeswehr (Federal Army), often have a central wage calculation and pay the wage tax at the place of calculation.

The original distribution of the whole tax revenue is modified by the horizontal financial equalisation. Thanks to regulations of the financial reform in 1969, the horizontal equalisation was totally intensified, at the same time the financial equalisation of the states is eased in the narrower sense. The great tax union made the financial power differences among the states diminish because they ceded a great part of the regionally differently distributed income and corporation tax to the Federal State, as for the Länder share there was introduced a tax disassembly and because the Länder participate in the value-

added tax, which was essentially distributed according to the number of inhabitants. Furthermore, the financial equalisation of the states was eased by the value-added tax equalisation according to article 107, paragraph 1, 4th sentence, semi-section 2 of Basic Law. According to that, those countries, whose whole tax revenues from the Länder taxes and the Länder share in income and corporation tax is below 92 % of the average per inhabitant, receive subventions amounting to the missing sum to 92 % of the average.<sup>1</sup> It was at the same time intensified by filling it with the financial power of the financially weak states to at least 95 % of the average per inhabitant.<sup>2</sup> In addition, in 1970 the weak states were able to get it through, that the Federal State grants them (again)<sup>3</sup> federal complementary payments (article 107, paragraph 2, 3rd sentence of Basic Law). Principally, the Federal State had had that possibility since 1949 (article 106, paragraph 3 of Basic Law in the version dated 23 May 1949), but the Federal State and the Länder regarded the horizontal equalisation for a long time as an exclusive matter of the Länder, in which the Federal State did not participate.

The Länder share of the corporation tax of big companies, which have branches in many Länder, is distributed on the single Länder according to resource evaluation.

### ***Complementary payments of the Federal Authority Amount to Approximately 25 Billion DEM***

The federal complementary payments won an unexpected dynamic. In 1970 and 1971, its volume amounted to merely 100 million DEM each, in 1972 and 1973 to already 550 million DEM. In 1974, they won more dynamic and were fixed on 1,5 % of the whole value-added tax revenue, for the years of 1988 until 1994 they were increased to 2 % of the whole value-added tax revenue, each of them payable from the share of the Federal State. Since 1995, they have been uncoupled from the whole value-added tax revenue and linked to the missing amounts of the financially weak states to the average. The States authorized to

<sup>1</sup>This provision had only an inferior significance before the German reunification and the inclusion of the new states into the financial constitution of the Basic Law as of 1. January 1995. Since 1995, this "line" has been used in order to transfer the agreed federal share to elevate the financial power of the new states (7 percentage points of the whole value-added tax revenues) into the cashiers of the new states.

<sup>2</sup>The calculations of the value-added tax adjustments are effected on another basis than the financial adjustment of the states, therefore the figures "92 %" and "95 %" are not comparable by all means. With the value-added tax adjustment they only calculate with the real inhabitants and the mentioned tax revenues, with the financial adjustment of the states they take into account also the "ennobled" inhabitants of the city-states, half of the municipal taxes, other incomes and the charges for the sea harbours.

<sup>3</sup>As early as in 1968 and 1969, the Federal State granted federal complementary payments, however, refused it originally to prolong them after the financial reform.

get equalisation payments receive 90 % of the missing financial power of the average, whereby the financially weak States are granted a minimum figure of 99,5 % of the average.<sup>4</sup> Furthermore, federal complementary payments were benefited for different charges - over-proportional costs of the political leadership in small states, special charges of the new states as a result of the former division of Germany, rehabilitation measures for the households of Bremen and the Saarland. Their overall sum increased up to 2,7 billion DEM in 1989.<sup>5</sup> In 1995, the federal complementary payments essentially increased due to the inclusion of the new states and due to the special payments to them of up to 25 billion DEM, followed by further financial aids to the Eastern German states in the amount of 6,6 billion DEM.

### ***A Shift from the Horizontal Financial Equalisation to the Vertical Payments of the Federal Authorities***

The financial equalisation of the states, the real centerpiece of the horizontal equalisation, increased from 1970 until 1989 from 1,2 billion DEM to 3,5 billion DEM. In 1995, it achieved a sum of 11,2 billion DEM, of which approximately 9,7 billion DEM were assigned to the new states, while 1,5 billion DEM were transferred to the financially weak old states. These figures, no matter in which limitation ever they are seen, prove with respect to the old states two things: namely - measured to tax development of the states (and local authorities) - a relative decrease of the transfer payments within the financial equalisation of the states and a shift of the equalisation function from the traditional financial equalisation of the states to the vertical payments of the Federal State. The over-expansion of the financial equalisation, which was lot criticized by politics and science - as can be seen here - has little to do with the economic development in the old States but a lot with reunification of Germany. In face of this development, there has to be asked whether it makes sense to hold on to the traditional ideal of the financial equalisation of the states or whether they should orientate - also in the interest of the "paying states" - more to a vertical equalisation with horizontal effects.

<sup>4</sup>According to the calculations of the DIW (= Deutsches Institut für Wirtschaftsforschung - German Institute for Economic Research Berlin) these 99,5 % of the financial power index mean in the case of the financially weakest States, i. e. the Eastern German States, approximately 95 % in real terms of the average tax revenues per inhabitant (compare remark 2).

<sup>5</sup>With respect to the reference years: 1970 was the first budget year after the financial reform in 1969, 1989 was the last one before the German reunification. The figures beginning from 1990 cannot be compared with those of the former years due to the interim regulations until 1994, which partly cancelled constitutional provisions for a fixed time and due to the consequences of the reunification charges on the finances of the Federal State and the States. The new States were included as of 1 January 1995 in the financial adjustment of the Federal Republic of Germany.

Political stability of the Federal Republic of Germany may to a considerable part be attributed to the effects of the financial constitution.

### *Making Debts is Awarded*

At the same time, the system developed false incentives. The distribution of the value-added tax between Federal State and the Länder according to the procedure of covering the proportion, awards the making of debts, the equalisation proportion and filling up proportion in the horizontal equalisation give little rise to make efforts to achieve an increase in tax revenues and eventually in one of the Eastern Federal states they drew the conclusion from the statements made by the Federal Constitutional Court in their decision of 1992 on the extreme state of emergency budget of Bremen and the Saarland that the principles which justify these financial aids apply "to a much larger extent to the new states". In the mutual relationship of the states there are incentives to a "running board ride" particularly for the smaller states and the states, which are measured according to the standards of the financial equalisation system - the weaker ones. The history of the financial equalisation of the Federal Republic is full of examples, where small and weak states downright "sold" their votes in the Bundesrat. The modernization pressure is for the small states, whose financial power depends first of all on their position within the financial equalisation system, smaller than for other countries. Despite this justified criticism concerning structures of the financial constitution one may not fail to see that normally there are other viewpoints, for example the successful set-up of industry and the creation of jobs, which have a stronger influence on the political decisions than (false) incentives in the financial equalisation system.

Apart from that, there are objections against the existing financial equalisation system, which say that due to missing economic incentives, the structures between the poor and rich states almost did not change. In fact, only three states were able to achieve during the last 50 years a clear improvement in standing: Bavaria, which in the 50s and 60s was regarded as the "richest" among the poor states, was promoted into the league of the "rich" states. Schleswig-Holstein, in the 50s by far the weakest state, today has reached the average. Among the ones in a better position, Hessen remarkably improved and is today the "richest" state.

### *The Causes of Different Efficiency Are Not Remedied by Financial Equalisation*

Due to such a development, the concentration of the charges of the States' financial equalisation had less and less influence on the states. In 1970, when the

financial reform of 1969 came into force, there were four States - Baden-Württemberg, Hamburg, Hessen and Nordrhein-Westfalen, which relatively equally shared the payments, towards the end of the old Federal Republic there were essentially only two left: Baden-Württemberg and Hessen. In the new Federal Republic of Germany there are five of now sixteen, which have been paying contributions regularly since 1995. There are four, which already in 1970 shared the charges of the financial equalisation of the states, Bavaria also joined: the structures, therefore, hardly changed during the past 30 years. So, one of the objectives of the financial reform of 1969, namely the equalisation of the efficiency of the states was achieved only to a relative degree. In face of the relationship of five payer- and ten receiver-states there is today the danger that there is going to be spoiled on the long term the balance among the paying and the receiving states: From a distribution system, which is dominated by one side, there could arise undesired distorted situations negative for the minority. For the payments, which the states liable to equalisation within the financial equalisation of the states have to pay, are not determined according to their efficiency but first of all according to the missing amounts of the States, which have the right to equalisation.

Strategically the financial equalisation is in a dilemma: on one side it should absorb the negative consequences of different efficiency, on the other side, however, it is not able to repair their causes in a sufficient way. The trend is that the amount of necessary financial contribution is rising, in order to close the gap between the efficient states and the ones whose efficiency is weak. The strong states have comparably favorable possibilities to improve their position by public investments. For the weak states, however, it is becoming more and more difficult, if not impossible to come up to their tasks without exaggerated encumbrance.<sup>6</sup>

### *Modernization of the Federal State: What Could Come?*

The permanent dispute about financial equalisation, but also the financial constitution of the Federal Republic itself gives manifold rise to criticism from science and politics. On the political level, the Western German Prime ministers of the states asked shortly before reunification of Germany for an examination and revision of the financial constitution with the objective to strengthen the

<sup>6</sup> The different possibilities of "poor" and "rich" states to execute economy promoting investments become clear if one sets the revenues in relation to the spending obligations: if one presumes a real span of tax power (states and local authorities) of about 95 up to 104 % of the average as well as a link to the budget of the states of about 90 to 95 % of their revenues by salaries, interests, payment laws etc, then it becomes clear that the rest of the tax power difference after the financial equalisation is considerable with respect to the self financed public investments.

states. True, that was included as an order in the Reunification Treaty but was not realized neither by the Joint Constitutional Reform Commission of the German Bundestag and Bundesrat nor within the framework of the negotiations on the solidarity pact (for the new German states) by the finance ministers. Lawsuits brought in by the states of Baden-Württemberg and Bayern before the Federal Constitutional Court initiated a new impulse for the discussion on reform. An essential objective of the suits were improved protection of the paying states from overstrain by the requirements of the receiving states. Bayern pleaded for a restriction of the payment obligations to the half of the financial power above the average. In its decision dated 11 November 1999, the Federal Constitutional Court did not follow that request of the states who lodged the lawsuit, asked, however, that the law on financial equalisation be rudimentary examined in two steps by the end of the year 2002 or 2004 respectively. After the end of the dispute before the Federal Constitutional Court the political debate began again. In the framework of the coalition agreements of the Federal Government under Gerhard Schröder there was already agreed to set up an enquete commission, which should elaborate propositions for a revision of the financial constitution and the financial equalisation. The Prime ministers of the states asked on their annual conference dated 2 to 4 December 1998 also for a Federal State - Länder - working group, which should develop propositions for the modernization of the order of the Federal Republic of Germany on the whole. At the conference of the representatives of the Federal and the Länder governments on 17 December 1998 there was agreed to install a joint committee of Federal State and Länder, which should show the possibilities of a reform of the financial constitution. If in this committee, there is achieved an agreement on the common objectives, there should be established a constitution committee of the Bundestag and Bundesrat, which has to prepare the necessary changes of the Basic Law. That complicated procedure was selected, because at this time there is none or only a little agreement on the objectives of financial constitution reform. It seems sure that a total revision will not take place, but only limited adaptations will be possible. According to the present phase in the discussions, it seems possible that a reform of the Federal State order and especially of the financial constitution for the year of 2005 will come - after expiry of the now valid regulations on the solidarity pact. It will not be easy, however, to develop a concept, which is in fact going to be accepted by the majority. The objective difficulty is that a reform concerning just the financial distribution, is not efficient enough. The political difficulty is that every change creates "winner" and "loser". The example of the mixed financing debate makes this clear. Essentially there is consent that the valid regulations are

at least partly inefficient. At the same time the states, which would apparently lose in case of a reform, are opposing strongly to that.

The precondition for a success promising modernization of the Federal State order would be a basic examination of the distribution of tasks in the Federal State, a definition of what under the points of view of a welfare state should be realized and financed on the federal state level, and an examination of the fields, which allow a scope of action and thus different solutions of the states. Only a revision of the definition of tasks with the aim of broadening the scope of action of the states allows a change of the existing financial distribution. The experience, however, shows that a shift of the tasks is extremely difficult. In their Sunday speeches the political class of the Federal Republic agrees: the back shift of tasks makes sense and is necessary. From Monday through Friday, when they talk about details, and it is known that the devil is in the nuts and bolts, almost every try fails to allow to the states' lawyers further space for decisions. Probably the form of the German party democracy is an essential impediment for decentralization as all parties aim at a unified policy without respect to the levels, which does not allow or allows only a little space for regional distinction. Even in fields where the constitutional order is clearly assigned to the state's legislator, the parties struggle for a relative unification in stating their positions. According to the present trend, a regional distinction would jeopardize the party political "alliance".

It would be thinkable to come back to a proposition discussed within the enquete commission "constitutional reform" 1976, which foresaw that the states could deviate from the federal legislation in the field of competing legislation, as long as the federal legislator does not oppose to that. The federal legislation continues to exist, while each of the states would have the possibility of an "opting-out" for an own legislation. Different the provisions of article 125 a, paragraph 2 of Basic Law such, a contract would not in every single case depend on the previous consent of the Bundestag. In Canada, they have had a good experience with such a construction of the constitution.

Opting-out clauses in the field of the federal legislation would apart from that have the charming that the Federal State could withdraw without great expense from disputes with or among the states. If one recalls the dispute about the reintroduction of the tax on property, a states' tax, or the dispute on the times of shop closure, which were carried out among the ministers of economy of the states, then you have to ask yourself, why the Federal State does not withdraw in order to leave the corresponding legislation with the states. The Federal State would be relieved of this dispute; the parliaments of the states would have to justify their decisions towards their voters.

## *There Will Be Posed Completely Other Questions in the European Context*

Although it can be seen that despite all justified critics in the present system, no convincing alternative is visible and the political formation of a majority is going to be very difficult, it seems thinkable that changed framework conditions actually urge for a paradigm change. At the time of the three most important situations of making fundamental political decisions - at the formulation of the Basic Law in 1948/49, when the financial reform was made in 1969 and when there were negotiations on the integration of the new states in the financial order of the Basic Law in 1992/93 - there were viewpoints of interregional equalisation in the foreground. In 1948/49 it was about the common surmounting of the post-war misery, in 1968/69 it was about concerting action of the Federal State and the Länder with the aim to create homogenous living conditions in the Federal Republic and in 1992/93 it was about the claim of the Eastern German citizens to assimilation with their Western fellow countrymen. As far as it is visible, there will be posed other questions in the years to come. True for many years, the realization of "inner unification" will remain a task of extraordinary priority, apart from that, however, ideas of unification, which might have had its justification in a closed national state, almost cannot be longer communicated in a Europe without borders. It is difficult to justify why things from Flensburg to Konstanz and from Aachen to Görlitz should be regulated uniformly, if the point of reference for the citizen and his (economic) action is no longer the national legal framework but the much more flexible European one. It will hardly be possible to communicate, to consider German standards as binding for the inner state, if at the same time other European ones are considered as equal. The renunciation of binding inner state norms, which, however, in the European context have become obsolete, means first of all that the Federal State renounces of its political possibilities to direct or that it uses them only restrictedly with the aim that the subsidiarity principle - which within the European Union is always stressed by the Germans - is respected also in the inner state and that the states are left with more scope to independently create politics. It has to be seen, whether the Federal State and above all also the political parties are prepared to that.

Not only as to the constitutionally legal position of the states, but also with respect to their role as sovereign sub-national territorial corporations within the European Union, the partition of functions of the Basic Law requires an examination. With the actual cessation of national borders and the arising new

competition situation, which developed between the German states and other regions in the European Union, which have other regulation regimes, there arises the need for strengthening the regulation competences of the states. The states are already facing new responsibilities, more will come, but their autonomous regulation possibilities are very restricted.

## Budgetary Financing of Local Self-Government in Slovenia

### Introduction

The Constitution of the Republic of Slovenia defines municipality as a basic local community, which fulfils the needs of its inhabitants by executing duties that are defined by its competence. Bearing in mind that municipality is the basic territorial unit of society and that it manages its property in order to fulfil a wide range of tasks, it needs to be considered that basic principles of economic and efficient operations apply to its activities. Municipality needs to manage its property like a good master, as it is holder of the right of ownership as a subject of the public law. For this reason, a set of legal acts regulates the management of municipality's property.

The following three basic rules need to be taken into consideration when managing the municipality's property:

- A principle of good master
- A principle of preserving municipality's property
- A principle of limited disposal (public infrastructure, public goods, etc).

Last amendments of the Act on Local Self-Government and the Act on Municipalities' Financing represent a system frame for managing and funding municipalities. At the same time they represent a basis for the implementation of the European Charter on Local Self-Government. The new Act on Public Finances, which was implemented in 1999, has entirely settled the area of funding municipalities and managing their property. With the enforcement of the new acts in the field of public finances, including the local level, the reform of public finances, which is taking place in Slovenia, has been initiated. This new system ensures greater autonomy of municipalities in making decisions about public matters. It is done with the intention of:

- Successful solving duties
- Considering needs of their citizens while executing their duties and
- Assuring the preservation of municipality's property.

The basic documents dealing with municipality's duties and managing its property are:

- The municipality's budget
- The balance of the municipality's property.

Both documents give a synthetic view of municipality's budgeting process.

### Documents on municipality's budgeting process

The Act on Public Finances defines the method of planning in a municipality'. This law defines documents and the procedures involved. Budget planning consists of:

- Preparation of the budget
- Creation of the property balance
- Preparation and passing of the final balance report
- Planning and execution of the budget.

Planning periods that are created in the process of the budget planning are shown in the table 1: "Planning periods by documents of the budget's planning". It is obvious that the adopted law invites a slither planning.

**Table 1: Planning periods by documents of the budget's planning**

Document	Planning period
Budget memorandum - state budget	Current year, next year, scenario for the next three years
Budget - special part, financial plan of users of the budget	Realisation of the previous year, estimation of the current year, plan for the next year
Plans of the development programs of direct users	Future four years
Proposals of the finance plans of direct users (goals, indicators, etc)	Current and the next two years
Instructions for the preparation of the municipality's budget proposal with: - Contents for the preparation of the financial plans of direct users - Schedule for the preparation of the municipality budget	Estimation for the next two years
Plans of development programs, work places and purchase of assets of direct users - preparation and harmonisation	- Four years (development programs and assets) - Two years (for assets)
Preparation of finance plans of indirect users (state, municipality budgets)	Realisation of the previous year, estimation of the current and plan for the next two years
State and municipality budget - plan of revenues and expenditures	only the plan of revenues and expenditures for the next year must be accepted

<sup>1</sup> Act of Public Finances, Official Gazette of the Republic of Slovenia, no. 79, 1999 (pp. 12394-12410).

Municipalities are obliged to prepare a final report on their budgets in the first half of the year. This phase of local self-government management is not identical with the phase of the budget's preparation. This might be considered a less developed function of the municipal management.

The procedures of planning state and municipality's budgets are being carried out simultaneously. The duration of particular phases is defined in the scheme 1: "Phases of the budgetary planning in Slovenia".

**Scheme 1: Phases of the budgetary planning in Slovenia**

	February, March, April	May, June	July, August	September, October	November	December
State Budget	Budget memorandum of the state budget	Instruction for the preparation of the budget's elements and budgets for direct users	Development plans, work places and financial plan of direct users of the state budget Adjustment of the users of the state budget		Voting on the budget in the government Voting and acceptance in the parliament	Planning of the monthly liquidity of the state budget Acceptance of the budget
Municipality budget		Start of municipal budgeting - information about the preparation and development	Preparation of plans: development programs, work places and financial plan of the municipality's budget users Adjustment of plans		Proposal of the municipality budget	Planning of the monthly liquidity of the municipality's budget

The budget documents are divided into three groups:

- General part of the budget (the balance of revenues and expenditures, the account of financial debts and investments and the fiscal account),
- Special part of the budget (financial plans for direct and indirect budget beneficiaries)
- Development programme plan of direct and indirect budget beneficiaries.

The planning process is organised into two types of information-documentation flow:

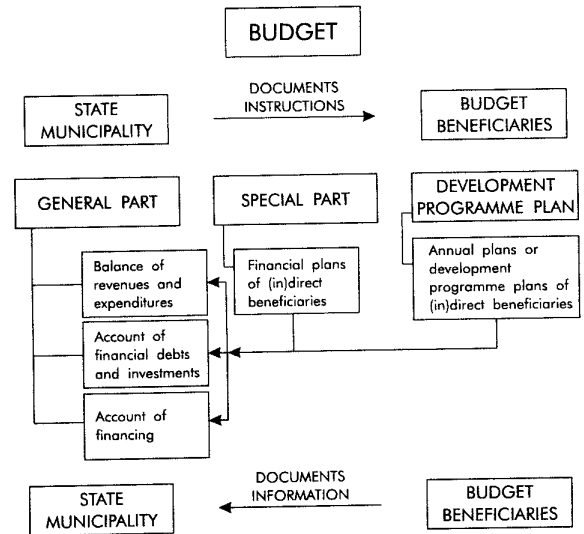
- Information on content, value and form of documents, the Ministry of Finance and municipalities provide financial support to direct and indirect budget beneficiaries,
- Budget beneficiaries provide documents (development programme plans and financial plans) to bodies responsible for preparing budgets in municipalities or the state.

Scheme 2 shows the information and documents flow-chart.

The process of budget planning can be understood as forming final documents (budget memorandums, budgets, balances of assets, financial plans, development plans) and as types of accompanying (supplemental) documents, all mutually connected, determining the activity content of the whole planning process.

Due to the municipality's duty to manage its property, property balances are of the same significance as accounting documents. Municipalities are obliged to prepare the balances every second year. When speaking about municipality's final accounts and property's balances, however, management functions in this area have not yet been established.

**Scheme 2: Information and documentation flow-chart in the budget planning process**





## Municipality's budget

Budget is a normative act, which determines the plan of inputs and outputs of the public expenditures in a municipality. It is a basic instrument of the executive policy and a basic financial instrument of a municipality when defining its tasks and execution of its basic functions.

Budget documents consist of:

1. Common part - common balance of revenues and expenditures, account of financial outstanding debts and investments and finance account.
2. Special part - financial plan of direct users (municipality's bodies, management, administration, funds and agencies).
3. Development plans - one-year plans and those concerning direct users that are defined by the acts on the long-term development plans, with special acts and other regulations. This part will take place for the budgeting year 2001.

Common and special parts of the budget deal with:

- Estimation of the realisation of revenues and expenditures of the past year
- Estimation of the realisation of revenues and expenditures for the current year
- Plan of revenues and expenditures for the next year.

The plan of revenues and expenditures for the next year is the only one which must be ratified by the municipality council.

Beside the described structure of revenues and expenditures, municipalities' budgets can also be shown by functional classification. It depicts expenditures by their functional purposes and it displays current and investment consumption by every single item.

## Municipality's property balance

The methodology of creating municipality's property balance is determined by law. Under Slovenian circumstances this process is much more troublesome than the process of budget planning. Disordered files and inadequate attention paid to property management do not enable appropriate implementation of management functions when creating property balances and managing property. This is due to the unsettled conditions and, on the other hand, due to accustomed patterns of thinking.

Undefined functional classification represents another problem, which calls performance indicators of successful municipality's property management for its urgent facilitation.

Basic structure of property balance is represented in the table 3.

**Table 2: Contents of the municipality's budget**

<b>A. BALANCE OF REVENUES AND EXPENDITURES</b>	
<b>I.</b>	<b>SUM OF REVENUES (70+71+72+73+74)</b>
	CURRENT REVENUES (70+71)
70	TAX REVENUES (7000+703+704+706)
7000	Individual income tax (35%)
703	Property taxes
704	Taxes on goods and services
706	Other taxes
71	NON-TAX REVENUES (710+711+712+713+714)
710	PARTICIPATION IN PROFIT AND PROPERTY TAXES
711	CHARGES
712	PENALTIES
713	REVENUES FROM SELLING GOODS AND SERVICES
714	OTHER NON-TAX REVENUES
72	CAPITALS REVENUES (720+721+722)
73	RECEIVED DONATIONS (730+731)
74	TRANSFERRED REVENUES
<b>II.</b>	<b>SUM OF EXPENDITURES (40+41+42+43)</b>
40	CURRENT EXPENDITURES (400+401+402+403+409)
400	Salaries and other administrative expenditures
401	Employers' contributions for social security
402	Expenditures for goods and services in the administration
403	Payment of interests
409	Funds extracted for a reserve
41	CURRENT TRANSFERS (410+411+412+413)
42	INVESTMENTS EXPENDITURES (420)
43	INVESTMENTS TRANSFERS (430)
<b>III.</b>	<b>BUDGET'S SURPLUS (OR DEFICIT) ( I. - II. )</b> <b>(SUM OF REVENUES AND EXPENDITURES)</b>
<b>B. BALANCE OF FINANCIAL OUTSTANDING DEBTS AND INVESTMENTS</b>	
75	IV. RECEIVED REPAYMENTS OF LOANS AND SELLING OF THE CAPITAL SHARES (750+751)
44	V. GIVEN LOANS AND INCERAS OF THE CAPITAL SHARES (440+441)
	VI. RECEIVED MINUS GIVEN LOANS AND CHANGE OF THE CAPITAL SHARES (IV. - V.)
	VII. TOTAL SURPLUS (OR DEFICIT) OF REVENUES MINUS EXPENDITURES AND BALANCE OF GIVEN AND RECEIVED LOANS (I. + IV.) - (II. + V.)
<b>C. FINANCING BUDGET</b>	
50	VIII. CONTRACTING DEBTS (500)
55	IX. PAYMENT OF DEBTS (550)
X.	NET CONTRACTING DEBTS (VIII.-IX.)
	XI. INCREASED (OR DECREASED) FUNDS ON ACCOUNTS (III.+VI.+X) = (I.+IV.+VIII.) - (II.+V.+IX.)

**Table 3: Municipal property balance**

Description of property balance	
Assets	Liabilities
Current value of undefined long-term means	General fund
- Purchase value of non-object long-term means	
- Corrected value of non object long term means	
Current value of fixed property	Reserve fund
- Purchase value of fixed property	
- Corrected value of fixed property	
Current value of equipment and other basic funds	Long term accepted loans
- Purchase value of equipment and other basic funds	
- Corrected value of equipment and other basic funds	
Demands for funds given into public enterprises	Long term liabilities as a result of operation
- Demands for funds given into state enterprises	
- Demands for funds given into municipality's enterprises	
Stocks	Short term liabilities
Long term capital investments	Other liabilities
Given long-term loans and deposits	
Long term outstanding debts from operations	
Monetary funds	
Short term funds	
Other outstanding debts	
Sum assets	Sum liabilities

(Scheme is being used since the year 2001 on)

Municipalities in Slovenia are obliged to introduce property balances gradually. However, due to unsettled property documentation and other files they are still not of greater importance.

### *Contents of the municipal balance documents*

#### **Basic structure of the municipalities' balances**

Items of the municipality's balances of budgetary revenues and expenditures are shown in the Table 4.

Personal income taxes represent more than a half of the municipalities' budget funds. Municipalities get 35% of collected personal income taxes. Moreover, they receive additional 14% from the state budget.

**Table 4: Budgetary revenues of Slovenian municipalities**

	Year 2000	Structure
Account	mio. SIT	Year 2000
<b>SUM OF REVENUES (70+71+72+73+74)</b>	<b>215.026</b>	<b>100</b>
CURRENT REVENUES (70+71)	155.143	72,15
70 TAX REVENUES (700+703+704)	125.895	58,55
700 Tax on incomes and profits	90.871	42,26
7000 Personal income taxes	90.871	42,26
703 Property taxes	25.471	11,85
704 Taxes on goods and services	9.553	4,44
71 NON-TAX REVENUES	29.248	13,6
710 PARTICIPATION IN PROFIT AND PROPERTY TAXES	11.811	5,49
711 CHARGES	1.035	0,48
712 PENALTIES	402	0,19
713 REVENUES FROM SELLING GOODS AND SERVICES	1.260	0,59
714 OTHER NON-TAX REVENUES	14.740	6,85
72 CAPITALS REVENUES (720+721+722)	8.781	4,08
73 RECEIVED DONATIONS (730+731)	975	0,45
74 TRANSFER REVENUES	50.127	23,31
Financial balance	30.272	14,08

**Table 5: Expenditures of Slovenian municipalities**

	Year 2000	Structure
Account	mio. SIT	Year 2000
<b>II. SUM OF EXPENDITURES (40+41+42+43)</b>	<b>214.429</b>	<b>100</b>
40 CURRENT EXPENDITURES (400+401+402+403+409)	46.568	21,72
400 Salaries and other administrative expenditures	11.827	5,52
401 Employers' contributions for social security	1.647	0,77
402 Expenditures for goods and services in the administration	31.319	14,61
403 Payment of interests	590	0,28
409 Reserve funds	1.185	0,55
41 CURRENT TRANSFERS (410+411+412+413)	89.611	41,79
410 Subventions	6.177	2,88
411 Transfers to individuals and households	23.622	11,02
Transfers to non-profit organisations	9.396	4,38
Other transfers	50.416	23,51
42 INVESTMENT EXPENDITURES (420)	58.258	27,17
43 INVESTMENT TRANSFERS (430)	19.992	9,32
<b>III. BUDGET'S SURPLUS (OR DEFICIT) (I. - II.) (SUM OF REVENUES AND EXPENDITURES)</b>	<b>597</b>	<b>0,28</b>

In the year 2000 current expenditures represented 65% of total budgetary expenditures. The leftover was represented by investment expenditures. The structure of expenditures of the budget funds by functional areas significantly varied by municipality. In the selected sample it varied in the intervals shown in the table 6. The structure is estimated approximately due to great oscillations between municipalities.

**Table 6: The structure of expenditures of budget funds**

Purpose	Structural estimation (%)
Public administration	10 - 15
Defence	2
Public security	1 - 3
Economic activities	15 - 35
Pollution, environmental protection	Up to 10
Health care	2
Culture, recreation, and other non-profit organisations	5 - 12
Education	20 - 30
Social security	3 - 5

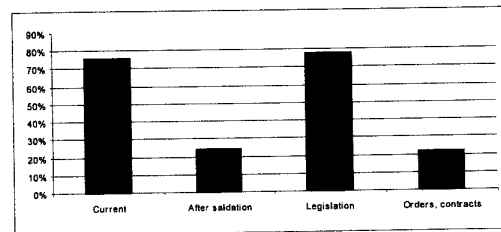
Dynamics of welfare expenditures is not influenced by the current consumption, whereas the investment expenditures vary according to investments. Expenditure dynamics is different by revenues, i.e. it varies according to funds. It has been estimated that the legally prescribed dynamics of revenues is structurally disproportional. Table 7 represents the dynamics of budget's funds by legal foundations.

**Table 7: Dynamics of budgetary funds by legal foundations**

Type of revenue	current	After balancing	legislation	Orders, contracts, decisions
Tax revenues	95%	5%	Over 95%	Up to 5%
Non-tax revenues	11%	89%	Up to 10%	Over 90%
Capital revenue	0%	100%		Up to 100%
Received donations	0%	100%		Up to 100%
Transfer revenue	82%	18%	Over 80%	Up to 20%
Incomes from selling capital shares	0%	100%		Up to 100%
Total revenues	76%	24%	cca 80%	cca 20%

On the basis of the table and the picture a conclusion can be drawn that the majority of current revenues is being outsourced into municipalities' budgets (over 75%) and that law proscribes the majority of revenues. The structure is shown in graph 1.

**Graph 1: Income Dynamics and Legislation basis**



The connection between the increase of the investments and the current expenditures for a period between 1995 and 2000 is shown in the table 8.

**Table 8: Fluctuation of current and investment expenditures for the period 1995 - 2000**

Expenditures	1995	1996	1997	1998	1999	2000
Investment expenditures	30444	41166	48763	56903	68102	78250
Current expenditures	73926	83080	92105	105581	119256	136179

Source: Bulletin of Public Finances, Ministry for finances RS, Ljubljana, April 2001

The graphic presentation of the correlation and regression line shows that current expenditures are growing more rapidly than investment expenditures. If the investment expenditure grows up to 1000, investment expenditure increases up to 1320. This can be seen from the regression line, which forms the equation:

$$Y = 1,32x + 30402$$

where x represents investment expenditure and y represents current expenditure.

This correlation shows that the growth of investment expenditures brings about

the accelerated increase of current expenditures, which is a commonly known fact in the public sector.

### Financial balance

Municipalities receive missing funds, necessary for their executive duties, from the state budget. The Law on Funding the Municipalities regulates this matter. The extent is calculated for each municipality by the equation:

$$P_{pi} = (0.70 + 0.05 \cdot C_i + 0.05 \cdot P_i + 0.16 \cdot M_i + 0.04 \cdot S_i) ZP \cdot O_i$$

The following means:

- P<sub>pi</sub>- appropriate volume of funds for the financing of the local needs of an individual municipality;
- C<sub>i</sub>- ratio between per-capita length of local roads in an individual municipality and per-capita length of local roads in Slovenia;
- P<sub>i</sub>- ratio between per-capita area of a municipality and per-capita area of Slovenia;
- M<sub>i</sub>- ratio between the share of the population under the age of 15 in the entire population of an individual municipality and the average of these shares in Slovenia as of 1st January of the year in which the amount of appropriate expenditure is determined for the subsequent year;
- ZP- appropriate per-capita expenditure;
- O<sub>i</sub>- number of persons whose permanent residence is in an individual municipality as of 1<sup>st</sup> January of the year in which the amount of appropriate expenditure is determined for the subsequent year on the basis of data from the central population register.

The basic sum of all coefficients shall be 1.00. The amount of these funds is calculated for each municipality once for the next year. It is paid out once per month.

Table 9 shows frequency distribution of the amount of the financial balance funds per inhabitant for the year 2001.

**Table 9: Frequency distribution of the finance balance per inhabitant for the year 2001**

Amount of financial balance per inhabitant (in thousands SIT)	Number of municipalities	Structure
0 do 1	28	15%
1 do 20	31	16%
20 do 40	71	37%
40 do 60	41	21%
60 do 80	17	9%
80 do 100	3	2%
100 do 120	1	1%
		100%

It can be concluded that most of the municipalities (nearly half of them) receive financial balance in the amount of 40,000 SIT per inhabitant. Furthermore, nearly 15% of them do not meet requirements for it.

### Conclusions

On the basis of the presented facts we can conclude that the budget planning in Slovene municipalities develops in the direction of the planning systems which are introduced in the developed European countries. Slovenia has been introducing the system of sliding four-year budget planning. Budgets are adopted annually for one fiscal year. The area of assets management (balance sheets) in the Slovene municipalities is still in its infant stage and the function of assets management is less developed than the function of budget management.

The structure of budget revenues shows that tax revenues represent more than a half and transfer revenues (including financial equalisation) almost one fourth of total budget revenues. Approximately 3/4 of revenues are inflows, which regularly (at least monthly) fill in the municipal budgets, and more than 3/4 of revenues are realised on the statutory bases.

We have found out that the increase in expenditures for the current implementation of tasks falling within the competence of municipalities (in the period of 1995 - 2000) is considerably faster than the increase in the investment expenditure. Due to limited budget possibilities, this will probably hinder further investment activities of the municipalities.

A mechanism of financial equalisation has been introduced to cover the budgetary needs of municipalities, whose own revenues do not suffice for current operations and urgent investment activities. The analyses shows that the size of a municipality is not a factor, which would influence the financial equalisation to which the municipality is entitled. This element allows for the progress of underdeveloped municipalities. From the aspects of development, the effects of these mechanisms cannot yet be determined.

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## Local Government Financing: Some Observations

Slovenia has not yet completed the reform of local self-government system. The right to self-government is a constitutional right of Slovenian citizens. According to the Constitution, municipalities are the basic socio-economic, political and administrative units, responsible for the development of the local economy and social services in their territories. Slovenia has introduced a single-level system of local self-government with the intention to upgrade it with a second tier later. Slovenian municipalities range from 400 to 276,000 inhabitants. However, most municipalities are rather small (less than 9000) and often lack the financial resources and administrative capacity to perform their functions successfully.

As a result of the reform of the local government system, the number of municipalities has tripled since 1991, increasing from the previous 62 communes to 147 municipalities in 1994, and to 192 in 1998. The number of municipalities is expected to increase further, since many new proposals for establishment of new municipalities have been already waiting for parliamentary decision<sup>1</sup> to be allowed to proceed with referendum for the establishment of new municipalities. A municipality may be established by statute following a vote in favor of its establishment at a referendum conducted to ascertain the will of the people in the area affected. If citizens accept proposals for new municipalities, they will have to start functioning on the 1<sup>st</sup> of January, 2003.

### *Is small really beautiful?*

When the reform of local self-government started nobody could imagine that Slovenia will end up with numerous very small municipalities and with no second tier of local self-government. It has been defined by law that the municipality should have at least 5,000 inhabitants, although in certain special circumstances an exception can be made due to geographic, historical, economic or national reasons. After the first and second phase of reform Slovenia has ended up with exceptions. One half of its municipalities have the population below 5,000. But the partition of municipalities is still going on and many proposals for new municipalities were submitted to parliament, so with the beginning of the year 2003, when new municipalities should be formally established, Slovenian

<sup>1</sup> In the 1996, the Law on the Procedure of the Establishment of Municipalities and on the Determining of Their Territory was enacted to regulate the establishment of new municipalities.

municipalities will become even smaller. The size of municipalities is an important issue. From the point of view of democratic theory one could argue that the smaller the municipalities the better for democracy since citizens could participate to a higher degree. Also different forms of direct democracy are much easier to practice. But certain size is still important, because municipalities should also have on their disposal needed resources (financial, human etc.) for successfully fulfilling local needs. Very small municipalities lack sufficient resources for provision of needed services to their citizens. And also there is no guarantee that they are more democratically run than larger municipalities. Very often the power can be more easily sized up by one group than in bigger, more diversified and resourceful municipalities.

The size of the municipalities is important factor in Slovenia can hardly afford additional partition of already small municipalities. With this their administrative and financial capacity will diminish further. The state should reconsider the way equalisation grant is distributed since it is one of the very important if not the most important reason for establishment of new municipalities. For local communities it is financially viable to become an independent municipality due to the expected state support. As parts of bigger municipalities they are much worse off, since the total amount of state financial support for larger municipality is smaller than if divided into smaller municipalities. As long as criteria which municipalities should fulfill are not respected and state financing favors establishment of small municipalities, the process of partition of Slovenian municipalities will continue. With received grants new municipalities can much easier improve their basic infrastructure (roads, pipelines etc.) but after that they meet their limits because most of the problems they have to address cross municipal borders or they lack capacity to deal with them (environment, development, education, etc.).

Small municipalities lack human and financial resources to fulfill their task on the long run. Although they should perform the same tasks as bigger municipalities they can afford only one or very few professional administrators to carry out these tasks. To talk about professional local administration under such conditions is very hard. On the other hand they lack financial resources, since their population is small and the possibility for collecting taxes very limited. They are almost entirely dependant upon the state and its financial support. Although they have a very small administration, almost half of the local budget is spent for local administration work, while larger municipalities spend between 10 to 12 per cents only.

Larger municipalities have on their disposal much wider range of different resources (financial, human, technological, etc.), but they are considered less

democratic and more removed from citizen influence. However, this obstacle can be overcome by internal division of municipality into smaller units to which certain responsibilities can be delegated.

### ***Voluntary or mandatory regionalization?***

At the moment there exist no official political and administrative entities at an intermediate level between the municipalities and the state level, and although municipalities may join into regional associations to regulate and pursue local matters of wider interest it has not been common practice to do so. Still, municipalities of certain areas (Koroška, Bela Krajina, etc.) joined together to formally establish region, but none of the proposals has passed the parliamentary procedure yet. The Parliament is waiting for a law on regions which should provide a general legal framework for regionalization of Slovenia. Regionalization is particularly relevant for successfully addressing major development and environmental issues necessitating resources of regional capacity, such as development agencies, for developments of a strategic nature such as waste removal and treatment or waste-water treatment facilities. In order to promote regional development, there is a pressing need to set up an appropriate mechanism or mechanisms to combine different elements and agencies at the regional level.

When the Constitution was drafted a great emphasis was given to local self-government and autonomy. The constitutional provision that regions should be formed voluntarily by municipalities is based on the assumption that local governments readily cooperate. It was expected that regional level would evolve spontaneously as municipalities would join voluntarily to form regions, but practice has not lived up to these expectations. This problem is actually more complex than first realized, but an intermediate level of government still must be established for a number of arguments, either by voluntary cooperation or mandatory by law. Under the present legal framework the state cannot impose regions upon the municipalities. One of the current proposals for changing the Constitution is related to this issue, empowering the state to regionalize Slovenia by law.

The intermediate level of government can be seen as a challenge to existing municipalities and national government, given the element of division of tasks and resources, and supervision entailed. This is especially apparent when the legacy of previous and present centralized system is taken into account. The question is still open to what a degree the central authorities have been really willing to decentralize or would they rather turn to deconcentration instead. At

the same time, do municipalities really want to co-operate and join their efforts and resources with neighboring municipalities? Or, would they prefer isolation, especially from the centers of previous communes which tend to dominate over smaller municipalities that parted away?

Thus, a very big challenge lies ahead concerning this issue. It is not only about providing a legal framework, the real challenge is to develop a true culture of local self-governance. On one side citizens and local governments must learn to assume the responsibility of making those decisions that have been delegated to the local governments, what presupposes also the readiness to co-operate with other municipalities in the area on a regular basis. On the other side, central authorities must learn that local communities can have their own priorities and solutions of concrete problems which they have to respect, within the bounds of legislation, of course. It is very important for all players to realize the mutual benefits of cooperation, since they are force into it if they want it or not. Of course, there will always be an aspect of tension between municipalities and the central and local levels, since their objectives do not always correspond, frequently, these objectives will even conflict. Nonetheless, it is important to focus on the positive aspects of such tensions and accept the necessity of cooperation. But difference cannot be resolved only by subordination of smaller municipalities to larger, or the local government to the central, but rather through negotiations and mutual adjustments.

If the emphasis is on decentralization, the accompanying regionalization is a precondition for success and at the same time local government capacity building is of utmost importance. Decentralization also requires both, the delegation of responsibilities and the delegation of financial and budgetary control. Slovenian financial system will have to be adjusted if tasks and functions will be decentralized. It is very important to recognize that true local self-government cannot be obtained without a clear connection between functions and finances. Competence and responsibility must always be connected.

### ***Local competencies between potentiality and actuality***

In accordance with current legislation, the municipalities shall be responsible for three sets of tasks:

- their own local public affairs (which can differ from one community to another),
- local public matters defined as such by central government through sectors national laws;
- tasks that have been transferred to them from the state competence (until now none).

Currently, Slovenian municipalities perform only their own local public affairs and local public matters defined as such by central government through sectors national laws, since the state has not yet transferred any of its responsibilities to the municipalities arguing that municipality cannot provide for equal and uniform provision of services due to big difference in their size and capacities.

Some of current functions are the solely responsibility of the municipality (kindergarten and nursery, fire and civil protection, family welfare services, refuse collection and disposal, town planning, local economic development, district heating, water supply, etc.), while for others the responsibility is shared between the municipality and the state (primary and adult education, social housing, social security, primary health care, theatres, museums, libraries, parks and public spaces, sport facilities, other cultural facilities, environmental protection, roads, transport, etc.) When responsibility is shared, programs are very often developed in close co-operation between responsible state and municipal authorities. The municipality has to participate by co-financing programs (for example: adult education, public work programs, local development programs, etc.). Municipalities also provide funding for programs of nongovernmental organizations that compliment public programs.

There is no real possibility that the state will be more willing to transfer its tasks to the municipal level in the near future. Due to expected increase in the number of municipalities it is really very unlikely. Rather it is ore likely that Slovenia will establish regions, although it is still open how many and what their competencies and financial resources will be, although they should have financial resources on their own.

### ***Cannot do it without money***

Local matters of public interest shall be financed by the municipality from its own sources, national means and from loans. Normally municipal tasks should be financed from municipal own sources (i.e. from local taxes and other duties, and from revenues received from municipal property) but it is rarely the case. Economically underdeveloped municipalities which cannot ensure the implementation of their tasks within their own financial resources should receive additional finance from the state.

Municipalities have on their disposal three kinds of financial resources<sup>2</sup>:

- locally derived sources:
  - taxes: property tax, gift and inheritance tax, tax on gambling, tax on use of goods);
  - rates and fees: administrative fees, fees on gambling machines, local fees,

- communal fees, charges for the use of buildings and land, fees on farming land and forest, fines;
- other: property sales, rental fees, leases;
- funds from national sources:
  - shared taxes: income tax (35 percent municipality, before 1998 municipality received 30 percent);
  - general grants: (monthly transfers from the Ministry of Finance based on projections of guaranteed spending until 1999 and, after, on relevant spending<sup>3</sup>);
  - special grants (by individual ministries for specific projects, but maximum to 70 percent of total project costs);
- borrowing - limited to 10 percent of the municipal revenues in previous year, only for financing housing, water supply and waste disposal they can exceed the limit; the interest payments cannot exceed 3 percent of revenues.

### **General grants - equalisation**

Until the 1999, Slovenia used for equalisation purposes the guaranteed spending, which was intended for financing of current expenditures and of investments. After that the relevant spending has been introduced, which is intended for financing of current expenditures only related to performance of local government tasks specified by the Constitution or laws. The amount of relevant spending per capita is determined by the Ministry of Finance according to a following formula:

$$RS_i = (0.70 + 0.05 \cdot Ri + 0.05 \cdot Ai + 0.16 \cdot Yi + 0.04 \cdot Oi) RS \cdot Pi$$

where:

- RS<sub>i</sub>: relevant spending for a municipality defined as an appropriate volume of funds for the financing of local government tasks specified by the Constitution or laws.
- R<sub>i</sub>: ratio between the per-capita length of local roads in an individual municipality and the per-capita length of local roads in Slovenia;
- A<sub>i</sub>: ratio between the per-capita area of the municipality and the per-capita area of Slovenia;
- Y<sub>i</sub>: ratio between the share of the population under the age of 15 in the entire population of individual municipality and the average of municipal shares in Slovenia as of the 1<sup>st</sup> of January of the year in which the amount of relevant spending is determined for a subsequent year;

<sup>3</sup> The Ministry of Finance determines the amount of relevant spending per capita in relation to municipal population, size of territory and length of local roads, share of population under the age of 15, and share of population above the age of 65.

<sup>2</sup> The Law on Financing of Local Government has been passed in 1994, and amended in 1998.

- Oi: ratio between the share of the population above the age of 65 in the entire population of individual municipality and the average of municipal shares in Slovenia as of the 1<sup>st</sup> of January of the year in which the amount of relevant spending is determined for a subsequent year;
- RS: relevant spending per capita as determined by the Parliament for each year, when adopting the national budget;
- Pi: number of persons with permanent residence in an individual municipality as of the 1<sup>st</sup> of January of the year in which the amount of relevant spending is determined for the subsequent year on the basis of data from the central population register.

Basic sum of all coefficients should total to 1. However, the first coefficient can be higher than 0.70 in cases of urban municipalities or municipalities which were the centers of previous communes. For urban municipalities the coefficient increases to 0.78, the sum of all coefficients thus totaling 1.08, while in the second case it increases to 0.74, leading to the sum of 1.04.

The criteria which determines if municipality qualifies for equalisation grant or not is the amount of its estimated own revenues, which is jointly prepared by the Ministry of Finance, the Tax Office and individual municipality. When calculating estimated revenues, all municipal revenues are included except the category of other non-tax municipal revenues (like property sales, rental fees, leases, etc.). The estimation of local revenues is based upon levels of revenues as determined by law or average levels in Slovenian municipalities if not determined by law. Municipalities that can cover relevant spending with their own estimated revenues do not qualify for state equalisation grant. In 1999, there were 20 such municipalities in Slovenia. All other municipalities received equalisation grant. In the form of equalisation grant which is paid in regular monthly installments, the state has to cover the whole difference between the relevant spending and estimated own revenues so that municipality can carry out their tasks.

The law stipulates that in the case two or more municipalities decide to merge, they are entitled to additional equalisation funds for a period of next three years. With this provision the state wants to offset negative effects that such a merger can have on the level of equalisation grant. However, it does not really represent an inducement for municipalities, since they still gain more by partition than by merger.

For the very same reason the amendment to the Law on Financing of Local government that was introduced in 1998 stipulated that the equalisation funds received by an individual municipality can be less or equal the amount of its own estimated revenues, but the Constitutional Court banned this provision as unconstitutional.

## Special grants

Investments are co-financed through special grants by individual ministries. Thus, they are provided separately by individual ministries in accordance with specified criteria and available resources. Level of income tax serves as a main criteria. Municipalities that have lower income tax per capita receive higher share of state financing for individual investments, with 70 per cent being the upper limit. Investment priorities has to be approved by the government. Special grants from individual ministries are transferred for different investments (demographically endangered regions, municipal services, construction of waterworks, municipal waste sites etc.). Currently, very often they have to co-finance projects that the state is willing to fund, even if these are not the most appropriate from the local point of view.

## Local revenues

It should be mentioned that general government consumption as a percentage of GDP is around 46 per cent. However, the Slovenian public finances are still very centralized, although some progress has been accomplished toward greater financial autonomy of local governments. Municipal government expenditure only accounts for around 5 per cent of GDP and percent of total general government expenditure, which is less than in other CEE countries (e.g. Poland being the nearest with 12,3%, Sycora, 1999). The Tax Administration of the Republic of Slovenia assesses, levies and collects taxes on behalf of municipal governments.

In accordance with valid legislation the state determines which revenue instruments are available to local governments, and it imposes tax limits, which entail still more revenue constraints. For municipalities, access to revenue diversity is dictated by the state. The benefits associated with revenue diversification must be tempered, however, with the recognition that for many poorer residents, increased revenue burdens could entail revenue sources that may be onerous. This could be especially true with regard to fees, if they are structured without regard to individual's ability to pay contributing to increase of social and spatial inequalities.

For now, local governments cannot implement any new taxes on their own. In most cases, they also cannot raise tax or fee rates to generate additional revenue, since they are determined by the state. They have almost no discretion over taxes, the exception being property taxes, which should become one of the most important revenue sources for municipalities. However, most municipalities



have not been able to collect it so far because they are lacking reliable records. Significant financial effects of that tax will not be seen until the new law on Property tax has been passed replacing current property taxes with a tax on real estate (buildings and land) being imposed on all individuals and legal persons. The state has been also intensively working on modernization and informatization of land and building cadastres, which will provide a reliable database for taxation. Until now, very often only owners of second homes in some very attractive areas where second homes are numerous have to pay property taxes.

Non-tax revenues allow greater autonomy and rates and fees vary among local governments, but their importance is greatly dependant upon the size of municipalities and the ability of its inhabitants to pay them. Smaller municipalities collect negligible amounts, which represent only around 5 percent of their revenues. The most important source is the Contribution for the use of buildings and land, representing one third of all local non-tax revenues.

It should be mentioned that from the point of view of municipalities, other revenues (property sales, rental fees, leases and residential funds) are very important, since they are the only revenues municipality can spend really independently. However, the amount collected is rather small in most municipalities, primarily due to the lack of property and financial management expertise, what should be greatly improved in the future. Furthermore, in the process of denationalization and privatization, municipalities have been left without sufficient amounts of real estate property, especially urban land (building plots) and housing since almost 80 percent of the social housing stock being privatized.

Municipalities borrowing capacity is also determined by the state. They can borrow only from national credit institutions. They can also issue local bonds, but due to the lack of regulation, it is not used very often.

### **Expenditures**

The great majority of expenditures are determined by the state. Most of municipal revenues goes for relevant spending as determined by state. More than half of municipal expenditures are in the area of administration, protection and public institutions. To this public sanitation, roads and fire protections can be added, what means, that more than two thirds of municipal expenditures are for public purposes. For support of local economic development municipalities spend around 6 percent of total municipal expenditures, however it varies greatly among municipalities, from 1 to 16 percent, depending on municipal resources.

Municipalities would like to gain greater financial autonomy, what is particularly important for development functions that the municipalities increasingly have to perform. Some municipalities have succeeded in maintaining their original level of development under the changed circumstances. Moreover, they have even managed to start new investments and realize new development projects. Analysis of the success (or otherwise) of the transformation of particular local economies has shown that amongst the most important factors are the quality or lack thereof, of urban management and institutional organization of local government. Municipalities are in a great need for additional support in this area.

### ***A lot to be desired***

Although all Slovenian local governments share common elements of the contemporary problem of local government finance, some have worse problems than others. Municipalities that have small tax base as a result of small or even declining population, no major industries, or falling agricultural values face greater pressures on the revenue side than those that are big or have been growing. They are left with fixed overhead costs for provision of public services and with a serious question of how to provide quality services to their residents or even harder question of how to introduce new types of services. Many services also require certain economies of scale, which usually cannot be obtained within one municipal jurisdiction. Municipalities will have to overcome obstacles that prevent closer cooperation and join their resources for common purposes. State should serve as facilitator of this co-operation providing also appropriate financial incentives and financial sources for provision of common tasks.

Also accountability to citizens has to be strengthened. Citizens should know how municipal revenues are used and be in control that they are used wisely, effectively and efficiently. Citizen involvement into local government operations is of crucial importance. Also modern information technologies can be used to provide better access to information related to municipal spending. This way citizen trust into local government and local officials, which is not very high today, could improve in future.

From decentralization point of view something has to be done, and this opinion is widely shared today also among municipalities. The question which still needs to be answered is how to approach it. On how there is no agreement yet, but Slovenia should search for such an agreement, because otherwise many opportunities will be missed. The recent reform of local self-government leaves a lot to be desired from the point of view of functionality and proper delineation of

central and local administrative boundaries and provision of fiscal autonomy of local governments. In the next few years Slovenia will need to carry out a reorganization of the whole administrative system and local government structure. Agreement will need to be reached about the formation of regions (districts, provinces), their functions and responsibilities, since one tier local government with small municipalities cannot fulfill more demanding tasks that local government should also perform. "Subsidiarity", as a new political and economic strategy requires an intermediate level of decision making and organization, to operate between the state and the municipalities. This is needed urgently, to counter the tendencies towards extensive centralization, associated with inappropriate and detached decision making at the state level, as well as to combat the opposite pressures for a complete decentralization of government, which can result in ineffective self-interested parochial decision making (and resourcing) at the local levels.

## Appendix

**Table 1: The structure of municipal revenues, 1997 and 1998**

Revenues	1997(%)	1998(%)	Real growth 98/97(%)
Tax revenues	42.6	41.2	2.9
Income tax (shared)	39.0	37.4	1.9
Property tax	0.4	0.4	5.6
Gift and inheritance tax	0.2	0.2	-8.7
Tax on gambling	0.2	0.2	19.9
Tax on use of goods	2.8	3.0	16.6
Non-tax revenues	35.6	37.3	11.5
Administrative fees	0.0	0.0	-3.7
Fees on gambling machines	0.9	0.7	-12.2
Fines	0.1	0.2	23.3
Local fees	0.3	0.4	15.3
Communal fees	2.7	2.7	8.3
Revenues from administrative bodies	1.9	1.8	1.9
Contribution for the use of buildings and land	10.3	12.0	24.5
Fees on farming and forests	0.6	1.1	81.6
Other revenues (property sales, rental fees, etc.)	18.8	18.4	4.3
General grants (financial equalisation from the state)	18.8	18.4	4.4
Special grants	3.0	3.1	11.3
Total (borrowing excluded)	100.0	100.0	9.0

Source: Cankar, Vlaj, and Klun: Local governments in Slovenia, 2000

**Table 2: The structure of municipal expenditures, 1997 and 1998**

Expenditures	1997(%)	1998(%)	Real growth 98/97(%)
Administration (wages, costs, etc.)	12.9	13.0	7.7
Protection and salvage funds	0.4	0.4	0.0
Public institutions	41.0	41.7	8.5
Primary education	11.7	11.9	8.7
Research activities	0.2	0.1	-35.0
Culture	5.4	5.3	-3.7
Sport	3.3	3.4	11.8
Social security	3.8	3.7	3.1
Kindergartens and nurseries	14.8	15.1	8.3
Public health	1.5	1.6	17.7
Other	0.4	0.5	49.9
Transfer to local economy	35.6	34.9	4.5
Public sanitation	12.3	11.6	0.6
Housing	4.8	5.6	24.6
Roads	10.6	9.6	-3.5
Fire protection	1.9	2.0	10.2
Other transfers	6.0	6.1	8.7
Reserve fund	0.8	0.5	-28.8
Transfers to sublocal communities	1.1	1.2	12.4
Other	8.2	8.3	-

Source: Cankar, Vlaj, and Klun: Local governments in Slovenia, 2000.

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## Reforming the System of Financing Local-Self Government in Croatia

### *Introduction - Structure of local-self government*

The Croatian Local Self-government and Administration Act from 1993 defines municipalities and towns as units of local self-government, and counties as units of local self-government and state administration.

Basic public functions of 420 Croatian municipalities and 123 towns relate to ensuring preconditions for the development of economic, social and public utility services and other activities important for the area, preconditions for physical planning, urban development planning and environment protection, design of settlements, quality of housing, public utilities objects, municipal services, children care, education, public health, social care, culture, sport, etc.

A county is a unit of local self-government and state administration comprising 10 to 30 municipalities and towns.

The county, in its self-governing sphere performs activities with the scope of a balanced economic and social development of municipalities and towns within the county and of the county as a whole, co-ordinates issues of common interest which are decided upon by municipal and town bodies of the respective county, establishes conditions for urban planning and environment protection of the county, co-ordinates the development of educational, cultural, medical, social and public utilities and infrastructure facilities in the county.

### **Institutional Framework**

County and municipal/town administration form the lower level fiscal authorities in Croatia responsible for sub-national government financing and public spending. Their system, financing and obligations are based on a number of laws, that partially or completely regulate issues of local administration and self-government. Besides the Constitution of the Republic of Croatia, there are three groups of legal acts defining these issues. The first group of legal acts regulates the system and organisation of lower level fiscal authorities, whereas

the second covers financing sources. The third group of acts regulates obligations of lower level fiscal authorities in the area of settling public services. Croatian legal acts defining the system and organisation of lower level fiscal authorities:

- Constitution of the Republic of Croatia (1990),
- Act on the Territories of Counties, Towns and Municipalities in the Republic of Croatia (1995),
- Act on the County of Zagreb (1995),
- Act on the City of Zagreb (1993),
- Act on the Local Administration and Self-government (1993),
- Act on Determining Tasks within the Self-government Activities of the Units of Local Administration and Self-government (1993).

Croatian legal acts defining sources of financing of lower level fiscal authorities:

Tax revenues are defined in the following legal acts:

- State Budget Act (1994)
- Local Administration and Self-government Act (1993),
- Act on Financing Local Administration and Self-government Units (1993),
- Income Tax Act (1995),
- Profit Tax Act (1995),
- Capital Transfer Act (1997),
- Tax Authorities Act (1993).

Non-tax revenues are defined in the following legal acts:

- Act on Administrative Fees (1996),
- Act on Public Utilities Management (1995),
- Forests Act (1993),
- Hunting Act (1995),
- Roads Act (1995),
- Waters Act (1995),
- Act on Financing Water Management (1995),
- Maritime Code (1994),
- Mining Act (1995),
- Act on the Sale of Apartments with Occupancy Rights (1993),
- Tourist Tax Act (1994).

Croatian legal acts defining obligations of the lower level of fiscal authorities in the area of balancing public services:

- Local Administration and Self-government Act (1993),
- Act on Determining Activities of the Self-governing Sphere of the Local Administration and Self-government Units (1993),
- Act on Public Utilities Management (1995),

- Fire Protection Act (1993),
- Fire-fighting Act (1993),
- Urban Development Act (1994),
- Nature Conservation Act (1994),
- Environmental Protection Act (1994),
- Health Insurance Act (1993),
- Health Care Act (1994),
- Act on Protection of Cultural Heritage (1994),
- Act on Financing Social Needs in Culture (1993),
- Act on Cultural Institutions Management (1995),
- Act on Social Care of Pre-school Children (1993),
- Act on Librarianship and Libraries (1993),
- Museums Act (1993),
- Act on Protection of Archival Materials and Archives (1993),
- Theatres Act (1995),
- Sports Act (1995),
- Technical Culture Act (1994),
- Building Land Act (1992).

## Current Situation

### Revenue Structure

The financing of local self-government units and administration is based on four types of revenue sources: their own funds, share in taxes levied by the central government (common taxes), state budget grants and borrowing.

**Table 1. County and Municipality or City Taxes**

County Taxes	Municipality and city taxes
1. inherited property tax	1. consumption tax on alcoholic and non-alcoholic beverages
2. motor vehicles tax	2. taxes on houses used as secondary residences
3. taxes on boats and other water vehicles	3. corporate firm name tax
4. entertainment and sport event tax	4. public land use tax
	5. advertising tax

### Own funds

The county's own funds are formed by revenues from own assets, county taxes, fines and other revenues including grants from the central government.

Whereas less developed counties rely mostly on grants from the central government, the developed ones base their budgets on a number of county taxes are levied on legal entities and individuals who have inherited property, including cash or monetary claims, or who received property as a gift. The taxable base is the market value of the property at the moment of tax assessment after the deduction of debts and expenses encumbering the property. The tax is charged at rates up to 5%. Movable property received in this way is taxable if the taxable base exceeds DEM 2000. County taxes on motor vehicles are levied on legal persons and individuals who own registered passenger cars and motorcycles. The taxable base is calculated according to the engine power and the depreciation of the vehicle. Taxes on boats and other water vehicles are levied to legal persons and individuals who own registered boats and vehicles for water transport. The taxable base depends on the length of the vehicle and its depreciation. Persons who organize performances are subject to the entertainment and sport event tax which is levied on the value of tickets sold (i.e. for movies, sports, etc.). The rate can be up to 5% of the value of tickets sold. Theatre shows, museum attendance and other cultural performances and industrial fairs and exhibitions are exempt. The own funds of a municipality or a town are formed out of revenues from own assets, municipal taxes, fines, administrative fees, tourist taxes, communal charges, charges for the use of public areas and other revenues that are, as a rule, regulated by special legislation.

Municipal revenue from taxes mostly depends on the level of the development of a municipality or a town. In more developed municipalities/towns, particularly those in touristic areas, revenues from taxes are a significant budget item, whereas underdeveloped ones depend mostly on external financing. There are a number of taxes on this level. Municipal consumption tax on alcoholic and non-alcoholic beverages is levied on the retail price of alcoholic and non-alcoholic beverages sold for catering. The rate can be up to 3 percent of the tax base for the sales tax. Taxes on houses used as secondary residences are levied on legal persons and individuals who are owners of country cottages and rest centers. The tax is based on the usable surface of the property at rates up to DEM 3 per square meter. Legal persons and individuals that advertise in public places are subject to the advertising tax which is levied at up to DEM 200 per advertisement. This tax is not paid on advertisements published in newspapers and in public media. The corporate firm name tax is levied on legal persons and individuals liable for profit

or income taxes. This tax is levied as a lump-sum of up to 500 German marks. Towns and municipalities also regulate the assessment and collection of the public land use tax which is paid at a rate, in a manner and under the conditions established by themselves.

Towns with more than 40,000 inhabitants can introduce a surtax on the income tax of up to 30% of their share in the income tax (i.e. up to 7.5% of the total tax). The City of Zagreb, as the capital, can introduce a surtax on the income tax of up to 60% (i.e. 27.5% of the total tax). The surtax rate is determined by the local government unit and the revenue accrues to the local administration and self-governments units where a surtax payer resides. Any municipality or a town may stipulate lower income tax rates for taxpayers in their territory on the portion of the income tax, provided that this reduction is not lower than 30 percent.

### Share in taxes levied by the central government

The main tax revenue of local self-government units and administration is a share in taxes levied by the central government. The common taxes are the income tax, the profit tax, the tax on lotteries and betting, and the real estate sales tax.

The share of municipalities and towns in common taxes is as follows:

- income tax 32 percent,
- profit tax 20 percent,
- taxes on lotteries and betting 70 percent,
- real estate sale tax 60 percent.

The City of Zagreb with its particular status receives 45 percent of the income tax.

The share of counties in common taxes is as follows:

- income tax 8 percent,
- profit tax 10 percent.

**Table 2. Shares in Common Taxes**

	shares in %			total
	central state	counties	municipalities /towns	
income tax	60	8	32	100
profit tax	70	10	20	100
taxes on lotteries and betting	70	10	20	100
real estate sale tax	40	-	60	100

### State budget grants

Several forms of budget grants and transfers are used in Croatia. The money comes from the state budget and the receivers are local authorities i.e. municipalities and counties. These are equalisation grants, specific-purpose grants, and ad hoc grants.

Counties provide grants from their budget whenever the consolidated county and municipal/town tax and non-tax revenues per capita are lower than 75 percent of the county average. Municipalities and towns receive a grant equal to the difference between their actual per capita revenues and 75 percent of the county average (excluding towns with more than 40,000 inhabitants; they are allowed to levy a surtax on income tax by themselves up to the level prescribed by the Act on Financing Local Administration and Self-government Units). The intent of these grants is to partially equalise local government revenues.

Similar subsidies are given to counties with less than 75 percent of the national per capita average. The grants are equal to the amount necessary to bring the county revenues up to three-fourths of the national average. Counties receive grants from the national budget and the amount of grant is equal to the difference between counties actual revenues per capita and 75 percent of the county average.

Towns and municipalities make transfers to counties to finance projects of mutual interest to people in more than one local government.

The national government provides ad hoc grants to help financing specific services. The grants are given to municipalities in areas of special interest.

Ad hoc grants are also given to finance health care, schools, housing and other services. The grants are proposed by the Ministry of Health, Ministry of Education and Ministry of Civil Engineering and Physical Planning. In some cases grants are provided directly to municipalities and towns.

The Republic of Croatia may grant specific-purpose subsidies. This is particularly provided to municipalities and towns that have suffered war destruction.

### Borrowing

Local self-government units and administration may borrow (from the state budget) only if the State Auditing Agency establishes that loan repayment will not affect the financing of its expenditures. A local self-government and administration unit can raise public debt or issue municipal bonds with the approval of the Ministry of Finance. Local self-government and administration units cannot borrow funds to finance regular activities of their bodies and budget

users, except in the short term and in the case where budget revenues are not generated equally throughout the year. Local self-government and administration units can take loans to finance construction, reconstruction, or adaptation of facilities or to supply equipment intended for providing permanent conditions for the operation of their bodies and budget users.

### **Structure of Revenue Sources for Financing Service Delivery**

Total revenues of both local governments (counties, municipalities and towns) amounted to 4,6 billion kuna in 1995, 6,6 billion kuna in 1996, 7,6 billion kuna in 1997, 9,0 billion kuna in 1998, 8,4 billion kuna in 1999, and 9,4 billion kuna in 2000. For the sake of comparison, the central government's budget amounted to 27,8 billion kuna in 1995, 31,1 billion kuna in 1996, 33,8 billion kuna in 1997, 43,8 billion kuna in 1998, 50,0 billion kuna in 1999 and 49,3 billion kuna in 2000.

Sub-national percentages of revenues indicate that Croatia is highly centralised according to international standards. The major part of GDP is spent by the central government budget. The share of Croatian local governments' total revenues and transfers in GDP was 4,7 percent in 1995, 6,1 percent in 1996, 6,2 percent in 1997, and 6,6 percent in 1998.

### **Tax Revenues**

Tax revenues make major part of total sub-national revenues. In 1995, tax revenues amounted to 66,2 percent of the total sub-national revenues. The share of tax revenues in the structure of sub-national revenues started to decline from 1996, and amounted to 53,1 percent in 2000.

Towns and municipalities receive nearly 60 percent of sub-national tax revenues. Most of the tax revenues come from shares of national taxes, income and profit, in particular.

Real estate sales tax is the third important tax revenue for the sub-national government; its share in total revenues amounted to approx. 6 percent in 2000. Local governments are permitted to impose rates on several tax bases (local taxes), within limits established by the national government. Towns with population higher than 40,000 inhabitants are permitted to levy a personal income surtax of up to 30 percent of the 32 percent share they receive from the national income tax, except in Zagreb where the surtax can be up to 60 percent of the city's share of tax revenues.

### **Non-Tax Revenues**

Non-tax revenues comprise a wide range of items including administrative fees and fees intended for the use of public resources, tolls, miscellaneous county and municipality/town fees, and communal fees. Non-tax revenues yielded 22,7 percent of total revenues in 1995. After 1995, the non-tax revenues started to increase their amount and share in total revenues of sub-national government. The non-tax share of revenues was significantly increased in 1996, because of a decision to bring communal fees from extrabudgetary communal fund to the budget. The share of non-tax revenues amounted to around 32 percent of sub-national revenues. Non-tax revenues are much more significant sources of revenues for municipalities and cities than for the counties, because the counties do not collect communal fees.

Capital revenues, which include the sale of land and property, represent around 5 to 8 percent of total sub-national revenues. Capital revenues are much smaller than capital expenditures, evidencing that much of the capital expenditures are financed from the current revenue sources or transfers.

### **Transfers**

Transfers from the national to the sub-national governments amounted to between six and nine percent of revenues (7,4% in 2000). Transfers provide a much larger share of revenues for counties, representing just over one-fourth of total revenues.

Counties in turn provide transfers to their municipalities and towns, equalling nearly 30 percent of the counties' revenues. These grants are intended to equalise municipal revenues partially. Grants are made to constituent local governments whenever the town or municipal revenues per capita are lower than 75 percent of the county average.

The above presented structure of the lower level of fiscal authorities points at basic conclusions. Financing of local self-government units and administration is mostly based on common revenues, which are in most cases common revenues from income tax. Other sources of income of the lower level of fiscal authorities are their own tax revenues and non-tax revenues. The percentage of participation of capital revenues and subsidies of the higher level of authorities is negligible in the total revenues of local authorities. Financing revenues is not a part of the structure of total revenues, which means that the units of local self-government do not use borrowing at all, or at least not often, as an instrument for financing of public expenditures.

## Expenditure Structure

General responsibilities of sub-national governments are defined in the Local Self-Government and Administration Act. Sub-national governments are responsible for services of local nature, i.e. local roads, housing, street lighting, local marketplaces, waste collection and disposal, local recreational parks and cultural services.

Counties operate as local self-governments but also as a home for detached units of a number of ministries. The counties' responsibilities in terms of local self government are mostly to co-ordinate local government activities within their borders and to regulate activities that are of common interest to. Overall, the counties have very limited service delivery responsibilities. Counties can perform functions transferred from the municipalities.

The national government delivers services with a country-wide interest, including justice, foreign affairs, and defence. The national government also provides public order and police services.

Many social and economic functions, such as education, health, and welfare, are shared between the national and sub-national governments. Sub-national governments often find their role in supplementing national financing to provide a differential quality of services that is needed locally.

Expenditure data for sub-national governments in Croatia are presented in the Table 3. Expenditure data reveal that the sub-national share of spending has been growing substantially from 1995 to 1998.

Towns and municipalities are responsible for about 90 percent of sub-national spending, with counties contributing with the remaining 10 percent. Towns and municipalities spend more on services than counties in every category.

Functional classification of local expenditures shows that the main expenditure categories of sub-national governments are housing and communal services. Housing and communal services make about one third of municipal/town expenditures. A large amount of it belongs to transfers aimed to help financing local utility companies. Transportation and communications, education, recreation and cultural expenditures also make a relatively large share of municipal/town spending.

Counties' major expenditures go to social security and welfare and to recreation and culture.

Economic classification of sub-national expenditures shows that sub-national governments make relatively more of the capital than the current expenditures. The share of current expenditure in the total sub-national expenditure started to decline from 1996. As for the structure, in 1998, about two-thirds of total sub-national expenditures went for current expenditures, and only one-third for capital expenditures.

**Table 3. REVENUES OF SUB-NATIONAL GOVERNMENT, 1995-2000 (Amounts in Thousands of Kuna)**

	1995		1996		1997		1998	
	Counties	Town/ Municipal	Counties	Town/ Municipal	Counties	Town/ Municipal	Counties	Town/ Municipal
I. Total Revenue and Transfers	569,806.6	4,079,600.4	786,154.7	5,836,160.3	742,705.2	6,830,932.8	856,829.5	8,212,502.1
II. Total Revenue	426,199.8	3,921,857.9	526,380.4	5,581,486.4	526,712.5	6,434,446.9	627,376.9	7,591,829.4
III. Current Revenue	412,886.5	3,721,734.7	516,326.4	5,264,784.0	533,089.1	5,985,438.9	609,815.5	6,956,951.5
IV. Tax Revenue	284,623.1	2,795,067.6	350,983.9	3,350,207.4	388,904.7	3,605,438.2	446,035.9	4,171,783.6
1. Individual Income	173,172.1	2,049,935.5	213,981.3	2,475,919.8	204,447.9	2,407,363.8	362,850.3	2,809,661.6
2. Profits	55,885.6	336,007.2	75,209.9	425,727.9	109,805.8	608,062.5	121,916.7	747,903.8
3. Property	15,856.2	318,235.2	20,375.3	358,947.9	16,214.5	469,825.4	27,399.4	493,185.7
Property tax	0.0	33,611.4	0.0	32,662.4	0.0	33,325.7	0.0	44,406.8
Gifts	15,856.2	0.0	20,375.3	0.0	16,214.5	3,931.4	17,149.9	2,227.8
Financial Transactions	0.0	206,207.4	0.0	250,948.8	0.0	394,832.7	17,149.9	332,425.7
Other	0.0	69,963.0	0.0	69,118.1	0.0	98,715.6	0.0	13,825.5
4. Sales	35,372.3	85,790.1	39,105.0	85,841.9	50,363.3	95,501.5	58,836.0	117,964.7
5. Motor vehicles & Boats	32,546.8	12,955.9	36,680.6	14,015.3	47,365.9	17,201.6	52,731.0	17,248.4
6. Other	193.3	5,099.5	2,312.4	3,789.9	8,073.0	4,694.9	0.0	7,695.8
V. Non-tax	128,283.4	926,667.0	165,342.5	1,914,576.6	144,184.5	2,380,010.7	162,779.6	2,185,069.2
1. Administrative fees	69,026.8	412,755.2	117,480.7	1,261,577.8	78,427.7	1,575,941.7	75,862.3	1,879,105.9
Communal Fees & Contributions	0.0	289,826.3	0.0	850,951.3	0.0	1,094,115.1	0.0	1,348,849.9
VI. Capital Revenues	13,096.2	210,733.3	10,054.0	316,702.4	3,623.4	448,987.9	17,561.4	634,977.9
VII. Transfers	145,600.8	147,742.5	259,774.3	754,673.9	205,992.7	376,465.9	209,422.5	370,872.7
National Transfers	143,246.8	44,924.4	259,369.6	79,498.4	205,779.5	228,619.4	208,725.2	391,386.7
County	0.0	90,321.2	0.0	154,563.7	0.0	98,677.3	0.0	16,1365.7

Source: Ministry of Finance.

Table 3. (continued)

	1999		2000	
	Countries	Town/ Municipal	Countries	Town/ Municipal
I. Total Revenue and Transfers	775,365.6	6,392,300.6	858,239.9	7,101,799.9
II. Total Revenue	578,357.2	6,180,687.9	655,733.8	6,864,541.1
III. Current Revenue	560,851.3	5,738,344.9	627,395.3	6,308,880.8
IV. Tax Revenue	449,871.7	3,803,095.7	478,674.3	4,090,171.8
1. Individual Income	372,438.9	3,292,363.8	407,634.0	3,553,601.6
2. Profits	149,210.9	789,904.8	162,160.0	887,716.6
3. Property tax	3,454.9	419,595.4	3,624.3	437,878.9
Other	0.0	20,084.6	0.0	23,118.7
Financial Transactions	3,193.0	0.0	3,424.3	0.0
Other	0.0	315,869.0	0.0	319,413.3
5. Other	62,433.9	83,399.8	0.0	94,636.9
6. Motor vehicles & Boats	46,403.7	25,497.4	64,749.0	92,423.2
7. Other	5,544.0	7,726.7	61,983.0	20,580.0
8. Other	0.0	0.0	2,450.0	6,068.0
V. Non-Tax	119,979.6	1,935,249.2	148,719.0	2,218,709.0
1. Administrative fees	53,945.5	1,334,259.3	57,083.2	1,538,715.6
2. Communal Fees	0.0	764,055.4	0.0	892,756.4
3. Contributions & Contributions	17,505.9	442,345.0	28,338.4	355,660.3
4. Capital Revenues	197,068.4	211,812.7	202,306.1	237,238.9
5. Transfers	16,935.0	114,942.9	173,346.3	136,205.5
6. National Transfers	0.0	0.0	0.0	0.0
7. County/City	2,322.2	19,280.4	5,340.0	14,897.7

Table 4. FUNCTIONAL CLASSIFICATION OF SUB-NATIONAL GOVERNMENT EXPENDITURE, 1995-1998 (Amounts in Thousands of Kuna)

	1995		1996		1997		1998	
	Countries	Town/ Municipal	Countries	Town/ Municipal	Countries	Town/ Municipal	Countries	Town/ Municipal
Total Expenditure	533,262.7	3,858,331.9	796,575.7	5,693,060.5	716,770.6	6,697,992.5	850,040.0	8,277,198.6
General Public Services	124,696.4	1,072,972.4	187,881.7	1,304,348.7	201,206.4	1,255,004.9	226,433.8	1,594,326.6
Public Order and Safety	4,788.4	18,167.9	5,165.2	28,703.7	39,179.5	30,296.9	5,033.0	34,292.1
Education	31,816.0	406,374.5	35,404.2	712,343.9	39,189.5	781,949.8	48,944.4	936,775.5
Health	20,947.6	19,599.1	35,404.2	28,296.5	31,940.1	41,033.2	40,788.0	50,209.5
Social Security and Welfare	60,006.4	37,139.7	96,964.4	138,206.3	91,650.9	171,220.3	97,892.0	245,460.2
Housing and Communal Services	45,781.7	911,370.1	53,015.9	1,697,017.7	48,999.5	2,222,676.8	65,923.5	2,622,590.5
Recreational and Cultural	8,729.5	15,062.7	9,543.3	23,892.2	23,634.5	39,126.7	32,258.5	38,948.3
Agriculture, Forestry and Fishing	13,725.9	89,961.3	19,543.3	248,613.7	19,264.2	228,687.8	36,207.5	306,601.7
Mining, Manufacturing	81,089.0	325,592.7	80,399.9	777,985.5	50,310.5	761,505.2	45,572.4	999,079.7
Transport and Communication	19,203.9	190,659.1	88,900.9	178,799.8	75,926.4	241,613.6	112,995.3	326,741.4
Other Economic	24,217.7	26,781.4	70,430.2	27,727.0	19,841.9	52,841.5	34,239.4	89,098.7

Source: Ministry of Finance



**Table 5. Economic Classification of Sub-national Government Expenditure, 1995-1998 (Amounts in Thousands of Kuna)**

	1995		1996		1997		1998	
	Countries	Town/ Municipal	Countries	Town/ Municipal	Countries	Town/ Municipal	Countries	Town/ Municipal
I. Total Expenditure and Lending minus Repayments (III + IV + V)	538 961,1	3 896 289,2	798 113,6	5 713 287,9	740 597,2	6 738 672,4	860 405,5	8 326 922,3
II. Total Expenditure	533 762,7	3 858 331,8	796 575,7	5 693 060,5	716 770,6	6 697 992,5	850 040,0	8 277 198,6
III. Current Expenditure	408 169,9	2 993 405,9	619 384,2	4 181 033,7	557 460,2	5 049 595,8	625 762,6	5 937 459,5
1. Expenditure on goods and services	140 462,9	1 547 379,4	209 857,9	1 935 754,3	240 775,8	2 250 517,8	279 800,0	2 801 889,9
1.1. Wages and salaries	33 257,1	584 183,9	48 748,3	661 778,6	61 898,3	771 456,1	79 344,5	966 713,1
1.2. Employer contributions	5 360,3	100 460,9	7 299,4	120 484,4	10 050,1	144 349,2	12 934,4	180 463,2
1.3. Other purchases (goods and services)	101 506,9	862 734,5	153 810,1	1 153 491,3	168 827,4	1 334 712,5	187 521,1	1 654 413,6
2. Interest payments	1 106,6	22 022,9	2 719,9	6 365,8	3 750,6	44 071,4	3 775,8	71 138,6
2.1. Domestic interest payment	1 106,6	22 022,9	2 719,9	6 357,2	3 750,6	43 786,1	3 275,8	70 917,6
2.2. Interest payments abroad	0,0	0,0	0,0	12,6	0,0	285,4	500,0	221,0
3. Subsidies	266 889,9	0,0	406 806,3	2 238 909,6	312 933,7	2 755 006,5	342 186,8	3 054 311,3
3.1. Current transfers	76 459,1	26 368,7	157 688,9	21 295,0	77 510,5	38 574,6	58 771,5	40 586,5
3.2. Capital transfers	125 597,7	874 925,9	177 191,5	1 512 026,7	159 310,4	1 648 396,7	224 277,4	2 349 739,1
4. Acquisition of fixed capital assets	47 387,9	477 276,1	60 338,7	945 176,8	44 332,2	1 107 873,2	57 465,6	1 590 827,6
5. Capital transfers	76 009,2	363 299,2	111 496,8	445 979,4	112 749,9	409 638,8	161 571,8	567 465,4
V. Lending minus repayments	2 198,4	37 957,3	1 537,9	20 227,4	23 826,7	40 679,9	10 365,5	49 723,7

Source: Ministry of Finance.

## The New Proposals for Financing and Responsibilities of Local-Self Government

### More Fiscal Autonomy?

Organization, structure and financing of local authorities cannot be examined by its own, because it is directly influenced by the division of responsibilities, functions, financing sources and spending of financial resources between central and lower levels of authorities. Croatia thus faces the issue of the level of particular functions of public expenditures and tax collection. Practically, this means that the scope of self-government and financial autonomy ensured by the legal system to local communities has to be determined.

Due to a shortage of financial resources, the Croatian local authorities are in a delicate position. Efforts to satisfy requirements of local population in ensuring the maximum level of public services are confronted with the lack of funds and they are constantly forced to apply to central authorities for additional financial resources.

However, the theory, as well as the experience of the regionally indented Croatia indicate the necessity of increasing the level of fiscal decentralization. However, the choice of the appropriate level of fiscal decentralization will depend on the degree to which the central state is willing to cede financial autonomy to local authorities in collecting means that would ensure financing public services and goods. So far it has been acknowledged that state subsidies to local authorities are a necessity and that they have to be in such a form that they do not influence the decrease of efficiency of local authorities in collecting own resources from taxes and user fees.

On the other hand, the balance of sources of financing depends on the responsibilities for public expenditures of particular levels of fiscal authorities. The "best" form of financing local authorities thus cannot be recommended. The structure, responsibility and mode of financing local authorities will depend on goals that local authorities need to achieve in the public sector. The principal features of the existing system and financing of local government and self-government in Croatia are the following:

- local government consists of a large number of relatively small units,
- the corresponding division of public functions between particular levels of authorities has not been completed yet, thus the system of the division of responsibilities often depends on negotiating,
- the central state is continuously transferring the responsibility for certain

public expenditures to local authorities, decreasing in such a manner the flexibility of local authorities regarding their own public spending and financing public expenditures,

- the county authorities play a relatively small role in the supply of public services,
- local public expenditures are predominantly financed through common revenues mostly based on the income tax
- own revenue sources of local authorities are very much limited, so that non-tax revenues (user and communal fees) appear as an important revenue source (insufficient to cover completely most of public services expenses, however)
- the percentage of capital revenue and subsidies from higher levels of authorities participating in local authorities revenues is negligible,
- local self-government units use very little, or none at all, borrowing as an instrument of public expenditures financing
- principal issues of the system of lower levels of fiscal authorities and their financing regard distribution of revenues between the central and local authorities, as well as the amount and distribution of subsidies, local authorities borrowing and defining adequate types of local taxes,
- direct transfers are relatively small in comparison with the international standards,
- stronger reliance on user fees and local taxes offers the best option for restructuring of local revenues and for reduction of share in the distribution of common tax revenues.

In order to ensure a favourable environment for the operation of lower levels of fiscal authorities the Croatian central state, that is the highest level of fiscal authorities, should adopt the following principles:

- stimulation in order to increase the share of tax revenues collected on the local level,
- correlation between local economic capabilities and tax revenues,
- introduction of a new system of financing, with the principal aim to balance economic differences between regions and municipalities within a region,
- motivating local administration to establish a long-term development strategy,
- stimulating efficiency and development of financial market and capital market in order to stimulate international aid and co-operation in the area of financing local authorities' activities.

## **Towards the Reform**

There is a strong need in Croatia for changes in finances of lower level fiscal authorities. The changes have to provide for

- distribution of functions between the levels of fiscal authorities has to be established,
- efficient distribution of public expenditures,
- increase of the responsibilities of local authorities,
- privatization of public services that are more efficiently delivered by private sector
- more efficient mode of public services financing,
- new instruments of increasing fiscal ability in public expenditures financing,
- instruments of borrowing, as well as of issuing guarantees for financing of capital expenditures.

## **Distribution of functions and public expenditures**

Current structure of delivering and financing public services in Croatia, suggests decentralization. This in particular refers to decentralization of elementary and secondary school education, decentralization of primary health care, and decentralization of social security and welfare. The central state should maintain main responsibility for establishing health and educational standards and programmes whereas the very services should be delivered on the local level.

It has been shown in Croatia that bigger cities deliver public services more efficiently than the counties do. In case of less densely populated municipalities it would be better if they associated and offered these services together or pass the responsibility to the county and thus avoid negative effects of the economies of small scale. The experience gathered so far points that the financial system should incorporate a system of initiatives for municipalities to act together in delivering public services. Those could be, for example, additional revenue sources to small municipalities that have got together to deliver services of education.

## **Public services financing**

The principal reason for changing the present system of financing local self-government and administration in Croatia, is an obvious disproportion between fiscal capacities of municipalities/towns and counties on one hand and their established responsibilities in providing for public needs on the other. Before

1993 when the new legislation regulating problems of local self-government and administration and its financing, municipalities and towns were mostly responsible for delivering public services.

The new legislation transferred a great deal of responsibilities in delivering public services to counties but underestimated their fiscal position, making thus the prescribed functions difficult to perform. Till 1997 the fiscal position of municipalities and towns remained more favourable, which is evident from surplus in municipality and town budgets at the time. From 1997 responsibilities became too heavy to bear and the county budgets soon dried up. The necessary change of the system of financing of local authorities should primarily ensure the increase of the counties' fiscal capacity.

The problems related to the system of financing local self-government and administration in Croatia, also suggest that a new mode of financing the units of local authorities should be considered. One of recently considered measures is introduction of a surtax on income tax which is expected to increase the fiscal capacity of local authorities. The surtax on income tax has all the characteristics of a local tax - it is paid at a rate established by the unit of local self-government, and it belongs to the local self-government where the surtax payer permanently resides. Legal acts should enable the units of local authorities, that is the municipalities/towns (not only towns of more than 40,000 inhabitants), to introduce this measure. In this way, towns could make their own extra income, and at the same time decrease their dependence on state subsidies. Only the upper limit of the surtax rate on income tax, should be prescribed which would enable each municipality/town and county to decide freely on level of the surtax rate in accordance with preferences of local population. The decisions on the introduction of this tax should be confirmed through local referendum.

The system of equalization grant will give enough revenues for particular local authorities for ensuring estimated minimum level of public needs (education). The units of local self-government in Croatia can incur debts by issuing securities or by raising loans from non-banking sector only for capital projects performed by budget beneficiaries. At the same time local authorities have the right of issuing guarantees up to a legally determined amount for carrying out obligations of public companies and institutions. However, it seems necessary to extend the possibilities of incurring debts for local capital construction at domestic and foreign banks. This particularly refers to borrowing from the Croatian Bank for Restructuring and Development and to stimulating the issue of debt securities (local bonds) for financing the construction of local capital objects.

## Concrete Actions

The new proposals of the Act on Financing Local Administration and Self-government Units defines the following issues:

1. The new proposal of the Act is based on ensuring adequate revenue sources for financing primary and secondary education, health care and social security and welfare.  
The new proposal will ensure some part of revenue sources for some decentralized functions.
2. The new revenue sources are:
  - the biggest participation of local authorities in common taxes - income tax,
  - adequate equalization grants for decentralized functions,
  - the possibility of introducing the new local taxes (tax on unused agriculture land, tax on unused properties for business activities, tax on unused land, tax on game machines, surtax on income tax).
3. The higher participation of local authorities in common taxes - income tax for financing some decentralized function - 9,8%:
  - 2,9% participation in income tax for financing primary education,
  - 2,0% participation in income tax for financing secondary education,
  - 2,0% participation in income tax for financing social security and welfare (0,4% for centers for social work, and 1,6% for retirement centers),
  - 2,9% participation for health care (2,5% for investment maintenance of county hospitals, 0,3% for health care for unsecured persons, 0,1% for health care of agriculture families above 65 years).
4. Adequate equalization grants for decentralized functions. Total amount of equalization grants is 21% of income tax revenues in 1999.
5. The new proposal of the Act ensures improvement of development of cities and municipalities on islands that finance capital projects of common interests for island development. The share of income tax that will be transferred to local authorities amount 29,2% of total income tax revenues from this area.
6. Estimation is that 1,937 billion of Kuna will be transferred from the state budget to the local budgets. Estimation is that expenditure for decentralized functions amounts 1,778 billion of Kuna, and the rest are for social security and welfare and for development of islands.
7. The new proposal of the Act provides more autonomy for local and regional authorities in introducing local taxes.

**Table 6. Comparison of the current and proposed municipality and city's revenue sources**

Current revenue sources	Proposed revenue sources
1. Municipality and city taxes	1. Municipality and city taxes
1.1. consumption tax	1.1. surtax on income tax
1.2. taxes on houses used as secondary residences	1.2. consumption tax
1.3. advertising tax	1.3. taxes on houses used as secondary residences
1.4. corporate firm name tax	1.4. taxes on unused agriculture land
1.5. public land use tax	1.5. taxes on unused properties for business activities
	1.6. tax on unused land
	1.7. corporate firm name tax
	1.8. public land use tax
2. surtax on income tax	2. surtax on income tax
- cities with more than 40.000 inhabitants can introduce surtax of up to 30% of up to 30% of their share in the income tax (i.e. up to 7.5% of the total tax)	- municipality can introduce surtax of up to 10%
- the City of Zagreb can introduce a surtax on the income tax of up to 60% (i.e. 27.5% of the total tax)	- city with less than 30.000 inhabitants can introduce surtax of up to 12%
	- city with more than 30.000 inhabitants can introduce surtax of up to 15%
	- the City of Zagreb can introduce surtax of up to 30%
3. common tax revenues	3. common tax revenues
3.1. income tax	3.1. income tax (state 29,2%, county 8%, municipality or city 32%)
3.2. profit tax	3.1.1. income tax for decentralized functions
3.3. tax on lotteries and betting	- primary education
3.4. real estate sales tax.	- secondary education
	- social security and welfare
	- centers for social work
	- retirement centres
	- health care
	- investment maintenance of county hospitals - 2,5%
	- health care for unsecured persons - 0,3%
	- health care of agriculture families above 65 years - 0,1%
	3.2. profit tax (state 70%, county 10%, municipality or city 20%)
	3.3. tax on lotteries and betting (state 50%, municipality or city 50%)
	3.4. real estate sales tax (state 40%, municipality or city 60%)
	3.5. concession revenues
	- for mineral water (state 80%, municipality or city 20%)
	- for drinking water (state 70%, municipality or city 30%)
	4. equalization grant 21%
	primary education
	secondary education
	centers for social services and welfare
	health care - investment maintenance of county hospitals

## Conclusions

Decentralization has often coincided with restructuring of public expenditures/reduction of fiscal deficits and demands for more local autonomy. Further efforts and research related to the problems of lower level fiscal authorities in Croatia will be without doubt directed to proper structuring of fiscal transfers from the central state to the local level. Defining a desirable model of financing of public needs is unthinkable of without establishing better mode of using user fees, borrowing, as well as the use of guarantees of the central state for particular public expenditures.

The following actions are recommended:

### 1. In the short term

Review of Expenditure Obligations and Revenue Sources, particularly with regards to nationally mandated responsibilities and revenues from the national government. The objective would be to develop transparent criteria for selection of investment and rationale for national government support, and to review the role of national government in the pricing of services and choice of investments. Review the administrative structure and the role of the different levels of the government, particularly that of counties.

Asses the impact of the restrictions on borrowings at the local level, while maintaining the strong monitoring role of the national government.

Review municipal investment plans and priorities as part of the budget planning exercise; develop indicative rolling 3-year budgets at municipal level including long term investment expenditures, and institute wide use of cost benefit criteria for selection of investments at the municipal level.

Undertake a study of ongoing cases of private sector participation to learn of potential and obstacles to identify potential, restrictions, and modalities for private sector participation in service provision.

### 2. Medium Term

Undertake measures to improve efficiency of operations of municipal owned enterprises, such as operating on commercial basis with the aim to reduce subsidies and move towards substantial cost recovery.

Enhance local government capacity to negotiate and implement private sector arrangements.

Review current legal framework with a view to improving incentives to private sector participation.

Assess potential for municipalities to access the capital markets within the government's monitoring and oversight system.  
Assess the potential for introduction of value based property taxation to replace the current ad hoc property tax system.  
Undertake a study of ongoing cases of private sector participation to learn of potential and obstacles to identify potential, restrictions, and modalities for private sector participation in service provision.

Katarina Ott and Anto Bajo

## Local Government Budgeting in Croatia: Problems and Recommendations for Reform<sup>1</sup>

### *Introduction*

Since 1990, when the first attempts were made to work out a concept for the local government financing system, the practical financing of the new communes has been bedevilled by a problem composed of four essential elements.

First, there were no reliable data about the fiscal capacities of the communes. Data about public revenue were available for the communes as they were then set up. There was a problem that some regions (or counties), in spite of having an appropriate tax burden, still did not have adequate sources of financing of their own. This problem showed up with some communes as well, since there were no data about per capita revenue, which would have been needed for the communes to be able to obtain the right to prescribe their own rates of tax, or for the central government to cede them a percentage of its revenue.

Secondly, the foundation of the new communes entailed the foundation of new commune records about potential revenue. Without such an insight into the financial capacity of the communes it was not possible to make a proposal about their own revenue. These communes could be financed only via the intermediacy of the counties. Funds were provided for the counties and for the communes in their area. There was a question of whether the central government should finance the local units directly from the national Budget or via the counties. According to previous experience about public revenue, it was realised that the cities needed to bring in taxes bigger than the average in order to cover the greater per capita expenditure.

<sup>1</sup> This text is a slightly altered version of conclusions and recommendations for policy-makers from a comprehensive research report on local government financing and budgets in Croatia. The authors have carried out this research project at the Institute of Public Finance in Zagreb. The project was financed by the Institute of Public Finance, the Tax Administration of the Ministry of Finance of the Republic of Croatia, the Open Society Institute and the Local Government and Public Service Reform Initiative. Katarina Ott's work in this area was co-financed by the Research Support Scheme of the Open Society Support Foundation. The research project was finished and prepared for publication in June 2001, at the very time when in the Croatian Parliament changes to the laws that govern affairs of local government financing and local government budgets were adopted. The whole research report was published in Croatian in *Financijska teorija i praksa* 25 (3), 2001, pp. 311-449, and these conclusions also in English on pp. 439-449. (Full text in English is available at request. Contact kott@ijf.hr or bajo@ijf.hr).

Thirdly, the problem of fiscal equalisation became still more complex because of the war, since the earlier model of financing through supplementary funds became unworkable. Reform of the tax system and the introduction of a new manner of local government financing took place in conditions that because of reconstruction and the consequences of the destruction brought by the war made the finding of optimum solutions for the vertical and horizontal division of budgetary revenue and expenditure more difficult.

Fourthly came the still current problems of the renewal and reconstruction of areas severely damaged in the war. Such expenditure could not be included in the regular local government financing system. There could only be speculation about the possible relative range of the revenues of the communes, that is, the extent to which they were discrepant with the national or county average.

All these and other problems need to be taken into account when preparing the reform of local government financing in Croatia. The authors argue that a structural fiscal problem exists in Croatia, manifested in the absence of a good budgetary system, clearly separated functions, and competencies for financing. Accordingly, the authors emphasise problems and give recommendations for the reform of the budgetary system of the local units.

### ***Territorial Organisation***

Croatia is a small country with a very great number of local government units: 422 communes, 122 cities and 20 counties (not to mention the city of Zagreb). The large number of local units makes it impossible for the central government to get a realistic picture of their finances.

Every place that satisfies the formal criterion of a population of 10,000 can become a city. This means that there are cities that are incapable of justifying the title either by revenue or by the functions that are statutorily stipulated. It is the same thing with communes. The fashionable trend to found communes that took Croatia by storm in 1993 permitted any petty rural area to found a commune of its own. The main problem inheres in the amassing of administrative bodies and employees in these communes. Such local government units are simply incapable either of financing current expenditure or of providing the basic services in their areas. And so they have to depend on direct transfers from the national Budget. This leads, in spite of the theoretical territorial decentralisation, to the actual centralisation of government.

- **Decision on an optimum number of local units should be made, based on a detailed analysis of the financial situation of local units and their**

**ability to finance themselves and provide public services. After that, the number of existing communes and counties, which is unsustainable, and is too much of a burden upon the national Budget, should be reduced.**

### ***Administrative functions***

It is the counties that are in charge of administrative functions at the level of the local units. The administrative bodies of the counties, i.e., the bodies of the national civil service, are financed from the national Budget, for the performance of administrative functions, but from the county budgets, when they undertake matters proper to the sphere of local self-government. These marks of duality can be seen in the prefect, who carries out functions of central government and of local self-government. New laws envisage these functions being split between two officials. But for this to be done the National Administration System Law will have to be changed - something no one seems to have thought about.

In this case too the question has arisen about the accumulation of administrative machinery at the level of the counties. Bearing in mind the numerous criticisms by the local units - the cities and communes - about the work of the counties and the county bodies, it is essential to settle on the number of administrative bodies and the people employed in them. Existing administration at county level is ineffective. Another problem is the level of the salaries in the administrative bodies of the local units, which frequently surpasses that in central government bodies. There are no criteria for evaluation of the work done in the administrative services of local units; in most cases the system for rewarding and penalising the performance or non-performance of work is based upon the internal regulations of the local units. Central government has practically no control over these regulations, or knowledge of their contents.

- **In all local units (counties, communes and cities), the number (situation) of the administrative units and the employees in them should be determined.**

### ***Functions and division of responsibility***

There is no clear delimitation of function between the levels of government, even in spite of the many laws that regulate the financing system. Almost all functions

are financed from both central and local government levels. Local governments do finance certain functions, such as welfare, and secondary education, although they have no legal obligation to do so. Some healthcare functions have been devolved upon the counties, which are incapable of financing them.

- It is necessary to clearly distinguish between the functions of the national and the local governments. The authorities and responsibilities for the financing of functions, and the provision of public services at the local level, should be united in a single law.
- There should be a clear distinction made between the rights and obligations of local units and those of the central government. In this way individual local units will have an interest in executing their obligations, and if they are not performed, it will be easy to affix individual responsibility for mistakes and oversights.
- The effectiveness of the financing of local unit public expenditure from the central government budget should be re-evaluated, particularly in the case of financing elementary and secondary education, health care, welfare, fire protection, road maintenance and construction at local and regional levels. As well as decentralisation of expenditure, the gradual decentralisation of revenue to local units should be ensured.

### *Areas of special national concern*

These areas were set up for the sake of more rapid development, and they have a privileged status in financing. Through many tax exemptions, the government is attempting to jump-start the economic development of these regions. However, these development measures have not been accompanied by any serious analysis, nor are there any tested economic indicators for the degree of development of the regions. And there is no precise number of employees in the administrative services, or employees in industry and business. The government provides current subsidies from the national Budget. However, the criteria are very questionable, as are the amounts of the funds that are sent year after year to these areas.

- Realistic conditions and indicators of development in the areas of special national concern should be determined, and effectiveness of state incentive measures to do with the functioning of the public sector in these regions should be ascertained.

### *Fiscal equalisation and fiscal capacity*

The system of financial equalisation and the allocation of subsidies. From the national Budget, central government provides numerous subsidies - current, capital, specific and general - to local units. The subsidies are sent to the counties, and the counties provide funds to the local units with below-average fiscal capacities according to the size of their revenues. Areas of special national concern to which the government gives subsidies directly are a story to themselves. The government has no clearly defined criteria for the subsidies it gives. There is complete confusion when an attempt is made to work out the total amount of funds that the state gives to local units. It is impossible to arrive at these sums, because numerous subsidies are given via the various ministries. The Finance Ministry has no way of checking on and making sure that these funds are used, to what extent and for what purposes. Local units do not have the obligation (except for areas of special national concern) to report to the Finance Ministry about the level of funds used. It is questionable to what extent the subsidies are used for fiscal equalisation, because most of them go on the financing of current expenditure.

- Fiscal equalisation criteria must be fixed. It should be achieved that funds for fiscal equalisation are given not only by the central government, but also by the richer counties and the more developed cities and communes.

**Fiscal capacity.** It is hard to measure the fiscal capacity of the local units because there are no precise figures about the populations involved. It is also hard to get a realistic account of the revenues and expenditure of the LGUs. An additional problem inheres in the tax bases and the rate of local taxes, which are not systematically controlled at the level of central government. The government has in outline terms, according to per capita revenue, determined the criterion for the allocation of the subsidies used for fiscal equalisation. However, the criteria and the equalisation of fiscal capacity on the basis of income are not applied.

**The local units' own tax revenues.** In practice to date, central government has not supervised the rate of local taxes that can be set autonomously by local units. The introduction of new local taxes is envisaged, and the possibility of all local units prescribing rates of surtax (on personal income tax). There is a question to what extent the introduction of new local taxes will affect the increase of tax revenue, for in current practice, local taxes figure in the budgets of local units but to a small extent.

- The central government should oblige local units to send information about the size of the base for local taxes, and the rate that is imposed in each unit.

## *Foundation of new local units*

In spite of the excessive number of local units, even today new units are being founded by splitting up existing units. The problem of the founding a new unit is intimately related to the division of assets. Many local units, that is, do not have any inventories of their assets (asset balance sheets), nor do they know the value of the assets they have. Many units are fighting court cases about the division of assets. The management of assets belonging to local units is a further complication, since there are no departments or individuals with the expertise required for this. Asset management is not institutionally settled even in the central ministries.

**•Once and for all the value of the assets of local units, and the responsibility for managing these assets, should be determined.**

## *Shared taxes*

The central government has stipulated the sharing of the main kinds of taxes with the local units. The main taxes like income tax and profits tax are thus shared in percentages among all levels of government. A special problem however is value added tax, which goes only to the central government. Many local units have a consumption tax, the rate of which they set autonomously. There are then problems of the double taxation of the same product - alcoholic and non-alcoholic beverages for example. Has the central government made a suitable determination of the amount that remains at local government unit? An analysis of revenue shows that the main resource of individual local units (especially the communes) is not tax but non-tax revenue. The small percentage of the local units in shared taxes needs increasing.

**•The share of local units (in the tax revenue sharing arrangement (above all, personal income and profits tax) should be increased (i.e. the share of central government should be reduced).**

## *Participation of citizens in the provision of public services*

Apart from the principle saying that citizens have the right to elect, and encourage the election of, representatives in the representative and executive bodies of government, no way, in which citizens can take part in the provision or financing of public services has been foreseen. Citizens do appear as the initiators of the financing of individual programmes and projects, but their

participation is not regulated by statute. However, among the non-tax revenues, we can come across income from **self-contributions**. These are self-imposed levies of citizens that they on their own initiative introduce for the financing of items of the utility infrastructure - water mains, local roads and the like. However, self-contributions are not governed by statute, even though local units do introduce them and use them as a result of grassroots initiatives.

**•A more active role for citizens in providing and financing public services should be ensured. The self-contribution system should be regulated by statute.**

## *Non-tax revenue*

Because of the low fiscal capacity and the low level of revenue from local (own) taxes, many LGUs have non-tax revenue as their main source of revenue. The main role in filling the local budgets, especially of cities and communes, is played by utility charges and contributions.

**Utility charges and contributions.** This area is regulated by the law. The issue is that many local units autonomously prescribe high rates of utility charges and contributions. Eighty per cent of cities (or utility firms) illegally charge for connections to the infrastructure, for which reason the population has to pay high prices for charges and contributions. There are whole series of charges and fees that the local units levy without the central government having any control of the rates, or records of the accounts.

**•The central government should control the rate of utility contributions and charges that can be set autonomously by local units.**

## *The position of the utility companies*

Little is known about the privatisation and ownership of these companies. Many local units do not evaluate the value of their assets realistically, nor have the responsibilities with respect to the management of these assets been institutionally allocated. Thus the value of the utility firms is not known either. An additional problem is the connection of the local budget and the utility firms. These firms operate as companies, i.e., on a profit basis. And yet the losses of these firms are covered from the budgets of then LGUs, which pay their debts.

**•The ownership of utility firms and the possibility of privatising individual functions at the local government level should be established.**



## ***Balancing budgets, borrowing and potential obligation***

In principle, there is the budgetary principle that a local budget has to be balanced. Every year the local units are enjoined to observe the "golden rule" that borrowing is resorted to only for the financing of capital expenditure. However, in many cases the balancing principle is not respected, and local units rely on borrowing for the financing of current expenditure as well, with the commercial banking sector, although this is expressly forbidden. There are many examples in which local units do not have a clearly separated part of the budget for the financing account, in which borrowing and repayment are presented. Many transactions, such as the issue of budget guarantees for utility firms, are simply not registered, nor is there a unified or unitary register of local government-backed guarantees. Guarantees are often kept in the financing account of the LGUs, even if they have not become a real obligation of the unit.

- **Financial control of the borrowing of local units should be introduced and the size of loans and potential obligations of local units limited.**

### **Potential obligations (guarantees)**

Local units record and book loans given and made and guarantees in various ways. Some units enter given guarantees as loans given. While planning the budget, many local units deliberately exaggerate the size of revenues and expenditure, and in this way, formally, provide for a greater level of borrowing than if they estimated budgetary expenditure and revenue more realistically, and at lower levels.

Exaggeration of the size of the budget has become a means for local units to arrive at greater amounts of money from borrowing. We should recall that the state has limited borrowing of local units to the level of 20% of the expenditure for the previous year. According to this logic, a bigger budget means a bigger borrowing ceiling the following year. For this reason financial reports can be consolidated only with difficulty, and one cannot be at all sure of the correctness of the information obtained from data shown.

- **The obligation for all units to keep registers (off-balance sheet) of guarantees issued should be introduced.**
- **Special auxiliary records about guarantees that have been made should be kept. On the basis of the instructions of the central government, local units should plan a guarantee reserve. However, in the instructions it is necessary to determine what amount, i.e., percentage, of the guarantees should be set aside in the guarantee reserve.**

## ***Internal control, treasury and audit***

Internal control is not organised, either in ministries or at the local unit level.

- **Internal control in larger local units should be set up. It is necessary to ensure that internal control is carried out in the counties on behalf of smaller units that are incapable of doing this themselves.**

The treasury system does not work at the national level, nor is there a national financial information system. There are no long-term plans for the structuring of treasuries at the level of local government units. **Cash management practice.** The function of cash management is not separated at central government level from debt management. Both functions are linked organisation-wise in the Finance Ministry in a single administration or agency - the Cash and Public Debt Administration. The basic problem is that there is no developed national treasury system at the central government level.

Although there is a single treasury, at the Croatian National Bank, most transactions and payments from the budget are done via the many accounts of the budget kept at the commercial banks. An additional problem is the absence of an effective national financial information system.

It is the same thing with cash management at the level of local units. They too have no treasury system, but make their payments and manage their cash through the many accounts at the commercial banks and ZAP (the Payments Clearance Institute).

- **The Finance Ministry should draw up a plan for organising a treasury at the local government level, and also of course get the treasury going at the national level. The Finance Ministry should also determine the way in which cash is to be managed, and oblige local units to keep their funds in a single budgetary account.**

Auditing of joint stock enterprises or firms owned by local units. These enterprises are subject to state and to commercial auditing, as are other, privately owned companies. It is not clear that both kinds of auditing are required.

- **It should not be necessary to carry out external commercial auditing of the utility companies, only the national auditing. For this reason the Accounting Law needs amending. This would reduce the costs of auditing, and the national auditing system would then carry out the audits of these firms within the required time limits.**

## ***Classification and Consolidation***

Classification of the budgets does not support the separation of functions according to level of government. Planning of the budget is carried out according

to the account plan, which cannot be applied at the LGU level, because of the particular kinds of revenue and expenditure.

It is impossible to present data about current and capital expenditure, and data about utility charges, according to an economic and functional classification. Thus, for example, some local units, within the framework of subsidies and current and capital transfers, include the pay and material expenses of employees, which should be shown in the framework of employee expenditure. The problem lies in the account plan of the budget(s), which does not enable the acquisition of information about overall expenditure by a purely functional or economic structure (since economic, functional and institutional classifications are all mixed up). In order to obtain data by functions and economic categories, the data from financial reports and other sources have to be constantly adjusted, and this does not give a very realistic picture of the state of affairs.

**Consolidation of local units' budgets** is still not performed, nor is consolidation at the same level of government (county, commune and city) done. In outline, for all local units, a summary balance sheet is drawn up. One of the main problems is the classification of the budget(s), which makes consolidation of local unit level budgets impossible, and this is exacerbated by the absence of any instructions about how to carry out consolidation.

- **A new account plan of the budget for the country as a whole and for the local units should be brought in, and it should be secured that there is a review of public expenditure in terms of functions and economic categories.**

There is no classification of expenditure by programme and subprogramme. For this reason many LGUs do not programme expenditure for more than a year ahead. If expenditure were programmed for several years ahead (with an effective estimate of revenue), in the first year it would become clear that there would not be adequate funds for the completion of many capital projects in the year(s) to come. In this way all the preventable expenditure that arises when projects are uncompleted would be avoided.

- **A programme and subprogramme classification of public, especially capital, expenditure should be introduced and applied at both national and local levels.**

### *The planning and financing of capital expenditure*

Decision making about capital investment and the financing of capital projects at the local level is one of the weaker links in the finances of local units. No analysis of the structure of capital expenditure or monitoring of the execution of capital

projects is made or done, and the current and capital budgets are not clearly separated. This is not even stipulated by the laws about local government financing.

When they make decisions about capital financing, local units make neither investment studies nor social justifiability studies. Such a manner of working leaves an impression of lack of seriousness, which puts off potential domestic and foreign investors. The financing of capital projects by borrowing is practically impossible because of the low fiscal capacities of the local units. The question of the asset balance sheets of some of the units is still unsettled.

**The planning of capital projects.** Local units do not undertake any long-term planning for capital projects, and most such projects are financed in line with the capacities of the local budget at any given moment in time. The reasons can be seen in the poor or non-existent registers of capital projects. Nor at the central government, alas, is there any programmatic classification of public expenditure. Local governments do not estimate the consequences of making decisions about financing (current investment maintenance and the construction of facilities) on the execution and financing of projects in the years to come. For this reason, most projects are financed at the central government level that, however, does not have a complete oversight of the use of budgetary resources at the local level. No programme of capital financing or sectoral analysis of programmes exists, either at the local or at the central government level.

- **The budget of local units should be separated into current and capital parts and all local units should be obliged to keep a financing account.**
- **Registers of capital projects at local and central government levels should be stipulated.**

### *Performance indicators*

The system of performance in local units comes down to a comparison of planned and realised. There are individual examples of steps forward towards programmes. However, there is still no monitoring of the performance of programmes in the sense of the production of some general good or citizen satisfaction.

Information about performance does not have to be, and largely is not, part of the documentation of the annual budget. What is fundamental is monitoring of the level of revenue and expenditure, and it is budgetary balance that is in the foreground, as well as control of the borrowing of the local units. Local units do not keep up with expenditure in terms of individual activities, nor do they measure effectiveness and the costs of the activity by making a cost benefit

equation, nor do they insist on quality, efficiency and management. Performance is not an imperative even at the level of central government, and hence not at the local levels either.

- **Every budgetary financial transaction should be able to identify the budget and centre of costs, its purpose or the service it provides, the source of funds and the kind of revenue or expenditure.**

**Evaluating and rewarding the work of employees.** The work of employees is not evaluated in local units. There is no system for monitoring success and quality of work, nor any incentive system for better performance. Performance is not evaluated at all. Thinking goes on within the framework provided by statute, and concrete shifts in the direction of change and improvement are expected from elsewhere, i.e., from the central government. The model of initiative and independent, active and creative, work has not been internalised. Because of the lack of existence of incentive measures or of any criteria for incentives to be awarded, individuals cannot be expected to perform creative, high-quality work. Ideas interest nobody, and the final result, in which there is no systematic effort to raise the level of the quality of the work of the employees, is inertia and red tape.

- **The national government and the local units should be able to prescribe an incentives system for work well done, and penalties for substandard work.**

### *Accounting and methodology*

**Accounting** of the budget is complicated and regulated by numerous regulations that overlap with each other and yet are conceptually and substantially unclear. Thus budget accounting underrates obligations, overrates assets and makes consolidation impossible.

There is no single model or **methodology** for showing revenue and expenditure for all the budgets. The lack of a unified methodology makes it impossible to keep up with and consolidate local unit budgets.

- **The Finance Ministry should clearly inform all local units about the prescribed form or model for financial reporting.**
- **A review of the whole budgetary accounting and reporting system is necessary; this should be embodied in a single law. Various different regulations should be terminologically unified, because local units understand and apply them in different ways.**
- **The Finance Ministry should lay down the obligation to adopt the annual accounts of the budgets of local units as financial reports.**

**Changes should start from the creation of the classification of revenue and expenditure according to a certain number of modified categories. This would make the financial data gathered analysable in various ways and for various requirements.**

### *Budget planning*

At the beginning of the planning of LGU budgets there appears the problem of the use of the Finance Ministry guidelines, which are over-generalised for most local units. For this reason the Finance Ministry has to pay more attention to specificities and adapt the guidelines to the units (communes, cities, counties). The problem lies in the MF sending the budget preparation and making guidelines first of all to the counties and the city of Zagreb. In line with these guidelines, the counties draw up draft estimates of their own budgets, and draw up guidelines for the cities and communes in their own areas. However, the counties do not fulfil their obligations, nor do they draw up guidelines with indicators for the cities and communes in their regions. This is the basic reason why most of these units consider the guidelines too generalised and partially inapplicable. As well as this, the communes, cities and counties are bound to draw up a budget by 15 December for the year to come. It is not rare for the budget to be passed in the very last days of December. Many of the units have at least one and perhaps two revisions of the budget during the year - some as many as three or four.

- **Finance Ministry guidelines should be adapted to individual levels of local units, with the obligation being placed on local units to draw up their own indicators. A single model of budgetary planning for all local units should be prescribed.**

**The plan and estimate of the budget.** The basic elements for the making of the plan and the estimate of the budget are not always uniform or detailed. They depend on the size of the budget, the structure of public expenditure and revenue, and the kind of public functions financed from the budget. Methods and quality of estimating LGU budgetary revenue and expenditure do not depend on the size of the budgetary unit or its economic power, but on the interest of the executive bodies, and the expertise and personnel of the finance departments charged with planning and preparing the budget.

- **Local units should base the planning of their budgets upon their own indicators. Local units that get transfers from the national Budget have to keep to guidelines about pay and expenditure trends. And so they have to keep up with expenditure in terms of items.**

The government has not to date dealt in any serious way with the planning of public investment, nor has any overall approach to the financing of capital projects at local unit level been set up. Only at the beginning of 2000, for the 1996-1999 period, for the first time, was a complete list of capital investment per sector. This list cannot even be found in the Finance Ministry, nor do decision-makers in the Finance Ministry know of its existence. It was made and signed by the government of the country. Because of this information blockage, the competent institutions, above all the Finance Ministry, find it hard to control to what degree local government capital investments are financed and carried out. Capital projects are not grouped into programmes of public investment.

- **At the central government level, a complete and detailed list of capital projects financed at local levels should be kept, in order to make possible control of capital subsidies transferred to local units.**
- **It is necessary to introduce into the procedure of planning capital investment the practice of making investment studies with consideration of possible sources of financing. Since this is to do with projects that are important for the society as a whole, the obligation to make a social justifiability study of each investment should be imposed.**
- **Local administration should be equipped and trained to work with contemporary ways of planning capital projects.**
- **All local units should be obliged to measure the costs and benefits of capital projects, and to plan capital projects over a longer period of time.**

Reform of the budgetary system of the local units should be carried out in several phases, for which additional concrete research into the financial position of the local unit still needs to be carried out, however. The main problem about reform is the excessive politicisation that might attend any new initiative. For this reason it would be better to concentrate on possible improvements to the present system of local units, with the emphasis on strengthening the budget and the technique of budgeting, the budgetary process in the local units, and the construction of a more powerful financial control mechanism on the part of the central government. All the main participants in the budgetary process should be educated to understand the aims and intentions of the steps proposed for the future.

## **Financing Local Self-Government: Report on Workshop Debate**

The experts from South Eastern Europe and Germany came together within the framework of the FES regional project on "Local Self-Government and Decentralisation" in Zagreb, on 29<sup>th</sup> June, 2001, for the second workshop dealing with "Financing of Local Self-Government". The workshop debate focused on three main issues:

- 1) What lessons can be drawn from a developed and complex system of financing local self-government, such as German, for the reform policies concerning local self-government in South Eastern Europe?
- 2) What are the basic features and problems of local government financing in South Eastern Europe?
- 3) What are the main options and dilemmas concerning the improvement of local self-government financing in the region?

An attempt to use German experience in financing local self-government as a possible model for reform policies in South Eastern Europe must acknowledge some specific features and peculiarities of the German system of territorial and administrative organisation. If this is done, certain general lessons may be learned. The German system of local self-government is characterised by several features:

- local self-government entities are integrated into the system of German federalism and are part of federal provinces (Länder);
- local self-government units are very heterogeneous and a great variety of them exist, depending on their size, geographic position, level of economic development and urbanisation, their social structure;
- decision-making is separated from implementation: thus a major part of local self-government tasks results from decisions taken at federal or provincial level and local administration has the obligation of fulfilling them without being able to influence or alter their character.

There are no principle restrictions of functions that can be delivered at local level (except for defence and foreign policy). These functions can be differentiated into obligatory (stipulated by law), mandatory (ordered by federal or Länder governments) and voluntary (decided by the entities of local self-government themselves).

The fiscal revenues of local governments are mainly based on taxes regulated at the federal level: they include both joint taxes, which are dominant, and original local taxes (e.g. property tax), the significance of which is negligible. Other revenue sources include fees and contributions and transfers through equalisation schemes (each source amounting to approximately 1/4 of the total revenues). Due to great differences between local self-government entities a variety of equalisation models is presently being applied. Borrowing as a revenue source for local self-government units is restricted to investment, it depends upon the permission of the Land government and, consequentially, it has only minor significance for the local budgets.

The complexity of the German system of local self-government has some negative consequences. Citizens are insufficiently informed about the system and therefore restrain from engagement in local affairs. Financial inequalities between local self-government units have grown with time and produced a serious financial crisis of big cities. Despite some 25 years of discussion and political attempts, it proved impossible to reform the fiscal system affecting local self-government (including equalisation schemes). This inability to agree on a reform concept was caused by the complicated process of decision-making in the system of German federalism: since the reform of the system of local self-government and its financing depended upon the consent of both houses of the parliament, Bundestag and Bundesrat, it was not possible to achieve a decision. The situation could change if certain decisions about local self-government would be delegated to the level of Lunder: it would increase their diversity and flexibility, thus making them better prepared for the conditions of increased regional competition in the EU.

While the system of financing local self-government remained unchanged for nearly three decades, reforms were implemented through privatisation of local public services. Real privatisation should be distinguished from fictional one: the former is carried out through delegation of certain public services (e.g. childcare) to private service-providers, the latter is based on the organisation of certain tasks of local government through city companies (e.g. transportation, electricity) rather than through public administration. In both cases the purpose is to achieve more efficient providing of services. The logic of fictional privatisation may be explained through an example: While the city of Bonn has privatised its agency for economic promotion, it has remained its only owner. The agency is organised as an entity of private law and is therefore not subdued to legal regulations and restrictions that apply for public administration. In the case of real privatisation, when services are provided on the basis of contracts with private companies, local governments must define and impose quality standards.

In order to maintain these standards, it may prove necessary to subsidise some of the service-providers. Limits to privatisation are defined by control functions of the state, which should not be privatised.

Local governments cannot go bankrupt: thus if a local entity fails to provide certain obligatory or mandated services, the Land, of which it is a part, must take care of this and secure their provision.

The German system of local self-government can be described as a mixed model, which combines elements of competition and co-operation. Local self-government units compete to attract investors in different ways, be it through reducing local taxes, providing favourable conditions for company sites or through offering better living conditions for company employees. This and the electoral competition among parties are the reasons why local governments cannot abandon voluntary services, but rather try to supply as many of them as possible. At the same time local self-government units depend on functional co-operation, in order to ensure a number of complex and expensive services (e.g. water supply, regionally integrated transportation, garbage recycling etc.) and to promote development. In some cases there is competition between Lunder and local governments (especially of larger cities), caused by opposed political majorities, which rule at regional and at local level. This competition, too, is limited by common interest in regional and local development. There are also legal and political limits to politicisation of local self-government: the system of financing local self-government is regulated by the constitution (both federal and in the Land) and laws and it cannot easily be manipulated for political purposes. Many provincial parliaments include representatives who perform different functions at local level and thus can ensure that local interests are preserved. Finally, if any local self-government entity would feel discriminated by the government of the Land, it might appeal to the constitutional court of the Land and ask for judicial review of the disputed decisions.

Another segment of the workshop debate aimed at a brief overview of the systems of financing local self-government in South Eastern Europe, their main problems and the reform plans.

The system of local self-government in Slovenia is characterised by a wide range of tasks performed at local level, which are financed by different sources of revenue: both joint (or shared) and own local taxes, fees and transfers from the national government through general and specific grants according to a well established formula. Main reform plans deal with the introduction of a regional level of territorial organisation. The reform has been prepared through the establishment of a Regional Development Agency at national level and its 12 regional branches. Another reform topic focuses on the introduction of long-term budget planning.



Croatia has recently started a comprehensive reform of the system of local self-government, which also affects financial sources of local and regional entities. The objective of the reform is administrative and fiscal decentralisation, which includes devolution of a number of tasks and services from national to regional and local levels and financial strengthening of regional and local governments. Revenues of local and regional self-government entities shall be increased through different measures: increased participation in shared taxes, introduction of new taxes and surtaxes and establishing of an equalisation mechanism to assist less developed local and regional entities.

The system of local self-government in Hungary consists of a great number of local entities, which vary in size and level of economic development. A wide range of tasks performed by local self-government requires a differentiated system of financing mechanisms. Own sources of local entities, which amount to 35% of local budgets, include local taxes, fees and revenues from local assets. Nearly 2/3 of the revenues of local budgets come from national sources: either shared taxes (which also include an equalisation scheme for local entities below 85% of the average development level) or different types of grants. An additional source of financing local self-government is borrowing, which is limited to maximally 8% of a local budget. Since local entities can go bankrupt in Hungary, borrowing is of marginal importance for smaller and less developed local entities, but big cities like Budapest use loans to solve liquidity problems or issue bonds for investment purposes.

Local self-government in Bosnia and Herzegovina is characterised by a complex 3-tiers system of territorial organisation, where local entities perform very limited tasks. The revenues of local self-government are also very limited, since higher levels of territorial organisation (cantons, the two entities of Federation and Republika Srpska) seek to maximally centralise the fiscal system. Bosnia and Herzegovina needs a new law on local self-government, which would also stabilise their revenue sources.

The Serbian system of local self-government is based on very large local units, whose functions are limited by a highly centralised system of state administration. All property is possessed and managed by the national government. Main revenue sources of local self-government include different taxes and fees. An equalisation scheme for less developed local entities is built into the distribution of consumption tax revenues. Local entities are not entitled to borrowing.

The 1-tier system of local self-government in Montenegro is financed through own revenues (local taxes and fees), shared taxes and additional transfers from the national budget for less developed local entities. The following features were

depicted as the most urgent problems: lack of adequate property and natural resources taxation, which might become an important additional source for local budgets, lack of clear criteria for equalisation transfers and a fragile bank system, which jeopardises the operation of local self-government.

Albanian government has been preparing a comprehensive reform of local self-government, aiming at greater decentralisation of the administrative and fiscal system. In the new system, all functions of local and regional entities (original, shared and mandated) shall be financed through a set of different revenues: local and joint taxes, fees, income from economic activities of local public enterprises, transfers through general and specific grants and borrowing. Local entities are entitled to levy taxes.

In Macedonia local self-government entities have limited competencies and are, consequently, entitled to very limited financial resources. Their revenues consist of local taxes and fees. Since all taxes are collected by national authorities, and the national government is faced with serious liquidity problems in financing its budgetary obligations, local governments sometimes have problems in getting access to the revenues, to which they are entitled. Equalisation transfers are managed through three specialised state funds: for underdeveloped rural areas, for road construction and maintenance and for water supply. Reform plans envisage the introduction of participation of local self-government in consumption and income taxes.

Bulgarian 2-tiers system of local self-government is financed through (local and shared) taxes and through government grants, which amount to about 30-40% of local budgets. Main problems in financing local government include the imbalance between tasks and resources, and a legally questionable practice of national authorities to transfer surplus local revenues into national budget. Reform plans aim at better adjustment between administrative tasks of local government and the available financial resources and at establishing a more adequate equalisation scheme, which should be included into the national budget.

The Romanian system of local self-government was until recently characterised by high centralisation of financial resources. Only 5% of local budgets were financed through own local revenues, while 95% were financed through transfers from national government, which were often influenced by political criteria. In 2000 a system of shared taxes was introduced, which gives the local authorities a more solid and secure financial basis for their activities. Presently, the most important task is to implement the new financial regulations and make local self-government less dependent on national government.

Finally, as a result of the debate certain dilemmas, open questions, and recommendations concerning financing local self-government were formulated.

The competence of local self-government to impose taxes was endorsed, whereby tax collection may be performed through national fiscal authorities. However, local governments are faced with a dilemma when they introduce additional local taxes: on the one hand, they may increase their financial sources for local purposes, but on the other hand, they may worsen their competitive position against other local units trying to attract investors. Therefore, fiscal competence of local self-government must be applied carefully, and as a part of comprehensive development policy.

Joint or shared taxes are, as a rule, the main source of local budgets in South Eastern Europe. Those countries which have not yet introduced a system of shared taxes should do this, in order to secure a more stable financial basis for local self-government.

It was stressed that most of the countries in the region are characterised by great discrepancies between local entities, which significantly vary by size, economic and fiscal power and level of development. Because of this, elaborated equalisation mechanisms, based on a formula composed of different criteria (such as in the case of Slovenia), should be introduced in order to assist less developed areas or areas with specific higher needs. Equalisation transfers must not by any means depend on political criteria.

It was agreed that the role of property owned by local self-government entities has until now not been adequately acknowledge in the region. There is a need for more efficient management and use of local property in order to increase their contributions to local budgets.

The role of borrowing by local government as a financial instrument, especially for investment purposes, has to be properly evaluated and introduced. National government may introduce certain limits to borrowing, in order to prevent bankruptcy of local governments.

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