Foundations of Fiscal Decentralization

Benchmarking Guide for Countries in Transition

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Budapest · Local Government and Public Service Reform Initiative / Open Society Institute
2003

Discussion Papers, No. 26
Published in 2003 by the Local Government and Public Service Reform Initiative
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ISSN 1417-4855

OPEN SOCIETY INSTITUTE

Produced by
Arktisz Studio
Budapest

INTRODUCTION TO THE SERIES

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

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

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Acknowledgment

I would like to express my gratitude to Gábor Péteri for his very careful review of the manuscript and several valuable suggestions that helped to improve the structure and clarity of arguments in this paper. The author, however, remains solely responsible for any errors or arguments presented.

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Abstract

The paper discusses issues of fiscal decentralization in European countries in both theory and practice. It starts with a short presentation of decentralization's fundamental values, and the general principles on which the allocation of revenues between tiers of governments should be based. Next it discusses in more detail the various sources of local government revenues: local taxes, grants and borrowing. This includes a brief clarification of terminology and theoretical principles. Each section then presents several examples from various European countries and finishes with a short discussion of the Polish example. The format of the paper does not allow for extensive discussion of specific cases, but indicates a variety of solutions adopted in European countries. A list of principles related to revenue assignments as well as the various examples given may be useful as benchmarks for analyzing inter-governmental arrangements in countries at an early stage of decentralization reforms. The paper is also intended to support LGI's training activities, so it is published both in English and Russian.

1. Why local government is useful and why it should provide services

1.1 Values in local government and decentralization

Why is local government important? Why is it valued? Why does it persist even into the post-modern world? Why was it that structures of local democracy were among the first reforms to be introduced in the post-communist era? In spite of two different rationales for local government (that the existence of local government is *natural* for communities, or that it is *functional* because it helps the state to function better), scholars often point to three basic values that the structures of local government may fulfil (see Sharpe 1973 and Stewart and Greenwood 1995 as examples):

- liberty (autonomy)—the existence of local government prevents over-concentration of political power and also allows for different political choices in different localities. Buchanan states: "even if the division of powers between the central government and the set of local governments should not be efficient, there would still be an argument in favor of delegating some power to those governments as a means of controlling or checking the central government authority" (Musgrave & Buchanan 1999, p. 178);
- participation (democracy)—the existence of local governments encourages the active involvement of citizens in self-governance;
- effectiveness—local governments are efficient structures for the delivery of services tailored to the varying needs of different localities.

Perhaps the last value requires more careful justification. Why would local governments provide greater effectiveness or efficiency? It is frequently argued that:

(1) with decentralization, decision–makers are closer to the results of their own decisions, which is helpful in predicting the real effects

of decisions to be made. Closeness to results in turn supports effective allocation of resources;
(2) local government enables a better match of policies with local conditions and preferences. Various solutions can be considered in the context of particular local settings. This supports effectiveness both objectively and subjectively (i.e., policies are closer to voters' preferences);
(3) variation in solutions promotes innovation and diffusion of positive examples.

That is why local government is a feature of all European states, despite the many differences between them. Its importance has been further highlighted and strengthened by the official adoption of the subsidiarity principle in the Maastricht Treaty of the European Union, and by the approval of the European Charter of Local Governments by the Council of Europe.

1.2 Justification for local public spending

But one could perhaps ask: if we operate within a market economy framework and the market provides the most efficient mechanism for resource allocation, do we really need local public finance? Indeed, it is true that the scope and supply of the public sector is often too wide, and many of the activities actually provided by local governments could effectively be left for private providers working in a competitive environment. But there are at least four areas in which public intervention is very much required in order to avoid a "local market failure."

(1) Provision of pure **public goods.** Such goods may be defined by two characteristics:
- their consumption is non-rival—i.e., consumption by an individual is not in competition with consumption by someone else;
- their consumption is non-excludable—i.e., it is not possible to exclude someone from their consumption because, for example, he or she did not pay for the service.

Among typical local services, the best example of a public good is perhaps street lighting. "Using" light produced by a streetlight does not place a person in competition with someone else who may benefit from the same light. It is also hard to imagine that the lamp would be switched on only for those who paid a fee for street-lighting while others were excluded from consumption of the service. Such an example serves to demonstrate how the market is not capable of regulating the provision of public goods.

(2) Several typical local services such as water provision, sewage collection and treatment, central heating and gas supply are **natural monopolies.** Natural monopolies can be defined as sectors in which a single provider can produce a lower unit cost (for technical reasons) than two or more providers could. Here too, market regulation is not efficient and public intervention is required.

(3) Externalities. By classic definition, externalities are positive or negative effects of transactions affecting actors who have not been directly involved in these transactions. Let us try to imagine a specific example of this in a local community: the provision of fire protection. Consider the consequences if this service was provided by the private sector only to those who paid a subscription. It may happen that house A, whose owner has not paid for fire protection, is on fire. However, should the fire brigade not intervene, there may be negative effects—the externalities—for neighbors who have paid their subscription. Obviously, the fire brigade should stop the fire because of the externalities.

A second example is environmental protection. Let us think about Mr. B. who burns old tires in his back-yard. This activity has negative effects that go well beyond his own property, affecting his entire neighborhood. In both cases, public intervention and the provision of some services from local budgets will be more effective, since it allows for internalization of externalities.

(4) Some authors argue that there are also **merit goods,** which legitimize public financing and intervention. Society may believe that the

provision of certain services is so important that we should not allow total freedom for individuals to determine their own level of consumption of those services. Public education is a good example. If society agrees on the importance of educating all children to a high standard, then the decision on whether or not to send children to school becomes a social, not an individual decision. Consumption of these services can be stimulated by public provision, even if they are not public goods by their nature.

In practice, the list of activities provided by public entities and financed from the budget of many local governments is longer than suggested by the principles described above. This raises the question of whether or not it might be more efficient to leave some of these additional services and activities to the private sector or NGOs. In some modern formulations, the role of local government is defined as enabling (facilitating the activity of other actors) rather than providing all services directly and exclusively.

2. Criteria for expenditure and revenue assignment

The principles discussed below are among the basic foundations of the fiscal federalism model. As Rattso (2002) notes, this model is based on four key assumptions: (1) local governments are mostly responsible for the delivery of public goods; (2) the base for local finance is provided by local taxes, i.e., those who pay for services also benefit from them; (3) there is considerable social (spatial) mobility; and (4) in the case of local services, the catchment area is close to the area of administrative jurisdiction, i.e., spillover effects are minimal.

Unfortunately, while these assumptions apply in the United States, they do not reflect the reality of European systems where local governments are heavily involved in redistribution, central grants play a significant role in financing local governments and people are much less mobile than in the US. Nevertheless, the principles of fiscal federalism remain a good normative base for the evaluation of local financial systems. In the following sections these are presented in more detail.

2.1 Allocation of local functions

What are the main features of a decentralized system of public finance, as recommended by fiscal federalism theory?[1] The main principles can be summarized in the following few points:

- The division of functions between central and local governments is based on the subsidiarity principle, which involves a considerable amount of fiscal and functional decentralization. The easiest, somewhat simplistic but still powerful indicator of functional decentralization is a ratio of local government spending to national GDP. In theory, local spending expressed as a proportion of total public spending would be even better. However, this measure creates several methodological and data problems because of the existence of various extra-budgetary public funds such as social insurance and pension in several countries. The highest indices in Europe can be found in Nordic countries, where local governments spend over 20% of GDP. The ratio is usually lower in the countries of Central and Eastern Europe, where it rarely exceeds 10% (see figure 1).[2]
- The allocation of functions takes into account the specific territorial organization. If, for example, the structure of a local government is heavily diversified and has many, very small units, the functional decentralization cannot be very wide. broad. Small local governments will not be able to perform many functions effectively. Also, the existence of many small local governments will require more developed fiscal equalization schemes. The relationship between the extent of functional decentralization and the size of local government units has been convincingly presented by Page & Goldsmith (1987) in their description of West European systems. They have shown that terri-

torial amalgamation in North European states (Scandinavia and the United Kingdom, for example) has supported the transfer of a wider scope of functions to local government. But in many countries of Central and Eastern Europe, small settlements are able to provide only a very limited scope of functions, despite official declarations that every local government—regardless of its size—has the same powers (for an extensive discussion of this issue see: Swianiewicz 2002).

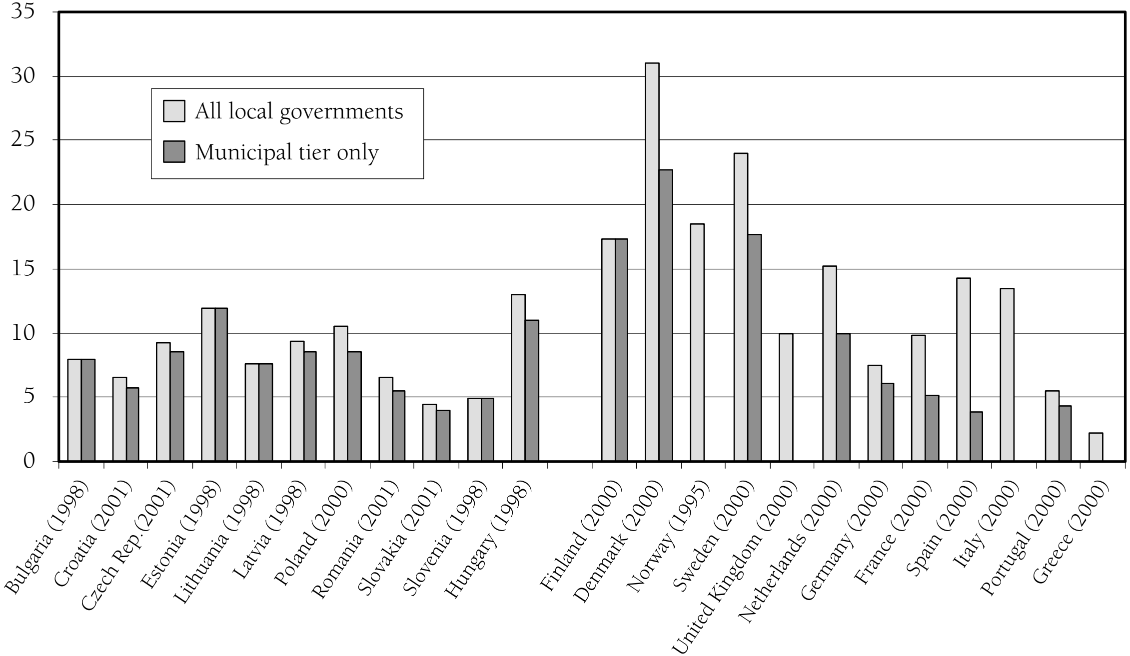
- The "golden rule" of the balanced budget (Dafflon 2002) is enforced by regulations and followed by local governments. In short, the rule states that current spending should be financed exclusively from current revenues (such as taxes, fees for services or grants), while capital investment expenditures are financed from capital receipts (e.g., borrowing, revenues from property, capital grants). Effective implementation of this rule requires a separation of current and capital budgets.
- The system of local finance is transparent—both for citizens and for potential lenders.
- Local government has a considerable amount of discretion to decide upon the structure of local expenditures. In practice, this discretion may be limited in several ways. First, by a high share of conditional grants in local budgets. Second, through detailed, centrally defined norms and standards for local service delivery. If such standards are too detailed, local fiscal autonomy becomes just an illusion.

2.2 Local government revenues

Where do local government resources come from? The most general classification of resources consists of three major categories (to be discussed briefly later on in this paper):

(1) Own revenues of local governments. The definition of own revenues includes three elements:
   - They are revenues allocated to local governments unconditionally, in full and for an undefined period;

Figure 1. Local spending as % of GDP



Sources: Local Finance in Fifteen Countries of the EU (2002), Horvath (2000), Kandeva (2001), Jurlina-Alibegovic (2002)

- They are related to the local economic base; that is, the growth of the local economy leads to the growth of local budget own revenues;
- The local government has at least some discretion to decide upon these categories of revenue. For example, it may set the local tax rate—at least within certain limits set by central legislation.

The most important category of own revenues is local taxes, and this category will be further discussed in the paper. Other examples of local own revenues are fees for services provided or revenues from local government property.

(2) Transfers from the central budget in form of grants. One should distinguish between general purpose grants which can be used freely for any purpose, and specific or conditional grants which can be spent only for a purpose defined by the grantee.

(3) Borrowed resources. Examples of these include inter-budgetary loans, bank credits or municipal bonds.

There is one more category of revenue which is very popular in most European countries: local government shares in central taxes. Quite often, the local government receives a fixed percentage of (for example) personal income tax collected within its territory. This is not an own revenue, because local government has no discretion to decide upon the tax rate, tax exemptions and so forth. On the other hand, it is also not a central government grant in a pure form. Regulations on shares are very diverse, and depending on the details this category is somewhat similar to own revenues or to general purpose grants. For analytical purposes, however, it is convenient to treat it as a separate category.

The structure of local revenues should conform to the following general criteria:

- Vertical allocation of resources (between tiers of government) should reflect the allocation of functions.

- A large proportion of local revenues should come from own sources (specifically in the form of local taxes). There are several arguments of both a political and economic nature supporting this expectation:
  - A system in which a large part of the local budget comes from own sources supports local government accountability towards the local population. The shape of the local budget depends to large extent on decisions on local taxes. This stimulates councilors' accountability and also increases citizens' interest in local government activities. In general, such a system helps in the development of local democracy.
  - Such a system exerts pressure on the "value for money" dimension—it provides incentive for the rationalization of spending and the search for possible savings. It is much more difficult to argue for an increase in local public spending when it is going to be covered by higher local taxes, than is the case when additional expenditures will be covered by grants from the center.
  - Fiscal policy can follow local preferences. In one locality citizens may expect a greater supply and better quality of services even if these require higher taxes, while in another people may prefer lower local taxes and inferior services.
  - Previous arguments suggest that a system with a high share of own revenues reduces pressure on the overall level of public spending. Having most of the local revenues financed through central grants leads to excessive demand for local services by local citizens. It follows that the local government will then exert pressure on central government in order to receive higher grants.
  - This suggested structure of revenues strengthens the political position of local governments within a state. Local governments become important partners who finance and provide significant functions, rather than simply clients who demand and receive resources from the center.
  - A system organized around high own revenues increases local government interest in supporting local economic development,

although as Peterson (1981) noted, local authorities are usually interested in economic growth for other reasons as well.

High own revenues, however, have an important consequence that should be noted in this discussion: they lead inevitably to increasing disparities between rich and poor regions. Local shares in central taxes have the same disadvantage, but they do not have most of the positive features of local taxes enumerated above. That is why, in the context of fiscal federalism, the shared taxes system is among the least attractive sources of local revenues.

- There is an equalization system which ensures that each of the local governments is able to provide at least a minimal set of standard services. This system attempts to ensure that the degree of disparity noted above is held to a certain level.

3. Local own source revenue

3.1 Local Taxes.

3.1.1 Basic principles of local taxation

There are various candidates for local taxes, and several criteria to help us choose the most appropriate mix for the country. Some of these criteria are identical with requirements for good taxes in general, but others are specific to local government. The most important elements of the "check-list" may be summarized in following way:

- **The allocation of tax yields is proportional to allocation of functions.** If we require that a large proportion of local revenues comes from own sources (as suggested in the previous section), we need a tax system that provides such an opportunity. So, it is imperative to ensure that the local tax base provides revenues nearly sufficient to deliver the most important local functions.

- **The distribution of the tax base is even geographically.** This ensures that differences between local authorities with high and low local tax bases are not overwhelming. For example, the tax base for the tax on exploitation of natural resources would be very unevenly distributed, while property taxes are much more evenly available for every local government. If this condition were not followed, there would be huge differences between "rich" and "poor" jurisdictions. If local government is responsible for important services, this will imply a complex system of horizontal equalization. Obviously, there is no tax from which yields are distributed in space in a perfectly even way, but some potential local taxes are better and some are worse from the point of view of this criterion.
- **The tax is well defined in geographical space.** Is it easy or difficult to decide which local government should collect and receive the tax? With property taxes, for example, collection is very easy because every property is located in one jurisdiction. Similarly, personal income tax is not a problem, regardless of whether it is paid at the place of residence (as in most European countries) or at the place of work (as in a minority of countries, such as Ukraine). But the case of corporate income tax is much more complicated. If a company is registered in one city but operates and generates income in several other places, which local government should benefit from the tax? A partial solution adopted in Poland is that tax revenues are distributed among local governments proportionally to the number of employees working in the individual localities. But this solution is complicated and far from perfect. The case of Value Added Tax is even more complicated, if not hopeless (from the point of view of the criterion discussed).
- **Visibility of the tax.** Certain taxes such as property tax or personal income tax are more visible than others, like VAT or excise tax. There is no doubt that visible taxes stimulate a local government's accountability.
- **The elasticity of tax yields against inflation.** This is an important item for every tax, but probably especially important in the case of

local taxes. On the one hand low elasticity (as in the case of property tax) enforces more careful financial policies of local governments. Increasing the tax rate, even if in reality it only reflects inflation, is always politically difficult. On the other hand, elastic taxes provide a better financial base for delivery of local functions.

- **The tax base should be relatively immobile.** Otherwise, tax payers can easily migrate between jurisdictions causing excessive tax competition. Property tax or even personal income tax is better from that point of view than corporate income tax.
- Last but not least: **the system of local taxes should not be too fragmented or too complicated.** In some countries there is a large number of small local taxes, none of which brings very significant revenue to local budgets. The cost of tax collection in such a system is usually relatively high. A system like this is also unnecessarily complicated and non-transparent, reducing the accountability value of local taxation.

3.1.2 Local taxes in the practice of European countries

In practice, most European countries have several local taxes, although one of them is usually more important than the others. The United Kingdom, with only one local tax (currently based on property, although not in a typical, orthodox form), provides one of the rare exceptions to this rule. Countries differ from each other in how much local discretion is allowed in deciding upon local taxes. In most cases there is a maximal ceiling or bracket within which local government can make its own decision. However, in some countries (for example Denmark, Sweden until recently, and the United Kingdom until the mid-1980s) local governments are totally free to decide on the local tax rate.

In European countries there are basically two models of local taxation:

- based on property taxes (there might be other local taxes, but property tax is the most important). The United Kingdom probably provides the best example, but France, Spain or Poland also fall into this category.

- based on local income taxes. All four Nordic countries provide good examples of this type of local taxation (note: local income tax should not be confused with receiving a local share in an income tax which remains a central tax). One of a very few countries in Central and Eastern Europe that have decided to go in the direction of building local income tax is Croatia.[3]

There are some countries in which local governments may make a choice from among a wider set of available taxes. This is the case in Hungary, where local governments are entitled to introduce any or all of the following taxes: land parcel tax, building tax, communal tax on private individuals, communal tax on entrepreneurs, tourism tax and local business tax (Hogye 2000).

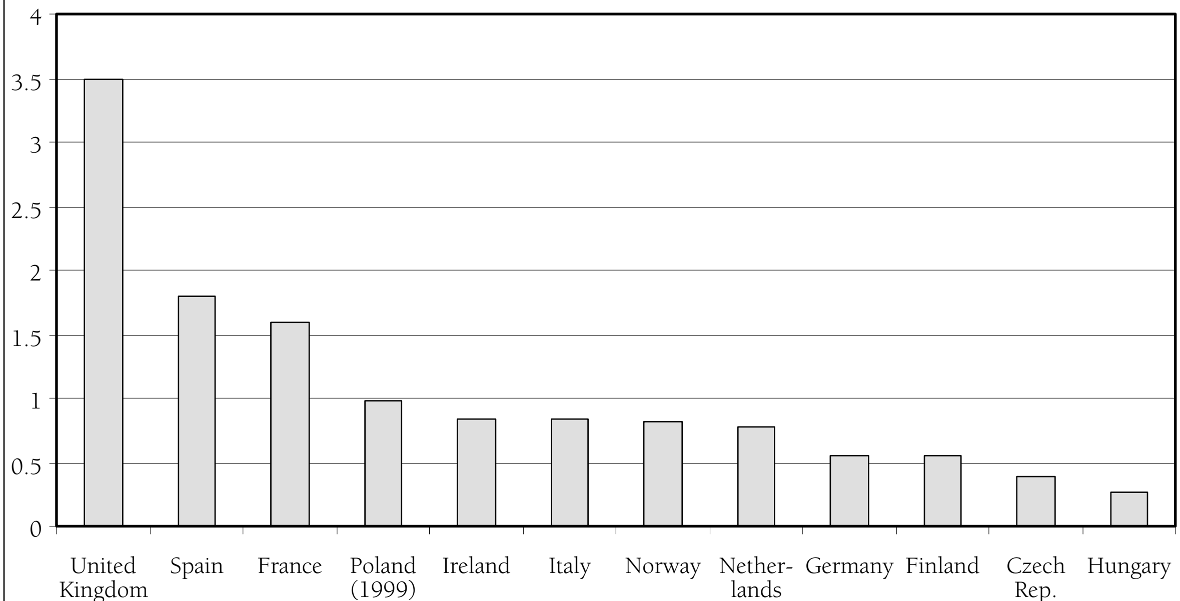
Local governments in different countries have a different amount of discretion in deciding upon rates of local taxes. Typically, a maximum tax rate or ceiling is set which the local decision cannot exceed. This is the case in Italy where the local property tax rate may vary from 0.4 to 0.7% of the taxable values. There is also a limitation on the extent of changes to the local surcharge on personal income tax. From year x to x+1, the change cannot be larger than 0.2% (Fraschini 2002). In the United Kingdom, the freedom to set local tax rates is indirectly limited through caps on the overall level of local government spending (*Finance and...,* 1996). In Sweden, local governments that set excessively high rates may be “punished” by the reduction of state grants. In Denmark, local governments are basically free to set any local tax rate. Whatever is the particular solution, in practice there is often a significant variation in tax rates between individual local governments. For example, in the UK in 1997 the basic rate of council tax varied from less than 300 to over 900 GBP. In Denmark, local tax rates vary by around 30% in municipalities and around 10% in counties (Pedersen 2002).

In most of the developed countries, the property tax paid is more or less proportional to the market value of properties. However, in most of the Central and East European countries property taxes are devised differently, being dependent on the type of property and its size, but not on market value. Most advisors working in our part of Europe for international organizations or Western governments recommend reforms leading to the introduction of *ad valorem* property tax. If treated literally, however, this reform may be considered controversial and administratively unmanageable or costly. Such a reform has to take a relatively long time, as it is expensive and feared by numerous tax-payers. There are two typical arguments for the reform: one is that only *ad valorem* property tax allows significant revenues to be collected for the local budgets. The second argument refers to the fairness of the *ad valorem* tax.

Figure 2, illustrating revenues from property tax in various countries as a proportion of GDP, shows that the first opinion is a myth. As shown below, one may argue that there exist alternative methods for varying the property tax which make it more fair and proportional to the "ability to pay," but which (although imperfect) are much cheaper and simpler to implement.

Polish property tax has very little to do with the value of properties; nevertheless, it provides a significant source of the income of local budgets. This does not mean the Polish system is perfect in this respect. It is definitely not fair that the owner of a poor house in a remote village can be taxed the same amount as the owner of a similar house (in size, not value) in the center of Warsaw. But there may be ways to get around this problem that are simpler and easier to implement. An interesting example is provided by the Czech and Slovak systems, in which the maximal rate of property tax is differentiated depending on the size of the town it is located in. In Slovakia, for example, the maximal rate in the capital city of Bratislava is 4.5 times higher than in a small village with fewer than 1,000 citizens. (Kling et al 2002). In addition, local government can differentiate the rate depending on the "zone" in which the

Figure 2. Revenues from the proerty tax as % of GDP (1994)



Source: Limitations of Local Taxation, Financial Equalization and Methods for Calculating General Grants, (1998).
Note: in UK data include also revenues from the tax on commercial properties, which is not a local government tax

property is located within the city. Such a system largely reflects the variation of the value of properties and at the same time is much cheaper and easier to implement than the typical *ad valorem* tax. These techniques are good approximations of an *ad valorem* property tax, but they are administratively feasible and less expensive.

3.1.3 Local taxes in Poland

Municipalities are the only local governments in Poland which have the power of taxation. For the time being, the upper tiers—counties and regions—are financed predominantly by central grants with the small addition of shared revenues from income taxes.

There are several local (municipal) taxes in Poland, the most important of which include:

- property tax (which alone brings in over 12% of total municipal revenues),
- tax on agricultural land, and
- tax on vehicles.

Municipalities also receive 27.6% of personal income tax and 5% of corporate income tax collected within their territory,[4] but these are shared revenues with no local discretion to decide tax rates or exemptions. In the case of local taxes, the Law regulates the maximum tax rate and the local council is free to decide any rate up to this ceiling. Local council can also grant tax exemptions.

In most cases the property tax yield depends on the taxable area (number of square meters), and not on the value of property. There are different rates adopted for different types of properties such as:

- residential houses (for example, in 2003 the maximum rate per square meter is 0.51 PLN, or about 0.14 USD);
- plots of land related to commercial activity (the maximum rate for 2003—0.56 PLN or 0.15 USD per square meter);

- commercial space in buildings (the maximum rate for 2003—15.86 PLN or 4.2 USD);
- undeveloped plots of land (but not used for agriculture or forestry purposes) .

As mentioned above, there is an on-going discussion on the reform of the property tax, in order to make it reflect the value of individual properties. But the discussion is far from finished and it is very difficult to predict the final result.

How may the Polish local tax system be assessed against the criteria formulated at the beginning of this section?

- **(-) The allocation of tax yields is not proportional to the allocation of functions.** The negative assessment applies primarily to the situation of county and regional governments which do not have own tax revenues; it is much better on the municipal level. The ratio of revenues from own sources to total budget revenues is somewhat lower than in some West-European countries such as Denmark or Sweden, but similar or even higher than in most of the others, including the United Kingdom, the Netherlands or Spain. A negative situation even in the municipalities, however, is the gradually diminishing role of revenues from own sources in municipal budgets — 47% of total budget revenues in 1992, but 40% in 1995 and only 33% in 2001.
- **(+/-) Uneven geographical distribution of the tax base.** There are significant differences in distribution of the local tax base. In 2001, own revenues constituted well over 40% of budgets in cities but just over 20% in rural areas. Taking into account inequalities between regions, the variation is even larger. But probably this level of inequality is inevitable regardless of the selection of local taxes.
- **(-)The system of local taxes is fragmented and complicated.** There are many small local fees and taxes (such as the tax on dog owners) that do not raise significant revenues but are costly to collect and complicated to administer.

- **(+)Tax is well defined in geographical space.** Polish local taxes do not produce major problems in this respect. Taking tax-sharing into account, there are problems with defining the local share of corporate tax in the case of companies that are registered in one municipality but operate branches in various locations. A partial answer to this problem is provided by regulation, by which municipalities receive an allocation proportional to the number of employees working in each of the local branches. This solution is far from perfect, however.
- **(+)Visibility of the tax.** Most of the local taxes in Poland are visible.
- **(-)The low elasticity of tax yields against inflation.** Property tax, tax on vehicles, as well as small local fees and taxes are not elastic against inflation. The only exception is perhaps a tax on agriculture, which is related to the market price of crops.
- **(+)The tax base is relatively immobile.** This principle is definitely true of the property tax, which is by far the most important local own revenue.

Thus, recommended changes might go in two directions: simplification of the system, and strengthening of the local tax base (perhaps at the expense of tax sharing) first of all at the county and regional, but also at the municipal level. Potentially, this might be done in one of the following two ways:

- Transformation of present shares in central income taxes into local surcharges to income tax. Implementation of such a reform might follow the experiences of Scandinavian countries;
- Reform of the property tax together with an introduction of county and regional parts of the tax. This can but does not need to include a change towards the *ad valorem* property tax system.

But it is necessary to stress that the overall level of tax burden for citizens and enterprises should not increase as a result of the reform. The reform of local taxes can never be discussed in abstraction from the broader change in public finance in general. If the overall burden of local taxes increases, there must be compensation through the reduction of some central taxes. The central level would not incur an additional burden from this, since strengthening of the local tax base allows state transfers to be reduced. The focus of this should be on the principle of equalization, rather than on a general vertical equalization (see next section).

3.2 Other revenues from own sources

Local taxes are by far the most important but not the only source of local own revenues. Two important additional sources are provided by:

- **Revenues from local government property.** These revenues may be related to the sale of plots or buildings, but also to the longer-term lease or rent of municipal properties. In Poland, for example, some local governments' considerable revenues come from renting commercial space on the ground-floors of municipal housing developments. In some countries revenues from property (especially from sales) can legally be used for capital investments, but not to cover current expenditures. Even if such a limitation is not imposed by law, its implementation is advisable as it helps to follow the "golden rule" of the balanced budget;
- **User fees and charges for services provided by local governments.** Some services, especially those that are pure public goods (such as street lighting) are delivered free of charge; i.e., they are financed from general budget revenues. Fees and charges for other services are often collected directly by service providers and they are not always reflected in the local government budget. In some accounting systems (such as those used in Poland) the municipal budget shows only the net flow of subsidy, if any, from local budget to local service provider. The general rule suggests that private goods (such as water consumption) should be financed entirely by consumers. But in some cases, there are important arguments for subsidizing delivery of the service. For example, most cities subsidize local public transportation

in order to stimulate the use of mass transportation instead of private cars, which may help to reduce traffic congestion and environmental pollution. In some British cities (Jasiński 1998), the private provider is expected to cover the full cost of most services from the sale of tickets, but the city subsidizes evening and week-end services. Local government systems vary in the discretion local authorities have to decide the level of local services. A detailed discussion of this issue is out of the scope of this booklet, but it definitely influences the assessment of fiscal decentralization.

4. Shared revenues

Shared revenues are treated in many different ways in various countries, so it is very difficult to compare these revenues internationally. In general, by tax sharing we mean allocation of a part of the revenue from certain taxes to local governments.

There are a few characteristics that help us to compare various systems:

- The stability of the local government's share of the tax yield. In several countries in transition the share of local governments is simply defined by annual budget law. Quite often the share changes significantly (even from 0% to 100%) and unpredictably from year t to t+1. This was the typical situation in Ukraine before the implementation of the new Budget Code in 2002. In such a situation it is obviously very difficult to expect that local governments will be able to develop medium or long-term financial plans, or to implement any coherent development policies. But in some countries the share is stably defined by laws that determine local government revenues (as it was in the Polish case described above).
- The manner in which shared revenues are allocated to individual local governments. In some cases (such as Poland, or Ukraine after the new

Budget Code of 2002) each local government receives a fixed share of the tax yield collected within its category. In such a situation the shared tax is very similar to local taxes with a flat (uniform across the country) tax rate. This solution, however, entails the disadvantages of local tax revenues described in section 2.2, not having most of the positive features related to financing through own local revenues. In some other countries, the share of individual local government does not depend on a local collection but is allocated on the basis of various criteria such as size of population. In England, for example, revenues from the tax on commercial properties are allocated proportionally to the population size of individual jurisdictions. This is frequently the approach taken in Central and Eastern Europe as well, especially where the share in personal income tax is concerned. Such a solution is closer to the general grant than to local tax, and sometimes is classified in that way. For example, in Poland, the so-called road grant (part of the general purpose grant) is fixed as a share in the excise tax on petrol and is distributed to local governments proportionally to the length of roads and intensity of traffic (see section below).

In some countries, instead of sharing taxes by origin or by formula, local governments are allowed to impose a surcharge on the central tax. In this case, local governments have at least limited discretion. Usually personal income tax is subject to surcharging, when the tax base and tax administration are kept under central government control. Lower levels of government (municipalities, counties) decide the size of the surcharge. They may levy a flat rate on the total amount of the central tax, as in Norway, or they might build up their own tax policy, as is the case in Denmark, Sweden or Switzerland. In most cases national legislation puts limits on the maximum local surtax rate in order to avoid harmful tax competition between different levels of government. For example, this is the case with the local surcharge to personal income tax in Croatia or in Italy (Fraschini 2002, Alibegovic 2002). In other cases (Denmark and—until recently—Sweden, for example), local governments are not legally limited in setting their rates (see the discussion in section 3.1.2). From the political economy point of view, such a solution locates the tax share very close to typical local taxes, since they support local accountability.

5. Grants

5.1 Reasons for grants

Why are grants necessary at all? As mentioned above, the root of most grant systems lies in the willingness to reduce inequalities between local governments. The following specific arguments for grants systems are typically mentioned in the literature:

- **vertical equity.** Sometimes the allocation of resources between tiers of government does not secure sufficient funds for local governments. If such vertical imbalance is significant, the situation should be treated as a violation of fiscal federalism principles. Nevertheless, it is quite common in European inter-governmental financial systems.
- **Horizontal equity.** Each citizen should have access to the same level of services for the same price (local taxes paid). If there were no equalization, citizens in poor municipalities would need to pay much higher taxes than citizens in more affluent localities.
- **Support for local governments that provide services to more than their own residents.** The catchment area of services can rarely be identical with the borders of geographical jurisdictions. This is especially obvious in big cities, which often provide many services (such as secondary education, street cleaning, street lights and maintenance of local streets) not only for their residents, but also for many visitors. If not for special support through the transfer grants, local communities might not be interested in providing a sufficient supply of those services.

- **Securing a minimal, national standard of services.** Standards are especially important if local governments are responsible for such services as education, health care or social welfare.
- **Stimulation of the supply of merit goods that national policies treat as priorities.**

But there are also arguments against equalization. The most typical include:
- Equalization is in conflict with the most effective—market—allocation of capital. It also disturbs the natural variation of prices (in particular, the prices of properties).
- Equalization is in conflict with local fiscal autonomy. It makes it difficult to adjust local policies to local preferences. This argument is especially valid if equalization is done through specific (conditional) grants.
- Equalization is a disincentive for stimulation of local development.
- Equalization leads to long-term dependency of some regions on external aid.

5.2 Types of grants

The most basic distinction is between general purpose grants and conditional grants. General purpose grants are transferred without any additional conditions. They can be spent on any function local government wishes, and if unspent until the end of a year, they can be kept by local government. Conditional (or specific) grants, on the other hand, are offered for and can be spent only for a purpose defined by the donor. Normally, grants unspent during the fiscal year have to be returned to the donor.

It is not always easy to distinguish between these two types. Sometimes there are grants which are calculated on the basis of sector-specific factors and have names like road-grant or education-grant, but which in fact can be spent freely by local government. They should therefore be treated as general purpose. The British system of Standard Spending

Assessment provides a good example. Spending needs are assessed separately for various services (for example there is a separate SSA for education, for police, for roads, for social services, etc.). But eventually, on the basis of comparison of spending needs with own revenues of local authority, a single "check" is transferred to local government and can be freely spent on any function according to local preferences. In Poland, the education grant or road grant to county authorities works on a similar basis. Despite the name or the method of calculation of the grant, the actual spending of the resources depends on local decision only.

From the point of view of allocation method, grants can be divided into those determined subjectively and those based on objective criteria:

- The first type is based on subjective decisions made by bureaucrats or politicians who decide upon grants allocations. "Traditionally" (i.e., before 1990) in most East and Central European countries, there were no clear and transparent criteria for grants allocations. Instead, decisions were made by central level or upper-tier administration on the basis of their subjective judgment of needs. This situation still prevails in some post-communist countries.
- Alternatively, we have systems based on objective, measurable criteria.

The latter approach may be criticized on the basis that the allocation criteria frequently may be accused of being imperfect. But criticism of the former method may be much more substantial:

- The subjective method is vulnerable to political manipulation. In the most extreme form of this, government helps its allies and discriminates against its political opponents in local governments);
- The subjective method is always not transparent;
- Allocations determined subjectively are unstable, so long-term financial planning is problematic.

If we concentrate on systems based on a set of objective criteria, we can still distinguish between two main types of formula:

- **lump-sum grants—**in which the fixed amount of transfer is calculated on the basis of measurable indicators such as population size, local tax base, economic wealth of population and demographic structure;
- **matching grants—**in which the amount allocated to individual local governments depends on the tax effort of the local community. In simple terms, the more resources that are provided by local government from its own revenues, the more matching funds it can receive from the center.

These systems have different macro and microeconomic consequences. On a micro level, with the matching grant it is much easier to follow the horizontal equity principle. Let us consider three jurisdictions in which spending needs and unit costs for local services are identical. We will also assume that the local tax revenues are proportional to the local tax base and that the grant system tends to achieve full equalization. (Releasing these assumptions would not change but only complicate the arguments presented below.) Let us further imagine that the distribution of the tax base is like that in table 1.

Table 1. Impact of lump-sum and matching grants on horizontal equity—an example

	Local tax base	Tax rate	Revenues from the local tax	Grant	Revenue from the reduced local tax (2%)	New grant in the form of:		Total local revenues in the form of:	
						Lump-sum	Matching grant	Lump-sum	Matching grant
A	1200	5	60	0	24	0	0	24	24
B	600	5	30	30	12	20	12	32	24
C	200	5	10	50	4	50	20	54	24

With a certain starting local tax rate (for example, with the maximum possible rate of the local tax—such is the logic of the Polish equalization scheme as well as grant schemes in several other countries) the principle of horizontal equity is precisely followed by both systems.

But what will happen if all local governments being considered decide to reduce the rate of local tax in the same proportion? The logic of matching grants will lead to similar reductions of the grant transferred to local governments, so the total revenues will remain identical in all three local governments. But if we follow the lump-sum system, the amount of the grant will remain the same regardless of the change in the local tax effort. As a consequence, the total revenues in jurisdiction A will be significantly lower than those in jurisdiction C, despite the fact that the local tax base in A is higher, and both local governments have the same tax policy. Obviously, the example in table 1 is an extreme one and it rarely exists in reality in such an extreme form, but it demonstrates equity problems with the lump-sum systems.

On the other hand, it has also been shown that the matching system tends to lead to stimulation of higher public spending than in the case of the lump-sum systems. This means that the lump-sum system is much safer from the point of view of macroeconomic fiscal and counter-cyclical policies. It also explains why lump-sum schemes are much more frequent in practice. Matching grants can be found more often in capital investment grant schemes. In the latter case, the idea of rewarding local community effort is widely accepted and any negative impact on macroeconomic indices is minimal.

5.3 Types of equalization

5.3.1 Equalization of revenues

Once we agree that equalization is one of the main reasons for the existence of grant systems, we need to define what we want to equalize. The simplest approach refers to the **equalization of revenues.** We take into account the local tax base but not actual local revenues, since local governments may have different tax policies which influence the level of budget revenues. We realize that the tax base is unevenly distributed among geographical regions, and we try to support units with the lowest tax base. We can do this in two ways:

- through vertical equalization schemes—in which "the poorest" local budgets are supported by grants transferred from the upper tier (most often from the central government);
- through horizontal equalization schemes—in which less affluent local governments are supported by the richest jurisdictions of the same tier. This method is often called a "Robin Hood tax."

The former of these systems functions in the United Kingdom, and the latter in Sweden. In Poland we have a combination of both. However, vertical equalization plays a much more important role than horizontal.

5.3.2 Balancing differences in spending needs

But equalization of revenues has important limitations. It does not take into account that **spending needs are diverse.** I do not mean the variation resulting from different local preferences (different demand for local services) but the variation that results from an external environment. A few examples will illustrate this:

Example 1. Snow removal from local and regional roads. The need for this service is obviously related to climate differences and will certainly be higher in mountain areas than in lowlands.

Example 2. Social care for the elderly and for people with long-term illnesses. The need for this service depends heavily on demographic structure. It is higher in localities with a higher share of elderly people.

Example 3. Health care. It is well known that usage of health care is most intense in the case of small children, women who are pregnant and elderly people. Spending needs will therefore depend on age and gender distributions as well as on factors which influence a number of diseases, such as environmental pollution.

Example 4. Street cleaning and maintenance of roads. The needs are larger in places where the number of users and traffic congestion are greater. In practice, higher needs are found first of all in the centers of the biggest cities.

If such factors are not taken into account, the equalization scheme cannot be fair.

5.3.3 Equalization of service costs

The third dimension that needs to be taken into account is related to **unit costs of service delivery.** Obviously, we should relate this to objective factors that influence unit costs, not to the variation of local governments' effectiveness. Once again we can use examples to illustrate this phenomenon.

Example 1. Primary education. Costs per pupil will be lower in the densely populated city than in sparsely populated rural areas with many small villages. In the latter case, it will be necessary either to maintain very small schools in every village (with a low rate of pupils per teacher) or to organize transportation for pupils traveling to the larger school. Both of these solutions are expensive.

Example 2. Construction of a new road. In a big city the value of plots that need to be bought from present owners is many times higher than in a small, rural locality. This will result in a variation of the cost per kilometer of the road built.

5.4 Criteria for grants allocation

Criteria used for grants allocation should be based on the following principles:

- Criteria used in the allocation formula should be significantly (in the sense that the word is used in statistics) related to spending needs and/or unit costs as well as grounded in theory.

- Variables used should have diverse values across geographical jurisdictions. It makes no sense to complicate the formula by using variables which have similar values across the country.
- Variables used in the formula should not be significantly correlated with each other—it would complicate the system without providing important, new information.
- Factors taken into account should be measurable, and information on them should be available and reliable.
- Factors considered should not be vulnerable to statistical manipulation by interested recipients of the grant. For example, Swedish experience in health care suggests using variables such as age and gender structure, standardized mortality rate and environmental pollution, but not variables such as the number of cases of individual diseases, the number of patients in the hospital, etc. It has been demonstrated that records kept in hospitals and ambulatories can easily be used to manipulate the latter group of indices if this leads to a potentially higher grant.
- The system should be neutral from the point of view of local tax policy (in the lump-sum system). In the matching grant system the higher tax effort is rewarded with a higher grant. But taking into account actual local revenues (not the local tax base) might lead to the opposite situation, in which lower tax effort would be "rewarded" with higher grants allocated. The unfairness of such a solution is obvious.

5.5 Examples of grants systems from European countries[5]

In most European countries, the last 20 years have brought a gradual shift from fragmented specific grants to the consolidated general purpose block grant system. The Council of Europe recommends that equalization systems should "enable local authorities, if they wish, to provide a broadly similar range of service while levying similar rates of local taxation" (Recommendation No. 4 R(91) of the Committee of Ministers, quoted after Blair 1993). This formulation clearly refers to the horizontal equity principle.

In most European countries the equalization function is performed by general purpose grants, although there are some cases of equalization through specific grants as well. The dominant form of equalization is through vertical schemes (i.e., grants from the centre to local governments), but in some countries (Sweden, Denmark) horizontal equalization between local governments of the same tier plays an important role.

There is a great variation in the number of criteria used for allocation formulas. Blair (1993) distinguished between three types of West-European systems:

- Sophisticated systems based on a huge number of criteria illustrating variation in spending needs, unit costs and local tax base. Examples are provided by the United Kingdom, Sweden, Denmark and Norway;
- Countries that tend to concentrate (in the assessment of spending needs) on a smaller number of key criteria. Examples are provided by Germany, the Netherlands, Belgium or Portugal;
- Simplistic systems that rely heavily on population size—Spain, Greece and Italy.

One could add to Blair's observations, that more complex systems are found first of all in countries with a higher degree of functional decentralization. When local governments are responsible for a wide range of services, simplification of grant systems becomes dangerous. But if the scope of local activities is narrow, complication of the system is unnecessary.

Perhaps the most interesting example of the sophisticated grant system is provided by the **United Kingdom.** The Revenues Support Grant (RSG) is a lump-sum transfer, the calculation of which is based on Standard Spending Assessment (SSA).[6]

SSA represents the amount that the government considers local authorities need to spend on all services. This amount is financed by a combination of local council tax, shares in a tax on commercial properties (National Non-Domestic Rate) and Revenue Support Grant. The SSA is calculated separately for the main sectors of local functions, but the grant calculated on this basis is transferred as one amount in the form of a general purpose, not an earmarked, sum. The actual budget at local government disposal may be higher or lower than the SSA estimation, since it depends also on the rate of the local tax (RSG is calculated on the assumption of one, standard local tax rate for all local governments across the country).

RSG has an equalization character and is calculated in such a way that if all local authorities were to spend at the level of SSA, all authorities should be able to set the same local tax rate. This means the system assumes full horizontal equity. The grant amount is calculated as:

RSG(i) = SSA(i) – NNDR (i) – CT(i)

where:

RSG(i) = grant for jurisdiction i
SSA(i) = standard spending assessment for jurisdiction i
NNDR(i) = revenues from shares in central tax in jurisdiction i
CT(i) = revenues from local council tax (assuming a standard tax rate for the whole country).

In other words, the higher the SSA for a given local government and the lower the tax base, the higher the amount transferred in the form of RSG will be. The list of criteria used for SSA calculation is very long and the method of calculation is complicated. For example, variables used in order to determine the SSA for the most important local services include:

- **Education.** The SSA is calculated separately for kindergartens, primary schools, secondary schools and other education tasks on the basis of following criteria:

    - Number of pupils in local government schools
    - Number of pupils residing in the local jurisdiction
    - Lone parent families
    - Families receiving support from social welfare
    - Children born outside the UK, Ireland, USA, former British Commonwealth countries, or whose parents were born outside of these areas
    - Population density
    - Number of free meals served in schools
    - Costs correction (for example, taking into account higher salaries in London).
- **Personal Social Services.** The SSA is calculated separately for children's social services, residential care of the elderly, domiciliary care of the elderly, social services for the 18-64 year age group. The calculation takes into account following criteria:
    - Number of children 0-17 years old
    - Children in lone parent families
    - Children in rented accommodation (families not being home owners)
    - Children in families receiving income support
    - Homeless households with children or a pregnant woman
    - People aged 65 years and over
    - People aged 75-84 years
    - People aged 85 years and over
    - Elderly people in rented accommodation
    - Elderly people living alone
    - Elderly people in receipt of income support
    - Elderly people with limiting long-term illness
    - Elderly people in receipt of attendance allowance
    - Elderly people who are not in a couple and who are not heads of households
    - Number of people aged 18-64 years
    - Children in non-white ethnic groups

Similar calculations are made to establish Standard Spending Assessment for police, fire protection, roads maintenance, housing benefits, other local services and capital financing costs.

The medium level of complexity of the grant system is found in the **Netherlands.** In the Dutch system, grants from the central government play a crucial role in financing local services. The list of variables used as factors in the allocation formula includes:

- Local tax base (related to the local property tax)
- Number of children
- Number of elderly people
- Number of people with low income
- Number of people receiving social welfare support
- Number of citizens in national minority groups
- Number of potential users of local services (established on the basis of Christaller's central place theory)
- Area of the municipality and area of surface waters
- Number of flats
- Built up area
- Presence of historical buildings
- Presence of buildings built before 1830
- Fixed amount for the biggest cities (Amsterdam, Rotterdam, Hague, Utrecht)

The Dutch system is much simpler than the British one; nevertheless, it is still much more complicated than that found in most post-communist European countries.

An example of the simplistic grant system is provided by **Spain,**[7] where 70% of the state grant to local governments is proportional to the size of the population. However, the population number is weighted according to the size of the various local government units. For jurisdictions below 5,000 citizens the weight is 1, but for cities over 500,000 the weight grows to 1.85. The next 25% of the total amount of grants is transferred according to a formula which takes into account the local tax effort (an element of the matching grant system). The last 5% of grants is based on the size of the school system in the jurisdiction.

A recent reform of the grants allocation system introduced in 2002 in Ukraine suggests that a change towards allocations based on a set of objective, measurable criteria is also possible in Eastern Europe. Although the present formula approved in Ukraine is far from perfect and requires serious modification, the system introduced by the new Budget Code is a huge step forward on the way towards a fair and transparent allocation system.

5.6 Grants to local governments in Poland

The general grant system in Poland is based on a similar methodology for all three tiers of local government (municipal, county and regional). It consists of the following elements:

- The equalization grant—which takes into account almost exclusively the local tax base, but leaves aside variation in spending needs and unit costs. In municipalities, the basis for equalization is the national average expressed in per capita terms, while in counties and regions there is an effort to achieve equalization with the richest local government. In municipalities there is a very small element (more symbolic than real) which takes into account the higher spending needs of big cities. On the municipal level a small portion of equalization comes from the horizontal equalization mechanism, while on the county and regional levels the system fully depends on vertical mechanisms;
- The education grant—which is basically per pupil, but with higher weightings given to rural areas (but not differentiating between sparsely and densely populated rural areas), handicapped pupils, some vocational secondary schools and schools for national minorities;
- The road grant (for counties and regions only)—taking into account the total length of maintained roads and the intensity of traffic;

- The compensation grant (for municipalities only)—which provides exemptions from local taxes which are decided by the National Parliament.

The Polish grant systems have some strengths which may provide a basis for recommendations in other countries, but they also display several weaknesses. These strengths and weaknesses may be summarized in the following way:

Strengths:

- The allocation of general purpose grants is based on objective and measurable criteria. The allocation is not vulnerable to political manipulation or to the subjective decision of bureaucrats.
- The total amount of the “pot to be divided” is defined by the Act (for example, the education grant reflects at least 12.6% of central budget revenues) and is not the subject of an annual bargaining process. Local governments assume their share of the business cycle burden, since overall budget revenues depend on the economic growth rate. At the same time, sub-national government interests are protected from manipulation by the central government.
- The allocation criteria for general purpose grants are relatively stable, enabling long-term financial planning by local authorities.
- There is a modest degree of equalization that is not enough to create a disincentive for more affluent local authorities.

Weaknesses

- The principle of horizontal equity is not fully implemented in the Polish system. The equalization grant is almost exclusively an equalization of revenues, and does not take into account variation in spending needs and unit costs. Even in those rare instances where spending needs are considered, it is done in a very problematic way.
- There are unfairly favorable arrangements for small local governments (below 15,000 citizens), which receive rewards in the form of higher grants for lowering the local property tax.

- The strengths discussed above refer to general purpose grants, while the complex system of conditional (earmarked) grants is unstable and not transparent.
- The proportion of grants within total local budgets is acceptable at the municipal level, where more than 30% of revenues comes from local sources, and the next 25% in the form of tax-sharing. At the county level, however, the proportion is definitely too high, with over 90% of budget revenue coming in form of grants. This is also the case at the regional level where grants constitute around 80% of total revenue. This structure is considered only temporary, but the situation still continues despite official declarations promising a general reform that was to have been introduced back in 2001.

6. Borrowing by local governments

As mentioned in the first section, the "golden rule" of the balanced budget prescribes that local authorities should never create a deficit in the budget for the purpose of covering current costs. But the same rule allows—and in some formulations even promotes—prudent borrowing for capital purposes. What are the reasons for such a recommendation?

6.1 Why local governments can (should) borrow to finance their investments

The most important arguments for borrowing by local governments may be summarized as follows:

- **Inter-temporal and geographical equity.** The costs of a project undertaken by a local government are incurred as soon as the project is implemented, but the benefits derived from the investment are spread out over a longer period. For example, the construction of a new sewage treatment plant requires a major one-time expenditure, but will last for many years. The same may be said of the purchase of city buses. If capital projects such as these are financed out of current revenues, then some local tax-payers who helped to finance the project through their local taxes may not benefit from them in the future (due to migration out of city, for example). At the same time, those who benefit from the project (users of the water treatment station or passengers of the city bus) may not have participated in financing it if they moved to the city after it was completed, or if it was completed either when they were small children or before they were born. By financing such projects through bank credit (or bond issues), local governments can ensure that most users pay for the benefits either through local taxation or directly in the form of user charges. In this way, payments from current users are partially used to re-pay the loan.

- **A close relationship between those who benefit from the project and those who pay for its completion supports optimal allocation of resources.** This argument sounds a bit abstract, but it can be found in every textbook of management or economics.
- **Benefits from the acceleration of local development quite often overshadow the cost of debt servicing.** This may be illustrated by a very simple example. Suppose that City A possesses a piece of land that may be very attractive to a potential investor, but there is no good access road to the plot. The city government has to choose from among following solutions: (i) finance the road construction from current revenues, agree to allow a few years to complete the project, and try to attract an investor a few years from now; (ii) try to find a potential investor now, agreeing that the price received for the plot will be lower and understanding that some potential investors may withdraw from the tender; (iii) arrange a loan, complete the construction of the road as quickly as possible and negotiate the sale of the plot. It may happen that benefits from the last solution (higher price or rent, wider scope of interested investors, quicker economic development resulting in multiple-effects that attract new projects, providing additional

jobs and tax revenues) are much greater than the cost resulting from interest payments to the bank.

- **Reduction of operational costs.** Let us consider another simple example. A local public transport company (owned by the city government) has ten old buses. These vehicles require frequent repairs and consume a lot of fuel. We can replace these buses using current revenues, but this will allow us to purchase only one new bus every two years. On the other hand, we could arrange a loan or issue bonds and replace all the buses at once. What are benefits of the latter solution? Apart from the comfort of citizens who will travel in the new buses, there will be a lower consumption of fuel, higher reliability of local transport, savings in the cost of repairs and the employment of service staff, and other secondary advantages. In fact, costs related to borrowing may even be less than costs involved in maintaining the old buses for a longer time.
- **Longer projects cost more.** Financing from current revenues usually results in a longer time being required to complete the project. It leads to higher constant costs and higher total volume of spent resources.
- **Stabilization of required budget resources.** The volume of capital spending in local government units fluctuates from one year to another. If we finance capital projects from current revenues, the demand for resources changes over time as well. In countries in which a large proportion of local revenues is raised in the form of local taxes, an irrational fluctuation of local tax rates can result.
- **Access to grants from European and other development funds.** This is one more rationale for borrowing, specific to Central and Eastern European countries. There are several investment grants available for local authorities, but a necessary condition is to provide matching funds that usually must equal at least 25% of the total project costs (as in the case of SAPARD or ISPA projects). Borrowing may be a means of increasing local capacity to apply for these development grants.

However, there are also potential hazards related to local government borrowing, of both a microeconomic and a macroeconomic nature. The microeconomic danger is related to the potential for excessive indebtedness of some local governments, leading to serious difficulties in repayment of loans and possibly jeopardizing the provision of vital public services. The macroeconomic limitation is related to the fact that local governments contribute to the overall level of public debt, which in turn may have a negative effect on inflation and other important parameters of the national economy.

6.2 Why local governments should not borrow to cover their operating spending

There is a common agreement that borrowing in order to cover current expenditures is acceptable only in very rare, specific cases—usually for very short periods, to cover deficits arising from uneven cash flows within a budgetary year. The most typical arguments for the importance of maintaining a balanced operating budget can be summarized as follows (for details see for ex. Dafflon 2002):

- Borrowing on operating spending would lead to an unmanageable debt burden. It would quickly lead to the rolling of loans (using new loans to finance the payment of an earlier debt's service) and to a very serious problem of excessive indebtedness.
- Using current revenues to cover current costs prevents the local public sector from growing beyond its optimal size, which may be defined here as the fiscal burden that voters/taxpayers agree to bear in order to finance the desired provision of public goods. Borrowing creates a short term fiscal illusion, in which the demand for public services is artificially high because it is distorted by the supply, financed not by local tax effort but in part by credits, bonds, etc.
- An unbalanced current budget may result in negative macroeconomic and microeconomic consequences, since private investments

may be crowded out. This could happen for the following reasons:

- Public sector borrowing draws on the pool of limited financial resources available from local banks etc. Local government borrowers are more attractive to banks than private borrowers, because giving credits to public entities implies lower risk;
- This competition for borrowing from the public sector exerts an upward pressure on the interest rate, making private investments more costly;
- Increasing budget deficits negatively affect expectations on inflation, which add more to the upward trend in interest rates.

It is worth noting that when local governments offer loans in order to finance investments, this negative "crowding-out" consequence does not occur (assuming that the current account includes debt service), unless someone postulates that public investments are less productive then private ones.

6.3 External regulations on local borrowing

Is regulation on local government debt necessary? It may be argued that it is enough to rely on financial market discipline. This line of argument would suggest that the adoption of legal rules might be redundant since tighter credit market conditions—in particular, higher interest rates—would already impose effective sanctions. If the total debt of local governments in the country grows too high, this will indeed be the case. Also, banks will be unwilling to provide credit or will demand higher interest from those municipalities that borrow more than they can carry out effectively. The same will happen if local governments try to issue bonds—the rating will be low and the market will refuse to buy them or will demand a very high interest premium.

Dafflon (2002) suggests, however, that in practice there are several doubtful assumptions behind the arguments presented in the previous paragraph.

One such assumption is related to the adequacy of the information possessed by lenders.

Another practical observation is that lenders usually assume that no real risk exists in case of local government default. They believe that someone else (the state?) will eventually pay the debt. Although a local government bankruptcy is technically possible in several countries, it is rarely observed in practice because it is so politically unacceptable.

Another doubtful assumption is that the borrower (local government) would adequately react to market signals before reaching the point of exclusion from the credit market.

For these reasons, then, external regulations and control of local borrowing may play a positive role supporting the local credit market.

6.4 Examples of local borrowing and borrowing regulations in Western Europe[8]

In most West-European countries, borrowing to cover operating expenditures is prohibited. Such is the case, for example, in Austria, Denmark, France, Germany, Italy, Norway, Spain, Switzerland and the United Kingdom. This general rule is not always very strictly followed. However, if it happens that in practice a deficit on the current account occurs, the local government is obliged to pay it back within one year (as in Denmark), or a maximum of two years (Norway). Interesting is the case of Switzerland, where cantons may decide upon a compulsory increase in the municipal tax rate, if a deficit occurs and the municipality does nothing to avoid it.

In general there are two modes of borrowing regulations found in European countries:

(1) control of borrowing (including individual borrowing limits and permissions), and
(2) control of the level of indebtedness and control of the current budget (which must include resources for servicing debt on capital projects).

Countries using the former method include:

- Denmark—where the basic principle says that any local borrowing is prohibited, but so many exceptions to this rule exist that in practice the situation is not significantly different from most other countries;
- The United Kingdom—which provides a model of administrative ceiling for borrowing, with each local government receiving an individual borrowing limit;
- Switzerland—where every capital project which cannot be covered from the annual budget goes to local referendum. Taking a credit for an investment requires approval from the canton.

Countries using the latter method include:

- Germany—where the municipality is required to demonstrate that borrowing will not lead to current deficit due to a planned repayment within the next four years;
- France—where the central government lifted almost all forms of *a priori* control by the state administration during the decentralization reform of the 1980s. The law protects local governments from bankruptcy, so the risk for banks is low. The prefect checks the legality of local borrowing every year, and if it is not in accordance with the law, such a case is passed to the Regional Audit Chamber (*Chambre Regionale des Comptes*). The ratio of debt to current budget surplus has to be lower than the rate of debt to annual repayment, which means that the current surplus has to be higher than annual debt repayment;

- Italy—where local borrowing is a relatively new phenomenon. Until 1985 local investments were almost entirely financed by central government, and from 1986 to1992 the role of central government was still dominant. Currently, the burden of local investments is to a large extent carried by local borrowing. There is a limitation that interest and capital payments in municipalities cannot exceed 25% of current revenues;
- Spain—where long-term borrowing requires the approval of the Ministry of Finance only if total debt exceeds 110% of annual current revenues or if there was a negative balance in the current budget during the previous year. Approval from the Ministry of Finance is also required for bonds or indebtedness in foreign currencies.

Where do West-European local governments go to borrow money? First of all, unlike the American (US or Canadian) model, taking bank credits is much more common than issuing bonds, although the latter method has been increasingly popular during the last few years in Europe as well. A good illustration of this fact is the number of ratings of local governments presented in a recent publication of one of the leading rating agencies, Standards and Poors (Local and Regional…, 2002).[9] The publication includes a list of rated local governments (below the regional tier).The numbers show 28 in Canada alone, 51 in the whole of Western Europe (the highest numbers are in Italy—fifteen, France—twelve, and Sweden—twelve), and seventeen in the whole of Central and Eastern Europe (including six in Poland, four in the Czech Republic and four in Russia). In 1997 in France, for example, banks lent over 70 billion French franks in the form of credits to local governments, while the number of bond issues was just about 5 billion French franks. Bonds are usually considered by French local governments to be more expensive and less flexible than bank credits. The situation is similar in other countries, although it should be noted that issuing bonds has gradually became more “fashionable” during the last fifteen to twenty years. In Italy, issuing bonds has been possible since 1990, and some big cities (such as Rome, Naples and Turin) as well as regions (Sicily) decided to use this form of project finance. Bank credits are still the main method used in Italy, however.

A significant bond issue (especially one located on international markets) requires a rating from one of the major rating agencies, such as Standard & Poors, Moody, or Fitch. The rating is a uniform, standard assessment of credit worthiness. The scale of rating is usually from AAA (the highest quality) to D (which means default). In Standard & Poor, methodology grades between AAA and BBB- mean investment grades, while those between BB+ and C- are considered speculative. Table 2 provides recent examples of ratings for local and national governments in Eastern and Western Europe.

If bank credit is a main borrowing method, the next question is whether there are special institutions or special lines of financing available to local governments, perhaps with subsidized interest rates. Or, are cities and regions simply to go through the normal procedures in commercial banks? The practice in this respect varies from one country to another, but the general trend in recent years has been a diminishing of the role of special borrowing institutions for local governments and an increase in co-operation with commercial banks.

In practice, the bulk of local indebtedness is found in the biggest cities. In Spain, most local debt has been produced by big cities. Six cities having over half a million citizens are responsible for one-third of the total local debt. Together with cities of over 200 thousand, their debt is well over half of all indebtedness of local governments. Similar observations have been reported in France, the United Kingdom and Germany, where the most indebted local government is the city of Frankfurt with a debt of almost 10,000 deutsche marks per capita in 1994 (Farber 2002). The same is true in several countries of Central Europe. In Poland at the end of 2000, the level of debt was just over 10% of annual revenues in local governments with fewer than 5,000 citizens, but almost 20% in cities of over 50,000. In Slovakia, differences were even more spectacular — in villages of fewer than 500 inhabitants debt was just 1.3% of annual revenues, but in cities of over 50,000 it was 7.9%. In cities with over 100,000, the number was a staggering 48.6%. (Kling, Niznansky, Pilat 2002). In the Czech Republic, as well, the debt of the three largest cities (Prague, Brno and Ostrava) constituted over a half of the total local government indebtedness at the end of 2000!

Table 2. Examples of ratings of national and local governments in East-Central and Western Europe (by Standard & Poors, long-term international rating, February 2002)

State	Grade	City	Grade
Central and Eastern Europe			
Slovenia	A	Brno (CZ)	A-
Czech Republic	A-	Olomunc (CZ)	A-
Estonia	A-	Ostrava (CZ)	A-
Hungary	A-	Praha (CZ)	A-
Poland	BBB+	Kraków (PL)	BBB+
Latvia	BBB	Gdańsk (PL)	BBB
Croatia	BBB-	Łódź (PL)	BBB
Lithuania	BBB-	Szczecin (PL)	BBB
Bulgaria	BB-	Wrocław (PL)	BBB
Romania	B	Bydgoszcz (PL)	BBB-
Ukraine	B	Riga (LT)	BBB
		Zagreb (HR)	BBB-
		Sofia (BG)	BB
		St Petersburg (RU)	B+
		Sverdlovsk (RU)	CCC+
		Irkuck (RU)	CCC+
EU Countries			
Denmark	AAA	Vienna (A)	AAA
Italy	AA	Paris (F)	AAA
Portugal	AA	Brussels (B)	AA
		Stockholm (S)	AA
		Naples (I)	BBB
		Avignon (F)	BBB-

Source: Local and Regional Government, February (2002).

The recent regulations of the Maastricht stabilization pact related to the introduction of a "Euro zone" have brought a new element into discussions on local indebtedness. The Masstricht agreement limits the overall level of public debt to a maximum of 60% of GDP, and also limits the annual total public budget deficit to 3% of GDP. It should be noted also that the level of central debt is usually much higher at the central than at the local level. For example, local debt in Germany constitutes just above 8% and in Switzerland 19% of the total public debt. More precise data are presented in figures 3 and 4. As is shown, except for Luxembourg, in all EU countries the local share in public debt is much lower than the local share in public spending. Also, in all fifteen countries, local governments finance the bulk of public investments. In France, Ireland, Italy and Spain, the local share exceeds two-thirds.

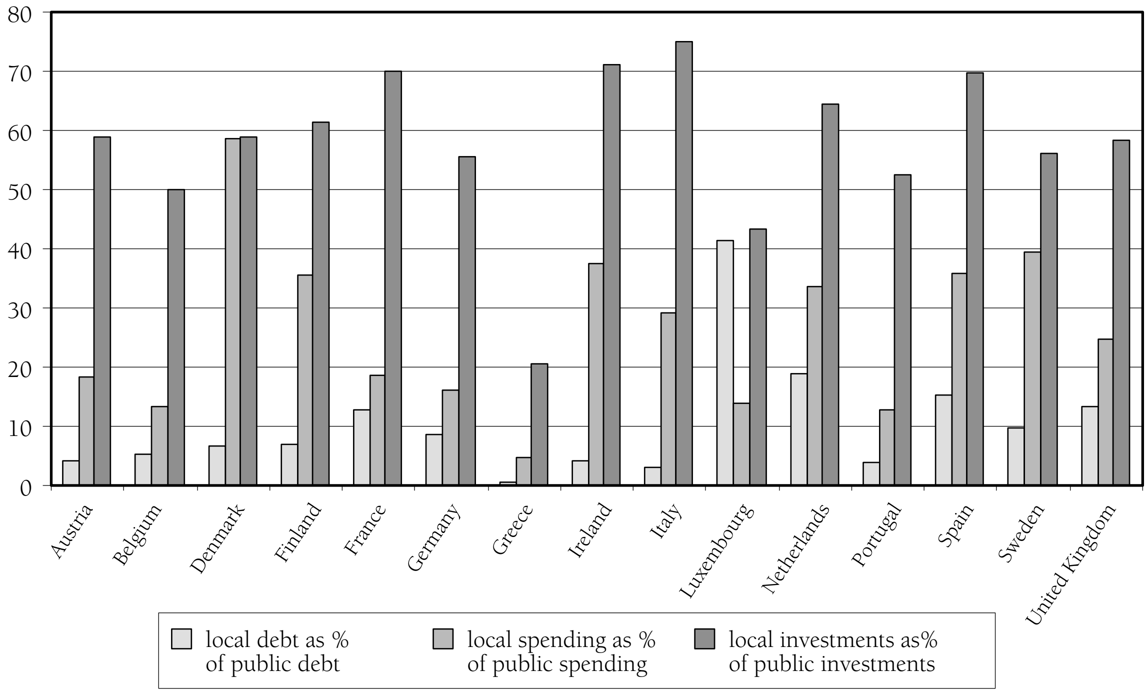
Figure 3 illustrates that in most EU countries the share of local debt to GDP is rather low—about 5% on average. The Netherlands and Spain, with a local debt ratio over 8%, are the only exceptions to this rule. In eleven out of fifteen EU countries the local debt-to-GDP ratio decreased between 1995 and 2000.

6.5 Borrowing by local governments in Poland

The borrowing regulations for local governments do not prescribe how the borrowed funds should be utilized—whether they should be spent on investments or on current expenditures. However, the size of local government debt (other than short-term, which needs to be repaid within the same budget year), is limited in the following ways:

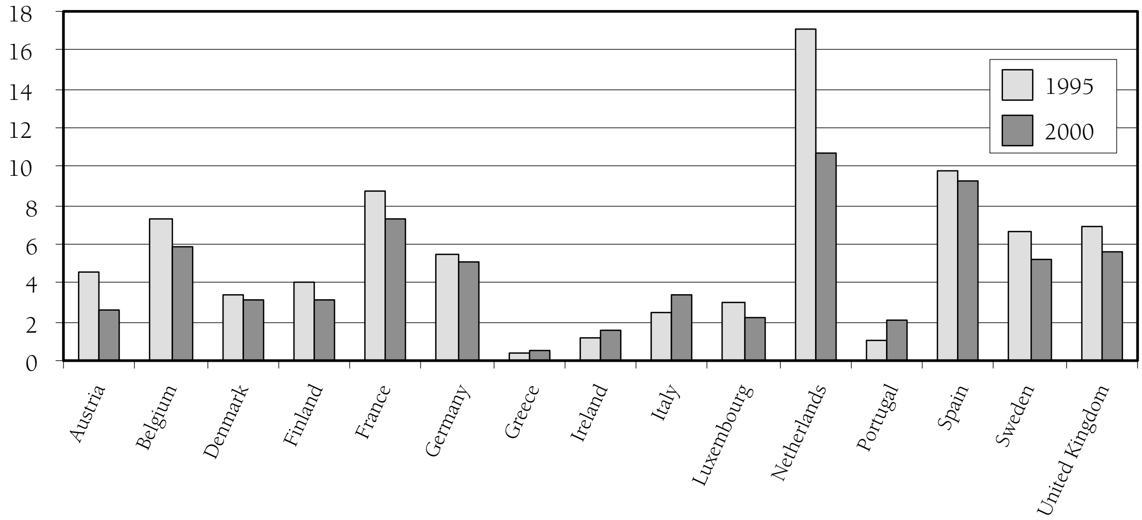
- The Polish constitution states that the overall public debt cannot be higher than 60% of the Gross Domestic Product. If the debt is larger than 50%, as it may be in 2003, a special limitation applies which makes new borrowing very difficult;

Figure 3. Public debt, spending and investments – the role of local governments (2000)



Source: Local Finance in the Fifteen Countries of the EU, (2002).

Figure 4. Local government debt as % of GDP



Source: Local Finance in the Fifteen Countries of the EU, (2002).

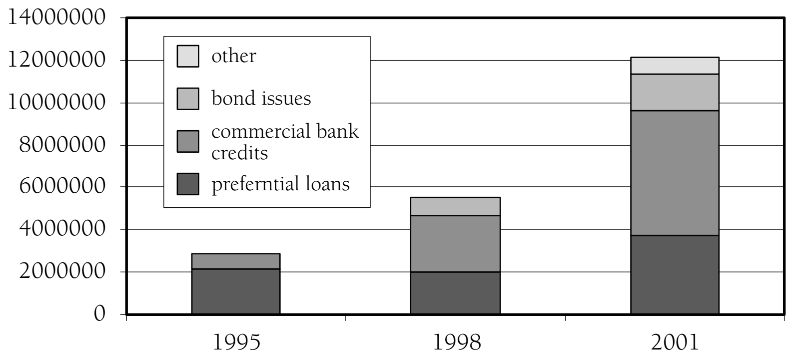
- The overall limit of local government debt cannot be higher than 60% of annual revenues;
- The debt service in a given year cannot exceed 15% of total budget revenues.

As in other countries in Central and Eastern Europe, the market of communal credits is much less developed than in Western Europe or the United States. However, in comparison to several other countries of the region, the market grows very quickly. Unlike some other countries, such as Bulgaria, Romania or the former Soviet Republics, the existing local debt in Poland is mostly in the form of bond issues, commercial bank credits, and preferential loans for housing and ecological projects. The system is not burdened with significant arrears in payments or with low-efficiency, inter-budgetary loans.

After the initial period of transition (1990-1995) when, for various reasons, local governments were very reluctant to borrow money, many municipalities increased their activity on the capital market. Nevertheless, most local governments are still very prudent and the level of debt is usually far from legal limits. By the end of 2001 the average level of debt was between 10% (in rural governments) and 23% of annual revenues (in the biggest cities).

Figure 5 illustrates the development of local borrowing in recent years. In 2001, for the first time, commercial credits were the largest category of the local debt. Previously, the dominant category was borrowing in the form of preferential loans (with the interest rate significantly lower than on the commercial market). These were offered mostly by the Environment Protection Fund for ecological investments, such as waste-water treatment, solid waste disposal and so on. Bonds still constitute a small but rapidly expanding part of the market.

Figure 5. Local government debt
(in thousand Polish złoty, end of a year)



Source: Levitas, Kopańska (2003).

7. Autonomy in local financial management and service delivery

Financial decentralization depends not only upon allocation of revenues and local government discretion to decide upon them. Even with these factors in place, local fiscal autonomy can be limited by strict regulations and control related to spending, financial planning and organization of local services.

In some countries, genuine financial decentralization is greatly limited by the number of standards which require allocation of centrally-defined resources to various functions. If these norms and standards are numerous and strict enough, local autonomy in spending policies remains just an illusion. To a large extent, this is the case of local governments in Ukraine, where standards of spending on social services (such as benefits for war and labor veterans) and health care are extremely numerous and hardly take into account the revenue capacity of local budgets.

A major limitation may also result from central regulation of wages and salaries of municipal employees. In Poland, in 1999-2000, the centrally-determined increase of teachers' salaries produced a lot of disturbances in the local financial situation. An alternative solution may be found in the United Kingdom or Scandinavian countries, where salaries of local employees are usually negotiated between relevant trade unions and associations of local governments.

Real autonomy may be also limited if local governments have no right to set charges for local services. In practice, artificially low fares, fees or other charges often force municipalities to allocate significant resources for subsidies to service delivery. A similar effect may limit decisions on the organizational structure of service delivery units.

The most important aspect of financial autonomy is local discretion over the form of municipal service delivery. Local governments should be free to design the internal structures of municipal administration, to decide the number of staff employed, and to use alternative forms of service delivery (private and non-profit organizations) if so desired. Obviously, local autonomy over these areas is limited by general laws on competitive tendering, company law and non-profit legislation, tax laws, etc.

* * *

The length of this booklet does not permit discussion of all the issues related to local financial decentralization. For example, we do not discuss issues related to tax administration, budgeting procedures and policies, or organization of municipal services (which has an important impact on financial arrangements). It should be noted that an extensive discussion of some of these issues can be found in other LGI publications.[10]

Nevertheless, the principles and examples presented above, although presented in a somewhat simplistic manner, may be treated as benchmarking useful for the analysis of inter-governmental financial arrangements in other transitional countries.

Notes

1. For a description of the main foundations of fiscal federalism see: Musgrave 1957, Oates 1972, King 1984.

2. Only spending of sub-national governments with clearly self-government status are taken into account on figure 1. Sub-national units which are primarily levels of state administration are left aside. In Ukraine, for example, the same figure would include spending of villages, towns and cities of oblast significance, but not of rayons and oblasts.

3. There are several countries in Central Eastern Europe in which local budgets depend heavily on revenue from personal income tax. Examples are: Poland, Czech Republic, Hungary or Ukraine. But in each of these cases the system is based on a share in central tax, with no local discretion to regulate such an income.

4. Note that personal income tax in Poland is residence-based (as opposed to being based on the place of work); i.e., part of the tax from every citizen goes to the home local government, not to the local government in which he or she works.

5. For a detailed review of European grant systems see, for example: Blair 1993, *Limitations of Local...,* 1998, *Local Finance in the Fifteeen…*, 2002.

6. For details see "Guides to the Standard Spending Assessments," published annually by the Chartered Institute of Public Finance and Accountancy.

7. See Monasterio-Escudero, Suarez-Pandiello 2002.

8. Examples quoted in this section are mostly quoted after: Dafflon 2002, *Local Authorites Budgetary…,* 1996.

9. A positive rating from one of the major agencies is usually a pre-condition for the issuing of major bonds.

10. For a discussion of local tax administration see Hogye 2000; for budgeting see Hogye 2002; for organization of utility services see Peteri & Horvath 2001; for education management and finances see Davey 2002; for social services see Tausz 2002, for details of borrowing regulations and practices see Swianiewicz 2003, forthcoming.

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