

About Regulations and Methodology for Granting the Financial Aid from the Central Government to the Local Authorities

The intragovernmental grant (the same as the transfer) is a cornerstone for financing local governments (both regional and local ones) in developing and transitional countries. Transfers enable the central government to control the state financial system as financial resources flow to various level budgets through transfers. The term “transfer” consists of several types of instruments, which are given below: grants, shared taxes, subsidies and subventions (the latter one is the least used form).

There are no unified regulations and methods for decentralization for all countries. Decentralization is implemented differently in every country depending on the country specifics, administrative-territorial arrangements, economic, financial, including fiscal policy priorities. Some transfers are of centralized character, others are directed towards decentralization. Distribution of transfers is constitutionally declared in some countries while in other countries a normative document issued by the president or the annual law regulates the process.

There is a discrepancy between expenditures and revenues of local governments in almost every country. This is especially noticeable in transitional countries where main priorities of governments include development of local infrastructure, creation of normal living conditions and ensuring and maintaining the economic stability. The local government is not able to finance the expenditures with its own revenue and there are two ways for filling in this gap:

1. Delegation of tax autonomy, i.e. entitling the local government to collect its own revenues;
- and 2. Give transfers from the central government budget.

The following two factors must be taken into consideration while defining the transfer methodology:

Measurement of vertical fiscal balance. Difference between the local government revenue and expenditures must be identified in order to determine size of a transfer. This is quite subjective as the amount of expenditures and corresponding liabilities to be incurred by the local governments is almost undeterminable. The vertical balance method is used in many countries when so called “minimum service level” (minimum expenditure level for the local government) is determined and the remaining difference is covered from the central budget. In many countries the size of

transfer is determined on the basis of central budget's capacities not by the local government's minimum requirements.

Incompliance of Vertical Balance Methodology and Effective Distribution of Revenues. For example, the vertical balance approach might result in certain amount of transfer for the local government but it might be possible to finance some of the expenditures from the local tax revenues as well. The result is that the service that might be financed from the local tax revenues might be financed through transfers.

So called the equalization principle is very important. Developing and transitional countries are characterized by economic and social inequality among their regions. Average economic and social indicators of rich regions far exceed (even twenty times in some countries) the same indicators of poor regions. The gap among regions will further increase in case they are given the tax autonomy as the more developed and urban regions have much larger tax base and better administrative infrastructure. The equalization system enables eradication of the discrepancies vertically among the government levels as well as horizontally among administrative units and regions. The equalization transfer is the best way to eradicate financial and economic inequalities. Naturally raises the question as to what should be taken as the basis for equalization – the level of revenue, fiscal capabilities, necessary amount of expenditures and priorities or revenue per capita. Besides, it is important to arrive at an average difference between the rich and the regions that lag behind.

Equalization systems differ across countries, specifically:

- there is a special body in many countries that receives financial resources from various level administrative governance bodies in the form of transfers and allocates them to various local bodies according to the requests;
- in many countries the central government (central or state budget) allocates grants for local bodies;
- in some other countries shared taxes are distributed among various level budgets.

The first method is mainly used in those countries where the gap among their regions is insignificant. The second approach is common in the countries with big financial and economic discrepancies among their regions.

For example, there is an equalization fund operating in **Iceland** providing one-time, as well as targeted, special grants to municipalities (mainly to those regions where the revenue level is low).

Norway adopted the targeted grant system in 80s. The new system replaced about 50 special grants. Sectoral grants were adopted in 90s (healthcare, transportation, primary and secondary educational institutions, culture and social welfare).

The equalization system for municipalities and districts was adopted in **Sweden** in 1996. As a result, revenues of the municipalities and districts became equal to the country average. Control of central government on municipalities was significantly reduced since special grants were replaced by main grants.

Municipal and district funds, which represent administrative bodies of central government, are main sources of grants in **Netherlands**.

Adoption of a formula based grant distribution system is being discussed in **Ireland**.

The financial equalization fund of central government, which issues targeted grants, represents main source of income for local government in **Portugal**.

The unified equalization system for confederation and cantons operates in **Switzerland**.

Australian Community Grant Commission issues recommendations every year on horizontal equalization among states. The local grant commission, which distributes transfers based on equalization formula, operates in each state.

Mexico has serious problems with regard to inequality among its regions. A newly established municipal support fund in Mexico supports local governments in getting aid from the central government.

In general, transfer system might be oriented on the following two main directions depending on specific circumstances in the country:

1. provision of standard expenditures;

2. total equalization, which means subsidies for lagging regions.

When determining transfer sizes there are quite intense debates underway between the central and local governments in many countries. Oftentimes the central governments ignore demands of local governments.

Apart from this, when a country has the three-level government and a transfer is given to the regional or state governments, there is a possibility that the transfer might not reach the local level, where the most of the expenditures are incurred. So, the issue of allocation of the funds by intermediary government is very important.

It should also be considered that the central government can more efficiently collect taxes at lower costs than the local government. That is why taxes are administered at the central government level and than transfers are allocated. But there are some taxes that are cheaper and more efficient to administer at the local government level. For example, property tax, automobile ownership tax, fees, such as license and permit fees.

Some factors, which influence the fiscal decentralization, is characteristic for developing and transitional countries. Two of them are important:

- the central government tries not to give up financial and economic control and gives as little autonomy to the local government as it is possible;
- there is an opinion spread in some countries that the local government is more corrupted than the central government and influence of the electorate on the local government is bigger. Thus, they think that the delegation of more responsibility to the local government might cause inefficient use of revenues.

Germany

Three-level local governments are created by the constitution in Germany. The constitution specifies all important issues, which are related to intra-governmental financial relations. Regulations related to revenue, revenue planning and administration are given in detail in the laws prepared on the bases of the constitution.

Administration of some taxes is exclusively delegated to certain local government levels. Revenues received from all main types of taxes are distributed among the federal government, territories and municipalities. Revenues received from shared taxes are distributed horizontally among the territories by equalization transfers and by special additional transfers vertically. Both types of transfers are regulated by special legislation.

Apart from this, the constitution enables the federal government to issue special targeted transfers. For example, for the public transportation.

Each local government body must independently finance main expenditures defined by law in order to ensure effective functioning of local governments. The expenditure authority of territories includes education (including high education institutions) and healthcare expenditures. Although, it should be noted that there is a duplication of competencies of federal and local governments in these areas (including social protection) and other spheres. Many investment projects are financed jointly by the federal and local governments.

One third of total budgetary expenditures (excluding transfers) is incurred by the local governments, which is lower than that in OECD countries (e.g. Canada and Switzerland) and higher than in Austria.

France

There is three-level local government in France - 26 regions, 100 departments and 36,763 municipalities. Unlike such a federal state as Germany, the constitution does not define revenue and expenditure competencies. The constitution only refers to relevant laws, which regulate financial and economic competencies of local governments. Article 72-2 of the constitution says:

- the local governments shall use tax revenues defined by the law;
- main resources of local governments shall be revenues received from the own sources defined by the law;
- delegation of expenditure authority from the central government to the local government must accompany the increase in own revenues;
- the equalization mechanism is defined by law.

The Code of local government that unites local government regulations consists of four main parts. According to the first part local financial committees are set up. They consist of representatives from both chambers of parliament, central government, regions, departments and municipalities (heads of municipalities). The committee prepares annual reports on local finance and studies long term development and prospects of the expenditures incurred and to be incurred in future. Second, third and fourth parts of the code covers regulations related to activities of municipalities, departments and regions. Revenue and expenditure, budgetary and accounting requirements for all the three levels of local government as well as for big cities and specific local self-governments are determined by the Code.

Spain

Decentralization process in Spain started in 1978, when the new constitution was adopted. In 2002 a complete delegation of healthcare service responsibility to the local government made Spain one of the most decentralized country in Europe.

The constitution ensures financial autonomy of local governments. Local budgets are adopted annually together with the central budget. Sources of revenue for local budgets are set in the constitution:

1. wholly of partially distributed central shared taxes;
2. taxes of local government;
3. transfers made through inter-territorial clearing fund;
4. revenues accruing generated from their property and production;
5. the yield from credit operations.

Transfers from the state budget to the local government budgets provide resources for state expenditures. Transfers are aimed at equalization among regions.

Local bodies also receive special targeted transfers in order to ensure financing for minimum expenditures related to healthcare and education.

United States of America

The US financial management system is not very decentralized and offers high autonomy to the local governments. The States cover about three third of their expenditures from their own budgets. The states impose taxes, manage the state finances and have direct access to stock exchanges. The federal government does not review and approve budgets of individual states.

As for federal transfers and aid, the States depend more on the State aid than on federal grants. The financial relations among different levels of government are carried out in the following way:

- equalization schemes. Most of the states use schools financial equalization system, which subsidizes public schools.
- grants for global projects and federal grants. Grants for projects are issued on the basis of tenders announced by a federal agency (eg. Department of Education or Transport Department). The federal grants represent transfers to the states. Federal agencies request plans for the grant expenditure. There are totally 700 different grant programs in the USA.
- federal aid. Federal aid to states and other local government bodies consists of grants, loans and tax subsidies. Beneficiary spheres are transportation, education, social services, healthcare and etc.
- state aid. State aid is allocated to the local government bodies through equalization formula.

Canada

Canada is distinguished by the level of fiscal decentralization. All provinces in Canada enjoy huge tax and expenditure autonomy and the intervention of federal government in activities of local governments is minimal. Financial relations between the federal and local governments are regulated by Federal-Local Fiscal Arrangement Act. Different kinds of transfers are issued to provinces. Equalization, as the main transfer is defined in the constitution adopted in 1867.

Equalization transfer. This is a vertical transfer from federal government to local governments, calculated based on the income per capita in each province (British Colombia, Manitoba, Ontario, Quebec and Saskatchewan).

Healthcare and social protection transfer system. The system helps provinces in provision of healthcare, education and social services with cash as well as tax transfers.

Formula based territorial financing. This is federal government's unconditional transfer to governments of Northern territories, which helps the local governments in improving quality of its services.

Japan

There is a two-layer local government in Japan consisting of prefectures and municipalities. Although the local government is authorized to impose and collect taxes, the process is mainly centralized and revenue of local government significantly depends on the aid received from the central government. Revenues received from the local sources make up 35-40 % of the total local government revenues. The local government is authorized by law to issue bonds (obligations) in order to meet capital expenditure and the state owned enterprises' expenditure requirements. The municipalities coordinate the issue of bonds with prefectures that further coordinate it with the Ministry of Internal Affairs and Communications. Besides, the local governments receive direct grants and revenues from shared taxes from the central government. Grants issued to the local governments from the central government are classified as follows:

- Special target grants. The central government allocates to the local governments national treasury obligations, which are broken into three groups: 1. National obligations, that are designed for covering expenditures that must be incurred jointly by the central and local governments; 2. National treasury grants, which are allocated as subsidies to the local governments to meet expenditure needs; 3. Financial resources of national treasury, which are for meeting expenditure needs of central government.
- Shared taxes aimed at equalization. Revenues generated from the state taxes are redistributed in order to balance income of local governments. The local governments receive the following percentages of tax revenue: 32% of profit, income and alcohol indirect taxes, 24% of value added tax (VAT) and 25% of tobacco excise.
- Special targeted Shared taxes. These are the taxes collected by the central government part of which is allocated as transfers to the prefectures and municipalities. For example, the local road tax.

South Korea

The principles for the local government autonomy and structure are set out in the constitution. There is a two-level government in South Korea. The autonomy of local government financing legislature adopted in 1963 ensures the autonomy of local government budgets and authorizes the local governments to impose taxes.

Reduction and eradication of fiscal differences among the local governments is ensured by various intragovernmental transfers. For example, the total revenues of the metropolis of Seoul local government account for 94% of the total expenditures of the local government, and in more than 80% of local governments this share is less than 50%. Major share of the fiscal difference is covered by the central government transfers, including by the shared taxes and grants.

Below is the list of legislature regulating fiscal relations between the central and local governments:

- *Local Shared Tax Act.* Regulates the vertical shared tax system. It establishes the percentages for allocation of total state revenue to the local governments (15% in 2005 then increased to 18.3%). About 10/11 of local government income consists of transfers and 1/11 consists of special target transfers.
- *Local Shared Tax Act for Education.* This law establishes the fixed percentage of total tax revenue (13%) that goes to the local government to be invested in the education system.
- *National Treasury Subsidy Act.* National treasury subsidies represent grants allocated to local budgets for special projects. They are allocated for certain sectors in accordance with the national priorities, which are determined according to the annual analysis conducted by the local government.
- *Special Act for Regional Balanced Development.* This law was adopted in 2003 and the Regional Development Fund established by this law replaced Local Transfer Fund that was in place before. The Fund assists less developed regions.

The comparative analysis of fiscal decentralization for some countries is given below.

Comparative Analysis of Fiscal Decentralization by Some Countries

| Criteria | Turkey | Czech | Poland | Hungary |
|--|---|---|---------------------------|---|
| Approval of budget locally | It is not approved locally. General assemblies of provinces prepare draft budget and submit it to the ministry of internal affair for approval. The ministry approves budget in 30 days. | It is approved locally. Preparation of municipal budget is quite a long process. Draft budget is prepared by various offices of municipalities and then it is publicly discussed. The budget is approved by the council of municipalities. | | It is approved locally. Local budget preparation, review and approval procedures are regulated by the special legislation. |
| Control of local government on revenues | Not applicable. Local government controls only small share of taxes and fees. | Not applicable. Municipalities control only limited share of taxes (tax base and tax rates). | Exercises control. | Exercises control. |
| Intragovernmental transfer system | Main sources of resources for local governments are intragovernmental transfers, direct transfers as well as shared taxes. | | | An average indicator of available resources is set by the parliament each year. There are no unified rules in the sphere. The grant structure is quite complicated. |

| Criteria | Kazakhstan | Kyrgyzstan | Tajikistan | Armenia |
|-----------------------------------|--|--|-------------------------------|--|
| Approval of budget locally | It is approved locally. Local representational bodies (Mislikhati) approve the budgets at each level of self-governance (region, district, city). | It is not approved locally. Budget preparation and implementation is a hierarchical process (province-region-city). Local | It is adopted locally. | It is approved locally. Local budgets are approved within one month after the approval of the state budget. |

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| | | budgets are adopted locally only in villages. | | |
| Control of local government on revenues | Not applicable. Local governments receive only insignificant revenue from their own sources. Moreover, they have insignificant control over distribution of revenue among the local budget levels. | Not applicable. Local bodies control revenue only at village levels. Hierarchical control is exercised at other levels. | Not applicable. Revenue allocation and expenditure is controlled locally by a body representation the central government. | Not applicable. |
| Itragovernmental transfer system | Amount of transfers for local governments is determined by the Ministry of Finance each year. | Transfers are allocated by the central government hierarchically (province-region-city-village). | Local budgets receive grants on the basis of agreements between the local and central governments. | Local governments significantly depend on transfers. The transfer system is quite complicated. |

Sources:

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