FISCAL DECENTRALIZATION AND MUNICIPAL BUDGET POLICY IN COUNTRIES WITH ECONOMIES IN TRANSITION: COMPARING LOCAL REVENUE SYSTEMS

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(ABSTRACT)

The thesis explores the effect of fiscal decentralization on local governments budgeting and fiscal autonomy in selected transition countries of Central and Eastern Europe. The implications of legislative changes on local budgets and revenue authority are analyzed. Discrepancies between legal provisions and actual fiscal practices are identified on the basis of case studies of four countries: Bulgaria, Georgia, Hungary, and Lithuania. The study explores some specific approaches to dealing with local finances based on the respective countries' fiscal legislation. An attempt is made to evaluate local revenue authority based on both comparable statistical data and legal provisions of the selected countries. Following a comparative conceptual framework, the thesis reveals both unique and common patterns of budget policy and local revenue raising authority in each of the four countries.

The results of the inquiry indicate that despite the greater fiscal authority and independence which local authorities gained during the transition, local governments in many CEE countries continue to operate within old centralized fiscal structures and budget policies. The right balance between the need for decentralization of governance and the ability and desire of local authorities to control and steer the local revenue policies is still to be found.
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I. INTRODUCTION

Recent years have witnessed a worldwide movement towards administrative and fiscal decentralization in an effort to enhance democracy and governance. The institutional separation of local government structures and finances from those of the central state is considered among the more important prerequisites for the success of the political and administrative reforms in the former socialist countries (Bird, 1995).

The evolution of independent local government structures has clearly begun in the early 1990s in almost all ex-socialist countries of Central and Eastern Europe (CEE), but has not yet ended anywhere (Bird, Wallich, 1995). In Poland and Hungary, for example, local governments were established in their present form in 1990, in Romania, Bulgaria, and in the Russian Federation in 1991, in Albania in 1992, in Latvia, Lithuania and Estonia - in 1993. In most of these countries, the process continues and efforts are directed towards handling the new responsibilities by incorporating accountability, expenditure responsibility, and revenue raising authority (Zsamboki and Bell, 1997).

The introduction of centrally independent municipal budget laws in recent years in many CEE countries is considered a major step towards sorting out local financing and providing a basis for distinct municipal self-government. Although there are some variations in local government structures and policies among the ex-socialist countries, there are many common elements that arise from their similar starting point and the apparently similar problems they are facing in the transition period (Surazska and Blazek, 1996).

Recent research (Bird, 1995; Zsamboki and Bell, 1997) shows that fiscal problems of local governments have become a central concern of policymakers in many CEE countries. Despite the considerable degree of fiscal autonomy provided to local governments by newly designed financial laws, many of them face substantial difficulties in dealing with the new responsibilities. Statistical data provide evidence that under the new economic and legal conditions, local governments tend to cause even stronger pressure on central governments for meeting local expenditure needs. In many countries the inertia of the socialist intergovernmental relations is not yet overcome.

Due to their unique, although often also precarious financial position during the socialist regime, central governments were able to either ignore or compensate local budget deficits through extended central debt or external borrowing. In many of the CEE countries this type of policy lead to large central government deficits financed by expended domestic credits, external
borrowing, or both. Under the new economic and financial conditions of the transition to a market economy, the opportunities for further extension of both the internal and external debts have become extremely limited in most of the CEE countries. Thus the need for increasing and stabilizing local revenue sources has gained importance.

Research Statement and Objectives of the Study

The main purpose of the present thesis is to analyze the effect of decentralization on budgeting and fiscal autonomy in the local governments of four ex-socialist CEE countries: Bulgaria, Hungary, Lithuania and Georgia. Consistent with this purpose, the study is guided by several research objectives. One of them is to explore the legislative changes in the sphere of public finance and their implications for municipal budgeting. Current discrepancies between legal provisions and actual practices are to be identified as well. An attempt is also made to discern the major factors determining the similarities and differences in the revenue systems of transition countries. Special attention is devoted to local budget and finance laws adopted after 1990 in the selected countries. The legal provisions for local revenue policies are examined in the light of the countries' specific social, economic and political aspects of development.

Background and Rationale for the Study

The ongoing transition from centrally planned to market economy in the CEE countries has already proved the predictions of some experts that this will be a complex and rather lengthy process and that at every stage of it, intergovernmental fiscal policies will be a major concern of policy makers (OECD, 1994).

The extensive political and economic changes in the early 1990s in the ex-socialist countries of Central and Eastern Europe were followed by rapid changes in the legal framework concerning state and local government policy. A guarantee for local autonomy and local self-government as major prerequisites for democratic development, was enshrined in newly passed laws in many of the transition countries. Local authorities were given general responsibilities for public services, new property rights, and the right of self-government through elected representatives (Zsamboki and Bell, 1997).

Although the principles of democracy were easily put down on paper, the process of turning the general rules into detailed provisions proved to be much more difficult than expected, and by far not yet accomplished in many of the CEE countries. Efforts to achieve effective administrative and legal solutions have already taken years and continue (Elander, 1997).
Many CEE countries started their ambitious large-scale economic and political reform with the adoption of new administrative laws providing for democratic governance, local government administrative authority and local fiscal autonomy. These laws were elaborated in compliance with the basic principles of democracy promoted by the European Charter on Local Self-Government. Some of these principles directly address local finances and local authorities’ fiscal policies:\(^1\)

1. *Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.*

2. *Local authorities’ financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.*

3. *At least part of the financial resources shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.*

4. *The financial systems, on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.* (Article 9 – Financial resources of local authorities: European Charter of Local Self-Government, 1988)

Although many CEE countries have already incorporated the above principles in their respective national laws on local self-government, state and local finances, very few of them have yet managed to provide real mandates and financial autonomy to the local authorities. Local governments in CEE Europe still lack administrative flexibility and fiscal stability that would permit them to establish their own priorities and fiscal policies beyond those prescribed and delegated by central authorities (Mitchneck, 1996).

While new national budget laws in most of the countries envisage decentralization of fiscal policy including shift of service provision and spending responsibilities to the local level, few of them provide the necessary financial autonomy and revenue authority to local governments to fulfill those central mandates. This discrepancy between legal provisions for fiscal autonomy and actual conditions for its practical application is further deepened by the fact that many central governments still prefer to maintain control over major local taxes and other local revenue sources. So, while the breadth of spending responsibilities assigned to local governments is

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\(^1\) The Charter of Local Self-Government, a landmark international treaty, open for signature in 1988, applies only to states that have ratified it. However, its principles have been widely accepted as the European standard on local government autonomy and democracy.
notable and includes many spending areas that have not been local responsibilities before (such as public education, health care, and other public services), the necessary revenue raising authority for financing those services is still missing. Thus, with the local governments kept on a tight fiscal leash, the autonomy provided for in the new laws seems to be more symbolic rather than real (Bird, Wallich, 1995).

Statistical data and research studies carried in several CEE countries indicate that despite legislative changes, central grants to local governments and respective transfer systems also remain *ad hoc* and often, instead of providing for fiscal equalization, they are counter-equalizing. Lack of local fiscal discretion, imprecisely defined spending responsibility, vague accountability requirements, as well as a general absence of revenue autonomy and authority to set local tax rates were and still are characteristics of local governments in the ex-socialist countries (Surazska, Blazek, 1997).

**Scope and Limitations of the Study**

Set in the context of post-communist restructuring of intergovernmental relations in the countries of Central and Eastern Europe, this study elucidates the specific response of four ex-socialist countries, Bulgaria, Georgia, Hungary, and Lithuania, to these market economy changes and the subsequent implications for their local governments’ fiscal policies. Despite the similar trajectories of economic and social changes in the ex-socialist countries, each of them has developed a specific strategy for dealing with the increased financial constraints and the pressing need for greater local revenue raising authority.

This study explores some specific approaches in dealing with local finances based on the respective country's fiscal legislation and municipal budget laws. It is also an attempt to link available statistical data to the legal bases of local government revenue systems in the selected countries. The research is limited to municipal governments only. It is noted that in many of the CEE countries the municipal government is the only local government, thus regions, towns and villages will not be a primary focus and will be referred to only as local governments in the context of intergovernmental fiscal relations and financial transfers where appropriate.

Following a comparative conceptual framework, the thesis addresses two specific local-government fiscal issues. First, the legal bases and the actual parameters of the newly assigned fiscal autonomy for local governments in transition countries are explored. Second, the study tries to identify common patterns of local revenue systems and revenue raising authority in the selected countries as major prerequisites for (exercising) local fiscal autonomy.
The research problems and their foundations are developed and analyzed on the basis of:

- official demographic, economic and social data for each country;
- comparative study of the four countries' laws providing for local fiscal autonomy and local self-government;
- detailed analysis of the legal provisions for municipal revenues and revenue raising authority in the selected countries; and,
- exploration of local government revenue structures and revenue raising patterns in the four countries from 1989 through 1997.

Data Sources

As already stated above, the thesis focuses on two specific areas of local government finance in selected countries with transitional economies. The study uses data that are drawn from different sources, the main of them being the respective countries' municipal budget laws, local government laws, as well as official statistics of the International Monetary Fund (IMF) and the World Bank (WB). It is also noted that the scarcity of data on local government finances, as well as their questionable reliability and comparability when available, present a major constraint in studying local finances in the CEE countries.

To gain a better understanding of the uniqueness or typicality of the fiscal problems faced by the transition countries in CEE, I often refer to studies on similar problems in developing and developed countries - mainly the USA and the member countries of the Organization for Economic Cooperation and Development (OECD). To support my claims, I also rely on the results of a number of cross-national and single countries' studies in Central and Eastern Europe carried out at different stages of the transition period.

This study employs fiscal concepts and categories in accordance either to official international classifications (where applicable) or as defined in related literature and previous studies. A thesaurus is constructed for some specific financial terminology and the way it has been used in the thesis.
Organization of the Thesis and Chapter Outline

In order to define the parameters of fiscal decentralization and their effect on local revenue systems in selected Central and East European countries, I have based my analysis on in-depth case studies of each country's local fiscal policies. A comparative trans-national analysis of specific issues consistent with the purpose and the research objectives of the thesis follows the individual case studies. An attempt at generalizing the results is provided as well. The analysis reveals both the processes that are due to the specific geographic, historical and economic characteristics of each country and those resulting from the common purpose and logic of the transition period in Central and Eastern Europe.

The thesis is organized in five chapters. Following the introductory chapter, which highlights the background, purpose and research objectives of the thesis, Chapter two offers an extended literature review of the basic concepts and issues applied in the study.

The methodology used in the thesis is discussed in the third chapter. It includes the rationale for choosing the specific research design, the shortcomings of the data, and other limitations of the study. A literature review of both the advantages and the shortcomings of the research methods used in the study is offered within this chapter. The chapter also provides the basic arguments for the selection of the particular countries and places each of them in a specific group from the point of view of different geographic, historical, macroeconomic and foreign-policy criteria.

Case studies of the fiscal decentralization processes in each country and their effect on the local budgeting and local revenue systems are reviewed in the fourth chapter. This chapter includes descriptive statistics as well as comparative tables and graphs from the data analysis. The chapter concludes with a comparative inter-country analysis revealing the common and specific problems experienced by each one during the transition period.

Chapter five summarizes the main trends identified across the countries and relates them to major theoretical paradigms of the processes and specific characteristics of the transition period. It offers some reflections on the extent to which the actual outcomes are a result of the logic of the transition process or represent the consequences of country-specific policies. The chapter concludes with an interpretation of the main findings and suggestions for future research.
II. LITERATURE REVIEW

Both, individual researchers and institutions like the WB, the IMF, the Council of Europe (CE) and the European Union (EU) have conducted studies on fiscal problems of the transition period in Central and Eastern Europe including changes in local government's responsibilities for local finances. However, scant research has been done so far on the discrepancies between legal provisions and actual practices in the sphere of local finances.

The development of the European ex-socialist countries during the last ten years - the so called "transition period" - presents enough evidence about the considerable variance between the constitutional and legal authority given to local governments and what occurs in actual practice. According to Richard Bird (1994), two main facts may account for this discrepancy. In some cases, it is the result of constitutional or national laws that are simply beyond the fiscal or administrative capabilities of local governments to implement. In other cases, it may simply be the result of a deliberate policy decision of a central government not to vigorously enforce the laws and regulations of previous or current administrations. While some of these issues are only briefly mentioned or referred to in relation to other country-specific problems in single studies, no particular research has been done on them.

Since one of the purposes of the present thesis is to elucidate the effect of fiscal decentralization on local fiscal autonomy and municipal budgeting, an extensive literature review is made on existing theories and research findings about these major concepts and processes. The literature review is structured according to the major concepts employed in the present study.

Theoretical Framework for Analyzing Public Budgeting

Much of the research and scholarly literature on public budgeting for state and local governments emanates from the United States, where in the 1960's "incrementalism" became the dominant theory of budgeting. Based on the work of Wildavsky (1964), Steiss (1972), Caiden (1974) and others, budget processes were seen as stable, predictable, changing little from year to year, based on well defined roles and decision rules. The growing comparative literature on budgeting was strongly influenced by this theory. A number of studies have dealt with incremental budgeting in other European democracies, in OECD countries, and in developing countries (Feldheim and Javeau 1972; Cowart, Hansen and Brofoss, 1975). During the late 1970s and 1980s incrementalism was seriously challenged as a theory of budgeting (LeLoup, Diez, 1998) because of the narrowness of its analytical focus and changes in the environment and
processes of budgeting. Given the magnitude of the changes in the CEE countries since 1989, public budgeting there can be defined as anything but incremental.

However, later works of Caiden (1981), Carr (1984), and Wildavsky (1986), developing a comparative theory of budgeting, provide a more appropriate theoretical basis for analyzing budgeting policies and practices in the CEE countries with economies in transition. Some of their hypotheses about budgeting in poor countries are partly adaptable to the situation in the CEE nations, even though their research had no reference to socialist countries. For the purpose of the present research it is worth noticing that transition countries have a very specific place in economic and financial classifications. They have never been considered either developed or developing but their economic and financial development has always been closer to that of the developing countries. When the above mentioned experts analyze the relationships between predictability and wealth, between uncertainty and repetitive budgeting, a lot of their findings are applicable to the processes that are currently taking place in the CEE region. Utilizing some of those variables to develop hypotheses applicable to the CEE countries, LeLoup and Diez (1998) formulated following expectations and hypothesized outcomes:

- the rapid transition from command to market economy in itself would reduce predictability in budgeting and the short-term reductions in wealth would tend to increase uncertainty;
- as uncertainty increases, repetitive budgeting - the need to frequently readdress and revise spending decisions - would also be likely to increase; and,
- a political culture of socialism cultivated over a period of 45 years and based on centralized resource allocation, artificially low prices, and only limited taxes on individuals, would make it more difficult to adapt new budgeting policies, particularly in the short term.

Straussman (1996) also points out the importance of political culture by referring to the "general case" of finance culture which indicates that "textbook-like prescriptions" need to accommodate the realities of history, particularly those of more than four decades of a command socialist economy.

Institutional Aspects of Fiscal Decentralization

While there is already a body of literature on the political and administrative aspects of decentralization processes during the transition period, the budgetary and fiscal aspects are less studied. Literature on budgetary developments and trends in the CEE region started to emerge after 1993. In a study on budgetary issues in the Czech and Slovak republics, Naomi Caiden
(1993) found that budgetary processes there were beginning to take on the rudimentary characteristics of those found in more developed democracies. Bird, Ebel and Wallich did the first extensive research on fiscal decentralization processes in 1994 in a number of CEE countries: Bulgaria, Hungary, Rumania, Russia, and Ukraine. It was the first attempt at comparing political, administrative and financial reforms in the CEE countries. Vanagunas (1995) has done some research on Lithuania which revealed that the previous command system not only disadvantaged national policymakers, but provided little budgetary expertise at the local level. Straussman and Fabian (1995) have described and analyzed disparities and problems of local government finance in Hungary. In another study carried in 1996, Straussman distinguishes a number of institutional changes taking place in the CEE countries since 1989, such as the strengthening of finance ministries, diversification of revenue sources, and proper classification of outlays. According to Straussman some of these changes are still slow and the rate of "fiscal learning" varies significantly among countries.

LeLoup, Diez and Hogye (1998) place special attention on the importance of budgetary and political institutions for achieving a country's macro- and micro-level objectives while maintaining legitimacy and satisfying the domestic constituencies and their needs. They argue that outdated budgetary institutions which have not adapted quickly enough, are fragmented and lack accountability and control mechanisms, and obstruct efforts to implement major budgetary changes. Conversely, strong political institutions that enhance policy-making can assist a government in making major policy changes. This refers with special importance to the new role of local governments and their administration in the CEE countries.

Many CEE countries have a multi-level government system that is composed of a central government, intermediate government (that may or may not have a sovereign position as regard fiscal matters) and local governments. When dealing with problems of fiscal decentralization, most studies, for the purpose of measuring decentralization, usually bifurcate all government units into local or subnational versus central government. Official statistical data also refer only to aggregated data for central and local governments.

In many developed European countries, such as Belgium, the Netherlands, Spain, and France, fiscal decentralization has been stimulated in the name of "new federalism" (Owens and Norregard, 1991), but in the transition countries of CEE Europe major institutional reforms have been pursued with the explicit purposes of either broadening the economic and social functions of local government or reducing fiscal deficits (Bahl, Wallich, 1994).

Researchers commonly ascertain the merits of fiscal decentralization both in political and economic terms (Bird 1994, Bahl 1999). One of its most important functions is seen in its
potential for improving the efficiency of local government by subjecting its actions to the scrutiny of the local electorate. According to Shah (1994), for example, decentralization should be the rule, unless a strong case can be made for centralizing specific responsibilities. Local public services can be provided more efficiently if expenditures more closely match local needs and preferences of the population. More closely linking benefits to costs promotes greater accountability. Increased fiscal autonomy can also help mobilize more revenue from local sources and improve a local government's fiscal position (Shah, 1994).

Unfortunately, central governments in many transitional countries appear to accept fiscal decentralization as an opportunity to reduce central expenditures. There are two possible ways in which they avail themselves of that opportunity: by "spinning off" expenditure responsibilities to the local level and by reducing fiscal transfers with the purpose of making local governments more 'independent' but reducing at the same time central outlays. Bird and Wallich (1994) convey a warning that a strategy for devolving expenditures downward while cutting back on transfers is unlikely to prove successful for long, especially if the revenue raising ability at the local level does not change considerably.

**Fiscal Roles and Responsibilities of Local Governments in a Decentralized System**

Traditional analysis of intergovernmental finance in developed countries with established market economies examines the fiscal functions of local governments in terms of their respective roles and responsibilities for stabilization, income distribution, expenditure provision, revenue raising authority, and the design of appropriate transfer system.

R. Bird and C. Wallich (1994) distinguish three main aspects in which local government roles, responsibilities, and economic functions in transition countries differ from those in developed countries. First, local governments in transitional economies have a major role as potential supporters of, or impediments to, privatization. Moreover, the assets conferred to them in the decentralization process represent a potential source of revenue (or in some instances, loss).

Second, the traditional approach ignores the shrinking role of government. In the socialist system, governments used to play the role of a major investor in the economy, which led to additional expenditure burdens to the budget - not only subsidies but also direct investments, inventory finance and wages, which in a market economy are not a responsibility of the central government. A major problem facing many transitional countries is the decline of government revenue, a decline which is more rapid than governments' ability to divest themselves of these expenditures. As a result, a common response is discernable in many countries, namely the attempt to shift the deficit downwards by making local governments responsible for more
expenditures, while simultaneously reducing central transfers and grants. Many authors view this policy approach as unsustainable for a longer period of time (Bahl and Linn, 1992; Bird and Wallich, 1995; Suraszka and Blazek, 1997).

Third, although the present role of local governments regarding social services varies from country to country, considerable problems appear in most of them. The reason is in the combined effect of a weakened central government's capacity to maintain social protection and a growing local governments' need for central financial assistance. As revenue sources assigned to local governments in many of the ex-socialist countries are insufficient to finance newly assigned local services, a paradoxical but unsurprising effect of the fiscal decentralization appears to be the increased demand for intergovernmental transfers.

**Impact of Fiscal Decentralization on Local Self-Government**

The trend of government decentralization observed over the last decade in many nations around the world has occurred in the CEE countries in the very first years of their transition period to a market economy. Proponents of local autonomy claim that government authority should be shifted closer to the people. This transfer of authority from the central to the subnational governments has, to some extent, gained a reputation as the "cure all" for a variety of political and economic problems (Shin, 1998).

In theory, decentralization may be used by central governments to cut deficits and reduce public sector spending by exporting these costs to subnational governments while only partially compensating the local authorities for the costs of new spending responsibilities. Furthermore, it can guarantee more effective citizen participation in civic life and higher standards of public accountability. Yet, decentralization initiatives that focus primarily on electoral issues and administrative processes without considering the fiscal and institutional dimensions cannot be sustainable. The ratio between decentralization of fiscal support mechanisms and government responsibilities is among the most important and most complex issue that transition countries need to address during this process (Shin, 1998).

The ongoing debate over fiscal decentralization in CEE is important because a fundamental problem in harnessing political accountability at the local level lies in the general attitude about the proper functioning and responsibilities of local governments. The central issue, the role of different levels of government in providing services and in undertaking development tasks, is the question that most CEE countries now tackle. It is subjected to dual forces that advocate both decentralization of political authority and deconcentration of administrative authority. In other words, the process of decentralization involves two dimensions. First, it is the
deconcentration process that requires delegation of administrative authority to the local level. Second, it is the devolution process, which entails the assignment of decision-making authority to local governments.

According to Shin (1998), local government's authority in implementation of certain fiscal policies can be measured by the scope of both the legal jurisdiction and its involvement in the enforcing process. It is important to know whether and to what extent the government decision-making system is centralized or decentralized, which government jurisdictions are responsible for the design and the implementation of municipal budget laws in order to judge the outcomes of certain local fiscal policies.

Local Fiscal Autonomy

A number of studies imply that fiscal autonomy is best indicated by the portion of own-source funding (the so called "self-reliance rate") of local governments (Carr, 1984; Le Loup, 1988; Goetz and Margetts, 1996).

Research in the field indicates that fiscal decentralization enhances local autonomy (Shah, 1998; Bahl, 1999). But local autonomy requires that local governments be allowed to act independently within their own sphere of competence, and with a careful consideration of both spending and revenue requirements. On the spending side, a local government that collects more money from own resources may have greater discretion in conducting its functions. In other words, a higher self-reliance rate helps to promote local fiscal autonomy (Shah, 1994).

These arguments suggest that the sound practice of local fiscal autonomy requires a balance between revenue and spending. There are two reasons. First, by decentralizing financial resources in accordance with local spending requirements, the central government can induce local jurisdictions to make more responsible local decisions. Second, if a local government finances a substantial portion of its budget through own source revenues, it will be able to make more efficient and independent spending decisions (Shah, 1994).

The question arises as to how different governments perceive the role of separate and independent local (municipal) budgets in addressing local needs? Separate municipal budgets can be interpreted as evidence that the central government has accepted the obligation to protect municipal rights on self-government and fiscal autonomy. Bird and Wallich (1994) criticize the common misinterpretation of the principle of "budgetary independence" in transition countries. In general, this principle implies financial self-sufficiency and independence of local governments and diminishes the need of central transfers. Despite fiscal difficulties at the national level in most of the ex-socialist countries, central transfers to local governments remain very large and even
appear to be increasing. In 1993 the structure of local government finance in several CEE countries is as shown in the following Table 1.:

Table 1. Shares of local government revenues across CEE countries

<table>
<thead>
<tr>
<th>Type of revenue</th>
<th>Hungary</th>
<th>Poland</th>
<th>Romania</th>
<th>Bulgaria</th>
<th>Czech Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own resources (%)</td>
<td>18</td>
<td>50</td>
<td>25</td>
<td>4.4</td>
<td>9</td>
</tr>
<tr>
<td>Shared Tax (%)</td>
<td>13</td>
<td>25</td>
<td>0</td>
<td>49.4</td>
<td>6</td>
</tr>
<tr>
<td>Total Local Resources (%)</td>
<td>31</td>
<td>75</td>
<td>25</td>
<td>53.8</td>
<td>15</td>
</tr>
<tr>
<td>Transfers from central government</td>
<td>68.5</td>
<td>25</td>
<td>75</td>
<td>46.2</td>
<td>85</td>
</tr>
</tbody>
</table>


Most of the discussions on decentralization processes in CEE countries originate in the discrepancies that exist between the theoretical postulates and the declared intentions of central governments on the one hand, and the practical assignment of functions to local authorities under the conditions of severe fiscal constraints, on the other.

The obvious need for greater flexibility in the rapidly changing and uncertain environment of the transition period still tempts many central governments to preserve a certain degree of freedom by continuing with a negotiated transfer and tax sharing systems of the past (Bird and Wallich, 1994). Bird and Wallich imply the necessity of replacing the popular "bargained" approach with an intergovernmental fiscal framework of transfers, that is both firm enough to serve as a basis for action and flexible enough to be compatible with the on-going structural changes and reform.

Public Revenue Systems

Revenue adequacy and balanced revenue-expenditure systems of local governments are problems addressed in many studies on local fiscal autonomy. Experts consider them a major prerequisite for the stability of local governments' financial systems.

McLain (1984) analyzes some policies for balancing municipal budgets that have already been applied in other developed and some developing countries. He draws the attention of the policy makers to the fact that the choice of a particular approach should be based on the specific problems facing a country's central and local governments. The chosen policy also should be in
compliance with the country's legislation. The practice in developed countries has shown, however, that reality often requires the combination of two or even more of the following efforts and approaches. (Mc Lain, Jr., 1984):

1. **Revenue increases**: Raising local revenues is one of the major avenues for solving the budget dilemma of local governments. This can be achieved either through a straightforward tax increase or through a combination of all reasonable revenue sources;

2. **Expenditure cuts**: This step usually accounts for a modest spending reduction necessary as an earnest budget constraint effort and helpful for minor balancing problems, but seldom resolves large funding discrepancies;

3. **Reduction of services**: The reduction may be either in the variety of services or in the quantity and level of particular services offered. It may lead to budgetary savings, although major service reductions are seldom accomplished because of the potential controversy associated with them. Such reductions are usually temporary because the public eventually demands restoration;

4. **Elimination of services**: A government rarely completely eliminates a service, although such action might facilitate the most significant possible decrease in budget spending;

5. **Improved productivity and efficiency**: Finding ways to provide more or better services with the same or less money. Productivity improvements can be hard to measure. This approach requires a considerable amount of time to identify, evaluate and implement; and,

6. **Shift of the expenditure burden**: The benefit of this budgeting solution is limited and usually controversial. This approach is exemplified in two forms. The first is by shifting payment responsibilities for a service to a particular group of people or government entity. The second is by asking another governmental entity to perform the service and of course to pay for it.

These solutions encompass some of the available balancing approaches as well as the generally accepted understanding of resource allocation as the essence of municipal budgeting. Similar approaches have been discussed by a number of other experts in an attempt to find the best solutions for overcoming local fiscal gaps. The issue is especially important in the light of the fiscal problems faced by the new democratic governments in CEE. Based on his research in some countries with economies in transition, Roy Bahl (1992) ascertains that it is particularly important for local governments in reforming economies to have an adequate revenue base, no matter whether it comes mainly from their own taxes, from shared taxes or from central transfers. Otherwise, they may turn to "economically undesirable sources of revenue, such as profits from direct public ownership of local businesses." At the same time, Bahl warns against the temptation of giving local governments only minor tax shares on a wide range of locally based property and activities. Bahl implies that local governments need an adequate and flexible revenue base, one
that automatically grows in step with incomes and spending needs. But neither the existing literature nor the actual practice has provided an eloquent answer to the question: how do we define "adequate"? If demand for government services and the cost of providing them increase roughly in proportion with a country's GDP or income, a revenue-GDP elasticity would maintain that relationship. The aim of the government then would be to design a local revenue system whose base would increase along with GDP.

Generating enough money to provide, maintain, and expand essential services is a challenge to every local government. Local governments in transition countries are facing considerable difficulties in raising sufficient resources. Given the economic and financial problems of the transition period a basic reform and a diversified portfolio of revenue sources are needed for continued provision of vital public services. Clifford McCue (1996) defines three possible options for local governments' revenue increase:

- development of new revenue sources;
- broadening of the existing sources through rate increases; and,
- increase of central transfers.

Comparing Revenue Systems

Based on a comparative study of the revenue systems of OECD member countries in the early 1990s, Spindler and Ward identify some major difficulties in comparing revenue systems across countries. They argue that one inherent problem in any cross-national comparison of public revenue systems is the variation in each country's historical and political base. Each revenue system is influenced by a unique combination of taxation, fiscal, and expenditure policies based on historical precedence and politics, and is further impacted by broad economic trends. The result is a continual evolution and change in revenue systems, which makes synopsis rather difficult (Spindler and Ward, 1997).

A second complication in comparing revenue systems, according to Spindler and Ward, arises from differences in utilization of particular revenues. An example is provided with different non-tax revenue sources and their use. Some governments own and operate public utilities such as water, electric power, and telephone enterprises which support government expenditure and offset taxes, while other countries must rely more heavily on tax revenues for services. As a result, countries may differ in the use of taxes compared to the use of fees or sale of government services. These differences ultimately impact the types and levels of taxes utilized in a particular revenue system. Such objective difficulties imply the need of establishing an appropriate basis for comparison according to the purpose of any particular study. Spindler and Ward suggest the use
of some ratios as a comparative framework for studying local governments’ revenue systems. These include among others:

- the ratio of total taxes to gross domestic product (taxes/GDP);
- the ratio of total taxes to population (taxes per capita); and,
- the ratio of each tax to total taxes collected (tax ratio).

Such ratios permit analysis of aggregated data, as well as comparisons between individual countries and levels of government.

**Summary**

The literature review indicates that in the complex field of public finances, the degree of fiscal autonomy and discretion provided to local government, *vis-à-vis* the national authority has been regarded as the most important issue of local government finance. Granting more administrative and fiscal discretion to lower hierarchical levels of government is an integral part of the public management system of each country. In the context of the CEE countries, the issue of granting of authority to local governments to make decisions on matters which affect them, and the implications of the decentralization processes for central and local management bodies, are of principle interest.

The literature review also has elucidated some fiscal policies for dealing with financial dilemmas at the local level, as well as creative approaches and techniques for revenue raising and additional income generation. While most of the analyses and conclusions of the cited experts are based on objective research findings and refer to either developed or developing countries, they may not be directly applicable to the CEE countries due to already explained specifics. Both the positive and negative experience on the road toward achieving greater local fiscal autonomy, however, should be taken into consideration in designing new fiscal policies for those countries. A key concern should be how to adjust inter-governmental relations so that the national objectives for the public sector as a whole are not compromised. Reality shows that there are always trade-offs between allowing more discretion to the lower levels of government and maintaining a steering capacity at the higher level. The benefits of more autonomy for local governments need to be carefully weighed against the risks to national goals, and the potential costs to the system of governance as a whole.
III. METHODOLOGY

The thesis has an exploratory and descriptive character employing several qualitative research methods. Due to the paucity and problematic nature of available data this study cannot meet the traditional empirical requirements for examining causality or testing hypotheses. For that reason it applies the method of verification which underscores qualitative research as a distinct approach and a legitimate mode of inquiry. The study also meets the main criteria for judging quality and assuring the credibility of the research by employing the concepts of trustworthiness and authenticity, and fulfils the conditions for them as defined by Lincoln and Guba (1985), namely:

- **credibility**: the research is based on primary documents and their analysis, on official statistical data, as well as on the results of previous research;
- **transferability**: the selection criteria for the case studies provide to a great extent opportunities for generalizing the conclusions as regard specific groups of countries;
- **confirmability**: available data and information are analyzed at multiple levels of abstraction. Triangulation is also applied for convergence of information and for justification of the conclusions.

To meet the stated goals and objectives, this study employs the following methodological approaches.

First, a case study methodology is used to identify the trends in local budget policies and the degree of success in implementing local budget laws in selected ex-socialist countries during their transition to a market economy. Although this transition period continues, for purposes of consistency and comparability of results, the study focuses on the years from the beginning of the large-scale political and economic reform in the early 1990s through 1997.

Traditional studies of the variation in budgetary practices between countries emphasize quantitative modeling and statistical testing of a broad range of social and economic data that assume predictable regularities and preliminary hypothesized outcomes. The present study cannot apply the traditional empirical approaches for studying local budget policies and practices for a number of reasons. Some of the more important reasons are:

- lack of sufficient comparative statistical data for the transitional period within each country and among the CEE countries due to the constant changes in currency's rates;
- questionable reliability of available data (not included in international statistical books);
- lack of transparency of budgetary accounting procedures, and last but not least
• growing importance of non-quantifiable political and social factors in the formation of the local administrative and fiscal policies.

The latter two points suggest that even if data could be collected, the reliability and significance of any statistical analysis would be problematic.

Second, a qualitative framework guides the analysis of local budget and financial laws and the related local government legislation. This approach is based on the view that political, economic and regional characteristics influence and shape local government policies and budgeting processes. The linkage between national and local policies and the general conditions associated with the transition to a market economy (e.g., privatization, political stability, international integration) contribute to explaining the formation of specific local government institutions, local fiscal policy, and local budget legislation (Mitchneck, 1997).

Another basic method of analysis used in the study is the cross-national comparison. This approach is widely used for comparing specific policies and issues of countries with similar political and economic development characteristics. One of the major advantages of cross-national comparison is that it provides opportunities for the researcher to get a deeper insight into the total context of a problem and compare the influence of a considerable number of interactive and interdependent factors on it. (Cseh-Szombathy, 1985).

In a study on fiscal decentralization in Central and Eastern Europe, Richard Bird points out the growing importance of local government finance in transition countries. According to him, local finance is no longer a local matter, and the ongoing reforms in sub-national finance in these countries are more important than is generally recognized. (Bird, 1993) Based on studies carried out in several CEE countries, Bird concludes that intergovernmental problems in transition economies are very different from those in market economies but very similar to each other. This statement supports the present study in justifying the choice of cross-national comparison as a major research method.

Content analysis will be applied in the study to local budget laws, legal documents, and regulations. Since each country has a different set of laws regulating local finances, additional effort will be put in constructing a framework (taxonomy) to allow a comparative approach. Local budget policies will be analyzed both as an evolutionary process within the market-oriented reform and as a stage of development. For this purpose the study will employ also some of the strategies of process analysis. The rationale behind this approach is to compare and analyze CEE local governments’ fiscal policy changes during the transition period. The analytical approach to the process of financial policy development is preconditioned by the fact that these policies are in
a constant state of flux in an endless attempt to keep pace with pressures created by political, social, and economic changes.

**Literature Review**

In addition to detailing the literature on theoretical considerations and aspects of the germane subject matter, that is local government finances and revenue authority, it is important to shed light on different conceptions about the advantages and disadvantages of the methodological approaches used in the thesis. The discussion of case study methodology and comparative case analysis takes place in the following section. The brief review of the literature on these topics is intended to show some of the advantages and the preferred areas of application of case studies and comparative cross-national analysis.

**Case Study Methodology**

Eleanor Chelimsky provides a comparatively synthesized definition of case studies, in an attempt to include both the variety and complexity pertinent to the case study methodology: "A case study is a method for learning about a complex instance, based on a comprehensive understanding obtained by extensive description and analysis of that instance taken as a whole in its context." (1990, p.4) Chelimsky also explains some of the most common advantages in applying a case study methodology. The case study is a special systematic way of looking at what is happening, of selecting the instances, collecting the data, analyzing the information, and reporting the results. Chelimsky ascertains that a good case study has features that may confer special benefits to the research. According to her, the instance selection is crucial to generalizability and to answering the research questions appropriately. There are three general bases for selecting instances: convenience, purpose, and probability. While convenience and probability are only rarely feasible, instance selection on the basis of the purpose of the study is the most appropriate method in many designs. Chelimsky makes also a claim that despite the conventional wisdom about the subjectivity and nongeneralizability of case studies, there are certain steps that can be taken to generalize from case studies when this is desired (Chelimsky, 1990)

Another proponent of the case-study methodology, Robert Y.Yin (1989), provides an excellent outline for use in conducting case studies. Yin's work argues that the case study's object should be both descriptive and explanatory. He notes that the case study is "a frequent mode of thesis and dissertation" in the traditional social science and practice-oriented fields and
disciplines (1989, 10). Yin asserts that "in general, case studies are the preferred strategy when 'how' or 'why' questions are being posed, when the investigator has little control over events, and when the focus is on a contemporary phenomenon within some real life context" (1989, 13).

Bryon Jones states that "best practitioners of the art of the case study use them both to examine the potential of theoretical propositions and to discover and explore the relevance of underappreciated factors in the process of governance" (1995, p. 35). Jones' admonition is that the researcher "ought to go on and show how decision-making is colored by context" (1995, p. 35).

The case study methodology is not without shortcomings. Yin points to some of the weaknesses, such as a lack of rigor in some case study research due to sloppy work and bias, the typical attempt for generalization based on a single case, lengthy, and not seldom - massive and unreadable documents. But he also believes in the good results that a well-done case study may produce.

It is desirable that a case study be more than descriptive and that it lead to generalizations or testing of theories and eventually to hypothesizing. The comparative case study is the basic vehicle to test replicability rather than simply to assert it based on generalizations from a single case. Multi-case studies lend credibility to patterns by providing matches in different environment (Jones, 1995).

**Cross-national comparative analysis**

The present thesis is based on the case study methodology but it is also comparative. As Yin points out (1989,53), for case studies' results to be "generalizable, transferable, and replicable," organized data gathering and pattern matching are strongly required. Yin also claims that replicability can be built into case studies through the use of multiple cases, where each case is selected to produce either similar results (literal replication) or contrary results but for predictable reasons (theoretical replication) (Yin 1989, p. 53).

The purpose of the present study's replication, for example, is to search for literal replications. According to Jacob, Herbert and Vine (1971) the comparative method is fundamentally simple and comparative analysis is usually used to discover patterns of association or causation. As used in this study, replication does not mean that all cases are the same, but rather that a common methodology is used to discover patterns, which are replicated among specific groups of CEE countries in a cause and effect relationship.
Even before policy research acquired the vogue it enjoys today, comparativists were beginning to ask how could cross-national comparisons among local government structures and diverse patterns of local politics be done (Ashford, 1975).

Literature and research since the late 1970s show that the possibilities for combining national governments’ concerns with policy and performance at the local level have been strongly supported by the enhanced understanding of local level politics and have thus offered exciting opportunities for qualitative comparative research.

Back in 1975, Douglas Ashford has outlined some of the advantages and disadvantages of cross-national comparative inquiry concerning local politics and policy. He devoted considerable attention to "subnational complexities" and the national linkages to local governments. His basic assumption is that local government and local administration have become a "respectable area" of political inquiry and the attention to sub-national problems and structures is growing. The basic question he poses in his theoretical research is "how can we better utilize local level studies to understand national politics?" According to him, "localities have an effect on the political system of a country but extracting what this effect is depends on renewed emphasis on comparison" (1975, p.67). Ashford is strongly convinced that only through a cross-national comparison one can penetrate the many ambiguities and confusions in theoretical writing about local government.

A basic methodology for such comparison has been outlined by Teune and Ostrowsky. They are claiming that it is important to know whether local decisions and behavior (the dependent variable) account for differences among the localities themselves or for differences in the system's relationship to localities. They also argue that if the local political units are components of a larger system, then the level of generalization must be shifted. The alternatives can be evaluated only if there are criteria, and procedures for applying them, determining whether the local units are themselves systems or components of systems (Teune and Ostrowski cited in Ashford, 1974).

In other words, the individual case studies are important for they alert those comparisons within nations and across nations to variables that might otherwise be ignored, but they do not contribute directly to the comparative theory. They are not designed to help separate what is "local" from what is "national" for any given country, simply because no concept of this kind can be defined without comparing several nations (Ashford, 1995 p.135).

Hantaris, Steen, and Mangen (1996) draw attention to some additional advantages of cross-national research, namely:
• the opportunity for deeper understanding of issues and processes that are a common concern in countries belonging to similar economic, geographic or ethnic groups;
• comparability of policies and processes with the purpose of discerning problems that can hardly be identified as such when analyzing a single country or case; and,
• higher availability of research conditions and prerequisites for grounded analysis and trustworthiness of the conclusions.

A summary of the above-cited claims shows that the methodology of comparative inquiry provides opportunities for dealing with the complexities of any real political system. It also implies that intergovernmental relations and other structural problems of societies, especially those of a hierarchical nature can be studied through cross-national comparisons.

Summary

The literature review on the methodology used in the thesis is an attempt to provide a backdrop to the story telling and to support the research based on the interaction between legal and numerical data applied in the case studies. The extensive literature on comparative case studies-based research shows that almost each methodology either has or may have shortcomings when applied to particular cases. Even a combination of methodologies can be imperfect, so the best thing one can do is be rigorous, mitigate the methodological shortcomings and "satisfice."

The selected case studies in the present thesis aim at the identification of specific patterns of local fiscal policies, their generalization to a specific group, and testing of some of the theories outlined in the theoretical section.

Selection of the Case Studies

This study is focused on four ex-socialist countries: Hungary, Bulgaria, Lithuania, and Georgia. The case studies follow a parallel analytical framework facilitating the analysis of key issues of local finance, the comparability of the study results, and their generalization.

Although CEE countries have the same aim - development of market economy an respective political and administrative structure, they differ less in their constitutional and legislative make up and modes of decentralization but much more in their economic and cultural development to facilitate ready comparisons. At the level of principles, however, the structure of local government finance confronts similar broad issues whatever the state under scrutiny is and
its generalized level of analysis provides the framework within which the present study is structured.

For those reasons, the four countries are chosen as representative of different geographical regions in Central and Eastern Europe with distinct historical, political and cultural traditions, as well as with similar degrees of economic development. Each of the four countries is further classified based on its belonging to a group determined by the specific influence of international political and economic factors. The rationale behind the latter classification scheme is to facilitate the analysis of the direct and indirect effect of these factors on the specific fiscal policies in each country (case study).

Regional and economic criteria

The cases are selected and grouped according to common criteria, such as regional traditions, economic structure, specific conditions and potential for development.

A. The Central European Group (Czech Republic, Hungary, Poland, and Slovakia -- the so called "Visegrad" group) These countries have achieved almost all economic and legislative requirements for accession to the European Union by the year 2000. In the present study Hungary represents them.

B. The Eastern European (the “Balkan”) Group (Bulgaria, Rumania, Albania). The reform processes in these countries have been hindered by considerable economic and financial difficulties and political instability in the region and within each of them. The economic and political crises in the Balkans is partly due to the war in Former Yugoslavia and the consequent heavy embargo policies. Bulgaria is chosen a representative of this group.

C. The Baltic Group (Latvia, Lithuania, Estonia) which follows a specific pattern of development after the political and economic independence gained through the official separation from the former Soviet Union, and represented in the study by Lithuania.

D. The most eastern part of Europe (The Transcaucasian Republics of Armenia, Azerbaijan, and Georgia). This group of countries lacks the immediate influence of Western Europe and is defined by strongly expressed regional specificity, political and ethnic conflicts. The group is represented by Georgia in this study.

Political and international criteria

Criteria, such as, proximity to/or active trans-border cooperation with developed countries with established democracies, affiliation with international organizations, direct or indirect
The influence of European political and financial organizations are the basis for determining the belonging of each of the selected countries to a particular group.

A. Countries experiencing strong economic and political influence of Western Europe due to border-sharing or traditional cultural and economic links: **Hungary and Lithuania.**

B. Member-countries of the Council of Europe, following closely its policy guidelines and resolutions on local self-government: **Hungary, Bulgaria, and Lithuania.**

C. Non-member countries of the CE, developing their legislation according to their own pattern and open to policy models other than that of the CE (mainly brought in by American experts): represented by **Georgia.**

**Development Criteria**

As regard some specific characteristics displayed by the countries during the transition period a categorization, based on the following three factors has been suggested by Dabrovski (1996):

A. The progress achieved in the three main areas of the transition process
   - macroeconomic stabilization
   - liberalization and institutional changes
   - privatization and restructuring (i.e. the extent to which a given country has adopted the standards existing in developed market economies);

B. The speed of the changes adopted; and,

C. The comprehensiveness and internal consistency of the reform package.

As a result, Dabrovski has identified five specific categories and based on empirical research and economic indicators has assigned each country to a respective group:

1. **The first generation of fast reformers** (Poland, Czech Republic, Slovakia, **Hungary**, Slovenia, Albania);

2. **The second generation of fast reformers** (Estonia, Latvia, **Lithuania**, Kyrgyzstan, Moldova, Croatia, Macedonia);

3. **The third generation of fast reformers** (Armenia, Kazakhstan, **Georgia**); and,

4. **Slow and inconsistent reformers** (Rumania, **Bulgaria**, Russia, Ukraine)

**The remaining countries**, which suffer from armed conflicts (New Yugoslavia, Bosnia and Herzegovina, Azerbaijan, Tajikistan) or have halted the reform process because of political reasons (Belarus, Uzbekistan, Turkmenistan).
Rationale for the Cross-National Comparative Study

From a methodological point of view there are at least two possible approaches to conducting cross-national comparative studies. The first one is based on a cross-country comparative framework of specific problems defined by the purpose and the objectives of the study. The second approach is based on a in-depth study for each country and subsequent identification of their commonalities and differences.

For the purpose of the present research the second method was considered as the more appropriate one. The following factors appear to support this choice:

- the uniqueness of each country within a common system of pre-and post-socialist development;
- difficulties in accessing available information, e.g., WB/IMF statistical data is presented in each country's nominal currency; many recent studies support their findings with data collected in a country-specific and not in a generally integrated or comparable manner;
- the in-depth review of each country provides a foundation for better understanding of both the unique logic and inconsistencies of its transition process; and,
- finally, following the individual country studies, it is more feasible to apply certain comparative criteria, e.g., only those problems are analyzed that are common to at least three of the four countries (with narrative data), and for at least two of the three countries when there is comparable statistical data.

Analyses of the Case Studies

The following chapter analyzes various reasons explaining the differing rates of reform in each of the selected countries. Special attention is devoted to the logic of the local government administrative and fiscal reforms taking place in the selected countries and their affect on the local revenue systems. The case studies are similarly constructed to analyze the main issues related to the thesis objectives.

First, a general overview of the geographic, historical, macroeconomic, and social characteristics of the country under study is offered. The factors that determine the specific
position of each country within the big family of ex-socialist countries are summarized. Next, an extended analysis of the administrative and fiscal reforms beginning with the transition to market economy is presented. The new legal, administrative and structural bases of the administrative and fiscal reform in each country are emphasized. The legislative changes and legal foundations for local self-government and fiscal autonomy are assessed.

Finally, the third part of each case study deals with municipal budgets and the structure of the revenue systems established by the new financial laws. Analyses of both the legal provisions and actual development of the revenue systems are presented for each country, based on available data. For Georgia, due to the lack of any statistical data, the analysis is based only on the financial and municipal budget laws. Special attention is devoted to intergovernmental fiscal relations in each country as a major indicator of local fiscal autonomy gained or achieved during the transition period. Each case study concludes with a summary of the main findings regarding the effectiveness and the efficiency of the existing local revenue system and its effects on the establishment of local fiscal autonomy - one of the main aims of the transition to a market economy.
IV. CASE STUDIES

The specific nature of fiscal decentralization processes, their logical and legal foundations in the new democracies of Central and Eastern Europe, as well as their impact on local finances are indicated by the experience of four ex-socialist countries: Bulgaria, Georgia, Hungary, and Lithuania. As pointed out in the previous chapter, each country belongs to one or more distinguishable groups of ex-socialist countries. The country case analyses considerations include the influence of the different geographic, historical, economic, political, and international factors on the fiscal processes taking place in each country.

The first two case studies deal with Bulgaria and Hungary. Both countries started their transition to a market economy largely independent of the former Soviet Union and with an ambition for a fast and painless affiliation with established West European structures and international organizations (e.g., the Council of Europe, the European Union, the European Bank for Reconstruction and Development, the IMF, the World Trade Organization). Differences in the starting economic conditions of these two countries have affected the pace of their reforms.

The next two case studies discuss how two countries that were a part of the former Union of the Soviet Socialist Republics (USSR), have gained their independence and embarked on differing roads to a market economy. The favorable geographic location of Lithuania, its proximity to the developed West European countries and their economic and cultural influences has considerably facilitated the transition process in this country. Despite its privileged position in the former Soviet Union due to its favorable geographic location, Georgia has remained further behind in establishing its reform processes. Civil wars and local political conflicts have affected Georgia's economic position and slowed down its desired integration into European structures.

The last section of this chapter discusses the cross-national comparisons resulting from the country analyses.
A) Bulgaria

Geographic, historical, macroeconomic and social condition of the country

Located on the Balkan peninsular, in the most South-Eastern part of Europe, Bulgaria represents a group of countries with similar ancient and recent histories. Five hundred years of Turkish occupation and forty-five years under socialist regime have determined the political, social and economic profile of Bulgaria, Rumania, and Albania. Although Russia is claimed to be the liberator from Turkish slavery for Bulgaria, it has always been an independent republic and not a part of Former Soviet Union.

During the socialist period, Bulgaria similar to the rest of the socialist countries in Europe was a member of the Council for Economic Development and Assistance and had a specially assigned sphere of industrial development. Its main specialization area were the metal processing and machine building industries, which consequently became a major reason for the severe economic crisis which the country entered after the liquidation of the common socialist market. The incompatibility of the old industrial standards on the international market as well as the small size of the domestic market further deepened the economic and financial crisis of the country. Bulgaria's heavy external debt burden (amounting in 1990 to $6.2 billion, and $9.3 billion in 1996 or $1,069 per capita) and relative lack of foreign investment considerably hindered its further economic development.

Despite the political instability and the high number of government elections (eight since 1989), all Bulgarian governments after 1989 were committed in one or another way to the market reform. Like Rumania and Albania, Bulgaria was prompted into faster-paced reform by a combination of EU and IMF pressures, together with pressures from the commercial banks that were owed the bulk of the country's external debt.

Although membership of the EU was a more distant prospect compared to Hungary and the Czech Republic for example, the EU was helping the country through various restructuring schemes, mainly coordinated by the PHARE (originally, Poland/Hungary Aid for Restructuring of Economies) program. The combination of technical and financial support, together with
funding from international financial organizations, such as the World Bank and the European Bank for Reconstruction and Development (EBRD) was intended to bring the country closer to the European social and economic norms and standards.

Despite the enormous enthusiasm and efforts for rapid change from the very first years of the transition period, the chances for success were considerably slowed down by the civil war that broke out in the early 1990's in Bosnia and Herzegovina and by the imposed trade embargo with the former Yugoslavia. Bulgaria's links with Western Europe were considerably reduced.

After the change in 1989, Bulgaria was determined to pursue a policy of integration with western Europe, and affiliation with the EU and NATO. Beside political and economic changes, the success of this policy was dependent to a great extent on the large-scaled legislative reform that had started in many spheres of the political, social and economic life of the country. Unfortunately, the legal reform was much slower than intended and lagged behind the actual changes that were taking place. These often lead to the necessity of solving problems by concurrent ministerial decrees or partial amendments of existing laws (the so-called "management by decree). For the most part, new legislation was elaborated following the standards of developed West European countries and under the guidance of foreign experts form the EU or the World Bank.

Legal, administrative and structural bases of local self-government and local finances

Constitutional provisions

The new Constitution of the Republic of Bulgaria provides some of the basic principles for the structure and functioning of local and regional authorities, such as separation of power, supremacy of the sovereignty of the people, the right to direct universal suffrage by secret ballot, and political pluralism. The constitutional guarantees underpinning local self-government are in Article 2(1) of the Preamble to the Constitution and are spelled out in Chapter 7. According to Article 2(1), "The Republic of Bulgaria shall be an unitary state with local self-government". According to Article 135, the national territory is divided into regions and municipalities. Article 136(1) defines the municipality as "the main administrative territorial unit within which local self-government is exercised."

Other legal provisions

Like most of the former socialist countries, Bulgaria became an official member of the Council of Europe in 1990 and in a comparatively short period of time ratified a lot of its legal conventions. Based on the European Charter on Local Self-government, Bulgaria elaborated and
adopted in 1991 its own Law on Local Self-Government and Local Administration, with some amendments introduced in 1995. This law became the basis of the large-scale reform towards administrative and fiscal decentralization. It gave explicitly formulated rights to local governments and defined the municipality as "the basic territorial entity within which local self-government shall be exercised." The Law also provided for municipalities the right to have their own individual budgets, separate from the National Budget. Municipalities are entitled to generate own-source revenue and receive state subsidies, according to criteria defined by the law.

This was only the beginning of a comprehensive liberalization program launched in the very first years of the transition period, whose main purpose was the decentralization of government and the establishment of strong local authorities with political, administrative, and financial independence (The Administrative and Territorial Reform - Reality and Future, 1995). The decentralization process was further mandated in the Law on Administrative and Territorial Division (1995). It confirmed the two territorial and administrative levels in Bulgaria: municipalities and regions with municipalities being "the main administrative territorial units of local self-government."

Local government finances: general provisions and legal constraints

Experience in developed countries has shown that fiscal decentralization can achieve efficiency goals only if it is accompanied by policies that assume local budget discretion, fiscal accountability, and the explicit linking of legislative decisions to the decision-makers. These links were and are still missing in Bulgaria due to the lack of local fiscal discretion and the contradictory legal framework regarding local finances. For example, according to the Law on Local Self-Government and Local Administration, local governments have unprecedented autonomy based on the right to prepare and approve their own budgets, to keep surplus funds, and to borrow for capital investment projects. At the same time, based on the current National Budget Law, active since the 1961 Central Budget Law, the central government has the right to absolutely control municipal finance. Although this law has been updated several times to meet some new requirements, its basic framework has remained the same through 1997. The 1961 Budget Law defines also several functions, such as education, health, and social welfare as compulsory for local governments but does not specify any rules covering the expenditures for these services.

The only way municipalities could get a central subsidy to cover such expenditures was through providing any kind of evidence for an expected deficit or by mere negotiation with the responsible officers in the Ministry of Finance. When the evidence is formally accepted, a
proposed subsidy was (and still is) sent to parliament for approval. But even municipalities that
do not receive subsidies from the central government were subjected to compulsory levels of
expenditure on education, health and welfare. Municipalities could, however, add funds to the
compulsory level of expenditures, and in 1992 amendments in the Law allowed for reallocation
of funds among those compulsory categories.

In a study on fiscal decentralization in Bulgaria, carried in 1994, Vazquez (in Bird, 1995)
identifies four major reasons for the delay in the fiscal decentralization of Bulgaria:

- the decentralization process in Bulgaria initiated as a center driven, rather than "bottom -
  up" process, which made it look like a political reform rather than like a means to
  increase local autonomy;
- the considerable opposition on behalf of worker unions, and especially the teacher trade
  unions based on financial concerns for unfavorable redistribution of central funds and
diminished bargaining leverage with a single (central) authority;
- the strong public mistrust in the technical capabilities and general competence of local
  authorities provoked by their evident lack of experience in taking independent decisions;
- and,
- the difficulties of the transition, such as overall government retrenchment, high inflation,
  and considerable decrease in the quality and quantity of public services, that made it
difficult for the public from distinguishing between the need for structural reform (fiscal
decentralization) and the containment of transitional problems (unemployment and price
instability).

**Administrative and territorial structure of local governments**

The current administrative territorial division of Bulgaria comprises 255 municipalities
and 9 regions, including the municipality of the capital Sofia - with its status as a region. The
administrative territorial subdivisions are the mayoralties and wards. The average area of a
Bulgarian municipality is 435.3 square kilometers, the smallest being 38.6 sq. km and the largest
1,364.3 sq. km (Map 1).

As evident from Table 2, the group of municipalities with a population between 10,000
and 50,000 is the largest with a total of 136 municipalities. The average population of a Bulgarian
municipality is about 33,000 inhabitants, with the smallest having 1,500 inhabitants and the
largest - the capital, 1,191,700 (Table 2). There are no special structures such as conurbations,
metropolitan or isolated areas. Only the capital municipality has the specific feature of forming a
region.
Table 2. Size of Municipalities by Population in Bulgaria

<table>
<thead>
<tr>
<th>Groups of municipalities based on population</th>
<th>Number of municipalities in the group</th>
<th>As percent of the total number</th>
<th>As percent of the country's total population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1000</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>From 1,001 to 5000</td>
<td>22</td>
<td>8.6</td>
<td>0.9</td>
</tr>
<tr>
<td>From 5,001 to 10,000</td>
<td>60</td>
<td>23.5</td>
<td>5.6</td>
</tr>
<tr>
<td>From 10,001 to 50,000</td>
<td>136</td>
<td>53.4</td>
<td>34.0</td>
</tr>
<tr>
<td>From 50,000 to 100,000</td>
<td>24</td>
<td>9.4</td>
<td>20.5</td>
</tr>
<tr>
<td>From 100,000 to 500,000</td>
<td>12</td>
<td>4.7</td>
<td>24.9</td>
</tr>
<tr>
<td>Over 500,000</td>
<td>1</td>
<td>0.4</td>
<td>14.1</td>
</tr>
<tr>
<td>Total</td>
<td>255</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

*Source: Structure and Operation of Local and Regional Democracy in Bulgaria, Council of Europe, 1996.*

The Administrative and Territorial Act of the Republic of Bulgaria adopted in 1995, laid down the procedures and criteria for the introduction of changes in the administrative territorial units. According to this law, the territorial and administrative arrangement of the country should be "a process that is carried with due reflection, continuously and in accordance with both the wishes of the inhabitants and the interests of the nation." The procedure for the formation of a municipality requires the organization of a local referendum and a favorable vote by the population followed by approval from the central government.

**Municipal Budgets and Local Revenues**

Despite the favorable conditions and the existing legal prerequisites for enhancing the role of local government in the first years of the transition period, there were still a lot of impediments to achieving real local self-government in the country. Theoretically, municipalities were given the right on preparing their own independent budgets by both the Constitution and other statutory laws. In practice, true local economy was and still is difficult to discern in many places. Bulgarian experts claim the discrepancy between the new and the old legal provisions as one of the main reasons for the lack of municipal administrative and fiscal autonomy. For
Map 2. Administrative and Territorial Division of Bulgaria
Source: Structure and Operation of Local and Regional Democracy, CE, 1996.
example, the major part of the laws dealing with budgeting, finance, and taxes had not been changed since the early 1960s, such as the Law on the Preparation and Execution of the State Budget, The Law on Income Taxes, The Law on Local Taxes and Fees. Until 1996 nothing was done towards defining expenditure guidelines for municipal budgets. A lot of problems were emerging because of the lack of methodologies for defining municipal expenditures for healthcare, education and social security. No regulations existed as regard planning and forecasting of budget revenues and expenditures. A great part of the necessary new legal provisions for the budget system of local governments were still missing (Grozdanov, 1996).

Additional impediments to the realization of self-government schemes were created by the growing economic crises, as a result of which local authorities had no real opportunities to prepare their own budgets with realistic parameters corresponding to the expenditure needs and the revenue potential of the local government units.

**Financing local government in Bulgaria**

**Revenue Assignment**

The use of the term "revenue assignment" is conditional since municipalities in Bulgaria have no autonomy to define the type and the rate of their main own-revenue sources - local taxes, charges and fees. Municipalities have only limited rights on defining the rate of some local fees and charges. The latest amendment in the tax law gave municipalities the right to define only the charges on real-estate and property transactions.

Despite the enumerated legislative changes introduced during the 1990s, there was still a tendency towards increased centralization of municipal revenues. In April 1992, for example, the central government mandated that personal income tax revenue, previously accruing exclusively to local governments, be shared. The central government retained 30 percent of the tax and local governments received 70 percent, with the new sharing made retroactive to 1992. For compensation purpose, a decision was made in August 1992 for sharing 10 percent of the central government's turnover tax with municipalities. But in January 1994, the turnover tax was replaced by a value-added tax, with no compensation to localities for the loss of the share from the turnover tax. In the meantime (February 1993) the personal income tax share fell from a 70 percent local and 30 percent central split to 50-50 percent split (Table 3). In 1995, 50 percent of the tax on municipal buildings was also apportioned to the central government.
Table 3. Local Taxes as Percentage of Total Local Tax Revenue (Bulgaria)

<table>
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</thead>
<tbody>
<tr>
<td>Tax on profit and capital gains**</td>
<td>23.4</td>
<td>25.9</td>
<td>23.8</td>
<td>24.8</td>
<td>31.2</td>
<td>37.8</td>
</tr>
<tr>
<td>Tax on Individual Income**</td>
<td>56.2</td>
<td>40.7</td>
<td>56.8</td>
<td>62.8</td>
<td>58.7</td>
<td>58.9</td>
</tr>
<tr>
<td>Tax on property*</td>
<td>2.2</td>
<td>4.9</td>
<td>8.3</td>
<td>7.6</td>
<td>6.9</td>
<td>2.8</td>
</tr>
<tr>
<td>Domestic tax on goods and services**</td>
<td>17.5</td>
<td>27.8</td>
<td>10.7</td>
<td>4.8</td>
<td>3.2</td>
<td>0.5</td>
</tr>
<tr>
<td>Other taxes</td>
<td>0.7</td>
<td>0.7</td>
<td>0.4</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Author’s Calculations based on IMF/WB data, 1998. (*own-source revenue; ** shared revenue)

In 1992, for the first time, municipal governments in Bulgaria could formulate their own budgets, which by far did not mean that central governments have stopped treating local governments as their administrative arms. Neither have local authorities stopped looking for guidance and special instructions from the center. In Bulgaria, as well as in other ex-socialist countries, recent experience and data show that the existence of proper legal framework is a necessary but not a sufficient condition for the implementation of decentralization policies. The lack of enough experience or enough will on behalf of both local and central authorities to practice a new form of governance may prove to be a strong impediment to the decentralization processes.

Local governments in Bulgaria have three main sources of revenues: shared taxes, own-source revenue, and central transfers.

Revenue from shared taxes

The existing revenue-sharing scheme for the profit tax in Bulgaria is based on both the principle of derivation - the pooled taxes shared are those actually paid in the jurisdiction-- and on ownership of enterprises. Until 1992 the sharing rates were specified in the respective tax laws. Municipalities retained the entire company tax profit levied on municipal and private enterprises operating in their jurisdiction, and also levied a 10 percent surtax on state enterprises operating in
their jurisdiction. State enterprises paid a regular 40 percent company profit tax to the central government. According to Vazques (1995), the dual character of this origination and ownership revenue-sharing system could not lead to enhanced financial autonomy of local governments. The 10 percent surtax on state enterprises was a much more important revenue source for municipalities than the 40 percent levy on municipal and private enterprises (Municipal Budgets in Bulgaria, 1996).

Data show that only 15 percent of the company tax revenues collected by municipalities in 1992 came from levy on municipal and private enterprises. In 1991 this figure was 13 percent. The company profit tax performed relatively poorly as compared with the other major taxes in 1992. This reflects both a shrinking state enterprise tax base and virtually no growth in the taxes paid by private enterprises because of tax holidays, legal avoidance, and tax evasion. This relatively poor performance continued in 1993 when the profit tax declined to 11.6 percent of total municipal revenues (WB/IMF data, 1998).

The individual income tax is the single most important source of revenue for local governments. This progressive tax is imposed on wage and salary income. Despite that, the relative importance of the individual income tax in the total revenues of local governments has declined from 38 percent in 1990 to 21.9 percent in 1993. This decline cannot be attributed to avoidance or evasion as with other taxes because this tax is typically withheld by the employers.

Property taxes are another source of own-source revenues for municipalities. These taxes are fully assigned to and administered by local governments. However, local governments have no discretion over rates, property assessments, or any other significant aspect of the property tax. Property taxes are levied on the value of the land and structures, on the value of transfers as gifts, or on an inheritance. For property owned by individuals, the tax is calculated on the basis of assessed values for land and structures in accordance with officially approved tables dating back in 1952. Property taxes constituted only 0.7 percent of total revenues in 1991, down from 3.7 percent in 1990. In 1993 property tax collection still represented only 1.2% of total local revenues. The experience of other countries suggests that property taxes, if properly designed to include regular ad valorem reassessments, could become a much more important source of local government revenue. In 1998 Bulgaria adopted a new Law on Local Taxes that will be effective in 1999.

Own-source revenue

Cost recovery charges and user fees continue to represent a small fraction of local government revenues, averaging 2.8 percent of total revenues between 1990 and 1993. This
revenue source continues to be relatively unimportant because the fees can only be changed with permission from the central government, which has kept them unchanged for long periods. Bulgarian local governments are authorized to introduce environmental fees, parking fees and sanitation fees but they have traditionally been fairly low. Other non-tax revenues have fluctuated widely, representing 4.6% of total revenues in 1990 and only 1.1 percent in 1993. This is partly a result of the restitution of municipal property to private individuals, limiting the sources of rental income (WB/IMF data, 1998).

Financial relations between municipal budgets and the state budget transfers

The link between the state and the municipal budgets in Bulgaria is realized through two mechanisms for redistribution of funds. The first, which is also the basic one, deals with the provision of central subsidies to local governments. The second mechanism takes the budget surplus from a small number of municipalities with higher own-source revenues for further redistribution by the central government.

State transfers in Bulgaria have two main aims:

- to provide the amount necessary to meet the expenditure needs of municipalities, uncovered by own-source revenues; and
- to equalize financial differences among municipalities thus contributing for better and adequate provision of local services.

A major difference exists between the methods for defining state transfers until 1992 and after that. Until 1992 the Ministry of Finance was defining the expenditure norms for municipalities. The size of the central subsidy was determined as the difference between the expenditure needs and expected revenues, that is, it had an equalizing effect. If during the execution of the municipal budget the expected revenues were not reached, the state usually subsidized municipalities with the respective amount. And vice-versa, if local revenues were higher than expected, the state had to take over the surplus. This mechanism led to the subsidization of all municipal deficits and the centralization of surpluses. This mechanism, provided opportunities for municipalities to negotiate the subsidies they eventually needed, while creating incentives for rich municipalities to hide their real revenues.

At the beginning of 1993, a new formula-based normative way for determining the state transfers was introduced. It was based on the so-called “objective criteria” for defining municipal needs. These criteria included variables such as the number of sick persons in hospitals, number of students, and number of people with low income. Based on those “per capita” indicators, the state determined the size of the subsidy for each municipality. Thus the Ministry of Finance
abandoned its role of a direct guarantor for municipal deficits and a regulator of their revenues (Foundation for Reform in Local Government, 1996).

In its most recent available design (1994), this formula is given by $C = C_1 + C_2 + A + C_3$, where $C$ is the total government transfer.

$C_1$ - represents a share (usually around 80 percent) of the previous year's transfer, net of specific capital grants and adjusted for changes in expenditure assignments.

$C_2$ - is the fraction of the transfer determined by an objective formula employing 17 weighted variables representing the municipality's need for public services in different areas..

$A$ - is an adjustment factor accounting for the relative tax base of municipalities.

$C_3$ - is a transfer for capital expenditures, which is distributed at the discretion of the central government.

The initial intent was to apply this approach for a period of five years. That is why, the portion of first element $C_1$ in the formula stays for the share of the subsidy in successive years, with the expectation being that the amount of funds would become smaller each year. The share of the second element $C_2$, which shows the amount of the subsidy base on objective criteria was expected to be growing each next year (Foundation for Reform in Local Government, 1996).

Although the initial aim of the formula-based approach was to get as much as possible objectivity in distributing the state subsidies, changing economic and political conditions led to unnecessary complication, lack of transparency and difficult applicability. Evidence and unsatisfactory results quickly revealed that:

- the attempt to encompass all aspects of the expenditure needs of the municipalities had lead to an increased number of criteria - from 5 in 1993 to 21 in 1997. In 1995 the State Budget Law introduced the right to a "compensating" subsidy for municipalities in poor financial condition with the intent for equalization; and,
- the lack of coordination between the departments within the Ministry of Finance, dealing separately with municipal own-source revenue, total subsidies, and earmarked grants was an additional impediment to the objective implementation of the formula;

Summary

Current revenue assignment in Bulgaria cannot be assessed as flexible or effective. Although local governments have been assigned certain taxes, most importantly the property tax, they have no control over the structure of these taxes. Local governments also lack the authority to set most fees and charges. Furthermore, despite legislative changes, the system of revenue assignment has become less stable and transparent since 1991. Revenue flows are also
unpredictable since the government keeps changing the revenue assignment every year leaving no opportunities for reliable revenue forecasting.

There are some a priori reasons and data indicating that the present revenue system in Bulgaria does not result in resource equalization. The importance of shared taxes, albeit decreasing, and the fact that they accrue to local governments on a derivation basis, imply that the existing revenue assignment system is not equitable. Relatively richer municipalities will inevitably have more available resources than poorer ones. Furthermore, property taxes, fees, user charges, and revenues from other local sources are all positively correlated with collections from the main shared taxes. Thus, the existing tax assignment schemes easily give rise to an unequal distribution of tax revenues across local jurisdictions. Some of the inequalities in tax revenues are supposed to be offset by a system of transfers. Thus, the equity issue becomes related to the effectiveness of the central government's transfer system. Unfortunately, neither the formula nor any actual results have ascertained so far the equalizing effect of the current transfer system.
B) Hungary

**Geographic, historical, macroeconomic and social conditions**

Similar to the rest of the countries in the so-called Visegrad group (Czech and Slovak republics and Poland,) Hungary was generally considered to be ahead of the rest of the CEE countries in its economic and political liberalization in 1989. Significant economic reforms in Hungary began in early 1980s with the establishment of some of the institutions necessary for a market system. However, these reforms did not lead to major institutional changes or fundamental shifts in the management of public finances of the country. Despite some initial advantages over other ex-socialist countries, the new, democratically elected Hungarian governments have faced daunting challenges in resolving a multitude of economic and budgetary problems. Most of the problems relate to the large foreign debt of the country, the proportionately large underground economy, the rapid but chaotic privatization and reduction of subsidies to state-owned industries, and the high social security expenses. The budget largely remained an instrument for centralized allocation of resources, particularly subsidies to firms and consumers. Revenues were raised mainly from taxation of firms and various turnover taxes (Leloup, Diez, Papai; et al; 1998).

**Legal, administrative, and structural bases of local self-government and local finances**

**Constitutional provisions**

Political and economic changes in Hungary after 1989 were not accompanied by elaboration of a new Constitution, as the case was in many CEE countries. The old Hungarian Constitution remained in power with some major amendments made to it. The new chapter IX of the revised Constitution sets the bases for democratic governance in the country and defines local self-government as "autonomous and democratic management of local affairs by the communities and exercise of local public authority in the interest of the population." Article 44 of the
Constitution defines the basic rights of local authorities such as the right of independent budgeting, property ownership, and the right to deal with it. In order to manage its duties, the local representative body is entitled to "an adequate income of its own". It can also rely on state support "proportionate to its scope of duties." Article 44 of the Constitution gives local authorities also the right "to authorize within the limits of the law local taxes rates, their types and measures."

**Other legal provisions**

Following the basic requirements of the European Charter on local governments, Hungary was among the first CEE countries to adopt in 1990 a Law on Local Self-Government. The purpose of this Law is to "support the self-organizing independence of local communities, assists the creation of the conditions necessary to self-government and promotes the democratic decentralization of public authority." Chapter I of the Law provides a definition for local government and its main responsibilities: "The local government of the village, the town, the capital city and its districts, as well as that of the county (hereinafter: local government) acts independently in the public affairs of local interest, belonging to its sphere of duties and jurisdiction." Some further rights and responsibilities provided to local government by this law are:

- to dispose independently of its municipal property;
- to allocate independently its revenues; and,
- to provide from its unified budget for the carrying out of municipal duties, whether undertaken voluntary or compulsory.

Besides these powers, local governments may pursue entrepreneurial activity on their own responsibility. They are also provided the right "to freely associate" with other local governments.

According to the Law, local governments that are in a disadvantageous situation "through no fault on their own," are entitled to a supplementary state subsidy aimed at equalization.
Map 3. Administrative and Territorial Division of Hungary

Source: Structure and Operation of Local and Regional Democracy, CE, 1993
Administrative and territorial structure of local governments

Until 1990 Hungary had a unitary system of government structure and respectively centralized budget. Local governments had little administrative independence and almost no independent sources of revenue. The government was organized in a multi-tier system, with the center tier imposing control over 1,523 local councils through 19 county councils. The Law on Local Self-Government eliminated the middle, that is the county tier but at the same time multiplied the number of local governments to 3,148 in 1993. The new units of local self-government, the municipalities, have an average number of only 3,482 inhabitants. The average number is even less if the capital, Budapest, is excluded - 2,834. Many of these local governments, however, proved to be too small to be able to efficiently provide the public services demanded from them by law. That is why they made full use of the right to form associations. Although the number of municipal associations has considerably grown since 1993, municipalities have started much later to jointly deal with common problems of service delivery and administrative functions (Bird, 1995). Despite the redefined functions of the local level, the sheer number of small municipalities proved to be and still is an impediment to the exercise of local government functions such as revenue raising, provision of public and administrative services, and managing of public property.

Municipal Budgets and Local Revenues

Macroeconomic and legal aspects

Hungary does not have a unified budget in the American sense. It consists of four subsystems:

- central government budget;
- chapters and ministries;
- social security budget; and,
- municipal budgets.

The present study is focuses only on the municipal budgets, since the municipality is the basic local government unit in Hungary, encompassing both the current problems and the main tendencies in local financing and local budgeting of the transition period.

The Law on Local Self-Government sets the basic principles for local governments' finances and the elaboration of local budgets. According to Chapter IX, Section 77 of the same law, the budget of the local government is part of the public finances and it is connected thereto with the whole of its cash flow. The local government's budget is distinct from the state budget but is linked to it by the state subsidies and other budgetary relationships.
Since the early 1990s, local governments in Hungary have received increased discretion in raising revenues (Straussman and Fabian, 1995). As a result, considerable variations appeared in the levels of taxation and services provided by local governments, which inevitably lead to enormous differences in their financial conditions. LeLoup (1998) defines the Hungarian system of local finances as extremely fragmented and broken down to rather small areas even within cities. This has made local budgeting and accounting in Hungary extremely difficult and complicated. Based on a study in 1992, the World Bank conclude that Hungarian officials "are unable to make an informed guess about the amount of double-counting of revenues and expenditures." Because of that, as LeLoup (1998) points out, it is advisable to rely only on the consolidated General Financial Statistics (GFS) estimated by the World Bank, the IMF or OECD for research purposes. The problem with data unavailability and data credibility in Hungary is further compounded by the immense complexity of the budget process taking place at a variety of levels and series of stages. High levels of uncertainty, fragmentation, and expansion of the deficit beyond forecasted levels have made the budget process in Hungary repetitive and unstable, characterized by frequent revisions during the fiscal year and outcomes that are significantly at variance from what was planned and approved (Straussman and Fabian, 1994).

Financing local government in Hungary

Revenue Assignment

The fundamental reform of local finances that started with the transition in 1990 against a background of national fiscal reform, significantly altered the expenditure responsibilities and revenue authorities of local governments in Hungary. The new system of local finances had two major goals: to make local authorities more independent from the central government and to make them more responsible and accountable. The first goal was to be achieved by the removal of central control over municipal spending, while the accomplishment of the second goal envisaged the development of new sources of locally controlled revenues. This well-intentioned policy was soon jeopardized by the inadequacy of the local taxes set in the 1990-year Law on Local Taxes. Some of the immediate implications of the inability of local governments to generate enough revenue to finance their increased expenditures were:

- increased local demands for transfers from an already strained central budget;
- increased regional and intermunicipal divergence in the provision of basic social infrastructure and services; and,
- increased pressure on local governments to engage in untypical entrepreneurial activities.
According to Bird (1995), the main problem of local governments in Hungary was that the shift of expenditure responsibilities was paralleled only in part by a shift in taxing authority. Central government's grants became and still are the main revenue source for localities in meeting their spending responsibilities. Under the socialist system, transfers to local governments in Hungary were about 10 percent of central government consolidated expenditures. With the introduction of the Law on Local Self-Government, transfers rose sharply in 1991 to more than 14 percent of consolidated expenditures and financed about 61% of local governments' expenditures. The level in 1994 reached 64 percent and only in 1995 a slight decreasing tendency became visible (Bird, 1995; Government Finance Statistics Yearbook, 1998, p. 182).

Given the extensive assignment of expenditures to local governments and the restricted revenue sources, it is impractical to expect that small governments will be able to finance services such as education, health and infrastructure with their presently assigned own resources. With Hungary's weakened economy, the open-ended responsibility of local governments for social assistance inevitably led to increased central transfers and shared taxes - a tendency that in the long run may seriously threaten the fiscal balance of the country. Statistical data confirm that the need for central transfers and shared taxes continued to be large in the period since 1994. (Appendix, Table 1.2)

**Local own-source revenue**

The Law on Local Self-Government specifies three major revenue sources for local governments: own-source taxes, shared taxes, revenues "taken from economic organizations", central grants, and subsidies. The 1990 Act on Local Taxes assigns three own-source taxes to local governments. These taxes can be introduced by local governments but are not mandatory. No other taxes or fees can be established at the local level, and maximum tax rates and the tax bases are fixed by the central government. The taxes assigned to local governments are:

1. **Property Tax**, including:
   - Building tax; and
   - Land parcel tax.

   The land tax is essentially an annual property tax on unimproved, privately owned land. It is levied at a maximum rate per square meter fixed by the central government.

2. **Communal taxes**:
   - Communal Tax on Private Individuals;
   - Communal Tax on Entrepreneurs
The communal tax can be levied on household dwellings or on businesses. If on dwellings, the occupant pays a fixed amount of money per dwelling annually, regardless of the number of inhabitants. This tax is suited to localities that have many government-owned flats and cannot rely on property taxes for revenue. If levied on businesses, the enterprise pays a fixed annual rate per employee.

3. **Local Business tax**: this local tax is a gross turnover tax that is levied at all stages of production/sale at a maximum rate of 0.8 percent or a set amount a day for temporary business activities (Act C of 1990 on Local Taxes)

**Local Taxing Discretion**

Except for the business tax, which was new in 1991, the other local taxes represent an extension of the taxes of the local councils collected and administered under the previous system. The decision to assign these taxes again to local government was driven by the objective of greater local independence (Bird and Wallich, 1994).

There were though some new elements introduced by the new Law on Local Taxes, such as the increased autonomy of local governments in managing local taxes. For example, localities now can decide whether to levy any or all of these taxes. The choice of tax, additional exemptions, and rates (subject to a ceiling) is also left to local governments, subject to three conditions: First, two taxes may not be levied on the same object, e.g. the same base cannot be taxed twice. Another condition is that preexisting, centrally mandated preferences and exemptions must be respected. According to the third condition, locally set rates cannot exceed the centrally mandated maximums set in the Act on Local Taxes. All local taxes are treated as deductions from both the personal and corporate income tax bases.

The implementation of the new tax system was not as easy as defined by the law since local governments in Hungary faced some major problems of the transition period. One of them was the fact that Hungary's tax burden at the national level was among the highest in Europe. Thus local governments were loath to overburden residents with new taxes - citing rent arrears as evidence of low capacity to pay. On the other hand, there was the concern, that higher local taxes might increase the demand for social assistance. Last but not least, local governments had both no time and no capacity to effectively set up the new tax system. For these reasons, the extent to which local governments exploited their new freedom and tax discretion was less than expected. It was expected that by the end of 1991, localities would apply their newly assigned revenue authority and introduce the new taxes with appropriate rates to cover some of the increased local expenses. This was, however, a rather optimistic expectation because Hungarian local
governments proved reluctant to introduce new local own-source taxes. In many localities taxes and tax rates remained unchanged (Straussman and Fabian, 1994).

Statistical data verify this statement as well. For example, in 1992 local taxes on property provided only 2.2 percent of local budget revenues, the same share as in 1991 and even less than that before the change. Table 4 shows that almost no changes have occurred in one of the major local taxes despite the greater authority and the right to impose higher tax rates provided to local governments.

Table 4. Property Tax as percentage of Local Government Revenue in Hungary

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</thead>
<tbody>
<tr>
<td>Total LG Revenues</td>
<td>205.2</td>
<td>243.0</td>
<td>249.9</td>
<td>390.1</td>
<td>508.5</td>
<td>581.2</td>
<td>702.6</td>
<td>796.6</td>
<td>922.5</td>
<td>1,104.5</td>
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<tr>
<td>Property Tax</td>
<td>6.2</td>
<td>6.2</td>
<td>N/A</td>
<td>8.0</td>
<td>11.3</td>
<td>13.7</td>
<td>11.8</td>
<td>16.8</td>
<td>26.7</td>
<td>32.3</td>
</tr>
<tr>
<td>% of Property Tax</td>
<td>2.8</td>
<td>2.5</td>
<td>2.2</td>
<td>2.2</td>
<td>2.3</td>
<td>1.6</td>
<td>2.1</td>
<td>2.8</td>
<td>2.9</td>
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</tbody>
</table>


Duties, fees, and taxes

Localities are supposed to continue to levy under the Act on Local Taxes a range of other centrally regulated taxes, fees, licenses, duties, and penalties but their rates are neither specified nor are any statistical data after 1992 available about their amounts in local government budgets.

In the preparation of the Act on Local Taxes, consideration was given to sharing a number of central taxes with localities. Because of the unequal spatial distribution of revenues from the value-added tax (VAT), sales taxes, and enterprise income tax, it was decided that the personal income tax would be the basic shared tax (Straussman, 1995).

In 1990 localities received 100 percent of the personal income tax collected two years before. These revenues were allocated to the place of residence of the taxpayer, that is, on a derivation, or origin basis. Usually localities received the taxes with a two-year delay because taxes were centrally collected and afterwards redistributed and returned to the location of the taxpayer's residence. Starting in 1992 local government's derivation-based share was decreased to 30 percent, such that the personal income tax contributed only 8.4 percent of the official local revenues. In 1993 the local share was further reduced to 19 percent and in 1997 the share for local governments could reach no more than 24 percent of the total income tax.
Because of the unequal regional distribution of personal income tax revenue (e.g., between poorer and richer localities), the 1993 Budget Act introduced a paragraph which guaranteed poorer localities a minimum per capita grant financed from central government revenues. While this additional grant totaled only 1.5% of the normative grant allocated in 1991, 89 percent of localities - most with fewer than 2000 inhabitants - received this equalization supplement (Bird, 1995).

Grants

Six types of central grants to Hungarian municipalities are specified by Law. The normative grant is considered to be the most important one. It is unconditional and broadly intended to redress the imbalance in the fiscal system. It is one of the most important sources of funds for municipalities. Its allocation across localities is based on a complex formula that incorporates twenty-four needs-based measures, and only two of them are per capita-based measures. There are no special requirements on how localities actually declare their funds and expenditure needs within these categories. It is only the "per capita" measures that allow for some objective horizontal equalization. Neither the magnitude of the normative grant nor its allocation is set forth in the Law on Local Self-Government, which prescribes only that a grant must be given and that a formula rather than discretion, be used for allocating grant funds. It is only in this respect that the normative grant is considered to be an important improvement over the previous system of bargaining. It is also distinguished from the former system in that localities now see the transfer as a right, not a subsidy.

The State Budget Act fixes the amount of the normative grant each year, following certain principles. Aggregate local spending is first estimated, then the estimated revenues accruing to all localities from their own and other sources are subtracted to generate a measure of the fiscal gap. That is, personal income tax share, local own-source tax collections (as estimated by Ministry of Finance), targeted grants, addressed grants, social security funds, and revenue from fees, duties and other centrally regulated revenue sources are deducted from estimated local spending. This subtraction generates a measure of the resources needed for the local sector as a whole.

Because of this complicated calculation, the normative transfer and its amount have been subject to ongoing modifications under the Law of Local Self-Government. In 1990, with localities receiving 100 percent of the 1988 personal income tax (PIT), better-off localities (whose tax base was larger) benefited since the PIT was distributed largely on the basis of residence. Simultaneously, the norms governing the grant's allocation increased from twelve to twenty-two, including such items as kindergartens and primary schools. In effect, the proportion
of total funds allocated by residence fell and the share distributed for expenditure needed rose. Since 1991, apart from small changes, the factors used in the grant formula have been much the same. Four new norms were added in 1993, driven by the need to accommodate political interests. There were, and still are, major philosophical differences between local and central government about the functions of the norms. Localities claim that all mandatory local expenditure functions defined in the self-government law should be supported by either central grants or delegated revenue authority. Central government, however, on the other hand, takes the view that it is not supposed to finance all locally assigned expenditures (Bird, 1995).

The rest of the grants are usually defined as special subsidies and their share is considerably small and inconstant depending on the purpose. These special grants are:

- **targeted grants** for investment on a prespecified list of investment activities - introduced in 1991;
- **addressed grants** for completion of specific unfinished, investment projects, many of which were started under the previous regime;
- **centralized appropriations** for specific purposes (public transport, hospitals, etc.)
- **grants for distressed areas**; and
- **personal income tax equalizing grant**, as well as special payments as compensation for centrally mandated salary increases.

**Summary**

Local government finance in Hungary is still in transition, and much remains to be done to assure the resulting decentralization of government activities will be economically efficient and fiscally sustainable. The Law on Local Self-government has assigned far more responsibilities to municipalities than they had under socialism. At the same time local revenues have remained too limited to pay for these new responsibilities and local governments have become even more dependent on central transfers. No incentives were created for either revenue generation or efficient spending on behalf of local authorities. The need for simplifying intergovernmental transfers and especially the normative grant is pressing.
C) Lithuania

**Geographic, historical, macroeconomic and social characteristics**

Lithuania is one of the smallest former Soviet Union republics with nearly four million inhabitants. Until 1991, it was an industrialized state, fully economically and politically integrated into the Union of the Soviet Socialist Republics (USSR) but still with a standard of living above the Soviet average.

Lithuania was the first of the Soviet republics to declare sovereignty in March 1991 and has the longest track record among the fifteen former Soviet republics of "going it alone." Lithuania serves as a good example of the transformation processes currently taking place in the former republics of the Soviet Union (Vanagunas, 1995).

In the present study, Lithuania is also chosen as a representative of the so called "Baltic states" which include the three former USSR republics of Estonia, Latvia and Lithuania. The three of them were considered as having the greatest potential among the rest of the Soviet republics. Their geographical situation and proximity to Western Europe provide a lot of advantages for their economic, social, and cultural development. As potential EU and NATO members all three Baltic republics pursued, from the very beginning of their independence, substantial legislative programs aimed at aligning their laws with those of the EU but the general progress of the economic reform was mixed.

Lithuania was the only one of the three Baltic states to have a significant majority for its ethnic population, and of the three, the only one to pursue the most erratic political and economic course. Unstable relations with Russia and the inability of the first administration after the independence to focus on economic matters caused a considerable delay in the reform (Central and Eastern Europe - Statistics Book, 1998).
A comparative study on the budgeting practices in Lithuania "before" and "after" the change, made by Vanagunas in 1995, shows the complexity and the deepness of the reform processes taking place in the country. His main argument is that many of the problems that beset the budgeting and finance of present-day Lithuania cannot be properly understood except in the context of Lithuania being one of the fifteen former Soviet republics.

The Soviet national budget differed considerably from that in other federal states, such as the USA or Canada. It was administered under conditions of strict hierarchical centralization with almost no budget discretion available on part of the Soviet Republics. The Supreme Council of the USSR approved not only the "all-union" ("federal") budget, but also the annual budgets of the fifteen constituent republics in term of general revenue and expenditure profiles. On average, about 60% of all revenue was allocated by the national government, whereas the greatest share of the most lucrative revenue sources - the turnover tax and the profit from socialist enterprises were preserved for the central government.

Soviet republics derived their revenue from profits of their own enterprises and not from the national state enterprises. Republics could dispose over the tax on the income of collective farms, cooperatives, and other collective enterprises as well as over 50% of the national individual income tax. The central government "rebated" to the republics the turnover tax that was collected according to the "national plan." According to this plan, high industrialized and better economically developed republics such as the Baltic states usually had to remit all the turnover tax collected by them to Moscow. In contrast, poor and underdeveloped republics such as the Transcaucasian ones (Tajikistan, Uzbekistan, Georgia) were normally not allowed to retain their turnover tax collections but were compensated by huge annual subsidies from the national budget. By official statutes, the Soviets republics voted annually to approve expenditures proposed by the Central Government in Moscow. Subsequently, these budgets attained the status of ordinances and laws. Thus, the Soviet budget was the result of a strongly centralized and ultimate top-down process (Vanagunas, 1995).

Compared to other republics that have emerged from the Soviet Union, Lithuania is considered to be among the most with regard to its stability, economic, political, and social development. In October 1992, Lithuania adopted a new "Western-type" Constitution, committing its society to protect human rights including the right to property. Lithuania also adopted a "French-style" parliamentary structure including a president as head-of-state and a constitutional court to uphold the rule of law.
Legal, administrative and structural bases of local self-government and local finances

Constitutional provisions

The new, independent Constitution of Lithuania, laid down for the first time the legal basis for local governments and local administration in the independent state. According to Article 11 of the Constitution, "the administrative territorial division of the State of Lithuania and their boundaries shall be determined by law." Chapter 10 defines the basis for local government operations and the entitlement of administrative territorial units to the right of self-government (Article 119). This right shall be implemented through local government councils, elected for a two-year term on the basis of "universal, equal and direct suffrage by secret ballot by the residents of their administrative unit." Article 120 provides for state support to local governments notwithstanding local governments' independence "within the limits of their competence established by the Constitution and laws." The Constitution gives explicitly local governments the right to draft and approve their own budgets (Article 121). The same article reads further: "Local government Councils shall have the right within the established limits and according to the procedure provided by law to establish local dues, and to provide for the leverage of taxes and duties at the expense of their own budget." Chapter 11 deals with provisions regarding state finance and the State Budget. According to Article 127, the budgetary system of Lithuania shall consist of the independent State Budget of the Republic and the independent local governments' budgets.

Other legal provisions

The Law on Local Self-Government (adopted in July 1994) is the main piece of legislation regarding the structure and operation of local governments in Lithuania. It contains comprehensive regulations on local self-government, on its main administrative principles and territorial bases, as well as the organizational and institutional principles of the process of self-governing. Local self-government is defined as the "right and actual power of the institutions of a local government to freely and independently, on their own responsibility regulate and manage public affairs and meet the needs of local residents." The law defines the municipality as the major administrative unit on the territory of the State, where the right on self-government shall be exercised and guaranteed by the State. The Law provides for two types of competencies allocated to local governments: autonomous or "own" competencies and competencies delegated by the state. Among the autonomous competencies listed in Article 15 are the following:

- the right of the municipal Council to determine the structure, list of stuff and the wage fund of the administration;
• the right to approve the municipal budget and the report on the implementation thereof;
• the right to approve the procedure for the establishment of "special-purpose" funds and the regulation thereof; and,
• The right to establish local fees according to the procedures established by laws.

Article 23 of the same Law specifies the financial resources of local authorities: they shall consist of the municipal budget and non-budgetary resources. The Law renders the municipal council the right to "amend the budget and make up an additional budget in the same procedure as it is made and approved" - a right that has and may have in the future rather contradictory implications on local finances. Municipal budget revenue sources are only generally listed in the law, without any particular parameters or ways for their obtaining. According to the law, municipal budget revenues shall be formed from the income received for the exploitation of property which is in the ownership of the local authority and from the taxes paid by enterprises, by institutions and organizations the municipal territory. The Law does not provide for any particular rights on the establishment of local taxes, their rates, and bases. Neither does it specify any expenditure competencies at the local level, autonomous or delegated.

Further, Article 23 deals with the case in which income assigned to the budgets of local authorities is insufficient to meet the social needs of the locality. In such an event, municipal budgets shall be provided with subsidies from the State budget "for the implementation of purpose-oriented programs." The Law gives local governments the right to keep eventual budget surpluses accumulated through the fiscal year.

**Administrative and territorial structure of local governments**

In 1989, the territory of Lithuania was divided into 44 regions, 426 districts and 11 cities with the status of a region. These regional and territorial units were set up by decision of the Presidium of the Supreme Council of the Lithuanian Soviet Socialist Republic. In 1995, in conformity with the new Law on the Territorial Administrative Units of the Republic of Lithuania, the former system of 2 administrative levels and 5 categories of administrative units was replaced by a system of 2 levels and 2 categories (Map 3). This resulted in the reduction of the total number of units to 66 and the following administrative structure, which is currently functioning in Lithuania:

• higher administrative units or counties (10), which are part of the State Government;
• lower-level administrative units: fifty-six (56) municipalities (or counties), including forty-four (44) districts and twelve (12) towns, which differ neither in status nor in competencies; and,
• neighborhoods (510), which do not have the status of a territorial administrative unit.

In other words, in Lithuania there is currently a two-tier system of government with local self-government exercised in 56 administrative territorial units - municipalities. Table 5 provides information on the size of municipalities based on the number of their population in 1996.

### Table 5. Municipalities in Lithuania According to Population

<table>
<thead>
<tr>
<th>POPULATION</th>
<th>No. of Municipalities</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 30,000</td>
<td>9</td>
<td>16</td>
</tr>
<tr>
<td>From 30,000 to 50,000</td>
<td>24</td>
<td>43</td>
</tr>
<tr>
<td>From 50,000 to 70,000</td>
<td>13</td>
<td>23</td>
</tr>
<tr>
<td>From 70,000 to 100,000</td>
<td>5</td>
<td>9</td>
</tr>
<tr>
<td>Over 100,000</td>
<td>5</td>
<td>9</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>56</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

*Source: Structure and operation of local and regional democracy. Council of Europe, 1996.*

**Municipal Budgets and Local Revenues**

The budget process in Lithuania is guided by a statute. The Ministry of Finance, acting through the Cabinet, prepares both the preliminary and the final revenue and expenditure estimates. These are formally submitted by the Prime Minister to the Parliament where they are first reviewed by a standing committee on the budget. This committee recommends the budget to the entire Parliament, which approves it and enacts it into a law. The budget details revenue estimates by source, appropriations according to ministries and various autonomous agencies of the national government, and statutory designated rebates of taxes to units of local government as well as national subsidies to such units.

Despite the right to have their own and independent budgets, provided both by the Constitution and the Law on Local Self-Government, municipal budgets in Lithuania still are an integral part of the State Budget Law. They undergo the same process of central approval. Since 1992, the Budget Law has undergone three amendments, which partly explains the still existing
Map 4. Administrative and Territorial Division of Lithuania

Source: Structure and Operation of Local and Regional Democracy, CE, 1996.
The basic changes introduced in the Law regarding local revenues are shown in Table 6. They are indicative of major trends in the process of development of local revenue authority and the efforts towards establishment of local fiscal independence.

1. There is a tendency towards diminishing the share of locally collected revenues that remain in the local budget. The 1993 Law explicitly defines 100 percent of the revenue from individual income tax and profit tax on the activity of legal entities on the territory of the municipality shall remain in the local budget. The amendments in 1995 do no longer fix this share and provide to the central government the right to decide on the percentage that should remain in the local budgets. This has a twofold effect - first it deprives municipalities of a portion of their single own-source income, and second gives the Seimas the right to change shares every year without establishing any possible limitations.

2. The 1995 amendments deprive local governments of the revenue from excise duties and shifts the entire locally collected amount to the State Budget (specified in Article 4 of the same Law).

3. The amendment as of 1998 show a tendency towards grouping the revenue sources into internationally accepted categories. Three new tax revenue sources have been added: rental tax (fee) for the use of water reservoirs belonging to the State Water Fund, market fees, and the inheritance tax on donated property. Even though the Law does not specify the share of these taxes that shall remain for the municipal budget, the introduction of these taxes suggests an increased local tax burden.

4. Lithuania remains an exception compared to other CEE countries with the lack of a property tax on individual property, which is one of the main sources of local revenue in many European states.

5. The amendments of 1998 to the Budget Law have in fact brought uniformity with the provisions of the Law on the Methodology (Procedures) for Establishment of Municipal Budgetary Revenues passed in July 1997. While the first section of this law specifies the three revenue categories (as cited in the 1998 amendments) it shifts the responsibility to the Seima or to the State Tax Inspectorate to decide upon the shares for the local budgets. Such references are usually made without citation of a definite law on which such decisions should be made (Table 6).
Table 6. Amendments to Law on Budgeting in the Republic of Lithuania

**Article 1.** State budgetary system of Lithuania shall consist of the independent State Budget of the Republic of Lithuania as well as of the independent municipal budgets.

**CHAPTER 3. Budgets of local governments**

<table>
<thead>
<tr>
<th>Text as of October 1993</th>
<th>Amendments as of May 1995</th>
<th>Since January 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 3. Title: Local Governments</td>
<td>Chapter 3. Title Local Budgets</td>
<td>Chapter 3. Title Local budgets</td>
</tr>
<tr>
<td><strong>Article 26:</strong> The budgets of local governments shall be a constituent part of the State budget system of the Republic of Lithuania. The budgets of local governments shall consist of resources appropriated for financing local socio-economic and other programs, as well as for operating and maintaining the institutions of local governments.</td>
<td>Article 26: Funds shall be accumulated in the municipal budgets to finance social economic and other programs of local significance and to support the institutions of local authorities.</td>
<td>Article 26: (the same as of 1995)</td>
</tr>
<tr>
<td><strong>Article 27:</strong> Each local government of a region, town, territorial unit or settlement shall have its own independent budget. Budgets of local governments must be adopted without deficits.</td>
<td>Article 27. Each municipality shall have its own independent budget. Municipal budgets must be approved without deficits.</td>
<td>Article 27. (the same)</td>
</tr>
<tr>
<td><strong>Article 28.</strong> The revenue sources of the budgets of local governments shall be: (1) profit taxes on legal persons; (2) excise duties; (3) income tax (individual); (4) income from the exploitation or sale of local govt.'s property (5) land tax; (6) real estate tax (7) motor vehicle duties; (8) stamp duties; (9) other payments; and (10) subsidies. 100 percent of taxes under (1) shall be paid to the budgets if local governments by the taxable entities in which local governments have property rights; Stock companies shall pay to local budgets 50 percent of the above taxes.</td>
<td>Article 28. The revenue of municipal budgets shall consist of: (1) profit taxes on legal persons; (2) income tax on natural persons; (3) immovable property taxes (including rent and land tax) (4) stamp duty (5) income from state-owned property; (6) other payments; and (7) grants. The Seimas of the Republic of Lithuania shall determine the percentage amount of taxes due under items (1) and (2) hereof which to be included into municipal budgets. Revenues under items 3,4,5, and 6 shall be included in accordance with the procedure established by laws on taxation.</td>
<td>Article 28. The following shall be sources of revenue of municipal budgets: 1) tax revenue 2) non-tax revenue 3) grants The amount of grants shall be established by the &quot;Law on the Methodology of Establishment of Municipal Budget Revenues. Article 28-1 Tax revenue of municipal budgets: 1) Personal Income Tax 2) Land tax 3) Rental fee for the use of State water reservoirs; 4) Tax on real estate of enterprises; 5) Stamp duty 6) Market fees 7) Inheritance tax on donated property 8) Other tax revenues Non-tax revenues (5 categories)</td>
</tr>
</tbody>
</table>

The available data show a slow but steady decrease in local government revenues. In 1994 these revenues amounted to 11 percent of GDP while by 1997, they declined to 7 percent. The decline of the ratio between local government revenue and central government revenue is even more rapid, from 47 percent in 1994 to 28 percent in 1997. Although these changes are largely explained by an unstable economy and the general financial crisis typical for many of the former Soviet republics, the steady downward trend is also indicative of the low revenue raising authority of local governments. Despite the already cited changes in the legislation, no visible tendency toward an increase in local own-source revenues is discernable. On the contrary, in 1997 the share of local revenues dropped to 70 percent from 76 percent in 1996, respectively, while the share of the central transfers increased by 6 percent in the same period. From all local taxes, the personal income tax is the most important one, showing a considerable increase from 52 percent (of tax revenue) in 1994 to 81 percent in 1997. By comparison, the share of the property tax of total tax revenue was only 11 percent in 1997.

Although the new legislation gives local government the right to define and collect local charges and fees, no increase has been registered since 1994. Just the opposite has happened: the portion of the non-tax revenue from total local revenue has dropped from 11 percent in 1994 to 7 percent in 1997. Again, these numbers are indicative either of the reluctance of local authorities to impose local fees and charges or simply of the impossibility to introduce them (which is usually due either to a lack of competence at the local level or to political constraints).

**Intergovernmental fiscal relations**

**During the Soviet Time**

The budget relations between central and local governments within the former Soviet republics followed very much the pattern at the federal level between center and republics, whereas local governments were strongly dependent on the center. The Supreme Soviets of the republics approved the budgets of subordinate units within their jurisdictions, rayons (districts) and municipalities (the latter were directly subordinated to the republic rather than to a rayon). This was part of the principle policy of Moscow control over national policy. Local governments were provided with some own-source revenues, such as a share of profits from locality-owned enterprises, entertainment tax, rent of public property, and licensing fees but were still dependent on subsidies from the central government of their respective republic.
In Post-Soviet Lithuania

The system for allocating state subsidies to local governments in Lithuania was established in 1997 with the "Law on the Methodology of Determination of Municipal Budget Revenues." The Law provides a very simple but imperfect formula for the establishment of the amount of general subsidy from the state budget to municipal budgets. There are several reasons underpinning this statement. Since they are not a main object of the current research, they will be elucidated only briefly with emphasis on some of the biases and weak points in the methodology. Moreover, because this is a comparatively new methodology, there is still no data on whether and how it has been applied so far.

According to the Law, the Ministry of Finance is supposed to calculate the total amount of the general subsidy (D) assigned to municipal budgets according to the formula:

\[ D = A - B - C \]

where:

- **A** constitutes the amount of expected expenditures "expected" planned for the budget year(s) from all municipalities, established as a percentage of the consolidated state budget;
- **B** constitutes the expected amount of tax and non-tax revenue receipts of all municipalities for the planned budget year(s); and,
- **C** encompasses the special purpose subsidies (defined only as a type by this law) from the state budget for the planned budget year.

Once established, based on that formula, the total amount of general subsidy \( D \) shall be allocated according to three main principles:

- one part of it is supposed to *form a reserve for contingencies* during the planned budget year;
- the second part shall *level municipal budgetary revenue*; and,
- the third part is envisaged to *level the differences within the municipal expenditure system, determined by objective factors independent of municipal activities*.

The size of each of these parts is established on the basis of very complicated and obscure formulae and criteria, and can be neither be manually calculated nor objectively determined and justified here. This makes the methodology ambiguous and leaves space for a lot of subjective estimates. The large number of specific criteria and multiple coefficients to those criteria, as well as the lack of instructions for their operationalization make accountability and transparency most difficult.
**Summary**

Both the tedious legal reform process and the statistical data reveal that the difficulty of the transformation processes from communism is still acute and pervades the public finance system of Lithuania. The considerable number of laws and ordinances affecting municipal budgets, shared taxes, and the procedures for their collection and redistribution is one of the reasons for the existing inconsistencies in the texts of the laws. Delayed amendments in superior laws as well as the opportunities often left to the central government for a final decision or a change "by ministerial decree" make the budgeting process much more complicated and less transparent.

The case study has explicated only some of the numerous problems in public finances and fiscal management with which the Lithuanian government and its policy makers are confronted. No clear solution or painless prescription has been found despite the ambitious and efforts to overcome these problems. The real market economy still seems to be somewhat of a dream for Lithuania, as it is for many of the ex-socialist countries.
D) Georgia

*Geographic, historical, macroeconomic and social characteristics*

Located in the Transcaucasian region in the most eastern part of the European continent, Georgia has traditionally played an important role as a link between Central Asia and and Europe. It is not accidental that Russia designated Tbilisi, the capital of Georgia, as an administrative center of Transcaucasia in the years of the Empire as well as in the early Soviet period. There are two main reasons for the strategic importance of Georgia within the region. Primarily it is the favorable geographic location, bordering Russia, Armenia, Azerbaijan, and Turkey, and having several convenient sea ports. The latter allow Georgia to serve as a transit route to Europe for its immediate neighbors as well as for the landlocked states of Central Asia. Second, there are political and cultural reasons. Georgia has long been a crossroad of different cultures and ethnic groups but has a long-standing record of neutrality in Transcaucasian politics. Today's geo-political games around oil transit routes have three great traditional actors: Russia, Turkey, and the United States. All of them are very active in pursuing their often-conflicting interests, which definitely leads to destabilization of the country (Matchavariani, 1997).

At the onset of the transition, Georgia might have seemed as prepared as the other republics of the former Soviet Union to face the challenges of sweeping economic and social changes. Until the late 1980s, the standard of living in Georgia was among the highest in the Union of the Soviet Socialist Republics (USSR). This was not reflected so much in per capita income (in which the republic lagged behind most of the other republics). Numerous other social and material indicators - from automobile registration to life expectancy at birth - were among the highest in the USSR. Seen from this perspective, the large welfare loss and economic crisis suffered by the Georgian population during the 1990s is particularly grave. Exasperating the sharp decline in wages, production, and the social disintegration, were the armed conflicts that broke out in two areas of the republic, as well as the rampant crime, political instability, and natural disasters. The economic crisis in Georgia was caused in great part by the unnatural and
inefficient structure of the national economy, which strongly relied on other republics of the Soviet Union for imported energy, raw materials, and manufactured goods.

Since independence in 1991, Georgia has been through an extended period of severe economic and financial crisis. Loss of markets in the former Soviet Union (FSU), loss of inputs from the same source, and internal civil strife are the major factors behind a fall in recorded, real GDP of about 80 percent from 1990 to 1994. For the same period of time, the decline in recorded industrial output was about 83 percent and the decline in recorded agricultural output, about 63 percent (Papava, 1996). In the wake of its recognition as an independent state by most industrialized nations, Georgia became a member of the IMF, the European Bank for Reconstruction and Development (EBRD), United Nations (UN), the Council of Europe (CE), and other international organizations. In the autumn of 1993, Georgia reluctantly joined the Commonwealth of Independent States. The war in 1993 caused the consolidation of opposition forces, which advocated bold economic reforms, a pro-Western foreign policy, and preservation of national sovereignty. Intensified political frictions in early 1994 made the country's political future seemingly unstable (Saakashvili, 1995).

The initial reaction of the government to the economic problems and the consequent loss of budgetary revenue, was to borrow in order to maintain government services and subsidies. At the same time, state banks and a large number of newly created private banks provided credits to ailing state-owned companies. The result was the accumulation of a large overseas and domestic official debt and an acceleration in the rate of the inflation as shown in Table 7:

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual inflation rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>5</td>
</tr>
<tr>
<td>1991</td>
<td>175</td>
</tr>
<tr>
<td>1992</td>
<td>1,304</td>
</tr>
<tr>
<td>1993</td>
<td>9,040</td>
</tr>
<tr>
<td>1994</td>
<td>8,380</td>
</tr>
</tbody>
</table>


The hyperinflation after 1992 only eroded the real value of incomes in both public and private sectors and even more so in government, and made governmental accountability and revenue forecasting almost impossible. The existing data and especially the recorded fall in output and GDP, relate to the formal economy. In Georgia, similar to other CEE countries, a
A reliable estimate of the informal economy can hardly be provided, but according to data from the Ministry of Economy of Georgia (Papava, 1996), in 1994 it was as large as 80 percent of the recorded economy. In Soviet times, the informal economy used to operate outside the law and was usually linked to activities of a common criminal nature. In the financial sphere, the powers of financial institutions to direct credits were used for speculative purposes. Much of the criminal activity emanated from the highest levels of government, as an offshoot of the civil unrest and of the financial needs of political factions. The economic shocks of mid-nineties, compounded by the civil conflicts, caused the economic activity of the country to decline to less than a third of its 1990 level, and severely undermined the Government's capacity to conduct economic policy. Government revenue fell to less than 3 percent of GDP, and despite very low wages and expenditure compression, government expenditures far exceeded revenues (Papava, 1996).

In 1994, Georgia started the implementation of an ambitious program of stabilization and structural reform designed to halt hyperinflation, address the country's massive domestic and external debts, and promote a market economy. With the assistance of the IMF, the government began to take drastic measures to overcome the crisis and to promote the transition to a market economy. One of the main focuses of this reform program was the restoration of financial and budgetary controls. Government credits were drastically curtailed; budget expenditures were reduced, in particular by the reduction or elimination of subsidies on bread and fuel. Government employment was reduced as well. Special measures, including sanctions for tax evasion, were taken to improve the collection of government revenues. At the same time, further liberalization of prices was introduced and the privatization program was intensified and extended. Various projects, mostly funded by external donors, were introduced to support the revival of industry and agriculture. Steps were undertaken to establish the legal and institutional framework for a market economy. The program entailed the provision of credits by the IMF to the government for covering the continuing budget deficits. These changes helped the government to overcome the threat of total economic collapse and to continue its stabilization efforts in a better microeconomic environment (Matchavariani, 1997).

**Budget considerations and the role of government**

Towards the end of 1995, the government's role continued to be constrained by budgetary considerations, to such an extent that it was unable to perform many of its nominal functions. In 1996 the government had to scale down the provision of government services. Where possible, some services were left to private initiatives and large arrearages developed in entitlements such as pensions, and in government payrolls.
In 1996, together with the World Bank and the IMF, the Government of Georgia developed a "Medium-term Objectives and Adjustment Strategy" for the period 1996-1998. The purpose of this strategy was to promote growth, consolidate stabilization, and accelerate transition to a market economy while improving social protection. One of the priorities of this strategy was the strengthening of public finances. The aim was to improve revenue performance in order to create sustainable fiscal policies that would finance basic government operations as well as urgent needs for investment and social expenditures. An extensive program of technical assistance was supposed to strengthen Georgia's institutional capability to administer taxes, control expenditures, conduct monetary policy, and to produce reliable economic and financial data. The authorities had to remove obstacles to economic growth through further restructuring and downsizing of the government, and by elaborating an adequate legal framework promoting market reforms (WB/IMF Report, 1996).

The reform in public finances had two main objectives:

- to strengthen public finances through improving revenue performance; and,
- to downsize and restructure budgetary organizations in line with the government's newly defined responsibilities.

These objectives had to be achieved through new policy measures, such as:

- substantial improvement of tax and customs administration;
- encouragement of tax compliance through simplified procedures and regulations for tax assessment, collection and audit; and
- tax policy change leading towards a reduced number of exemptions.

Local Government in Georgia: Administrative and Legal bases

Georgia has a population of 2.2 million over a territory of 69,700 square kilometers. It includes two autonomous republics Abkhazia and Ajaria, 53 municipalities (rayons) and nine cities. These are the administrative units within which local government is exercised.

Due to political and regional conflicts the issue of local self-government is not even mentioned in the new Constitution of Georgia adopted in 1995. Neither does Georgia have a law on local self-government similar to most of the CEE countries (it did not become an official member of the Council of Europe until April 1999). Despite the lack of these basic legal provisions for local self-government, Georgia is among the few East European countries that have adopted a local budget law, arranging local finances independently from the central budget. The principles underlying this law are the same as those in the European Charter on Local Self-Government.
Map 5: Administrative and Territorial Division of Georgia
Local governments finance

In 1996 the government of Georgia revised the Law on Budget Systems and Budget Authority and reviewed the structure of state and local finances. Special attention was paid to the revenue sharing mechanisms, the potential revenue sources for each level of government, and as well to the implications of increased decentralization on expenditure programs. The Law on Budget Systems and Budget Authority is the law that determines the basic principles for compilation, discussion, and approval of the state and local budgets of Georgia. According to this Law, the approval of the budgets of the territorial entities is made by the respective local representative body of government in compliance with the amounts of targeted transfers as defined by the law. Chapter V of the Law contains the provisions for the budgets of the autonomous republics of Abkhazia and Ajaria and the other territorial entities of Georgia. According to Article 29(2), "local bodies of state authority and government" of the Autonomous Republics and other territorial entities "compile, approve and execute their respective budgets independently." Article 30 of the same Law deals entirely with local revenues. The Law defines the following types of local revenues:

1) **General national taxes** (identified by the tax Code of Georgia) that shall be fully deposited in the budgets of the Autonomous Republics of Abkhazia and Ajaria and other territorial units:
   a) tax on land;
   b) tax on property (improvements to property);
   c) tax on transfer of property;
   d) tax for environmental pollution;
   e) tax for use of natural resources.

2) **Local taxes** (identified by the Tax Code of Georgia) that shall be fully deposited in the local budgets:
   (a) tax on entrepreneurship;
   (b) tax on gambling business;
   (c) resort tax;
   (d) hotel tax;
   (e) tax on advertising;
   (f) tax for parking;
   (g) tax for using of local symbolics.
(3) **Non-tax revenues** (in compliance with the procedures set by "relevant legislative and other normative acts":

(a) fees and charges for delivery of services and issuance of licenses  
(b) state duties;  
(c) revenue from rent of state property and land under the authority of local government;  
(d) dividends and share of profit from or partially state-owned legal entities under the authority of local government;  
(e) royalties;  
(f) interest on government loans, deposits, bills and other.  
(g) Revenue from lotteries;  
(h) Revenue from sale of state property under authority of local government;  
(i) Revenue from transfers;  
(j) Revenue from grants; and,  
(k) Other non-tax revenues.

While the Law enumerates all types of local taxes and fees, it does not define the procedures for setting their rates and bases. These are supposed to be determined by the State Tax Code. Due to the difficulty in accessing any legal information on Georgian public finances, at the time this thesis was written, it was not possible to acquire more definite information as to whether or not the Tax Code has already been updated in accordance with the new Budget Law. If Georgia has already a new or amended State Tax Code, it is very likely to escape the problems that other CEE countries have faced with discrepancies between new and old legislation. If not, Georgia will likely suffer the same problems based on the discrepancy between the new budget policies and the old tax system and tax rates. It is very difficult at the present time, if not impossible, to estimate only on the basis of the State Budget Law the real budget authority and respective fiscal autonomy local governments in Georgia have received based on the amendments of that law. It provides no information on the rights of local governments to set up tax bases and tax rates. Article 32 gives local authorities only the right to independently determine the directions of usage of the respective budget revenues (except the targeted transfers and loans from other levels of government). Article 31 provides that the distribution of budget revenues between the budgets of different levels of government should be performed "in compliance with the regulations set by representative bodies of the Autonomous republics and local representative bodies of government or territorial entities." The lack of any official statistical data does not allow for further discussions of the effectiveness of the current revenue system.

In 1998, with the technical assistance of foreign experts (American and British), a draft "Law on the Budget System and Budgetary Rights of the Autonomous Republics and Local Governments of Georgia" was elaborated. The Law basically defines the budgetary rights and obligations of the two autonomous republics and the local governments. According to the General Provisions (Chapter 1): "Development, approval and execution of local budgets are sole responsibility of local government bodies." According to Law, local budgets remain an integral part of the national budget (Article 1(e)). Chapter II of the Draft establishes general principles for the conduct of budgetary activity by local government officials. Most of the principles enunciated in the chapter are common in modern budget systems, such as the requirement that all revenues and expenditures must be included in the budget. Failure to include all of them in the budget, which used to be a common practice in the former SU countries, is indicative of bad economic and budget management. Besides, the central government cannot transfer any of its activities and functions to local governments unless it transfers the necessary funds for carrying out these activities. In other words, the law prohibits unfunded mandates. This is a provision which some countries are adopting lately, especially under conditions of scarce budget resources but increasing demands for public services. Basically the purpose of Article 7 is to prevent any shifts of responsibility for services to local government unless special resources have been provided to them.

The General Provisions of the Law contain a very important Article (4), which provides for the avoidance of a problem that existed in many former Soviet countries and CEE countries: the recognition of the budget as a law. This provision is especially important for keeping a strict budget balance and disallowing any expenditures that are unfunded. A specific purpose of this article is also the allocation of tax revenues only for authorized programs and services. Unless there is money in the budget for the program or service, no expenditures may be made for it. An interesting provision, which almost all local budget laws of the CEE countries are now trying to introduce is the right of local governments to contract with the private sector "wherever practicable" to provide services rather than to use government employees. These are usually commercial types of activities, which the private sector can often perform at lower cost and often more effectively than the government.

Chapter III of the Draft Law deals with local government revenues and expenditures in a slightly different manner from the exiting Law on Budget Systems. Seven types of local revenue categories are specified:
a) **Local taxes**, including:
   1. Land tax;
   2. Environmental tax;
   3. Tax on property of enterprises and individuals;
   4. Tax on registration of enterprises and businesses; and
   5. Other local taxes authorized by law.

b) **Shared taxes**, a proportion of national taxes and other revenues as authorized in the annual state budget law:

c) Fees and charges;

d) General and special transfers from higher level of budgets;

e) Sales of assets of local public administration bodies;

f) Sale of local government securities; and,

g) Other collections provided for in law.

Basically, the specific taxes listed in this Article are consistent with Chapter 5 in the current "Law on Budget Systems." According to the Draft, the exact shares of revenue and the amount of the transfers should be established in the annual budget law but can also be covered by the Tax Code. Article 8, similar to other articles in the Draft Law is left broad enough to authorize the sharing of national revenues irrespective of the particular laws that provide for the legal authority and the share amounts. A new and different point in the Draft Law, compared to the existing one, is that it identifies the sale of local government assets as a source of revenues. Another new item is the right of local governments to issue securities. Although it may seem early and premature to give this right to local governments, the Draft Law envisages provisions for expected changes in the distant future, which is certainly an advantage for any legislation created under conditions of economic and political uncertainty. The law determines that local bonds will be used solely for financing capital projects.

The basic weakness of this Draft is that it doesn't handle at all the issue of who is responsible for the establishment of tax rates and tax bases. Neither does the law provide further directions as to who should determine the expenditure rates for different services. According to a note of the authors of the law, these responsibilities should be determined by another law, usually by the Law on Local Self-Government. Since Georgia still does not have such law, the question remains open as do many other questions regarding local self-government and local finances in Georgia.
It would be premature to make any conclusions about the success or the failure of the latest administrative and legislative reforms in Georgia. Even the most precise analysis of the strengths and weaknesses of the reform and the special policies for its accomplishment cannot render credible estimates about outcomes. The history of the region is replete with civil conflicts and regional wars which have jeopardized long-term and well-designed policies and programs.
E. Cross-national Comparisons

A quick glance at the latest historical developments in Europe shows that the process of transition to a market economy started after the fall of the Berlin Wall and the political upheavals of late 1989. Many Central and East European countries embarked on road of reforms as soon as these changes occurred. Others, such as Georgia and Lithuania, had to first gain their independence from the former Soviet Union. Only then could they start their efforts toward a market economy. The purpose of the transition process, departure from a centrally planned economy to the establishment of the foundations for a market economy, is common for all CEE countries. But as the case studies show, each country pursued this course through varying approaches which differently affected the speed of reform. The present section of the chapter offers a comparative approach to some common issues identified in the case studies.

The transition process in Central and Eastern Europe: Similar or different paths to a market economy?

The case studies reveal a rather dynamic and differentiated but not consistent picture of the general economic, political, and social conditions in the four countries. The first impression is that the unique characteristics and problems seem to outnumber the common ones. The selected countries have at least three major common characteristics:

- all four countries are located very close to each other in the central and eastern part of the small continent of Europe (See Map);
- all four countries have been for more than 45 years under the political, social, and economic laws of a socialist system;
- all four countries began their transition in the late 1980s and early 1990s from a centrally planned to a market economy; and
- all four countries have elaborated a similar legal framework in support of the local fiscal and administrative reform, consisting of the same types of laws.

The case studies confirm the statement of Bird and Wallich (1995) that the transition to a market economy has started in almost all socialist countries but has not ended anywhere. The short descriptions of the macro- and micro-economic framework within which the reform processes take place in each country indicate the importance of the initial conditions and policies for the speed of the transition. The case studies also describe the differences in the inherited economic conditions, natural resources, histories, culture, and traditions between independent CEE countries (Bulgaria and Hungary) and former Soviet republics (Lithuania and Ukraine). The
differences, however, are not limited only to these two groups of countries - such exist even within each of these groups. For example, although both Lithuania and Georgia were among the Soviet republics having the highest living standard and favorable economic conditions, the proximity of Lithuania to Western Europe, and the isolated geographic location of Georgia, have caused a different rate of reform. While Georgia gained its independence from the Soviet Union in 1991, the progressive democratic changes did not start until about 1994 (they were practically stopped by the civil wars that broke out in the country in 1993 and 1994).

Similarly, a close look at Bulgaria and Hungary shows the significance of the geographic location and that of the political and economic situations in neighboring countries. Since the very beginning of the transition period Bulgaria has suffered severe economic damages from the wars and the embargos imposed on the former Yugoslavia.

The picture becomes more complete by the comparison of some economic indicators. In the very first years of the transition process, the inflation rates in Bulgaria and Georgia reached annual rates exceeding 1000 percent (See Tables and explanations in the case studies), while in Lithuania and Hungary the fiscal crisis was not so pronounced. In 1991, the GDP in Bulgaria fell almost three times from its 1990 value while in Hungary it continued to increase. In 1992, Hungary had a GDP per capita three times higher than that of Bulgaria and six times higher than Lithuania's. After five years of restructuring, the ratios have changed in a rather unpredictable pattern. Hungary still has the highest rates but Lithuania has exceeded twice the rates of Bulgaria (Table 8).

Table 8. GDP Per Capita (in US$) Comparative Table CEE and Developed Countries

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>5,098</td>
<td>5,297</td>
<td>2,286</td>
<td>851</td>
<td>1,008</td>
<td>1,279</td>
<td>1,151</td>
<td>1,567</td>
<td>1,176</td>
<td>1,224</td>
</tr>
<tr>
<td>Hungary</td>
<td>2,738</td>
<td>2,803</td>
<td>3,191</td>
<td>3,231</td>
<td>3,609</td>
<td>3,752</td>
<td>4,043</td>
<td>4,330</td>
<td>4,400</td>
<td>N/A</td>
</tr>
<tr>
<td>Lithuania</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>514</td>
<td>715</td>
<td>1,142</td>
<td>1,624</td>
<td>2,127</td>
<td>2,574</td>
</tr>
<tr>
<td>USA</td>
<td>20,602</td>
<td>21,992</td>
<td>22,975</td>
<td>23,423</td>
<td>24,450</td>
<td>25,389</td>
<td>26,614</td>
<td>27,583</td>
<td>28,760</td>
<td>30,173</td>
</tr>
<tr>
<td>Germany</td>
<td>19,379</td>
<td>19,077</td>
<td>23,876</td>
<td>22,039</td>
<td>24,461</td>
<td>23,547</td>
<td>25,179</td>
<td>29,612</td>
<td>28,816</td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>16,652</td>
<td>16,545</td>
<td>206,334</td>
<td>21,294</td>
<td>23,644</td>
<td>22,931</td>
<td>24,465</td>
<td>26,710</td>
<td>28,344</td>
<td>25,564</td>
</tr>
</tbody>
</table>

Regarding the GDP rates, the major common feature of Bulgaria, Hungary, and Lithuania, which confirms their belonging to one and the same group, that of transition countries, becomes apparent from the GDP comparisons with developed countries, which are up to twenty times higher that those of the transition ones. The change of GDP through the transition period in each country is also indicative of the economic problems taking place within each of them (Figure 1).

**Figure 1. GDP per Capita ($ USD) in Bulgaria, Hungary, and Lithuania**

![GDP per Capita Chart](chart.png)

*Source: Author's calculations based on IMF/WB data, 1998.*

Figure 1 shows that Bulgaria, Hungary and Lithuania have experienced the economic burden of the transition period in quite different ways. Bulgaria experienced a sharp drop in its GDP as a result of economic contraction and is continues to have problems. At the same time, Lithuania has experienced a revival in its economic growth. While these developments can be estimated as positive for Lithuania, compared to Hungary, for example, it lags behind and has some distance to go to reach any of the developed countries. So do Hungary and Bulgaria, given their low GDP rates relative to those of West European countries.

Drawing the attention to these differences, the study finds that the transition path of a given country depends both on its initial conditions and on the economic policies it chooses to
implement. A logical question arises at this point that cannot be answered only on the basis of statistical data: Through what channels might initial conditions affect policies? While this issue is worthy of future research it goes beyond the purpose of this thesis. The present study focuses only on some of the processes resulting from the transition to a market economy and its effect on local government and local fiscal policies.

Decentralizing Government and fiscal systems in transition economies: the experience of four CEE counties

The worldwide shift towards government decentralization and devolution of functions to the local level is largely a reflection of the political evolution toward more democratic and participatory forms of government (Bahl, 1999). In the ex-socialist countries, the political motivation for decentralizing fiscal systems relates to the rejection of long years of extensive central control. The economic rationale for it in transition countries relates to efforts by the central government to ease the strain on its finances by minimizing transfers and shifting spending responsibilities to the local level. If well designed, fiscal decentralization may lead to an improved allocation of public services and a better accountability in providing them. But if systems are ill-designed, decentralization can instead create serious problems. Transition countries have already made mistakes but now, being midway in the process they should try to avoid such errors as much as possible.

Administrative Basis of the Fiscal Reform

The first step towards decentralization in Bulgaria, Hungary, and Lithuania was local administrative reform. Hungary first introduced the Law of Local Self-Government in 1990, followed by Bulgaria in 1991 and Lithuania in 1994. The principles of local self-government and the right of municipalities to have their own independent budgets and revenue systems were enshrined in the constitutions of the three countries. The new Constitution of Georgia, accepted in 1995 does not have a single chapter or article on local finances and local government. (See Appendix II, Table 2.1)

Following the enactment of the laws on local self-government, the countries initiated administrative and territorial reforms establishing the municipality as the basic unit where local self-government would be exercised. While there have been neither theoretical nor specific political directions regarding the size of the local-government units, each country has basically followed the logic of its political and historical traditions. None of the countries has redesigned the boundaries of the lowest level of territorial units. The reform was implemented either:
• by consolidating a number of small units into bigger ones so that they can meet the newly assigned responsibilities; or
• by dividing bigger units into smaller ones of a size, feasible for the provision of local services and the exercising of reasonable revenue authority.

In either case, an amazing diversity of numbers and sizes of new local self-government units was established in each of the four countries, that appears to confirm a previously cited theoretical statement that there is no "optimum" size for a local-government unit. Research on OECD countries (Lynch and Martin, 1993) indicates that many countries have encouraged significant amalgamation of small local authorities with a view to providing more and better services at the lowest level of government. To address service improvements, the new legislation in Bulgaria, Georgia, and Hungary has explicitly provided municipalities with the right of association and encouraged cooperation between localities. The effectiveness of the processes within the different-sized governments deserves attention especially with regard to assigning new expenditure and revenue responsibilities to the local level.

The newly adopted administrative division in each of the three countries also provokes questions and concerns about the opportunities for horizontal and vertical financial equalization. The establishment of accountability requirements and mechanisms for central fiscal control, for over 3000 Hungarian municipalities, for example, is questionable. The same applies to the feasibility of applying a formula-based approach for the distribution of central subsidies across such a big number of local government units. Unfortunately, comparable data are not available for the countries which show the extent to which different territorial units manage the newly assigned functions. Based on aggregated for local finance data of the three countries, an attempt is made to analyze the general effect of the new fiscal policies on the financial performance of local governments.

**Legal Basis of the Local Fiscal Reform**

As evidence since 1989 from CEE countries shows, a successful transition to a market economy and the undertaking of sustainable macroeconomic reforms require a legal system supportive of the political, economic, and administrative changes. The first steps of the legal reform which many CEE countries made in the sphere of local public finances was largely facilitated by administrative reforms that started as soon as the political changes made it possible in each country. Among the selected countries, Hungary was the first one to introduce, in 1989, the principles of local self-government and the right of municipalities to have their own,
independent budgets in the revised State Constitution. In 1990, Hungary was again the first country to adopt a Law on Local Self-government, which detailed the rights and spending responsibilities of local governments, as well as the sources of their revenues. Bulgaria followed the same steps with about a year's delay (Appendix II, Table 2.1). In 1991, Bulgaria adopted a new Constitution and the Law on Local Self-Government. In Lithuania, the legal reform in local self-government and local finances started in the autumn of 1992 with the adoption of the new Constitution. Chapter X of Lithuania's Constitution deals explicitly with Local Government and Local Administration. In 1994, following the Principles of the European Charter of Local Self-Government, Lithuania adopted the Law on Local Self-Government.

Although Georgia adopted its new Constitution late in 1995, it does not refer in any way either to the problems of local governments or to the matters of public finance. So far, Georgia has not adopted a Law on Local Self-Government (Appendix, Table 2.2). The country became a member of the Council of Europe only in April 1999. Along with the adoption of laws on local self-government, Bulgaria, Hungary and Lithuania revised their old State Budget Laws or adopted new ones. In 1992, Hungary adopted Act N XXXIII on the Public Finance System, which defines the basic principles and parameters of the budgets of the local governments. Otherwise, both Bulgaria and Hungary only revised their State Budget Laws and the chapters referring to local government. As a former Soviet Republic, Lithuania never had a State Budget Law until independence. In 1990 the country adopted its new "Law on Budgeting of the Republic of Lithuania." The comparative study of the four countries reveals a substantial similarity both in the titles and in the contents of the newly adopted laws. The legal framework is very much the same in all the countries with the exception of Georgia (Table 9). The in-depth revision of the single laws also suggests the availability of similar patterns among the provisions within each type of law despite the time differences of their adoption and the specific economic situation in each country. In fact, this is one confirmation that the general framework for reform is similar for the CEE countries, only the paths and the speed toward the final destination, a market economy, are different.

Since the research objectives of the present study are focused more on the specific issue of local fiscal autonomy and the revenue systems as a prerequisite for its achievement, a comparison of the local revenue systems (as defined by law) was made (Appendix II, Table 2.3).
<table>
<thead>
<tr>
<th>Type of Law/Act</th>
<th>Bulgaria</th>
<th>Georgia</th>
<th>Hungary</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter VII: Local Self-Govt. and Local Administration</td>
<td>Defines the municipality as the basic administrative territorial unit;</td>
<td>Local government and local finance issues are not treated at all.</td>
<td>- defines the meaning of “Local self-governments” - provides to local authorities the right to have independent budgets and incomes.</td>
<td></td>
</tr>
<tr>
<td>Article #52 defines the right of municipalities to set their own economic program and budget</td>
<td>N/A</td>
<td>Section #91 defines the right of municipalities to set their own economic program and budget and defines the structure of the local revenue system</td>
<td>Article 23: Defines the revenue sources for local governments.</td>
<td></td>
</tr>
<tr>
<td>Chapter II: Municipal Budgets</td>
<td></td>
<td></td>
<td></td>
<td>Chapter III “Local Budgets”</td>
</tr>
<tr>
<td>3. Law on Municipal (Local) Budgets as a separate document form the Central State Budget law</td>
<td>Adopted :1998</td>
<td>1998 (Draft)</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Chapter V: The Budgets of Local Governments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.Methodology on Determining Municipal Revenues and State Subsidies</td>
<td>1993-1997</td>
<td></td>
<td></td>
<td>“Establishes the sources of revenue of municipal budgets and procedure of calculation, confirmation and transfer of the subsidies allocated from the state budget to municipal budgets”</td>
</tr>
<tr>
<td></td>
<td>Annually Revised</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: The respective countries' laws
Despite the different wording and design of the laws that define them, the common (for all countries) revenue sources are much more than the specific or unique ones, which appear occasionally in each country. While there is a considerable uniformity in the types of tax revenue, more differences appear in the non-tax revenue, and especially in the fees and charges. Although these are among the few own-source revenues which local governments in the CEE countries possess, as the country data show their share in the total local revenue remains quite modest. Despite that, an indepth study may reveal the relative importance and feasibility of imposing particular fees and charges. The different sources, i.e., the different types of laws, where local revenue categories are specified, often do not provide concise definitions of the different revenue categories. An attempt at cross-country comparison of the available revenue categories in each of the four countries has been made as well (Appendix II, Table 2.4).

Despite the visible uniformity of the legal framework, the case studies indicate a major problem, which creates impediments for the implementation of some of the new laws. As noted in each table, and also discussed in the individual case studies, most of the laws have been subjected to a number of amendments. While at the higher level of statutory law, the introduction of changes rarely directly affects the revenue and tax systems, the inconsistencies in the time frames regarding changes of budget laws and other documents that support the implementation of tax policies may cause significant problems. This happens most often when special ministerial decrees are issued, temporarily giving or taking away some taxing instruments and powers (changes by decree).

A comparison between the legal provisions for revenue sources and the actual revenue generation indicates that sharp changes in the rates of raised revenue are not so often the result of some legal changes, rather they are the result of economic or financial problems of each country.

**Financing local governments**

Data available from the IMF/WB reflect how much each major (aggregated) category of local government revenue has contributed to financing local government expenditures (Appendix II, Tables 1.1,1.2, and 1.3). Although data comparison helps a lot in discerning common trends, the analysis of the municipal budget laws of the four countries shows some considerable variations in the structure of the local revenue systems that also may be claimed as a possible reason for the existing differences in the statistical data. Other reasons, such as traditions, economic, and regional characteristics also should be considered, especially in the process of
discussing potential reforms in the local revenue system. Of course the general tendency of decreasing local revenue indicates, at the least, conditions of scarce public resources (Figure 2).

Figure 2. Local Government Revenue as a Percentage of GDP in Bulgaria, Hungary and Lithuania

![Local Government Revenue as a Percentage of GDP](image)

Source: Author's calculations based on IMF/WB data, 1998

The present study is not intended to go deeper into the structural problems of local revenue systems but discusses them only to the extent to which they are indicative of local fiscal autonomy. The data reveal that local-government revenues in Bulgaria, Hungary, and Lithuania, since the beginning of the transition period have not been and are still not sufficient to cover expenditure needs. There is clearly a discernable tendency towards increased central financing, a trend which has definitely not been the aim of any of the new laws on local self-government and local finances of these countries (Table 10).
Table 10. Share of LG Expenditures Financed by Central Government Transfers

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>18</td>
<td>14</td>
<td>16</td>
<td>27</td>
<td>36</td>
<td>46</td>
<td>46</td>
<td>43</td>
<td>40</td>
<td>36</td>
</tr>
<tr>
<td>Hungary</td>
<td>49</td>
<td>49</td>
<td>40</td>
<td>66</td>
<td>57</td>
<td>51</td>
<td>53</td>
<td>58</td>
<td>57</td>
<td>56</td>
</tr>
<tr>
<td>Lithuania</td>
<td>54</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Georgia</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>


Local taxes: Property Tax

The property tax is considered among the most important local taxes in many West European countries and in the US. This tax is still not under the control of local governments in the CEE countries and makes an insignificant contribution to the total local revenue (Appendix I, Table 1.1 - 1.3). Although it is certainly an important revenue source, it may not necessarily be viewed as an effective revenue-raising instrument for local governments in the ex-socialist countries. According to Bahl and Linn (1992) there are several objective reasons for property tax concerns:

- land taxes are difficult to administer;
- land taxes may have undesirable land effects; and
- they are very unpopular with taxpayers.

In the countries selected for this thesis, the picture is even more intriguing but unfortunately, inconsistent. For example, following the former Russian traditions and despite the strong West European influence, Lithuania has not yet introduced tax on individual property or improvements to property, just on land and on property of enterprises. In Bulgaria this tax was very low until 1997 and the rates have always been centrally determined. The land tax contributed only 6 percent of total local revenue in Bulgaria and between 5 and 7 percent in Hungary (depending on the year). Local governments in Bulgaria were only allowed to estimate, based on centrally determined criteria, the value of the property used in the tax base. The new legislation on local taxes in Hungary has given local governments the authority to impose their own rates on property but data show that this has not lead to any significant change or increase in local revenue (Appendix I, Tables 1.1 - 1.3). The current research points to the reluctance of local governments
in Hungary to avail themselves of this revenue-raising opportunity by local taxation and assuming responsibility for local decisions.

There are three main explanations for the reluctance of local governments to use their newly provided rights to set taxes and tax rates:

- unwillingness to take political responsibility in taxation;
- lack of competent skills and knowledge in public finances at the local level; and,
- concerns for diminished political power, including influence in election campaigns as a result of the introduction of unpopular taxed or increased rates.

The extent and nature of exclusive local taxes and the authority to set the rates of those taxes are key factors in the autonomy and accountability of local governments. This is often described as a trade-off, since more local discretion in this field can hamper central government's interests in controlling overall tax burdens and aggregate public expenditure.

In Georgia, the latest Local Budget Law provides local governments with the right to change old and introduce new, local tax rates but no data or other evidence are yet available to show whether this right has been used or not.

In the case of Lithuania, the lack of a tax on improvements to private property may be viewed not only as an inheritance from the old Soviet system but an inertia which the government chooses not to eliminate. A delicate political element should also be emphasized: currently it is politically unfeasible within the new, fragile democracies to additionally increase the financial burden of taxes that have never been popular. The fragility of democracy during the first years of transition should always be considered when analyzing the feasibility of introducing new or increasing old taxes.

The main revenue sources for municipal budgets in Bulgaria are the shared taxes (profit and personal income tax), the portion of which is growing within the structure of local tax revenues in the period 1992 through 1997. Bulgarian municipalities mainly rely on the individual income tax and on the turnover tax of local enterprises. It sounds like a paradox that the revenue from individual taxes is almost twice as high as that from municipal enterprises and other economic activity. The property tax, which could be a substantial source of revenue, is very low and practically of no major significance in local budgets. The share of local fees and fines is relatively low, and after 1994, shows a steady decline, which means that despite the rights given to local authorities to determine the base and the size of some local fees and charges, this right has not been widely used (Table 11).

Where property value assessment is a local responsibility it may be freely handled by local authorities or it may be centrally controlled - depending both on the respective country's
legislation and the ability of local governments to handle that responsibility. General sales and income taxes are less frequently at the disposal of local government and their rates are usually centrally controlled.

Local public enterprises have always been a major revenue source for local governments during the socialist period. After the mass privatization of state and municipal property that began at various times in almost all ex-socialist countries during transition, many local governments lost this important source of revenue or were prohibited from using it. Any income from privatization activities is generally considered as a one-time and non-recurrent revenue source.

### Table 11. Shared Taxes in Bulgaria, Hungary, and Lithuania (\%)  

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<td><strong>Dom. Taxes on Goods and Services</strong></td>
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*Source: Author's calculations based on Government Finance Statistics Yearbook, IMF/WB, 1998*

**User charges**

A rule of thumb in local public finance is to charge for services wherever possible (Marshall, 1969). According to Bird and Wallich (1994), if direct beneficiaries can be identified, user charges, and not the budget should be the first resource. In the selected countries, however, user charges are not being applied as much as they ought to be based on Bird's argument. Many public service prices continue to be affected by subsidies, inefficiency, and inequality. In Hungary, for example, general revenues, rather than user charges, finance such budgetary items as public transport and housing. In Bulgaria and Lithuania, local revenue from fees and charges
varies between 6 and 9 percent of total local revenues. In both countries there is no discernable tendency toward increasing their share in local revenue despite the power given to local authorities to impose user fees and charges.

**Central Transfers**

The case studies show that the system of central transfers in the three countries has not yet been satisfactorily accomplished. Over the past few years, Bulgaria, Hungary and Lithuania have been trying to improve their central grants’ systems through constant amendments in the number and type of the criteria for assessing local needs with a shift from capacity-based to more needs-oriented criteria. The imperfect formulae, however, and the difficulties with their application, as well as the constantly changing economic and financial circumstance in the countries, often lead to abandoning the formulae and acting on the basis of general estimation. The improvement of the current system for distribution of central grants is of vital importance under the conditions of scarce resources and strained fiscal conditions. The implementation of a sophisticated system of equalization grants requires good databases, which is still not available in many CEE countries. When better data are developed it may be possible to reduce the great number of currently used criteria for determining the size of the grants or central transfers to each municipality (e.g., 21 in Bulgaria, and 25 in Hungary) by substituting capacity-based criteria with a needs-based approach.

The data show that local governments in Hungary rely extensively on central transfers: an average of 70 percent of total local government revenue is from central grants. Although this share is much lower for Bulgaria and Lithuania, they also show a trend towards increasing financial reliance on central government money (Figure 3).

The current transfer system in Bulgaria severely discourages the generation of own-source revenues. The adjustment factor (A) in the formula, for example, is based on the actual revenue collections of local governments rather than on a measure of tax capacity or the relative level of tax effort. This issue is of little importance at the present time because municipalities have little authority to raise taxes or even nontax revenues. However, the adjustment factor (A) as designed, can be effective only if system of revenue assignment allows for local discretion in tax effort.
In Hungary several changes seem desirable as well. As shown in the case study, the normative grant in Hungary has three important characteristics. First, the grant is unconditional and local governments can spend the money however they see fit: the total amount distributed to all local governments is entirely discretionary, set in the annual budget exercises. Second, the basic formula contains both per capita and needs-based components. Finally, the combination of these facts does not provide for an effective distribution of central financial funds, it rather creates favorable conditions for municipalities to further prefer he reliance on central grants instead of mobilizing their own-source revenues.

Although in the current political environment in Hungary, where local autonomy remains a sensitive issue, it is probably not feasible to to make central grants conditional. Yet, national governments could increase the efficiency of their grants-distributive system by increasing the requirements for reporting and accountability at the local level and introducing more transparency in the intergovernmental transfer system. For example, the provision of financial reports could
become a condition for receiving grants. Under the conditions of fiscal strain this will increase the allocative efficiency and considerably improve the distributional equity. The size of the normative grant could also be reconsidered. Currently, it is entirely determined by the national government, which sets the transfer each year in the national budget. Being based on need, rather than on estimates of local revenues, it has the appearance of a gap-filling transfer. This feature enhances the reluctance of local governments to mobilize local revenue raising.

The Lithuanian methodology for central transfers is extremely complicated and difficult to apply. Although there is no available information whether it has been applied, it may need some basic revision before being fully implemented.

Due to the lack of data Georgia's comparability cannot be assessed.

Regarding central transfers, the case study research helped identify a number of common problems that can be summarized to the following:

- current intergovernmental fiscal systems in the selected CEE countries lack effective equalization;
- they do not contribute in a fair way avoiding revenue gaps, rather they still allow the old "negotiation" process to take place; and,
- the lack of transparency and accountability requirements is a further impediment to the avoidance of regional disparities.
V. SUMMARY AND CONCLUSIONS

This chapter summarizes some major problems of the transition period related to the processes of fiscal decentralization and local finances. Based on the findings of this study, particular issues are generalized to the extent that reasonable suggestions for future policies can be made. Problems worthy of future research are identified as well.

The transition from a centrally planned economy to a market one in the countries of Central and Eastern Europe has provided a unique opportunity for the analysis of rapid changes in budget systems, financial institutions, fiscal policies, and their overall implications. One of the purposes of the present thesis was to elucidate the similarities and differences in the restructuring processes taking place in this part of the world. Four ex-socialist countries, belonging to specific geographically and historically determined regions in Europe were subjected to similar study. The aim of the applied comparative approach was the identification of typical patterns of local government structures, municipal finances, and fiscal policies in different national contexts but within the common political, social and economic frameworks of the transition period in Central and Eastern Europe.

In search of decentralization and deconcentration

The philosophy and logic of the transition period leave no doubt about the radical change in the role of the public sector during the shift from an economy dominated by the state to an economy based on private property and market values. The size of government is bound to shrink, a fact that is generally accepted as a logical consequence of this transition process. There is much less agreement, however, on questions regarding the appropriate speed of the state sector's decline, the optimal size of government and the extent to which government activities should be decentralized. The degree to which expenditure responsibilities and revenue authority should be delegated to the local level of government also remains in dispute. Although many ex-socialist countries have unconditionally embraced the idea of local self-government, the case studies have shown that each country approached its establishment from a different starting point and with a different speed in implementing the necessary legislative and administrative changes. These facts do not necessarily indicate particular theoretical contradictions but they confirm the availability of opportunities for different paths toward the administrative and legal reforms of the transition. The analysis and particular examples provided in each case study identify one major
and common problem, the lack of consistency in the legislative reform. Evidence from all four countries shows how new and progressive laws have been hampered in their implementations because of theoretically outdated and contradictory but still effective "old" laws. Sufficient examples from the sphere of local finances are provided in the case studies, ascertaining that many of the new legal provisions for local fiscal autonomy cannot be practically implemented. Several explanations but no "excuses" can be provided for the existence of such discrepancies:

- first, it is the discrepancy between the initial enthusiasm for rapid changes and the objectively slower process of elaboration of new legislation;
- second, even if quickly elaborated, the new laws are normally subjected to a long process of discussions and formal approval by an extremely busy (and overwhelmed with the reform processes) parliamentary system in each country; and
- last, but not least, it is the considerable amount of old socialist-time laws regulating public finances and the tax system in each country that cannot be simply replaced or enacted. They are subjected either to a gradual process of amendment or replacement with new ones when possible.

While these facts explain some of the difficulties in the actual implementation of the new legislation, they cannot serve in the long run as an excuse for the lack of effectiveness, transparency, and accountability in the sphere of public finance. In this sense they are a substantial impediment to full reform.

Administrative-territorial aspects of the reform - implications for local self-government and local finance

Over the last few decades, a clear worldwide trend has emerged of devolving spending and revenue-raising responsibilities to subnational levels of government. This trend is also discernable in the ex-socialist countries. In the CEE countries, the shift towards devolution of administrative and fiscal power is largely a reflection of the political evolution to more democratic and participatory forms of government. The fiscal decentralization in these countries, as in other countries, is also expected to assure a closer correspondence between the quantity, composition, and quality of publicly provided goods and services.

Decentralization of spending responsibilities usually brings substantial welfare gains. Government resources can be allocated more efficiently by shifting the responsibilities for expenditure to the beneficiaries of these outlays (Ter-Minassian, 1997). However, decentralization can also entail significant costs in terms of distributional equity. This is especially valid for the transition countries in CEE, where the economic differences among local
government units are substantial and where small municipalities have no capacity to either provide local services such as primary education and primary health-care, or raise own-source revenue (Municipalities in Hungary and Bulgaria, for example with less than 500 residents). In small local government units it is also very difficult to provide trained personnel with fiscal and accounting knowledge and skills, capable of assessing real needs or of formulating and implementing spending programs. These problems are further compounded by the incidence of corruption and the lack of transparent public expenditure management systems in the new democracies of CEE.

**Local Fiscal Authority**

The issue of local fiscal authority gains considerable importance in evaluating the capacity of local governments to respond to newly assigned spending responsibilities and public service delivery. The same refers to the degree of local control over revenue sources which municipalities can exercise.

The present study on local government fiscal authority is performed on the basis of the countries' local budget and finance laws. A comparison between revenue authority (as provided by law) and actual revenue performance (according to statistical data) in Bulgaria, Hungary and Lithuania suggests that local governments in these countries differ not only in the degree of flexibility they possess but also in the way in which they can use the authority provided to them by law. Hungarian's local governments, for example, have considerable freedom to raise local revenues but have not used it to the extent one might expect, despite growing expenditure needs no own-source revenue increase has been registered since 1993 (Appendix I, Table 1.2). Bulgarian local governments, by contrast, are more restricted in their use of local taxes and consequently have expanded their use of local taxation very slowly. To compensate for the increasing expenditure needs, they have used their fiscal autonomy to develop systems of local fees and benefit charges, such as market fee, street sale fees, and a dog tax. This has lead to a partial recovery of some costs for providing municipal services.

**Shared taxes**

Tax sharing is an approach which gives local authorities the right to a share of the yield of certain national taxes. It is an attractive source of revenue to local governments because its administrative costs are relatively low and it distributes the tax burden over a large base.

The present study has also revealed some of the inconsistencies of central government policies regarding shared taxes, especially the profit and personal income taxes (Bulgaria,
Hungary). The examples show that tax-sharing bears a risk that central governments may seek to impose some conditions or controls, or simply increase central government's revenue. This is an issue, usually provoking much political debate and negotiation in both the vertical sense (regarding the respective shares of central and sub-national government) and the horizontal sense (regarding the basis of allocation between sub-national units). It is not surprising that external revenue sources are even less amenable to local control than are locally-raised revenues. Local governments rarely have a say in determining shared taxes and grants.

**User charges, fees and other sources of income**

The more widespread adoption of market-type mechanisms, especially in the form of user charges and fees, is another factor of growing importance in the autonomy of local governments. Charges for locally provided services are relatively efficient and have low administrative costs. They may generate quite significant revenues. Charges also can reduce excess demand for services and improve service quality as customers tend to demand better and more tailored services when they pay for them directly. Local governments in transition countries should be encouraged through adequate policy mechanisms to increase local fees and charges collection. Creating certain incentives or imposing conditions on behalf of the central government are feasible approaches but somewhat contradictory to the new democratic legislation of these countries.

**Other external revenue sources**

Local borrowing has not been subjected to detailed analysis in the present research but similar to most countries, even the developed ones, it is almost always controlled by central government. The new legislation in Bulgaria and Georgia provides for some variations in the extent of this control, while Lithuania does no permit local debt. In many of the CEE countries this issue gains importance because accumulating local debt was a normal policy during socialist times. At the same time, new opportunities for modification of the local debt appear with the recent establishment of stock markets and bond policies.

**Central Transfers**

Central transfers and grants are traditionally used to fill in the gap between the revenue-raising capacities and the expenditure requirements at the lower levels. In this sense, they provide a crude measure for the degree of dependence/autonomy of local governments. At the same time
the nature of the transfers - based on their degree of specificity, type and number of conditions attached, are equally important in determining the equalizing effect of the transfer system.

There are many types of transfer arrangements in terms of the degree of discretion available to local governments. The examples provided in the case studies show that some transfers may be relatively simple, while others may involve complex conditions and formulae for determining the amount to be transferred. The type of grant used can be a critical factor affecting accountability by making vertical lines of responsibility more transparent.

Revenue Assignment

The principles of revenue assignment among governments typically incorporate the concepts of revenue adequacy, efficiency, fairness (equity), and administrative feasibility. Of course, no revenue assignment scheme can simultaneously satisfy all of these objectives. Well-defined trade-offs usually exist between them (Vazquez, in Bird, 1995). For example, an assignment that allows local governments to rely more heavily on their own resources would promote greater efficiency at the local level, although the system may generate large differences in the level of services provided across jurisdictions.

Regarding the revenue assignment system, different approaches are possible, two of them representing extreme cases. First, are the policies that assign most taxing powers to local governments. The practices of developed countries and recent research in the field (Bahl, 1999; Ter-Minassian, 1997) show that this approach can be viable only in countries with established traditions of close policy coordination among different levels of government, which is certainly not the case in the CEE countries. The second type of revenue policies are those which assign all or most taxing powers to the central government, a policy which due to socialist experiences and central regulation, none of the transition countries would accept unconditionally accept. Either extreme is either not applicable or undesirable in the case of the ex-socialist countries. A third, more balanced alternative, which is strongly favored in the literature and most frequently applied in both developed and developing countries, is the one that provides for the assignment of own source revenues to each level of government. A combination of various types of intergovernmental transfers assures that eventual gaps between revenue and expenditure assignment will be covered.

The present study has shown that the most difficult issue for many CEE countries is to find the right balance between local own source revenue and central transfers under the conditions of fiscal strain and limited central resources.
Despite enumerated theoretical paradigms, it is not possible to discuss a feasible revenue assignment for all CEE countries: they may vary among countries depending on many specific factors. Each country should choose the most appropriate intergovernmental revenue assignment system by weighing specific or desired objectives. Revenue assignments should change as these objectives change, assuming consideration is given to providing local governments with sources of stable and predictable revenue.

Conclusions

Although the study provides evidence that local governments in the newly democratic states of CEE aim at achieving their revenue autonomy, most of them still face severe constraints in choosing the appropriate fiscal pattern. Even after local governments have been given a substantial freedom of action, their revenue authority has not always been fully utilized or changed. The revenue instruments, which seem to be mostly underutilized, include property taxes, motor vehicle taxes, and user charges. The existing legislation suggests that the degree to which a local government is able to meet its rapidly raising expenditure requirements depends only in part on its revenue capacity, as determined by the respective country's laws. Rather, a number of historically inherited and newly created impediments prevent local governments from the utilization of their local revenue authority. For example, the expansion of local government's tasks in Bulgaria, Hungary and Lithuania has not been matched by increases in the independent local revenue base. Furthermore, the financial problems created by increased service demands are heightened by dependence on inelastic revenues such a property taxes (although they have the advantage of being relatively stable irrespective of the economic cycle). Any shortfall is supposed to be met largely by increased transfers from central government. However, given the deteriorated financial situation of most of the CEE national governments, and their large foreign debt, local governments have started to also face cutbacks. Hence, the potential conditions appear for underfunded mandates and for the emergence of local fiscal crises.

Given the limitations of local authorities to generate their own revenues, evolving fiscal and financial relations across levels of government in the CEE countries reflect a more pronounced interdependence between levels of government. This situation is leading to new forms of partnership between levels of government: the revisions of tax-sharing schemes and of equalization policies. In parallel, transfers to lower levels are generally shifting away from specific-purpose grants, thereby providing opportunities for broad goals and targets to be accepted. These strategies underlie the importance of setting national objectives and supporting fiscal policies.
The issues identified in this thesis highlight a number of basic, similar tensions in intergovernmental fiscal relations of all four countries. These tensions challenge policy initiatives towards finding the right balance between:

- promoting greater autonomy at the local level of government, while assuming a main policy direction.
- allowing for differentiation through flexibility, yet ensuring some minimum degree of uniformity and compliance with legal and other norms; and,
- more responsiveness to local needs, but not to the detriment of efficiency and economy.

A challenge for all CEE countries should be the design of mechanisms which would facilitate the effective distribution of responsibilities and funds between different levels of government, and assure greater local fiscal flexibility and financial accountability. Such mechanisms should consider a number of factors, including the extent to which responsibilities are mandatory or optional, clearly defined or indistinct, exclusive, or shared with another level of government.

These factors have been discussed in each of the four countries. A clear discrepancy between the current fiscal legislation and the reality is evident. The analysis revealed some reasons for these differences, such as:

- legal changes proceeding cultural, administrative, and economic adjustments;
- economic instability and financial deficits impeding the implementation of some legal provisions;
- constant amendments to new laws creating ambiguity in their application;
- ministerial decrees obscuring the implementation of current laws;
- political instability and uncertainty causing reluctance among local authorities in implementing new tax rates or unpopular taxes; and
- insufficient administrative flexibility and experience at the local level resulting in resistance to fiscal policy changes.

The research work, based on both data and legal provisions, has provided sufficient evidence that, despite these current difficulties, local governments in the selected transition countries have a significant potential and that they can be an important factor for national resource mobilization despite conditions of political tension and economic crisis.
Beyond the responsibilities of the present research

If fiscal decentralization is to achieve its intended efficiency goals, it must be accompanied by policies that assure local budget discretion and fiscal accountability, and the explicit linking of legislative decisions to the decision-makers. The more the responsibility for fiscal decisions is obscured by hidden or complex institutional arrangements, the less accountable (and efficient) the system of public service delivery will be.

Building the budget capacity of local governments is not a linear process. Fiscal decisions in particular create tensions, many of which result from the conflict between often competing national objectives that depend on successful implementation. In these cases:

- developing a fully operational market economy within a democratic context; and
- maintaining social protection in the form of a wide array of social benefits.

While the new laws and regulations provide much greater freedom to local authorities in budgeting and financial management, local governments in many CEE countries are continuing to operate within the old centralized fiscal structures and thinking. It is essential, therefore, that central governments define additional sets of fiscal relationships with municipalities that would enable them to find the right balance between the needs for decentralization of governance and the ability and desire to control and steer the local revenue and policy processes.

There is an impressive array of budget reforms and improvements that yet need to be addressed in the CEE countries. The most important of them should be oriented towards:

- more effective mobilization of local resources;
- better utilization of all potential sources of revenue;
- proper allocation of local government's resources among competing demands;
- prompt and economic disbursement of public funds; and,
- establishment of transparent accounting and budgeting practices.

These issues, of course, are more than worthy of extensive future research.
Term Identification

**Governance**
The manner in which power is exercised in the management of a county’s economic and social resources for development, also the complexity of intergovernmental relations when treated as a system;

**Transition Period**
The period of transition from centrally planned autocracies to market-based democracies;

**Fiscal decentralization**
The transfer of fiscal responsibility to democratically independent lower levels of government, thereby giving them more managerial discretion but not necessarily more financial independence;

**Delegation**
Used for the formal relationship in which competence for an aspect of the regulatory process is given by one level of government to a second level of government;

**Devolution**
Used seldom as an umbrella term covering all forms of transfers of responsibility;

**Deconcentration**
The transfer of responsibility from central ministries to field offices or more autonomous agencies, thereby becoming closer to citizens while remaining part of central government;

**Tax sharing**
A system, in which one government (usually the central government) collects revenue from a tax and shares it with subnational governments, usually on the basis of the geographic origin of the revenues. Such sharing is common in transition economies.

**Horizontal equity in tax payment distribution**
Horizontal equity considers equal treatment of tax payers, who have equal capability to pay taxes. If two tax payers are equivalent in all relevant aspects, but one tax payer pays significantly greater tax, the tax structure lacks horizontal equity. An obvious problem in this case is defining equivalent tax units.

**Vertical equity**
Vertical equity concerns the proper relationship between the relative tax burdens paid by individuals (government units) with different capabilities to pay taxes. The comparison is among unequals and the main question is by how much should tax payments differ;

**Revenue flexibility**
The degree to which revenues can be changed to allow adjustments to changing conditions;

**Revenue elasticity**
The ability of revenues to respond to changes in inflation and in the economic base. As inflation and the economic base increase, elastic revenues increase in roughly the same or greater proportion; if inflation declines or the economic base shrinks, elastic revenues drop in proportion;

**Revenue diversity**
A diversified revenue system normally facilitates governments in meeting short-term fluctuations in any one revenue source;

**User charges**
User charges are prices charged for voluntary purchased, publicly provided services that, while benefiting specific individuals, are closely associated with pure public goods. Some of these services, when purchased by one person, may yield external benefits to others.
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APPENDIX 1.
### Bulgaria

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### Consolidated Central Government

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### Local Government

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<th>LG Expenditure as % of GDP</th>
<th>LG Revenue as % of GDP</th>
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### A. Revenue and Grants (Local Government)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue &amp; Grants (II + VII) as % of GDP</th>
<th>TOTAL REVENUE (III + VI) as % of Total Rev. &amp; Grants</th>
<th>Tax Revenue as % of Total Local Rev. (without Grants)</th>
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### APPENDIX 1.
Table 1.1. Bulgaria: Local Government Revenues (Percent Ratios)
Source: Author’s calculations based on IMF/WB Data, 1998.
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### Consolidated Central Government

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<th>Total Exp. - Central Govt. as % of GDP</th>
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### Local Government

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<th>LG Expenditure as % of GDP</th>
<th>LG Revenue as % of GDP</th>
<th>LG Revenue as % of Central Govt. Revenue</th>
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### A. Revenue and Grants (Local Govt.)

<table>
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<tr>
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<th>TOTAL REVENUE (III + VI) as % of Total Rev. &amp; Grants</th>
<th>Tax on Inc., Profits, Cap. Gains as % of Tax Revenue</th>
<th>Individual Tax as % of Total Local Revenue</th>
<th>Taxes on Property as % of Tax Revenue</th>
<th>Dom. Taxes on Goods and Services as % of Tax Rev.</th>
<th>Other Taxes as % of Tax Revenue</th>
<th>Nontax Revenue (8-12) as % Total Revenue</th>
<th>Entrepen. &amp; Property Income as % of Total Revenue</th>
<th>Non-tax Revenue as % of Total Revenue</th>
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### APPENDIX 1.

Table 1.2. Hungary: Local Government Revenues (Percent Ratios)

Source: Author's calculations based on IMF/WB data, 1998.
### Lithuania

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### Consolidated Central Government

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<td>Total Exp.- Central Govt. as % of GDP</td>
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<td>40</td>
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### Local government

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<td>LG Expenditure as % of GDP</td>
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### A. Revenue and Grants (Local Govt.)

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<td>Individual Tax as % of Tax Revenue</td>
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<td>Entrepen. &amp; Property Income as % of Total Revenue</td>
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</table>

### APPENDIX 1.

**Table 1.3. Lithuania: Local Government Revenues (Percent Ratios)**

*Source: Author's calculations based on IMF/WB data, 1998.*
APPENDIX 2.
## NATIONAL CONSTITUTIONS

<table>
<thead>
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<th>Georgia</th>
<th>Hungary</th>
<th>Lithuania</th>
</tr>
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<td><strong>Chapter IX:</strong> Local Governments and Administration</td>
<td></td>
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</tr>
<tr>
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<td><strong>Article 119:</strong></td>
</tr>
<tr>
<td>(1) The territory of the Republic of Bulgaria is divided into municipalities and regions. The territorial division and the prerogatives of the Capital and the other major cities shall be established by law.</td>
<td>(1) The territory of the Republic of Hungary consists of administrative units including the Capital, the counties, cities, towns and villages.</td>
<td>The enfranchised citizens of the villages, towns, the capital city and its districts, and of counties are entitled to the right of local self-government.</td>
<td>(1) Administrative units provided by law on State territory shall be entitled to the right of self-government. The right shall be implemented through local government councils.</td>
</tr>
<tr>
<td><strong>Article 137:</strong></td>
<td><strong>Article 43:</strong></td>
<td>Local self-government means autonomous and democratic management of local affairs by the communities and exercise of local public authority in the interest of the population.</td>
<td>(2) Members of local government councils shall be elected for a two-year term on the basis of universal, equal and direct suffrage by secret ballot by the residents of their administrative unit who are citizens of the republic of Lithuania.</td>
</tr>
<tr>
<td>(1) <strong>A municipality is the basic administrative territorial unit at the level of which self-government shall be practiced.</strong> Citizens shall participate in the government of the municipality both through their elected bodies of local self-government and directly, through a referendum or a general meeting of the populace. (2) A municipality shall be a legal entity.</td>
<td>(1) All local authorities have the same fundamental rights (44/A). However the duties and responsibilities of local governments may be different.</td>
<td></td>
<td>(2) Local governments shall act freely and independently within the limits of their competence, which shall be established by the Constitution and laws.</td>
</tr>
<tr>
<td>Bulgaria</td>
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<tr>
<td><strong>Article 137:</strong>&lt;br&gt;(1) Municipalities shall be free to associate in the solution of common matters.</td>
<td><strong>Article 138:</strong>&lt;br&gt;The body of self-government within a municipality shall be a municipal council elected directly by the populace for a term of four years by a procedure established by law.</td>
<td><strong>Article 44/A:</strong>&lt;br&gt;(1) The local representative body: a) regulates and administers matters that belong to the competence of the local authority; its decisions may be revised only if there is a question of their legitimacy.&lt;br&gt;b) <strong>Exercises ownership rights in regard to local-authority property, independently budgets the incomes of the local government, and may start ventures on its own responsibility:</strong>&lt;br&gt;c) To deal with its duties as laid down in the law, the local authority is entitled to an adequate income of its own to perform its functions and also receives state support proportionate to its scope of duties.&lt;br&gt;d) Authorizes within the limits of the law, local taxes (rates), their types and measures.</td>
<td><strong>Article 121:</strong>&lt;br&gt;(1) Local government shall draft and approve their own Budget.&lt;br&gt;(2) Local government councils shall have the right within the established limits and according to the procedure provided by law to establish local dues, and to provide for the leverage of taxes and duties at the expense of their own Budget.</td>
</tr>
<tr>
<td><strong>Article 140:</strong>&lt;br&gt;A municipality is entitled to own municipal property, which it shall use to the interest of the territorial community.</td>
<td><strong>Article 141:</strong>&lt;br&gt;(1) A municipality shall have its own budget.&lt;br&gt;(2) A municipality's permanent sources of revenue shall be established by law.&lt;br&gt;(3) The state should ensure the normal work of the municipalities through budget appropriations and other means.</td>
<td></td>
<td><strong>Chapter 11.</strong>&lt;br&gt;Finances, State Budget&lt;br&gt;<strong>Article 127:</strong>&lt;br&gt;(1) The budgetary system of the Republic of Lithuania shall consist of the independent State Budget of the Republic of Lithuania and the independent local governments' budgets.</td>
</tr>
</tbody>
</table>
## Laws on Local Self-Government

<table>
<thead>
<tr>
<th>Bulgaria</th>
<th>Georgia</th>
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<th>Lithuania</th>
</tr>
</thead>
</table>

### Chapter I. General provisions

**Article 1.** This Law arranges the public relations related to local self-government and local administration.

**Article 5.** The municipality is a basic territorial entity within which local self-government shall be performed.

**Article 10.** The municipal territory consists of the territory of the settlements included in it.

**Article 14.** The municipality is a legal entity and has the right on its own and independent municipal budget.

### Chapter VII

#### Municipal Property and Finances

**Article 51.** The municipality has the right on its own property, the scope and acquisition of which are determined by law.

**Article 52.** The municipal council prepares its own and individual budget, outside of the State budget on the basis

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Following the progressive local government traditions of our country, as well as the basic requirements of the European Charter on Local Governments, Parliament recognizes the rights of the local communities to self-government.

Local self-government makes it possible, that the local community of electors – directly, and/or through its elected local government - manage the public affairs of local interest independently and democratically.

Supporting the self-organizing independence of local communities, Parliament assists the creation of the conditions necessary to self-government, it promotes the democratic decentralization of public authority.

#### Chapter 1. General Rules of Local Government

**Municipal Rights**

1. The local government of the village, the town, the capital city and the districts as well as that of the county (hereinafter: local government) acts independently in the public affairs of local interest, belonging to the sphere of duties and jurisdiction.

2. Within the framework of the Act, the local government disposes independently of its municipal property, allocates independently its revenues; it

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Local self-government denotes the right and actual power of the institutions of a local government which is elected by the residents of an administrative unit of the territory of the Republic of Lithuania, to freely and on their own responsibility regulate and manage public affairs and meet the needs of local residents according to the Constitution and laws of the RL. The municipality shall be the an administrative unit of the territory of the State, the community of residents whereof has the right to self-government guaranteed by the State.

**Article 2. The Principles of self-government.**

Self-government shall be implemented on the basis of the following principles:

1. the coordination of the interests of the municipality and the state;
2. the direct participation of the citizens of
of own-source revenue and State subsidies, distributed among municipalities according to criteria defined by law.

provides from its unified budget for the carrying of the municipal duties, whether undertaken voluntarily or compulsory. It may pursue entrepreneurial activity on its own responsibility.

**Chapter IX**  
**Funding Local Governments**

**Section 77**

(1) The local government offers public services. It disposes of its own property, and manages its budgetary revenues and expenses independently.

(2) The budget of the local governments is part of the public finances; it is connected thereto with the whole of its cash flow. The local government’s budget is distinct from the state budget, but is linked to it with state subsidies and other budgetary ties.

**Revenues of the Local Government**

**Section 81**

(1) The local government shall perform its tasks, resulting from the needs of the local population and from legal provisions, via its own budgetary organ, with the support of other economic organizations, by purchasing services, and/or through other ways. The local government shall select the forms of (financial) management suited to its duties, and it shall – within the framework of fiscal regulations – formulate the rules of interestedness independently.

(2) The local government provides the means of fulfilling its duties from its own revenues, from central taxes assigned, from revenues taken over from other economic organizations, from the normative/trend setting contributions of the central budget, as well as from subsidies.

the respective municipality in the election to the municipal council, polls, meetings of the residents and petitions; 3) the accountability of self-government institutions and their officers to the residents; 4) publicity and response to public opinion; 5) lawfulness and social justice; 6) economic independence; 7) respect for human rights and freedom.

**Article 23. Financial resources of the Local Authority.**

- Financial resources of the local authority shall be comprised of the municipal budget and non-budgetary resources.
- Each local authority shall have an independent budget. The municipal budget shall be drawn up and approved for the period of one year.
- The relations between the Lithuanian State budget and the budgets of local authorities shall be regulated by the Laws of the Republic of Lithuania on Budget Structure and Taxation.
- In the event that the income assigned to budgets of local authorities is insufficient for meeting the social needs of local authorities, municipal budgets shall be provided with subsidies from the State budget for the implementation of purpose-oriented programs.
### Local Budget Laws

<table>
<thead>
<tr>
<th>Bulgaria</th>
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</table>

#### Chapter 1. General Provisions

**Article 1.**

This Law provides (arranges) the preparation, approval, implementation, and the year-end close-out of municipal budgets, the budgetary relations between the municipal and the State budgets and the regime for the off-budget funds of the municipalities.

**Article 2.**

Municipal budgets and municipal off-budget funds shall be drawn up and managed by the bodies of the local self-government and the local administration in compliance with the provision of this Law.

**Chapter I. General provisions**

**Article 8. Independence of Budgets**

The State Budget of Georgia, budgets of the Autonomous Republics of Abkhazia and Ajara, budgets of other territorial entities of Georgia are independent from one another. The higher bodies of government authority have no right to interfere in budget rights of lower bodies of government authority.

**Chapter I. General Provisions**

**Article 1.**

(1) The public finance system is the system of the performance of public functions and funding management of the central government, the separated state funds, the local governments and the social security system.
**Bulgaria**

**Chapter II. Municipal Budgets**

**Article 3.**

(1) The municipality has its own budget.

(2) The municipal budget is an independent financial account for the revenues and the expenditures of the municipality within a period of one year.

**Article 6.**

Municipal revenues are based on own source revenue, subsidies and subventions provided to the municipality from the State budget.

**Article 10.**

The budget deficit formed during the constitution (preparation) of the municipal budget shall not exceed 10% of the total revenue.

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**Georgia**

**Chapter V. Budgets of the Autonomous Republics of Abkhazia and Ajara and Other Territorial Entities of Georgia**

1. Budgets of the AR of A&A and other territorial entities of Georgia are the financial basis of the state authority and local bodies of government of these territories. Financing of economic, social, cultural and other programs, local and regional activities of the Autonomous Republics and other territorial entities is carried out through these budgets.

2. Local bodies of state authority and government of the AR of A&A and other territorial entities compile, approve and execute their respective budgets independently.

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**Hungary**

**Chapter V. The Budgets of Local Governments**

**Article 62.**

(1) A local government finances and performs its duties defined in the Act on Local Governments and in other laws, from its own budget.

**Article 63.**

(1) The amount of the normative state contribution and the legal titles and amounts of the normative state contributions as well as the legal titles and the criteria of other subsidies are defined in the Budget Act.

**Article 67.**

(1) A local government complies the draft of its budget with regard to the budgetary guidelines made available by the Government and to the preliminary considerations of the local governmental financial governance. A local government defines its budget following the adoption of the Budget Act, in accordance with the provisions, requirements thereof, and the normative contributions of the central budget to the local government.

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**Lithuania**

**Chapter III Local Budgets**

**Article 26.**

Local budgets shall be appropriated for financing social, economic and other local programs as well as for maintaining the institutions of local governments. Each local government shall have the independent budget of its own. Only local budgets bare of any deficits shall be approved. Amendments to Articles 28 (on municipal revenues), 33, 39, and 40 in 1998.
### LOCAL GOVERNMENT REVENUES AS DEFINED IN THE COUNTRIES' LAWS

<table>
<thead>
<tr>
<th>Type of Revenue</th>
<th>Bulgaria</th>
<th>Georgia</th>
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</thead>
</table>

**Typology:**

- **Article 6. (1)** Municipal revenues are formed on the basis of:
  1) own-source revenues
  2) Revenues from the State: portion of the State revenues - subsidies - grants

- **Article 8.** Revenues of Local Budgets.
  Revenues of local budgets include:
  a) Local taxes.
  b) A proportion of national taxes and other revenues as authorized in the annual state budget law;
  c) Fees and charges established by local administrative bodies for services provided to the population;
  d) General and special transfers from higher level budgets as authorized by law;
  e) Sales of assets of local public administration bodies;
  f) Sale of local government securities subject to the provisions of Articles 15 and 16 of this law; and
  g) Other collections provided by law.
  h)

- **Article 81.** The local government provides the means of fulfilling its duties from:
  - own revenues,
  - central taxes assigned,
  - revenues taken over from other economic organizations
  - normative/trend - setting contributions of the central budget
  - subsidies

- **(Article 2. Municipal Budgetary Revenue)**
  1. Municipal Budgetary Revenues shall consist of:
  1) tax revenue
  2) non-tax derived revenue
  3) grants

  2. The sum of the funds borrowed by municipalities shall be indicated in the revenue system of municipal budgets.
<table>
<thead>
<tr>
<th>Type of Revenue</th>
<th>Bulgaria</th>
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<th>Lithuania</th>
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<tbody>
<tr>
<td>TAX REVENUES</td>
<td>Article 6. (2) Own-source Revenues: 1. Local and other taxes as defined by law  a) tax on property improvements (immovable property)  b) tax on inheritance  c) tax on gifts  d) tax on purchase of property  e) tax on transport vehicles  f) tax for municipalities  g) tax on the legal entities with more than 50% municipal share (participation)  h) other local taxes defined by law  2. Local fees for:  a) household sewer removal  b) the use of market places, fairs, streets and town squares.  c) The use of kinder care centers, kindergartens, social homes and other social care establishments  d) the use of resorts  e) Quarries  f) Technical services  g) Administrative services  h) Dogs  i) Graves  j) Protection and maintenance of agricultural property  k) Other local fees as defined by law</td>
<td>Article 30. Revenue of the Budgets of the Autonomous Republics and other territorial entities of Georgia. 1. Following types of general national taxes identified by the tax Code of Georgia shall be fully deposited in the budgets of the Autonomous Republics of Abkhazia and Adjara and other territorial entities of Georgia.  1) Tax on land  2) Tax on property of enterprises and of individuals  3) Tax on transfer of property  4) Tax for environmental pollution;  5) Tax for use of natural resources  6) Other local Taxes  2. Besides the general national taxes under paragraph 1 of this article, revenue determined by long-term economic norms of allocation from the taxes and profit and income shall be deposited in the local budgets.  4. Following types of local taxes identified in the Tax Code of Georgia shall be fully deposited in the budgets of the Autonomous Republics and other territorial entities of Georgia:</td>
<td>Section 82.  (1) The local government own revenues are:  a) local taxes/rates assessed and levied by the settlement's local government, in a way laid down in an Act;  b) profits, dividends, interest and rent resulting from its own activities, from undertaking, and from the yield of the property of the local government;  c) duties, in accordance with the contents of a separate Act;  d) Transferred funds received;  e) A proportion - set in a separate legal provision - of the fines for violating environmental protection and monument protection rules imposed in the territory of the local government, and collected therefrom;  f) Revenue from the sale of hunting licenses in the administrative territory of the local government;  g) Other revenues of the local government.  (2) A part, as determined in a separate Act, of the amounts resulting from the sale by State Property Agency of non-public utility enterprises founded by the councils, shall qualify as (the</td>
<td>Article 3. The composition of Municipal Budgetary Tax Revenue  1. Personal Income Tax  2. Land Tax  3. Lease tax on state owned land and water basins  4. Tax on real estate of enterprises and organizations  5. Stamp duty as specified by law on &quot;Stamp duty&quot;  6. Market fees  7. Inheritance or gift property tax  8. other tax revenue established by law.</td>
</tr>
</tbody>
</table>
### Section 83.

Central taxes, assigned in a separate Act by Parliament are the following:

- a) a definite part of the income tax of private persons
- b) other divided taxes

### Non-tax Revenues

3. Revenues from concessions
4. Fines and property sanctions gathered on the basis of punitive decrees issued by the local administrations
5. Interest (rates)
6. Rents, leases and other local revenues

5. Non-tax revenues of the budgets of the Autonomous Republics and other territorial entities, in compliance with the procedure set by relevant legislative and other normative acts, are as follows:

- a) fees and charges for delivery of services such as issuance of licenses, rights and other types of public services (or those on behalf of the government)
- b) state duties
- c) revenue from rent of state property and land under authority of local government;
- d) dividends and share of profit from fully or partially state owned legal entities under the authority of local government;
- e) royalties
- f) interest on local government loans, deposits, bills and other;
- g) revenue from lotteries
- h) revenue from sale of state property under authority of local government;
- i) revenue from grants
- j) other non-tax revenues.

Section 84.

1. Parliament shall assess a normative/trendsetting budgetary contribution, to be proportionate to the population of the settlements, to certain groups, to those provided for by institutions and on the basis of other indices:
2. The amount determined in the central budget shall be due directly to local governments, or to the local government fulfilling the duty within the sphere defined by the Act, without any restriction relating to its use, following the performance and settlement of the deductions and contributions burdening the benefits of personal nature and other payments, which were incurred by the local government.

(Article 5. The composition of Non Tax-Derived Revenue)

1. revenue gained from municipality owned assets (property)
2. fines and revenue from forfeits (according to law)
3. local levies (according to law "On Local Levies")
4. revenues on municipal services provided by municipal budgetary organizations
5. other revenue:
   a) revenue on the balances of municipal funds in accounts current
   b) revenue from leased or sold of state-owned land (?), not designed for agricultural use according to established procedures
   c) other non-tax derived revenue, established by law.
<table>
<thead>
<tr>
<th>Type of Revenue</th>
<th>Bulgaria</th>
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<th>Hungary</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidies from the State Budget</td>
<td>(4) Subsidies from the State Budget are:</td>
<td>Article 31 (LBSBA) Distribution of Budget revenues between the Budgets of Different Level:</td>
<td>Section 85.</td>
<td>Article 7. Subsidies to Municipal Budgets.</td>
</tr>
<tr>
<td></td>
<td>1. General subsidies defined on the basis of objective criteria, established by the Law on the State Budget for each year.</td>
<td>Distribution of budget revenues of the Autonomous Republics and (Other Territorial Entities) OTE of Georgia between the budgets of different levels on their respective territories shall be performed in compliance with the regulations set by the supreme representative bodies of the Autonomous Republics and local representative bodies of government of territorial entities.</td>
<td>(1) Parliament defines the socially prioritized targets. The rate and condition of the subsidies by targets are contained in an Act.</td>
<td>Municipal budgets shall receive subsidies, the procedure of calculation, confirmation and transfer whereof, shall be established by this law.</td>
</tr>
<tr>
<td></td>
<td>2. Earmarked subsidies - in special cases for the acquirement of long lasting material equipment and for the performance of regional programs.</td>
<td>(2) Local governments may claim target subsidies individually and jointly as well. A local government that meets the conditions is entitled to the target subsidy;</td>
<td>(2) The earmarked subsidy may only be spent on the specific target.</td>
<td></td>
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<tr>
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<td>3. Subventions - funds appropriated by the state under special conditions.</td>
<td>(3) The target subsidy may be used exclusively for the set target.</td>
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<td>Article 7. (LLG) The Parliament may not adopt any law or the central government take any action which increases local government expenditures or reduces local government revenues unless they also provide sources of covering the increase in expenditures or reduction of revenues.</td>
<td>Section 86-2</td>
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<td>(1) Parliament may grant earmarked subsidies to selected local governments for the realization of certain investment projects with high costs.</td>
<td>(1) In case Parliament sets a new task for a local government, it ensures simultaneously the funds necessary to accomplish it.</td>
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<td>(2) The earmarked subsidy may only be spent on the specific target.</td>
<td>(2) The amount of the state subsidies defined in Section 84 may not be reduced in the course of the financial year.</td>
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<td>(e) Other special purpose funds designated from the state budget</td>
</tr>
</tbody>
</table>
VITA

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EDUCATION:
Master of Urban Affairs, 1999
Special studies: Strategic Management and Budgeting, Public Finance, Comparative Budgeting.
Virginia Polytechnic Institute and State University, Blacksburg, Virginia

Master of Arts - Architecture (including B.A.), 1982
Kunsthochschule, Berlin, Germany

INDEPENDENT STUDIES, INTERNATIONAL EXPERIENCE:
- Problems and Perspectives of Securities Markets in Transition Countries - (IOSCO Training Program), Rome, Italy (1997)
- Municipal Management and Fiscal Responsibilities under the Conditions of Local Self-
- Local Self-government and Housing Policy Issues (Special Course for Governmental Officials from Central and Eastern Europe), Vienna, Austria, (1992)
- Urban Renewal Policy: Academy of Urban Sciences, Germany ( Summer Academy 1991)
- Urban Policy Analysis , Urban Institute Berlin, Germany ( Summer 1982)

HONORS:
- (1998) Marykathryn Kubat Award of the American Association for Budget and Program Analysis
- (1997) Fulbright Scholarship
- (1995) JAICA – Grant from the Japanese Government
- (1991) DAAD – Fellowship from the German Government through the German Academy for Research Exchange
PROFESSIONAL EXPERIENCE
(1998 - Present)
Graduate Assistant to the Executive Vice President for Budgeting and Finance of Virginia Polytechnic and State University

(January - August 1998)
Institute for Public Management, Virginia Polytechnic Institute and State University
Senior Assistant to the Director of the Institute for Public Management and Managing Editor of Public Budgeting & Finance

(February - August 1997)
Securities and Stock Exchanges Commission (1997)
Head of Department International Relations:
- Advisor to the Chairman of the SSEC on international projects,
- Coordinator of projects with the International Organization of Securities Commissions (IOSCO), The World Bank, The International Monetary Fund (IMF), the International Finance Corporation (IFC), USAID, The European Union and the British Know-How Fund.

(1993 -1997)
Ministry of Regional Development and Construction (MRDC)
Head of Department International Relations (1993-1997);
- Advisor to the Minister on international projects and programs;
- Responsible for the elaboration of the management and financial program of the International Relations Department and the budget for the international activity of the MRDC, their implementation and execution;
- Coordinator of international projects in the sphere of urban and regional planning, local self-government and administrative reform, housing policy;
- Chief Coordinator of the joint economic commissions and bilateral Intergovernmental Sessions for Economic and Technical Cooperation with: Egypt, Morocco, Russia, Former Yugoslavia, Zimbabwe, the Republic of South Africa, and Nigeria (1993-1997)

(1992-1993)
Ministry of Regional Development and Construction
Chief Expert at the Housing Policy Department;
- Research and applied work in the sphere of housing policy and real estate development.

(1985-1991)
National Research Center for Urban Planning and Housing policy
- Research Fellow; Research projects on housing and real estate management; Member of the Working Group for the elaboration of The National Strategy for Regional Development.

(1982-1985)
Research and Design Institute for Metal Constructions,
- Expert: Research, planning, design and application of metal constructions for public and industrial buildings.
OTHER PROFESSIONAL AND HONOR ACTIVITIES:


(1993) Team leader of a bilateral project for “Establishment of Housing Associations in Bulgaria” funded by the British Know-how Fund

Participation in over 30 national and international professional workshops, ministerial and high-level conferences in Europe, Asia, Africa, and the USA

ADDITIONAL ACTIVITIES IN THE SPHERE OF MANAGEMENT:

(1995-1997) Chairman of the Board of Directors of “Escana” LTD (Bulgarian investment and construction company),

(1994-1995) Member of the Board of Directors TECHOEXPORTSTROY LTD (the largest Bulgarian investment and construction company with major activities in Africa and Asia,

(1993-1997) Private consultant of British, German and Greek Companies on investment opportunities and projects in Bulgaria

FOREIGN LANGUAGES:
- High command of spoken and written: English, German, and Russian
- French – average speaking and writing ability
- Native Language: Bulgarian

QUANTITATIVE SKILLS:
- Advanced Quantitative Methods, Regression analysis;
- Budgeting

SOFTWARE:
- Microsoft Office: Word, WP, Excel, SPSS, Quatro Pro, etc.