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Czech Republic

Intergovernmental Fiscal Relations in the Transition

João do Carmo Oliveira
Jorge Martinez-Vazquez

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Foreword

The Poverty Reduction and Economic Management Unit in the World Bank's Europe and Central Asia Region has been undertaking a series of analytical works on issues pertinent to the economies in the region. These issues include transition issues, issues of economic integration pertinent for the Central and Eastern European countries that are candidates for accession to the European Union; poverty issues, decentralization issues, and other economic management issues. The analytical work has been conducted by staff of the unit and other bank staff, as well as specialists outside of the bank.

This technical paper series was launched to promote wider dissemination of this analytical work, with the objective of generating further discussions of the issues. The studies published in the series should therefore be viewed as work in progress.

The findings, interpretations, and conclusions are the authors' own and should not be attributed to the World Bank, its Executive Board of Directors, or any of its member countries.

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Preface

Like most countries in transition, the decentralization process in the Czech Republic is best understood as driven by both economic and political forces. From the economic perspective, decentralization aims to increase public sector efficiency and to improve allocation of resources in the economy as a whole. From a political perspective, decentralization tends to strengthen Czech Republic's democratic institutions, align public policy more closely with people's needs and preferences, and increase the accountability of public officials.

Political events both past and present have shaped the path of decentralization and have set constraints that for the time being limit the options available to policymakers. For instance, one of the main challenges to successful decentralization in the Czech Republic is the fragmentation of municipalities into entities of inefficient sizes. The negative experience with forced amalgamation of local governments under the previous regime—the result of arbitrariness and lack of representation—has created resistance to non-voluntary solutions to fragmented local government. The administrative reform of 2000, which created new intermediate-level governmental regions, addressed this problem only partially.

The Czech Government also faces a host of other constraints inherited from the previous socialist regime that limit the design of a decentralized public finance system. A culture of subsidies and free services—resulting from absence of a cost recovery tradition—still plays a role in the scope of local expenditure responsibilities, such as housing and transportation. In addition, the lack of an active private market for housing has so far made any meaningful reform of the real-estate tax difficult, the argument against reform being that increased property taxes would create negative incentives to private investment in this sector. Furthermore, a tradition of centralized government and weak grassroots demand for authentic local autonomy has had an impact on the revenue assignments between the central and local governments. Finally, efforts to equalize fiscal opportunities across the country in the face of enterprise restructuring and low labor mobility have stressed government finances. Nevertheless, strong historical accountability to the center and a tradition of fiscal discipline have helped most local governments maintain balanced budgets and stay free of debt even when no explicit limitations to borrowing have been imposed.

The single most important political objective of the Czech Republic is to join the European Union. This in turn will place new challenges on intergovernmental finances. With EU membership will come an obligation to consolidate public finances, including reduction of the general government deficit, and its maintenance within the limits of the EU's Stability and

Growth Pact. The question then arises of the appropriate division of this responsibility between the national and subnational levels in meeting this aggregate fiscal objective

Consequently, the problem of developing new institutions for fiscal coordination among different levels of government has become critical for the Czech Republic. Legal and procedural frameworks are needed to ensure that subnational governments' fiscal behavior is consistent with the obligation of EU membership. In this regard, the Czech Republic can learn from other European countries, which also had to develop different institutions and procedures to conform to the EU. For example, Belgium adopted a mechanism based on multilateral negotiations for fiscal coordination, which resembles the German approach, and created a High Financial Council to supervise the budgetary policies of regions and communities. Spain, in the context of the convergence program, has relied on bilateral negotiations leading to a set of agreements between the central government and subnational governments, where targets are set for deficit and debt. Austria and Italy have used a different policy based on statutory rules, where the law fixes for a period of time the criteria for distributing the limit set in the Maastricht Treaty of European Monetary Union on public deficit among levels of government.

Furthermore, EU regional policy, including a number of programs such as the structural funds, will impose constraints and set directions on the Czech Republic's own regional policies. Unlike in most other European countries, the new regions in the Czech Republic were not created along historical lines (for example, Bohemia or Moravia), but instead following the EU's Territorial Statistical Units Nomenclature (NUTS). This may facilitate the mobilization of EU pre-accession and structural funds, without sensitizing traditional regional sentiments.

This report covers the most important elements of intergovernmental fiscal relations in the Czech Republic, including administrative structure, expenditure and revenue assignments, fiscal imbalances and transfers, access to borrowing and indebtedness, and budgeting. While each of these aspects is discussed in a separate chapter, it is necessary to keep in mind that these elements are intimately related to each other, and that reform design needs to be conducted in a coordinated manner.

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The report was written under the general guidance of Mr. Roger W. Grawe (Country Director), Pradeep Mitra (Sector Director), and Helga Muller and Kyle Peters (Sector Managers). Ms. Teresa Ter-Minassian (IMF/FAD Director) and Mr. Robert Ebel (World Bank Institute) were the peer reviewers. Valuable input and suggestions were also received from Bernard Funck, Carlos Silva-Jauregui, Peter Fallon (World Bank), Jana Matesova (World Bank-EDS), Rachel Van Elkian, Marco Cangiano, and Teresa Daban and Luiz de Mello (IMF). The report was edited by Ms. Emily Evershed and processed by Nancy Davies-Cole.

Acronyms and Abbreviations

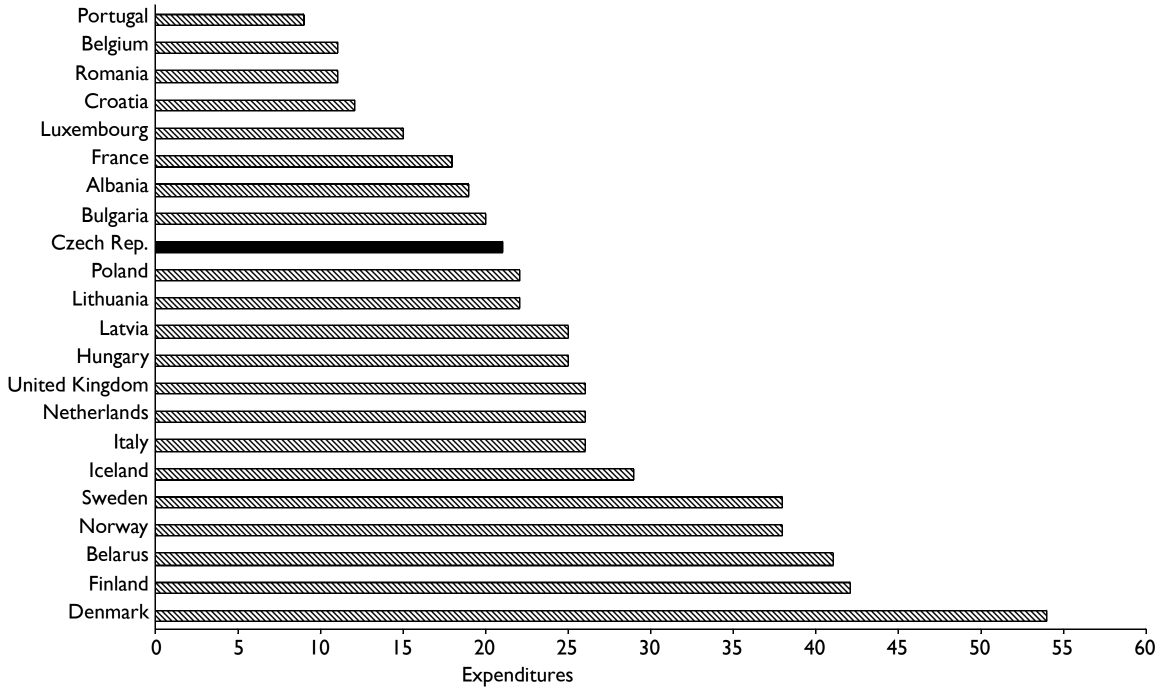
CIT	Corporate Income Tax
EMU	European Monetary Union
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
ISPA	Structural Policy Instrument for Pre-Accession
MTEF	Medium-Term Expenditure Framework
NUTS	Territorial Statistical Unit Nomenclature
OECD	Organization for Economic Cooperation and Development
PER	Public Expenditure Review
PHARE	Assistance for Economic Reconstruction
PIT	Personal Income Tax
SAPARD	Special Accession Program for Agriculture and Rural Development
USAID	U.S. Agency for International Development
VAT	Value Added Tax

Executive Summary

During the last decade, the Czech Republic has made progress in overcoming the legacy of the socialist past, the 1993 breakup of the Czech and Slovak Federal Republic, and the transition to a market economy. In recent years, an evolving intergovernmental fiscal relations agenda has had to address critical emerging issues, including the prospect of joining the European Union and the need for substantial improvement in the overall efficiency of the public sector.

Because of the Czech Republic's cultural and political traditions, including its recent history of central planning, expediture responsibilities assigned to local governments have not been as extensive as those in the Northern European countries, although they have been more extensive

Figure 1 Czech Republic, Comparative Local Expenditure Share



Sources: World Bank DEC subnational database initiative, and GFS/IMF (most recent years available—between 1994–98).

than in Southern European countries (Figure 1).[1] Similar to the situation of other Eastern European countries in transition, the local government share in total public expenditures basically remained stable during the 1990s, at about 21 percent.[2]

In addition, local government expenditures (and revenues) relative to GDP have fluctuated little since 1993, around an average of 9.4 percent (Table 1), and one-third of expenditures were capital expenditures. About half of local government revenues were in the form of taxes, of which "own" (purely local) taxes (including the real estate tax and other local taxes) represented only 11 percent. The rest came from shared taxes with the central government, in particular personal income tax (PIT) and corporate income tax (CIT). Privatization proceeds were another important source of revenues and were used by local governments during the 1990s to help finance their deficits.[3]

This Summary presents an overview of the most relevant intergovernmental fiscal issues at the present time in the Czech Republic, with a focus on the available options for moving the policy agenda forward. A more extensive analysis of the main issues and options is presented in Chapters 1 to 6.

Background

The 1993 Constitution established the Czech Republic as a sovereign unitary state and guaranteed two levels of territorial self-government: the higher self-governing units (the regions), and the basic self-governing units (the municipalities). Until 2000, the regions did not exist as self-governing units. There were instead 77 district offices, which were deconcentrated units of the state territorial administration and which, to a certain extent, worked as surrogate regional governments.

The system of intergovernmental fiscal relations in the Czech Republic remains quite centralized. A fair assessment of the current system is that the Czech Republic may be considered as having a significantly deconcentrated state administration structure. This is because all of the activities of district offices and the bulk of the activities of municipalities have been aimed at

Table 1 Czech Republic: Structure of Local Government Operations, 1995–2000

	Budget executed (in percent of GDP)							*Bdgt. Est.*
Operation	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Total revenue	**9.2**	**9.5**	**9.4**	**10.4**	**8.7**	**8.7**	**10.2**	**9.3**
Tax revenue	3.8	4.6	4.9	4.5	4.6	4.6	4.7	4.8
Shared tax revenues	2.8	4.1	4.6	4.1	4.1	4.2	4.3	4.3
"Own" taxes[1]	0.9	0.5	0.4	0.3	0.5	0.5	0.4	0.5
Transfers from State & State Funds	2.8	2.6	2.5	3.9	2.1	2.1	2.3	2.1
Capital revenue	0.8	0.5	0.4	0.5	0.5	0.5	1.7	0.7
o/w privatization	*0.6*	*0.5*	*0.3*	*0.5*	*0.3*	*0.4*	*0.3*	—
Other non-tax revenues[2]	1.9	1.7	1.6	1.5	1.5	1.5	1.6	1.6
Total expenditure and net lending	**8.9**	**9.5**	**9.6**	**10.9**	**9.0**	**8.7**	**9.2**	**9.8**
Current expenditure	5.8	5.9	5.9	7.5	6.0	5.9	6.4	6.6
Capital expenditure	3.2	3.5	3.6	3.3	3.0	2.9	2.9	3.1
Bal.incl.privatization receipts	0.2	0.0	-0.2	–0.5	–0.3	0.1	1.0	–0.5
Bal.excl. privatization revenue	–0.4	–0.4	–0.5	–0.9	–0.6	–0.3	0.7	–0.5

— Not available.
1. Includes real estate tax.
2. Includes entrepreneurial and income from property.
Sources: Ministry of Finance; World Bank Staff.

implementing the central government's policies at the local level. Most of the fiscal decisionmaking power emanates from the center and local level governments have only a marginal influence on local fiscal matters.

Nevertheless, a degree of decentralization has evolved during the transition. On the expenditure side of the budget, local governments have been given some discretion to make decisions for their own expenditure responsibilities (for example, opening and closing schools). On the revenue side, the structure of financing has been transformed since the early 1990s by reducing the previous heavy reliance on "transfers" from higher levels of government and by increasing the relative importance of tax-sharing. Local governments have also been provided with own" revenues since the beginning of the 1990s. But the most important of these local revenues, the real estate tax, is not yet fully established. The base for the real estate tax is still assessed by the central government according to a decree that specifies values by type of use rather than on the basis of market values.

In the wake of the 1993 constitutional precepts and in preparation for EU accession, but also bowing to internal political pressures, the territorial administration reform of 2000 (Act of Parliament No. 129/2000) established 14 new regions with elected representatives (elections took place in November 2000).[4] The government also revamped the revenue assignment to municipalities in 2000 by completely redesigning the tax-sharing system. With the creation of the regions, the district offices will be phased out from January 2001 through the end of 2002, and there would be a phasing-in period for the full implementation of the regions' responsibilities through the end of 2002. These changes will have a major impact on the Czech Republic's system of intergovernmental fiscal relations.

The 2000 reform package[5] created self-governing regions, intended to complete the long-overdue decentralized administrative structure of the Czech Republic. The reform package also changed tax-sharing arrangements with municipal governments in order to address important problems that had emerged during the previous seven years of the transition. These problems included the following:

- increasing vertical fiscal imbalances that favored municipalities during the 1990s, as perceived by the central authorities;
- increasing horizontal fiscal disparities among municipalities, because of different development experiences and incidences of industrial depression, unemployment, and rural poverty;
- predatory tax-cutting among jurisdictions competing for an increased tax base; and
- increasing administrative fragmentation due to a mixture of political liberalization, reaction to negative past experiences with forced amalgamation, and wrong incentives (Chapters 1, 2, and 4).

The new tax-sharing system for the municipalities has positive as well as negative implications for fiscal decentralization in the Czech Republic. On the positive side, it has made the revenue system for municipalities more stable and predictable by moving away from a single tax base toward a pool of taxes. It has also made taxation more equitable by moving away from a derivation basis, in general, toward an adjusted per capita, size distribution of the tax-sharing pool.

On the negative side, the reform has introduced some weaknesses into the revenue assignment system, which have, among other things,

- practically removed all tax-effort incentives;
- allowed for the continuation of incentives for harmful interjurisdictional tax competition by retaining the "residence-of-taxpayer" criterion for the allocation of 30 percent of the unincorporated PIT; and
- introduced an adjustment coefficient for the per-capita distribution of the tax-sharing pool that in its conception lacked both transparency and a sound economic rationale.[6]

The changes in revenue assignment in 2000 were not meant to be part of a tax reform, since new taxes were not introduced and existing ones were not eliminated. Nor were tax rates or the tax base modified, or the overall tax burden affected. Most important, the 2000 reform did not affect the distribution of fiscal decisionmaking powers among government levels. This latter aspect, in particular the granting of more tax autonomy to self-governing entities, is the crucial pending issue still to be addressed in the redesign of intergovernmental fiscal relations in the Czech Republic.

It is too early to tell how effective the reforms of 2000 will be in modernizing intergovernmental fiscal relations and in increasing the overall efficiency of public service delivery. The functions of the new regions and their system of financing will need further definition over the next two years. Nonetheless, it should be noted that the reforms fell short of maximizing the potential benefits implied by a more complete reform agenda, which at a minimum should have included

- explicit incentives for local tax efforts, tax autonomy at the margin, and more accountability (particularly with the full implementation of a modern local property tax);
- explicit incentives for the voluntary amalgamation of small communities;
- a well-defined adjustment coefficient for the per capita distribution of the tax-sharing pool; and
- a separate fiscal equalization mechanism, to partially compensate the fiscally distressed areas of the country.

These are among the most critical issues for the future intergovernmental fiscal reform agenda.

On the basis of the analysis developed in the next Chapters of this work, the following discussion summarizes the pending issues and offers options for reform in the main areas of intergovernmental fiscal relations in the Czech Republic, including administrative structure, expenditure responsibilities, revenue assignments, fiscal imbalances and the system of transfers, access to borrowing, and subnational governments' budgeting.

Policy Issues and Reform Options

Administrative Structure

The most striking feature of the Czech Republic's administrative structure is its fragmentation at the lowest tier of government. The proliferation of municipalities during the earlier period of the transition led to a current administrative structure in which a majority of these local governments lack adequate technical and financial capacities. Despite their inefficient scale, smaller municipalities have not been inclined to enter into cooperation agreements or to associate among themselves; nor has there been enough outsourcing to improve the efficiency of public service delivery. Another distinguishing feature of the current administrative structure is the limited decisionmaking power attributed to the local governments. As deconcentrated territorial administration bodies of the state, the district offices now being phased out were heavily dependent on and financed by the state budget. Roughly half of the district offices' revenue came from tax sharing, with the remaining part essentially from state subsidies (Chapter 3). But municipalities, even as self-governing bodies, are still significantly dependent on state transfers and revenue sharing (Chapter 1).

The 2000 reform of territorial administration was aimed at building up administrative capacity and democratic representation at the intermediate tier of government. The central authorities intend to implement this goal over a period of two years ending in December 2002. During the interim period the new regions will be fully funded by the state budget, while the definition of their responsibilities will be pending on each area ministry's decision to decentralize. Such an approach to administrative reform may well become a problem in itself, since there is little motivation for ministries to voluntarily relinquish their own current decisionmaking powers in support of decentralization.

Another concern relates to the potential fiscal impact of the 2000 reform, because all indications are that the bureaucracies of the new regions will be created afresh, while the employees of the district offices will be absorbed mostly by the state and the municipalities. This is likely to increase overall public expenditures and to put at risk the overall fiscal balance of the public sector.

Finally, although the Ministry of Interior is conducting the new territorial arrangements in the wake of the 2000 reforms, there is not yet in place any *multilevel* government coordination mechanism which, with the leadership of the central government, would focus exclusively on the fiscal decentralization process, and which would ensure the continued credibility and sustainability of the reform process.

Recommendations. A good strategic direction for further administrative reforms would be *to sustain the fiscal decentralization process* by empowering territorial self-governing units with a meaningful degree of autonomy and giving local representatives enough authority to perform their functions. Specifically, the government may consider the following:

- Formally establish a multilevel government coordinating body, led by the central government, to proceed with the fiscal decentralization process. This body would serve as a forum for initial conflict resolution. It would also be a mechanism for the central government to (1) improve the design and gauge the direction, pace, and extent of decentralization, and (2) disseminate information, provide training, and directly engage the local authorities in the decentralization process. This is a critical institutional aspect for the sustainability of fiscal decentralization.
- Immediately define autonomous functions (on expenditures and revenues) for the new regions, in order to create the right sense of accountability from the beginning, rather than merely fully financing state deconcentrated functions (Chapters 1, 2, and 3).
- Reverse the municipal fragmentation by
  (1) Creating stronger incentives (financial and legal) that promote voluntary amalgamation of the small communities into economically and financially viable municipalities. For example, the central government might be involved in promoting cooperative arrangements among municipalities, such as the creation of joint stock companies for the delivery of services which require large infrastructures (or the formation of special associations of municipalities, or contracting among municipalities, for the same

purposes). The government could also consider outsourcing public services delivery to the private sector as a means of overcoming the inefficiencies associated with the small scale of most municipalities. Also, special support could be designed to help small communities secure the matching funds needed for their access to the EU pre-accession funds, on a concessional basis, but conditional upon their voluntary, economically viable amalgamation (Chapter 4).

(2) Asymmetric assignment of revenue and expenditure responsibilities, using the new regional self-governing administrative structure (and acting in cooperation with larger municipalities) as a tool to facilitate the amalgamation process (Chapters 2 and 3).

Expenditure Responsibilities

The current assignment of expenditure responsibilities between central and municipal governments broadly conforms to accepted principles, although coordination and cooperation among different levels of government in the case of concurrent responsibilities has been weak (Chapter 2).

In the Czech Republic significant disparities still exist across jurisdictions (municipalities as well as regions) in both actual per capita expenditures and "expenditure needs" (as reflected by unemployment rates, poverty levels, infant mortality rates, and so forth). There is also empirical evidence that smaller municipalities are less efficient in the delivery of basic services.

House rents and tariffs on public utilities (such as water and gas) are still controlled by the central government and are far from full cost recovery levels. The salaries of local government employees are also controlled by the central government. In theory, municipalities are responsible for their own capital infrastructure. In practice, municipalities still depend significantly on the central government for the financing of capital expenditures, including the reconstruction and rehabilitation of infrastructure and housing. This financing takes the form of grants and highly subsidized loans.[7]

Recommendations. A good strategic direction for expenditure assignments would be to further *clarify the responsibilities* for each level of government and to make local authorities fully accountable before their respective constituencies for policy results, measured in terms of their effectiveness and efficiency in delivering quality public services. Specific policy actions should include the following:

- Develop institutions for intergovernmental cooperation and dialogue. This will be central to increasing local public expenditure efficiency in areas of concurrent expenditure responsibilities.
- Establish a broad-based commission to make recommendations on the new regions' expenditure responsibilities.
- Make provisions for de facto capital expenditure responsibilities for local infrastructure that are currently at the central level to be, in due time, transferred back to the respective local governments (both regions and municipalities).
- Amend the Budget Rules Law to *preempt* unfunded mandates to local governments.
- Gradually lift central government controls on utility prices at the local level.
- Increase reliance on the private sector in both financing and the delivery of public services to improve the overall efficiency of local government expenditures. The role of local governments in the provision of housing services should be scaled back and ultimately eliminated. Alternative private provision of education and health services should also be promoted.

Revenue Assignments

The 2000 reform of revenue assignment (that is, the new tax-sharing arrangement) leaves serious weaknesses in the intergovernmental fiscal relations system. These include (1) the risk borne by local governments of further discretionary changes in revenue assignments, which may affect predictability and reform credibility; (2) the absence of incentives to encourage tax effort, which may reduce efficiency; (3) the incentives for undesirable "tax-cutting" competition signaled by the present allocation criterion for the unincorporated personal income tax (PIT), based on taxpayer residence; (4) the insignificant degree of autonomy of local authorities over their own revenue sources, which adversely affects efficiency and accountability; (5) the full dependence of the new regional administration on the state budget; and (6) the absence of an economic rationale for the adopted coefficient that adjusts the per capita distribution of the tax-sharing pool according to population size (Chapter 3).

Recommendations. In this area, a good strategic direction for reform would be to *boost revenue autonomy.* More revenue autonomy would improve budgetary predictability and the accountability of local authorities by (1) clearly defining revenue assignments (both tax-sharing arrangements and own local taxes autonomy), respecting fairness in resource allocation and encouraging local tax efforts; and (2) attributing adequate decisionmaking powers on tax rates and the determination of tax bases. In the short run, the government may consider developing an agenda for the reform of revenue assignments along the following lines:

- Increase the predictability of local budgets by establishing all *structural policy parameters* of intergovernmental fiscal relations (such as coefficients of tax-sharing pooling and distribution, bandwidth of local tax rates, and local tax base and exceptions) in the *organic* laws (instead of in the *annual* budget law, as is presently done).
- Provide more local autonomy and restore tax-effort incentives by reassigning the personal income tax (PIT) as follows: (1) bring the totality of the *unincorporated* PIT into the shared tax pool; (2) reduce the progressive rate of the "wage-tax" component of the PIT by a corresponding amount; and (3) devolve to the municipalities the right to impose their own flat-rate (proportional) PIT local surcharge (piggybacking on the national adjusted progressive PIT rate) within a bandwidth of rates. Overall, these reforms should be fiscally neutral.
- Provide the new regions with adequate own funds, by assigning to them (1) shared taxes (commensurate with their expenditure responsibilities); and (2) autonomous revenue sources, including surcharges that can piggyback on national taxes or a flat-rate PIT similar to that proposed for the municipalities.
- Strengthen local revenue autonomy by providing municipalities with the instrument of market value assessment of properties, and assist them in building the tax-administration capacity of local government \for this tax.
- Review the adopted adjustment coefficient for the tax-sharing distribution mechanism, in order to introduce a clear economic rationale to it. Separate consideration should be given to the convenience of a more transparent formula-based equalization transfer scheme (see next section).

Fiscal Imbalances and Transfers

An outstanding characteristic of the Czech system of intergovernmental fiscal relations is that, despite the existence of significant horizontal fiscal disparities, there is no clear, separate policy instrument to deal with "fiscal equalization transfers" that can explicitly take into account regional differences in both tax capacity and expenditure needs (Chapter 4).

The system of conditional transfers (that is, the specific subsidies) may be considered vulnerable in several aspects:

- The system is, at present, too complex and unwieldy.
- Although there are numerous constraints and conditions for access, the system has little de facto control.
- Access depends heavily on negotiation skills and political connections.
- The system presents little transparency as to how it actually works.
- Transfers have become an unstable source of local government revenue.
- Funding practices may lead to negative incentives if the central government is perceived as reducing transfers because local government revenue has increased.

In addition, transfers from the EU pre-accession funds have not yet been used as an additional means of conditional leverage either to reverse the fragmentation of municipalities or to strengthen the fiscal decentralization policy.

Recommendations. A good strategy would be to *rationalize the transfer system* so as to (1) increase its transparency; (2) make it a more effective instrument for the implementation of policies of national interest at the local level; (3) reduce horizontal fiscal disparities; and (4) help reverse the fragmentation process of municipalities. In the short run, in order to rationalize transfers and increase allocative efficiency, the government may consider reviewing the current system of specific subsidies in the following ways:

- Increase the efficiency and simplicity of the system by decreasing the number of specific subsidies and by establishing a programmatic goal of fewer transfers. Alternative *block grant* systems should also be examined.
- Use explicit rules or formulas for the allocation of grants, in order to boost the transparency and predictability of the transfer system.
- Carry out systematic ex post performance evaluation of programs, to improve efficiency and planning.
- Prioritize programs and stabilize transfers within the context of the central government's medium-term expenditure framework to improve the predictability of local budgets.
- Evaluate the establishment of a separate "Fiscal Equalization Fund" (independent from the tax-sharing mechanism) to specifically address the issue of reducing regional fiscal disparities. These disparities arise from to cross-regional differences in tax capacity and unmet expenditure needs, in turn arising from, among other things, differences in unemployment rates, poverty, and health conditions.
- Review the financial conditions for the matching funds that the local governments must contribute to access the EU pre-accession funds. Also evaluate the potential effectiveness of increasing financial concessions to support the smallest and financially weakest municipalities—but conditional on voluntary (non-revertible and legally binding) amalgamation that could substantially increase the efficiency of public service delivery.

Access to Borrowing

Although it is apparently low in the aggregate, the "true" level of local debt is not entirely transparent in the Czech Republic owing to the existence of contingent liabilities and other forms of off-budget fiscal operations. Reading the true level of local debt is also complicated by the possibility of diverse interpretations of the standard national chart of accounts. In principle, municipalities can have free access to all forms of borrowing, but in practice access to borrowing by small municipalities has been limited by their low creditworthiness. The largest municipalities have had access to international financial markets, and the rest of the municipalities have mostly borrowed from domestic banks. It appears that many small and middle-size municipalities are already deeply in debt (Chapter 5).

The municipal capital market is still developing in the Czech Republic. Under the present conditions of market failures, the current sole reliance on market discipline as an approach to control and to guarantee responsible access of municipalities to capital markets is risky and is unlikely to prevent financial crises. However, direct control of every local credit operation would increase central bureaucracy and would run contrary to other decentralization objectives.

The institutional framework that would enable the financial sector to operate with subnational governments is still being developed. For example, the Bankruptcy and Composition Act does not yet include municipalities as a subject, and this may have been a risk factor explaining the reluctance of the banking system to participate more actively in the municipal capital markets. In addition, there is no official monitoring and supervisory mechanism in place for subnational government indebtedness and credit operations as an assurance against systemic financial crises in the future.

Recommendations. A good strategic direction for reform would be to *put in place an institutional framework and prudential rules* that would ensure fiscally responsible borrowing by subnational governments, and would encourage competitive behavior and market discipline in the financial system in its dealings with self-governing units. Institutional development is critical at this juncture to improve control and responsible access of subnational governments to the capital market in the Czech Republic. The government might consider upgrading regulations and institutions related to municipal and regional credit markets in the following ways:

- Formally establish basic parameters for subnational governments to access to capital markets by (1) restricting medium- and long-term loans to investment projects only; (2) limiting the ratio of debt service to subnational governments to 0.1; and (3) limiting subnational government's debt stock to revenue ratio to perhaps 0.8 (gradually implemented).
- Formally establish prudential rules for interaction of banking systems and subnational governments by limiting bank portfolio exposure to local and regional governments (individually) to a certain maximum limit recommended by prudential banking rules.
- Approve and diligently implement a "bankruptcy law" that clearly defines debt workout procedures in cases of municipal or regional government default.
- Adopt a law mandating fiscal responsibility to curb excessive deficits and imprudent buildups of public debt, including municipal and regional public debt.
- Encourage the dissemination of "risk and credit rating analyses," aimed at improving transparency and promoting market discipline.

- Establish an official monitoring agency to keep track and record the overall development of the municipal and regional capital market and indebtedness, including contingent liabilities. The database organized by such an institution should be publicly accessible.

Local Budgeting

Lack of budget predictability is a major problem for local *budget formulation* in the Czech Republic, because (1) budget formulation is still a top-down process, with no participation by local authorities; and (2) the state and local budget cycles are not synchronized in practice. In *budget execution*, the lack of a *single account approach* for treasury operations leaves the local budgetary process less effective and less transparent. The *implementation of the standard accounting system* seems to lack uniformity in respect to interpretation and coverage of each specific budget item. The external audit has focused exclusively on inputs and on financial and legal compliance. To date, there has been no evaluation of the performance of budget programs. Moreover, with the discontinuation of the district offices, a new solution for the external audit function, both for the new regions and for municipalities, is urgently called for (Chapter 6).

Recommendations. A good strategic direction for reforms of local budgeting would be to *strengthen the budgetary process* by increasing the transparency and accountability of local budgets congruent with the objectives being pursued for the state budget on budget formulation, execution, and evaluation. The increased transparency and accountability of the decisionmaking process is highly dependent on how well the budgeting process works in its formulation, execution, and evaluation phases. Although many improvements have been carried out at the central government level, there is ample room for strengthening the budget process at the local level. The most urgently needed reforms include the following:

- Upgrade the skills of local officials in the standard accounting system and control, especially in smaller municipalities.
- Introduce a Treasury function, including a single account approach for budget execution at the local level.
- Expand the scope of the external audit beyond the evaluation of input content and legal and procedural compliance to include performance evaluation of the outputs and outcomes of expenditure programs.
- Establish new (external) audit authorities for the new regions and municipalities. One option is for the Supreme Audit Office to be charged with the responsibility of auditing the 14 newly created regions, and for the new regional audit offices subordinated to the regional self-governing units to be charged with auditing the accounts of municipalities.
- Boost the predictability of local budgets by synchronizing the de facto budget cycles (central and local or regional), by improving cooperation on budget preparation among government levels, and by encouraging the formulation of simplified multiyear expenditure frameworks for local or regional governments congruent with a central government Medium-Term Expenditure Framework (MTEF).

Conclusion

The Czech Republic has adopted an evolutionary reform approach to the system of intergovernmental fiscal relations. This approach has been re-embraced with the creation of the new regions, which will be phased in over a transition period of two years. This is a promising effort that helps to put the intergovernmental fiscal reform in perspective as part of a process, rather than as a single, irreversible policy event. Nevertheless, there still are significant gaps in the strategic direction of the current reform agenda. The future reform strategy needs to refocus on the principles of budgetary autonomy, transparency, and accountability.

The paramount objectives of the fiscal decentralization process are to increase the overall efficiency of public expenditures and to improve equity in access to public services. However, the Czech Republic still falls short of these goals and will need to overcome several key challenges, including:

- *inefficient local administration*, reflected by the highly fragmented municipal administrative structure;
- *lack of autonomy*, evidenced by the very limited decisionmaking power of local authorities and their excessive dependence on the state budget transfers and tax-sharing system;
- *increasing regional fiscal disparities*, resulting from asymmetric economic developments and diverse needs among regions; and
- *lack of transparency in the level and composition of local government expenditure and debt*, owing to the presence of off-budget operations and contingent liabilities, reflecting the inconsistent implementation of budgeting and accounting rules, and the absence of ex post performance evaluation of policies and programs.

The options and recommendations presented in this summary are aimed at enabling the Czech government to proceed in a timely way with administrative and institutional reforms toward consolidating the process of fiscal decentralization, but reorienting the course of the current reform. This strategic reorientation should include the following:

- Strengthen financial and legal incentives for small municipalities to voluntarily amalgamate, including the leveraging of the EU pre-accession structural funds, enhanced cooperation among local governments and with regional governments, and greater participation of the private sector in service delivery and financing.
- Attribute to subnational governments clearer responsibilities, decisionmaking powers, and autonomy to perform. Responsibilities, autonomy, and power can most significantly be enhanced by redefining taxing powers, with more reliance on own tax revenues (such as local fees, property tax, and rights to impose piggyback surcharge rates on personal income taxes), so as to provide incentives for local fiscal effort and increased accountability.
- Improve equity of access to public services, without compromising incentives for local tax effort, by rationalizing the current system of earmarked transfers (mainly through simplification, increased transparency, and better prioritization), by revising the recently adopted tax-sharing mechanism (the per capita adjustment coefficient), and by considering the establishment of a separate "Fiscal Equalization Fund" at the regional and local levels.
- Reform the regulatory framework for subnational credit, by (1) restricting borrowing to investment projects; (2) adopting maximum levels for debt stock and debt service ratios; (3) enforcing stricter prudential rules on banks operating with self-governing units; (4) adopting

a "Bankruptcy Law" that includes municipalities as a subject; (5) adopting a "Fiscal Responsibility Law"; and (6) officially monitoring the municipal credit market.
- Strengthen uniformity, transparency, and predictability in self-government budget systems, by upgrading the skills of local officials, introducing local treasury functions including a single account, and reinforcing external audits for both the new regions and the municipalities, including program performance evaluation practices.

One risk in carrying out the recommended strategic redirection is that the specific reforms to be adopted could become inconsistent with the *Acquis Communautaire*. This is to be avoided at all costs. However, not redirecting the current strategy could reduce the efficiency of public expenditures, slow economic growth, increase inequalities, erode national cohesion, and encourage uncontrolled local borrowing, thus bringing about a real threat to macroeconomic stability.

1. Administrative Structure

Profile of the Current Territorial Administrative Structure

The Czech Republic is a democratic, unitary state.[8] The constitution establishes that the country shall be governed by a three-tier government structure, composed of the state (the central government), the high-level self-governing entities (the regions), and the basic self-governing entities (the municipalities).[9] However, until 2000, only a two-tier self-government structure (with elected representatives and fiscal decisionmaking powers) operated in practice: the central government and the municipalities. During this period the system relied on the districts, which essentially were deconcentrated administrative units of the central government, to fill the legislative gap between the central government and the municipalities. The administrative reforms of 2000 (Act of Parliament No. 129/2000) established the self-governing regions, to be phased in over a period of two years at the same time that the districts are phased out by end-2002. Through 2000, the implementation of a significant part of the central government's fiscal policy was "delegated" to local authorities (both districts and municipalities). (Delegated functions are those transferred by the central administration to the municipalities only for the actual delivery of services; all decisions on regulations remain at the central level.) In the future, this authority will continue to be delegated to both the new regions and the municipalities.

Local Self-Government: Municipalities

Until 2000, municipalities were the only self-governing territorial authorities, with a directly elected Municipal Council exerting ultimate power within the municipal jurisdiction, as established by law. The Municipal Council, the deliberative branch of the municipal government, indirectly elects the members of the Municipal Board, which is the municipal executive body.[10] The head of the Municipal Board is the Mayor, who is chosen from among the Board's representative members. The Chief Administrative Officer of the Municipal Board is appointed by the Mayor in consultation with the Municipal Council and (until 2000) the head of the District Office.

As the capital city, Prague enjoys a special status. In addition, Prague and the other largest municipalities (Brno, Plzen, and Ostrava) have district status. Sixteen other municipalities of relatively large size, and of economic, social, and cultural importance, are the so-called "statutory" towns.[11] There are also 383 "designated" municipalities that are authorized to perform some delegated state competencies, including functions on behalf of smaller surrounding communities. The rest are small communities which have gained the legal status of municipality, a condition which qualifies them to have direct access to state subsidies. Since the late 1980s, with the end of the communist regime, the Czech Republic has experienced a proliferation in the number of municipalities (Table 1.1). This trend has been attributed to historical reasons, including the repudiation by the local population of the previous socialist planning and central control system based on the "national committees," and the generally unsuccessful experiences with imposed amalgamations of smaller communities that were tried during the 1960s and 1970s. In the early 1990s, when popular pressures for increased democracy were strong, it was especially difficult to discipline the fiscal decentralization process and to contain the creation of new municipalities.

In 1999, the Czech Republic was again fragmented into 6,239 municipalities, close to the level reached in the 1960s. Currently, 86 percent of the municipalities have fewer than 1,500 inhabitants, and 42 percent have fewer than 300 inhabitants (Table 1.2). Fragmentation of municipalities has been a major problem for a rational local administration, since the smallest communities have too little tax revenue capacity to (1) retain qualified staff with the necessary expertise, and (2) take advantage of externalities in the consumption of, and economies of scale in the production of, public services (especially utilities). The lack of tax revenue capacity has deprived small municipalities of fiscal independence, leaving them highly dependent on transfers

Table 1.1 Czech Republic: Subnational Government Entities

		Municipalities [2]			
Year	*Districts* [1]	*Total*	*Designated* [3]	*Statutory* [4]	*Regions* [2]
1851		11,925			
1857		12,636			
1881		10,245			
1921		11,435			
1931		11,793			
1950	179	10,870		13	
1951		10,870			
1961		7,557			
1971		7,308			
1981		4,571			
1990		4,100			
1991	76	5,763			
1992	76	6,092			
1993	76	6,191			
1994	76	6,225			
1995	76	6,227			
1996	77	6,228	383	13	
1997	77	6,229			
1998	77	6,238			
1999	77	6,239			
2000	77	6,246	383	16	
2001	77	6,254			14
2002			<200		14

1. Deconcentrated state administration.
2. Self-governing authorities.
3. Municipalities performing additional delegated state competences.
4. Cities enjoying state delegated authorities of regional importance (excluding Prague).

Source: Ministry of Finance.

Table 1.2 Czech Republic Municipalities (Size Distribution and Adjustment Coefficient)

Inhabitant brackets	*No. of municipalities*[1]	*Percent distrib.*	*No. of citizens*	*Percent distrib.*	*Approved coefficient*
<100	592	9.5	41,844	0.4	0.42130
101–200	1,166	18.7	174,254	1.7	0.53700
201–300	876	14.0	214,982	2.1	0.56300
301–1500	2,772	44.4	1,820,722	17.7	0.58810
1,501–5,000	567	9.1	1,452,584	14.1	0.59770
5,000–10,000	134	2.1	927,426	9.0	0.61500
10,001–20,000	66	1.1	929,334	9.0	0.70160
20,001–30,000	27	0.4	660,344	6.4	0.71020
30,001–40,000	11	0.2	371,306	3.6	0.74490
40,001–50,000	6	0.1	269,836	2.6	0.81420
50,001–100,000	17	0.3	1,252,788	12.2	0.84880
100,001–150,000	1	0.0	103,372	1.0	1.03930
150,001–150,000	3	0.0	875,260	8.5	1.67150
Prague	1	0.0	1,193,270	11.6	2.76110
Sum	**6,239**	**100.0**	**10,287,322.00**	**100.0**	**12.6137**

1. 1999.
Source: Ministry of Finance.

from the state (Chapter 4). The lack of qualified staff, the small population size, and inadequate scale for the production of public goods and services may have seriously jeopardized the efficacy of local public service delivery and the efficiency of local public expenditures in general. Moreover, small municipalities in the Czech Republic have not yet cooperated or associated among themselves sufficiently, or outsourced enough of the public service delivery to the private sector, to overcome these problems (Chapter 2).[12]

As a result of varying fiscal capacity and expenditure needs, increasing *horizontal fiscal disparities* have been observed among municipalities (Chapters 2 and 3). Dislocation of economic activity, worsening conditions in the labor market, and the nature of the tax-sharing system are the forces behind this trend. In particular, the industrial depression and economic restructuring efforts since the mid-1990s have led to increased unemployment (for example, in Most, Karvina, Chomutov, and Ostrava-mésto), with serious consequences for the respective local government budgets in the form of decreased tax revenues and increased social assistance needs. On the other hand, the most prosperous industrial and tourist areas (such as Plzen, Brno, and Prague) have enjoyed buoyant revenues, have gained more fiscal independence, and have even successfully accessed financial markets through bond issues to expand their opportunities for capital investments.

Deconcentrated State Administration: The Districts

The 73 districts, as territorial divisions of the state administration, were merely deconcentrated units of the central government. The head of the district office, who was appointed by, dismissed by, and reported to the central government (Minister of Interior), was responsible for assisting and following up the *implementation* of state policies at the local level and supervising the legality of the performance of local authorities (Municipal Council, Board, and Office) on delegated functions (Chapter 2). District offices also represented some ministerial departments. But many ministerial departments (including Education, Financial Affairs, Employment, and Environment) had their own field services, which were not subordinate to the district offices. Although this policy had some operational advantages, it often made policy implementation and coordination more difficult, adding to the overall inefficiency of public service delivery.

The districts had an Assembly that deliberated and approved the budget and the policy agenda submitted by the district office. The members of the District Assembly were the Mayors (or their deputies) of municipalities in the district, which ordinarily convened twice a year to approve the district budget and the final accounts. The District Assembly could also function as a forum in which municipalities could discuss issues of common interest. For example, state transfers to municipalities for the execution of delegated functions were made through the district budget. Also, to a certain extent, the District Assembly could function as an institution for conflict resolution and as a complement to the courts at the district level. In some ways, the District Assemblies functioned as surrogate regional governments for matters of local interest, but without self-governing powers.

Decisionmaking Power at the Local Level

As an integral part of the state administration, district offices, although enjoying some limited decisionmaking power on local resource allocation, had neither independent property rights nor total budgetary independence. In contrast, municipalities retain legal decisionmaking powers within their jurisdiction and run an independent budget. The actual degree of autonomy and decisionmaking power that municipalities enjoy is uncertain, since they have limited tax autonomy or capacity, and since most municipalities are highly dependent on transfers from the state (see Chapter 3).

Municipalities do have a considerable degree of autonomy with respect to own expenditures financed either by local revenues or by nonconditional transfers (that is, revenue sharing in state taxes). However, in the case of delegated functions, the decisionmaking powers of municipalities are practically nonexistent, since "subsidies" are earmarked (see Chapter 4). But even in the case of own expenditures, actual local autonomy varies across municipalities because of considerable disparities in fiscal capacity. The largest and industrially prosperous municipalities are those with some degree of revenue autonomy and some decisionmaking power on local expenditures. Conversely, the myriad of small municipalities has practically no revenue autonomy or relevant decisionmaking powers on local expenditures.

The Establishment of Regions and the Interim Period

In April 2000, Parliament approved Law No. 129/2000, establishing the regions (as the higher self-governing entities).[13] Two of the main motivations behind this change in territorial administration were to build up administrative capacity and to build democratic representation at the intermediate level of government. More important, this move resulted from both internal pressures for the fulfillment of the constitutional precept[14] and the urgent need to put in place a more consistent institutional framework for the implementation of the EU pre-accession and structural funds. This institutional framework would require strong regional implementation capacity, transparency, and accountability.[15]

Law No. 129/2000 established 14 regions, with elected representatives,[16] to be effective from January 1, 2001. The 14 new regions have geographically consolidated the previous 77 districts basically around the existing "statutory towns" plus Prague. The 14 newly created regions are Prague City (Praha), Central Bohemia, Ceské Budejovice, Plzen, Karlovy Vary, Usti Nad Labem, Liberec, Hradec Kralove, Pardubice, Jihlava, Brno, Olomouc, Zlin, and Ostrava (Table 1.3).[17]

The Law on Regions establishes the basic administrative structure for regional self-government. This structure includes the Regional Assembly as the deliberative body, the Regional Council as the executive body, and the Regional Office. The Assembly is composed of regional representatives directly elected by the regional population. The Regional Council and the President of the Assembly are both elected by the Assembly from within its members, while officers of the Regional Office are appointed by the Regional Council, and these officers appoint the staff. The Regional Office can carry out state-delegated functions. However, the central government can create regional special bodies to perform special delegated functions.

The new government structure will be phased in over a period of two years through December 2002. Districts will be formally dissolved and will cease to exist at the end of 2002, and from January 1, 2001 they will be financed through the state budget and will no longer provide grants to the municipalities. During this interim period, the new regions will be fully funded via transfers from the state budget. Although no concrete expenditure responsibilities have as yet been assigned to the regions, the general plans call for the regions to basically absorb some responsibilities of the state (such as secondary education, intercity transport, environment, and regional planning). The district offices (see Chapter 2) previously performed some of these functions. Other state functions carried out by the districts will be absorbed by "designated" municipalities, which the Minister of Interior intends to reduce to a smaller group of no more than 200. The method of financing the new regions beyond December 2002, including the assignment of autonomous revenue sources, has not yet been defined.

Table 1.3 Regions in the Czech Republic, 1999

Region	*Extent in km^2*	*Inhabitants*	*Number of districts*	*Number of municipalities*
Prague City (Praha)	496	1,209,855	(15)	1
Central Bohemia	11,014	1,103,738	12	1,147
Ceské Budejovice	10,056	626,867	7	623
Plzen	7,560	555,410	7	505
Karlovy Vary	3,315	305,086	3	131
Ústí Nad Labem	5,335	825,074	7	353
Liberec	3,163	428,974	4	216
Hradec Králové	4,757	553,827	5	448
Pardubice	4,519	510,072	4	451
Jihlava	6,925	522,846	5	730
Brno	7,067	1,141,172	7	643
Zlín	3,965	600,617	4	297
Olomouc	5,139	645,804	5	392
Ostrava	5,555	1,289,002	6	297

Sources: Parliamentary Act no. 347/1997; Ministry of Finance, and Journal OBEC & finance 3/99.

Parliament has prudently adopted a two-year interim period to put in place the functions, responsibilities, and revenue sources of the new regional authorities. Such an approach may avoid major disruptions in service delivery in particular, since the phasing out of the old districts over the same period will be used as an administrative bridge. For strategic reasons, parliament decided to initiate the decentralization reforms by allowing the election of regional representatives to take place first, and only then proceeding with further reform. In addition, the government's initial move in the sequence of reforms was, appropriately, shifting some major responsibilities to the regions (for example, secondary education, intercity transport, environment, and regional planning, which will be initially fully funded by the 2001 state budget). Only then will parliament proceed with the definition of own sources of resources. Thus, an important general principle in the design of intergovernmental fiscal relations—that resources should follow responsibilities—has been adhered to in the government's strategy. This procedure should help guarantee sufficient resources and adequate vertical fiscal balance from the beginning of the new intergovernmental structure.

Nevertheless, the government should minimize the period of keeping the new regions fully dependent on the state budget. As soon as possible, the government should assign equivalent autonomous revenue sources to the regions. Fiscal decentralization (as opposed to a mere deconcentration of state administration, as was the case until now) requires that regional and municipal authorities be given a degree of autonomous decisionmaking power in order to adequately perform their functions and deliver quality public services. Decisionmaking power is a necessary incentive to make subnational self-governing authorities accountable to the residents in their jurisdictions for policy results.

A potential issue during the interim period is a probable increase in public expenditures related to the implementation of the regional government administration. Apparently, the Ministry of Interior intends that part of the district offices' staff and officers should be given the opportunity to join the municipal personnel structures where they are currently situated, while the remaining staff might well be accommodated in the state administration. This could mean that the bureaucracy of the new regions would be built afresh, thereby expanding public employment, the wage bill, social benefits, and possibly capital expenditures. If this situation is not properly equated and controlled in time, it could result in a large-scale structural fiscal imbalance that might be difficult to reverse in the future. This should be a matter of concern for the central government.

Challenges Ahead and Reform Issues

If responsible local governments are to be developed, the right institutions and incentives should be in place. For this purpose, the attribution of clear responsibility, the delegation of specific decisionmaking powers, and the autonomy to perform the tasks of local government are essential incentives to make local authorities accountable for results before their own constituencies.

With the new territorial administration, the potential for a more efficient delivery of public services will lie with (1) *meaningful decentralization* of some relevant functions to the regions; (2) *optimization of the size* of operation of basic self-governing units; (3) provision of a minimal degree of *revenue autonomy* to new regional governments; (4) promotion of *private sector participation* in financing as well as delivery of public services; and (5) proper *coordination of decentralization policy.*

1. ***Decentralizing Functions to the Higher Self-Governing Units: The Regions.*** Apparently, some of the responsibilities transferred to the regions will be on a delegated basis, at least at the beginning of the reform (for example, secondary education). Although this means that a considerable share of these expenditures will be state financed via specific or categorical transfers, several other initiatives are under consideration. For example, giving school boards and school directors greater discretion to enhance their decisionmaking powers and to use transfers on a "capitation" basis in secondary education (as is now done for elementary education with municipalities) is a welcome step that should encourage operational efficiency. Further decentralization reforms that could significantly increase the efficiency of public expenditures would be (1) giving the regions direct responsibility over resource allocation for specific functions, and (2) local delegation of autonomous decisionmaking powers for issues closer to the regional population's interests, such as tertiary education, intercity transport, environment, and regional planning (Chapter 2).

2. ***Rationalizing the Size of Basic Self-Governing Units: The Municipalities.*** The excessive fragmentation of municipalities has been a historical feature of the Czech Republic (Chapter 2). Because fragmentation has brought about serious administrative, technical, and financial difficulties, it will probably be a recurrent issue in the agendas of both the government and parliament in the coming years. The main concern will be to scale the operations of the small municipalities to economically viable sizes while respecting the local preferences of these municipalities.

   One option is to put in place incentives (including financial incentives) that can help reverse the fragmentation process and promote the merging of small communities wherever possible. Another option is to take advantage of the restructuring of the territorial administration and shift some responsibilities from small municipalities to the regions or to "designated towns."[18] The assignment of expenditure responsibilities does not need to be uniform across the basic self-governing units in cases of extreme variance in local capacities. In any case, adherence to the reform should be voluntary, and the government should be able to articulate reform instruments so that the following are true:

- Affected communities would realize that the changes would make them relatively better off, in both the short- and long term. For example, they would have a substantially higher per capita share in the tax-sharing system,[19] an amplified tax base and revenue capacity, and better access to quality services.
- The provision of public services should be more effective and efficient, as a result of being able to internalize current externalities in consumption, as well as economies of scale in the production of public services (such as water and sewage treatment and garbage collection).
- The changes should clearly improve the affected communities' chances of benefiting more directly from the EU pre-accession funds, as planned.

3. ***Providing Local Government with a Minimum Degree of Revenue Autonomy.*** Once local expenditure responsibilities have been established, it will be urgent to clearly define the regions' own sources of revenue. Own revenue should come from predictable sources, including taxes, with discretion at the margin on rates, and non-tax revenues (fees, surcharges, rent on property, and so forth) (Chapter 3). In addition, property rights (on social facilities such as school and hospital buildings, and nonsocial facilities such as energy

generation plants, water treatment plants, and roads) should be well established. For nonsocial facilities, clear regulation should be adopted concerning the limits of property disposal, whether for privatization and asset-recycling programs, or as collateral for responsible access to credit markets. This regulation should be aimed at expanding the capital investment capacities of self-governing units. Transfers out of the pool of tax-sharing systems should always be of a lump sum, nonconditional grant nature.

It is most important that self-governing units (both regions and municipalities) be given decisionmaking autonomy concerning their own revenue sources. This will enable subnational authorities to operate with a margin of resource predictability and flexibility, so that they can choose from a set of constrained policy options and can be directly accountable for their decisions.

4. ***Promoting Private Sector Participation.*** Private sector participation in the provision and delivery of local services remains too low. Private sector participation (in financing and provision) could help to increase the efficiency of service delivery (through increased competition) and to release scarce financial resources for the local budgets so that they could provide other necessary services. On both efficiency and equity grounds, it is critical that local governments should be able to (a) promote the increasing participation of the private sector in the social sectors; (b) authorize public facilities to operate with user charges on some service delivery; and (c) continue the privatization of utilities' property, as well as promote the privatization of housing and some educational, health, and entertainment facilities, when it becomes clear that the private sector can deliver a better service.

   While local governments in the Czech Republic have been making a considerable effort to attract private investment (Chapter 2), it is very much up to the central government to continue its policy of assuring the proper legal and regulatory framework to consolidate an enabling business environment for the development of private initiative, inclusive of the social sector. Such an environment will need the assurance of property rights, well-regulated financial and health insurance markets, well-designed school admission procedures and accreditation systems, and deregulated rents on commercial buildings, land, and housing.

5. ***Coordinating the Decentralization Process.*** The government realizes that intergovernmental fiscal reform is a process and not a single, irreversible policy move. In this context, the government should be prepared to face evolving challenges in a process that is participatory—involving all stakeholders, in particular local governments (both the new regions and the municipalities) and their representative organizations. The creation and nurturing of multilevel institutions of intergovernmental dialogue and cooperation should improve the design of the system, its daily operations, and the necessary periodic adjustments. Specifically, an intergovernmental relations agency for cooperation and dialogue, led by the central government (but with representatives from the state, the regions, and the municipalities) and charged with monitoring the implementation of the decentralization process, should prove particularly useful. Such a multilevel agency could work as a technical intergovernmental body to coordinate intergovernmental relations and to promote communication, management of information, and dissemination of best practices in decentralized public administration. Such an institution would accommodate divergent interests and could serve as a first point for conflict resolution.

2. Expenditure Responsibilities

Current Expenditure Assignments

Intergovernmental expenditure assignments in the Czech Republic mostly conform to conventional principles. In particular, they largely respect the principle of subsidiarity. Until 2000, the assignment of expenditure responsibilities at the local level included those responsibilities assigned to the municipalities and those assigned to the districts. There have not been any major changes in the expenditure responsibilities of municipal governments since the Municipal Act of the early 1990s.

Currently, municipal expenditure responsibilities are divided into "delegated" responsibilities and "own" responsibilities.[20] Delegated responsibilities are those transferred by the central administration to the municipalities only for the actual delivery of services while all decisions on regulations remain at the central level. The responsibility for financing delegated responsibilities also remains partially at the central level. Central government contributions to the financing of delegated responsibilities only cover a part of the costs of provision. Delegated responsibilities include activities in civil registry (birth, marriage, and death), building codes, regulation and enforcement of laws pertaining to the environment, transportation, sanitation, and so on. The largest 383 municipalities perform more delegated responsibilities than the rest of the municipalities. The larger municipalities may provide delegated services to the other municipalities (5,856 in number) under mutual agreements or under arrangements designed by the district offices. The district offices have been responsible for overseeing the performance of municipalities in regard to delegated responsibilities.[21] State financial support to the municipalities for delegated services goes through the district offices.[22]

In the domain of own responsibilities, municipalities have in principle the discretion to make their own decisions on how to deliver services, although in many cases they are subject to state regulations. Municipalities may also receive funding from the central government for the delivery of own responsibilities. Among own responsibilities, the Municipality Act further distinguishes between "mandatory" and "optional" responsibilities. Among the latter are cultural activities and institutions, such as libraries, galleries, and recreational facilities.[23] Within the mandatory responsibilities, a further distinction is made between "public services" which are financed from general revenues, and "technical services" which are financed by fees. The latter include water and sewerage services, waste collection, and public transport. While technical services can be denied if charges are not paid, public services must provided to all residents.

No major changes are envisioned in the assignment of expenditure responsibilities at the municipal level other than the possible absorption of some functions that have until now been the responsibility of districts. The current division of expenditure responsibilities among different levels of government is summarized in Table 2.1. Own responsibilities for municipal governments are shown in Box 2.1.

Expenditure responsibilities at the district level currently include health services, with the registration of all types of health facilities and the operation of public hospitals with central government subsidies; the distribution of benefits to people with disabilities; the operation of nursing homes and orphanages; and the organization of fire protection services.[24]

As districts will be merged into the central government administration in 2001 and will be discontinued by the end of 2002, a decision has to be made on the allocation of district responsibilities to other levels of government.[25] The Czech government is allowing itself a transition period of two years, during which the disposition of district responsibilities will be decided. Two main choices of strategy are being discussed. In the first, some responsibilities of the districts would be transferred to the regions and some to the municipalities. In the second strategy, the district responsibilities would be exclusively shifted to a group of 180 "designated" municipalities.[26]

The Role of the New Regions

The most significant aspect of the territorial administration reforms of 2000 has been the creation of 14 new regions, effective from January 2001. But both responsibilities and financing for the new regions will be provisional through December 2002. During this two-year transition period direct transfers from the central government will finance the new regions, after the costing out of the newly transferred responsibilities (Chapter 1).[27]

The Law on the Establishment of Regions contains some references to the responsibilities and authority of the new regions,[28] but on the whole no explicit expenditure assignment for these higher self-governing entities is provided. Paralleling the current arrangements that exist for municipalities, the Law on the Establishment of Regions mandates that the new regional governments will perform the duties of the state administration in matters delegated by law, and that the regions will receive financial compensation from the central government for the discharge of the delegated tasks. The law also mentions several own expenditure responsibilities for the regions, including regional development, land-use planning, and transport network planning within the region. One important aspect of this law is that the regions are not given any power to legislate, but they may initiate legislation by submitting proposals to parliament. To a large extent, the determination of the expenditure responsibilities for the new regions has been left to the line ministries.[29] This does not augur well for an effective process of decentralization of central government powers.[30]

Box 2.1 Own Responsibilities for Municipalities

a. ***Education,*** including operation and maintenance of buildings for kindergartens and basic education (up to 15 years of age).[1] Responsibility for basic education is shared with the central government, which is responsible for teacher salaries and social insurance contributions, textbooks, and school supplies.[2] Municipalities can open or close schools upon approval of the Ministry of Education. Responsibility for capital expenditures for rehabilitation or construction of new schools lies with municipal governments but in reality the central government has continued to provide most of the funding. Municipalities also receive a subsidy per student from the central government to help cover operating costs.

b. ***Social care***, consisting mainly of the operation of nursing homes, orphanages, and facilities for the disabled.[3] Municipalities receive a subsidy or grant from the central government, calculated on a per bed basis, to cover a share of the operating costs of the facilities. Municipalities, funded by the central government, also provide payments to families in poverty or distress. Larger municipalities also pay recurrent benefits to supplement income up to a minimum subsistence on behalf of the state,[4] and the central government covers the administration costs of these programs.

c. ***Health care services,*** by partly financing small hospitals and clinics.[5]

d. ***Culture and recreation,*** including libraries, theaters, local museums, and zoos, as well as sport complexes, stadiums, swimming pools, and so on. Cultural activities are supported in part by discretionary central government grants.

e. ***Public safety*** (civil defense) and local traffic police. Fire brigades operate under the local government budget but they are mostly funded by central government grants to the districts and organized according to central government rules. However, the four largest cities have their own fire protection services.

f. ***Sanitation***, including solid waste disposal and street cleaning. Often these activities are contracted out to the private sector.

g. Street lighting, cemetery, and park construction and maintenance.

h. ***Water and sewerage treatment***, often also contracted out to privatized companies, but rates are regulated by the central government.

i. Urban planning and zoning.

j. ***Local roads and intracity transport*** by subsidizing private local transport companies.

k. ***Public housing services***. Municipalities still own a substantial amount of housing.[6] Rents are regulated by the central governments except for the newly built apartments. Municipalities continue to build apartments with central government subsidies.[7]

Notes

1. Large cities may also run secondary schools. Some municipalities run specialized schools for handicapped children, which in general are the responsibility of the central government. In both cases, municipalities receive a subsidy per pupil from the central government.

2. Teachers' salaries do not go through the municipal budgets, and teachers are not municipal government employees.

3. Most of the institutional care for the elderly and the disabled is provided directly by the central government or the district offices. The most important social welfare services (including pensions, child, and sickness benefits) are also the responsibility of the central government and are distributed through the district offices (World Bank, 1999).

4. Visek (1999).

5. Health services are financed through the national health insurance system and the majority of hospitals are run by the central government.

6. In 1999, 23 percent of the stock of apartments was still owned by municipalities. All housing built by the state before 1990 was transferred to the municipalities at the start of the transition and over time a sizable share of this housing was privatized or sold to long-term occupants.

7. Some of the subsidies are for the repair and maintenance of prefabricated houses and there are also subsidies for the construction of assisted-living facilities for the elderly.

Source: Author's data.

Table 2.1 Czech Republic Expenditure Assignment

Expenditure	***Central government***	***Districts/regions[1]***	***Municipalities***
Monetary policy	100 percent	—	—
Defense/foreign economic relations	100 percent	—	—
Justice/internal security	100 percent	—	—
Delegated responsibilities for Civil Registry and enforcement of national regulations	-Financing and regulation	-Supervision	-Delivery and implementation
Regional development	**Overall policy direction**	**Regional development**	**—**
Education	-All university and research institute expenditures -Teachers' salaries at all levels -Subsidies for school building	-*Technical/vocational* -*Secondary schools* -*Other* (incl. Special care)	-Pre-primary[2] -Basic 9-year schools[2]
Culture, recreation and parks	-National museum -National theater	-Regional museums -Theaters -Zoos	-Recreational activities -Sports park facilities
Health	-Primary health care -Medical research institutes	Hospitals	-Secondary hospitals[2] -Primary health[2]
Roads	National roads	Regional roads TYPES II AND III ROADS	Local roads
Public transportation	-Highways, air, and rail transport	Regional transportation facilities	Local transport
Fire protection	—	Fire protection services	Several large cities also assume fire protection
Libraries		Regional libraries	Local library services
Police services and civil defense	National police	Local police and civil defense	Local police[2]
Sanitation (garbage collection)	—	—	-Collection and treatment of solid waste -Street cleaning
Sewage treatment			Treatment plants and operation
Water and public utilities	—	—	-Water treatment and supply -Natural gas supply -Heating
Housing and spatial/city planning	Support for housing	**Regional planning**	-Maintenance of public housing and building -City planning[2]
Social safety net and welfare	Social security benefits	-Nursing homes –Orphanages -Handicapped facilities	-Pensioner residential homes[2] -Orphanages -Homes for the mentally handicapped -Nursing homes for the elderly[2]
Environment and tourism	-National environmental issues -National tourism	-Regional environmental problems	-Local environmental issues[2] -Local tourism

— Not applicable.
1. The assignments to the new regions are still tentative and are in italics.
2. These are mandatory responsibilities for municipalities, although some are concurrent with other levels of government.

Source: Ministry of Finance.

Nevertheless, concrete plans do exist for the transfer of responsibilities from the central government to the regions:

- The Ministry for Regional Development plans to transfer to the new regions some responsibilities related to the regional development in their territories, including authority over spatial and zoning plans.
- The Ministry of Education will be phasing out the current School Board Offices at the district level and will transfer all their functions to the new regions. The ministry will transfer to the regions the responsibilities for (upper) secondary education, which parallel those responsibilities that municipalities now have for basic education. The regions will have the authority to appoint school directors and to open and close secondary schools.[31] The regions will also be responsible for the operation and maintenance, as well as the construction, of secondary schools, but the central government will continue to be financially responsible for teacher salaries and social insurance contributions, and for school supplies.[32]
- The Ministry of Labor and Social Affairs has plans to transfer to the regions the responsibility for 11 social care facilities.
- The Ministry of Health has plans to rely on the new regional health departments to coordinate policies with the municipalities and approve the network of health facilities. The transfer of the ownership of hospitals now controlled by the districts to the regions is expected to be difficult because many of these hospitals are currently heavily indebted.[33]
- The Ministry of Transport has plans to shift responsibilities of ownership and maintenance for roads of Category II and III to the new regions together with a proportional share of the State Transport Infrastructure Fund. The deconcentrated offices of the Ministry of Transport, now at the district level, will also be transferred to the regions.

In addition to the decentralization of services from the central government, as mentioned above, the regions may assume other expenditure responsibilities from the districts, such as expenditure responsibilities for fire brigades, hospitals, nursing homes, orphanages, facilities for handicapped people, theaters, museums, and parks and zoos.

Expenditure Patterns

Local government expenditures (encompassing districts and municipalities) as a percent of GDP have remained fairly stable, but would plot a mildly inverted U-shape on a graph over the transition period. In 1993, local budgets represented 9 percent of GDP and are projected at 8 percent of GDP for 2001 (Table 2.2). They reached their peak in 1996 at 11 percent of GDP. The share of local budgets in general government expenditures has exhibited a similar pattern. Local budgets represented 21 percent of general government expenditures in 1993 and are projected at 20 percent for 2001; they reached a peak of 27 percent in 1996.

Local expenditures by function have continued to evolve during the transition. Expenditures on Housing and Community Amenities have been the most important component of local expenditures throughout these years, representing 27 percent of total expenditures in 1999, down from 35 percent in 1993 (Table 2.3). Among other important expenditure categories, three items have increased over the transition years, with Economic Affairs and Services reaching 18 percent of the total in 1999, General Public Services 15 percent, and Social Security and Welfare 12 percent.

Table 2.2 Distribution of Expenditures between Levels of Government, 1993–2001

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000Bgt*	*2001Bgt*
					(As a percentage of GDP)				
State budget [1]	34.49	33.08	30.96	29.86	30.21	30.31	31.48	35.81	33.83
Local budget	8.94	9.67	9.54	10.80	9.02	8.79	9.42	9.79	8.33
Total	43.43	42.75	40.50	40.66	39.23	39.09	40.90	45.60	42.16
					(As a percentage of total)				
State budget [1]	79.41	77.39	76.44	73.45	77.01	77.52	76.96	78.53	80.25
Local budget	20.59	22.61	23.56	26.55	22.99	22.48	23.04	21.47	19.75
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

1. Includes SFAL—State Financial Assets and Liabilities
Sources: Ministries of Finance, IMF.

Table 2.3 Composition of Subnational Expenditures—Function Category, 1993–1999

Percent of total	*1993*	*1994*	*1995*	*1996*[1]	*1997*	*1998*	*1999*
General public services	12.46	13.28	15.41	14.19	15.85	15.18	14.96
Defense	0.03	0.10	0.08	0.08	0.49	0.31	0.15
Public order & safety	1.32	3.03	3.20	3.01	3.86	3.77	4.06
Education	12.47	10.89	10.47	9.53	9.08	8.79	8.36
Health	7.14	5.45	5.49	3.79	3.82	3.62	4.11
Social security & welfare [1]	10.18	10.39	10.91	23.26	10.00	11.19	11.81
Housing & community amenities	35.10	31.92	28.55	24.01	28.35	27.03	26.74
Recreation, cult.; relig. affairs & serv.	5.17	5.70	6.29	5.73	6.65	6.76	6.62
Economic affairs & services	13.24	17.80	17.65	14.42	17.92	19.24	18.00
Other expenditures	2.89	1.45	1.95	1.97	3.97	4.11	5.19
Total expenditure	100.00	100.00	100.00	100.00	100.00	100.00	100.00

1. The 1996 data is provisional, and likely to change. Major statistical adjustment is underway on "Social Security & Welfare" because of changes that occurred in the accounting of the new system of social benefits late-1995.
Source: Ministry of Finance.

On the other hand, the relative importance of expenditures on Education and Health has decreased steadily since 1993. In 1999, Education represented 8 percent of total expenditures and Health 4 percent, down from 13 percent and 7 percent, respectively, in 1993. However, this does not mean that the real provision of these services has decreased, since these are concurrent responsibilities of the central and local governments. For example, in the case of basic education and kindergartens, expenditures per pupil were practically unchanged from 1993 to 1999.[34]

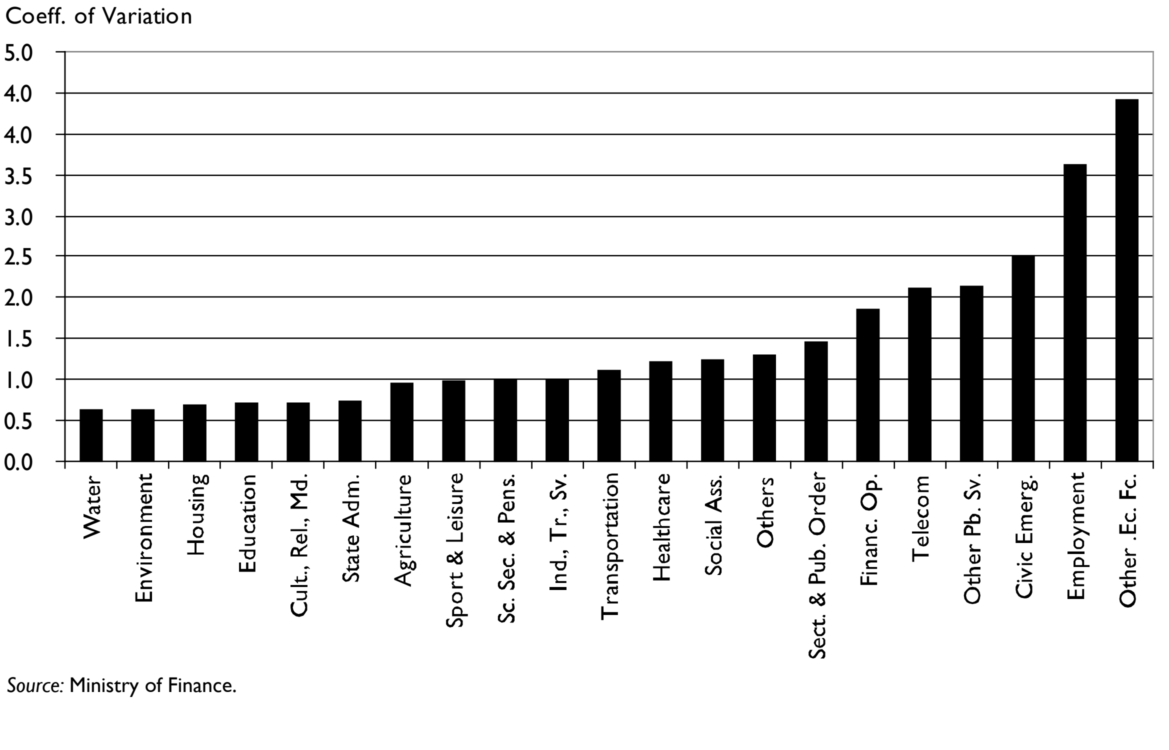
A notable feature of local expenditures by function is their significant variation across municipalities. Tables 2a, 2b, and 2c in the Statistical Appendix show per capita expenditures for functional expenditure categories for all municipalities aggregated at the district level for 1997 to 1999, and the averages for the coefficients of variation over the three-year period are summarized in Figure 2.1. For example, the coefficient of variation for expenditures per capita on education is one of the lowest, but was still at 0.54 in 1999 and with a maximum expenditure per capita of 7,794 CZK and a minimum of 395 CZK.

Differences are more marked in other expenditure items, such as social assistance, which had a coefficient of variation of 1.22 in 1999, a maximum expenditure per capita of 9,181 CZK, and a minimum of 164 CZK. Differences in expenditure per capita are more pronounced for less basic expenditures items, such as telecommunications (coefficient of variation of 2.21) or security and public order (coefficient of variation of 1.59). The largest expenditures per capita have been on housing and communal services, with a maximum in 1999 of 22,353 CZK and a minimum of 1,050 CZK. By and large, the average coefficients of variation (Figure 2.1, and also Table 2d in the Statistical Appendix) demonstrate that municipalities have followed a responsible expenditure pattern. The variations in expenditures per capita are the lowest for basic services, such as education, health, and welfare.

The economic composition of local expenditures reveals a high but unstable share of capital expenditures in the budgets of the last seven years.[35] Capital expenditures at their low represented 31 percent of total local expenditures in 1999, down from 35 percent in 1993 (Table 2.4).[36] For 2000, capital expenditures were projected to represent 41 percent of total expenditures, which to a large extent may be reflecting the high capital *revenues* of local governments for this year.[37] These high levels of capital expenditure are not expected to be sustainable, as capital revenues of local governments are expected to decrease significantly from the heights of the past several years. The relative importance of wages and salaries plus contributions has steadily increased from 10 percent in 1993 to a projected 15 percent in 2000. Subsidies and transfers have fluctuated widely over the past seven years, reaching a high of 35 percent in 1996, but they are projected to be at 20 percent in 2001, the same level they reached in 1993.

While the aggregate data by economic and functional classifications reveal some information on expenditure priorities and on the input composition of the delivery of local services, they reveal little about the relative efficiency of different local governments. From this viewpoint, one of the most important issues is how the significant size variation of municipalities affects the composition and efficiency of local public expenditures. Size tends to affect the composition of expenditures because smaller municipalities are less able to afford and to spend, for example, on responsibilities involving culture and the arts and other "optional" sectors.

Figure 2.1 Czech Republic: Local Government Expenditure Coefficient of Variation (Average 1997–99)



Source: Ministry of Finance.

Table 2.4 Composition of Subnational Expenditures—Economic Classification, 1993–2001 (Percent of Total)

	1993	1994	1995	1996[1]	1997	1998	1999	2000Bgt	2001Bgt
Total expenditure	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Current expenditure	64.73	62.77	61.81	69.34	66.22	67.12	68.58	58.82	65.77
Expendit. on goods & services	44.15	39.98	37.60	33.78	40.64	42.11	42.11	57.16	44.05
Wages & salaries	7.50	6.41	6.45	6.23	8.65	8.72	8.94	11.28	7.96
Employer contributions	2.70	2.35	2.43	2.37	2.91	2.87	3.00	3.95	2.79
Other purch. of goods & serv.	33.96	31.22	28.73	25.19	29.09	30.52	30.18	41.93	33.30
Interest payments	0.00	0.35	0.91	0.95	1.60	1.48	1.31	1.66	1.50
Subsid. & other curr. transfers	20.58	22.43	23.30	34.60	23.97	23.53	25.15	28.37	20.23
Subsidies	17.29	18.82	18.62	15.95	18.03	17.28	17.90	20.55	13.70
Transf. to other levels of gov.	0.00	0.00	0.00	0.00	0.90	0.55	0.47	0.00	0.00
To household & nonprofit instit.	3.29	3.61	4.68	18.65	5.04	5.69	6.77	7.82	6.52
Capital expenditure	35.27	37.23	38.19	30.66	33.78	32.88	31.42	41.18	34.23
Fixed capit. assets, stocks, land	28.46	29.64	31.26	25.72	28.91	27.06	26.38	33.15	29.14
Capital transfers	6.81	7.59	6.93	4.94	4.87	5.81	5.04	8.03	5.09

The 1996 data is provisional, and likely to change. See footnote in Table 2.3
Source: Ministry of Finance

One particular area of interest is whether there are disadvantages for smaller municipalities because of their inability to realize economies of scale in the production and delivery of services. The size distribution of municipal expenditures does provide some evidence of this phenomenon,[38] but with the important caveat that expenditure shares do not necessarily represent differences in costs. For example, for 1995 municipalities with less than 200 inhabitants spent 35 percent of their funds on internal administration. This went down to 25 percent for slightly larger municipalities (those with 500 to 1,000 inhabitants) and continued to decline with the size of the municipality. For those municipalities with populations over 500,000, internal administration represented 11 percent of total expenditures.

A similar pattern is present for services requiring heavy infrastructure, such as water and sewerage. These services represented 23 percent of total expenditures for the smallest municipalities and only 6 percent for municipalities of over 500,000 population. Thus, although in theory the disadvantages of small size for the delivery of services can be overcome by entering municipal associations or by contracting with private companies, these options (at least in 1995) were not sufficiently exercised by municipalities, or were not able to offset the diseconomies of scale inherent in small-size communities.

Regional Disparities in Local Government Spending

Little information is available on fiscal and economic disparities at the municipal or district levels, although currently some disparities at the regional level are evident. At the municipal level, there were significant disparities in 1995 in per capita expenditures across municipalities of different sizes. For municipalities with less than 500 inhabitants, public expenditures per capita were under 6,000 CZK, while for municipalities of over 500,000 population, expenditures per capita were slightly over 19,500 CZK.[39] In terms of fiscal capacity, the worst off are municipalities with fewer than 200 inhabitants where the majority of the population works in agriculture and a smaller percentage of the population is economically active. It is not immediately obvious what effect these disparities have on uniformity in the provision of basic services. For example, the Ministry of Education considers that the existing disparities in the level of service or the quality of schools across local governments are not significant.[40] However, the previous section has indicated that, despite the relatively low coefficient of variation in the distribution of per capita expenditures in education across municipalities, education expenditures per capita in 1999 ranged from a maximum of 7,794 CZK to a minimum of 395 CZK.

At the regional level, significant differences appear in GDP per capita, although these disparities arise from the differences between Prague and the rest of the country. For 1996, GDP per capita as a percent of the EU average was on the low side (49 percent in Stredocesky and 55 percent in Vychodocesky). At the high end was Prague, at 120 percent of the EU average. The next highest region was Zapadocesky, at 63 percent of the EU average.[41] It also appears that regional disparities have grown during the transition because of different unemployment rates associated with the decline of heavy industry in some regions and redundant labor from agricultural areas.[42] These imbalances have not been helped by the low inter-regional mobility of the labor force in the Czech Republic.

A similar picture of economic disparities is drawn in a recent report of the Ministry of Regional Development.[43]The main conclusion is that there is a marked difference in economic base and available resources between Prague and the rest of the country. In 1995, GDP per capita in Prague was 182 percent of the national average. The disparities among other regions in the country were less pronounced. Only Plzen and Brno were at the national average, and the poorest region, Central Bohemia, had a per capita income of almost 22 percent under the national average. Disparities in personal income tax revenues per capita were more pronounced than those in GDP per capita. On average, between 1995 and 1997, Prague had PIT revenues per capita that were 2.5 times higher than the rest of the nation. At the other extreme, PIT revenues per capita for Jihlava were 40 percent below the national average. There are also differences in other socioeconomic indicators. For example, infant mortality rates were slightly over 10 per thousand in Ostrava and Trutnov and under 2 per thousand in Znojmo.[44]

Issues on Expenditure Assignments

The New Regions and the Fragmented Local Governments

The next step in decentralization will be the assignment of direct expenditure responsibilities (beyond delegated functions financed by the state) and associated decisionmaking power to the regions. These responsibilities should encompass areas of the interest of the regional population, including for instance intercity transport, environment issues, and regional planning. Caution, however, should be exercised to avoid interjurisdictional conflicts of power, unfunded mandates, and soft budget constraints. Clear definition of powers is critical, since concurrent mandates may emerge, leading to inefficiencies. Unfunded mandates can be an incentive for local governments to trigger a bailout, and can easily become a major source of soft budget constraints.[45] To ensure local (regional as well as municipal) hard budget constraints, significant, legally enforceable penalties to fiscally irresponsible behavior should include (1) the loss of autonomy, with the central government taking over and restructuring the local activities; or (2) the establishment of standards of fiscal responsibility and holding local officials personally accountable for results. Both penalties may apply at once.

One of the most significant problems in the Czech system of intergovernmental fiscal relations is the small size of many municipalities, which does not allow for an efficient delivery of services.

The amalgamation of these municipalities is a highly charged political issue for the near future. However, in theory most of the problems created by the small municipalities could be remedied by reassigning current municipal responsibilities for services with economies of scale, such as water and sewage treatment, to the new regions. Because the inability to realize economies of scale in the delivery of services is confined to small municipalities, the alternative of introducing asymmetric expenditure assignments at the municipal level should be considered, in conjunction with the creation of new regions. This strategy could take different forms, but it would basically give fewer responsibilities to smaller municipalities in some critical services that are negatively affected by small size and would give the new regional governments the responsibility for providing those critical services in the smaller municipalities.[46] The responsibility for additional services, and the funding sources to accompany them, would devolve in the future to municipalities that reach a minimum prescribed scale through voluntary amalgamation. The year 2000 reform package of new laws appears to allow the voluntary upward delegation of municipal responsibilities to the regions. It is too early to tell whether this approach will work, but there is little evidence from international experience that this is an effective solution to the problem of the small scale of municipal governments.

It seems that the Czech government has not focused sufficiently on the potential of the new regions as a means of resolving municipal fragmentation in a politically acceptable manner. There may still be time for such a focus because the expenditure responsibilities of the new regional governments have not yet been determined. However, the government has already proceeded with the revenue assignments to the municipalities, and therefore, transferring some municipal responsibilities to the regions would entail a new change in revenue assignments. Furthermore, this route for addressing municipal fragmentation may have been preempted by the political consensus that the assignment of responsibilities to the regions should not be detrimental to the municipalities, except for voluntary assignments.[47]

Several other aspects of the small size of municipalities go beyond the failure to realize economies of scale. The first is that some municipalities provide services for residents of other municipalities without having a mechanism that explicitly allows for compensation among jurisdictions. Sometimes this compensation does seem to exist, as in the case of education and health or the connection to water services.[48] But in other cases, such as cultural and recreational programs, no such compensation mechanism exists. A solution to this problem might be to shift to the regions some of these responsibilities, with spillover effects across certain municipalities for which it is hard to devise compensation mechanisms. Another problem arising from small size is the inability of certain municipalities to finance critical responsibilities. Some municipalities may not be able to cover the difference between the real cost of social assistance programs and the funds actually transferred to them for this purpose by the central government.[49]

A final aspect of small size is the diminished administrative capacity of small municipalities. Although it is clear that the new regions will not be in a hierarchical position in regard to the municipalities, one unresolved question is what limited control and supervision, if any, the new regions will have over the municipalities. Should the powers that district offices have had over the municipalities until now be kept, or should they be expanded, or narrowed? This raises highly charged political issues in the Czech Republic which go well beyond the issues of efficiency and economic rationality. But from that viewpoint alone, given the very small size of most municipalities in the Czech Republic, it would seem reasonable to provide the regional governments with powers to supervise and assist public service delivery at the local level, at least in the case of municipalities under a certain critical size.

Privatization of Services

Municipalities have begun to rely increasingly on contracting with private companies for the delivery of services or privatization of service delivery completely. This is a positive trend that can provide an adequate solution to the problem of high costs of delivery stemming from the fragmentation of municipal governments.[50] In some cases, these relationships are contractual and are the result of open bidding competitions.[51] Services that have been contracted out include garbage collection, housing services for the elderly and the handicapped, and the management of municipal hospitals and clinics. In other cases, there are local government associations and partnerships between municipalities and private or semi-private companies. These are more common in particular service areas, such as water and sewerage, landfill waste sites, municipal transport, street cleaning, street and park maintenance, municipal lighting, and municipal housing. Some of the privatizations, for example in water and sewerage, had their origin in the process followed early in the divesting of state public enterprises (Box 2.2).

The privatization of public services has brought important changes to tariff and cost recovery policies at the local level. Tariffs for public utilities are still regulated by the central government on the basis of economically justified costs plus reasonable profit. The increased tariffs have brought about significant operational efficiencies, and have reduced "consumption" by significant levels, thereby alleviating the need for infrastructure expansion. The official policy has been to gradually increase tariffs to a level that covers all operational costs. Although at present there are no subsidies for operations purposes, in the case of water and sewerage services the central government still provides significant subsidies for infrastructure replacement and expansion.

Box 2.2 Privatized Public Utilities and Services in the Czech Republic

Services for *water and wastewater* treatment are mostly privatized in the Czech Republic. Most of this privatization took place through the transfer of ownership rights of the regional branches of former state enterprises. A government decree declared that the new owners of water and sewerage treatment plants could only be municipalities, associations of municipalities, or joint-stock companies with majority ownership by municipalities. The latter two arrangements were used for the transfer of ownership for infrastructure that was serving more than one municipality. Ownership of assets was made proportional to population or water consumption. In some cases, the transfer of ownership of infrastructure and the operational property were made into two separate entities. In these cases, the operational company leased the infrastructure or entered into an operational contract or concession. Operational companies can have foreign participation of up to 20 percent of the market value of the stock. British and French companies have participation in a number of Czech water and wastewater treatment companies.

Other privatized public utilities include *city gas and electricity*. During the privatization process, the central government provided the municipalities with a 34 percent ownership of the companies distributing gas and electricity. The rest of the gas and electric companies are owned either by private companies, domestic and foreign, or by the central government (National Property Fund). Buildings in the city centers are often linked to a local heating plant that is run by a corporation owned by the municipality.

Municipal *solid waste and dumpsites* have also usually been privatized. Some of these corporations are jointly held by foreign companies and the municipality. For example, in the city of Otrokovice, the waste dump is administered by a corporation, 60 percent of which is owned by a Danish firm.

Intracity public transportation is typically run by a municipal company, which may be jointly held by several municipalities. Such is the case in the cities of Otrokovice and Zlín. Municipalities typically provide the transport company with a yearly subsidy to cover its operating deficit. Municipalities also provide investment grants to the transport companies, often with support from the central government.

Although long-term plans are to eliminate these subsidies and replace them with loans, this strategy will be sustainable only if tariffs are sufficient for full cost recovery, including the replacement costs for infrastructure. What stands in the way of a full-cost recovery tariff structure is the perception that current charges may be on the verge of being "socially intolerable." However, this can only be true for families in poverty and not for middle- and high-income families. Therefore, a preferred policy will be to raise tariffs to full cost recovery level, including replacement costs for infrastructure, and to devise ways to target the subsidies only to poor households. Cost recovery in local transport appears to be at much lower levels. For example, the municipal transport company in Prague has a level of cost recovery of less than 30 percent.[52] This is also a politically sensitive area, but a policy of gradual price increases with the goal of significantly reducing (if not eliminating) subsidies will preempt budget-led crises in the future.

Capital Expenditure Responsibilities

The assignment of responsibility for expenditures in capital infrastructure is murky. In theory, municipal governments are responsible for capital expenditures in certain areas: for example, they are responsible for school buildings, for water and sewerage treatment plants, for local roads, and so on. In practice, the central government has continued to provide a considerable amount of funding to local governments for capital infrastructure. This help from the central government has taken different forms. For example, there is subsidized state lending to local governments (Box 2.3). In addition, a long list of capital transfers or subsidies is provided to municipalities by a number of central government agencies.[53]

Central government policy has been to concentrate state aid in the form of subsidies and interest-free loans in certain areas, such as education, water, and sewerage services, which may be justified because of public interest or the presence of externalities. The issue is whether these policies are helping to create a mentality of dependence and negative incentives for the proper maintenance of infrastructure. An example of negative incentive would be if municipalities believe that they can divert funds from maintenance to other issues in the hope that the central government will provide the funds for the reconstruction or rehabilitation of the infrastructure. The

Box 2.3 Subsidized Loans to Municipalities

Many municipalities are able to get subsidized loans (including interest-free) from the Ministry of Finance, the Ministry of Agriculture, and the State Environmental Fund (SEF). These loans, which are known as "reimbursable financial assistance," can be granted only for particular types of investments. The Ministry of Finance grants these loans for major water treatment projects, for the building of schools and hospitals, for housing construction, and for rural revitalization. The Ministry of Agriculture grants this type of loan for water treatment and distribution systems and sewerage treatment plants. Similarly, the SEF provides this type of loan for water and sewage treatment plants and distribution systems, solid waste disposal plants, and the conversion of heating systems.

Interest-free loans are a significant source of capital expenditure financing but by no means the most important. For example, in 1996, the financing of municipal expenditures in infrastructure was 25.5 percent from state capital subsidies, 17 percent from loans, 5.1 percent from zero-interest loans, and the rest from own resources.[1]

1. See Peterson and others (1997).

criteria used by central government agencies may also have an impact on these incentives. For example, the Ministry of Education uses the "emergency situation" criteria (for schools that are in a serious state of disrepair) as the top priority.

There is little information available on infrastructure maintenance practices and expenditures at the local level. Thus, it is not possible to make a judgment on the seriousness of any negative incentives stemming from the dichotomy between maintenance and capital expenditure responsibilities. What is known from international practice is that these negative incentives can be effectively neutralized by a variety of financing schemes that give ownership of the projects to local governments. One of these schemes is to always require cofinancing or matching funds for any capital transfers from the central government. Actually, the Czech government has been requiring or has plans to require matching funds for most capital subsidies to the municipalities. Maintaining and extending this policy would be important.

The use of subsidized lending (interest-free loans, discussed above) may be less transparent than capital transfers or even direct construction by the central government. However, it serves the purpose of leading municipalities to take ownership of the projects and creating a fiscal culture that involves the necessity of borrowing and repaying loans for the development of municipal infrastructure. However, the danger with this type of financing is that municipal governments may become accustomed to this soft loan practice and not recognize the actual opportunity cost of public funds. It would be desirable over the medium term to shift these activities to the actual lending institutions and provide central government incentives exclusively through matching grants.

Expenditure Coordination among Levels of Government

Expenditure assignments can never be sufficiently delineated in the law so as to eliminate the possibility of friction and misinterpretation among different levels of government. One significant feature of fiscal decentralization in the Czech Republic is the absence for the most part of mechanisms of coordination and cooperation among different levels of government. These institutions of cooperation and dialogue perform useful functions in countries such as Austria, Denmark, Estonia, Germany, and Latvia and involve regular and transparent exchanges of information and dialogue at the political and technical levels.

In the Czech Republic, some coordination has taken place between the districts and the municipalities. For the most part, this relationship has been hierarchical with municipalities dependent on or responding to the districts. The lack of coordination and cooperation among institutions may be explained by the very large number of municipalities, which makes it difficult or impossible for the central government authorities to coordinate with local governments. The natural avenue for this coordination would have been the Union of Municipalities, which has been in existence since 1991. However, an open and regular dialogue with the union has not been maintained, although this institution does comment on most of the draft laws that would have an impact on municipalities.[54] In a conference in Brno in 1999, the central government accepted the European Charter of Self-Government's recommendations on coordination among different levels of government. However, no arrangements have yet been specified.

Unfunded Mandates

Central government expenditure mandates to subnational governments are a challenge in most systems of decentralized finance. The assignment to subnational governments of expenditure responsibilities without the corresponding resources (unfunded mandates), among a host of other problems, tends to soften budget constraints. Fortunately, unlike many other countries in transition, the Czech Republic has, for several reasons, so far been able to generally avoid imposing open unfunded mandates on local governments. First, the central government has continued the wide use of specific grants for a number of activities that in other countries may be left unfunded. Second, there is a tradition of delegated functions that obligates the central government to guarantee full funding for the municipalities.[55] Third, there appears to have been an open policy by the central government for transferring adequate resources for any new mandated increase in municipal expenditures. Despite these factors, there have been cases of unfunded mandates, the most recent involving the transfer to the municipalities of responsibility for issuing personal identification cards and passports. In addition, many municipalities still argue that the past transfers of housing responsibilities to the municipalities had a strong unfunded component, that is, not enough funds were made available for this responsibility. Moreover, it should be considered that, even when "funded," subnational governments may not feel responsible if prices (of inputs and of services) are centrally determined. This policy tends to open the door for bailouts and soft budget constraints, since price controls may actually become a hidden form of unfunded mandates. On public sector pricing practices, the Czech Republic still has room for improvement in several areas, including the price of some utilities and house rents.

The best way to avoid unfunded mandates in the future would be to continue to strive for a clear and stable assignment of expenditure responsibilities. This assignment should be transparent as to which level of government has power to regulate the activity, to finance it, and to implement it. The outright prohibition of unfunded mandates should also be made part of the legal framework and the actual practice of the central government, especially parliament. Developing institutions for dialogue and coordination among different levels of government is the best means of controlling unfunded mandates.

Options for Reform in Expenditure Assignments

1. ***Establish a Broad-Based Commission to Propose the New Regions' Expenditure Responsibilities.*** Providing the new regional governments with meaningful expenditure responsibilities is the critical step needed to ensure that the recent administrative reforms contribute to a more efficient and accountable public sector. Relying completely on the goodwill and wisdom of line ministries to select what current central government functions should be decentralized to the regions may not produce optimal results, given the vested interests of these agencies. The government should consider charging a special broad-based commission with this work. This commission could also be charged with providing recommendations as to which expenditure responsibilities now assigned to municipalities could be shifted to the regions (but only in the case of small municipalities). This would require the formal acceptance of asymmetric expenditure assignments at the local level, although, de facto, the Czech Republic has had asymmetric expenditure assignments for many years.

2. ***Transfer De Facto Responsibility for Local Infrastructure Investment and Fire Protection to Local Governments.*** There are areas in the assignment of expenditure responsibilities to local governments that will require careful review, evaluation, and ultimately policy action. Realignment of the de facto and de jure capital expenditure responsibilities at the local level

is needed. The central authorities must move more decisively to make municipalities the main providers (in the planning, financing, and implementation) of capital infrastructure, as is stated now in the law. In addition, there are some expenditure responsibilities that could be efficiently reassigned, such as fire protection services, which many larger municipalities could provide by themselves.

3. ***Strengthen Privatization and the Role of the Private Sector in the Financing and Delivery of Public Services.*** One of the strengths of fiscal decentralization in the Czech Republic is the growing privatization of public service delivery. This, no doubt, has helped to build a more efficient public sector and to provide better quality and cheaper services to citizens. Numerous central government policies have contributed to this trend, as in the case of the privatization of electricity, gas, heating, and water and sewage treatment. This goal should be a top agenda of government sectoral policies, in particular in sectors such as housing, where continued reliance on public sector solutions is unwarranted. The municipal governments should give up the business of providing housing. Most, if not all, of the housing stock at the municipal level should be sold and privatized—with the possible exception of housing for the very poor. The central government needs to redirect the funds for new municipal housing to help the local governments divest themselves of this responsibility. As the Czech Republic completes its transition to a market economy, the role of the private sector should also increase in the financing and delivery of services in traditionally socialized sectors, such as education and health.

4. ***Preempt Unfunded Mandates.*** Unfunded mandates from the center to decentralized governments have not been a serious problem to date. Nevertheless, international experience from developed and developing countries indicates that as decentralization progresses there are increased pressures on the central authorities to pass on different forms of legislation that are tantamount to unfunded mandates. Now is the time to include explicit amendments in the budget process laws, including, in particular, the Law on Budget Rules. It is also the time for parliament and the central government agencies to adopt explicit protocols that make the occurrence of unfunded mandates less likely, including the formal review of all draft legislation for the existence of unfunded mandates.

5. ***Develop Institutions for Cooperation and Dialogue.*** Building a decentralized system of intergovernmental fiscal relations in the Czech Republic has been for the most part a one-way street, with the center dictating solutions. The overall performance, the quality of design, and the day-to-day operations of the intergovernmental system would be much improved by the creation of formal institutions for coordination and dialogue among different levels of government. The Czech Republic might look to the experiences of its neighbors in Germany and Austria to find good examples of how this can be done.

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3. Revenue Assignments

In the Czech Republic, tax policy (decisionmaking power over tax rates and bases) and tax administration have been national prerogatives. Local governments (districts and municipalities) cannot introduce new taxes, and have very limited revenue autonomy. Districts, as deconcentrated state territorial administrations, have been funded by state transfers, shared taxes, and some local service charges. Municipalities, as self-governing authorities, also have (besides the state transfers and shared taxes) independent property rights (which provide them with the corresponding capital or property incomes, such as interest revenues, privatization proceeds, and rents). Municipalities also have their local fees and "own" taxes (at the present time only the real estate tax, for which municipalities have some discretion in setting the tax rate).

The present revenue assignment system evolved from the 1993 tax and budget reforms, which established the foundations for a fiscal decentralization process in the Czech Republic. The goal was to reduce local dependence on the state budget (transfers) and to foster local self-reliance on regular revenue flows (fundamentally on the basis of shared taxes) and some decisionmaking power (the ability to determine the rate of the real estate tax within some pre-established margins).[56] The revenue reassignment component of the 2000 public sector reform represented only an ambivalent step in the process of fiscal decentralization, since it placed less emphasis on self-reliance and more on transfers and revenue sharing.

Local Revenue Sources

Evolution of the Revenue Assignment System

Before 1992, practically all local government expenditures were directly "subsidized" (by state grants), and practically all local government fiscal decisions were taken by central government. Act 337/92 marked the beginning of a new era by introducing several important innovations. This Act (1) assigned, for the first time, a *real estate tax* as a "local" tax, and (2) introduced the concept of stable tax-sharing arrangements, with a well-defined specific attribution of proceeds from the *personal income tax* (PIT) entirely to the municipalities. Since then, the PIT has been levied on "dependent income" (that is, the so-called "wage tax") and on the incomes of the self-employed (that is, unincorporated economic activities) at a *progressive* tax rate which varies between 15 and 40 percent.[57] Dependent income PIT proceeds are allocated on a derivation basis (based on the place of work rather than the residence of workers), and PIT on the self-employed is allocated on a residence basis (rather than where the economic activity actually takes place). These reforms represented a meaningful departure from the prevailing and ineffective stopgap intergovernmental budgetary approach inherited from the previous regime.

Despite the merits of the 1992 budgetary reforms, serious weaknesses, which affect the revenue assignment system to this day, were introduced by the reform itself. The first such weakness concerns the design of the *real estate tax,* which, although the most appropriate tax to be allocated to the local level, was left quite incomplete. Only minimal discretion of decisionmaking power was provided to the local authorities on the *tax rate* and none on the measurement of the *tax base*.[58] Actually, property values since 1993 have been assessed at a *fixed* amount per square meter and the amount has been *determined by decree*. These limitations have led to a failure to create a relevant margin of local autonomy on this so-called local tax. Consequently, the real estate tax has not attracted much interest and collections have been fairly insignificant.

The second weakness of the 1992 reforms was to assign 100 percent of the *progressive rate* PIT to local governments on a *derivation basis*. Four significant issues can be identified in this assignment:

(1) The assignment of the PIT on the self-employed (that is, the unincorporated PIT) on a residence basis has promoted a negative *tax-cutting competition* among jurisdictions, resulting from their efforts to attract the right to receive the tax.[59] From an economic perspective, competition tends to increase efficiency and these gains are also possible in a system of decentralized government. In this case the goal became simply to move the declared residence of the self-employed. This represents an inefficient fiscal policy, since its incentives do not necessarily increase production and employment in the aggregate, and they certainly reduce public revenue.

(2) The allocation of the wage PIT on a derivation or place-of-work basis instead of on a residence basis *tends to be inefficient and unfair,* given that workers and people in general consume more services in the place where they live than in the place where they work.

(3) A *progressive* income tax rate embodies the purpose of national income redistribution, and as such it should be assigned at the central level.[60] If allocated to lower level governments, the progressive PIT becomes a powerful source of regional revenue disparity, instead of serving its original purpose of promoting equity. On the other hand, a *proportional* or flat rate PIT at the local level would better approximate the notion of a price for services—an important criterion for an efficient assignment of revenue sources at the local level.

(4) The PIT is a potentially important and buoyant source of revenue (that is, it tends to be an income-elastic tax), which has the potential for creating major *vertical fiscal imbalances* when revenue sources assigned to the central government are less income elastic (Table 3.1). (See Chapter 4 on vertical imbalance issues.)

The Current System of Revenue Assignments

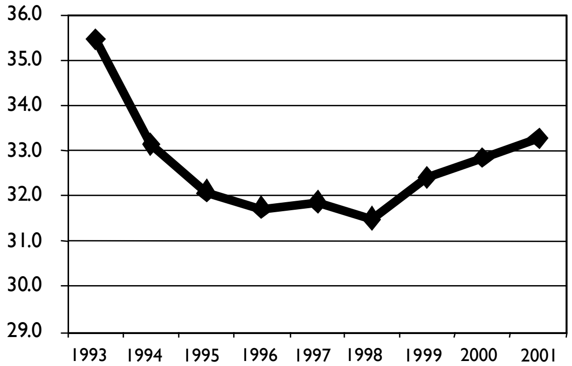
In fact, the dynamics of the tax-sharing system during the 1990s showed it to be unstable, because of the increasing vertical fiscal imbalance that it brought about. The buoyancy of the PIT, assigned to municipalities contrasted sharply with the lackluster performance of taxes assigned to the state, especially the corporate income tax (CIT) which showed a dramatic decline in terms of GDP share (Figures 3.1 and 3.2) (see also Chapter 4 on this issue). These trends led the government to adjust the system in 1996 (Act No. 154/96). First, the "wage tax" component of

Table 3.1 Czech Republic: Tax Buoyancy
$Tx = a \cdot (GDP)^b$

	1993–2000			1994–2000		
Tax	*b*	*t Statistics*	R^2	*b*	*t Statistics*	R^2
PIT	1.71	9.00	0.93	1.24	20.09	0.99
CIT	–0.02	–0.15	0.01	0.15	0.72	0.10
VAT	0.98	8.30	0.92	1.12	6.77	0.90
Excise	0.96	22.50	0.99	0.95	14.15	0.98

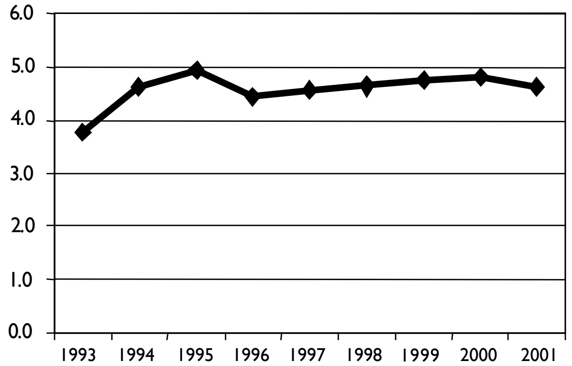
Note: Tx is nominal tax, GDP is nominal gross domestic product, a is the intercept of regression, and b is the tax buoyancy.
Source: Ministry of Finance, 1993–2000; Table 1, Statistical Appendix.

Figure 3.1 Czech Republic: State Tax Revenue (Percent GDP)



Source: Ministry of Finance.

Figure 3.2 Czech Republic: Local Government Tax Revenue (Percent GDP)



Source: Ministry of Finance.

the PIT was reassigned, with 70 percent attribution back to the state and 30 percent to municipalities. Second, to compensate for this revenue withdrawal, 20 percent of the CIT, the so-called "profit tax," was shared with municipalities. Such an adjustment in the tax-sharing system—mixing taxes with distinct income elasticity—was presented as a necessary move in order to stabilize the intergovernmental fiscal balance. In fact, it had essentially a once-and-for-all impact on the revenue trends, since the CIT decline continued affecting *mainly* state revenue. These trends eventually led to the reforms of 2000.

Table 3.2 summarizes the statutory tax assignment before and after the 2000 reforms. Before the 2000 reforms, the tax assignment configuration was as follows.

Central Government Taxes. One hundred percent of the collection of VAT, excise taxes, customs duties, taxes on property transfers, road tax, and social security contributions have been assigned to the state budget. Among these taxes, VAT has been the most dynamic tax source, particularly since 1998. Excise tax collection has been stagnant as a percentage of GDP, while customs duty collection steadily declined during the 1990s (Figure 3.3, and Statistical Appendix, Table 1). Social insurance contributions increased, particularly before 1997.[61]

Shared Taxes. PIT, CIT, and environmental levies were the only taxes shared between central and local governments prior to the 2000 reforms. A 40 percent share of PIT went to the state, and 60 percent to local governments (district offices and municipalities), mainly distributed on a derivation basis.[62] The sharing rates for the CIT since the 1996 reform have been 80 percent to the state and 20 percent to municipalities, with the municipal share being distributed nationally according to population size. The environmental levies (on withdrawal of land from forestry and from agriculture, waste deposits, and air pollution) are shared between the State Environmental Fund and the municipality, 60 percent and 40 percent respectively, also on a derivation basis. Shared taxes, although quite unstable, have represented the most important and increasing source of local government revenues (up to 47 percent in 2000, from 31 percent in 1993).

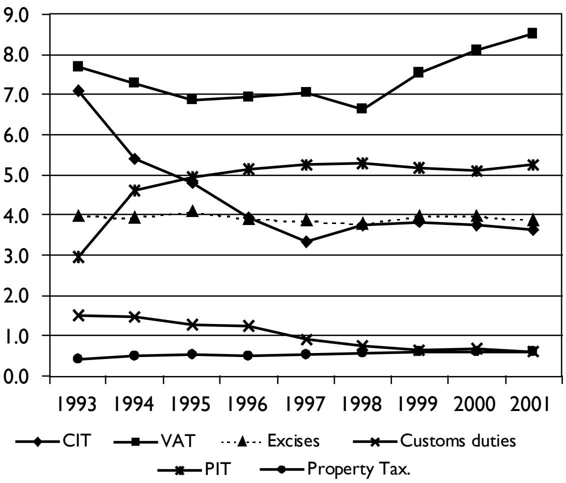
Table 3.2 Czech Republic: Tax Sharing System

				Tax sharing (until 2000) (Percent)			***New tax-sharing***	
Tax[1]	***Type and rate***	***Levied on***	***Exemptions***	***Central***	***District***	***Munici-palities***	***Central***	***Munici-Palities***
PIT	Progressive 15 to 40%	Individual Wages	Some capital income	70-30; 40 [a]	30 [a]	30 [a]	20.59% of the pool of PIT*, CIT, and VAT effectively collected is distributed to municipalities on an "adjusted" per capita basis.	
		Self-employment incomes		—	—	100 [b]		
CIT[3]	Flat 35%	Profits,Legal entities	Charitable & non-profit	80	—	20 [c]		
VAT	On the value added basic rate 22%	Sales	5% on food pharmaceuticals, books & newspaper	100	—	—		
Excise Tax	15% HST (wholesale)	Petroleum products, tobacco, beverages	Heating gas oil	100	—	—	100	—
Property Tax[d] (Real Estate Tax)	Area, quality, use. 0.3% to 4.5% of decree value	Land, buildings, structures	Extensive list of exemptions	—	—	100	—	100
Property transfera (gifts and inheritance)	Real estate 5% Inheritance, gifts 1 to 12%	Real estate, inheritance and gifts	State organ. and privatization	100	—	—	100	—
Road tax	Annual, thousands fo. CZK 1.2-50.4	Vehicles	Public transportation. and low emissions	100	—	—	80**	—
Customs import duty	15% HST	Imported goods	Exports	100	—	—	100	—
Fees, levies, fines, serv. rents [2]	Miscellaneous	Utilities, housing	Charitable, disabled, children, seniors	—	—	100	—	100
Social security contributions	Health. 13.5%[4] Social Insurance. 34%[4]	Wage bill Self-employment income		100	—	—	100	—

Notes:
— Not available.
* Except 30% of PIT on self-employment income, which is collected in advance on a derivation basis (that is, it remains in the payer's domicile).
** Effective January 1, 2001, 20% of Road Tax is earmarked to the new *extra-budgetary* State Transport Infrastructure Fund (STIF).
a. On "dependent income," that is, the so-called wage tax. See text on distribution.
b. On self-employment income (unincorporated economic activities). Distributed according to the residence of taxpayer.
c. On corporate economic activities, shared with municipalities since the 1996 tax-sharing reform on a population size basis.
d. Introduced by the 1993 tax reform as "real estate tax" (on land and buildings).
1. In principle, all taxes are state taxes, regulated by the parliament and administered by central government bodies (under the Ministry of Finance).
2. District state offices and municipalities administer some levies (including environmental protection), fees, and fines. See text for sharing rates.
3. Flat rate of 35% applies, but pension fund investment profits are taxed 25%. CIT includes "tax withholding on interest and dividends". Municipalities retain all CIT paid by their "own commercial activities."
4. Employees and employers contributions are about one-fourth and three-fourths, respectively.

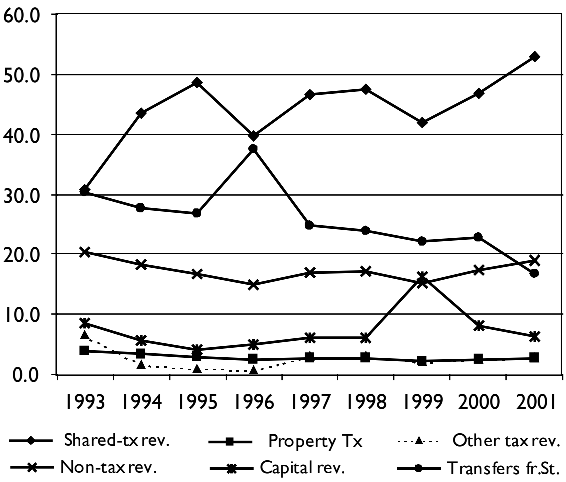
Source: Ministry of Finance (Ref.no.111/1700/2000); *Czech Taxation in 1999;* new legislation 2000.

Figure 3.3 Czech Republic: Evolution of Tax Revenues (Percent GDP)



Source: Ministry of Finance.

Figure 3.4 Czech Republic: Local Government—Revenue Composition



Source: Ministry of Finance.

Figure 3.4 shows the trends in the composition of local government revenues during the 1990s. An outstanding feature is that while the relative importance of shared taxes increased, state transfers to local governments decreased correspondingly (to 23 percent in 2000, from more than 30 percent in 1993), so that the joint contribution of shared taxes and state transfers remained at about 70 percent of local government revenue during the 1990s. One possible interpretation of these trends is that the central government has made ad hoc adjustments to local budget transfers, so that they are always equal to 70 percent of a given local budget. Another possible interpretation is that, because of decreasing state transfers, the local governments had to make significant efforts to attract economic activities and raise taxes. In any case, what is important is that during the 1990s a decentralization process took place, in the sense that municipalities started to become less dependent on state budget transfers and began to rely increasingly on shared tax revenues. Although this development represented a first important stage in the decentralization process, a meaningful degree of tax autonomy for local authorities was still missing.

Local Taxes. Local taxes include the real estate tax (or property tax), local fees, fines, service charges, and levies. Municipalities can set real estate tax rates within a bandwidth (0.3 percent to 4.5 percent), but the band itself and the value of the tax base are determined by the central government. In addition, the central government establishes provisions for a long list of exemptions. Municipalities do not have the discretion to give exemptions on the real estate tax. The most significant feature of the current property tax is that it is still assessed by the old system of fixing land value per square meter by "decree," without regular adjustments being made for either market price shifts or general inflation. As a result, the property tax has been ineffective, playing a minor role as a local government revenue source. In fact, its collection performance has shown a steady decline as a proportion of local total revenue.[63]

Regarding other local sources of revenues, municipalities are free—within the limits determined by the central government—to set rates, define tax bases, and give exemptions for permits to sell tobacco and alcoholic drinks and to operate gambling machines. Municipalities also charge for municipal motor vehicle permits, advertising permits, hotel bed fees, recreation facility user fees, dog licenses, entrance tickets, fees for the use of public areas, fees on small air pollutants, and other licenses and permit fees. In addition, municipalities collect rents on housing and charge tariffs on water and other utilities owned by them. However, the prices (rents and tariffs) are still regulated by the central government. This has had a significant impact on local budgets, especially in the case of rents on housing.

Patterns of Local Government Revenues

Since 1993, local government revenues have represented about 9 percent of GDP on average (corresponding to about 22 percent of the general government revenue) without showing significant variation or any clear trend.[64] About half of local government revenues have been from shared taxes, particularly PIT and CIT. During the 1993-96 period, the PIT averaged 40 percent of total local revenues and the CIT 3 percent; these shares shifted to 33 and 10 percent, respectively, during the 1997-2000 period (Table 3.3). "Own" local taxes (including the real estate tax, local and administrative fees, and "other taxes") have contributed a smaller and declining share of total local revenues—8 percent on average during 1993-96 and only 5 percent on average during 1997–2000.[65]

With a slight declining trend, non-tax revenues contributed around 15 percent to the total revenue of local governments during the entire 1993-2000 period. If "local revenues" are defined as the sum of non-tax revenues (contributions from budgetary and non-budgetary organizations, rent on properties, interest received, and so forth) and own tax collections (excluding shared taxes), this figure adds up to no more than 2.2 percent of GDP during the period 1993-96 and falls to 1.7 percent during the period 1997-2000. The latter figure compares very unfavorably with other European countries' non-tax revenues, such as Denmark and Sweden (17 percent), Norway (12 percent), Spain (5.9 percent), France (4.4), and Hungary (3.8 percent).[66]

Capital revenues (property sales and returns from capital investments) have increased in relative importance since 1993. Mostly as the result of privatization policy, capital revenues more than doubled their relative importance as a source of local revenues from the first half to the second half of the 1990s. State transfers and transfers from state funds still represent about one-fourth of local government revenues, although their relative importance declined slightly during the decade.

Table 3.3 Czech Republic: Local Governments Revenue, 1993–2000

	(In percent of GDP)						*(In percent of total revenue)*					
	Average 1993–1996 Execution			*Averaged 1997–2000 Execution*			*Average 1993–1996 Execution*			*Averaged 1997–2000 Execution*		
Budget line	*Total*	*Municipal*	*Distr. Off.*	*Total*	*Municipal*	*Distr. Off.*	*Total*	*Municipal*	*Distr. Off.*	*Total*	*Municipal*	*Distr. Off.*
Total revenue	9.1	7.6	1.5	8.9	7.5	1.4	100	100	100	100	100	100
1. Current revenues	6.1	5.1	1.0	5.6	4.9	0.7	67	67	64	63	66	46
Tax revenue	4.6	3.8	0.8	4.3	3.8	0.6	51	50	56	48	50	39
Corporate prof.tax	0.3	0.3		0.9	0.9	0.0	3	4	0	10	12	0
Personal inc.tax	3.6	2.8	0.8	3.0	2.4	0.6	40	37	55	33	32	39
Property tax	0.3	0.3		0.2	0.2		3	4	0	2	3	
Administration fees	0.1	0.1	0.0	0.1	0.1	0.0	2	2	1	1	1	0
Local fees	0.1	0.1		0.1	0.1	0.0	1	1	0	2	2	0
Other tax revenues	0.1	0.1	0.0	0.0	0.0		2	2	0	0	0	
Non–tax revenues	1.5	1.3	0.1	1.3	1.2	0.1	16	18	8	14	16	7
2. Capital revenues	0.5	0.4	0.0	1.1	1.0	0.0	5	6	0	12	14	1
3. State bdgt. transfers	2.4	1.6	0.7	2.2	1.5	0.8	26	21	49	25	19	53
4. State funds & other trsfs.	0.1	0.1	0.0	0.1	0.1	0.0	2	2	0	1	1	0
5. Donations	0.1	0.1	0.0				1	1	1			
6. Others	0.0	0.2	–0.2				0	2	–14			

Source: Ministry of Finance.

District offices have not had access to the CIT and the property tax. Since 1997, district offices have obtained about 19 percent of the shared PIT, and their collection of service fees has been insignificant. Corresponding to their local share of responsibilities, municipalities have obtained around 87 percent of total local government revenues, and have been the recipients of about two-thirds of total transfers from the state budget and state funds to local governments (including transfers received from the district offices).

The pattern of local revenues during the 1990s, when summarized, shows two main features: (1) slightly declining transfers from the center being replaced by shared-tax and capital revenues, which may have brought some sense of autonomy to municipalities; and (2) a low level and declining trend of "own revenues" (tax and non-tax), which are contrary to the desired attribution of accountability to local authorities. These trends, however, do not tend to be sustainable (because privatization proceeds are temporary). In addition, they do not provide local authorities with the right incentives to increase efficiency and accountability (because of the lack of decisionmaking power over shared taxes and the insignificance of "own" sources of revenue, particularly the property tax).

The 2000 Reform in Revenue Assignment

The 2000 public sector reforms, effective from January 1, 2001, essentially transformed the tax-sharing mechanism between the central government and local governments. In addition, the reform earmarked 20 percent of the road tax proceeds to a new extrabudgetary fund, the State Transport Infrastructure Fund.[67] The elimination of district offices from the state territorial administrative structure has meant that for the first time the tax-sharing system will involve only central government and municipalities. The revenue assignment for the 14 new regions has not yet been determined, and it will be on hold for an interim period until December 2002 while the assignment of expenditure responsibilities is under consideration.

The government's 2000 reform of the tax-sharing system represents a major effort to address some of the most serious problems affecting intergovernmental fiscal relations. The new system moves away from the personal income tax on a derivation basis, toward a more egalitarian and sustainable revenue-sharing mechanism. The system pools a share of the total collection of the three main taxes (PIT, CIT, and VAT), and distributes the pool to municipalities on an adjusted per capita basis (Table 1.2).[68] To avoid major disruptions in local government financing, the intention was to keep the initial size of the new tax-sharing pool basically the same as the current one, but with the basis of the system and the allocation mechanism changed. Therefore, a share of 20.59 percent of the aggregate collection of the three main taxes was determined to be equivalent to the total of municipalities' tax-sharing revenues in 1999 (under the old system for revenue sharing).

During the interim period (January 2001 through December 2002), the new regions will be fully funded from the state budget through transfers. This precautionary phased-in approach is quite adequate for the particular circumstances, since the size of the required resources is still to be determined and the necessary administrative capacity still needs to be built in the regions. However, it would be desirable to shorten the interim period, if possible, in order to avoid creating a mentality of dependence and to increase the efficiency of regional budgets from the beginning. To this end, congruent and predictable sources of revenue (suitable tax-sharing arrangements and own revenue sources), with an appropriate margin of autonomy, should be clearly and quickly assigned to the regions.

The Objectives of the Reform

The new mechanism of tax-sharing with municipalities was designed to basically address four major problems related to the previous revenue assignment system: (1) the perceived growing *vertical fiscal imbalances* between the center and the local governments, rendering the system macroeconomically unstable and fiscally unsustainable in the medium term; (2) the widening *horizontal disparities* in terms of revenue capacity among distinct localities, which raise serious questions on the equitability of the system; (3) *tax-cutting competition* among municipalities, which entails a reduction in the effective tax base and a misallocation of public resources; and (4) the *persistent fragmentation* of municipalities, which is an obstacle to the implementation of the current fiscal policies, to economic integration in the EU, and to more effective decentralization.

(1) *Perceived vertical fiscal imbalances* between expenditure responsibilities and the resources of central and local governments have developed mostly as a result of the income-elasticity differentials of the respective assigned revenue sources.[69] As observed above, the PIT assigned to local governments has been a relatively dynamic source of revenue compared with the central government's sources of revenue (VAT, CIT, excise tax, and import tax). By pooling VAT, CIT, and PIT, the new tax-sharing mechanism aims to average and homogenize the income elasticity of both local and central government revenues and thereby to freeze the vertical fiscal balance and bring more stability to the system.

(2) *Horizontal fiscal disparities* have emerged from differences in economic bases and also from the incidence of industrial depression, unemployment, and poverty that has stricken several areas of the country. In the absence of any explicit equalization transfer mechanism (see Chapter 4), the present revenue assignment of personal income taxes on a derivation basis has accentuated the fiscal disparities among local governments.[70] The new system aims to factor in equity considerations by redistributing the tax-sharing pool among municipalities, on the basis of national per capita average by population size. Moreover, the system will adjust it by a coefficient structure that was intended, among other things, to take into account the level of unemployment so as to favor structurally depressed areas.

(3) *Tax-cutting competition* among local governments to attract businesses has not been a good fiscal incentive, since it tends to lead to a reduction of the aggregate effective tax base and tax collection. Because the PIT on individual businesses is allocated on the basis of the declared residence of the entrepreneur, the current system may misallocate tax revenue in favor of jurisdictions other than those in which the economic activity takes place and in which the critical public service demand exists. The reform objective was apparently to reduce the effects of tax-cutting competition by adopting a more diversified tax-sharing pool, allocated on a national per capita basis by population size instead of on a derivation basis. However, the basic problem remains with the 30 percent of unincorporated PIT, which remains with the municipalities in which the taxpayers reside. This was intended as a marginal incentive to encourage tax effort and local economic development. However, this policy still retains a strong and perverse tax-cutting competition incentive, because municipalities will continue to compete simply to attract people to move their residences, thus shifting resources away from where the economic activity is taking place.

(4) *Administrative fragmentation* is a result of the increase in the number of municipalities over the last decade (to more than 6,200 municipalities in 2000, from about 4,000 ten years ago) (Table 1.1). This increased fragmentation is in part a response to legitimate demands for self-governance, but it is also a response to perverse incentives ingrained in the system. The

system had a built-in bias toward local self-governing status, because municipalities became eligible for administrative independence (entailing new local authorities, new local public employment, and so forth) and for access to state budget grants, regardless of the existence of administrative capacity or the minimum required scale for effectively producing and delivering public and technical services. By the adoption of an adjustment coefficient structure, the new revenue-sharing system aimed to create incentives for voluntary amalgamation of the very small municipalities.

The Implications of the Reform

The Czech government sought to resolve the four issues identified above with a *single* policy instrument, the new tax-sharing mechanism. The new mechanism aimed at achieving the following:

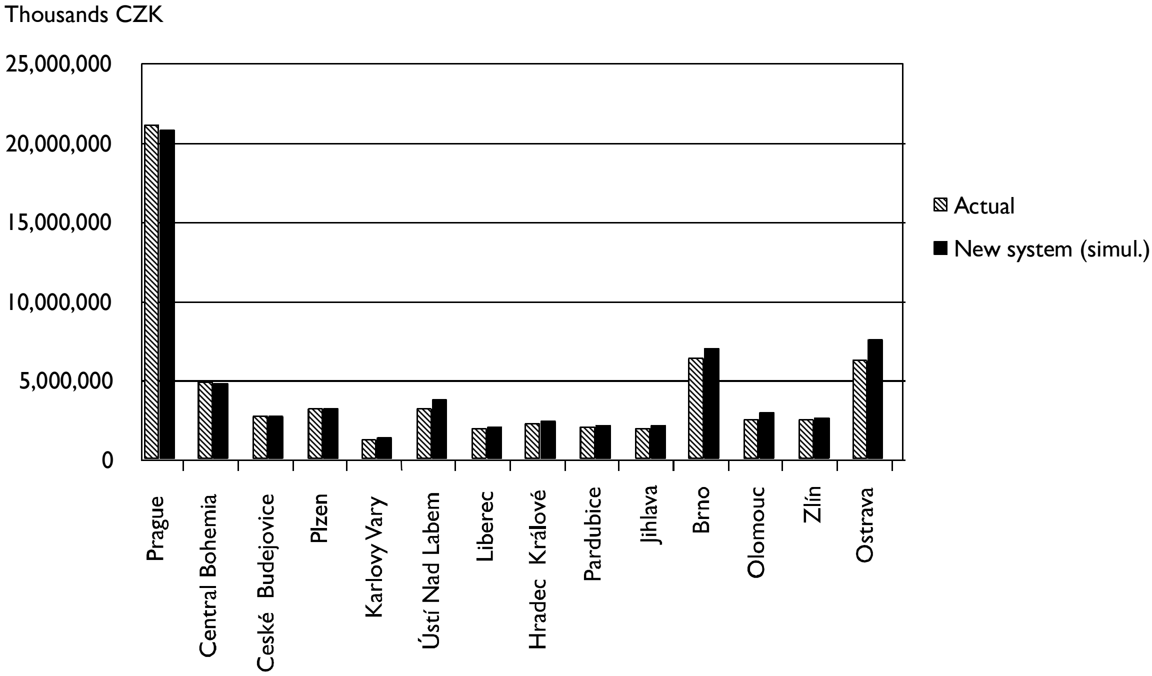
(1) a more broad-based pool of shared taxes, so as to bring more vertical balance to the system;
(2) a distribution of the tax-sharing pool to municipalities according to population size, in order to reduce revenue capacity disparities within the fiscal system;
(3) an environment less conducive to tax-cutting competition; and
(4) a per capita adjustment coefficient to population size, in order to promote voluntary amalgamation of small-size communities, but also apparently taking into account the specific problems of structurally distressed areas and the costs of service delivery.

There is, however, no assurance that the reform in the revenue sharing system will be able to attain all four objectives. Rather it appears that some objectives have a better chance of success than others. Nevertheless, through the pooling of a larger number of important taxes as a base for tax-sharing, more balance will eventually be brought to the assigned revenues of state and local government, since the buoyancy of taxes specific to each government layer will tend to even out.[71]

The per capita distribution of the new pool of taxes addresses the issue of horizontal equity, with population size of municipalities being used probably as a proxy for expenditure needs. The per capita distribution also tends to reduce tax-cutting competition (except for the remaining 30 percent of self-employed PIT that continues on a residence-of-payer basis). However, the new tax-sharing mechanism alone cannot effectively address either the issue of differences in expenditure needs based on the demographic and socioeconomic characteristics of local jurisdictions, or the issues of fiscal capacity and autonomy. Therefore, the government may need to put in place some compensatory fiscal equalization mechanism (see Chapter 4) and promote incentives to encourage local tax efforts and economic development.[72]

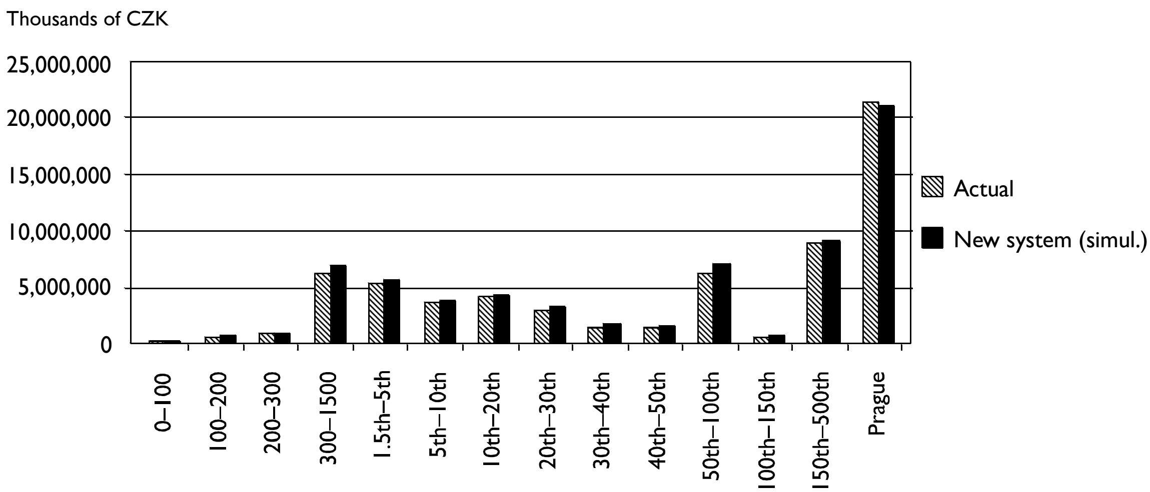
The government's intention to use a coefficient structure to adjust the per capita distribution of shared taxes, aiming at considering cost and incentive elements, is commendable, but the rationale behind the adopted adjustment coefficient structure (Table 1.2) is not yet explicit. For example, it is not clear to what extent the disparities in expenditure needs arising from differences in the cost of provision are being adequately captured by the adjustment coefficients.[73] Certainly, there was a political motive behind the adopted adjustment coefficients—namely, improving the financial flows of the majority of municipalities to create the necessary political support for the approval of the reform (Figure 3.5). However, without an explicit economic rationale, the adjustment coefficient finally adopted merely imitated the structure of the existing revenue-sharing system, with some variations in a few brackets at both ends of the size distribution of municipalities (Figure 3.6). Although there were winners and losers in the 2000 tax-sharing reform (Box 3.1), the overall distribution of resources among municipalities did not change significantly

Figure 3.5 Czech Republic: Tax-Sharing Pool Distribution by Region



Source: Ministry of Finance.

Figure 3.6 Czech Republic: Tax-Sharing Pool Distribution by Size of Municipalities



Source: Ministry of Finance.

(Figure 3.6). The most important changes lie in the implications of the reform over time. Local resources are now likely to grow at a slower rate, and there will be a delinking of local revenues and local economic development (and government performance), since, with the new system, municipalities will receive their share of resources largely independent of any tax effort.

The Unfinished Reform Agenda

The 2000 reform of revenue assignments still leaves important unresolved issues in the Czech Republic's system of intergovernmental fiscal relations. These issues include the following. (1) There is a risk that fundamental changes will be conducted at the discretion of the Ministry of Finance simply through ordinary annual budget laws, which may affect the credibility and effectiveness of the new system.[74] (2) Effective incentive mechanisms to encourage revenue mobilization and tax effort are absent, which may perpetuate the dependence of local authorities on tax-sharing revenues and transfers from the center. (3) The insignificant degree of autonomy provided to local authorities over their own revenue sources will not make them fully accountable before the local population. (4) The full dependence of the new regional administration on the state budget could create a mentality of dependence and jeopardize budgetary efficiency. (5) There are insufficient economic incentives for the voluntary amalgamation of small municipalities, which would help resolve the current excessive fragmentation. (6) There is no economic rationale for the adopted adjustment coefficient for the tax-sharing pool distribution, which may jeopardize the sustainability of the new system. Possible means of addressing main issues and options related to each of these remaining weaknesses are presented in the following paragraphs.

1. ***Establish the Structural Policy Parameters in the Organic Laws.*** The 2000 reform left to the discretion of the Ministry of Finance the right to propose, through annual budget laws, modifications in the 20.59 percent coefficient of the collected taxes that will form the tax-sharing pool, and in the structure of the per capita adjustment coefficient itself. This gives the central government discretionary powers, for example, to claw back (in the aggregate) even the increased revenues that result from local governments' tax efforts from their own sources. Such provisions create serious instability and uncertainty for the administration of local budgets and represent a step backward in the process of designing a sustainable system of intergovernmental fiscal relations. Local authorities need a minimum level of predictability and stability if they are to conduct effective local budget management. Thus, to preserve a reasonable level of revenue predictability for local governments, many countries have instead operated with fixed rules of revenue assignment (including the coefficients of tax-sharing pooling and distribution, the bandwidth of local tax rates, and the local tax base and exceptions) in their *organic* laws (for example, the Budget Rules Law), which are subject to less frequent changes.[75] These organic laws tend to be changed only after extensive debate based on technical studies that can clearly justify the need for modifications.[76] In order to bring predictability and sustainability to the new system of revenue assignment, the Czech government might consider revisiting this aspect of the 2000 reform package.

2. ***Restore Tax-Effort Incentives and Fairness in Tax Assignment.*** With the exception of 30 percent of unincorporated PIT, the 2000 reform converted all shared tax distribution into a population size basis, which is commendable from the equity standpoint. The downside of eliminating the derivation basis as an allocation criterion, however, was that the tax-sharing system lost most of its tax-effort incentive. What was left in place was the most inefficient aspect of the previous tax-sharing system—namely, the unincorporated PIT allocated according to the place of residence of the taxpayer. The continued use of this criterion still threatens to cause destructive tax-cutting competition, whereby municipalities offer

incentives to attract residents who are developing economic activities in other jurisdictions. To circumvent this lack of tax-effort incentive and the unfairness of the allocation criterion of the unincorporated PIT, the government could consider a two-step strategy. First, the *totality of the unincorporated PIT could be brought into the shared-tax pool* and submitted to the common rule of allocation based on population size distribution. Second, the *"wage-tax" component of the PIT could be split into two taxes*: (1) a *progressive* PIT similar to the existing one but with an overall lower structure for the progressive rates and which would equally enter the tax-sharing pool; and (2) a *proportional* (or flat) rate PIT which would be assigned to local governments, with some discretion for setting the flat rate (between legislated minimum and maximum rates), and piggybacking on the national progressive PIT.[77] The first step would resolve the issue of the present unfair distribution of the unincorporated PIT, while the second step would represent a significant means of local revenue mobilization, would contribute to local tax autonomy, and would help make local authorities more accountable to their constituencies.[78]

3. ***Strengthen Local Revenue Autonomy.*** One of the most important elements of the unfinished agenda on revenue assignments at the local level is the small degree of revenue autonomy provided to municipalities. A significant degree of revenue autonomy and some tax effort incentives are critical to encouraging the accountability and increasing the efficiency of local government operations.[79] Such autonomy and incentives are also the most effective means of addressing the vertical imbalance issues that inevitably arise with dynamic changes in revenue bases and demand for public services. Actually, the new system has neither provided municipalities with additional meaningful sources of revenues nor introduced the necessary reforms of the real estate tax (or a broader concept of the property tax). Municipalities need the ability to use market assessments of urban properties, while keeping, at the same time, their ability to decide on the tax rate within a legislated bandwidth. Market-assessed values can make this tax a meaningful source of local revenues. Reforming the property tax would not only improve the level of autonomy and local accountability but would also contribute to revenue mobilization at the subnational level and would improve equity in the current distribution of tax burdens.[80, 81]

4. ***Assign Shared Taxes and Autonomous Revenue Sources to the New Regions.*** As observed above, the 2000 reform took a wise precautionary step by providing a two-year interim period to phase in the implementation of the new regional administrations by first attributing the regions' expenditure responsibilities and only then defining the regions' sources of revenue. During the interim period, the regions' expenditure programs will be fully maintained by the state budget. It would be desirable, however, to shorten the interim period in order to avoid creating a mentality of dependence and to start with efficient regional budgets from the beginning. To this end, a congruent and predictable mix of sources of revenues, with an appropriate margin of autonomy, should be clearly and quickly assigned to the regions. To avoid vertical imbalances, the revenues to be assigned to the new regions should be congruent with and commensurate to the level of responsibilities attributed to them. Like the municipalities, the regions could have access to the tax-sharing pool and should also have some degree of autonomy on their own tax base. Several options exist. The rural property tax could possibly be assigned to the regions. In addition, the regions could be allowed to impose a surcharge piggybacking on some of the national tax rates.[82] A clear and quick decision on

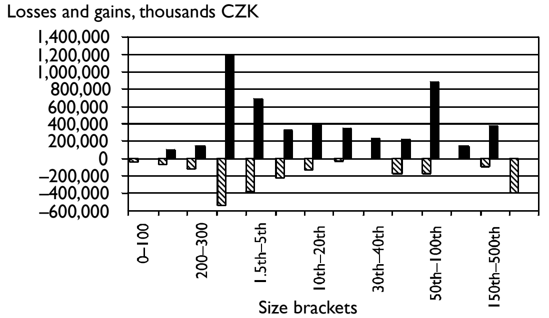
these options would create a sense of budgetary independence, prevent vertical imbalances, and build up responsibility by making the newly elected authorities accountable for their respective decisions at the regional level.[83]

5. ***Strengthen Economic Incentives for Voluntary Amalgamation.*** The new tax-sharing system intended to provide incentives for administrative consolidation for the very small municipalities, where economies of scale are most needed. It is not certain, however, that the incentives provided by the approved structure of the per capita adjusted coefficients are sufficient to stop, much less to reverse, the fragmentation process. Furthermore, these incentives are not yet clearly structured. As the incentive structure presently stands, the adjustment coefficient provides the larger municipalities (of 100,000 inhabitants and even larger) with similar incentives to merge. Incentives to merge, however, should cease when economies of scale tend to be internalized for most public services. This is an area that deserves more focused attention and stronger incentives if concrete results are to be obtained. For this, the government could consider using the new structure of territorial administration, with the creation of the new regions, and also the EU pre-accession funds, as leverages to promote stronger administrative consolidation. For example, many revenue and tax functions of municipalities below a certain size should be attributed to the regional governments or to larger municipalities (see also Chapter 2, for issues on expenditure assignment). The government could also use the incentive of matching funds to the EU pre-accession funds to promote amalgamation (see Chapter 4). Adopting an approach of asymmetric revenue assignments, responsibilities, and financial support might be the best way of increasing overall administrative and technical efficiency in the current context of such a high level of municipal fragmentation.

6. ***Establish an Economic Rationale for the Adjustment Coefficient.*** It is not yet clear whether the reform was intended to introduce a fiscal equalization mechanism embodied in the distribution of the new tax-sharing system. The new system has some elements that resemble a fiscal equalization approach, but they are not explicit (see Box 3.1). Although a loose "per capita adjustment coefficient" has been adopted, no serious, transparent consideration was given either to the *revenue capacity* or to the *expenditure needs* of the regions and municipalities. The new tax-sharing pool distribution mechanism still calls for a clear economic rationale. This is a critical pending issue of current intergovernmental fiscal relations in the Czech Republic, which could evolve toward consideration of a more transparent, formula-based equalization transfer scheme. Chapter 4 addresses this issue and the options.

Box 3.1 Winners and Losers in the 2000 Tax-Sharing Reform

Figure 3.7 Czech Republic: Municipalities Tax-Sharing Loss and Gain, by Size

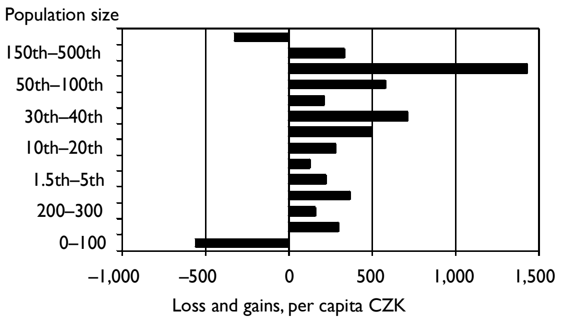


Source: Ministry of Finance.

Simulations developed by the Ministry of Finance show that, in most of the size distribution spectrum, municipalities will end up having net gains from the change in the tax-sharing system (Figure 3.7). This was probably an important element in political negotiations to gain parliamentary approval for reform. The only two exceptions are the city of Prague, which loses only 1.8 percent of its total receipts from the tax-sharing pool, and the very small municipalities (the ones in the 0–100 inhabitants bracket) which are penalized with a 17 percent loss in the total share of revenues. The latter was apparently intended as an incentive to help reverse the fragmentation of municipalities; this is also apparent because municipalities of average size (particularly for those between 300 and 10,000 inhabitants) will still benefit from the reform.

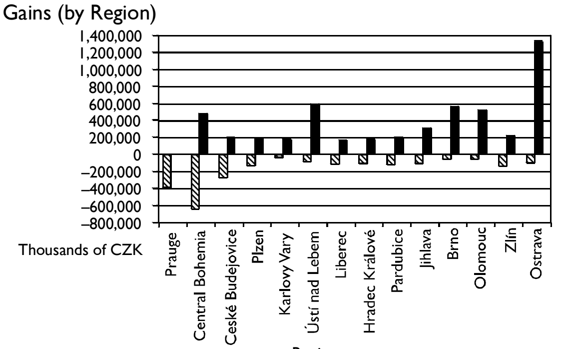
In per capita terms, although the winners and losers in terms of *population size distribution* are basically the same, the profile of the new tax-sharing distribution tends to lean more in favor of "larger" municipalities (especially those above 20,000 inhabitants), confirming the remarks in the previous paragraph, but probably revealing the influence of *regional* factors not properly rationalized by the adjustment coefficient (Figure 3.8). Certainly every new region (NUTS III) will have some municipalities that will gain and some that will lose with the new tax-sharing arrangement. Besides the city of Prague, the net losers are Central Bohemia and Ceske Budejovice regions, while the larger net winners are situated in the area of Northern Moravia (mainly Ostrava and Olomouc regions) and Northern Bohemia (Usti Nad Labem and Karlovy Vary regions) (Figures 3.9 and 3.10). These shifts *may* reflect political decisions that took into account regional income disparities and unemployment considerations of the structurally distressed industrial large areas, including Ostrava-mesto and Usti nad Labem. This *could* indicate some equalization concerns behind the present arrangement, but they are neither explicit nor rationalized by the adopted adjustment coefficient.

Figure 3.8 Czech Republic: Municipalities Per Capita Tax-Sharing Loss and Gains



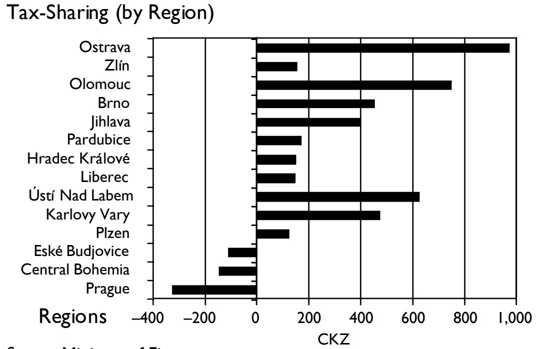
Source: Ministry of Finance.

Figure 3.9 Czech Republic: Municipal Tax-Sharing, Loss and Gains (by Region)



Source: Ministry of Finance.

Figure 3.10 Czech Republic: Per Capita Changes in Tax-Sharing (by Region)



Source: Ministry of Finance.

Source: Authors' data.

4. Fiscal Imbalances and the System of Transfers

The Current System of Transfers

Two dominant characteristics of fiscal decentralization stand out in the Czech Republic compared to most other countries, including countries in transition. One of these characteristics is that there is no clearly defined system of equalization grants at the municipal or the district level, and the 2000 reforms have not put in place an explicit mechanism for such equalization grants. Nevertheless, as discussed in the previous chapter, the new tax-sharing system with the municipalities (based on an adjusted per capita basis coefficient) has some built-in equalizing features. As regards the new regions, although at present there are also no government plans to introduce an explicit system of equalizing transfers at that level, the poorest regions in the Czech Republic will tend to benefit from EU structural funds in the near future.

The other dominant characteristic of the current system of transfers is the existence of a complex system of subsidies (or conditional grants), which are used by the central government to pursue a variety of policy objectives at the local level. Common features of these grants is that they are earmarked for specific purposes, and, in most cases, local governments have to provide separate accounts reporting on how these grants have been used.

The relative importance of earmarked subsidies has continued to decline during the transition. Despite their complexity, earmarked subsidies accounted for only 24 percent of all local (district and municipality) revenues in 1999. For municipalities alone, earmarked subsidies accounted for about 19 percent of municipal total revenues, whereas in 1993 earmarked subsidies represented 31 percent of local government total revenues and 28 percent of municipal total revenues. Most of this decline has been at the municipal level, since earmarked subsidies have been a fairly stable source of district financing. On average, subsidies have represented about half of the districts' total resources throughout the transition period (Table 1, Statistical Appendix).

Central government earmarked subsidies to local governments are for both current and capital expenditure activities, with the subsidies for current expenditures being dominant. Although they have been losing importance compared to capital subsidies, subsidies for current expenditures still represent two-thirds of the total transfers budgeted for 2001.

Two main types of earmarked grants exist for the current expenditure activities of local governments. The first type is for financing the central government's legally delegated responsibilities to municipalities. These legally mandated grants are categorical and are to be spent on well-defined specific programs; they do not require any matching funds from the municipalities. In general, these transfers are distributed on a "per client" or "per head" basis and cover expenditures in the areas of social assistance and benefits, kindergarten and primary education,[84] selected hospital and assistance institutions, fire brigades, and the execution of general government services including registration and permits (Table 4.1).

The second type of specific subsidy for current expenditure activities is discretionary (as opposed to being legally mandated). These subsidies require application by the municipalities according to established rules, and are awarded at the discretion of the granting central government agencies. Often, they require conditional or matching financing arrangements by the municipalities. These subsidies cover a variety of areas, including crime and drug-addiction prevention, environmental issues, and employment and development policies. Table 4.2 provides a list of these transfers and their funding levels to municipalities and districts for 1999 and 2000. A summary description of existing transfer programs is presented in Box 4.1.

Table 4.1 Transfers to Local Governments to Finance Delegated Functions

	Criteria of allocation	
Type of transfer	*1998*	*1999*
Social assistance a) asylums for social care all-year, all-week stay b) other centers	63,000 CZK/head 33,900 CZK/head 50,500 CZK/head	63,000 CZK/head 33,900 CZK/head 50,500 CZK/head
Social benefits	These are mandatory expenditures allocated for the social needy and the handicapped according to particular laws.	
Education (primary and nursery schools)	1,110 CZK/head	1,221 CZK/head
Selected hospital institution (children and baby homes)	63,000 CZK/head	63,000 CZK/head
Execution of government service	Administration services provided by the municipal authority. Contribution for 100 inhabitants: 1,100 CZKm. with independent activity 2,200 CZKm. with register activity 6,550 CZKm. with building activity 10,500 CZKm. w/ delegated authority 7,550 CZKm. with activity of district authority.	Administration services provided by the municipal authority. Contribution for 100 inhabitants: 1,210 CZKm. with independent activity 2,420 CZKm. with register activity 7,205 CZKm. with building activity 11,500 CZKm. w/ delegated authority 8,305 CZKm. with activity of district authority.
Fire brigades	Grant for service of fire brigades in according to legal norms.	

Source: Ministry of Finance.

Table 4.2 Subsidies to Local Budgets for 1999–2000 (in Millions of CZK)

Item	***Estimated actual 1999***	***District** offices*	*Municipal*	***Budget 2000***	***District** offices*	*Municipal*
Subsidies to district offices and municipalities	**20,977.0**	9,546.3	11,430.7	**23,797.0**	9,731.3	14,065.7
Including:						
Social payments	**6,920.0**	1,303.5	5,616.5	**9,500.0**	1,300.0	8,200.0
Social care institutions	**1,047.6**	821.0	226.6	**1,068.5**	856.1	212.4
Retirement homes	**1,721.3**	1,028.6	692.7	**1,769.6**	1,042.5	727.1
Education	**1,696.6**	n.a.	1,696.6	**1,687.6**	n.a.	1,687.6
Transportation services	**1,114.1**	1,100.9	13.2	**1,214.1**	1,167.2	46.9
Selected health care facilities	**128.9**	96.4	32.5	**128.7**	96.2	32.5
Provision of state administration services	**2,477.3**	n.a.	2,477.3	**2,477.1**	n.a.	2,477.1
Firefighting and rescue corps including JPOs	**3,121.0**	2,445.7	675.3	**3,148.2**	2,466.1	682.1
Territorial balancing subsidy	**2,750.2**	2,750.2	n.a.	**2,803.2**	2,803.2	n.a.
Anti-radon measures	**70.1**	70.1	n.a.	**56.1**	56.1	n.a.
Resources to increase social care payments	**2,480.0**	377.2	2,102.8	n.a.	n.a.	n.a.
Contribution to district offices for provision of state administration services	**120.0**	120.0	n.a.	**139.8**	139.8	n.a.
Land parcel modification	**847.0**	820.8	26.2	**652.2**	632.0	20.2
Administrative expenditures involved in the system of making social support payments	**240.0**	219.0	21.0	**184.8**	168.6	16.2
Comprehensive cooperative programs for crime prevention and prevention of drug dependency at local levels	**110.0**	n.a.	110.0	**84.7**	n.a.	84.7
Resources for implementing the amendment of law No.133/1985 on fire protection (severance pay and compensation for lost pay)	**50.0**	50.0	n.a.	**38.5**	38.5	n.a.
Reserves to strengthen transportation services	**100.0**	100.0	n.a.	n.a.	n.a.	n.a.
Other non-capital subsidies in the VPS chapter of the state budget	**4,017.1**	1,757.1	2,260.0	**1,156.1**	1,035.0	121.1
Non-capital subsidies in the VPS chapter of the state budget	**24,994.1**	11,303.4	13,690.7	**24,953.1**	10,766.3	14,186.8
Including: non-capital subsidies excluding social payments	**15,594.1**	9,622.7	5,971.4	**15,453.1**	9,466.3	5,986.8
Capital subsidies in the VPS chapter of the state budget	**3,008.4**	1,550.8	1,457.6	**2,249.9**	1,347.7	875.2
Subsidies in the VPS chapter of the state budget	**28,002.5**	12,854.2	15,148.3	**27,303.0**	12,141.0	15,062
Other subsidies accepted from state budget (in the chapters of state administration organs)	**8,666.3**	1,981.5	6,684.8	**8,593.0**	1,859.1	6,733.9
Including:						
Non-capital	**882.7**	459.6	423.1	**1,702.9**	430.6	1,272.3
Capital	**7,783.6**	1,521.9	6,261.7	**6,890.1**	1,428.5	5,461.6
Total subsidies from the state budget	**36,668.8**	14,835.7	21,833.1	**35,796.0**	14,000.1	21,795.9
Capital subsidies from the State Environmental Fund	**1,396.0**	n.a.	1,396.0	**1,200.0**	n.a.	1,200.0
CUMULATIVE TOTAL OF SUBSIDIES	**38,064.8**	14,835.7	23,229.1	**36,996.0**	14,000.1	22,995.9

n.a. Not applicable.
Source: Ministry of Finance.

On the side of capital transfers, funds are also transferred for a variety of purposes, including schools, hospitals, social care facilities, gas distribution, equipment of fire brigades, development of industrial zones, public transport, water and sewerage treatment plants, and so on (Box 4.1). All subsidies for capital infrastructure require matching funds from the municipalities. The only exception is for building new institutions for the delivery of social care in those cases in which the municipality has had to restitute the property to its original owners. In such cases, the central government funds the cost of the facility in full, subject to specifications and norms. For most other cases, capital matching arrangements provide central government funds at established sharing rates up to a maximum amount, but in some cases capital grants are set to cover "standard costs" as opposed to the actual costs of the project.[85]

In addition to these capital transfers from the central government budget, municipalities also receive capital transfers from the State Environmental Fund. These grants are for environmental purposes, interpreted broadly to include water supply systems and the introduction of gas, flood control, the revitalization of the countryside, and energy conservation measures. The Environmental Fund favors project financing, including loans, with matching shares of the Fund going to the municipalities.[86] The matching rate for grants to the municipalities is usually set by the State Environmental Fund at a minimum of 20 percent. Total transfers from the State Environmental Fund represent about 7 percent of all transfers budgeted for 2001 (Table 4.3).

Through 2000, district governments also received earmarked subsidies for social welfare, education, fire protection, and the administration of state services. In addition, some districts received capital subsidies for social care institutions, retirement homes, transport, and health facilities. The new regions will be entirely financed by transfers (or subsidies) on a cost-reimbursement basis through the transition period from January 2001 to December 2002.

Vertical and Horizontal Imbalances

Government transfers can be used mainly to address vertical and horizontal imbalances among levels of government. Vertical imbalances exist when there is a mismatch between the expenditure responsibilities assigned and the resources made available to different levels of government. Horizontal imbalances exist when there are significant disparities among local governments because of differences in capacity to raise adequate revenues with a standard level of tax effort, or because of differences in expenditure needs caused by higher costs of the provision of services or particular features of the local government over which local authorities have no control.

Table 4.3 Subsidies to Local Governments Budgeted for 2001

	Current transfers (billions of CZK)	*Capital transfers (billions of CZK)*	*All transfers (billions of CZK)*	*Share in total (%)*
Subsidies from central government	17.8	6.9	24.7	92.8
Subsidies from State Environmental Fund	0.08	1.9	2.0	7.2
Total transfers	17.9	8.8	26.7	100.0

Source: Ministry of Finance.

Box 4.1 State Subsidies to Municipalities and Districts in 2000

Total subsidies to districts and municipalities in 2000 were budgeted at 37 billion CZK**.** The subsidies came from three different sources: (1) 74 percent subsidies from the General Treasury Administration (VPS) Chapter of the State Budget; (2) 23 percent subsidies from organizations of the state administration; and (3) 3 percent from the State Environmental Fund. Of the total, 62 percent was assigned to the municipalities and the balance, and 38 percent to the districts. Close to three-fourths of the subsidies were for current expenditures, and 73 percent of all capital subsidies were allocated to the municipalities.

(1) Subsidies from the General Treasury Administration (VPS)

Subsidies from the VPS were set at 27.2 billion CZK. Close to 92 percent of these subsidies were for current expenditures in services such as transportation, state administration activities delegated to the municipalities such as the civil registry, education, social benefits and services, and others. The VPS subsidies are divided into two basic blocks. The first block of subsidies are the "mandatory" subsidies represented by the financial relationship between the state budget and the municipalities and districts. These subsidies are determined by law according to explicit criteria and computation indicators. The main mandatory subsidies include the following:

Subsidy	*Aimed at*	*Amount (in billion. CZK)*
Social payments	Socially needy citizens, also the handicapped and sick	5.5
Social-care institutions	Operational expenditures of communities' and district offices' institutions	1.1
Retirement homes	Operational expenditures of communities' and district offices' institutions	1.8
Education	Operational expenditures of basic schools and kindergartens	1.7
Transport services	Partially compensate losses of basic bus transportation services in the territory (does not include municipal mass transportation companies)	1.2
Health care facilities	Selected child health care facilities (for example, infant institutions and children's homes) not covered by the health insurance system	0.13
State administration Services	Compensate municipalities for the cost of execution of state administrative services	2.5
Firefighting	Compensate firefighting and rescue organizations (including Community Volunteer Fire Departments.- JPOs II and III) at districts for non-capital expenditures	3.2
Territorial Balancing	Compensate for uneven distribution of wage tax collection (districts with annual per capita tax collection below CZK 2,870.60 are eligible for the subsidy). *This is the only non-special purpose subsidy awarded by the State Budget to the districts*. The territorial allocation of this subsidy is decided by the district assembly.	2.8

The second block of subsidies included in the VPS Chapter of the State Budget represents capital and current subsidies allocated to districts and municipalities for various purposes. Capital subsidies (CZK 2.2 billion) are paid for health and education purposes to organizations in the districts and municipalities. Non-capital subsidies (CZK 1.2billion) are for anti-radon measures; state administrative activities; modification of lots (appraisal, identification, and surveying of land parcels subject to restitution); administration of state social support payments (including postage and remittance costs); prevention of criminality and drug dependence; implementation of the amendment to Law No. 133/1985 SB on fire protection.

(2) Subsidies from the Budgets of Other State Administration Organizations

These subsidies are used to implement municipal infrastructure programs. They primarily involve an extensive housing construction program (including rental apartments and the technical infrastructure, houses to provide community care services, and support for maintenance of the housing stock); a program for the construction and maintenance of water supply lines and water purification facilities; sewerage treatment; a program for construction and maintenance of the highway network of statutory cities; and a program for rural renewal, among others. The total of these subsidies amounts to CZK 8.6 billion. Of this amount, 80 percent is set aside for capital subsidies, and 78 percent of the total amount goes to municipalities.

(3) Subsidy from the State Environmental Fund

A further source of subsidies for municipalities is the State Environmental Fund with a total of CZK 1.2 billion. The subsidies are provided for construction of wastewater cleaning facilities, sewerage disposal, water supply lines, and the communities' gas programs.

Source: Information in this box is drawn from "2000 State Budget," Attachment G.

Unlike horizontal imbalances, no precise ways of measuring vertical imbalances exist. The 2000 reform in revenue assignments may imply a perception held by the central level that a vertical imbalance gap had developed against the central government (and in favor of local governments) over the past decade. Essentially, the argument was that the imbalance was a result of differences in revenue elasticity, with respect to the GDP, of the assigned revenues at the central and local levels. These differences would have been more obvious for the personal income tax (PIT) assigned to local governments and for other tax revenues such as the VAT, the corporate income tax, and excise taxes assigned to the central government. Another aspect of the argument (not always fully developed) was that there had been a higher GDP elasticity of local spending on delegated functions and on certain components such as teacher salaries that have basically been financed from the center. These arguments led to the 2000 reform in revenue assignments to the municipalities, as reviewed in Chapter 3. However (as was also discussed in Chapter 3) the central government had in actuality been addressing the perceived vertical imbalances in relation to local budgets by controlling the rate of growth in the overall funds dedicated to financing the transfers (or earmarked subventions) to the local governments.

The actual tax revenue performance over time provides some support to the broad-based "perception" mentioned above (Chapter 3, Table 3.1). The buoyancy coefficient for the PIT (which has been more heavily shared by local governments) is consistently over 1 (one) and exceeds the buoyancy of the other central government taxes. Other more conventional readings of vertical imbalance, although weaker measures, might not necessarily indicate an increasing vertical imbalance against the central government. A common way to measure vertical imbalances is to estimate the *share of local government expenditures that is financed by revenue sources over which local governments have control*. If only own local revenues are defined as controlled sources of revenue (that is, property tax, administration fees, and other fees and local revenues), then the coefficient is about 0.13 in 1999, down from 0.17 in 1994 (Table 1, Statistical Appendix). This would indicate a considerable worsening in the already bad vertical imbalance against local governments.[87] However, if the definition of controlled revenues is enlarged to include local taxes shared with the central government, the measure of vertical imbalance (0.60) improves considerably and becomes more closely aligned with measures for other fiscally decentralized countries.

Another of these conventional, weak measures for vertical imbalances is the aggregate budget performance of local budgets. The presence of a *sustained deficit for local governments* might be interpreted as evidence of unsatisfied expenditure needs. Table 4.4 shows the aggregate performance of local budgets between 1993 and 2000. Over the last seven years the table shows a predominance of budget deficits over budget surpluses. The most significant exception is a very high budget surplus for 1999, owing to an unprecedented inflow of capital revenues when the municipalities began selling stockholder rights in their shares in the electric and gas distribution companies.[88] Also, these two measures of vertical imbalance, especially the first, highlight the absence of meaningful revenue autonomy at the local level. It is only through the ability to raise their own revenues in the margin that local governments can really close any vertical imbalances that may arise over time.

Table 4.4 Aggregate Municipal Deficit or Surplus, 1993–2000 (in Billions of CZK)

	1993	1994	1995	1996	1997	1998	1999[1]	2000[1]
Budget balance	0.9	–1.1	–3.2	–9.6	–4.8	1.5	19.0	–1.4

1. Projected.
Source: Ministry of Finance.

With respect to horizontal fiscal disparities, information is scarce regarding differences in fiscal capacity or expenditure needs at this time. Some of the available evidence was discussed in Chapter 2 on expenditure assignments. Certainly, horizontal disparities should not be insignificant, given the differences in economic base across municipalities of different sizes and across different regions, and particularly because of the emergence of industrial depression, unemployment, and poverty in some areas of the country. The aggregate evidence available at the level of NUTS II regions shows that in the period 1995–97 average revenues from the PIT in Prague were 219 percent of the national average, while all the other NUTS II regions were below the national average. The lowest standing was for Central Moravia at 79 percent of the national average. Excluding Prague, the other NUTS II regions ranged from 106 percent of the national average for the Southwest to 94 percent for Central Moravia. The differences are less marked for GDP per capita at the NUTS II regional level. For 1996, GDP per capita was 186 percent of the national average in Prague and 84 percent in Central Moravia. These implied fiscal disparities are not insignificant but they are not large by international standards, and in particular in reference to other transitional countries.[89]

Nevertheless, whatever these disparities have been, in the absence of any explicit equalization transfer mechanism, the revenue assignment prevalent through 2000 (with the PIT assigned to the local level on a derivation basis) may have accentuated fiscal disparities among local governments, in particular when Prague is considered. The new revenue assignments, with the distribution of tax revenues on an adjusted per capita basis, should reduce those fiscal disparities on the revenue side of the budget. However, it is not entirely clear what the impact of the adjustment on the per capita basis may be. Actually, as discussed below, the approved per capita adjustment coefficient is unlikely to properly address the disparities on the expenditure side of the budget owing to differences in expenditure needs.

Main Issues Concerning the System of Transfers

This section focuses on three main issues: (1) the current reliance on the system of conditional transfers and how to improve these transfers; (2) the absence of an equalization transfer mechanism and whether there is justification for one; and (3) the transfers related to the Czech Republic's accession to the EU.

The Current Reliance on Specific or Conditional Transfers

The current system of conditional transfers (or specific subsidies) to local governments has many strong features but also several weaknesses. On the positive side, most of the specific subsidies to municipalities and district offices are designed to cover only partially recurrent expenditures on education, health care, and so forth. In fact, specific subsidies fully cover all operating costs only in the cases of social welfare and fire protection and rescue crews. Equally notable is that practically all specific subsidies for capital investment purposes require matching funds from local governments. These practices tend to increase the efficiency of public expenditures at the local level by increasing local ownership of the programs and setting a price (or opportunity cost) for the use of central government funds at the local level. Another positive feature of some of the specific subsidies is that the allocation mechanism induces positive or neutral incentives for good expenditure management at the local level. For example, the allocation of specific transfers for social assistance, health care, or education is on the basis of *per head* indicators. This approach tends to eliminate any incentive to accumulate idle physical capacity or to overstaff service delivery.[90]

On the downside, the current system of specific subsidies is vulnerable to criticism on the following grounds:

- The current system is complex and unwieldy.
- The numerous constraints and conditions placed on the transfers may be too restrictive to local autonomy, while at the same time there is little actual control by the central government over the final use of these funds.
- The actual allocation of many of these transfers, including the criteria for eligibility and award, remains murky. In particular, there is a sense that the award of many of these transfers still depends heavily on political connections and bargaining skills or the political power of municipalities.
- There is little transparency on how the system works. For example, the list of subsidy recipients was never published.[91]
- The current system of specific subsidies has proven to be a rather unstable source of revenue for local governments, and this, in turn, has damaged the ability of local governments to plan and budget their expenditures in an efficient manner.
- The funding practices for specific transfers may have led to negative incentives for revenue mobilization at the local level if the central government was perceived to be reducing the level of discretionary transfers at any time that local governments increased their own revenues.

There is no easy way to design categorical or conditional grant programs, but there are some general rules that the government should keep in mind to streamline and simplify the current system as well as to make it more transparent (Box 4.2). An in-depth review of the current system of conditional grants should be instrumental in finding ways to decrease the number of transfer programs by consolidating existing similar programs. This should be possible, for example, with the various existing programs supporting local investment in water and sewage treatment plants. Especially in the case of current grants, an alternative *block grant* system could be designed. In the latter case, transferred funds would be untied, as long as allocated within larger expenditure categories such as education or health care. It would be desirable wherever possible to use formulas for the allocation of grants as opposed to discretion, and, when discretion is inevitable, the rules for application and the criteria for awards should always be made explicit and public—as should the list of awarded projects and their amounts. The review could also be used to explore ways of increasing funding stability and predictability.

An Equalization Transfer Mechanism?

As mentioned before, one of the most significant peculiarities of the system of intergovernmental fiscal relations in the Czech Republic is the absence of an explicit equalization mechanism at the local level.[92] One reason for this situation may have been that fiscal disparities across local jurisdictions are not very pronounced, especially when Prague is not included. To date, the main source of disparities in the availability of revenues has been the relative size of per capita PIT revenues. Other taxes, such as the real estate property tax, also have the potential of introducing significant disparities, but only in the distant future. Less is known at this point in time about differences in expenditure needs and apparently not much attention has been paid to this issue. Perhaps to compensate for the absence of an equalization fund, revenue assignments to local

Box 4.2 The Design of Categorical Transfers

International experience shows a considerable variation in the design of categorical transfers. Categorical transfers are used for many different objectives, including redistributing fiscal resources, addressing externalities, addressing vertical imbalances, addressing limitations with borrowing at the subnational level, and promoting subnational expenditure in areas of national importance or in support of national programs implemented locally. Several considerations enter into the efficient design of transfers. Unconditional grants have the advantage of respecting decisionmaking autonomy at the local level. The exclusive use of earmarked grants means that the central authorities have identified all priorities at the local level, and that the central authorities possess better information on needs. Earmarking resources can also interfere with a more cost-effective provision of public services, including a common bias in favor of capital expenditures over recurrent expenditures. Earmarking also implies higher management and monitoring costs. However, matching arrangements enhance efficiency by increasing ownership and decreasing the chances of corruption and wastefulness. The design of conditional transfers must take into account the potential strategic behavior of subnational governments and the incentive signals provided to them.

Using conditional transfers for equalization purposes is fraught with difficulties. Significant resources need to be dedicated to measuring differences and care must be given to avoid rewarding voluntary decisions to spend resources in particular patterns. Matching arrangements can be used for equalization purposes by granting lower matching rates to jurisdictions with lower fiscal capacity or higher expenditure needs. The allocation of conditional grants through objective formulas tends to be more efficient and fair than the use of discretion by the central authorities. Discretional systems are subject to distortions brought about by lobbying pressures from local governments or by national representatives defending or lobbying for local interests. Formulas have the added benefit of simplicity and transparency. If formulas are not used, and they are not always feasible, the allocation of funds or the selection process of projects should be subject to legislated criteria and procedures.

An alternative to a project-by-project based “application” process may be to evaluate the entire local government expenditure plan and then selecting items for funding according to fund availability. In some countries, the criteria for the selection of subnational government capital projects include matching the priorities for infrastructure investment established in a multi-year national capital investment plan.

The advantage of a program-based approach for categorical grants is that it can help ensure that funds are used as intended. However, it tends to have higher administration costs, especially in countries with a more centralized and hierarchical tradition, and is likely to be more bureaucratic and inflexible. The project-based approach also has led in many countries to a myriad of central government programs with fragmented decisionmaking. As a reaction, it has become more common for countries to abolish all the fragmented ongoing programs and to pool the existing funds in a handful of programs with the funds distributed according to a formula. A formula approach ensures a fair and consistent treatment of all local governments. However, a formula approach is not always possible. In such a case, funds should be allocated via a competition process. The discretion element in the latter approach can be reduced by requiring transfers to fit into a national policy and by requiring explicit selection and award rules. Nevertheless, the competitive approach rewards grantsmanship ability and skills, diverting public resources and focus from the direct provision of public services.

governments have always had significant equalizing features. As discussed in the previous chapter, municipalities already had a 20 percent share in the revenues from the corporate income tax distributed among all municipalities in the country on a per capita basis.[93]

The reforms in revenue assignments in 2000 strengthen this equalizing feature. Starting in January 2001, the lion’s share of revenue sharing for the municipalities (20.59 percent of corporate income tax, the VAT, and the wage or personal income tax) will be allocated on an adjusted per capita basis by size of municipality. Thus, to certain extent, the fundamental question of whether there is a need for a formula-driven equalization transfer system appears to have been answered by the 2000 reform itself, with the new revenue assignment. In particular, the new tax-sharing pool distribution system is using population size (instead of derivation basis) and the per capita adjustment coefficient as a proxy for local needs.

However, the question arises of how well the proposed adjustment coefficient structure applied to the per capita basis criterion will be able to close fiscal disparities. The government seems to be trying, with this single instrument of revenue sharing, to achieve other objectives besides a more equal satisfaction of needs. Such objectives include providing incentives for small local governments to amalgamate, supporting the structurally depressed areas where unemployment and poverty are more intense, and so forth.

Pursuing several different aims with a single instrument may mean sacrificing some of the objectives. This would appear to be the case with the new revenue assignment approach. As the previous chapters have shown, the adjustment coefficients to be applied to the per capita distribution are progressive, starting at 0.42 for municipalities under 100 inhabitants and reaching 2.76 for Prague. However, if this progressive scale on population size is to be equalizing, there should be a high inverse correlation between population size and fiscal capacity (or availability of local tax bases) per capita. There should also be a high positive correlation between population size and expenditure needs per capita caused by higher costs for the provision of public services and higher incidence of population groups with greater public service needs, such as the very young, the elderly, the unemployed, or the poor.

It is unlikely, however, that either of the correlations mentioned above will hold in reality. It is much more likely that the availability of tax bases (such as for professional income or the relative value of real estate) in per capita terms will tend to increase with population size. It is also much more likely that expenditure needs from the relative incidence of population groups in need will be higher in smaller communities. In fact, it is the very young and the elderly who remain behind in the migration to larger urban areas from the countryside. The incidence of unemployment and poverty may also be higher in rural areas with small towns. Only the cost or price of services may increase with the size of the municipality because of congestion and higher input prices. Even in this case, however, small and remote communities may experience higher costs of provision in per capita terms for basic infrastructure services such as roads, heating, and water and sewage treatment.

If the unequalizing effects of the adjustment coefficient prove to be sizable, two options are open to redress these disparities.[94] The first would be to transform the adjustment coefficient scale of the new revenue sharing approach to better take into account differences in both fiscal capacity and expenditure needs. This option would, of course, affect other objectives now being pursued with the adjustment coefficient scale, such as providing incentives for the amalgamation of smaller municipalities. The second option would be to introduce an explicit and separate mechanism to equalize fiscal capacity and expenditure needs across municipalities on a per capita basis. Box 4.3 provides the basic steps required in the construction of an effective equalization mechanism.

Given the government's plans over the next two years to revise the revenue assignments for municipalities in order to give more emphasis to incentives and to the development of local tax bases, the use of a separate and explicit equalization mechanism may prove instrumental in properly addressing the many conflicting objectives. Therefore, during the next two years, while the revenue and expenditure assignments of the new regions are being evaluated and finalized, the government may also find that the best way to deal with fiscal disparities across regions is through a centrally funded Equalization Fund, which would better serve the specific purpose of reducing horizontal disparities among regions.[95]

Box 4.3 Basic Steps in the Design of an Equalization Mechanism

The first step is to decide how much equalization will be performed in light of its potential effects on the overall incentives for revenue mobilization and the impact on regional growth. A high degree of equalization may take away incentives for the development of tax bases.

The second step is to decide on the use of different instruments to pursue economic objectives other than equalization, such as categorical grants for sectoral policy objectives and revenue assignments and autonomy to address vertical imbalances. Equalization grants should be lump-sum, distributed with no conditions.

The third step is the determination of the overall funding level for equalization. The pool of funds can be formed by direct contributions from the richer local governments, as in the "fraternal" systems used in Scandinavian and some Central European countries, or through direct central government contributions. The level of funding can be determined on an ad hoc basis every year, or using a rule that could provide a more stable basis, such as a percentage of central government revenues that is fixed for a number of years. A "grants commission" may also be charged with this and other implementation issues of the equalization mechanism.

The fourth step is the allocation of funds to local governments. This can be accomplished by using a formula or by using ad hoc rules. Formulas range from equal per capita basis to complex explicit formulas. More complete formulas attempt to capture existing fiscal disparities arising from differences in tax capacity and differences in expenditure needs. Formulas can take many shapes and forms but they should not create negative incentives for revenue mobilization and efficient expenditure choices, and should be relatively simple, transparent, and stable over time.

The EU Pre-Accession and Structural Funds

The need for equalization transfers may decrease to the extent that EU funds will be available during the pre-accession period and that structural funds will also be available after the Czech Republic joins the EU. However, use of these funds will also require matching funds from the regions benefiting from the EU funds. Therefore, a mechanism must be in place to ensure that even the poorest regions have the capacity to contribute the necessary matching funds.

During the pre-accession period of 2000-2006 the following EU funds will be available to the Czech Republic:

- PHARE funds of EUR 79 million per year for the preparation for accession to the EU, including preparation for the Structural Funds (that is, institution building);
- SAPARD funds for approximately EUR 22 million per year for agricultural and rural development; and
- ISPA funds for between EUR 57 million and 83 million per year for environmental and transport projects.

After accession, EU aid will be provided through the individual structural funds and the Cohesion Fund with an amount limited to 4 percent of GDP. The structural funds for the Czech Republic will fit under the first EU criterion of GDP per capita being less than 75 percent of the EU per capita GDP, with the exception of Prague.[96] The significance of the structural funds is that they will be implemented at the decentralized level, and this will provide the government with convenient leverage to strengthen its fiscal decentralization policy. Therefore, if the policy is well designed, the central government could use the EU pre-accession and structural funds as a powerful instrument for promoting the amalgamation of small communities, by offering those communities attractive conditions for local matching funds, conditional on their voluntary decision to join alternative spatial and scale arrangements that could entail a more efficient delivery of public services.

The Ministry of Regional Development has been in charge of steering the policy process to ensure that the structural funds are well utilized. The recent difficulties with the award of SAPARD and ISPA funds, however, have been due to the EU Commission's delays in passing its own legislation and also to the fact that the Czech line ministries were not timely in proposing the right financial instruments and presenting high-quality projects.

Options for Reform

The government may consider three major lines of reform to improve the current transfer system, namely (1) revision of the current transfer system, aimed at rationalizing local expenditures; (2) reconsideration of an equalization grant mechanism, separate from the tax-sharing system, aimed at reducing regional disparities; and (3) use of the opportunity of the EU pre-accession and structural funds as leverage to rationalize the government's decentralization policy, aimed at amalgamating the financially weak small municipalities.

1. ***Review the Current System of Specific Subsidies to Rationalize Local Expenditures.*** The continued reliance on categorical transfers to fund delegated functions and other central government programs will require finding ways to improve on the positive features of the transfer system and to correct some critical problems that these transfers present at this time. It is important for these transfers to be kept efficiently structured. In particular, it is important to retain a per capita or per client design and to avoid going back to using capacity-based criteria. Reaching for "additionality" in these programs will also be significant, in view of the requirement of matching funds for capital grants and the less-than-full funding of most recurrent expenditure programs.

   The government should conduct an in-depth review of the current system of conditional grants with the objectives of decreasing their number and simplifying the system, and of examining the alternative of introducing block grants (untied funds within larger expenditure categories). It will also be important to improve the fairness and transparency of these grants by considering the use of formulas for their allocation whenever possible, or by using explicit rules for the selection and award of projects and by making public the recipients and the levels of the awards. Performance evaluations across municipalities and regions should be carried out on a periodic basis, and the results of these evaluations should be used to improve state budget resource allocations and to increase the efficiency of service delivery at the local levels.

   Determining the level of funding for government transfers annually may be instrumental from the macroeconomic viewpoint, but it can create too much uncertainty in subnational government fiscal plans. There is, therefore, a need to find ways to stabilize transfer funds and to make them more predictable for local governments, at least for a period of two or three years within the context of a central government medium-term expenditure framework.

Funding rules for specific transfers may also have to be reexamined to ensure that there is no explicit or implicit claw-back of local revenues that have been raised by greater local tax efforts.

2. ***Reconsider the Role of Equalization Grants in Reducing Regional Disparities.*** The introduction of revenue sharing on an adjusted per capita basis at the municipal level represents a resourceful solution to a complex set of objectives, including vertical balance, equalization across jurisdictions, and the provision of incentives for the amalgamation of small jurisdictions. Nevertheless, as is usually the case in economic policy, it will be more effective to pursue conflicting objectives with separate instruments. In this respect, the issue of reducing regional disparities by means of equalization transfers may require the introduction of a separate instrument. As an alternative (although perhaps a much less effective one), the government could consider modifying the adjustment coefficients to take into account differences in fiscal disparity and expenditure needs across municipalities. Either of these alternatives will be needed if the unequalizing effects of the adjustment coefficient prove to be sizable. The use of a separate equalization mechanism may prove additionally helpful during the next two years if the government plans to revise the revenue assignments for municipalities to give more emphasis to incentives for the development of local tax bases. The concept of an equalization mechanism at the regional level could also provide the government with additional freedom to design a revenue assignment for the new regions that contains greater revenue autonomy.

3. ***Leverage EU Regional Funds to Increase Local Efficiency.*** The smallest municipalities are not always in a financial condition to contribute their matching shares to the EU pre-accession and structural funds. The government may approach this problem as an opportunity to help reverse the fragmentation process of the municipalities. Since a mechanism must be put in place to ensure that even the poorest communities have the capacity to participate in the structural programs, the use of strong "financial incentives" or "conditionalities" may be the best approach.

   The government may promote the use of EU funds as convenient leverage to strengthen its fiscal decentralization policy and to increase administrative, technical, and allocative efficiencies at the local and regional levels. Therefore, the required matching funds could be made available by the central government on a highly concessional basis for small municipalities, conditional on voluntary arrangements that could ensure an effective and efficient amalgamation. The explicit financial incentives should be attractive enough to induce the local inhabitants to concede on amalgamation. In any case, the arrangements should be final, legally binding, and economically viable to ensure economies of scale in production and internalization of the externalities in consumption of local public services.

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5. Access to Borrowing by Subnational Governments

Public Sector Debt

Public debt outstanding in the Czech Republic during the 1990s averaged around 13.5 percent of GDP, with local governments' debt—a relatively recent phenomenon in the country—increasing from 0.3 percent of GDP in 1993 to 2.2 percent in 1999 (Table 5.1). Thus, in terms of the Maastritch general criterion for fiscal discipline, the Czech Republic seems to fare well.[97] Nevertheless, a more conclusive inference, on both local finance sustainability and macroeconomic stability, would require that all forms of contingent liabilities existing in the Czech Republic (in each level of government) also be taken into account.[98] This chapter is concerned with the local governments' debt and access to borrowing.

As in many other unitary countries, local governments in the Czech Republic have had only limited discretion to finance expenditure. Since local governments cannot print money and their tax autonomy is very limited (see Chapters 2, 3, and 4), the single most important alternative available for financing local fiscal imbalances has been to borrow. Commercial sources of borrowing include banking and non-banking loans and credit, including bond issuing; non-commercial sources include interest-free or subsidized loans from the state, mainly the Ministry of Finance and the State Environmental Fund. In addition, municipalities have often provided guarantees and assumed contingent liabilities that may lead to expanding their effective financial exposure. Although this exposure has not as yet been excessive, it still represents a potential fiscal risk that the central government should monitor, in order to prevent it from becoming a threat to macroeconomic stability. It is important for the government to bear in mind that local government debts may or may not become a macroeconomic threat, depending on how the economic system perceives these debts and whether indebted local governments are (explicitly or implicitly) backed by the central government.

Table 5.1 Czech Republic Outstanding Debt

Debt item	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
			(in billion CZK)				
Municipal	3.4	14.3	20.3	28.3	34.4	39.0	40.0
Loans	2.5	4.9	8.7	11.6	13.5	18	17.6
Bonds		7.6	8.5	11.9	13.2	11.9	10.9
Others	0.9	1.8	3.1	4.8	7.7	9.1	11.5
State	158.9	157.3	154.4	155.2	173.1	194.7	228.4
			(in percent of GDP)				
Municipal	0.3	1.2	1.5	1.8	2.1	2.2	2.2
Loans	0.2	0.4	0.6	0.7	0.8	1.0	1.0
Bonds	0.0	0.6	0.6	0.8	0.8	0.7	0.6
Others	0.1	0.2	0.2	0.3	0.5	0.5	0.6
State	15.9	13.3	11.2	9.9	10.4	10.8	12.4
Total	16.2	14.5	12.6	11.7	12.4	13.0	14.6
			(in percent of State Debt)				
Municipal	2.1	9.1	13.1	18.2	19.9	20.0	17.5
Loans	1.6	3.1	5.6	7.5	7.8	9.2	7.7
Bonds	0.0	4.8	5.5	7.7	7.6	6.1	4.8
Others	0.6	1.1	2.0	3.1	4.4	4.7	5.0
			(in percent of Municipal Total Revenue)				
Municipal	4.5	15.4	19.1	24.8	27.8	28.3	23.6
Loans	3.3	5.3	8.2	10.2	10.9	13.0	10.4
Bonds	0.0	8.2	8.0	10.4	10.7	8.6	6.4
Others	1.2	1.9	2.9	4.2	6.2	6.6	6.8
			(in percent of Municipal Tax Revenue)				
Municipal	11.4	31.6	34.8	45.1	52.3	54.1	52.9
Loans	8.4	10.8	14.9	18.5	20.5	25	23.3
Bonds	0	16.8	14.6	19.0	20.1	16.5	14.4
Others	3.0	4.0	5.3	7.6	11.7	12.6	15.2

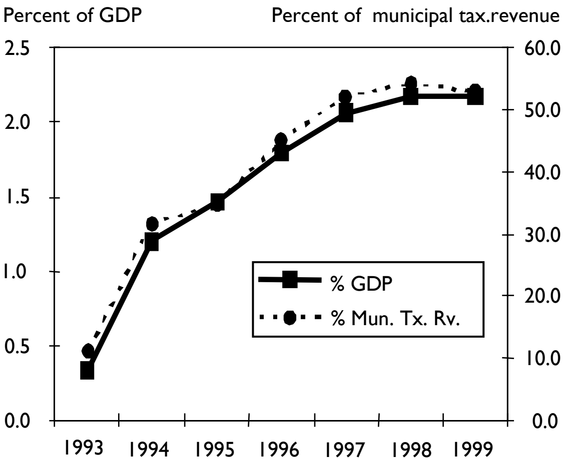
Source: Ministry of Finance, World Bank Staff.

Local Fiscal Imbalances and Debt Accumulation

In the Czech Republic, only municipalities, as self-governing entities, can have access to borrowing. District offices do not have the power to assume financial contractual obligations of their own because they are merely deconcentrated bodies of state territorial administration.

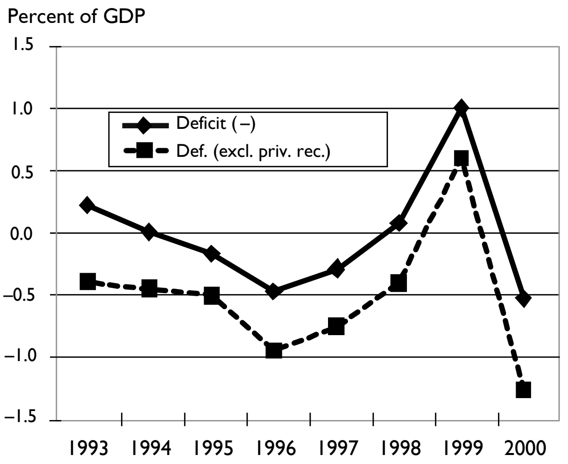
The outstanding debt of Czech municipalities has shown a systematic increase over the period 199399, reaching 53 percent of municipal tax revenues in 1999 from 11 percent in 1993. This debt corresponds to 2.2 percent of GDP and about 20 percent of the state debt in 1999.[99] Although that municipal debt may still be considered too small to be an immediate threat to macroeconomic stability, it is worrisome that it grew rapidly—more than sixfold—during the period (Figure 5.1). The 1999 stabilization of municipal debt outstanding in relation to GDP (and even the slight drop in relation to municipal tax revenue) appears to have been a result of significant sales of financial assets during 1999, which allowed municipalities to cope with their entire financial needs for the year, including some debt amortization.[100]

Figure 5.1 Czech Republic: Municipal Debt Outstanding, 1993–99



Source: Ministry of Finance.

Figure 5.2 Czech Republic: Local Fiscal Deficits, 1993–2000



Source: Ministry of Finance.

What is more worrisome, however, is the fact that, except for 1999, the reasons why municipal outstanding debt grew so rapidly during the decade are not entirely transparent. There is no evident correspondence between the imbalances of the fiscal accounting flows of municipalities (reflected in the deficit curves of Figure 5.2) and the municipalities' debt accumulation (Figure 5.1). While fiscal flow statistics show the municipalities' fiscal standing as reasonably stable during the 1990s (that is, with rather small deficits alternating with small surpluses), aggregate municipal outstanding debt accumulated quite rapidly. This apparent statistical discrepancy may reflect lack of uniformity in accounting and lack of transparency, which could result from (1) probable differing interpretations by municipalities of accounting procedures (see Chapter 6); (2) off-budget financial operations, including reimbursable components of grants from the state budget and Extrabudgetary Funds inadequately recorded as revenue by some municipalities; and (3) *credit guarantees* to budgetary and non-budgetary organizations (and other off-budget *contingent liabilities*) that have been effectively assumed by municipalities only when these guarantees were due.

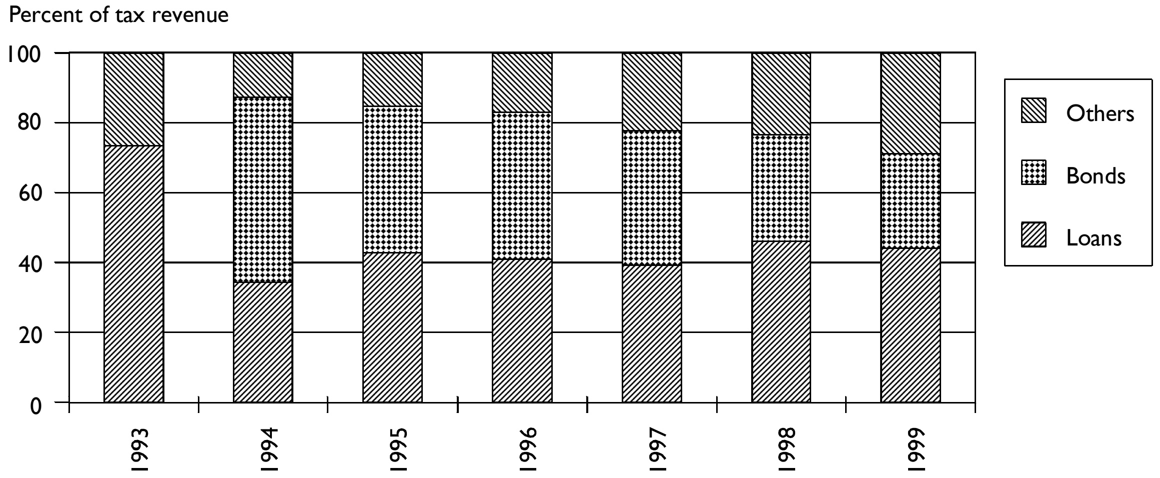
The lack of uniformity in accounting and the absence of full transparency in fiscal operations (including those affecting assets and liabilities of the public entities) may represent a major macroeconomic risk, because, in such situations, statistics tend to become unreliable and *non-transparent contingent liabilities* tend to show up as direct municipal liabilities only when the obligations are called upon. As non-transparent contingent liabilities have not been properly reflected in the flows of the fiscal accounts, there is no early warning system in place indicating the level of risk to which municipalities are exposed.[101]

Expansion and Composition of Municipal Debt

The expansion of municipal debt during the 1990s was broad-based. All forms of municipal debt expanded substantially: loans, bond issues, and "other" (the last including non-commercial loans, and, especially, "refundable transfers").[102] Bond debt expanded intensively in the mid-1990s (Table 5.1). Toward the end of the 1990s, the Exchange Commission[103] actually prohibited new bond issues as part of the general fiscal adjustment policy. As a consequence of the regulations and prohibitions of the late 1990s, no municipal bond issuance occurred until early 2000, and the municipal bond debt outstanding has fallen slightly in nominal terms (Figure 5.3). Recently, only Prague has issued bonds in the foreign financial market (EUR 200 million in 1999 (Table 5.2).

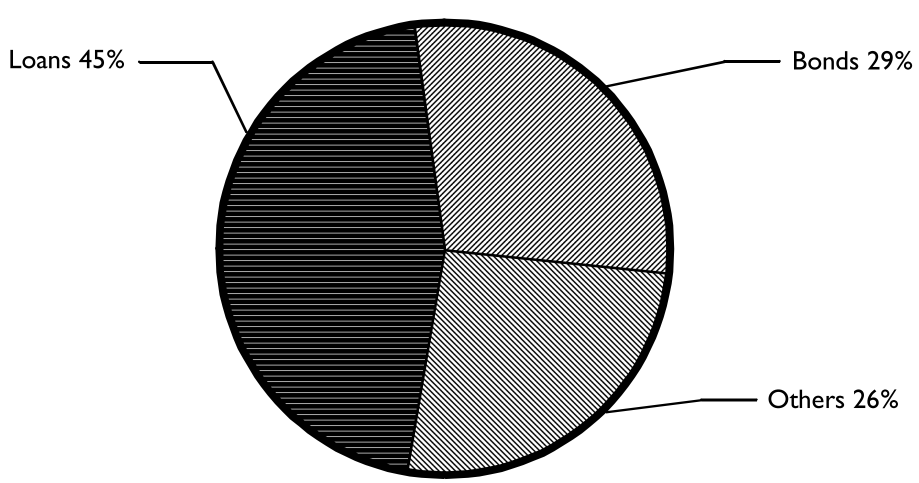
In the late 1990s, municipalities' outstanding debt was composed of 45 percent loans, 29 percent issued bonds, and 26 percent "other" (Figure 5.4). While most local governments have had access to banking loans and credit, bond issuance (especially the placement of bonds in foreign financial markets) has been accessed only by the larger cities (Prague, Ostrava, Plzen, Brno, Liberec, Usti nad Labem, and a few others). Municipal bond issues (mainly by large cities in foreign capital markets) and municipal commercial loans (mainly domestic) have essentially been aimed at financing city public construction works and transportation systems. Concessional loans from the state have been on a programmed basis (for example, to supplement the required counterpart funding for the EU pre-accession structural funds for investment projects) and on a discretionary ad hoc basis (as in the case of the State Environmental Fund and the state budget).

Figure 5.3 Czech Republic: Evolution of Debt—Outstanding Composition, 1993–99



Source: Ministry of Finance.

Figure 5.4 Czech Republic: Municipality Debt Outstanding Composition (1998–99 Average)



Source: Ministry of Finance.

Table 5.2 Municipal Bonds Issued, 1992–99

Year of issue	*Municipality*	*Face value (million CZK)*	*Maturity (years)*	*Interest rate (%)*	*Underwriter*
1992	Ostrava	8.5	6	D+1,5	City Hall
1993	Sumperk	20	5	18.00	CSOB
1994	Smrzovka	115	7	14.25	CS
	Liberec	100	5	14.25	CS
	Prague	US$250 mil. (equivalent to CZK 7.3 bil.	5	7.25	Nomura International
	Pardubice	50	5	12.70	KB
	Usti nad Labem	150	5	12.70	KB
	Caslav	90	8	15.50	Burzovni spolecnost pro Kapitaloy trh
	Rikytnice nad Jizerou	120	7	12.00	CS
	Veseli nad Moravou	10	7	14.10	Velkomoravska banka
1995	Rychnov nad Kneznou	100	7	13.10	KB
	Plzen	500	5	11.50	Bayerische Vereinsbank Prague, ING CR, Capital Markets, SCFB Prague, KB
	Marianske Lazne	200	5	11.50	KB
1996	Brno	1,200	7	11.10	IPB
	Frydek-Mistek	150	5	11.80	CS
	Decin	250	7	12.50	CSOB
	Kladno	250	7	12.50	CSOB
	Ostrava	DM 75 mil. (equivalent to CZK 1,318.2 mil)	5	LIBOR+0.2 25%	ING Barings
1997	Zidlochovice	40	10	12.90	CMZRB
1999	Prague	EUR 200 mil.	5	4.63	ING Barings

Source: Ministry of Finance.

Municipal borrowing from the State Environmental Fund has mainly financed gas and water supply systems, sewerage, and wastewater treatment plants. Municipal borrowing from the state budget has been mostly for housing. Arrears is another component of local government indebtedness (to wages and salaries, as well as to suppliers), although this item does not appear to be a significant component of local debt in the Czech Republic.

Access to Borrowing by Municipalities

While large Czech municipalities have had access to all financial markets and to the most sophisticated debt instruments for the financing of their investment projects, small municipalities have only had access, if any, to local banking and non-commercial credit sources. This difference is at least in part reflected in the vast contrast in creditworthiness between these two groups of municipalities. While larger municipalities have inherited substantial assets and have enjoyed buoyant tax bases (showing good performance of revenue from shared taxes, mainly the PIT and CIT), small municipalities do not have sufficient assets and have shown only meager revenue and tax capacity, insufficient to support credit operations.

Moreover, there has been the perception that the current Czech Commercial Code restricts collateral for credit operations to existing assets at the time of the debt agreement signature (in other words, the Commercial Code does not recognize future revenue as collateral).[104] This perception (though not confirmed by the current regulations) together with the limited tax autonomy of local governments, may be a factor in preventing small and medium-size municipalities from improving their access to financial markets.

Banking sector representatives have seen these issues as major concerns when dealing with municipalities' credit and have argued that banks would prefer municipalities to have more freedom on their own tax bases, rather than being heavily dependent on state transfers.[105] In spite of this, it appears that most small and medium-size municipalities are indebted, and in these cases beyond their ability to service the debt. Indeed, it appears that some of the weaker municipalities are actually insolvent. The perception in the banking sector is that only a few of the small municipalities have shown good creditworthiness in the recent past, because of their potential development as tourist centers. In fact, some of these municipalities (such as Smrzovka and Rokytnice nad Jizerou) are already borrowing heavily from the banking system (especially from Ceska Sporitelna—the Czech Savings Bank) and investing in tourism infrastructure.

Local Government Indebtedness

Debt financing of *capital* expenditure is a common feature of decentralized subnational governments, which in general have (or should have) the responsibility for financing local public infrastructure. This has not always been the case in the Czech Republic, where the central government still participates heavily in the financing of local infrastructure, mainly through matching grants (Chapter 4). On the one hand, transferring this responsibility to subnational governments (especially the richest ones) is an important step in developing a sense of ownership at the local level, which tends to result in improved maintenance of the capital stock and increased rationalization and efficiency in the use of facilities.

On the other hand, full financing of local capital needs out of local current revenues (without borrowing) would be neither quantitatively feasible—even if the local authorities had the desired autonomy on local tax bases and rates—nor economically efficient (or equitable). It would not be efficient or equitable because in general the benefits of these investments persist for several years (or decades), and future generations should participate in expenditure financing as well.

There is also a cash management argument to the effect that local government borrowing may also be justified by the need to match nonsynchronized expenditure and tax flows within the same year. Moreover, borrowing may provide an important independent mechanism for fostering political accountability, since financial markets may signal the performance quality (good or poor) of local governments through credit ratings and actual interest rates charged, or simply by blocking the governments' access to credit.

Overall, local government access to borrowing may be desirable as an instrument for optimizing inter-temporal allocation of resources and promoting economic growth and fiscal equity. However, in the absence of clear rules and accountability, financial market failures and soft budget constraints may lead to irresponsible excessive indebtedness on the part of local governments and can easily become another kind of problem. In particular, local officials can be tempted to overspend on popular programs by borrowing in excess now and leaving the bill to be paid by future taxpayers. Uncontrolled local borrowing may lead local governments to default on their debts, forcing the central government to assume these unpaid liabilities. This would pose major macroeconomic and stability risks, which would justify the Czech government's adopting adequate regulations and monitoring mechanisms to ensure that local government access to borrowing and indebtedness is fiscally responsible.

Management of Local Government Debt

The international experience offers several approaches to the management of local government debt from which the Czech Republic might profit when designing its own model.[106] The most common approaches include (1) leaving financial *market discipline* to operate freely; (2) establishing strict *administrative, case-by-case control*; and (3) establishing explicit, preemptive, and *legally binding general rules* to prevent crises and encourage good market behavior. A combination of these options may prove more advantageous for the Czech Republic.

Market Discipline

In principle, market discipline would set the most desirable benchmarks. However, governments realize at times that market discipline alone cannot be as effective as desired, because of prevailing market failures, such as the following.

- *Restricted financial markets*. Market discipline will not be effective when financial markets are not free and open, as is the case in the Czech Republic. Some common market failures are restricting access to foreign capital markets, which limits options, and compulsory allocation of resources (including those of official financial agencies and parastatals) to facilitate the placement of government bonds. In addition, market failures lead to suboptimal financial sector portfolio composition.
- *Lack of transparency*. Without the adequate availability of and dissemination of information, and without full transparency on debt outstanding and capacity to pay, market discipline will fail. Obtaining reliable financial information in the Czech Republic—especially for the local governments (as observed above)—is not a trivial effort. Municipalities may not follow the same interpretation of the chart of accounting, or may not maintain clear and uniform registers of their assets and liabilities, or may not publish and disseminate information on debt and capacity to pay on a systematic and reliable basis. Moreover, extrabudgetary or contingent liabilities assumed by direct or indirect guarantees provided by local governments to their parastatals or funds are major areas in which considerable transparency improvement is needed.
- *Soft budget constraints and moral hazard incentives*. When moral hazard incentives permeate the relationship of the public sector with the financial system, the efficacy of market discipline as an instrument for checking excessive local government indebtedness is jeopardized. Ad hoc, extraordinary, and off-budget financing, or the concession to municipalities of guarantees to certain loans by the Czech central government (either through grants or through lending operations), or by municipalities to municipal budgetary and non-budgetary organizations, are also "hidden" forms of soft budget constraints that may lead to moral hazard incentives.
- *Insensitivity to market signals*. For market discipline to be effective, the borrower should evidence sensitivity to market signals by seeking financial policies consistent with full solvency. Increasing interest rates should stop or should at least make the borrower review its borrowing decision. It is unlikely, however, that municipal mayors and heads of regional

executive boards, as elected politicians, will be concerned with market signals when deciding on their current expenditure programs.

The international evidence is that even in mature financial markets, such as that of Canada, *sole reliance on market discipline* has not been satisfactory in checking the excessive indebtedness of subnational governments. In the mid-1990s, subnational government debt in Canada reached 23 percent of GDP. The subnational governments were forced by this to adopt fiscal adjustment programs, but only after they were excluded from the market, which entailed high social costs. In Brazil and Argentina, without the necessary market conditions in place, the experience in the 1980s proved disastrous and the central government had to intervene with large bailout operations to rescue the creditors and to avoid systemic crisis.

Under the present market conditions in the Czech Republic, *sole reliance* on market discipline is unlikely to be sufficient to improve the responsible access of local governments (municipal and regional) to the capital market. A more viable alternative is to have regulation in place that is adequate to prevent excessive local government indebtedness (as is discussed below). Nevertheless, to the extent possible, regulation should imitate desirable market discipline, in order to minimize distortions and encourage market practices in the future. In addition, the government should explicitly encourage market discipline, participation of the private sector, and development of independent institutions. Periodic monitoring reports by independent organizations on municipal and regional indebtedness and on the current and prospective financial situation of municipalities and regions also tend to have a major impact on the development of market institutions and should be encouraged by the government.[107]

Administrative Controls

Some countries exercise direct controls over the access of local governments to capital markets by (1) requiring approval by central agencies for credit operations proposed by local governments; or (2) prohibiting local governments from directly accessing capital markets. Requiring central agency approval means that credit operation contracts are individually evaluated on their financial terms and conditions. In such a case, central government micromanagement, bureaucracy, and inefficiency are likely to crop up. India has used this approach because the central government is a major creditor of the states and because such approval is a constitutional provision. Australia, during the 1980s, prohibited direct access to capital markets, centralized all loans, and then on-lent to the subnational governments. However, as direct control was not effective, Australian subnational governments have again been allowed free access to capital markets, but they are controlled ex ante from an aggregate perspective and more closely monitored ex post from an individual perspective.

In general, central governments have realized that increasing direct control over local governments' credit operations is inconvenient in that (1) it increases the centralization of financial decisions, which runs counter to the fiscal decentralization goals of greater accountability on the part of local authorities and enhanced allocation efficiency; and (2) it involves the central government in micromanaging every local government credit operation, which tends to increase central bureaucracy and administrative inefficiencies, and tends also to foster undesirable inefficiencies in the financial system. It is well understood why direct control of every credit operation has not been recommended for the Czech Republic: the country's 6,239 municipalities and 14 regions would make direct control both costly and difficult.

Regarding the indiscriminate prohibition of access to borrowing, such an option would seem incompatible with the Czech Constitution (Art. 101)—which allows self-governments to freely operate their own properties and budget—and with certain parliamentary acts establishing and regulating the regions (ActNo.129/2000) and municipalities (ActNo.128/2000). These acts empower the respective Assembly of Representatives with the right to decide on credit and loan operations.

Rules-Based Approach

Rules for access to capital markets can be effective only if they are legally binding, simple to follow, transparent, and applied across-the-board. Such rules should comprise clear quantitative limits and procedural norms, which respect and imitate, to the extent possible, good practices of financial market discipline and creditworthiness indicators. Many countries have adopted the *rules-based approach* as a preventive measure, or according to the needs of particular situations, to curb subnational government access to capital markets (examples include the United States, Spain, Japan, the Republic of Korea, and Brazil).

Some countries limit the credit operations of local governments, in order to preempt systemic crises, by prohibiting the following: (1) central bank financing; (2) non-investment expenditure financing; (3) short-term liquidity assistance; and (4) external (foreign) financing. These rules are, in many cases, well justified. Aiming at monetary stability, independent central banks should not provide any kind of direct finance to government, including local governments. Also, noninvestment expenditure financing by the banking system should be banned, as a *golden rule,* to force local governments to stop postponing necessary adjustments in their recurrent expenditures.[108] While the Czech Republic should pursue restrictions (1) and (2), it may not be wise for it to follow restrictions (3) and (4). In fact, short-term loans for liquidity assistance purposes create an opportunity to smooth out local government cash flows during the year, and can optimize financial inflows with outflows. In many countries (including the United States and Brazil) short-term loans for liquidity assistance are quite common and appropriate. But for liquidity assistance to perform its function well, there must be a contract-binding proviso to the effect that local governments are obliged to liquidate their debt during the same fiscal year.

The most compelling reasons for the prohibition of subnational government access to foreign capital markets have been macroeconomic:

- Such operations may have an impact on stabilization.
- A concerted negotiation approach could be beneficial for the country.
- The default of one individual entity might spill over on the creditworthiness of the other entities and on sovereign risk rating.
- Multilateral financial institutions usually require a sovereign guarantee.

However, this prohibition would be counterproductive in terms of promoting European market integration and in terms of opportunities lost through inability to access international capital markets. This is evident because of the rapid evolution of market conditions in the Czech Republic, the imminent integration to the EU market, and the ongoing progress of the fiscal decentralization process. . For the time being, instead of an outright prohibition or complete liberalization, it may be prudent to continue to require permission of the Exchange Commission for foreign loans to local governments.

The Practice in the Czech Republic

In the Czech Republic, access of municipalities to capital markets has been controlled by a mix of market discipline and some implicit government control, exercised by moral suasion on the part of the central authorities on both the financial institutions and the municipal governments. Since 1997, the Ministry of Finance has suspended authorization by the Exchange Commission to local governments to place new bond issues in foreign markets and has recommended that financial institutions stop lending to those municipalities that have reached a 15 percent debt-to-service ratio. In addition, the Ministry of Finance has threatened to discontinue state "subsidies" (grants and loan transfers) to municipalities that do not obey these rules. Although banks apparently have followed the recommendations, these rules are not legally binding.

The only formal instrument of local indebtedness monitoring and control is the Exchange Commission. However, this institution only decides on the authorization of bond issuance for a domestic borrower in foreign capital markets. It does not monitor the spectrum of municipal debt, including domestic indebtedness. Legally, there is no formal limitation for municipalities on borrowing, and they can borrow from whatever financing source, for whatever purpose (even to finance recurrent expenditures), and under any financial condition of time and rates.[109] Some of the financial operations of municipalities are guaranteed by official institutions (including Ceska Sporitelna), but the majority of these operations are not explicitly guaranteed and it is not certain how creditors would recover their money in case of default. The current Bankruptcy and Composition Act does not include municipalities as a subject, and this may be a reason for the increasing reluctance of the banking system to continue financing most municipalities.

On the other hand, municipalities themselves have been granting loans and guarantees to local businesses in support of local developmental activities. Although such financial activities are subject to the approval of Municipal Assemblies, the procedures are not clear. The lack of monitoring and supervisory mechanisms has left room for soft budget constraints and has also produced moral hazard incentives—both features of a high fiscal risk situation.

Options for Reform

There is a clear need to develop a financial system that includes basic operational and supervisory rules specifically designed for the indebtedness of local governments (municipalities and regions). This system should be aimed at promoting responsible access to capital markets as leverage for optimizing local capital investment financing but also keeping in place hard budget constraints. In addition, institutional arrangements on the availability and reliability of local debt information need to be seriously considered in order to improve transparency and accountability in the system as a whole.

Nevertheless, reform options should not preclude the continuation of the basic current legal structure that allows normal access to borrowing subject to Local Assembly approval. It is recommended, however, that such borrowing be subject to reinforced supervision rules of the Exchange Commission, the Czech National Bank, and the Ministry of Finance. At the present juncture, the government may consider examining the implementation of the following reform options in relation to the municipal and local capital market.

1. ***Restrict loans to high-return investment expenditures*** by banning medium-term and long-term loans for the recurrent expenditures of local governments and by enforcing full repayment in the same fiscal year of any short-term liquidity assistance.

2. ***Limit the debt service ratio*** of local governments to a maximum of, for example, 0.1 (that is, the flow of due interest and amortization to the flow of revenue should not surpass 10 percent).[110] Above this limit further indebtedness should not be allowed, because debt service commitment would be likely to jeopardize the normal delivery of basic local public services (such as education, health, and social assistance).

3. ***Limit the total indebtedness*** indicator of local government (that is, the ratio of debt stock outstanding—including indirect and contingent liabilities—to the flow of total annual revenue excluding conditional grants) to a maximum of, for example, 0.8 (gradually over time).[111] For the time being, the central authorities should adopt a prudent approach by allowing only gradual increases in the total indebtedness indicator of individual subnational governments.[112]

4. ***Limit banks' portfolio exposure*** to a certain maximum dictated by recommended banking prudential rules, enforced on a bank-by-bank assets basis, for each local government. The Central Bank should apply strict norms of supervision, especially to the official credit institutions (for example, Ceska Sporitelna).

5. ***Pass and implement a financial emergency or bankruptcy law for local governments*** that could clearly define debt workout procedures in case of local government default. This is a necessity in view of the current conditions of the Czech capital market. Once approved, this procedure for the settlement of local government debts should be implemented diligently. The Hungarian "Procedure for Settlement of Local Government Debts"[113] may be a good practical case to be observed during the review of the Czech Republic's own bankruptcy law. Nevertheless, putting in place a sound bankruptcy mechanism does not diminish the need for setting up a proper system of controls and incentives to harden the budget constraints of lower-tier governments in Czech Republic.[114]

6. ***Adopt a Law on Fiscal Responsibility*** that would aim at limiting reiterated, excessive deficits and the imprudent buildup of (local) public debt. This type of law would create the conditions that would increase efficiency, fiscal transparency, and the accountability of public administration in general, and of local government in particular. Fiscal authorities and managers (including municipal and regional officials) would be personally, legally accountable for their decisions. Financial guarantees by subnational governments (either to their enterprises or to local businesses) should be prohibited and central government guarantees to (and bailouts of) local government indebtedness should be explicitly banned by this law. New Zealand's, and particularly Brazil's, Fiscal Responsibility Acts may also provide some guidance for this reform.

7. ***Review the Commercial Code financing rules,*** including clarification of the role and conditions of future revenue of local governments as collateral for loans. Such clarification could interject a dynamic element in the process of financing public budgets by forcing local

governments to be more transparent and accountable, and by encouraging lenders to evaluate risks more seriously. This reform would be effective only if sufficient marginal tax and revenue autonomy can be given to local authorities so that they can exercise flexibility on local own revenue possibilities.

8. ***Encourage the dissemination of risk and credit rating analyses*** of local governments to improve transparency, impel the financial system to operate as closely as possible to market discipline, and promote the practice of creditworthiness analysis. In the United States, Canada, and Australia this has been a common practice, with private risk rating companies playing a central role. This practice helps local governments to obtain the necessary financing from domestic and foreign capital markets, while at the same time it monitors the risks of excessive indebtedness. This practice of rating the credit worthiness of municipalities has just begun in the Czech Republic, and should be decisively encouraged. The government can help by making reliable information on municipalities' fiscal and financial situation (including budgetary and indebtedness) regularly and openly available to the market.

9. ***Establish an official monitoring agency*** to keep records and monitor the overall development of local government indebtedness, including all kinds of contingent liabilities. This agency, possibly under the Ministry of Finance, should exercise statistical, coordinating, and supervisory roles. The agency would be essential for the dissemination of reliable information on a systematic basis, as well as for enforcing the Fiscal Responsibility Law, for initiating financial emergency measures, and for supporting the development of market institutions and fostering market discipline. Such an agency would increase transparency and create a system of early warning for local government indebtedness.

6. Subnational Government Budgeting

Until very recently, the budget process at the subnational level in the Czech Republic was regulated by the Budgetary Rules Act of 1990, which also applied to the state budget and the budgets of other public institutions. In July 2000, Parliament passed the Law on Budget Rules of Territorial Entities (Law No. 250/2000), which exclusively regulates the budget process of the municipalities and the new regions. This law also regulates the partnerships of municipalities for the joint provision of services.

Although the new Law on Budget Rules of Territorial Entities contributes significantly to a more efficient and transparent budget process at the subnational level, important aspects of subnational budgets still require review and reform. This chapter addresses the most important outstanding issues in the areas of (1) local autonomy, budget discretion, and accountability; (2) budget preparation, predictability, and transparency; (3) budget execution, monitoring, and reporting; and (4) budget control and performance evaluation.

Autonomy, Discretion, and Accountability

At the beginning of the transition, municipalities had little autonomy or discretion in setting expenditure priorities and making budget decisions on the delivery of public services. Paralleling this lack of autonomy and discretion, local governments had little or no accountability to residents within their jurisdictions. Instead, accountability was vertical, to the central government.

Local government autonomy, which was proclaimed in the constitution,[115] developed initially with the reforms of 1993 and has continued to evolve. Many features of the current system of intergovernmental relations also add to the autonomy and discretion of local governments. Municipalities have their own democratically elected governments and have independent administrations. In particular, municipal finance officials are not under any central authority but respond exclusively to municipal elected representatives. Also important is the fact that the budgets of local governments are not linked to the central government budget and local budgets do not, in principle, require approval by central authorities. As has been noted, of course financial links do exist between the central and municipal budgets through revenue sharing and transfers, as well as limitations on the use of transfer funds when these are in the form of specific subsidies. For the most part, municipal governments are also free to make decisions on the most efficient way to deliver public services without intervention from central authorities. In this context, local governments are not subject to uniform standards of services (unless they are delegated responsibilities financed by specific subsidies from the center), and local governments are not subject to expenditure or capacity norms or to minimum expenditure requirements.

In addition, each municipality has its own personnel services and has complete freedom to hire and fire. Municipalities are also completely free to contract with the private sector for the delivery of public services, and, in fact, many do so.

Nevertheless, several features of the current budget system limit municipalities' autonomy and discretion on both sides of the budget. These features include the following:

- *Local governments have no flexibility in setting wages.* Thus, even though they are free to hire and fire their employees, local governments cannot adapt to local labor market conditions.
- *Several important fees and charges for government services are still regulated by central authorities*. The budget consequences are particularly important in the case of housing—the highest expenditure item in municipal budgets—where the central government still controls rents.
- *Municipalities have, as has been analyzed in previous chapters, little autonomy over the revenue side of their budgets*.[116] In particular, municipalities have little discretion over the tax rates of meaningful tax instruments. This lack of tax autonomy undermines municipal government accountability to citizens.

Several other features of the current budget system limit the autonomy of local governments in less precise, although no less important, ways. One form of restriction is brought about by the current norms used in education, social assistance, and health, pertaining to workloads, average class size, and so forth. Municipal discretion is also reduced by the matching fund requirements in many subsidies and by the increasing importance of mandatory expenditures for social assistance. These latter forms of restriction on local autonomy are much harder to control, since in many ways they may be justified: for example, norms are needed to regulate the size of teacher payrolls in the education sector. Thus, there is a need to balance conflicting objectives without unduly sacrificing local autonomy.[117]

Budget Preparation, Predictability and Transparency

Several aspects of budget formulation practice at the local level contribute to the transparency of municipal budgets. Local governments are obliged by law to publish the draft budget. Legally, the budget structure for local governments is uniform and follows the structure used for all elements of the general government budget. The budget calendar is also uniform and follows the calendar year. The municipal budget and the new regional budgets as a rule need to be drafted as balanced budgets. A deficit is allowed only if it can be covered by accumulated financial assets or by loans, bonds, or financial aid.

Other aspects of budget formulation detract from the predictability and certainty of the budget process; however, these features are essential for planning and expenditure efficiency at the local level. Currently, budget formulation in the Czech Republic is strictly top-down. Central authorities basically determine unilaterally the amount of transfers and other resources that the state budget will allocate to the local budgets in a specific year, and local governments are not involved sufficiently in the derivation of the budget envelope for subnational governments. The introduction of organizations for coordination and dialogue between the different levels of government (discussed in Chapter 2) could alleviate this problem.

One difficulty affecting budget predictability at the local level is that the budget cycles of subnational governments and the central government are not synchronized. While local budgets are approved in November and December, the central government budget often may not be approved until well within the fiscal year. In the Czech Republic, this lack of synchronization is important because of the dependence of local governments on central government subsidies, transfers, and shared taxes. To date, local governments have coped with this uncertainty but it has nevertheless affected budget planning at the local level. Using formulas for the allocation of transfers and using stable rules for funding over the years should enable local governments to better cope with this situation.

However, the state and municipal budgets will continue to be sequentially linked. This will apply also to the state and the regional budgets. It is clear that regional budgets will not be formulated and approved until the state budget is approved. Because of this time dependency, it will be worth reconsidering the time periods allowed in the law for the formulation and approval of both the state budget and the local budgets. The obvious solution would be to advance in time the deadline for approval of the state budget and provide the regions and municipalities with more time for a realistic formulation of the budgets and for thorough discussion by the respective elected councils.

Another way of increasing predictability would be to widen the planning horizon for public expenditure programs. Although municipalities are only required to prepare annual budgets, it is recommended that they maintain multiyear projections for capital investment projects and loans. In particular, the Law on Budget Rules of Territorial Entities requires that municipal and regional governments produce a "budget overview" as a tool for medium-term financial planning and that they take into account all their contractual obligations. The budget overview must include data on revenues and expenditures and, especially, information on long-term obligations and outstanding debts, as well as financial resources. In addition, from 2001 the central government will be required to produce a medium-term budgetary outlook that will be prepared by the Ministry of Finance in cooperation, among other entities, with the territorial self-governments.[118] In the future, these requirements may be instrumental in introducing the concept of a simple medium-term expenditure framework for local governments. A more formalized medium-term budgetary framework should help local governments to better cope with the dynamic aspects of public expenditures. For example, given the significant decline in fertility in the country, it is likely that excess capacity will develop in primary education. At the very least, there should be an increase in local budget predictability as a result of the multiyear budget framework required for the state budget.

Another aspect of the budget process at the local level that adds to the overall uncertainty of municipal budgets is that local governments are allowed to offer guarantees to budgetary and nonbudgetary organizations and appear to do so quite often (Chapter 5). Little information exists as to what the actual financial exposure of local governments is in relation to these guarantees and to other contingent liabilities. Nevertheless, the overall stability of subnational budgets hinges upon reining in these practices, if not eliminating them entirely. Transparency in this area needs to be significantly improved.

Another factor contributing to local budget uncertainty is that budgeting for capital investment at the local level remains weak and there are no provisions for separate capital budgets. At the central government level, the process in support of local government investment is quite fragmented and often lacks transparency. For example, the lists of recipients and the amounts of funds granted by parliament have not been made public until recently, and the selection of local investment projects by the executive branch is often not transparent.

Local Budget Execution, Monitoring, and Reporting

The new Law on Budget Rules of Territorial Entities is sparse on the treatment of budget execution issues. Currently, no treasury function exists at the subnational level and consequently there is no comprehensive monitoring system for the performance of budget execution for local governments. While the recent reform of the budget system will introduce a single account approach at the central government level, there are no provisions in the Law on Budget Rules of Territorial Entities requiring local governments to adopt a similar approach.

Despite this relatively lax budget execution environment, the actual performance of local budgets has apparently displayed no major disruption. In particular, there has been, at least in recent years, no sequestering of the budget or reported significant development of budget arrears to suppliers or wage arrears to employees. Local governments are required to send the Ministry of Finance a monthly report on a uniform basis.[119] Although more in-depth research is needed, the level of overall operational efficiency seems reasonable, given the current level of budgetary discretion. The widespread use of public bids for the procurement of services may have contributed to keeping delivery costs reasonably in check and may have reduced the opportunities for corruption in the public sector.

As at the central level, most budget adjustments at the local level have been made through reductions in public investment. Although bureaucratically convenient, significant jumps or discontinuities in capital expenditure tend to be a less efficient way of cutting overall expenditures. It would be desirable for local governments to take a wider approach to budget adjustments and to prioritize expenditures by deciding on the desired outcomes in the preparation phase.

Accounting principles are uniform for all local governments and are dictated by law.[120] Nevertheless, incomplete accounting systems (lack of precise rules and instructions on how to apply them) remain one of the most serious problems at the local level. The current municipal accounts do not provide a full picture or a complete statement of the balance sheet of municipalities. In practice the implementation of the current accounting system can be weak, owing for the most part to the proliferation of very small municipalities with low administrative capacity. Although there is a uniform budget classification, interpretations of the accounts vary and budget items capture different information in different municipalities. One apparent reason for this is that municipalities do not have enough information on procedures. Another cause is the lack of skills of officials, especially in smaller municipalities.

To a large extent, the acceptable budget execution performance of many municipalities may be attributed to the oversight and assistance provided to them, until now, by the district offices, particularly in the case of the smaller municipalities. The phasing out of the district offices since the beginning of 2001 raises the important issue of whether the new regions will be willing to provide the same service, and whether they will be able to do so, given that the load or number of municipalities will be much higher per region. Moreover, at least at this initial stage, it is understood that there will be no hierarchical relationship among the self-governing entities, which would make regional oversight difficult. This is an important issue requiring the immediate attention of the government. One option, then, would be to find an acceptable means of making the regional governments responsible for oversight of and assistance to smaller municipalities in budget execution matters.

Control and Performance Evaluation

Municipalities are required to make public the budget outturns, although no standard format is required for this final accounting result. The law also requires that the budgets of all municipalities be audited annually. District offices have carried out the vast majority of the municipal external audits. However, private firms audit the budgets of some municipalities.[121] There are concerns over the quality and accuracy of the external audits of municipal accounts in part because the district offices have had to perform on average the audits for over 80 municipalities in a very short period of time.[122] There is some consensus among practitioners that the independent auditors tend to do a more thorough job. However, fewer municipalities used them because they can be costly, and the audit by the district office was free.

The 2000 Law on the Establishment of Regions (Act of Parliament No. 129/2000) requires an external ex post audit of the regional government accounts every year either by an independent auditor or by the Ministry of Finance.[123] In the case of the former, the regional government would have to pay for the cost of the audit. The Regional Assembly must discuss the results of the audit before June 30 of the following fiscal year. This puts budget oversight and audit at the regional level on the same footing as that of municipal governments.

External audits of municipalities have concentrated exclusively on financial and legal compliance. Thus, the focus of the evaluation has been on the use of inputs, budget resources, and compliance with rules rather than on the outputs, the outcomes, and the performance of local expenditure programs. These concerns also apply to the future audits of regional budgets.

Carrying out full-fledged performance audits at the local level is probably not feasible at the present time, especially for the smaller municipalities. However, *improving the efficiency* of public expenditures at the subnational level will require the introduction of budget evaluation programs in the near future, at least in Prague and the larger municipalities as well as at the new regional level.

Options for Reform

1. ***Increase budgetary autonomy.*** The realization of benefits from decentralization (that is, increasing the efficiency of public expenditures) is not possible without an adequate degree of budgetary autonomy. Although local governments in the Czech Republic enjoy some degree of budgetary autonomy, there are three specific areas in which policy changes will be needed. First, local budget autonomy will require that local governments are able to increase (or decrease) the size of their budgets, at least at the margin, by setting the tax rates for some meaningful taxes. Second, rent and tariff controls by central government agencies at the local level should be gradually lifted over time, with the proper regulatory arrangements in place. Third, local budget autonomy will also require that local governments have not only the discretion to use their resources according to their own priorities but also the freedom to deliver public services using the production techniques and combinations of inputs they consider most cost efficient.

2. ***Increase budget predictability.*** Budgetary predictability requires that local governments are able to prepare their budgets separately from the budget process of the central government. This means that local governments would be able to approve their budgets even when the central government failed to do so on time. For this to be the case, local governments must have certain and stable sources of financing. If some of the financing comes from the central government, as in the case of earmarked transfers, then predictability means that these transfers are determined by formula or other objective means, or that local governments have a different (lagged) budget schedule, or that local government budgets are amended once the exact level of transfers is known. Increasing the predictability of local budgets would also require that central government capital transfers are regrouped into a few well-defined sectoral programs and that more explicit and clearer guidelines are used for the eligibility of local governments. The new regions and large municipalities should be encouraged to adopt a more formalized medium-term budgetary framework, which should help local governments to better cope with dynamic aspects of public expenditures.

3. ***Increase budget transparency.*** Budgetary transparency can be improved by facilitating better use of the uniform budget classification at the local level. The Ministry of Finance should issue clear information and guidelines on procedures and should more effectively facilitate the training of local officials, especially in smaller municipalities. The new regional governments should be charged with assisting small municipal governments in budget preparation and execution, thus taking over the work carried out until now by the district offices. Accounting and reporting requirements should be enforced prior to attributing additional expenditure responsibilities to lower level governments.

4. ***Strengthen budget execution and internal control.*** Part of the solution to the problem of expenditure monitoring and control at the local level would be the adoption of a treasury function. The current reform at the central level, which adopts elements of a modern treasury function, such as a single account, should be extended to the new regional governments and to municipalities of at least a certain size. The advantages of adopting a modern treasury function at the local level are that it would strengthen internal expenditure control and would help with such aspects of budget execution as cash and debt management, accounting, and procurement.[124]

5. ***Strengthen oversight and audit over budget performance.*** It will be necessary to maintain and to strengthen the current financial audits for local governments, with an emphasis on financial and legal compliance. Although external private auditors are likely to produce better quality audits, it is unlikely that the smallest municipalities could afford private auditing companies. Thus, an important task for the new regions will be to improve on the audit services rendered to the municipalities in the past by the district offices. The regional governments may find it more efficient to contract out these services with private accounting firms. While capacity is not likely to be in place soon, there will be a need in the medium-term for a new kind of audit that focuses on the evaluation of budget performance (that is, on the outputs and outcomes from local expenditure programs). These evaluations may be carried out by the local governments themselves and discussed by local councils at the time of the presentation of the annual financial audits.

Matrix of Main Issues and Options/Recommendations

Matrix of Main Issues and Options/Recommendations

Issues	Main Findings	Options/Recommendations		Timing (*)
		Strategic Direction of Reforms	**Specific Policy Actions**	
I – Administrative Structure	**1. Increasing fragmentation** of municipalities, with most of them lacking adequate technical and financial capacities. **2. Lack of cooperation/association** among the small municipalities and insufficient outsourcing to improve efficiency in service delivery. 3. **Lack of decisionmaking power** of local governments (especially the small ones), because: (i) they are mostly executing "delegated" functions; and (ii) they are highly dependent on transfers. 4. **Unclear responsibilities** of the newly created regions because they are still pending on each area ministry decision. 5. **Risks of structural fiscal imbalances** because of indications that new regions' bureaucracies will be created afresh and expenditures will tend to increase. **6. Lack of a multilevel government coordination mechanism** to focus on the fiscal decentralization process.	**Sustain fiscal decentralization by attributing meaningful decisionmaking power to territorial self-governing units (regions and municipalities), and amalgamating the smallest municipalities to reasonable size (for example, smaller size boundary of 10,000 inhabitants).**	**a.** Consider formally **establishing a multilevel government coordinating body**, led by the central government, to spearhead the fiscal decentralization process. **b. Decentralize well defined spending functions to the newly created regions**, together with the commensurate source of resources. **c. Reverse the process of municipal fragmentation** by (i) providing stronger incentives to promote voluntary amalgamation of small communities into economically and financially viable municipalities; and (ii) adopting an approach of asymmetric assignment of revenue and expenditure responsibilities, and using the new regional self-governing administrative structure (and cooperation with the larger municipalities) as a tool to facilitate the amalgamation process.	Immediate Short-term Medium-term
II – Expenditure Responsibilities	**1. Weak coordination and cooperation** among different levels of government, although current assignment broadly conforms to general principles. **2. Significant disparities across jurisdictions** on per capita effective expenditures and "needs" (reflected in the variations in the economic basis and the social indicators). **3. Inability of small municipalities to reach an efficient service delivery.** 4. **Regulation of public utilities tariffs (for example, water and housing)** by the central government without considering total cost recovery basis.	**Clarify expenditure responsibilities per government tier and make local authorities fully accountable for policy results (in terms of effectiveness and efficiency of quality public service delivery).**	**a. Develop institutions for intergovernmental cooperation** and dialogue aiming to increase local public expenditure efficiency in areas of concurrent responsibilities. **b. Establish a broad-based commission to propose definition of the newly created regions' expenditure responsibilities.** **c. Transfer de facto capital expenditures responsibilities** to self-governing entities. **d. Amend the Budget Rules Law to *preempt* unfunded mandates.** **e. Gradually lift central government controls** on public utilities prices at the local level. **f. Scale back public provision of housing.** **g. Encourage private sector participation** in both financing and delivery of public services, by promoting gradual privatization also of education and health care.	Medium-term Immediate Medium-term Short-term Medium-term Short-term Short-term

Issues	Main Findings	Options/Recommendations		Timing (*)
		Strategic Direction of Reforms	Specific Policy Actions	
III – Revenue Assignments	**1.** Insignificant degree of **autonomy** of local authorities over revenue sources. **2**. Absence of an effective incentive mechanism to encourage **tax effort.** **3. Perverse incentives for tax-cutting competition** signaled by the allocation of unincorporated personal income tax (PIT) on a residence of taxpayer basis. **4.** Full **dependence of the new regional administration** on the state budget. **5.** Absence of an **economic rationale for the adopted coefficient** that adjusts the per capita tax-sharing pool distribution according to population size. **6.** Risk of further **discretionary changes** in revenue assignments (and on regulation affecting the intergovernmental fiscal relations in general).	**Boost local revenue autonomy to improve budget predictability and local authorities' accountability.**	**a.** Establish all structural parameters of intergovernmental fiscal relations policy in the **organic laws (such as Budget Rules Law), instead of annual budget laws**, in order to increase predictability for the local budgets. **b. Reassign PIT to restore tax-effort incentives and fairness on tax-sharing allocation** by (i) bringing the totality of unincorporated PIT into the shared tax pool; (ii) reducing the progressive rate of the "wage-tax" component of the PIT in a corresponding amount; and (iii) devolving to municipal authorities the right to impose a flat-rate (proportional) PIT local surcharge (piggybacking the national adjusted progressive PIT rate). **c.** Consider **assigning the newly created regions with** (i) **shared taxes** (commensurate with their responsibilities); (ii) **autonomous revenue sources**, including rural property and **surcharges that could piggyback** the rate of some national taxes (for example, a flat-rate PIT similar to that proposed to the municipalities). **d. Strengthen local revenue autonomy** by providing local governments with the instrument of market *value assessment of properties*, and help build local government tax administration capacity for this tax. **e. Review the adopted adjustment coefficient** for the tax-sharing distribution mechanism in order to introduce a clear economic rationale to it. Considering the convenience of a more transparent formula-based equalization transfer scheme separately.	

Issues	Main Findings	Options/Recommendations		Timing (*)
		Strategic Direction of Reforms	**Specific Policy Actions**	
IV – Fiscal Imbalances and the Transfer System	**1. Absence of a separate instrument to deal with fiscal disparities** across regions. **2. Vulnerable system of specific subsidies** because (i)it is too complex and unwieldy; (ii) there is too little de facto control; (iii) access depends on negotiation skills and political connections; (iv) there is little transparency on how it really works; (v) it has become an unstable source of local budget revenue; (vi) total allocation may be perceived as being intentionally reduced as local revenue increases **3.** Transfers from the EU pre-accession funds have not yet been positively used as conditional leverage to rationalize the fragmented municipality structure and to strengthen the fiscal decentralization policy.	**Rationalize the transfer system as an instrument to implement policies of national interest, to reduce regional disparities, and to help reverse the fragmentation process of municipalities.**	**a. Review the current system of specific transfers by** (i) decreasing the number of specific subsidies and *simplifying the system*; (ii) using explicit, transparent rules or *formulas for the allocation of grants*; (iii) carrying out systematic ex post *performance evaluation* of programs; (iv) prioritize programs and stabilize transfers within the context of central government *medium-term expenditure framework*, aiming at improving predictability for local budgets. **b. Consider establishing a separate "Fiscal Equalization Fund"** (independent of the tax-sharing mechanism) to specifically address regional fiscal disparities. **c. Consider reviewing the financial conditions for the matching funds** that the local governments have to contribute to access the EU pre-accession funds, aiming at increasing concessions to the smallest municipalities, but conditional to voluntary, economically efficient amalgamation.	Short-term Medium-term Medium-term

Issues	Main Findings	Options/Recommendations		Timing (*)
		Strategic Direction of Reforms	Specific Policy Actions	
V – Access to Borrowing	**1.** Official local debt (in the aggregate) is low, but the **"true" level of local government indebtedness is not transparent** because of contingent liabilities, off-budget operations, and diverse interpretations of the standard national chart of accounts. **2.** Municipalities can have free access to all forms of borrowing, but **access by small and medium-size municipalities is highly limited by their low creditworthiness** (owing to shortage of assets and lack of tax autonomy, as collateral). **3.** Because of **market failures** in the financial system, sole reliance on market discipline is unlikely to provide an adequate guarantee of orderly and responsible fiscal behavior. **4. Direct control** of local credit operations would undesirably increase central bureaucracy and would run against the decentralization process. **5. The Bankruptcy and Composition Act does not include municipalities** as a subject, causing credit to municipalities to be perceived as a high risk factor in the capital market. **6.** There is **no official monitoring or supervisory mechanism** in place for subnational government indebtedness that could help prevent irresponsible and destabilizing behavior constraints.	**Create the institutional framework and prudent rules to ensure fiscally responsible borrowing by subnational governments and to encourage competitive behavior and market discipline in the financial system in its dealings with self-governing units.**	**a. Consider formally regulating the municipal capital market**, by establishing basic parameters for the access of subnational governments, by (i) restricting medium and long term loans to **investment** projects only; (ii) limiting **debt to service ratio** for subnational governments to 0.1; (iii) limiting their **debt stock to revenue ratio** to 0.8. **b. Consider formally establishing prudent rules for the banking system** to operate with subnational governments by limiting bank portfolio exposition to local/ regional governments (individually) to certain maximum limits recommended by prudent banking rules. **c.** Approve and diligently implement a **bankruptcy law** which clearly defines debt workout procedures in case of municipal/ regional government default. **d.** Adopt a **"Law on Fiscal Responsibilities"** to curb excessive deficits and imprudent buildups of public debt, including municipal and regional public debt. **e. Support** institutions that promote **the dissemination of risk and credit rating analyses,** aiming at improving transparency and promoting market discipline. **f.** Establish an **official monitoring agency to keep records and to monitor** the overall development of the municipal/ regional capital market and indebtedness, including contingent liabilities. The database of such an institution should be publicly accessible.	Immediate Immediate Short-term Short-term Immediate Short-term

Issues	Main Findings	Options/Recommendations		Timing (*)
		Strategic Direction of Reforms	**Specific Policy Actions**	
VI – Local Budgeting	**1.** Local budget **predictability** is a major problem because (i) budget formulation is still a **top down process**; (ii) budget cycles in practice are **not synchronized.** **2.** Transparency of local budget execution may be affected because a **single account approach for the treasury is not yet mandatory.** **3.** Implementation of the standard accounting system seems to lack uniformity because of **diverse interpretation and coverage of budget items.** **4. External audits** have focused exclusively on financial and legal compliance and evaluation of program performance is absent. **5. Discontinuation of district offices** calls for urgent definition and the establishment of new external audit functions for the new regions as well as for municipalities.	**Increase the transparency and accountability of local budgets congruent with the objectives being pursued for the state budget in the areas of budget formulation, execution, and evaluation.**	**a. Upgrade skills of local officials** in the standard accounting system and control, especially for smaller municipalities. **b. Make implementation of a single account approach mandatory** for treasury operations in the self-governing units as well. **c. Expand the scope of the external audit** toward program performance evaluation, by focusing on output/outcomes besides the input content, and legal and procedural compliance. **d. Establish new external audit authorities for the new regions and municipalities**. **e. Synchronize the de facto budget cycles** (central and local/regional), boost cooperation on budget preparation among government levels, and encourage formulation of simplified multiyear expenditure frameworks for local/regional governments congruent with the central government MTEF.	Medium-term Medium-term Medium-term Short-term Medium-term

(*) Immediate = to be implemented in the next three months.
Short-term = to be implemented during the next budget cycle.
Medium-term = to be implemented during the next two budget cycles.

Statistical Appendix

Table 1 Structure of Government Operations in the Czech Republic, 1993–2000—Consolidated Budgets

	1993 (execution)			1994 (execution)			1995 (execution)			1996 (execution)	
Operation	Central[1] gov. bdgt	Local auth.	Gen. cons. bdgt	Central[1] gov. bdgt	Local auth.	Gen. cons. bdgt	Central[1] gov. bdgt	Local auth.	Gen. cons. bdgt	Central[1] gov. bdgt	Local auth.
	(in millions of CZK)										
Total revenue	354,764	91,908	446,672	392,042	112,241	504,283	448,347	130,041	578,388	470,612	163,831
Tax revenue	355,437	37,624	393,061	391,663	54,428	446,091	443,036	68,167	511,203	498,880	70,000
Direct tax	73,174	31,639	104,813	71,517	52,695	124,212	75,044	67,056	142,100	81,253	68,982
Corporate profit tax	70,880	0	70,880	63,624	128	63,752	63,337	3,145	66,482	47,670	14,139
Personal income tax	1,509	28,198	29,707	5,804	48,716	54,520	8,491	60,096	68,587	29,726	50,818
Property taxes	785	3,441	4,226	2,089	3,851	5,940	3,216	3,815	7,031	3,857	4,025
Indirect tax	132,257	0	132,257	149,568	0	149,568	168,861	0	168,861	190,159	0
VAT	77,104	0	77,104	85,849	0	85,849	94,801	0	94,801	109,313	0
Excises	39,983	0	39,983	46,360	0	46,360	56,650	0	56,650	61,170	0
Customs duties	15,170	0	15,170	17,359	0	17,359	17,410	0	17,410	19,676	0
Social insurance contrib.	132,073	0	132,073	162,302	0	162,302	192,455	0	192,455	222,204	0
Other budgetary tax revenue	17,933	5,985	23,918	8,276	1,733	10,009	6,676	1,111	7,787	5,264	1,018
Non-tax revenue	27,015	18,584	45,599	31,259	20,633	51,892	39,964	21,746	61,710	32,979	24,324
Enterpreneurial & prop.income[2]	11,342	1,103	12,445	8,853	2,333	11,186	11,035	2,241	13,276	10,417	2,911
Fees and fines	11,197	13,368	24,565	12,101	15,416	27,517	18,472	16,197	34,669	13,889	18,163
Other	4,476	4,113	8,589	10,305	2,884	13,189	10,457	3,308	13,765	8,673	3,250
Capital revenue	161	7,851	8,012	100	6,200	6,300	150	5,325	5,475	257	8,003
o/w privatization	161	5,915	6,076	73	5,411	5,484	23	4,594	4,617	185	7,452
Transfers (grants)	-27,849	27,849	0	-30,980	30,980	0	-34,803	34,803	0	-61,504	61,504
From other government level	-27,849	27,849	0	-30,980	30,980	0	-34,803	34,803	0	-61,504	61,504
Other[3]	0	0	0	0	0	0	0	0	0	0	0
Total expenditure & net lending	330,434	89,648	420,082	382,909	112,112	495,021	441,241	132,314	573,555	467,609	171,112
Total expenditure	353,053	89,648	442,701	407,624	111,040	518,664	462,109	131,796	593,905	490,744	169,747
Current expenditure	321,582	58,028	379,610	365,599	69,696	435,295	414,408	81,459	495,867	442,194	117,701
Expenditure on goods & services	87,271	39,580	126,851	85,978	44,395	130,373	73,827	49,554	123,381	81,957	57,349
Wages & salaries	30,381	6,720	37,101	41,445	7,118	48,563	41,748	8,497	50,245	46,795	10,578
Employer contributions		2,419	n.a.		2,610	n.a.	-3,197	3,197		-4,019	4,019
Other purchases of goods & services	59,309	30,441	89,750	47,143	34,667	81,810	35,276	37,860	73,136	39,181	42,752
	0			0		0	0			0	
Interest payments	17,739	0	17,739	15,030	394	15,424	15,366	1,196	16,562	14,650	1,620
	0			0			0			0	
Subsidies & other current transfers	216,572	18,448	235,020	264,591	24,907	289,498	325,215	30,709	355,924	345,587	58,732
To other central government		0	n.a.	0	0		0	0		0	0
Subsidies	49,349	15,499	64,848	62,226	20,894	83,120	89,526	24,538	114,064	98,398	27,080
To nonfinancial public enterprises & departmental enterprises	48,349	15,499	63,848	53,478	20,894	74,372	72,320	24,181	96,501	77,131	26,767
To Financial Institutions	1,000		1,000	2,625		2,625	4,990		4,990	3,516	
To other enterprises	0		0	6,123		6,123	12,216	357	12,573	17,751	313
Transfers to other levels of national government		0	n.a.	0	0		0	0		-2	2
To households & nonprofit institutions	166,608	2,949	169,557	201,556	4,013	205,569	235,134	6,171	241,305	246,567	31,650
Abroad	615	0	615	809	0	809	555	0	555	624	0
	0			0			0			0	
Capital expenditure	31,471	31,620	63,091	42,025	41,344	83,369	47,701	50,337	98,038	48,550	52,046
Fixed capital assets, stocks, land	14,055	25,516	39,571	21,347	32,914	54,261	22,334	41,197	63,531	25,540	43,657
	0			0			0			0	
Capital transfers	17,416	6,104	23,520	20,678	8,430	29,108	25,367	9,140	34,507	23,010	8,389
Domestic	17,416	6,104	23,520	20,678	8,430	29,108	25,367	9,140	34,507	23,010	8,389
To other central government		0	n.a	0	0		0	0		0	
To other levels of national government			n.a	0					n.a.		
To nonfinancial public enterprises	5,378	6,104	11,482	5,635	8,430	14,065	2,034	6,718	8,752	1,812	4,091
To financial institutions	0		0	0		0	0		0	0	
Other	0	0	0	352	0	352	1,291	2,422	3,713	3,014	4,298
Abroad	0		0	0		0	0		0	0	
	0			0			0			0	
Lending minus repayments	-22,619	0	-22,619	-24,715	1,072	-23,643	-20,868	518	-20,350	-23,135	1,365
Bal.incl.privatization receipts	24,330	2,260	26,590	9,133	129	9,262	7,106	-2,273	4,833	3,003	-7,281
Bal.excl. privatization revenue	24,169	-3,655	20,514	9,060	-5,282	3,778	7,083	-6,867	216	2,818	-14,733
Bal.excl.priv.rec.&Grants Tr.Inst.	24,169	-3,655	20,514	9,060	-5,282	3,778	7,083	-6,867	216	2,818	-14,733
Memo item:											
Grants to transf. institutions											
Nominal GDP	1,002,300	1,002,300	1,002,300	1,182,700	1,182,700	1,182,700	1,381,100	1,381,100	1,381,100	1,572,300	1,572,300

Table 1 (continued)

	1997 (execution)			1998 (execution)			1999 (preliminary)			2000 (estimate)		
Operation	Central[1] gov. bdgt	Local auth.	Gen. cons. bdgt	Central[1] gov. bdgt	Local auth.	Gen. cons. bdgt	Central[1] gov. bdgt	Local auth.	Gen. cons. bdgt	Central[1] gov. bdgt	Local auth.	Gen. cons. bdgt
					(in millions of CZK)							
Total revenue	516,788	145,342	662,130	548,814	157,178	705,992	573,252	187,700	760,952	600,040	175,700	775,740
Tax revenue	531,641	76,091	607,732	566,221	83,319	649,540	595,031	87,011	682,042	622,455	90,900	713,355
Direct tax	80,535	71,808	152,343	93,913	78,922	172,835	93,391	83,099	176,490	92,100	86,600	178,700
Corporate profit tax	42,202	13,361	55,563	51,324	16,232	67,556	51,343	18,773	70,116	51,300	19,800	71,100
Personal income tax	33,378	54,503	87,881	36,339	58,581	94,920	35,224	60,078	95,302	33,900	62,500	96,400
Property taxes	4,955	3,944	8,899	6,250	4,109	10,359	6,824	4,248	11,072	6,900	4,300	11,200
Indirect tax	196,758	1	196,759	200,817	1	200,818	223,523	0	223,523	241,500	0	241,500
VAT	117,656	0	117,656	119,395	0	119,395	138,330	0	138,330	153,600	0	153,600
Excises	64,171	1	64,172	67,801	1	67,802	73,143	0	73,143	75,100	0	75,100
Customs duties	14,931	0	14,931	13,621	0	13,621	12,050	0	12,050	12,800	0	12,800
Social insurance contrib.	246,755	0	246,755	264,401	0	264,401	270,623	0	270,623	281,880	0	281,880
Other budgetary tax revenue	7,593	4,282	11,875	7,090	4,396	11,486	7,494	3,912	11,406	6,975	4,300	11,275
Non-tax revenue	20,572	24,678	45,250	19,681	26,991	46,672	19,100	28,649	47,749	17,130	30,722	47,851
Enterpreneurial & prop.income[2]	10,109	5,938	16,047	9,384	7,656	17,040	6,343	7,719	14,062	0	0	0
Fees and fines	7,273	15,487	22,760	6,005	16,974	22,979	9,105	18,319	27,424	0	0	0
Other	3,190	3,253	6,443	4,292	2,361	6,653	3,652	2,611	6,263	0	0	0
Capital revenue	369	8,701	9,070	260	9,475	9,735	281	30,603	30,884	533	14,000	14,533
o/w privatization	319	5,833	6,152	226	6,783	7,009	184	5,774	5,958	0	0	0
Transfers (grants)	-35,794	35,872	78	-37,348	37,393	45	-41,160	41,437	277	-40,078	40,078	0
From other government level	-35,839	35,839	0	-37,355	37,355	0	-41,374	41,374	0	-40,078	40,078	0
Other[3]	45	33	78	7	38	45	214	63	277	0	0	0
Total expenditure & net lending	531,860	150,109	681,969	577,706	155,723	733,429	602,123	169,214	771,337	863,600	185,500	1,049,100
Total expenditure	547,065	150,505	697,570	590,598	158,020	748,618	617,593	173,043	790,636	856,167	185,500	1,041,667
Current expenditure	505,389	99,657	605,046	548,378	106,067	654,445	568,978	118,675	687,653	787,314	126,000	913,314
Expenditure on goods & services	75,275	61,172	136,447	80,129	66,548	146,677	83,475	72,875	156,350	124,505	82,600	207,105
Wages & salaries	49,252	13,013	62,265	48,860	13,778	62,638	54,003	15,466	69,469	55,054	16,300	71,354
Employer contributions	-4,350	4,376	26	-4,494	4,542	48	-5,137	5,190	53	18,989	5,705	24,694
Other purchases of goods & services	30,373	43,783	74,156	35,763	48,228	83,991	34,609	52,219	86,828	50,462	60,595	111,057
	0			0			0			0		
Interest payments	18,351	2,407	20,758	18,982	2,335	21,317	17,065	2,275	19,340	18,003	2,400	20,403
	0			0			0			0		
Subsidies & other current transfers	411,763	36,078	447,841	449,267	37,184	486,451	468,438	43,525	511,963	644,807	41,000	685,807
To other central government	0	0		0	0		0	0		48,388		48,388
Subsidies	102,287	27,139	129,426	111,867	27,309	139,176	108,147	30,979	139,126	179,584	29,700	209,284
departmental enterprises	62,782	18,004	80,786	64,071	18,024	82,095	74,238	19,474	93,712	0		
To Financial Institutions	17,586	2	17,588	27,110	42	27,152	10,015	1,291	11,306	67,853		67,853
To other enterprises	21,919	9,133	31,052	20,686	9,243	29,929	23,894	10,214	34,108	111,731	29,700	141,431
Transfers to other levels of national government	-1,355	1,355		-876	876		-819	819		28,816		28,816
To households & nonprofit institutions	309,226	7,583	316,809	336,566	8,996	345,562	358,708	11,723	370,431	385,159	11,300	396,459
Abroad	1,605	1	1,606	1,710	3	1,713	2,402	4	2,406	2,860		2,860
	0			0			0			0		
Capital expenditure	41,676	50,848	92,524	42,220	51,953	94,173	48,615	54,368	102,983	68,852	59,500	128,352
Fixed capital assets, stocks, land	17,259	43,514	60,773	17,454	42,765	60,219	20,619	45,647	66,266	29,246	47,900	77,146
	0			0			0			0		
Capital transfers	24,417	7,334	31,751	24,766	9,188	33,954	27,996	8,721	36,717	39,607	11,600	51,207
Domestic	24,417	7,334	31,751	24,766	9,188	33,954	27,996	8,721	36,717	39,607	11,600	51,207
To other central government	0	0		0	0		0	0		0		0
To other levels of national government	-16	16		0	0		0	0		11,262		11,262
To nonfinancial public enterprises	18,268	3,888	22,156	17,470	4,320	21,790	18,900	5,086	23,986	28,345	11,600	39,945
To financial institutions	58		58	0		0	0		0	0		
Other	6,107	3,430	9,537	7,296	4,868	12,164	9,096	3,635	12,731	0		
Abroad	0		0	0		0	0		0	0		0
	0			0			0			0		
Lending minus repayments	-15,205	-396	-15,601	-12,892	-2,297	-15,189	-15,470	-3,829	-19,299	-47,436	0	-47,436
Bal.incl.privatization receipts	-15,072	-4,767	-19,839	-28,892	1,455	-27,437	-28,871	18,486	-10,385	-325,801	-9,800	-317,201
Bal.excl. privatization revenue	-15,391	-10,600	-25,991	-29,118	-5,328	-34,446	-29,055	12,712	-16,343	-325,801	-9,800	-317,201
Bal.excl.priv.rec.&Grants Tr.Inst.	-15,391	-10,600	-25,991	-29,118	-5,328	-34,446	-29,055	12,712	-16,343	-325,801	-9,800	-317,201
Memo item:												
Grants to transf. institutions												
Nominal GDP	1,668,800	1,668,800	1,668,800	1,798,300	1,798,300	1,798,300	1,836,300	1,836,300	1,836,300	1,895,000	1,895,000	1,895,000

1. Consolidated State Budget = State budget + Social Security Budget + Central Extrabudgetary Funds (State Financial Assets and Liab. Account, National Property Fund, Czech Land Fund, Health Insurance Fund). In 2000 and 2001 it also includes State Transportation Fund and State Housing Fund.
2. Includes interest and subsidies from orgon.
3. In the year 2000 includes a transfer of "privatization funds" (CZK 45523 million) from the "National Property Fund" to the "Central Government Budget."
Sources: Ministry of Finance; World Bank Staff.

Table 2a Czech Republic: Per Capita Expenditure for Municipalities Aggregate at the District Level, 1997

District[1] Expenditure (CZK/per capita)	Agriculture and Forestry	Industry, Construction, Trade and Services	Transportation	Water Industry	Telecommunications	General Issues and Other Economic Functions	Education[2]	Culture, Churches, and Media	Sports and Leisure Activities	Health care	Housing, Communal Services, and Territorial Development	Environment Protection	Social Assistance and Benefits	Employment Policy	Social Care and Assistance and Common Activities in Social Security and Pension Insurance	Civic Emergency Planning	Security and Public Order	State Administration, Territ. Self-Governments, Political Parties	Other Public Services and Activities	Financial Operations	Other Activities	Total Expenditure
Mean	85	86	1214	979	10	2	1442	590	262	116	2769	624	398	1	435	41	233	1930	9	224	190	11639
Minimum	1	1	324	85	0	0	568	78	25	0	814	88	74	0	5	0	55	583	0	0	0	3540
Maximum	475	594	9401	2704	103	61	8586	4054	1937	795	15790	2909	4575	14	2265	364	2367	7891	158	2016	1400	57801
Coef of Var	0.97	1.14	1.17	0.63	2.02	4.36	0.61	0.81	0.95	1.37	0.65	0.58	1.31	4.46	0.92	1.60	1.46	0.44	2.85	1.34	1.09	0.56

Table 2b Czech Republic: Per Capita Expenditure for Municipalities Aggregate at the District Level, 1998

District Expenditure[1] (CZK/per capita)	Agriculture and Forestry	Industry, Construction, Trade and Services	Transportation	Water Industry	Telecommunications	General Issues and Other Economic Functions	Education[2]	Culture, Churches, and Media	Sports and Leisure Activities	Health care	Housing, Communal Services, and Territorial Development	Environment Protection	Social Assistance and Benefits	Employment Policy	Social Care and Assistance and Common Activities in Social Security and Pension Insurance	Civic Emergency Planning	Security and Public Order	State Administration, Territ. Self-Governments, Political Parties	Other Public Services and Activities	Financial Operations	Other Activities	Total Expenditure
Mean	93	71	1375	889	11	3	1,463	612	299	105	3077	621	592	2	481	19	246	1909	5	235	248	12357
Minimum	0	1	369	89	0	0	466	123	45	0	1160	162	101	0	6	0	45	529	-2	0	1	4698
Maximum	595	311	10548	3216	94	114	7,806	3290	2186	571	17076	3699	6294	46	2791	574	2282	10453	99	1416	2644	62359
Coef of Var	0.98	0.97	1.08	0.66	2.10	4.81	1	0.67	0.94	1.14	0.63	0.67	1.20	3.46	1.03	3.69	1.30	0.59	2.97	0.99	1.50	0.56

Table 2c Czech Republic: Per Capita Expenditure for Municipalities Aggregate at the District Level, 1999

District Expenditure[1] (CZK/per capita)	Agriculture and Forestry	Industry, Construction, Trade and Services	Transportation	Water Industry	Telecommunications	General Issues and Other Economic Functions	Education[2]	Culture, Churches, and Media	Sports and Leisure Activities	Health care	Housing, Communal Services, and Territorial Development	Environment Protection	Social Assistance and Benefits	Employment Policy	Social Care and Assistance and Common Activities in Social Security and Pension Insurance	Civic Emergency Planning	Security and Public Order	State Administration, Territ. Self-Governments, Political Parties	Other Public Services and Activities	Financial Operations	Other Activities	Total Expenditure
Mean	98	78	1448	994	6	2	1536	636	346	129	3234	720	852	4	471	5	179	108	2102	7	399	13655
Minimum	1	1	445	82	0	0	405	179	50	0	1050	207	164	0	11	0	3	22	547	0	25	4749
Maximum	510	419	9954	3694	78	49	7798	3264	3138	700	22353	4446	9181	85	2987	64	2352	1007	12196	176	3651	75335
Coef of Var	0.91	0.94	1.09	0.65	2.21	4.09	0.54	0.68	1.04	1.13	0.76	0.69	1.22	2.93	1.09	2.23	1.59	1.20	0.62	3.23	1.28	0.60

Table 2d Czech Republic: Coefficient of Variation of Per Capita Expenditure for Municipalities Aggregate at the District Level, 1997-99

	Agriculture	Ind,Tr,Sv.	Transportation	Water	Telecommunications	Oth.Ec.Fc.	Education	Cult,Rel,Md.	Sport & Leisure	Health care	Housing	Environment	Social Assistance	Employment	Social Security & Pension	Civic Emergency	Sec&Pb.Order	State Administration	Other Pub.Services	Financ.Op.	Others	Total Expenditure
CV97	0.97	1.14	1.17	0.63	2.02	4.36	0.61	0.81	0.95	1.37	0.65	0.58	1.31	4.46	0.92	1.60	1.46	0.44	2.85	1.34	1.09	0.56
CV98	0.98	0.97	1.08	0.66	2.10	4.81	1.00	0.67	0.94	1.14	0.63	0.67	1.20	3.46	1.03	3.69	1.30	0.59	2.97	0.99	1.50	0.56
CV99	0.91	0.94	1.09	0.65	2.21	4.09	0.54	0.68	1.04	1.13	0.76	0.69	1.22	2.93	1.09	2.23	1.59	1.20	0.62	3.23	1.28	0.60
AV.CV(97-99)	0.95	1.02	1.11	0.65	2.11	4.42	0.72	0.72	0.98	1.21	0.68	0.65	1.24	3.62	1.01	2.51	1.45	0.74	2.15	1.85	1.29	0.57

1. Since only three among all 75 districts have defense expenditure, this category has not been included.

2. The column "Education" is added from two "Education" categories, No. 31 and No.32 in the original data.

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Notes

1. The reported share of local governments in total expenditures can be a misleading indicator, as is the case with any single dimension indicator, of the true degree of decentralization across countries. A higher share of local expenditures does not necessarily mean that there is more expenditure or revenue autonomy at the local level.

2. Like Hungary and Poland, the Czech Republic initiated reforms of its intergovernmental system in the first half of 1990s, but their implementation lagged behind until recently. Like the Slovak Republic, a major decentralization effort did not take place until the late 1990s and early 2000 in the Czech Republic with the creation of intermediate level governments (the regions), consistent with aspirations to EU accession. In terms of local expenditure share in public expenditure, the Czech Republic is still less decentralized than Hungary and Poland, but significantly more decentralized than the Slovak Republic (with about 7 percent—not shown in Figure 1).

3. In the Czech Republic, local government includes both municipalities and district offices, the latter representing the state deconcentrated territorial administration. See Chapter 1 for a separate analysis of municipalities.

4. The concept of *geographic* regions was first introduced by Law 347/97. However, regions as *self-governing entities* only became a reality in January 1, 2001, after Act No. 129/2000 was approved and the elections for the regions' representatives took place in November 2000.

5. Including Act No. 129/2000 on the New Territorial State Administration and Establishment of the Regions, Act No. 243/2000 on Tax Assignment, Act No. 250/2000 on the Local Budget Rules, Act No. 218/2000 on the State Budget Rules, and Act No. 104/2000 on the Establishment of the Extrabudgetary State Transport Infrastructure Fund.

6. Since this adjustment coefficient depends on only one factor (population), it is easy to compute, but the approach may be considered unfair because it ignores other factors (such as tax effort and poverty indicators).

7. However, the most important sources of capital financing for municipalities are own revenue and loans.

8. Constitution, Art. 1.

9. Constitution, Arts. 99 through 105. Art. 101 establishes "self-governing territorial divisions" as public-law entities with *own property rights*, operating according to their own independent budgets. The state may intervene in activities of self-governing territorial divisions only in accordance with and to protect the law.

10. Some nonmembers of the Municipal Council may be chosen to participate in special committees.

11. A statutory town may also be divided into town districts, and the head of a statutory town is the Lord Mayor.

12. The downside of municipality fragmentation (lack of administrative capacity, lack of fiscal resources, and lack of realization of scale economies) should be weighted against the good result of increased political accountability. Smallness of communities and the proximity of voters to decisionmakers facilitate the satisfaction of local preferences at the same time that they increase representation and political accountability (see also Chapter 2.)

13. The *geographic and statistical* concepts of these regions were established by Act of Parliament No. 347/97 (see footnote 4).

14. Constitution, Art. 99.

15. In accordance with the Czech Republic's formal commitments for the implementation of the *Acquis Communautaire*. The EU pre-accession funds for the Czech Republic are disbursed by three programs: the PHARE programs for institution building; the ISPA programs for environment and transport; and the SAPARD for agriculture and rural development (Chapter 4).

16. The first elections for the Regional Assemblies' representatives were held on November 12, 2000, together with the election for one-third of the Senate.

17. These new regions coincide geographically with the NUTS III regional classification of the Territorial Units Statistical Nomenclature adopted by the EU as a criterion for grant allocation. NUTS III regions are subdivisions of the EU "basic administrative units" (that is, the eight NUTS II regions of the Czech Republic, which are Prague, Central-Bohemia, South-West, North-West, North-East, South-East, Central Moravia, and Ostrava).

18. Administrative and financial incentives for matching funds to EU pre-accession funds could be used in combination as suggested in Chapter 3.

19. This kind of incentive should explicitly represent a redistribution of the tax-sharing poll. A small reduction of the shares in the upper end (the municipalities situated in the highest two or three brackets) could have a large impact on the middle and lower range of the present tax-sharing distribution (the municipalities between 1,500 and 10,000 inhabitants). The 2000 tax-sharing reform approved by parliament actually started providing some of these incentives, but should go further (Chapters 3 and 4). Also, for macroeconomic reasons, it is important that the reform should be deficit-neutral. The premise of a hard budget constraint is essential in order to avoid morally hazardous behavior and to keep the reform sustainable.

20. New Municipal Act of Parliament No.128/2000; OECD (2000); Kamenickova (1999).

21. District offices can suspend municipalities' decisions, which can be overturned only by parliament or the courts.

22. Given the elimination of district offices in the near future, it is not yet clear whether the central administration would delegate the oversight of the municipalities' performance responsibilities to the regions.

23. These types of services are more affordable and more common among larger municipalities.

24. In addition to the district offices, many line ministries have their own regional offices (Chapter 1). In the case of education, there are School Board Offices in all 86 school districts directly subordinate to the Ministry of Education. These offices are in charge of supervising the operation of the basic schools run by the municipalities and the allocation of central government funds for teacher salaries. The School Boards are also in charge of maintaining the network of upper secondary schools.

25. At present, the districts have responsibility for over 1,000 institutions including hospitals, home care facilities, libraries, museums, and so on. By 2003, all these institutions should have been transferred to the new regional governments or to the municipalities.

26. The municipalities in this group would be chosen according to population size and by geographical location—for example, surrounded by other smaller municipalities at a distance not greater than 30 kilometers. (Note, however, that "designated" municipalities should be of at least 10,000–15,000 inhabitants). The fate of some line ministry offices has not been decided. In the case of the Ministry of Education, the School Board Offices will probably be replaced by the new regional governments' education departments, which will be part of the regional government and no longer subordinate to the Ministry of Education.

27. Hích and Larischová (1999).

28. Act of Parliament No. 129/2000, Articles 14, 29, 35, 36, and 59.

29. The strategy is to follow a two-step process. In the first phase, during 2001, the line ministries will decentralize implementation responsibilities to the new regions. In the second phase, during 2002, some decisions about responsibilities of the disappearing districts may be shifted to the regions and the rest to the municipalities.

30. Usually, central administrations are highly protective of their sphere of power and reluctant to give up a part of their budgets.

31. This passes on to the new regions the difficult decision on what schools to close or consolidate because of shifting demographics. The possible moral hazard of opening schools and passing up the teacher costs to the central government will apparently be controlled—as in the case of basic education—by the use of transfer mechanisms, including, for example, teacher salaries derived on a per student accommodated basis.

32. Unlike the case of basic education, the central government does not pay for textbooks at the secondary level and the students have to buy them.

33. An important reason for this indebtedness is that hospitals are not being paid on a timely basis by the insurance companies. The new regions will also be facing the difficult decision of closing and consolidating tertiary health facilities.

34. World Bank (1999a). Table 6.8.

35. One factor affecting this pattern is the discretionary earmarked capital transfers and loan subsidies from the central government (Chapter 4).

36. See footnotes in Tables 2.3 and 2.4.

37. In addition to the proceeds from privatization, in 1999 the local governments also received a substantial amount of money by selling out voting rights of their shares of electricity companies. Some of these extraordinary receipts were used for paying debt, some were used for new investments (with a reflection in 2000), and some were kept as financial assets.

38. Karel and Vajdova (2000). with provisional data for 1995 from *Moderni obec* (*Modern Municipality*) (1996), Prague.

39. Czech Statistical Office (1996).

40. The uniformity in provision standards is attributed to the concurrent central government funding of education and the uniform standards imposed on local governments throughout the country.

41. Czech Statistical Office (1999). Regional variation in GDP per capita was higher in the Czech Republic than in most other countries in Central Europe including the Baltics. These differences also increased from 1993 to 1996. But, as mentioned, most of this variation is directly related to the fact that Prague has done so much better than the rest of the country.

42. Some regions have historically had a weaker economic base as in the case of Jihlava and Olomuc Regions. More recently, others have been negatively affected by the economic restructuring of heavy industry leading to significantly higher unemployment, as has been the case of Ustí nad Labem and Ostrava.

43. See Ministry of Regional Development (2000).

44. Czech Statistical Office (1998).

45. See subsection on “Unfunded Mandates” below.

46. Possible side effects of the asymmetric assignment of fiscal responsibilities to municipalities include (1) increasing differences in the political influence of the local governments in national policy; and (2) affecting the relative economic capacity of the less endowed local governments to provide public services.

47. Kamenickova (1999).

48. For example, in the case of education, the municipality in which the child actually resides pays the other municipality for a share of the school costs.

49. World Bank (1999a), Chapter IV.

50. Private companies that provide the same services for a number of municipalities can realize economies of scale in the delivery of services. These cost savings may be passed on to the municipal budgets if there is an adequate level of competition among potential providers.

51. The Czech Republic passed a Procurement Act in 1994, which applies to all public entities including local governments.

52. World Bank (2000), Chapter VII.

53. Subsidies for capital infrastructure are discussed in Chapter 4.

54. Early on in the transition, the Union of Municipalities did not help itself in gaining a seat at the table of policymaking because there were significant differences of opinion among municipalities and often open disagreement between larger and smaller municipalities.

55. Actually, Article 105 of the Constitution requires a law for the delegation of state responsibilities to local self-governments.

56. Kamenickova (1999).

57. “Wage tax” in this case should be understood as “income tax” withholdings on the wage bill. Actually, a payroll tax does not exist in Czech Republic since its abolition in 1993.

58. Law no. 338/92 Coll. (latest amendment no. 248/1995 Coll.) regulates the “real estate tax” on land and buildings.

59. Actually, the competition has taken place not through reductions in the PIT tax rate, which are outside the legal powers of the municipalities, but through the granting of incentives such as free land, local taxes, and other subsidies. The current legislation allows the entrepreneur to pay the tax where the entrepreneur resides independently of where the economic activity actually takes place.

60. It certainly is less necessary to implement redistribution at the local level. Localities with many high-income taxpayers already have a higher tax base and are less in need of increased resources.

61. Social security contributions are levied on the wage bill and self-employed incomes. They are levied at a rate of 13.5 percent for health insurance and 34 percent for the other social security items. The health care component of these contributions goes to the extrabudgetary Health Insurance Fund; the rest remains in the state budget to cover pension, sickness benefit, and employment policy expenditures.

62. The wage taxes collected from the largest municipalities (Prague, Ostrava, Brno, and Plzen) are shared between the municipality (70 percent) and the central government (30 percent). The wage taxes collected in the other municipalities have been distributed as follows: 40 percent to the state, 30 percent to the municipalities *(derivation basis)*, and 30 percent to the district offices (*derivation basis*). Thirty (30) percent of the latter has been distributed as follows: *10 percent also on a derivation basis*, and the remaining *20 percent according to the size of the population* of each municipality in the district. The *effective* share of the local governments has been more than 47 percent of the wage tax (OECD, Eco/wkp (2000) 18, working papers no. 245, 2000).

63. From 3.7 percent in 1993 to 2.4 percent in 2000, which corresponded to only 0.2 percent of GDP, compared to the 2 percent average of the OECD countries (OECD 2000).

64. Including tax and non-tax current revenues, capital revenues, and transfers from both the state budget and state funds.

65. The real estate tax collection fell from 0.3 percent of GDP in the first period to 0.2 in the second.

66. See “Intergovernmental Finance in Hungary: Continuous Progress, Continuous Change and Options for Reform,” unpublished World Bank note (Draft May 7, 1999b), and OECD (1999).

67. Act No. 129/2000 on the New Territorial State Administration and Establishment of the Regions, Act No. 243/2000 on Tax Assignment, Act No. 250/2000 on the Local Budget Rules, Act No. 218/2000 on the State Budget Rules, and Act No. 104/2000 on the Establishment of the Extrabudgetary State Transport Infrastructure Fund.

68. An adjustment coefficient structure is intended to correct for population distribution by a total average public service cost element, which is supposed to be higher for larger cities. The adopted adjustment coefficient (see Table 1.2) tends to favor larger municipalities, by replicating, to a certain extent, the previous system’s effective shared-tax distribution by bracket-size of municipalities. With exceptions for the extremes of the size distribution, Prague’s share was slightly reduced, while the shares of municipalities with populations below 1,500 increased (with the exception of municipalities of less than 100 population).

69. These imbalances were more obvious in the higher buoyancy coefficient of the personal income tax (which had been assigned to local governments) with respect to GDP, in comparison to the buoyancy coefficient of other tax revenues, such as the VAT and the corporate income tax (which had been retained by the central government) (see Table 3.1). To some extent, the perceived vertical imbalances may also have developed as a result of the higher income

elasticity of delegated and other local expenditures that are still largely financed from the center (such as teachers' salaries, other education expenditures, and social assistance).

70. With the exception of 20 percent of the PIT wage tax that is redistributed by the District Assembly in accordance with the size of the municipal population in the district.

71. Another potential advantage of the new tax sharing system is that by not pooling the entire state tax revenues, but rather reserving some leeway for implementing discretionary fiscal policy, the government will still have the required flexibility to pursue macroeconomic stabilization objectives.

72. Although 30 percent of the income tax on the self-employed now remains in the municipality in which the taxpayer resides, this is an inadequate incentive to promote local tax effort. An equalization transfer mechanism (see Chapter 4) will be considered more seriously if a significant degree of tax autonomy is introduced. This is because an effective encouragement of local tax effort would require that the tax proceeds remain where the economic activity that generates them takes place.

73. The formula for obtaining the adjusted shares (Si) for each municipality out of the pool of shared taxes is the following: $Si = P \times A$, where P stands for the size of the tax-sharing pool and A for the *distribution* coefficient. In this case P = (tax collection of the taxes entering the pool, that is, VAT, CIT, and PIT) x (.2059), and $A = (mi/Z) \times C$, where mi represents the population of municipality i, Z is the country population, and C is the approved *per capita* adjustment coefficient. For the approved coefficient (see Table 1.2) it is true that the cost of some services may increase with urban congestion in larger cities, for example, roads and bridges (as the adopted adjustment coefficient structure seems to imply). However, it is also true that the cost of other services, such as school transportation and heating, may increase with the lower density of rural areas and small towns.

74. A separate issue related to the past, but which may also affect the credibility of the new system, is the need to work out compensatory mechanisms for those municipalities that were already engaged in capital investment projects based on previously planned revenue streams, and on which the 2000 reform may have inflicted a loss.

75. In the presence of asymmetric expenditure arrangements, as proposed in this report, the resources to be assigned to regional and municipal governments should be adequately balanced.

76. As a rule, the Annual Budget Laws should be stripped of matters strange to the *annual* "estimation of revenue" and "determination of expenditure limits." Those matters should be addressed by the proper organic or specific laws.

77. An effort should be made to achieve a fiscal neutral result, in terms of overall tax burden and in terms of overall tax sharing. Each municipality could impose its own flat (proportional) percentage rate of PIT on top of the uniform (progressive) national rate. The proceeds collected by each municipality would be complementing the tax-sharing amount (resulting from the same 20.59 percent PIT share) that it would receive according to the 2000 reform. Correspondingly, the uniform national rate should be reduced in such a proportion as to allow the municipal surcharge enough room so that the overall tax burden would not necessarily increase.

78. Following the principle of allocating PIT according to where the demand for services is, the proposed piggybacked flat-rate levy on the "wage-tax" should—at least at the beginning—be collected centrally and allocated according to the residence of the taxpayers (that is, the workers).

79. It should be noted that, on the one hand, the higher the intermunicipal mobility of factors and goods, the higher the chance that local tax autonomy will affect tax competition and distort location decision. On the other hand, it is unlikely that marginal local tax differentials would increase mobility when they are accompanied by improved service standards.

80. In general, difficulties with reforming the property tax lie in vested interests (interests which keep substantial wealth in the form of valuable real estate for speculative purposes). Vested interests can neutralize the potential that the property tax can have for developing the real estate markets and as an adequate source of local government revenue. The following reasons are sometimes mentioned for the ineffectiveness of a property tax: (1) difficulties related to the *estimation of the market value* of land and buildings, mainly because of the relatively low level of market transactions, sometimes due to economic stagnation; (2) problems with the *incompleteness of registries and cadastres*; and (3) *lack of local administrative capacities*, especially in the small municipalities. In the case of the Czech Republic, however,

these arguments are weak (except for the small municipalities), since the country is prepared to overcome these shortcomings, if any remain, very quickly.

81. Also, as the real estate tax is an important source of information on net wealth changes, the reforms should include an enforceable agreement between the central tax administration and subnational governments on the exchange of relevant information in order to avoid fraud.

82. The regions could possibly be allowed a flat piggyback PIT, similar to that discussed above for the municipalities. In any case, the general approach should be overall fiscal neutrality.

83. Although not directly applicable to the present context of Czech Republic, recent literature shows the possibility of attaining greater subnational government self-reliance through the introduction of subnational value added taxes (VAT) levied on the basis of income (production). See Bird (1999) and Keen (2000).

84. These subsidies to schools are exclusive of teacher salaries, which are paid directly by the central government to the School Boards at the district level.

85. This is the case for the building of apartments by municipalities, where the transfers are set at 370,000 CZK per regular apartment and 750,000 CZK per apartment for community care.

86. The Environmental Fund currently provides loans to municipalities at rates as low as 3 percent.

87. The 0.13 coefficient is considerably less than the coefficients for countries with significant levels of decentralization. Using the same definition, countries such as Denmark, Germany, and the Netherlands have coefficients between 0.2 and 0.3.

88. Municipalities had been given free of charge by the National Property Fund 34 percent of the shares of the 16 new electric and gas distribution corporations.

89. Ministry of Regional Development (2000).

90. This practice departs from old systems that, for example, compensated for health care or assistance facilities on a *per bed* basis, giving local governments an incentive to open new facilities or to oppose the consolidation of existing underutilized facilities. Instead, the current practice in the Czech Republic is that the allocation of funds for those services is on the basis of *occupied* beds. It should be noted, however, that even a criterion of occupied beds may not be entirely incentive-compatible, if the decision makers have a choice to err on the side of longer stay periods for temporary services.

91. Apparently, in March 2001, the government published for the first time the list of subsidy recipients for 1999.

92. It should be noted, however, that in 2000 there was a “territorial balancing” subsidy for CZK 2.8 billion provided to some districts in compensation for the uneven distribution of tax collections for the personal income tax on wages (dependent activity). This subsidy was provided to those districts in which the yield from the personal income tax on wages failed to reach the per capita average for the Czech Republic of CZK 2,870.60 in the year 2000 (Box 4.1).

93. Another, but less important, equalizing element in *current* revenue assignments is that two-thirds of the wage tax received by the districts (30 percent of the total wage tax collected in the districts) are uniformly distributed back to the municipalities in the districts on a per capita basis.

94. Among other things, the 2000 reform in revenue assignments was supposed to benefit municipalities in distressed regions. By size of population, the losers were Prague and the smallest municipalities. The most significant gains were realized by municipalities with populations between 100,000 and 150,000 inhabitants (Chapter 3, Box 3.1).

95. The size and distribution of the Equalization Fund should be determined by objective factors. The total amount of funds to be used for this purpose will vary according to the level of equalization desired. The size of the Equalization Fund can be simply predetermined on an ad-hoc basis or, preferably, computed as a function of some pool of central government regular revenue sources. The Equalization Fund should be distributed in a way to minimize the discrepancies between regional or local fiscal capacity and expenditure need. Regional or local *fiscal capacity*, as opposed to actual tax collection, should be measured by the *tax basis* (or some proxy, such as regional GDP). Population size (directly) and per capita income (inversely) has sometimes been used as a proxy for regional or local needs, but a more encompassing measure of needs should include other objective factors. Such factors include indicators for cost of living; unemployment; specific population features (such as numbers of school-age children or

elderly citizens); population size; relative incidence of poverty; relative incidence of infectious diseases; environmental damages; and so forth. In the latter case, a system of weight should be attached to the indicators. This is a complex matter that deserves special, closer attention—including extensive simulation exercises—once the Government has decided to examine the benefits of a separate Equalization Fund for the Czech Republic.

96. Government Resolution no. 682/2000, and "Regional Development Strategy of the Czech Republic," Ministry of Regional Development, July 2000.

97. The Maastricht criterion for fiscal discipline (Article 109j(1) of the EC Treaty) requires a public sector deficit/GDP ratio smaller than 3 percent, and a public sector gross debt/GDP ratio smaller than 60 percent. These are the "government finance" criteria, as part of the European Monetary Union (EMU) convergence criteria to which member countries are submitted. The other criteria are price stability, exchange rates, and long-term interest rates. Although compliance with the convergence criteria is not a precondition, accession to EU entails acceptance of the objectives of the EMU. Since these criteria are indicative of a macroeconomic policy geared to achieving stability, all Member States must, in due course, comply with them on a permanent basis.

98. For example, including the "hidden" fiscal risks of special institutions (Konsolidacni Banka, Ceska Inkasni, National Property Fund, and Ceska Financni) as well as state guarantees, the 1997-98 estimated average "true" fiscal deficit was 5 percent of GDP (instead of the conventionally estimated average of 1.25 percent), and the "true" public sector liability, *without including local governments*, was 22 percent. See Polackova Brixi and others (2000).

99. Even if an upper-bound level of 4 or 5 percent of GDP—including contingent liabilities—is assumed, the level of indebtedness of subnational governments would not appear high by international standards. For example, in Germany subnational government debt represented 21 percent of GDP in 1996 and in Australia this figure was 11 percent.

100. As mentioned in previous chapters, in 1999 municipalities cashed in a substantial part of their stockholder rights in shares of energy distribution companies.

101. On the design of a warning system, see Jun Ma (2000).

102. "Refundable transfers" are concessional loans from the Ministry of Finance to municipalities.

103. A central government agency created in 1998 to regulate access to foreign capital markets and to control the country's exposure to foreign debt.

104. Kamenickova (1999).

105. This preference was widely revealed during the Bank Staff Mission in all the interviews held with financial sector representatives.

106. For a survey and a discussion of the relevant international experience, see Ter-Minassian and Craig (1997), Lane (1993), and Giugale and others (2000).

107. An example of a highly positive initiative that has voluntarily contributed to disciplining municipal access to borrowing, and to disseminating good market practices, is the *Credit Finance Analysis Handbook for Municipalities in the Czech Republic,* developed by the Union of Town and Communities with the assistance of USAID. The handbook provides municipalities with guidance on debt management, including dissemination of software that provides a Financial Management Model to help municipalities' decisionmaking and capital financing programming. Another remarkable initiative is the dissemination of analytical work on the financial stance of various municipalities, now being developed by the Czech Rating Agency. These initiatives are highly beneficial to the development of a healthy Czech capital market for municipalities and regions and should be decisively supported by the Ministry of Finance through facilitating the provision of a reliable database.

108. While an effective implementation of this golden rule may be difficult (because money is fungible), the amount of loans should not exceed investment.

109. Kamenickova, 1999.

110. Revenue in this case should be understood as total local government revenue excluding conditional grants.

111. This indicator in a way takes into account the burden of financial obligations that cannot be captured by the debt service ratio alone**,** because of grace periods. Together, this and the previous indicator aim to protect local

governments' solvency in the long term and are important to signal the balance between present consumption and future liabilities.

112. This prudent approach is recommended in the short run especially in the case of the new regions, which will be born free of debt. Otherwise, the mere announcement of limits that may be sustainable in the long run may trigger adverse fiscal and macroeconomic effects in the short run, since regional politicians may want to compete for financing in the new decentralized environment.

113. Initially promulgated in April 1996 (Act XXV/96), with a revision approved by the Hungarian Parliament on February 29, 2000. The new, revised version of the Act has been effective since January 2000.

114. In any case, rules will not be a cure if, when the time for their enforcement comes, they are not followed. International experience has also shown that central government oversight remains a key source of financial discipline (including, in some cases, the temporary takeover of responsibility from the local authorities).

115. Article 8 of the Constitution states that the "self-government of territorial self-governing units is guaranteed." In addition, Article 101 establishes that the central government can only intervene in the affairs of local governments through legal acts.

116. Municipalities gained some autonomy during the transition on the revenue side of the budget by the reduction in the level of funding through earmarked transfers and the corresponding increase in revenue sharing. At least, the resources from revenue sharing were not earmarked. However, as discussed in Chapter 3, shared taxes are under full control of the central government and therefore revenue sharing is no more than another form of transfer, although the distribution of funds is by lump sum (or not earmarked).

117. The possibility of reduced budgetary autonomy has always been present. For example, the Ministry of Interior has recently drafted an Act on the Standards of Services that, if passed as law, would impose expenditure priorities and other constraints on the decisionmaking process of municipalities. This act, if adopted as law, would represent a significant step back in the development of efficient and responsible local budgets in the Czech Republic. Regulating minimum standards of *a few basic services* may be desirable, but this should not be an excuse for centrally mandating local expenditure priorities across the board.

118. See Section 4 of the 2000 Act on Budgetary Rules and on Amendments.

119. Local government quarterly consolidated reports are included in the quarterly report of the central government to parliament.

120. Until recently, municipalities had the choice of using double-entry accounting or a simplified system, but since 2000 all municipalities, including the smallest in size, are required to keep a double-entry system.

121. The Chamber of Auditors, the Supreme Audit Institution in the country, does not perform municipal audits. The extent of interest by the Chamber of Auditors in the municipal budgets stops with the specific subsidies from the central government to the municipal budgets. In reality, the Chamber only audits a sample of municipalities in the use of particular subsidies, such as those for health care.

122. See Kamenickova (1999).

123. See Articles 20 to 22.

124. While the development of separate local treasury functions is important to preserve budget autonomy, priority should be given to enforcing uniform budget classification and charts of accounts at the local level.

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