

(DE)CENTRALIZATION UNDER EXAMINATION



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(DE)CENTRALIZATION UNDER EXAMINATION

To centralize, or to decentralize, that is the question. But is it really? Do we not already know the answer? The less central government in everyday matters, the better, right? The more power is given to local authorities, the faster things get done, correct? The only problem is that not everyone feels the same way. What is the perfect balance between the two, if the latter cannot be fully achieved?

Through the ages, European states have had various ideas about to what extent their domains shall be governed via a central authority. The more recent push for decentralization in all aspects of governance – from fiscal policy, to administration – appears to be a perfect manifestation of the highly attractive and appealing concept of subsidiarity.

The same rule applies not only to individual states, but also to the make-up of the European Union itself. After all, as an institution it is governed chiefly from the center, yet aspiring to be perceived as a federation, encouraging member states to take responsibility for their own actions, while at the same time setting the agenda for further development from Brussels (or Strasbourg). These and other paradoxes are embedded in the constant struggle between the two ideas, thus making the search for the ever so elusive golden means a means of tug-of-war negotiations between the proponents of centralization and advocates of decentralization.

In the ninth issue of *4liberty.eu Review*, by investigating a number of national perspectives from Central and Eastern Europe, we attempt to find this elusive middle ground – which, bear in mind, does not necessarily have to be in the middle, at least this is our belief. Hopefully, it will be one that leans more towards decentralization. After all, *sic parvis magna*¹. We trust that by exploring the presented ideas and examining them from various perspectives you will find the answers to how, to what extent, and at what levels decentralization is (or should be) a must. These are the questions that are truly central to the discussion on (de)centralization.

Enjoy your reading.

Olga Łabendowicz
Editor-in-Chief of *4liberty.eu Review*
Coordinator of 4liberty.eu network

¹ Latin for “Thus great things from small things (come)”.

Self-Governance (Net)Works



*

MIŁOSZ
HODUN

Central and Eastern Europe is not a stranger to the experience of strong centralization – it was the official state policy, expressed in the doctrine of democratic centralism, embodied in the one-party system and often rooted in constitutions. For more than half a century, the republics of the region perpetuated the Soviet model of state management from one decision-making center, bypassing the regional specific features, and above all, by ignoring the will and needs of their residents. Unified state power was a denial of self-government, which was perceived as a threat to the monopoly of communist power. The basic principles of self-government were incompatible with the instruments of the authoritarian state and the aspirations of the omnipotent bureaucracy. The hierarchized councils at local and regional levels existed only as relays of the political will of the central committees. Their boundaries, structural shape, and names were changed whenever the dynamics of relations within the ruling party demanded it.

This is why one of the most fundamental points in the agenda after the political upheaval of the 1990s was the need for decentralization. The restoration of democratic instruments, civil rights, freedom of the press, and free elections made it possible to introduce reforms in the spirit of decentralization. In addition to building democratic institutions and market economy, the establishment of local governments has become one of the pillars of the modern state and a symbol of the transformation of the entire region. In some Central European countries, the role of self-governance was appreciated very quickly, and an effective administrative division was introduced, which was then improved over the years. In other countries the pace of these changes was slower, and the positive results were

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THE LOCAL
GOVERNMENT
CONSTITUTES
THE FOUNDATION FOR
THE REASONABLE
SHAPING OF PUBLIC
AUTHORITIES,
EXERCISING
ADMINISTRATION,
THE PROVISION
OF PUBLIC SERVICES,
AND SPENDING
OF PUBLIC MONEY

noticed only twenty years after the transformation. However, it became clear that the local government constitutes the foundation for the reasonable shaping of public authorities, exercising administration, the provision of public services, and spending of public money.

Decentralization is the subject of the 9th issue of *4liberty.eu Review*. We present to you a collection of ten articles, the majority of which provide analyses of the self-government statuses in particular countries of Central and Eastern Europe. Not only do the authors describe different paths to achieving self-governance, but they also focus on the latest reforms that have changed the face of the local government in a positive or negative way and propose liberal solutions that can significantly contribute to improving the activities of local communities.



TERRITORIAL REFORMS
HAVE BEEN
ON THE POLITICAL
AGENDA IN MANY
COUNTRIES.
NEVERTHELESS, THEY
VERY OFTEN FAIL
TO MATERIALIZE DUE
TO FEARS OF IDENTITY
LOSS OR PROTESTS
FROM LOCAL CLIQUES

Although the challenges faced by individual countries of the region vary, they have one common denominator – attempts to find the right system of financing self-government. Fiscal decentralization – which entails shifting some responsibilities for expenditures and/or revenues to lower levels of government – became a central point of most of the analyses published here. All the authors analyzing the existing solutions in the field of financing local government emphasize the need to reform them if the local and regional authorities are to successfully fulfill their roles, i.e. effectively perform public tasks on their own responsibility, without interference of the central state authority. There are multiple suggestions: sharing part of income tax revenues with municipalities (Bulgaria), transferring all revenue from the first income tax threshold (Poland), or even partial independence of local government finances from the annual budget-related decisions of the parliament (Slovenia), as well as – from a completely different perspective – the call for invest-

ment of the budgetary surplus of local governments in the necessary infrastructure (the Czech Republic).

Several authors, not knowing the other articles, unwittingly got involved in an engrossing discussion regarding the sufficient and perfect size of a commune. There are multiple suggestions. In order not to reveal too much, I will only ask a few questions that may arise after reading this issue: Is 200 people in a commune not enough? What should be done with the communes which have too few inhabitants? Or differently: What should be done with the communes that seem to have too few inhabitants, but are doing quite well? Is 8,000 really the perfect number? Can the EU average of 5,500 inhabitants become a model for the countries of the region?

Many of the arguments cited by the authors can serve as a guide for the readers from other parts of Europe. The articles contain examples of communes too small to survive in the European self-government network, and solutions that helped save some of them from the fall, as well as the final result of dashed hopes of residents enjoying a good level of communal services...

Among the examples of positive reforms of recent years, Estonia stands out among the crowd, where the liberal government formulated and carried out a comprehensive reform of the administrative division considered one of the greatest systemic successes after regaining independence. Territorial reforms have been on the political agenda in many countries. Nevertheless, they very often fail to materialize due to fears of identity loss or protests from local cliques. Estonia chose a mixed strategy of bottom-up and top-down elements that succeeded, proving that a lot depends on the consensus among stakeholders and government's commitment to long-term goals.

Unfortunately, there is a negative, dangerous trend that can be observed in some countries of the region, namely recentralization. The wave of populism and nationalism, which is best seen today in Poland and Hungary, demolishes the successes of self-government and returns to the model of a state controlled from the seat of the ruling party in the capital. Sometimes, the "reforms" introduced by these illiberal governments are unambiguous and directly interfere with self-government, taking away competencies from local and regional authorities, strengthening the government pillar in territorial units at the expense of local self-government bodies, and destroying the plurality of legislative bodies by means of the electoral law. More often, however, they are in the form of regular, but incremental changes, the consequence of which is limiting the freedom of self-government units by reducing funding – directly through income cuts, or indirectly by imposing new/additional tasks without increasing the budgets of local government bodies.

This trend is dangerous and inconsistent with the *European Charter of Local Self-government*, which protects the autonomy and independence of local communities. It is also at odds with the spirit of liberalism. It is worth quoting the words of Friedrich Hayek, referring them not only to the economy, but also to other social phenomena, including state management:

"The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design. To the naive mind that can conceive of order only as the product of deliberate arrangement, it may seem absurd that in complex conditions order, and adaptation to the unknown, can be achieved more effectively by decentralizing decisions and that a division of authority will actually extend the possibility

of overall order. Yet that decentralization actually leads to more information being taken into account".

I encourage you to explore all the articles featured in this issue and I hope they will be inspirational. ●



✱

MIŁOSZ
HODUN

Content Editor of the 9th Issue of *4liberty.eu Review*
Board Member at Projekt: Polska Association

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Principle of Subsidiarity: Concept and Criteria



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AISTĖ
ČEPUKAITĖ



*

ŽILVINAS
ŠILĖNAS

Subsidiarity is a principle which applies to the division of functions between different levels of government and society.

At the core of the principle of subsidiarity lies freedom of action of individuals, communities, municipalities, and other small entities which the central government can only intervene if the said entities fail to perform independently.

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DEPENDING
ON THE LEVEL
OF AUTONOMY
OF SELF-GOVERNMENT,
DECENTRALIZATION
CAN BE ACHIEVED
BY MEANS
OF DECONCENTRATION,
DELEGATION,
OR DEVOLUTION

The principle of subsidiarity presupposes decentralization of government functions. The benefits of decentralization include better service provision due to a closer proximity to citizens and hence better access to information, increased likelihood of innovative solutions, lower monitoring costs, and a more stable system of government.

Depending on the level of autonomy of self-government, decentralization can be achieved by means of deconcentration, delegation, or devolution. To achieve better

government accountability, the application of the subsidiarity rule should involve fiscal decentralization, including both spending and revenue generation, balancing the amount of money collected and expended by local government.

SUBSIDIARITY MATTERS

The division of functions between central and local governments is a question yet to be solved. Economies throughout the world, especially those of developing nations, are gradually decentralizing by transferring government functions to lower levels. There is a growing need for a comprehensive analysis of how government functions should be divided. On the one hand, optimal division may vary between countries due to unique local circumstances. On the other hand, scientific research is not intended to discover a factual answer but rather an algorithm for evaluating functions regardless of such factors as a country's size, system of government, and the like.

Subsidiarity is one of the most important principles applicable in the analysis of the functional division between central and local governments. According to the principle of subsidiarity, government functions should be performed at a lower level unless local government fails to cope with them and the performance of said functions at a higher level would be more efficient. It is thus essential to identify criteria for determining whether a certain function should be elevated to a higher level of government.

The principle of subsidiarity is oftentimes stipulated in national legislation. Yet, its implementation framework is not always clear. For example, the principle of subsidiarity is not explicitly defined in the Constitution of the Republic of Lithuania, but rather it is derived from other constitutional principles and provisions. Notably, Lithuania's system of government is supposed to build



NOTABLY,
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OF GOVERNMENT
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YET NO CRITERIA
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AND ASSESSMENT
ARE DEFINED

on the principle of subsidiarity, yet no criteria nor system of monitoring and assessment are defined, so it is unclear whether the process is systematic and justified.

This article is intended to elicit and substantiate criteria that should be used as a basis for the division of functions between the central government and local government (municipalities) according to the principle of subsidiarity.

DEFINING SUBSIDIARITY

There is no unanimous definition of the principle of subsidiarity in theory or in practice. Subsidiarity is compatible with separation of powers in the European Union (EU) between different levels of government since subsidiarity implies decision making at the lower rather than higher level of governance. The principle is intended to ensure a certain degree of independence to lower-tier government institutions from the institutions of a higher level. This means that institutions at different levels share authority.

In accordance with the principle of subsidiarity, the EU has no right to act in areas which member states are able to efficiently regulate at the national, regional or local levels. On the other hand, according to the same principle, the EU has the right to exercise its authority if member states fail to properly achieve pre-defined objectives and if such action creates added value at the EU level¹.

In Lithuania, the principle of subsidiarity is laid down in the Law on Public Administration. It states that the decisions of public administration entities must be adopted and implemented at a level that is considered to be the most effective (The Law of the Republic of Lithuania on Public Administration).

However, considering its origins, the principle of subsidiarity has a broader meaning. Althusius in the 16-17 c., also known as the father of federalism, was the first to describe the principle of subsidiarity. He claimed that society and communities were fundamental in helping individuals to fulfill their preferences².

This highlights the inherent link between the principle of subsidiarity and freedom: individuals are free to act and fulfill their preferences, while the role of government is not to regulate but rather to facilitate the freedom of action of individuals³.

A more comprehensive approach to the rule of subsidiarity can be found in Christian teachings. At the end of the 19th century,

¹ Chateau, C. (2016) *Fact Sheets on the European Union. The Principle of Subsidiarity*. Available [online]: http://www.europarl.europa.eu/ftu/pdf/en/FTU_1.2.2.pdf

² Føllesdal, A. (2013) "Competing Conceptions of Subsidiarity", [in:] *Nomos LV: Federalism and Subsidiarity*, New York: New York University Press. Available [online]: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359964

³ Ibid.





THE PRINCIPLE
OF SUBSIDIARITY
IS UNDERSTOOD
AS A CONCEPT
THAT HOLDS
THAT INDIVIDUALS,
COMMUNITIES,
MUNICIPALITIES,
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TO ACT ON THEIR
OWN ACCORD

Pope Leon XIII wrote in *Rerum Novarum* that the state must allow people the freedom of action rather than exploiting them and intruding into their everyday lives⁴. Pius XI (beginning of the 20th c.) furthered the concept of subsidiarity. He wrote that subsidiarity started with the individual, while an intervention from a higher level was warranted only when an entity was unable

to cope without it⁵. The term subsidiarity comes from the Latin word *subsidium*, meaning “assistance”⁶.

There are multiple interpretations of subsidiarity in theory and in practice. Here, the principle of subsidiarity is understood as a concept that holds that individuals, communities, municipalities, and other small entities have freedom of action, which can be intervened by a higher level of government only when said entities are unable to act on their own accord.

The following analyzes the application of the principle of subsidiarity in the division of functions between the central government and self-governments.

PERFORMING FUNCTIONS AT A LOWER LEVEL OF GOVERNMENT IS DESIRABLE

In practice, subsidiarity is often equated to decentralization. However, the two concepts are not the same. Subsidiarity is defined as a rule by which government functions are performed at the lowest level. Only when such an arrangement is inadequate in terms of the accomplishment of a certain task (also considering the criteria described further in the article) can the said task be transferred to a higher level of government. Meanwhile, decentralization is the transfer of power, authority, and responsibility from a higher to a lower level of government⁷.

⁵ Ibid.

⁶ Sirico, R. A. (2014) “Subsidiarity, Society, and Entitlements: Understanding and Application”, [in:] *Notre Dame Journal of Law, Ethics & Public Policy*, no. 549. Available [online]: <http://scholarship.law.nd.edu/nd-jlepp/vol11/iss2/8/>

⁷ World Bank. Decentralization & Subnational Regional economics. *What, Why and Where*. Available [online]: <http://www1.worldbank.org/publicsector/decentralization/what.htm>

⁴ Ibid.

Decentralization is a complex and multifaceted concept. It can mean political, fiscal, administrative or market decentralization. These types of decentralization are frequently interrelated. For instance, fiscal decentralization occurs together with political decentralization.

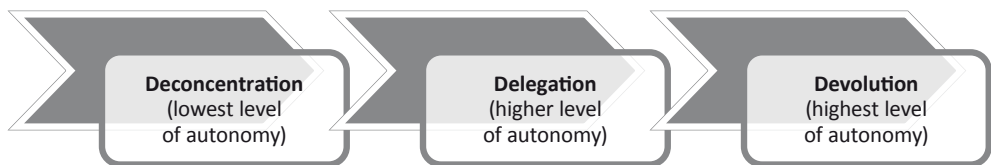
ADMINISTRATIVE DECENTRALIZATION

Administrative decentralization is the division of functions and responsibility between entities at different levels of public administration or state government that is accomplished by transferring functions to a lower level. In other words, administrative decentralization occurs when the responsibility to perform certain public functions is transferred from central government entities to territorial government units or local and regional municipalities.

According to the World Bank⁸, the aim of administrative decentralization is to redistribute authority, responsibility, and financial resources in order to provide public services at different levels of government [See Figure 1].

1. **Deconcentration** is the weakest form of decentralization. Its purpose is to redistribute the decision-making authority, financial and managerial responsibility between different levels of central government. Deconcentration can be used to transfer responsibilities from central government authorities in the capital city to regional or district authorities. It can also serve to strengthen local administration while under the supervision of central government representatives.
2. **Delegation** is a broader form of decentralization. It involves transferring the responsibility of making and administering decisions related to public functions to semi-autonomous institutions (those not under complete control of central government but accountable to it). These institutions may charge users for their services.
3. **Devolution** is based mainly on political decentralization. It is the transfer of decision-making, finances, and man-

Figure 1: Types of decentralization by the level of autonomy



Source: Compiled by LFMI based on Schneider (2006)⁹

⁸ Ibid.

⁹ Schneider, A. (2006) "Who Gets What from Whom? The Impact of Decentralisation on Tax Capacity and Social Spending", [in:] *Commonwealth and Comparative Politics*, 44(3) pp. 344-369.

agement to semi-autonomous local branches of government (municipal companies). In such a system there are clear geographical and legal boundaries between local governments, separating the territories where public functions are performed.

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IN A POLITICAL SYSTEM THAT IS HIGHLY DECENTRALIZED, CITIZENS SHAPE INTERESTS BASED ON LOCAL NEEDS, WHILE ORGANIZATIONS AND POLITICAL PARTIES ACT AT THE LOCAL LEVEL AND COMPETE IN LOCAL ELECTIONS

The use of these three measures decentralizes the public administration system and reduces fiscal centralization of the government.

POLITICAL DECENTRALIZATION

Political decentralization entails transferring the state management authority to public administration entities, which function on the basis of autonomy¹⁰. In the case of political decentralization, citizens are involved in political activities and their opinion is taken into account while making and implementing public policies on a larger scale¹¹.

¹⁰ Astrauskas, A. (2007) "Internal Decentralization: Purport and Forms", [in:] *Viešoji politika ir administravimas*, no. 20. Available [online]: https://www.mruni.eu/upload/iblock/1f3/1_a.astrauskas.pdf

¹¹ Chattopadhyay, S. (2013) "Decentralised Provision of Public Services in Developing Countries: A Review of Theoretical Discourses and Empirical Evidence", [in:] *Social Change*, 43(3): 421-441.

In a political system that is highly decentralized, citizens shape interests based on local needs, while organizations and political parties act at the local level and compete in local elections¹².

MARKET DECENTRALIZATION

Market decentralization results in more deregulation and privatization. Market decentralization involves non-governmental organizations as well as the private sector¹³.

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PURE FISCAL DECENTRALIZATION IS A SYSTEM WHERE LOCAL GOVERNMENTS COLLECT TAXES AND ALLOCATE EXPENDITURES WITHOUT THE INTRUSION OF CENTRAL GOVERNMENT. IN REALITY, SUCH MARGINAL SITUATIONS DO NOT EXIST

¹² Schneider, A. (2006) "Who Gets What from Whom? The Impact of Decentralisation on Tax Capacity and Social Spending" [in:] *Commonwealth and Comparative Politics*, 44(3), pp. 344-369.

¹³ Halaskova, M. and R. Halaskova (2014) "Impacts of Decentralisation on the Local Government Expenditures and Public Services in the EU Countries", [in:] *Lex Localis*, 12(3), pp. 623-642.

In pursuing market decentralization, the task of the government is not to regulate but to implement such methods of governing that allow the market to develop on its own.

FISCAL DECENTRALIZATION

Fiscal decentralization is the type of decentralization that usually comes to one's mind when the topic of decentralization is addressed. It means that when local governments are assigned additional functions, an adequate increase in their revenue should be ensured.

In other words, fiscal decentralization occurs when lower-tier government institutions are assigned new functions and together with these functions they are given the right to make decisions regarding revenue collection¹⁴. Pure fiscal decentralization is a system where local governments collect taxes and allocate expenditures without the intrusion of central government¹⁵. In reality, such marginal situations do not exist.

Fiscal decentralization can also be described as the shift of fiscal impact from the central level to lower levels of government. The aim is to reduce the vertical fiscal gap, the gap between decentralized expenditure and decentralized revenue [See Figure 2]. A large vertical gap means that municipalities spend more money than they themselves collect. If the vertical fiscal gap is large, the system holds that the local government is able to make decisions regarding a relatively large part of its expenditure, while receiving a still higher proportion of its revenue from the central government. In such cases, the local government spends more than it otherwise would because there is no link

¹⁴ Kim, A. (2008) "Decentralization and the Provision of Public Services: Framework and implementation", [in:] *Policy Research Working Paper* 4503, The World Bank.

¹⁵ Prud'homme, R. (2005) "The Dangers of Decentralization", [in:] *The World Bank Research Observer*, 10(2), pp. 201-220.



A WIDE VERTICAL
FISCAL GAP CAN IMPAIR
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DEVELOPMENT,
INCREASES
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TO THE PEOPLE

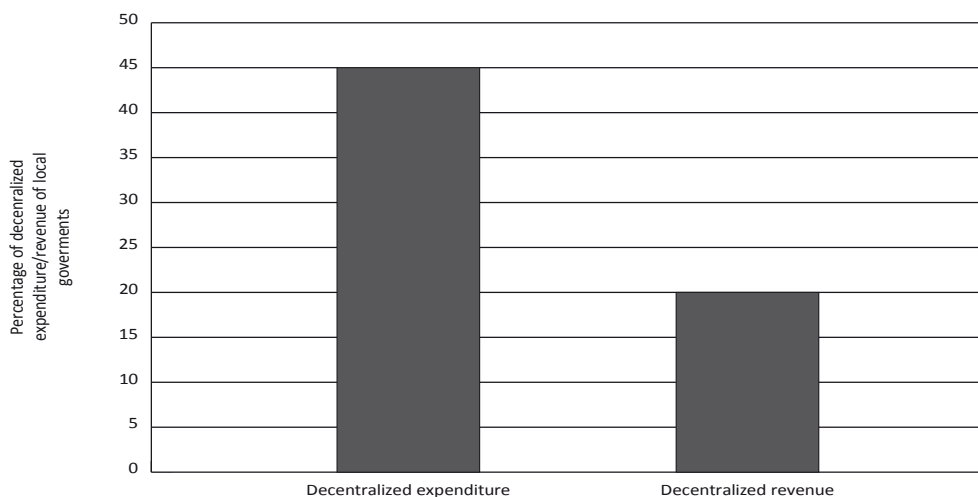
between revenue and expenditure. Philip Booth claims that revenues should be generated by the same level of government that spends them¹⁶.

The aim should be to reduce the vertical fiscal gap because it creates incentives for the government to expand, over-spend, and borrow more. When the local government receives a large share of its proceeds from the central government, it feels less responsible for spending and so the link between revenue and expenditure is weaker. Research shows that a wide vertical fiscal gap can impair economic development, increases debt, and makes local governments less accountable to the people.

The above explains that decentralization is a complex and multifaceted process-system. Its main attribute is the transfer of authority and responsibility from a higher level to a lower level of government.

¹⁶ Booth, P. (2015) *Federal Britain. The case for Decentralisation*. The Institute of Economic Affairs. Available [online]: <http://www.iea.org.uk/publications/research/federal-britain-the-case-for-decentralization>

Figure 2: Vertical fiscal gap



Note: decentralization of expenditure = spending of local government / (spending of local and central governments); decentralization of autonomous revenue = autonomous revenue of local government / (revenue of local and central governments).

Source: Compiled by LFMI based on Sorens (2016)¹⁷

Why then is the decentralization of government functions the primary concern when applying the principle of subsidiarity? Philip Booth and other economists outline the following benefits of decentralization:

1. **Local government can organize the provision of resources and public services in ways that better meet people's preferences.** Local government is closer to its citizens and therefore better positioned to properly evaluate citizens' varying needs and to adopt more effective solutions. Information can be used at a more immediate level, and this ensures better public policy decisions. As economist Friedrich Hayek wrote, decentralization is needed precisely for the purpose of collecting and using such knowledge. People are a source

of information, and a closer proximity to the source allows sounder and better-suited decisions.

2. **Local government becomes more accountable to its citizens.** As residents are able to migrate between local governments, or *foot vote*, local authorities have more incentives to function efficiently. Just like in an ordinary market, competition improves the quality of services provided by self-governments, and promotes the adoption of decisions that are designed to better meet citizens' preferences.
3. **The more variations of service provision exist, the higher the possibility to find a better and more innovative solution.** When functions are performed by a unified central government, this likelihood decreases¹⁸.

¹⁷ Sorens J. (2016) "Vertical Fiscal Gaps and Economic Performance. A theoretical Review and an Empirical Meta-Analysis", *Mercatus Working Paper*.

¹⁸ Booth, P. (2015) *Federal Britain. The case for Decentralisation*, The Institute of Economic Affairs. Available [online]: <http://www.iea.org.uk/publications/research/federal-britain-the-case-for-decentralization>



COMPETITION IMPROVES THE QUALITY OF SERVICES PROVIDED BY SELF-GOVERNMENTS' FULFILLMENT OF CITIZENS NEEDS

4. **The costs of monitoring (of consumer needs and behavior) are lower under decentralization** because local government is closer to its citizens¹⁹.
5. **A more stable system of government.** When there are several sources of power instead of one, complications affect only a part of the country, reducing their negative effects.

As regards the fulfillment of citizens needs, it is logical to think that a problem should first be addressed at the most immediate level where the most information about the problem exists. Obtaining the information from the most immediate level is instrumental for finding the most suitable solution. Only when the efforts fail can the solution be entrusted to a higher level.

Admittedly, this condition is not specific enough to determine when the rule of subsidiarity should be applied to transfer government functions to a higher level. It requires more explicit criteria that would help to systematize the application of the subsidiarity principle under the most objective conditions possible.

CRITERIA FOR APPLYING THE PRINCIPLE OF SUBSIDIARITY

Analysis of the application of the principle of subsidiarity reveals a lack of criteria to justify the transfer of government functions to a higher level. A general condition is that such a transfer occurs when a certain function fails to be adequately performed at a lower level. However, without knowing specific circumstances it is impossible to determine whether the transfer of a certain function was justified.

One of the most frequently used criteria is efficiency. The Lithuanian Public Administration Law stipulates that activities of public administration entities must be based on the principle of subsidiarity which holds that decisions must be adopted and implemented at the most efficient level of public administration.

Efficiency means performance that uses the lowest amount of inputs to create the greatest amount of outputs. It is outputs divided by inputs. If moving a function to a higher-level leads to a better ratio of the two, then the rule of subsidiarity comes into effect.

However, this is not an easy criterion to follow as it requires knowing specific numerical values of outputs and spending on particular occasions. In addition, the efficiency criterion is too narrow to define the rule of subsidiarity. In the division of functions, it is also essential to ensure that the principle freedom of action is not restricted.

Explicit criteria are needed to perform a justified evaluation of the division of functions between central and local governments. Such criteria should help even when specific conditions and circumstances of a situation are unknown.

¹⁹ Ibid.



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SELF-GOVERNMENTS
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THE CITIZENS'
PREFERENCES

The following outlines the criteria for the division of functions between the central and local governments following the principle of subsidiarity. The criteria include differentiation of consumer preferences, economies of scale, competition, and externalities. Importantly though, prior to applying these criteria, the principle of freedom of action at a lower level should be observed. The move to a higher level should be made only when the lower level fails to cope with its functions or when functions are performed inefficiently.

DIFFERENTIATION OF CONSUMER PREFERENCES

It is of the most important criteria that is used to decide on the application of the subsidiarity principle. Consumer preferences can be homogeneous or heterogeneous. Homogeneous preferences are characterized by similar features, for instance all citizens have similar preferences for national defense. In contrast, heterogeneous preferences vary, as illustrated by the example of social services: people of old age, people with disabilities,

and children at social risk all have different needs. Heterogeneous preferences are better met by local government. Self-governments are closer to citizens, and this makes it easier for them to decide which services are the most suitable to best meet the citizens' preferences.

Consumer preferences may not be only homogeneous or heterogeneous but also unevenly distributed across the country. For example, local government near the sea or another large body of water is concerned about providing rescue and beach maintenance services, whereas the rest of the country has no such need. Therefore, in the case of uneven division of consumer preferences, assigning functions by relevant municipalities is a better decision. The opposite stands when a preference is relevant uniformly across the country. For instance, tax administration services are needed across local governments regardless of geographical differences, so this function can be left to the central government [See Table 1].

On the other hand, some may claim that varying consumer preferences could be met just as well if more local government units

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IN THE CASE
OF UNEVEN DIVISION
OF CONSUMER
PREFERENCES,
ASSIGNING FUNCTIONS
BY RELEVANT
MUNICIPALITIES
IS A BETTER DECISION

Table 1: Criteria for the application of the principle of subsidiarity

Criterion	Functions of Self-Government	Functions of Central Government
Differentiation of consumer preferences	Heterogeneous (different) preferences	Homogeneous (similar) preferences
	Geographically uneven preferences	Geographically even preferences
Economies of scale	Low economies of scale; low fixed costs	High economies of scale; high fixed costs
Competition	Strong competition	Weak or no competition
Externalities	A small spill-over effect	A large spill-over effect

were in place. An important consideration here is that the performance of a certain task is not limited to implementation. The Lithuanian Public Administration Law states that public administration comprises not only the provision of administrative services, but also the adoption of administrative decisions, control of the implementation of laws and administrative decisions, and so on. It means that the very act of establishing more local units to accomplish defined functions cannot be regarded as a transfer of government functions if the said units are not able to adopt decisions and empower other public entities (such as communities, non-governmental organizations, and the like).

A function can be said to have been transferred between levels of government when the transfer involves the authority to adopt decisions, control their implementation, and empower smaller public entities to act. Of course, a partial transfer (for instance, the transfer of the implementation task) is more significant than no transfer at all, but without the authority to make decisions and exert control, the process is not complete.

ECONOMIES OF SCALE

Economies of scale²⁰ occur when an increase of outputs produced (goods or services) reduces the inputs that are required to produce them. In this case, social services are an example of low economies of scale. Providing social services to additional recipients does not make service delivery any cheaper, as allowance amounts as well as salaries of social workers remain unchanged. However, when economies of scale are achieved, it is advisable to provide services at a higher level of government because more goods can be produced, or services rendered at lower costs. This makes the performance more efficient.

High economies of scale are linked to fixed costs. Normally, municipalities do not have sufficient financial or other resources to afford an airport or fleet of their own. Services such as waste collection have limited fixed

²⁰ Kim, A. (2008) "Decentralization and the Provision of Public Services: Framework and implementation", *Policy Research Working Paper 4503*, The World Bank.

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SERVICES THAT
REQUIRE HIGH-FIXED
COSTS SHOULD BE
PROVIDED BY CENTRAL
GOVERNMENTS

costs. It is thus obvious that services that require high-fixed costs should be provided by central governments.

COMPETITION

The third criterion is competition. Normally, competition is desirable because it reduces prices, increases quality, and essentially improves the fulfillment of consumer preferences. This holds true for many public services. For instance, parents choose to send their children to schools which they think are better than others. In such conditions, schools compete to attract as many students – and, consequently, public funding – as possible. Services which can show quality improvements due to competitive forces should be transferred to local government so that local governments can compete with one another. After all, for competition to occur, at least two parties must be in play.

It is important to note though, that for certain functions, competition may bring undesired effects in terms of the efficiency of performance and the general stability of a country. For example, if every local government had its own central bank, it would be inconvenient to use different currencies in each municipality. Macroeconomic stability could be affected too. Therefore, centralization works better in such cases.

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LARGE-SCALE POSITIVE
EXTERNALITIES
DISCOURAGE CITIZENS
WHO PAY FOR
SERVICES
OR FUNCTIONS
BECAUSE ANYONE
IS IN A POSITION
TO ENJOY
THE BENEFITS

EXTERNALITIES²¹

This criterion shows how the presence of external effects can encourage centralization. Externalities occur when some utility provided by organizations in one municipality spills over to create welfare for citizens in other municipalities. Such cases lead to the “free rider” problem when non-payers benefit from the paying entities in a different municipality. Naturally, utility spillover effects always occur to some extent.

However, large-scale positive externalities discourage citizens who pay for services or functions because anyone is in a position to enjoy the benefits. The free rider problem does not exist when utility is gained mostly by those who pay for it. Thus, in the case of zero or marginal spillover, functions can be performed by local government. Otherwise, they should be left to central government [See Table 1].

²¹ Ibid.



IF A MUNICIPALITY
IS SMALL, IT MIGHT
NOT BE ABLE
TO PERFORM
A CERTAIN FUNCTION
ADEQUATELY DUE
TO A LACK
OF RESOURCES (BOTH
FINANCIAL AND HUMAN)

The criteria discussed above help to determine how functions should be assigned to a certain level of government. However, a comprehensive analysis should consider specific characteristics, such as the size of the municipality. If a municipality is small, it might not be able to perform a certain function adequately due to a lack of resources (both financial and human).

The practical division of functions is illustrated by Norway's example. At present, Norway is implementing a reform that is intended to merge municipalities into large units. A decision to merge and revise the division of functions was made after evaluating the efficiency level of the performance of local government functions. It was concluded that some municipalities were too small and had insufficient resources to properly perform functions assigned to them. The ongoing reform is to be accompanied by a transfer of additional functions to municipalities²².

²² Report of the Ministry of Local Government and Regional Development of Norway (2015–2016) Available [online]: <https://www.regjeringen.no/no/dokumenter/meld.-st.-22-20152016/id2481778/>

The main criteria that Norway used to evaluate the division of service provision were financial capacity, experience of performance, efficiency, and freedom of action. The two main considerations were ensuring that new municipalities were able to perform the tasks assigned to them (have sufficient resources) and that the same functions could also be performed outside the boundaries of a municipality considering population density and geographical distance²³.

This example shows that to ensure an effective division of functions it is necessary to consider specific circumstances at play; the characteristics of municipalities, a country's geographical peculiarities, division of the population, and so on. The criteria outlined in this article may therefore provide guidance for better-informed decisions regarding the transfer of certain government functions to a higher level. However, it is important to keep in mind that functions should be moved up only when a municipality is unable to perform them independently. (It is necessary to consider if measures to reduce the vertical fiscal gap were taken. Also, municipalities can fail to perform if the revenue-expenditure mechanism is misadjusted.)

CONCLUSIONS

The principle of subsidiarity holds that individuals, communities, municipalities, and other small entities have the freedom of action, which can be intervened by a higher level of government only when the said entities are unable to act on their own accord.

Local government should be warranted the freedom to act, whereas the transfer of functions to central government under the rule of subsidiarity should only take place when self-government is unable to perform its functions, or the performance is ineffi-

²³ Ibid.

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TO ENSURE
AN EFFECTIVE
DIVISION
OF FUNCTIONS
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A COUNTRY'S
GEOGRAPHICAL
PECULIARITIES,
DIVISION
OF THE POPULATION,
AND SO ON

cient. The following criteria thus help to apply the principle of subsidiarity and determine what government functions need to be transferred:

- A. **Differentiation of consumer preferences.** Functions are transferred to the central level when citizens' preferences are highly homogeneous and/or geographically uniform.
- B. **Economies of scale.** Functions should be transferred to the central level when high economies of scale occur.
- C. **Competition.** Functions should be transferred to the central level when competition between municipalities which provide certain public services are not functional.

- D. **Externalities.** Functions should be moved to the central level when their provision produces large spill-over effects between municipalities.

The vertical fiscal gap in municipalities should be as low as possible. It is important to reduce the gap between decentralized expenditure and decentralized revenue. A proper link between revenue and expenditure is the key factor in order to disincentivize government expansion, over-spending, and borrowing, to increase government accountability and to promote economic development. •



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Informal Institutions and Decentralization of Governance



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JIŘÍ
NOHEJL

In recent years, the Czech Republic experienced significant economic growth. Should this fact be a reason for enthusiasm, or is there a reason to worry? Sound economics should analyze social processes in depth and at their structure rather than rely on aggregate indicators. Together with F. A. Hayek, who famously claimed “nobody can be a great economist who is only an economist – and I am even tempted to add that the economist who is only an economist is likely to become a nuisance if not a positive danger”¹, we have to maintain that only through a detailed analysis of economic systems with a thorough understanding of underlying political, legal, and institutional processes can we come to more robust conclusions about the nature of its development.

Famous economists (most recently, Thomas Piketty) together with many economic reporters, point out that post-communist countries are rather economies with cheap labor colonized by foreign investors than structurally developed economies with prospects for innovation. Regardless of the positive development of GDP, these countries lack a tendency to converge with its economically stronger neighbors in the European Union (EU). Nevertheless, it is not necessarily caused by the scarcity of physical resources or financial capital, but instead by a conflict of institutions, which are at first glance well-aligned with those of more developed Western democracies, but which are not dovetailing on the margin of individual action.

This article explores a relationship between a feasible degree of decentralization of governance and totalitarian mental models, which prevail in the society. Current political and business leaders in post-communist

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CURRENT POLITICAL
AND BUSINESS
LEADERS IN POST-
COMMUNIST
COUNTRIES OFTEN
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MENTAL MODELS
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AND EXPERIENCES
DURING
THE COMMUNIST ERA

countries often belong to a generation which formed mental models through education and experiences during the communist era. These mental models are on various margins in the conflict with formal institutions of property rights and contractual relationships which were introduced to those countries to mimic the free-market capitalism of the West. The following analysis explores this potential clash, which might cause friction that could further obstruct development of economic systems in post-communist countries.

IN INSTITUTIONAL ANALYSIS, HISTORY MATTERS: RATIONALITY, PATH-DEPENDENCE, AND INSTITUTIONAL CHANGE

To understand the interplay between institutions, governance, and (de)centralization, the fact that rationally acting human individ-

¹ Hayek, F.A. (1956) “The Dilemma of Specialization”. [in:] White, L.D. (ed.) *The State of the Social Sciences*. Chicago: University of Chicago Press, p. 463.

uals make choices utilizing specific mental models²³, which have been formed by their experiences embedded in institutional environment, must be taken into account. Peter Boettke, when praising the Bloomington School of Political Economy, emphasized that: "[Vincent and Elinor Ostrom] did rational choice theory as if the choosers were human and they did institutional analysis as if history matters"⁴. His viewpoint thus connects human action to irreversible historical (real) time⁵, in which acting individuals formed their experiences and shaped their mental models.

When historical time enters our analysis, a step sideways from mainstream economics with formalized theory of static equilibrium towards "order defined in the process of its emergence"⁶ is being made. This side-step may be explained as a realization that the "economy at all levels and at all times is path dependent" and "large and small probabilistic events at particular non-repeatable moments determine [...] the future

path taken"⁷. As such, an emphasis shall be placed on a theoretical connection between the Political Economy of Adam Smith and Carl Menger, and the emerging field of Complexity Economics.

Crucial non-repeatable events that structured the institutional environment (and through this environment shaped mental models of respective individuals) may be easily identified in the history of Czechoslovakia. Those events happened in an arguably fast manner, whereas the periods between them were usually shorter than one generation. The periods of free society and totalitarian regimes were changing rapidly in the 20th century and tensions between the two systems of governance play an important role in politics and economic performance to the present day.

In *Micromotives and Macrobehavior*, Thomas C. Schelling explains how the motives of individuals and the incentives they face when combined through interactions among these individuals are causing macro behavior⁸. The puzzle, of course, lies in understanding what the circumstances that shape individual action to produce a certain macro outcome are. Rationality of individuals does not exist regardless of a particular institutional environment. On the contrary, it is deeply interconnected to the incentive structure of that environment. This idea is one of the key elements of the complexity economics framework, which studies how "interacting elements in a system create overall patterns, and how these overall patterns in turn cause the interacting elements to change or adapt"⁹.

² Caton, J.L. and E.J. Lopez (2018) *The Cognitive Dimension of Institutions*. SSRN. Available [online]: <https://ssrn.com/abstract=3214278>

³ "In order to understand decision-making under conditions of strong uncertainty, we must understand the relationship between the mental models that individuals construct to make sense of the world around them, the ideologies that evolve from such constructions, and the institutions that develop in a society to order interpersonal relationships." Denzau, A.T. and D. North (1994) *Shared Mental Models: Ideologies and Institutions*. Kyklos, Vol. 47, Issue 1, pp. 3-31

⁴ Boettke, P.J. (2016) *YouTube Interview: Bloomington School of Political Economy I: The Science & Art of Association*. Arlington: Mercatus Center. Available [online]: <https://www.youtube.com/watch?v=MFkdG69J1f8>
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⁵ In contrast to "Newtonian time". For more details see O'Driscoll, G.P.Jr. and M.J. Rizzo (1996) *The Economics of Time and Ignorance*. London: Routledge, pp. 52-70.

⁶ Buchanan, J.M. (1982) "Order Defined in the Process of Its Emergence." [in:] Reader's Forum on Norman Barry's "The Tradition of Spontaneous Order," The Forum at the Online Library of Liberty, Available [online]: http://oll.libertyfund.org/?option=com_content&task=view&id=1636&Itemid=282.

⁷ Arthur W.B. (2014) "Complexity Economics: A Different Framework for Economic Thought", [in:] *Complexity and the Economy* Oxford: Oxford University Press, p. 28.

⁸ Schelling, T.C. (2006) *Micromotives and Macrobehavior*. New York: W. W. Norton Company.

⁹ Arthur W.B. (2014) "Complexity Economics: A Different Framework for Economic Thought", [in:] *Complexity and the Economy*. Oxford: Oxford University Press, p. 3.



INCENTIVE STRUCTURES AFFECT SOCIETAL STRUCTURES AND MENTAL MODELS OF INDIVIDUALS

Institutions which form an incentive structure in a socialist totalitarian state are radically different from an institutional setting which is required for the functioning of the Smithian invisible hand. Given the same circumstances, a rationally acting individual behaves differently while facing a different incentive structure. Even simple day-to-day interactions between neighbors would differ under different institutional settings. These small, even invisible, differences when taken together produce very visible outcomes on the macro level.

Incentive structures affect societal structures and mental models of individuals. Given the fact that human brain structures are not infinitely elastic, and become even less elastic with age¹⁰, inertia of mental models can play an important role in institutional change. Historical events which formed the mental models of individuals are therefore important in understanding why there may exist barriers of progress towards cooperation, decentralization, and free society when institutions of coercion, dominance, and obedience are changing into institutions based

¹⁰ "As our mental models become more complex, such major rearrangements become more difficult. Reorganizing an older, more experienced mental model is like reorganizing General Motors, whereas reorganizing a younger, less experienced model is more akin to reorganizing a small startup". See Beinhocker, E. (2006) *The Origin of Wealth: Evolution, Complexity, and the Radical Remaking of Economics*. Brighton: Harvard Business School Press, p. 360.

on Hume's principles of "property, contract, and consent"¹¹. Institutional settings are based on human interaction, and their change is embedded in history and are therefore path dependent.

EXPERIENCE WITH COMMUNISM IN CZECHOSLOVAKIA: THREE PERIODS OF TOTALITARIAN EVOLUTION AND THE VELVET REVOLUTION

History of the Lands of the Bohemian Crown, Czechoslovakia, and more recently the Czech Republic (together with pretty much every other country in Central Europe) in the 20th century and at the beginning of the 21st century may be characterized as turbulent and unsettling. The most significant events in contemporary development were the years 1948 and 1989, which marked a change between two very diverse regimes of recent Czech history – communism and a Western-style democracy.

Following the events of World War I, the Austrian-Hungarian Empire was divided into separate republics, and in 1918 Czechoslovakia was formed. Its early development had had a liberal vibe and leaders from that time (like Karel Engliš) were celebrated classical liberals, whose influence resonated in the country to the moment of the infamous February of 1948¹².

¹¹ "The key point: Smith's analysis does not turn the behavior postulate of self-interest but instead on the institutional specifications that are in operation. [...] Individuals pursuing their own self-interest within an institutional setting of property, contract, and consent will produce an overall order that, although not of their intention, enhances the public good. Absent that institutional setting, self-interest may very well not produce publicly desirable outcomes and, in fact, may produce the opposite". See Boettke, P.J. (2012) *Living Economics: Yesterday, Today, and Tomorrow*. Oakland: Independent Institute, p. 7-8.

¹² Sima, J. and T. Nikodym (2015) "Classical Liberalism in the Czech Republic", [in:] *Econ Journal Watch*, May, pp. 274-292.



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THE PERIOD THAT
PRECEDED THE END
OF THE PRAGUE
SPRING HAD GIVEN
HOPE AND PRODUCED
LEADERS WHO WERE
LATER INSTRUMENTAL
IN INTRODUCING
THE IDEAS OF FREE
SOCIETY AFTER
THE FALL
OF THE BERLIN WALL
AND THE EVENTS
OF THE VELVET
REVOLUTION

After the Communist Party took power in 1948, socialist totalitarian institutions were put in place in a shockingly fast manner. All citizens learned the lesson of obedience through propaganda and observing brutal kangaroo courts, wherein those who resisted were made to agree with the newly established regime. Those events made a mark on the mental models of everyone who was there to witness such atrocities. Property, trust, and voluntary exchange – traditional liberal institutions – were replaced with theft, deception, and obedience.

The Communist Party and its grasp on power lasted until the year 1989 – with only a brief interlude in the 1960s (following de-Stalinization in the Soviet Union), when Czech society

could for the time being breathe more freely again. Unfortunately, the struggle to gain independence and freedom was destined to fail.

This very unique period of Czech history lasted only five years. The abrupt stop to this development in 1968 – commonly referred to as The Prague Spring – by the invasion of Warsaw Pact armies in August 21, had a significant impact all around the globe as it was a clear manifestation of the horrors of totalitarianism. At the same time, the period that preceded the end of the Prague Spring had given hope and produced leaders who were later instrumental in introducing the ideas of free society after the fall of the Berlin Wall and the events of the Velvet Revolution.

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WHAT
FOLLOWED
THE PRAGUE SPRING
WAS ONE
OF THE SADDEST
HISTORICAL PERIODS
FOR CZECHOSLOVAKIA:
NORMALIZATION

What followed the Prague Spring was one of the saddest historical periods for Czechoslovakia: Normalization. The oppression of the regime, now physically supported by the presence of the Soviet army, was less visible – it appeared more on the margins – but, nevertheless, very effective. It can be argued that it was the Normalization period of the 1970s and 1980s that really changed

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NORMALIZED
CZECHOSLOVAKIA WAS
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FELLOWSHIP, TRUST,
AND SYMPATHY
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THIS WAS ABOUT
TO CHANGE

institutions and incentive structures into a totalitarian state and left deep scars in the mental models of a whole generation.

The sole purpose of Normalization was to reward conformity and suppress critical thinking. The institutional environment was put in place to form incentive structures that supported the goal. It worked. Individuals accumulated human capital, which was productive only in this particular incentive structure and which consisted of skills to limit own individual thinking and to express agreement with those in power. An unintentional feature of that human capital which individuals developed during Normalization was tacit knowledge of the technology of power – tools and strategies to force other people to conform and suppress their critical thinking. These features may be still found in the mental models of present day citizens.

Normalized Czechoslovakia was a dark place, where fellowship, trust, and sympathy disappeared. This was about to change. The Fall of the Berlin Wall and Gorbachev's decision not to interfere sparked hope in Central Europe and brought about the Velvet Revolution in Czechoslovakia. People demanded

freedom and were enthusiastic about peace and prosperity, which should be guaranteed by institutions of Western-style capitalism and democracy. Leaders of the revolution joined by dissent of communism and self-proclaimed classical liberals¹³ became mediators of change and started extensive collaboration with influential intellectuals to give Czechoslovakia (and later the Czech Republic) a democratic structure and free-market institutions. As we know, unfortunately, it is futile to try to design a society in a top-down fashion regardless how celebrated and free-minded the experts involved are.

This concise sketch of historical patterns shows that whole generations of Czechs and Slovaks were influenced by years of life in specific institutional environments. The rules of the game were different in those different environments and individual mental models were changed. Individuals learning how to perceive the world in Normalization formed radically different mental models than those who learned how to perceive the world after the Velvet Revolution.

THE MEANING OF THE DECENTRALIZATION OF GOVERNANCE: WHAT IS GOVERNANCE AND WHY DECENTRALIZATION MATTERS

The process of institutional change from communism to capitalism, or from totalitarianism to democracy, requires an understanding of governance and tensions between centralization and decentralization. Governance has a more general meaning and does not simply mean *government*. It has to do with special kinds of relationships which are present in many social artifacts (like states, firms, non-profit organizations,

¹³ Sima, J. and D. Stastny (2000) "A Laissez-Faire Fable of the Czech Republic", [in:] *Journal of Libertarian Studies* 14, No. 2, pp. 155–178.

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DESIRED
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AS COOPERATIVE
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COORDINATED

trade associations, educational institutions, among others), and which have a more vertical, rather than horizontal, form.

Even the concept of self-governance relates to a hierarchical relationship which individuals impose on themselves. Indeed, self-governance is a very voluntary process by nature. Government is on the other side of the spectrum from self-governance and refers to the structure of a governing body, selected either democratically or by totalitarian means, which oversees a process of mainly involuntary control over citizens of a particular state or members of a societal group.

Governance with full decentralization would be the situation where the only type of governance is the self-governance of individuals. Governance with total centralization is,

on the other hand, a dystopian government which has absolute control over every individual and dictates every action in such a society. It is a spectrum from free market anarchism of exchanges to totalitarian central planning and control.

This line of thought raises an important question: what kind of decentralization leads to peace and prosperity? One type of decentralization could be autarky, but autarky is not the kind of decentralization economists have in mind when they talk about benefits of decentralization, as it may be peaceful but not very prosperous. Desired decentralization could be described as co-operative decentralization where individuals interconnected through complex networks of exchanges interact and their plans are coordinated. Governmental structures, even in democratic systems, tend to be more centralized than private businesses – still, downsides of centralization negatively affect both private and public ordering¹⁴.

The dichotomy between decentralization and centralization can be described as coordination over control. Analyzing how a system of hierarchical relationships of social interactions function offers a better idea of the feasibility of decentralization inside governmental structures. It has been widely studied by numerous scholars that under private ordering, the incentive structure is better suited to guide individuals to be beneficial to one another than under the public ordering.

In other words, decentralization tends to be easier to achieve in the market setting because the incentive structure coordinates individual plans towards peace and prosper-

¹⁴ Wagner, R.E. (2017) *Politics as a Peculiar Business: Insights from a Theory of Entangled Political Economy*. Cheltenham: Edward Elgar Publishing, pp. 256.

ity rather than in the governmental setting where the incentive structure tends to favor bureaucracy and centralized control.

If one agrees that decentralization is the right direction and one that enables a further development of an economic system, one might ask where are the possible limits of achieving decentralization and what are the barriers in the system which tend to keep centralization, not only in place, but even increasing its scope? Decentralization of governance is a function of institutions which can allow decentralized decision-making to be efficient and productive. Without the right institutional setting with the proper incentive structure, decentralization would not only be less productive but also impossible to achieve.

THERE IS MORE THAN CAN BE LEARNED FROM FORMAL INSTITUTIONS: FROM ACEMOGLU AND ROBINSON TO OSTROMS

In their book *Why Nations Fail*¹⁵ Acemoglu and Robinson show that to answer the essential economic question “why certain countries are wealthy and successful, and others are not” first it is crucial to gain understanding of institutions which play a key role in forming an environment in which individuals interact. The authors put forward a model in which they differentiate between economic and political institutions, where both can be either inclusive or extractive.

Extractive institutions in a political realm are limiting access to power, whereas in an economic realm they are redistributing wealth to those politically connected. On the other hand, **inclusive institutions** rely on open access to political power through a democratic process, where wealth is shared based



THE PATH
FROM COMMUNISM
TO CAPITALISM,
FROM TOTALITARIANISM
TO DEMOCRACY,
IS ONE
FROM EXTRACTIVE
TO INCLUSIVE
INSTITUTIONS

on merits rather than political connections. The path from communism to capitalism, from totalitarianism to democracy, is one from extractive to inclusive institutions.

In post-communist countries, democratic institutions replaced totalitarian institutions and people once again had the chance to vote in the election process to choose their representatives. Special types of laws, called lustration laws, prohibited former members of the repressive communist apparatus (e.g. the communist-era secret police) to run for designated public offices were proposed and agreed upon by parliaments in many post-communist states. These laws were intended to secure inclusiveness for political institutions. The process of making political institutions more open seemed to happen rather quickly. The pathway to more inclusive economic institutions was paved with struggles as it first focused on “getting the prices right”. Only later was it realized that it is important to focus on “getting the institutions right”¹⁶.

¹⁵ Acemoglu, D. and J.A. Robinson (2012) *Why Nations Fail: The Origins of Power, Prosperity and Poverty*. New York: Crown.

¹⁶ Boettke, P.J. (2005) “Anarchism as a Progressive Research Program in Political Economy”, [in:] Stringham, E. (ed.) *Anarchy, State and Public Choice*. Cheltenham: Edward Elgar Publishing, pp. 206-219.

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THE SYSTEMS WHICH
APPEAR AT FIRST
GLANCE AS “TRAGEDY
OF COMMONS”
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THE PERSPECTIVE
OF HOW THEY
ACTUALLY FUNCTION

The approach of Acemoglu and Robinson, which concentrates more on the macro level and analyzes aggregate behavior, may be further developed to broaden their viewpoint and to look into subtle nuances of marginal games. Theorizing about the interplay between political and economic institutions should further consider two important propositions.

First, next to the formal institutions (either political or economic) there exist also informal institutions, which might not be evenly spread across the society. Second, every individual action takes place at the margin rather than in the aggregate. To better understand the real mechanism of institutional dynamics, the level of analysis must be at the margin and at local clusters, where informal institutions are structuring incentives and, through them, individual action. When resorting to formal institutions (e.g. solving conflict through a judicial system) has prohibitive costs, informal institutions are, in fact, those which are more significant for macro-level outcomes.

The distinction between the two types of rules (rules-in-use and rules-in-form), as can be found in the work of Vincent and Elinor Ostrom¹⁷, may be used to identify features of the system of the post-communist transition, which might work against cooperative decentralization. Their argument shows that in the absence of a very particular set of rules-in-form (e.g. property rights), which are commonly required for economic systems to show self-organizing properties, one has to search for rules-in-use. Rules-in-use, in the Ostroms' framework, may emerge in the system to play the function of desired institutions to facilitate cooperation. Their point is therefore to show that the systems which appear at first glance as “tragedy of commons” are not necessarily so tragic when looked at from the perspective of how they actually function.

Their argument could be analytically used as a reverse argument, showing that even though free market rules-in-form (which should incentivize agents towards cooperative decentralization) exist in the system, rules-in-use emerge, arising out of totalitarian mental models of individuals, which leads to conflict rather than cooperation.

Formal institutions, which should lead to peace and prosperity through cooperative decentralization, are present in almost all of the post-communist countries – at least at the constitutional level. In the Czech Republic (as well as in all EU member states) free trade and open borders are formally guaranteed. From the very existence of formal institutions, it cannot be concluded that those are, in fact, the institutional environments in which individuals are making their decisions. On the margin, various associations and organizations – especially those with

¹⁷ Ostrom, E. (2007) “Institutional Rational Choice: An Assessment of the Institutional Analysis and Development Framework”, [in:] Sabatier, P.A. (ed.) *Theories of the Policy Process*. Boulder: Westview Press, pp. 21-64.

near monopoly power – could be in a position to establish themselves as a filter mechanism. Such a mechanism may informally put in place institutions, the purpose of which is to bypass formal institutions of free trade and open borders and increase costs to individuals who aim to offer their products or services on the market or engage in international trade.

Let us take the example of a trade association for ski instructors and ski schools (APUL) in the Czech Republic. Since its establishment in 1992, the executive board of the association made numerous decisions which increased the costs for Czech ski instructors to realize gains from international trade. These decisions were, in essence, made in order to keep local wages in the industry at a low level. Measures like limiting the information flow or refusing to facilitate qualification recognition were put in place to impede free international movement of labor. As formal institutions in the form of border walls and barbwire were replaced by open border formal institutions of the European Union, locally established informal institutions within the association functioned as a continuation of impediment of movement of labor outside the country. Although none of these decisions violates legal rules, they have an important impact on creating a filter mechanism to *de facto* bypass formal institutions. Rules-in-use, which ski instructors face, are not the same as rules-in-form, which should be *de jure* institutions of free movement of labor. In contrast, similar trade associations for ski instructors in the USA (PSIA-AASI) or New Zealand (NZSIA) act exactly in an opposite manner and establish procedures to align institutions in the industry with the institutions of free international trade and facilitate the movement of its members.

These are not isolated events, but rather repeating patterns in post-communist countries, where on the margin and through in-

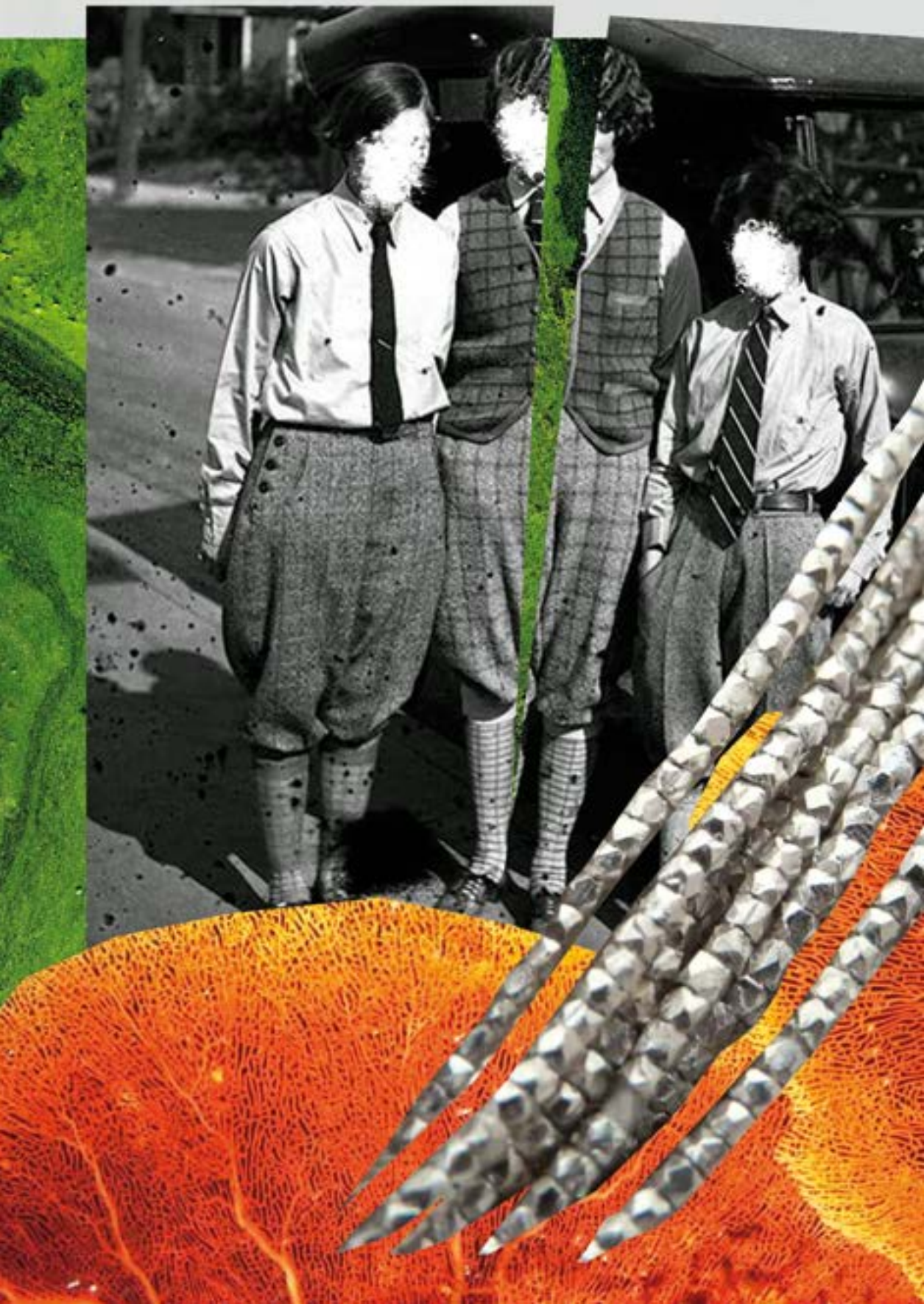
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THE POSSIBILITY
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formal institutions incentive structures that resemble the Normalization era rather than free society are put in place by individuals with a mental model that is rooted deeply in the past.

POST-COMMUNIST DEVELOPMENTS: THE STORY OF TWO COHABITATING SOCIETIES GOVERNED BY DIFFERENT INFORMAL INSTITUTIONS

Almost three decades have passed since 1989. By taking a look at indicators such as GDP, the Czech Republic is a country with steady economic growth. Yet, in general, the overall pattern of convergence to the EU or the West did not match the expectations that had been formed shortly after the Velvet Revolution. When analyzing the structure of the economy and political process, it may be argued that country's development towards institu-





INSTITUTIONAL ENVIRONMENTS IN ONE PARTICULAR SOCIETY DO NOT HAVE TO BE AS HOMOGENEOUS AS IT MIGHT SEEM WHEN OBSERVING ONLY WRITTEN-DOWN RULES-IN-FORM TYPE OF FORMAL INSTITUTIONS

tions of free-market and democracy either slowed down or ceased to exist completely. This situation might be explained by the existence of reverse tendencies in the system, which resist further decentralization.

As Peter Boettke put it: “economic, political, and legal reforms are not just abstract impositions, but rather a process of growing economic, political and legal institutions [...] culture and imprint of history determine which rules can stick in certain environments”¹⁸. The possibility of the decentralization of governance, which would lead to peaceful cooperation, is determined by establishing shared concepts within informal institutions in every situation on the margin. Inelasticity and inertia of mental models can function as a barrier to the desired development.

¹⁸ Boettke, P. (1996) “Why Culture Matters: Economics, Politics and the Imprint of History”, [in:] *Nuova Economia e Storia*, No. 3, pp. 189-214. Available [online]: <https://ssrn.com/abstract=1531000>

Everyone in the society shares formal institutions because they are present in the form of a legal and judiciary system. Opposing informal institutions may, however, prevail on various margins within the society. Therefore, institutional environments in one particular society do not have to be as homogeneous as it might seem when observing only written-down rules-in-form type of formal institutions¹⁹.

The sole fact that all individuals in the society agree with one another that they are and ought to live in democracy, does not mean they live in the same system and relate to one another in the same way. While for some, *democracy* means a process to acquire power and gain from established vertical relationship of superiority and inferiority, for others it might mean the way people relate to one another with respect and how they achieve coordination in a situation of horizontal conflict, which might be costly to solve through market decision-making. Rules of the game in public ordering can have the same names and be very similar in form, but if interpreted through mental models in different or even opposite fashion, such rules cannot efficiently lead to peaceful solutions of the conflict.

“Other, perhaps deeper, conditions for social order include shared beliefs and norms within communities about how they regard one another, what they consider to be fair, how they distinguish right from wrong, and how they see society and nature as wholes coming together to constitute a univer-

¹⁹ Even though citizens are bound to obey formal rules *de jure* it does not follow that individuals are not facing rather opposing *de facto* rules when making decisions, e.g. weak formal laws and strong mafia in contrast to weak property right but rules-in-use to avoid tragedy of commons. In various situations based on where the action is taking place, individuals can be guided by different institutions and therefore institutional environment is not homogeneous, i.e. sometimes it can be like property rights exists and sometimes as if they do not.

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sal order. If there were no bases for trust, and no shared community of understanding about the meaning of right and wrong, then the terms of trade in exchange relationships, or the patterns of reciprocity in communal and social relationships, would become extraordinarily precarious. Such societies could not develop”²⁰.

A generation that has formed their ideas on how to understand the world and social relationships under a strict totalitarian regime unavoidably have, by necessity, formed correlated perceptions about the rules of inter-

personal conduct. Although these rules are well suited to guide action in a totalitarian society, this does not imply that they are also the best guidelines for action in a free society. The Czech Republic (and likely all post-communist countries) is characterized by a complex institutional environment where formal institutions are almost exactly the same for anyone, while individuals at specific clusters of the society are facing conflicting informal institutions at various margins. These discrepancies can promote barriers to cooperative decentralization between individuals with conflicting mental models, and negatively affect coherence of the overall institutional environment. Incomprehensible institutional environment inhibits feasibility of cooperative decentralization.

Many clusters of Czech society can be characterized as having very centralized governance. The function of centralization which functions well is to simulate as if the institutional environment in which individuals are making their decisions resembled the one which was in place during the era of Normalization, where innovation was not present, and stagnation and decay ruled the country. People were afraid of expressing their opinions and fearful to raise their voice against the oppression and unfairness that existed. Even to this day, Czech society resembles on various margins this era, as some clusters are populated by individuals imposing their mental models on the institutional environment.

CONCLUSIONS

People who invested in human capital advantageous under totalitarian regime usually prefer to operate under rules-in-use, which allow for their human capital to be utilized. They therefore promote these rules to endure on the margins where they have power to influence such an outcome. Horizontal relationships of exchange and cooperation are replaced at various margins by the ver-

²⁰ Aligica, P. (2003) *Rethinking Institutional Analysis: Interview with Vincent and Elinor Ostrom*. Mercatus Center at George Mason University, p. 5. Available [online]: <https://ssrn.com/abstract=1723393>

tical relationship of power and dominance. This behavior pattern of post-communist democracies leads to increased costs for any potential cooperative decentralization, while promoting processes which lead to centralization, where skills of power and control have more use.

Many commentators²¹ are displeased with the current form of the Czech government and criticize the fact that it has been created by votes of the members of the Communist Party. However, it is not the existence of the Communist Party *per se* one should be afraid of, but rather the totalitarian and communist way of thinking in general. This type of a mindset is still deeply ingrained in the mental models of many Czech citizens. When the prime minister claims he wants to “run the state like a business firm”²² and this idea is supported by the masses, one should worry. We should be even more concerned when we realize what is his, and his generation’s vision for business management – hierarchical centralized channels of control with a powerful omnipotent commander on top.

²¹ See Tait, R.: Czech communists return to government as power brokers. [in:] The Guardian 12 Jul 2018 Available [online]: <https://www.theguardian.com/world/2018/jul/12/czech-communists-return-to-government-as-power-brokers>; Muller, R., Lopatka, J.: New Czech government has shaky support, strong anti-migration stance. [in:] Reuters June 27, 2018 Available [online]: <https://www.reuters.com/article/us-czech-government/new-czech-government-has-shaky-support-strong-anti-migration-stance-idUSKBN1JN0R9?il=0>; The Economist: The enduring influence of the Czech Republic’s communists. [in:] The Economist Jul 11th 2018 Available [online]: <https://www.economist.com/the-economist-explains/2018/07/11/the-enduring-influence-of-the-czech-republics-communists>

²² See Tait, R.: Czechs tipped to join populist surge in Europe by electing billionaire. [in:] The Guardian 19 Oct 2017 Available [online]: <https://www.theguardian.com/world/2017/oct/19/czech-republic-andrej-babis-billionaire-agrofert-populism>; Bendová, J.: Řídit stát jako firmu? Naposledy to zkoušel Lenin, říká ekonom Zelený. [in:] INFO.CZ 29. září 2017 Available [online]: <https://www.info.cz/cesko/ridit-stat-jako-firmu-naposledy-to-zkousel-lenin-rika-ekonom-zeleny-16776.html>

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THE CZECH REPUBLIC (AND LIKELY ALL POST-COMMUNIST COUNTRIES) IS CHARACTERIZED BY A COMPLEX INSTITUTIONAL ENVIRONMENT WHERE FORMAL INSTITUTIONS ARE ALMOST EXACTLY THE SAME FOR ANYONE, WHILE INDIVIDUALS AT SPECIFIC CLUSTERS OF THE SOCIETY ARE FACING CONFLICTING INFORMAL INSTITUTIONS AT VARIOUS MARGINS

Not only should we oppose the idea that a state is the same as a business, as we know very well from Hayek that this type of thinking constitutes a road to serfdom, but we should also oppose extremely hierarchical and centralized management in general. Relying solely on hierarchical management structures is ill suited for more complex organizations, in both private and public ordering, and causes management costs to skyrocket while suppressing potential innovation.

Google, Spotify, as well as Aspen Skiing Co. employ decentralization and horizontal relationships to promote the autonomy of their employees. An extreme example of this approach is Valve Corporation (an innovative video-gaming and digital distribution company), with virtually no horizontal structure at all. These companies and their approach to decentralization should serve as an example for the development of business management and public administration in post-communist countries.

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INCOMPREHENSIBLE INSTITUTIONAL ENVIRONMENT INHIBITS FEASIBILITY OF COOPERATIVE DECENTRALIZATION

There are still some unexplored and unused potential benefits of cooperative decentralization in the Czech Republic. By aligning informal institutions with formal ones, the incentives for cooperation among generations would lead to beneficial innovations. In contrast, by enforcing rules-in-use, which resembles a totalitarian state, and establishing barriers for younger generation (which does not have the skills necessary to efficiently navigate such an institutional environment), there are two possible outcomes: the youth will either leave the country or will stay but instead will become frustrated and apathetic. In both cases the drive and potential for innovation will be massively impaired.

It is not only in physical capital and foreign financial capital where a developing post-communist country could find resources to grow and converge with the EU and the West, but also in allowing unused human capital to be implemented through cooperation between generations. The key problem may lie in the necessity of disinvestment in human capital acquired during life in a totalitarian socialist state. It is only in the hands of the generation with mental models from the past to make a conscious decision to leave such a mindset behind and move forward to make the country successful in the future. •



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NOHEJL

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Local Government Reform in Estonia



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ARTO
AAS

Having restored its independence in 1991, the Republic of Estonia has been one of the most successful reform countries in Eastern Europe.

After the disintegration of the Soviet Union, a number of liberal reforms were implemented quickly, which consisted in the breaking up of national monopolies, the establishment of the rule of law, privatization, and the establishment of the capitalist rules of the game.

The transition from the socialist planned economy to a market economy was very complicated and painful for many, but it proved to be the correct decision after a short number of years. Estonia became a rapidly developing, open, and Western-minded Nordic country. The e-government model and the digital society of Estonia are also an example for many developed countries in the West nowadays.

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LOCAL GOVERNMENTS
HAVE PLAYED A VERY
IMPORTANT ROLE
IN THE FORMATION
OF THE INDEPENDENT
ESTONIAN STATE

However, there was one area where there had yet been no success in carrying out the necessary changes over 25 years: the local government reform. During two decades, six attempts had been made to carry out the local government reform, but all the attempts had failed.

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LOCAL GOVERNMENTS
HAVE BEEN IMPORTANT
SHAPERS OF IDENTITY
AND HOTBEDS
OF DEMOCRACY
THROUGHOUT
HISTORY

Estonia, with its population of merely 1.3 million, was fragmented into 213 local governments of extremely varying size and capability. Against the background of that stagnated local government model, creeping centralization took place, and the role of the state in the shaping of social processes and public services was gradually increasing.

At the same time, the petrified local government structure did not consider the rapid demographic changes that had taken place in society, such as the ageing of the population and urbanization. This article sheds light on the governance in Estonia, the role of local governments, and on how local government reform was finally implemented in 2016–2017.

THE ROLE OF LOCAL GOVERNMENTS IN ESTONIA

Local governments have played a very important role in the formation of the independent Estonian state, both at the beginning of the 20th century and in the restoration of its independence in 1991. In the last century, local level elections were the first elections to produce the Estonian politicians and statesmen.

Legend:

- County
- City
- Rural municipality

Scale: 50 km

Counties and their divisions:

- Harju:** Tallinn, Viimsi, Järva, Jõelähtme, Rae, Raasku, Anija, Kuusalu, Lohja, Harku, Saku, Kili, Kose, Rapla, Kohila, Saue, Lääne-Harju, Kella.
- Lääne-Viru:** Rakvere, Vinni, Mustvee, Jõgeva, Põltsamaa, Järva, Pärnu, Põhja-Pärnumaa, Pärnu, Lääne-Harju, Kella.
- Ida-Viru:** Jõelähtme, Rakvere, Vinni, Mustvee, Jõgeva, Põltsamaa, Järva, Pärnu, Põhja-Pärnumaa, Pärnu, Lääne-Harju, Kella.
- Jõgeva:** Jõgeva, Põltsamaa, Järva, Pärnu, Põhja-Pärnumaa, Pärnu, Lääne-Harju, Kella.
- Tartu:** Tartu, Põltsamaa, Järva, Pärnu, Põhja-Pärnumaa, Pärnu, Lääne-Harju, Kella.
- Põlva:** Põlva, Kanepi, Otepää, Torva, Mulgi, Saarde, Hädameeste, Kihnu.
- Võru:** Võru, Rõuge, Aniste, Valga, Torva, Mulgi, Saarde, Hädameeste, Kihnu.
- Valga:** Valga, Torva, Mulgi, Saarde, Hädameeste, Kihnu.
- Viljandi:** Viljandi, Põhja-Sakala, Pärnu, Põhja-Pärnumaa, Pärnu, Lääne-Harju, Kella.
- Pärnu:** Pärnu, Põhja-Pärnumaa, Pärnu, Lääne-Harju, Kella.
- Rapla:** Rapla, Kõhna, Märjamaa, Pärnu, Põhja-Pärnumaa, Pärnu, Lääne-Harju, Kella.
- Lääne:** Lääne-Harju, Kella.
- Hiiumaa:** Hiiumaa.
- Saaremaa:** Saaremaa.
- Muhu:** Muhu.

Hill County

Local governments have been important shapers of identity and hotbeds of democracy throughout history. It may be said with a slight reservation that already when Estonia was still in the Soviet Union the first almost free elections were held in 1989 at the local level. The central power of Moscow was already weakened, and the freedom movement gained momentum. Moscow was unable to control all the local candidates, thus local governments have played an important role in the establishment of the independence of Estonia and therefore are important to many people. Exactly in the same way, the Estonian local government leaders attach great importance to the European Charter of Local Self-Governments that emphasizes the autonomy of local governments and the importance of making decisions for oneself.

The political model of state management in Estonia is relatively simple. After all, a small country cannot afford a complicated and costly system. We have only one national level – parliamentary elections. Besides, there is only one local level – local council elections every four years. There are fifteen counties in Estonia, but they are mainly of historical and cultural importance. The county governments had very little administrative power and were finally closed on January 1, 2018. No elections are held at the county level as a part of the national administration.

FRAGMENTATION OF LOCAL GOVERNMENTS

When the independence of the Republic of Estonia was restored in 1991, more than 250 local governments were born, including rural municipalities and cities with a long history, as well as units that had emerged within the boundaries of the rural councils dating back to the time of occupation. Over the course of twenty years, about thirty local governments who merged with their neighbors voluntarily disappeared from the map.



OR THE MOST PART
LOCAL GOVERNMENTS
DEPEND
ON THE SUCCESS
AND GEOGRAPHICAL
LOCATION OF THEIR
WORKING AGE
POPULATION

Those mergers were mostly considered to be success stories, which never brought about a greater wave of mergers. Local government leaders defended their power positions very jealously, and various fears and myths prevailed among the population. Merger negotiations between local governments often broke down at the very last minute when no agreement could be found on the name or the location of the rural municipality government of the new local government.

The local government landscape was very fragmented in Estonia. Tallinn, the capital, was the largest local government (450,000 residents), while the small island of Pärnu was the smallest (99 residents). At the same time, they had to equally ensure all functions and services, according to law.

Of course, that was an absurd requirement. While there are wealthy local governments in the capital region who are not significantly inferior to Scandinavian local governments in terms of capacity, in poor micro-rural municipalities in the periphery the state subsidies accounted for 70% of the local government budgets in order that the rural municipality would be able to ensure basic services at a minimum level.





FUNDING AND EDUCATION

The model of funding local Estonian governments is similar and uniform for all. 11.7% of the personal income tax of the people residing in a local government is given to the budget of the local government (the general rate of personal income tax is 20%). The more taxpayers and the higher the incomes, the larger the local government budget. Of course, added to this are various regional subsidies and the European Union funds, but for the most part local governments depend on the success and geographical location of their working age population. The proportion of local taxes are very marginal in Estonia, and excluding the land tax, very few have been established in fact.

Estonia is a country with one of the lowest population densities in Europe (30 people per km²). Very few people live in a relatively large territory. Estonia is larger than the Netherlands by size, but thirteen times less people live here. The population density is especially low in rural areas and the periphery. At the same time, the offering of certain services and the maintenance of the infrastructure is significantly more expensive in a large territory than in densely populated cities.

This brings us to the core of the problems of many rural areas – a large region, high costs, but few taxpayers and a low salary level. It is clear that local governments cannot get out of this vicious circle on their own. These problems can be solved only in cooperation with the central government.

In spite of the emotional and historical importance of local governments in Estonian politics, they have not really played a very large role in organizing national life and offering public services. According to the 2013 OECD data, for example, local and regional expenditure accounts

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IN SPITE OF THE EMOTIONAL AND HISTORICAL IMPORTANCE OF LOCAL GOVERNMENTS IN ESTONIAN POLITICS, THEY HAVE NOT REALLY PLAYED A VERY LARGE ROLE IN ORGANIZING NATIONAL LIFE AND OFFERING PUBLIC SERVICES

for 36.4% of GDP in Denmark and 23.9% of GDP in Finland¹. In Estonia, the relevant indicator has been as low as 9.9% of GDP. Over the years, the power balance at national and local levels has clearly shifted in favor of the central government. The main reason is often the fact that the central government has had more sources of income, and more professional organization of work. It is, of course, no big surprise that a local government the size of an apartment building is not capable of being an equal partner and balancer to the central government.

The role of Estonian local governments, cities, and rural municipalities with equal status has been mainly confined to organizing

¹ See <http://www.oecd.org/regional/regional-policy/country-profiles.htm>

the local life at the lowest level, such as road construction, property maintenance, social protection, the nursery service, and municipal planning. In addition, they also deal with the shaping of the local school network and the property relating to that.

Education is valued very highly in Estonia and a local school is often considered the heart of local government. If a school disappears, children, parents, jobs, tax money and identity disappear together with it. Unfortunately, society is undergoing great changes and many rural schools are forced to shut down. Because of urbanization and low fertility rates there are not enough students, teachers or money to manage a school. This has also been one of the greatest fears in the merger of local governments. Yet, changes became increasingly more inevitable. Why?

DEMOGRAPHIC CHANGES AND URBANIZATION

Similar to other developed countries, Estonia is also experiencing long-term but indisputable demographic trends that affect the functioning of local governments. Primarily urbanization, which in Estonia manifests itself in a population concentrating in the city of Tallinn and its surroundings.

Already around 45% of the population live in the capital region alone, and this trend is continuing. Higher paid jobs and higher tax revenue also concentrate around the capital. As the population of Estonia is not growing, concentration into Tallinn also mean that some rural municipalities in the periphery have lost 30-40% of their former population. If we add here the ageing of the population, greater pressure on the working-age population, and ever higher expectations of local public services, it becomes clear that continuing in this way will lead to a dead end.

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AS THE POPULATION OF ESTONIA IS NOT GROWING, CONCENTRATION INTO TALLINN ALSO MEAN THAT SOME RURAL MUNICIPALITIES IN THE PERIPHERY HAVE LOST 30-40% OF THEIR FORMER POPULATION

Obviously, there are also positive changes for rural regions; such as the growing mobility of the people, improved transport opportunities, Internet and e-services, and more flexible employment relationships that enable teleworking from any forest farm. However, if we analyze the big picture it becomes evident that changes are needed to adapt.

In Estonia, the administrative reform is mainly associated with the merger of local governments. Historically, the majority of the attempts at administrative reforms have focused on drawing borders, which has always created a very big resistance. Local people and local government leaders did not like the fact that politicians on a state level were deciding on their fate in back rooms in the distant capital.

THE CORE OF THE ADMINISTRATIVE REFORM

For me, the administrative reform meant much more than mergers of municipalities. Above all, the government's aim was to in-

crease the capability of local governments. The capability also meant updating the functions and improving the funding. That was also the focal message in the public communication which helped deliver a much more pertinent message than drawing borders. It is true that without the merger of local governments it was often impossible to achieve greater capacity and quality, but there were several other components to it.

The current mergers brought about positive effects, which have been repeatedly confirmed by local government executives and that will very likely appear also in future mergers:

1. A significant **growth of investment capacity** arising from the scale effect, and capability to accomplish things that would have been impossible in separate local governments. There are numerous examples of such large investments that have been implemented that were only dreamt of earlier. Be they new sports buildings, highways, renovated cultural centers or school buildings.
2. **Specialization of officials**, increased proportion of officials with higher education, higher prestige of rural municipality officials, and competitive salaries of employees. In the merged local governments, the salary level has become comparable with that of county centers which gives the possibility to hire competent specialists and avoid "brain drain" from the regions.
3. **The quality and variety of services**, including the quality of social welfare services, has improved. The benefit levels have, as a rule, been harmonized towards the higher level of the merging local governments. Several necessary services have emerged in new local governments which they were incapable of offering earlier.
4. **Emergence of the capability to support enterprise**. Local governments now have funds to develop the business environ-



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ment and to build infrastructure (for example, to develop the infrastructure of an industrial park with considerable cost-sharing).

5. **Local communities have become more active**, and self-governments now have clear cooperation partners locally. The system for supporting local initiatives has been organized.
6. **A clear improvement in the quality of the work of municipal councils**, as requirements for the professionalization of council members have increased. A better balance has been struck between officials and council members in the decision-making process, while the role of council committees has increased. As a rule, greater political competition ensures higher management quality.
7. The total **number of officials, and the proportion of general governance costs in local government budgets has decreased significantly** compared with the period before the merger. In many places it has become possible to direct nearly a third of the current governance costs elsewhere, for example, to the development of nursery schools or the cultural sphere.
8. **Possibility for comprehensive development of the region is created**. This may include development of road con-

struction, as well as waste economy. As a good example, school transport has been better organized with decisions being made with a larger region in mind.

9. **Payments between local governments and bureaucracy in the provision of services to residents in other local governments are eliminated.** Less paper-work and fewer officials make the decision-making process faster and cheaper.
10. **The work of the divisions of municipal councils can be made more efficient and flexible** by uniform organization of their management in places where local governments tend to remain too small when the population decreases, e.g. libraries, cultural institutions, and public utilities. It is better to have branch libraries or community centers with uniform management in a larger region in a situation where the alternative may be closing something down.

Urbanization and the ageing of the population is a proliferating characteristic in many countries. If we take the right action, we are able to balance these demographic changes, but in a democratic country it is neither possible nor necessary to reverse these processes entirely. However, it was definitely impossible to ignore the fact that when many local governments had lost a large part of their population and revenue base, the structure of the local governments remained unchanged for decades. No one was happy with the current situation, yet at the same time they were fearful about changes.

THE PREPARATION AND TIME SCHEDULE OF THE ADMINISTRATIVE REFORM

The coalition agreement entered into between the liberal Reform Party, led by Prime Minister Taavi Rõivas, the conservative Pro Patria and Res Publica Union, and the Social

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Democrats in spring 2015 set out that the aim of the local government reform was well-functioning and capable local governments.

The government wanted the local government reform to enhance the competitiveness of rural areas and make local governments stronger in order to enable them to offer higher quality services to their residents. Local governments must play a greater role and be more independent in organizing local life. Only a strong local government is able to really balance the central power and to protect the interests of local people. One of the important objectives of the reform was also to strengthen local representative democracy.

There were too many local governments in Estonia whose subsistence depended wholly on assistance from the state. The state support fund payments made up more than

one-third of the budget revenue in these rural municipalities. There were local governments who had received no investments from European Union funds over eleven years. They lacked the actual capacity to write project applications, not to mention the possibility to ensure the necessary self-financing. Their budget and the smallness of their service area did not allow for hiring specialists with the required professional education – be it a financial analyst or a child protection official. As the municipalities were very small, there were neither enough political parties, nor independent local politicians represented. The non-existent competition in local elections was described as a democratic freeze. In such a situation, the principle of local autonomy is merely an illusion, and not reality. All this had to change.

The expert body preparing the reform wrote down the core capabilities of a future local government, and the main functions that every city and rural municipality had to be able to perform. These included competence in law, financial management, development work, planning, construction, and the environmental sphere.

Likewise, a local government must be able to independently organize education and youth work, the social field and the utilities. It is clear that the performance of these functions in a modern and high-quality manner requires competent specialists and a sufficiently large customer and revenue base.

In preparation for the reform, it was possible to consider many different alternatives. Local government reforms have been carried out in many neighboring countries and the studies and analyses conducted in the designing of previous reforms were easily accessible. It was also clear that it was impossible to copy exactly one-to-one the reforms of any other country or age, because the historical, cultural, and political situation is always unique.

Nevertheless, the expert committee that assisted the Minister of Public Administration reviewed three or four different alternatives on how to assess the capability of a local government and how to carry out mergers. Finally, it was decided that – similarly to several other countries – the number of residents would be taken as the basis for merging local governments. The revenue base, the capacity to offer services, and the investment capability of a local government are contingent on the number of residents. Therefore, the following principles were agreed on in the Administrative Reform Act:

- the minimum size of a local government is 5,000 residents;
- the recommended size of a local government is 11,000 residents;
- the government may grant exceptions to islands (four) and rural municipalities with a very large territory.

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TO ENCOURAGE
THE ESTABLISHMENT
OF LARGER UNITS,
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MONETARY BONUS

Of course, the requirement of the minimum size of local governments created the biggest debate. Many local government executives considered it too large, while several political powers considered it too small. It was definitely not reasonable to lower the bar any further, because then the whole reform would have become pointless.

To encourage the establishment of larger units, it was proposed that local governments with more than 11,000 residents would receive an additional monetary bonus. Experience showed that for many local governments the sizeable merger bonus was a fairly strong argument for a more ambitious merger.

The drafting of the Administrative Reform Act, and the political debates that ensued began in spring 2015. The parliament (Riigikogu) adopted the Act on the reform in June 2016. A conscious choice was made in the Act to the effect that, at first, local governments would have the possibility to find suitable merger partners for themselves, and the government would intervene only in the second phase. In the implementation of the reform, several important stages can be marked out:

- I The drafting of the Act and its adoption in parliament (June 2016)
- II The phase of voluntary merger of local governments (until December 31, 2016)
- III Forced merger of local governments that failed to meet the criteria (January 2017–July 2017)
- IV Election of new municipal councils (October 2017)

After the Act had been adopted in parliament, local governments had only half a year to find suitable partners for themselves, enter into a merger agreement, and agree on the name and center of the new local government. This may seem to be an extremely short period, which was made all the more so as a request to declare the Act adopted in the parliament

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to be in conflict with the Constitution was submitted to the Supreme Court immediately, and the final response did not arrive before December 2016.

Unfortunately, the time schedule for carrying out the reform did not allow for greater flexibility because certain principles and the election terms are fixed in the Constitution of the Republic of Estonia. However, nobody wished to amend the Constitution. Moreover, debates on mergers had been going on for a good many years, and the majority of local government executives knew very precisely with whom to hold merger negotiations. Many local government executives had started negotiations already before the Act was approved in parliament.

The later experience eloquently showed that everything hinged on political will. The majority of the local governments were able to meet the deadlines without problems. Yet, there were still those who, for personal or political reasons, never started the mergers.

The government used several other incentives to motivate voluntary mergers:

- 1) **a merger bonus for voluntarily merged local governments** (total expenditure ca. EUR 65 million);
- 2) **a lump-sum compensation** to the extent of up to one year's salary to local government executives who leave office, if they do not continue in the same post in the new local government;
- 3) **merger experts funded by the government and documentation** to assist local governments.

Of course, such incentives created a certain amount of discontent among the media and the opponents. The lump-sum compensations paid to local government executives faced the greatest wave of criticism. According to the most vocal critics, it was all too expensive and unnecessary². Yet, every reform comes at a price. The experience of other countries also showed that granting lump-sum compensations to local government executives released many tensions and obstacles³. After all, in the final analysis, these are the people who have to carry out the merger successfully on the spot.

The carrying out of the administrative reform concerned nearly all Estonian local governments and a large part of the population. Before, 80% of the old local governments did

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BEFORE, 80% OF THE OLD LOCAL GOVERNMENTS DID NOT MEET THE CRITERION OF 5,000 RESIDENTS. THE LATER RESULTS SHOWED THAT THE MAJORITY OF LOCAL GOVERNMENTS MERGED VOLUNTARILY

not meet the criterion of 5,000 residents. The later results showed that the majority of local governments merged voluntarily. Some local governments were granted exceptions under law, and there were a few dozen local governments that the government had to merge by force with some of their neighboring local governments⁴. There were also some local protests by inhabitants, but surprisingly not on a state level. None of these protests had any remarkable influence on the decision-making process. The relatively wealthy and densely populated capital region was the least affected by the administrative reform, but capability was never an issue with them in the first place.

Out of the 213 local governments, 79 remained in place after the reform (15 cities and 64 rural municipalities). The median

² See <https://www.saartehaal.ee/2017/01/14/lahku-mishuvitis-tekitab-eriarvamusi/> [in Estonian]

³ For example, Finland had used a similar lump-sum compensation system. It reduces the risk of losing the living standard for local government executives. One year is a long time to find a new suitable job.

⁴ For details see <https://haldusreform.fin.ee/vv-algatatud-uhinemised/> [in Estonian]

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OUT OF THE 213 LOCAL GOVERNMENTS, 79 REMAINED IN PLACE AFTER THE REFORM (15 CITIES AND 64 RURAL MUNICIPALITIES)

number of residents in local governments grew four times (from 1,887 to 7,865), whereas the average size of local governments grew three times to 512 square kilometers. The size and capability of local governments were clearly harmonized. In a later phase of the reform, the state also transferred additional functions together with an increasing funding to local governments, and therefore it may clearly be said that the role and financial situation of local governments improved significantly.

After the reform, 96.2% of the Estonian people lived in local governments that met the criteria of the administrative reform. In the European context, starting from 2017, Estonia belongs among *the average* in terms of the number of residents of local governments, ranking next to the Nordic countries⁵.

Certainly, no reform is ever ideal, and the debates will go on for a long time. Yet, another local government reform will likely follow at some time in the future and it might go in an entirely different direction. However, a great majority of the Estonian local gov-

⁵ Rahandusministeerium (2018) *Administrative-Territorial Reform*, p. 159. Available [online]: <https://www.rahandusministeerium.ee/en/objectivesactivities/local-governments-and-administrative-territorial-reform/administrative>



ernment leaders, politicians, and experts are of the opinion that the reform carried out in 2016–2017 was a success⁶.

MAIN LESSONS IN CARRYING OUT AN ADMINISTRATIVE REFORM

Implementing sophisticated reforms always teaches politicians several substantial lessons. Here are some of the most crucial ones that have a wider range of application:

- political will and leadership at the highest level of governance are of key importance. When there is a will, there is a way;
- it is important to be clear that those who manage are responsible for the whole process. In Estonia, a separate portfolio for the Minister of Public Administration was established for that purpose, which was justified. The processes is complicated and cannot be managed in parallel with other functions;
- for reforms to succeed, a clear aim, a time schedule, a team, and a budget are needed. Every reform comes at a price (budget) that pays off later;
- choosing the right pace for a reform is of vital importance. When things are done in a hurry, involvement suffers, and technical and legal mistakes occur. On the other hand, if there is too much delay, reform tiredness sets in, and problems tend to amplify. It is impossible to please everyone and at some point decisions must be made and implemented;
- decisions must be made and explained in an involving and broad-based manner. The researchers and political experts participating in the carrying out of the reform increased the quality, reliability, and legitimacy of the decisions;
- communication is the key. Repeating your simple and clear message and fighting the fears and myths of skeptics is a te-



THE ADMINISTRATIVE REFORM WAS FORMALLY COMPLETED WITH THE LOCAL ELECTIONS OF 2017, BUT ITS REAL IMPACTS WILL AFFECT ESTONIANS FOR DECADES TO COME

dious but inevitable part of any political campaign. Of course, modern technical means and social media can be put to use here.

It is common that complicated public sector reforms do not reward the reformers with huge public support in the short run. One might even lose the next election. But liberals should not hesitate and still do the right thing. After all, it is our moral duty to think and act for the benefit of the next generations.

CONCLUSIONS

The administrative reform initiated in 2015 in order to increase the capability of local governments was undoubtedly one of the changes with the greatest social impact in Estonia in the last 15 years. The accomplishment of the administrative reform is all the more miraculous as all earlier attempts had failed, causing a certain amount of disbelief in many parties involved. The administrative reform was formally completed with the local elections of 2017, but its real impacts will affect Estonians for decades to come.

⁶ Valner, S. (2017) *Haldusreform 2017*. Available [online]: <https://haldusreform.fin.ee/static/sites/3/2018/07/haldusreform-2017.pdf> [in Estonian]

With such a great and complicated change, it is no wonder there were many opponents – both for political and personal reasons. The local government merger considerably shook the established power positions and forced many to come out of their habitual comfort zone. Yet the reform became reality, thanks to very clear political will, social maturity and professional execution.

The opponents of the reform (opposition parties in the Riigikogu and some local politicians) tried to stop the process both at the governmental level and in the parliament, not to mention the complicated court actions that reached as far as the Supreme Court. Some of the local governments applied for a constitutional review of the Reform Act in the Supreme Court. The Supreme Court decided that the government-initiated mergers were in accordance to the Constitution and other legislative acts. This was probably an even more important moment than the adoption of the Act in the parliament itself half a year earlier that had been politically predictable, despite the difficulties. Political forecasts have no importance in the Supreme Court, however. At that moment, all legal obstacles have disappeared.

It was undoubtedly a positive development that the revolutionary change of government at the end of 2016 (the Reform Party who had been in power for 17 years went into opposition) did not halt the carrying out of the administrative reform, and it continued according to current plans. Discarding all the work that had been done so far, and repealing the Administrative Reform Act would have postponed the long-awaited reform for yet another decade. Local governments and the credibility of the whole Estonian political system would have stood to lose.

Of course, to increase the capability, investment capacity, and the professionalization of the officials of local governments, it is nec-

essary to improve the funding and shape the functions of local governments in addition to merging cities and rural municipalities. The vision of the administrative reform was that the role of strong and capable local governments in the Estonian governance must grow. Fortunately, both previous governments and the current left-center government have supported that vision.

Many ideas that have strengthened local governments have already been enshrined in law, whereas several proposals are still being processed. One of the most important issues is that of a local government funding model that would help alleviate (instead of aggravating) the problems associated with regional varieties, low density areas, and urbanization. It is clear, however, that without the vigorous wave of the merging of local governments, all these changes would be no more than a surface ripple. The local government merger constitutes the foundation on which new layers can be laid.

What assessment the next generation will make of the administrative reform now largely depends on the new local government leaders and no longer on the members of the government of the Republic or the Riigikogu. It is in the hands of the freshly elected local government leaders how the new opportunities will be handled and what the identity of the local community will be. ●



ARTO
AAS

A member of Estonian Parliament (Riigikogu). Former Minister of Public Administration in Estonia, in the years 2015–2016. He is also long-time member of the Estonian Reform Party (Liberals)

Planning for Shrinkage? Battle Between the Slovenian State and the Municipalities¹



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SIMONA
KUKOVIC

Slovenia is one of the most centralized countries in the European Union with a one-tier local government system. While the country ratified the European Charter on Local Government in 1996, the charter was never fully implemented – for example, the subsidiarity and connexity principles are still lacking full implementation and regions have not yet been established. This is the reason why the relations between the state on the one side and municipalities on the other have slowly deteriorated, especially over questions of local funding and the existence of small municipalities.

Every year we witness unpleasant (and certainly unfriendly) negotiations between the municipalities and state government over the funding, as the government unilaterally provides less money to municipalities as is guaranteed by the law. Furthermore, the government is quietly trying to force municipalities into consolidation. Both actions lead into even stronger centralization.

Time and again we read about the intentions of the Slovenian state to reduce the municipal financing, which in the system of local government ensures sufficient financing to the minimal legal framework of municipal mandatory tasks. At the same time, there are (sometimes hostile) calls for the total abolition or at least compulsory consolidation

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of municipalities, with the main argument of saving substantial public funds, solve the financial problems of the state and contribute to the greater financial autonomy of the large municipalities, which would be formed with such an action.

There are so many inaccuracies, distorted truths, half-truths, and misrepresentations here that it is very hard, if not impossible, to believe how much the state's attitude towards local government has changed in the twenty years since the (re)establishment of the local government system in 1994. Since then, the issue of municipal financing has been one of the key factors in the functioning of local democracy.

In the Slovenian local government system, the municipality is defined as a basic local community, which independently regulates all local public affairs and independently disposes of its assets. The Slovenian state has – probably in the eagerness of the reintroduction of local government – ratified the European Charter of Local Self-Government (MELLS)² in 1996, which has the status of an above-constitu-

¹ The article is based on the materials and texts published in the following publications: Kukovič, S., Haček, M. and A. Bukovnik (2016) “The Issue of Local Autonomy in the Slovenian Local Government System”, [in:] *Lex Localis*, 14(3), pp. 303–320; Kukovič, S. and M. Haček (2018) “Cross-Border Cooperation as a Tool of Escaping Crisis Conditions in Slovenia”, [in:] *Transylvanian Review of Administrative Sciences*, 53(E), pp. 54–66; Haček, M., Kukovič, S. and M. Brezovšek (2017) *Slovenian Politics and the State*. Lanham, Boulder, New York, London: Lexington Books; Haček, M. and S. Kukovič (2014) “Financiranje občin: bitka med državo in občinami”, [in:] *Delo*, December, 26. Available [online]: <https://www.delo.si/mnenja/gostujoce-pero/financiranje-obcin-bitka-med-drzavo-in-obcinami.html>.

² European Charter on Local Self-Government (1985) Available [online]: <https://rm.coe.int/168007a088>.

tional document in the legal order, and which defines the basic principles of local government regulation in Europe.

Although the state has (deliberately) forgotten about the ratified charter, MELLs nevertheless clearly requires that:

- a) the local communities have adequate and autonomous financial resources, with which they should freely dispose;
- b) the financial resources of local communities must be in proportion to their tasks and competences;
- c) at least a part of the financial resources must originate from autonomous taxes and fees, which local communities should determine themselves;
- d) the financial resources of the local communities are sufficiently diverse and adaptable to follow – as closely as possible – the costs of carrying out the entrusted tasks;
- e) the state needs to consult local communities about the allocation of redistributed financial resources;
- f) the funds allocated by the state to local communities as subsidies and grants are not strictly dedicated, and;
- g) the provision of such funds should not interfere with the fundamental freedom of local communities to freely decide within their own competences.

A quick overview of the above-mentioned elements of MELLs tells us that the Slovenian government and its ministries do not take MELLs into serious consideration and sometimes seem not even to realize what is written in MELLs.

Half of Slovenian municipalities have fewer than 5,000 inhabitants, which was, however, not in line with the 1994 legislative criterion for the establishment of a new municipality³. But the National Assembly intentionally

³ The requirement was in the subsequent years ignored by the legislator.



THE AVERAGE SLOVENIAN MUNICIPALITY (9,700 INHABITANTS) IS STILL RELATIVELY LARGE IN TERMS OF INHABITANTS AS THE AVERAGE MUNICIPALITY IN THE EU HAS ONLY 5,500 INHABITANTS, WHILE MANY COUNTRIES HAVE EVEN SMALLER MUNICIPALITIES

did not follow this criterion. The fact is that new (small) municipalities could not self-establish or even propose their own establishment, as in this process active participation of members of parliament was always required. Accusing municipalities today for being small and weak is therefore not only unfair, but also hugely misleading.

Nevertheless, the average Slovenian municipality (9,700 inhabitants) is still relatively large in terms of inhabitants as the average municipality in the EU has only 5,500 inhabitants, while many countries have even smaller municipalities. German municipalities, which are often proclaimed as an ideal of modern European regulation, have on average only 8,000 inhabitants. The problem,



therefore, is not "smallness" itself, but rather an unimaginative and failed system of division of competences between the state on one side and the municipality on the other. Another issue is that of the absence of a regional government and a completely inadequate system of municipal financing, where municipalities do not have their own financial resources to make decisions autonomously.

The purpose of this article is to address some on-going issues in the Slovenian local government system and to highlight *problem-atiques*, which obstruct the development of Slovenian municipalities and their performance.

LET'S START AT THE BEGINNING: THE BACKGROUND

On the territory of what is now Slovenia, local government was already introduced in the mid-1800s by the Austrian provisional act on municipalities signed by the then Kaiser in 1849. The first municipal representative bodies in Carniola were elected in 1850. Sixteen years later, a provincial act on municipalities was adopted and from then on, legislative regulation of local government was being performed continuously until 1955, when the introduction of a socialist communal system occurred, which *de facto* abolished local government. In the communal system, the municipality was a so-called socio-political community that primarily acted in the name of state, whereas local government proper was in part taking place only in local communities at the sub-municipal level.

After gaining independence in 1991, Slovenia had to re-define and establish a system of local government, which was significantly different to the earlier communal organization. The introduction of local government was one of the most important and difficult tasks in the new country, as it was a radical

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change within the then self-governing communal organization in a direction of "classical local government" of a European type.

The first steps were preparations for the technical groundwork for the project of local government, which had already been prepared in 1989 (before formally regaining independence by Slovenia) for the adoption of the new Slovenian Constitution with a significant emphasis on local government at the end of 1991, and the adoption of the framework law on local government on December 21, 1993. Constructing foundations for the implementation of the reform of local government were set with the adoption of the Act of Referendum for the Establishment of Municipalities in 1994. Referendums were carried out on May 29, 1994, except in the municipality of Koper, where the referendum was conducted on September 11, 1994. The results were very difficult, almost impossible

to fully take into account, as voters voted in favor of the establishment of new municipalities in only 111 referendum areas (out of 339). Since the nature of the referendums were merely advisory, the National Assembly of the Republic of Slovenia opted for “loose” compliance with the election results and adopted the Act on the Establishment of Municipalities on October 3, 1994, in which 147 municipalities were established, including 11 urban municipalities⁴.

From this point of view, local government in Slovenia has been in operation since January 1995, when territorially modified municipalities – having new substance and new bodies – became operational. In the years following the re-introduction of local government, many changes have occurred, especially in the legislative domain.

A 1994 decision was widely criticized, reaching its pinnacle when the local communities made considerable initiatives on the Constitutional Court of the Republic of Slovenia to assess the constitutionality of the Act on Establishment of Municipalities. The Constitutional Court ruled that the legal articles that determine which municipalities were established are not in accordance with the Constitution and that the National Assembly must abolish the non-compliance not later than six months before calling the next elections for municipal councils in 1998.

In 1996, a law of the procedure for the establishment of municipalities and determination of their areas was passed. The actual implementation of the law in 1998 – when it was first used for the restoration of the consti-

tutional decision declared unconstitutional of the entire first network of Slovenian municipalities – proved to be unsuccessful. The network should have been consistent with the Constitution and with the provisions of the Act on Local Government. Instead,

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LOCAL GOVERNMENT REFORM IS FAR FROM BEING CONCLUDED

there were 45 new municipalities additionally established, among them many that failed to meet the statutory requirements, either not having enough inhabitants or lacking some of the mandatory public services.

In February 2002, the National Assembly discussed another 31 proposals for the establishment of municipalities, but eventually came to the decision that only one municipality should be established this time⁵.

In January 2006, referendums were held where residents of respective areas voted on the creation of new municipalities. On March 1, 2006, the National Assembly approved the referendums and new municipalities, increasing the number of municipalities in Slovenia to 205. On May 4, 2006, the Government of the Republic of Slovenia sent a proposal on the establishment of five

⁴ Haček, M. (2005) “Zgodovinski kontekst nastajanja občin na slovenskem”, [in:] Brezovšek, M. and M. Haček (eds.), *Lokalna demokracija II: Uresničevanje lokalne samouprave v Sloveniji*. Ljubljana: Faculty of Social Sciences. See also Brezovšek, M. and S. Kukovič (2012) *Organizacija lokalne oblasti v Sloveniji*. Ljubljana: Faculty of Social Sciences, p. 113.

⁵ Haček, M. (2005) “Zgodovinski kontekst nastajanja občin na slovenskem”, [in:] Brezovšek, M. and M. Haček (eds.), *Lokalna demokracija II: Uresničevanje lokalne samouprave v Sloveniji*. Ljubljana: Faculty of Social Sciences.



new municipalities to the National Assembly, thus the number of municipalities further increased to 210⁶.

In February 2011, the number of municipalities changed for the last time to the current number of municipalities (212). However, local government reform is far from being concluded, which is made evident by numerous comparisons of Slovenian arrangement and those abroad and this becomes especially visible in encounters of Slovenian institutional setup and practices with European standards of local and regional democracy enshrined in MELLs, in the tendencies, directions, and recommendations made by the Council of Europe and the European Union. An opportunity to establish new municipalities emerges only once per term, i.e. in last 12 months prior to local elections⁷.

As the entire system of local government was introduced very quickly, often without serious consideration of expert opinions, and as the area was new and relatively unknown, certain issues have arisen and remain unsolved still today.

THE BATTLE BETWEEN MUNICIPALITIES AND THE STATE

The general provisions of the Constitution of the Republic of Slovenia⁸ (Article 9) guarantee local government to all citizens. Hence, the local government has become a constitutional category. The constitutional provisions for local government are general because detailed regulations are provided by the law.

⁶ Brezovšek, M. and S. Kukovič (2012) *Organizacija lokalne oblasti v Sloveniji*. Ljubljana: Faculty of Social Sciences, p. 113-114.

⁷ To find out more about structural aspects of local government reforms see Kukovic, S. and M. Brezovšek (2016) "From Parliamentarisation Towards Presidentialisation: Institutional Aspects of Local Political Leadership in Slovenia", [in:] *World Political Science*, 12(1), pp. 69–85.

⁸ *Constitution of the Republic of Slovenia* (1991) Official Gazette of Republic of Slovenia, no. 33-1409 / 91-I.

Local governments mainly implement the policies made at a higher level instead of creating their own policies⁹. The result is an unequal division of competences between state and local governments. The regulations of local governments do not provide much room to formulate independent policy in certain areas. Therefore, we can only talk about relative autonomy¹⁰.

Local government is primarily based on a clear division of responsibilities between the state, its bodies, and local community bodies. The main objective of the regulation of the relationship between the state and the local communities is to allow the municipality to obtain under authentic competence the functions that are essential for the life and work of its inhabitants, which are more effectively and rationally exercised within the local community than through the state authorities.

One of the key objectives of the local government in Slovenia was to establish such a system of division of authority between local communities and the state that would enable the creation of a certain level of autonomy for local communities in relation to state authorities.

In a broad sense, today's Slovenian local government resulted in entrusting the management of local affairs to the representative bodies of municipalities, which directly administer the affairs and perform their function within their own responsibility. The principles of local governments are based on three fundamental ideals:

⁹ Kukovič, S. (2015) *Lokalno politično vodenje: slovenski župani v primerjalni perspektivi*. Ljubljana: Faculty of Social Sciences.

¹⁰ Schultz, A. (1979) *Local Politics and Nation-States*. Oxford: ClioPress Ltd., p. 79. See also Brezovšek, M. and S. Kukovič (2012) *Organizacija lokalne oblasti v Sloveniji*. Ljubljana: Faculty of Social Sciences, p. 60.

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TODAY'S SLOVENIAN
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1. Local authorities may have their own administrative structure.
2. Local authorities may hold their own powers.
3. Local authorities may freely manage their own affairs, which exclude subordination to other bodies and the use of methods associated with the principle of hierarchy.

However, the municipal competencies are narrowly defined in the Slovenian Constitution. The first paragraph of Article 140 provides that the jurisdiction of the municipality comprises local affairs that are governed autonomously by the municipality, and that affect only the inhabitants of the municipality. Slovenian municipalities are therefore not responsible for exercising all the public functions in their territory (unlike German municipalities, for example) but only in mat-

ters of local importance. The Constitution does not analyze in detail local issues that are not in the municipality's authentic jurisdiction. Thus, the legislation¹¹ deals with the issue of municipal competences and applies the terms "own and delegated competencies".

Municipalities' own competencies reflect the fact that they comprise local affairs that may be regulated autonomously and that affect only the residents of a municipality. Upon prior agreement with the municipality, the state may transfer specific duties to the municipality if it also provides the financial resources required. This transfer of certain state competences to the municipal level may, on the one hand, be understood as a regulation that prevents the state from intervening in the autonomy of the local community. On the other hand, it may represent an insurmountable obstacle to the transfer of state functions to municipalities. The latter is also a Slovenian characteristic because the state has not delegated competences to the municipalities for more than two decades.

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THE STATE HAS NOT
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¹¹ *The Local Self-Government Act* (2007). Available [online]: <http://www.uradnilist.si/1/objava.jsp?urlid=200794&stevilka=4692>.



THE LOCAL SELF-GOVERNMENT ACT (2007) LIMITS THE STATE RATHER THAN THE MUNICIPALITY

In matters of municipal competences, the Local Self-Government Act (2007) limits the state rather than the municipality. It prevents the state from interfering in the municipalities' governing sphere. The Act classifies the tasks that are independently governed by municipalities into six groups:

1. **In the field of normative regulation**, the municipality adopts the municipality ordinances and other municipal acts, the municipal budget, the municipality development plan and annual accounts, etc.
2. **In the field of governance**, the municipality manages the municipal property and local public services, public and other companies, the municipal public areas and other public goods, local public roads and other routes.
3. **With its own resources**, the municipality builds and maintains local public roads and other routes, promotes cultural and social activities, etc.
4. **With its own measures**, it encourages the economic development of the municipality, provides fire safety, orderly waste collection, etc.
5. **It provides assistance** in the supervision of local events and rescue measures in the event of natural disasters.
6. **It concludes contracts** on the acquisition and alienation of movable and immovable property, concessions, the use of the public goods, and other relationships into which the municipality enters.

It should be noted that the work performed by the municipality is governed primarily by sectorial legislation. Thus, the municipal competences are also governed by laws such as the Roads Act, Environmental Protection Act, Kindergarten Act, etc. Nevertheless, there are numerous conflicts in connection with the competences of the municipality and the state in which the Constitutional Court interferes.

We may conclude that due to the unwillingness of the state to give up its powers, the division of powers causes disagreements and tensions. The tasks imposed on the municipalities by the state in the previous two decades were mostly non-essential. At the same time, the state was not willing to increase the municipal competencies in certain other areas, such as spatial planning, agriculture, small industries, etc.

The municipalities thus performed a relatively narrow scope of local tasks, while no national competence has been delegated to them. A modest range of original tasks hinders the process of decentralization, which is typical of the development of local government in other European countries.

MUNICIPAL FINANCING: ACHILLES' HEEL OF THE SLOVENIAN LOCAL GOVERNMENT

One of the findings of the Conference of the MELLs of 1985 is that the inadequacy of financial resources can undermine the very essence of each local government. Therefore, the MELLs indicates the basic principles for financing local authorities¹².

- **The principle of adequacy** requires the local community to have its own relevant financial resources, with which it freely disposes within its powers.

¹² Vlač, S. (1998) *Lokalna samouprava – občine in pokrajine*. Ljubljana: Faculty of Social Sciences.



THE INADEQUACY OF FINANCIAL RESOURCES CAN UNDERMINE THE VERY ESSENCE OF EACH LOCAL GOVERNMENT

- **The principle of proportionality** requires that the local communities' financial resources must be in proportion to their tasks and competences.
- **The principle of self-financing** requires that at least part of the financial resources must originate from levies that are under the law defined by local communities.
- **The principle of elasticity** requires the local communities' financial resources to be sufficiently diversified and flexible in order to follow – as closely as possible – the cost of the implementation of delegated tasks and needs.
- **The principle of equalization** protects financially weaker local communities and requires that the state ensures uniformity between local communities – not only with financial equalization, but also with other appropriate measures.
- **The principle of cooperation** means that the local communities are asked – in an appropriate way – to provide their opinion regarding the allocation of reallocated financial resources.
- **The principle of autonomy** requires that the resources granted by the state to local communities in the form of subsidies and grants are not strictly eligible, and that the provision of such resources should not interfere with the fundamental freedom of local authorities to decide within their own powers.

- **The principle of borrowing** specifies that local communities have access to the domestic capital markets in order to borrow funds for larger investments within the limits of the law.

Many experts who deal with the relationship between the state and local communities noted that the area of funding is crucial to the status of local communities and their autonomy. The municipal financial autonomy significantly contributes to the image of a democratic state and the autonomous local authority.

Page¹³ argued that one of the methods used to assess the decisions made by local authorities is the degree to which they can independently increase the tax burden on the population. The legal authorization to perform certain tasks is meaningless if the local authorities lack financial resources. The basic obligation of elected local representatives is to make political decisions about the benefits of the provided services and the taxpayers' costs¹⁴.

The lack of financial resources changes local communities. Therefore, stakeholders have observed the recent desire of local communities to introduce a local public finance system that would be independent of the state authorities. The municipalities' taxes and contributions enhance their autonomy, but only if they can be regulated according to their own tax base at their own tax rate.

The autonomy of the local government is recognized in the possibility that a municipality can prescribe specific municipal

¹³ Page, E. C. (1991) *Localism and Centralism in Europe. The Political and Legal Bases of Local Self-Government*. Oxford: Oxford University Press, p. 31.

¹⁴ Vljaj, S. (1998) *Lokalna samouprava – občine in pokrajine*. Ljubljana: Faculty of Social Sciences, p. 313.



THE MUNICIPALITIES' TAXES AND CONTRIBUTIONS ENHANCE THEIR AUTONOMY, BUT ONLY IF THEY CAN BE REGULATED ACCORDING TO THEIR OWN TAX BASE AT THEIR OWN TAX RATE

taxes in order to finance its basic functions. In this respect, local governments are not directly tied to conditions that are otherwise prescribed by tax legislation. However, in prescribing other taxes such as charges, utility charges, and so on, the municipality is bound by the legal conditions¹⁵.

Article 142 of the Constitution of the Republic of Slovenia specifies that the municipalities are financed from their own resources. However, if a municipality fails to fully ensure the performance of the tasks due to its poor economic development, the state must allocate the municipality additional resources. The Local Self-Government Act of 1993 has not been amended in the part stating that the municipality sources of financing are from its own resources, state

resources, and borrowings, and in the part that states that the municipalities finance local matters of public importance.

According to the Court of Audit of the Republic of Slovenia¹⁶, the structure of the municipal finances in the period from 1994 up to and including 2010 consisted of 79.4% own resources, 17.2% of government funding, and borrowing – 3.4%. Since 2006, the new Financing of Municipalities Act (ZFO-1)¹⁷, which is not fully harmonized with the Local Self-Government Act, governs the financing of the tasks that are within municipal competence.

The financing of municipalities is based on the principles of the MELLs – in particular the principles of financial resource proportionality to the tasks of the municipalities and the principle of the municipalities' autonomy in financing municipal tasks (ZFO-1 2006, article 3). The principle of proportionality is also taken into account in financing tasks under state jurisdiction that the state transfers to the municipality by law. In accordance with the ZFO-1, the state must determine the method of state financing by law, upon which it transfers to the municipality the performance of specific tasks within its jurisdiction – the funds must be commensurate with the nature and extent of the delegated tasks (ZFO-1 2006, article 5).

In accordance with the ZFO¹⁸, the municipalities are financed from their own fiscal resources, municipal taxes, and borrow-

¹⁵ Ibid., p. 86. See also Brezovnik, B. and Oplotnik, Ž. (2012) "An Analysis of the Applicable System of Financing the Municipalities in Slovenia", [in:] *Lex Localis*, 10(3), pp. 277–295.

¹⁶ *Court of Audit of Republic of Slovenia* (2012) *Revizijsko poročilo – ureditev področja občin*. Ljubljana: Court of Audit of Republic of Slovenia, p. 29.

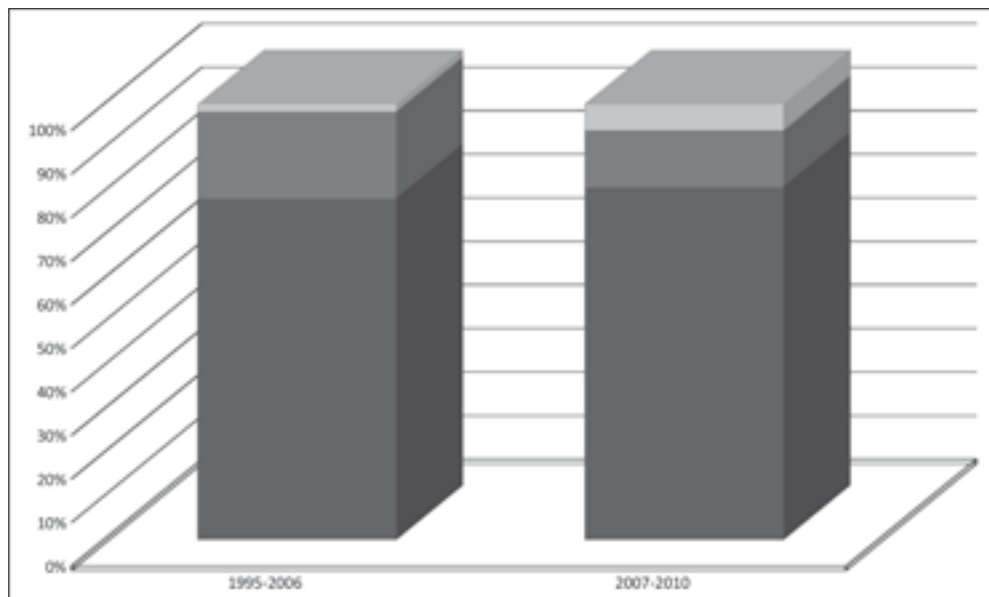
¹⁷ *The Financing of Municipalities Act-1* (2006). Available [online]: <http://pisrs.si/Pis.web/pregledPredpisa?id=ZAKO4615>.

¹⁸ *The Financing of Municipalities Act* (1994). Available [online]: <http://www.pisrs.si/Pis.web/pregledPredpisa?id=ZAKO385>.

ing. In connection with own tax resources, the ZFO indicates the revenues of the municipal budget – namely, property tax, tax

2007 to 2010 it amounted to 80.9% own municipality resources 13.1% state funds, and 6.0% borrowing¹⁹.

Figure 1: Comparison of the municipal financing structure



Source: Own elaboration based on Court of Audit of Republic of Slovenia (2012), p. 30

on watercraft, tax on real estate, tax on inheritance and gifts, tax on winnings from classic gaming, and other taxes, if so defined by the law that regulates an individual tax. Sources of municipality income are also revenues from the 54% personal income tax paid in the previous year plus inflation for the year before, and the year for which the calculation of municipal eligible expenditure is made in accordance with ZFO-1.

With the adoption of the new Financing of Municipalities Act (ZFO-1, 2006), the structure of municipality financing sources changed. Namely, in the period between 1994 and 2006, it amounted to 78.3% own municipality resources, 20% state funds, and 1.7% borrowing; in the period

It should be noted that the own municipality resources include personal income tax, of which the share allocated to the municipalities increased from 30% to 35% in 1998 and to 54% in 2008²⁰. The increase in the share of personal income tax also resulted in the reduction of the necessary financial resources equalization that falls into the category of state funds. The proportion of borrowing financing sources also increased due to the reduction in limiting municipal borrowings.

¹⁹ Court of Audit of Republic of Slovenia (2012) Re-vizijsko poročilo – ureditev področja občin. Ljubljana: Court of Audit of Republic of Slovenia, p. 30

²⁰ Ibid.

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SLOVENIA DOES NOT HAVE A SO-CALLED REGIONAL LEVEL OF GOVERNMENT. THE ONLY DECENTRALIZED LEVEL CONSISTS OF 212 MUNICIPALITIES, OF WHICH 11 ARE SO-CALLED “URBAN MUNICIPALITIES” OR MUNICIPALITIES WITH URBAN STATUS (I.E. LARGE CITIES)

Furthermore, Slovenia does not have a so-called regional level of government. The only decentralized level consists of 212 municipalities, of which 11 are so-called “urban municipalities” or municipalities with urban status (i.e. large cities). During the last decade, approximately 12% of total public finance (5.5% of the GDP) was earmarked for local finance²¹. Article 142 of the Slovenian Constitution specifies that the municipalities are financed by their own resources. However, if the municipality fails to ensure the performance of the tasks because of its poor economic situation, the state must allocate additional resources to the municipality.

²¹ Oplotnik, Ž. J., Brezovnik, B. and B. Vojinovič (2012) “Local Self-Government Financing and Costs of Municipality in Slovenia”, [in:] *Transylvanian Review of Administrative Sciences*, 37(E), p. 129.

Since 2006, the new Financing of Municipalities Act (ZFO-1), which is not fully harmonized with the Local Self-Government Act, has governed the financing of tasks that are within municipal competence. In connection with own tax resources, the ZFO-1 indicates the revenues of the municipal budget – namely, personal income tax, property tax, tax for the use of local building lands, tax on inheritance and gifts, tax on winnings from classic gaming, and other taxes, as defined by the law that regulates individual tax. It should be noted that the share of personal income tax allocated to the municipalities hiked from 35% in 1998 to 55.2% in 2012²², in a series of governmental attempts to increase the sustainable development of both urban and rural municipalities.

The tax for the use of local building lands is the only substantial revenue source over which municipalities have independent control. All other tax revenues are con-

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THE TAX FOR THE USE OF LOCAL BUILDING LANDS IS THE ONLY SUBSTANTIAL REVENUE SOURCE OVER WHICH MUNICIPALITIES HAVE INDEPENDENT CONTROL

²² *Court of Audit of Republic of Slovenia* (2017) *Revizijsko poročilo – financiranje primerne porabe občin*. Ljubljana: Court of Audit of Republic of Slovenia, p. 21-22.



THE FINANCIAL AUTONOMY OF SLOVENIAN MUNICIPALITIES IS VERY LIMITED, SINCE THEIR FINANCING LARGELY DEPENDS ON THE LAW AND THE ANNUAL BUDGETARY DECISIONS OF THE NATIONAL PARLIAMENT

trolled and set by the state, which in effect diminishes the autonomy of the municipalities and increases the power of the state over them. Because the economic crisis also affected municipal revenues in the last decade, in 2012, the state decided to ignore its own legislation and allocate lower state co-financing to local governments.

Both the Association of Municipalities and Towns of Slovenia and the Association of Municipalities of Slovenia opposed government proposals to lower state co-financing of local governments. The municipalities rightfully claimed that they are autonomous according to the Constitution and the MELLs, which was adopted in Slovenia in 1996. The government is therefore required to provide adequate financing²³. In September 2015, both municipal associa-

tions went before the Constitutional Court to file a lawsuit against the state, asking it to fulfill its contractual financing obligations for 2015. Three years later the decision has still not been reached.

The amount of state financing to the municipalities remained well under the legislative framework also for 2018 according to the national budgets, which is forcing municipalities in two directions. First, there are on-going legal processes between the state and the municipalities over the (lack of) state co-financing. Second, the municipalities continue the search for financial rationalization and additional external financial resources, mainly using the mechanisms available to acquire funds from the EU and – although mainly intended for border municipalities – cross-border cooperation projects.

Overall, the financing of local communities represents an important aspect of relations between the state and local communities, indicating the level of autonomy of local communities in relation to the state. The financial autonomy of Slovenian municipalities is very limited, since their financing largely depends on the law and the annual budgetary decisions of the national parliament.

In Slovenia, the financing of municipalities is quite centralized, as the state has significant power and supervision over the use of public income. What is more, its power is also reflected in a high proportion of grants and transfers allocated to the municipalities from the state budget. The problem also lies in the high fragmentation of the Slovenian territory and absence of regional government, as a lot of municipalities established during the process of introducing the new local government system are too small and too weak to be financially autonomous and self-sustaining.

²³ Haček, M. (2016) *Slovenia Country Report, Nations in Transit 2016*. New York: Freedom House. Available [online]: <https://freedomhouse.org/report/nations-transit/2016/slovenia>.

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IT WOULD BE LOGICAL
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WHAT NEXT?

What would be the recipe that could overcome the current situation? Firstly, the financial base for municipal operations must come from their own resources, where municipalities would also have the right to prescribe their own taxes, subsidies and fees.

Secondly, with the new municipal financing system, it is necessary to provide municipalities with higher own revenues thereby increasing their financial autonomy and responsibility in deciding the use of financial resources to carry out local tasks. This would further stimulate not only the financially rational behavior of municipalities, but also, in particular, efforts to create additional value in relation to the amount of funds invested for individual projects.

Thirdly, on the basis of the accepted criteria and criteria of solidarity towards less developed municipalities, the government would annually decide which municipalities are entitled to financial compensation and funds for investment co-financing.

Lastly, it would be logical to further improve the efforts to connect municipalities on a functional rather than a territorial basis,

that is, through the establishment of joint municipal bodies and common public services.

At the end of the day, state and local government are both established with the same purpose – to serve the people, which is certainly easier to perform in cooperation. Obviously, Slovenia is not there yet. However, with a little political willingness and effort Slovenia could reduce and maybe even eliminate the conflict between the state and municipalities. ●



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Regional and Local Self-Governance: How Decentralization Developed in the Czech Republic



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KRYŠTOF
KRULIŠ

In the 1990s, the Czech Republic undertook a process of gradual transformation that resulted in the development of institutions of a liberal democratic state and economy based on market principles. An essential part of this process consisted in recreation of truly decentralized corporations of public law at two levels – the level of self-governed municipalities and later also the level of self-governed regions. Besides horizontal division of powers between legislature, executive, and judiciary – which is a must in a democratic state – this transformation provided also division of powers within a unitary state in a vertical sense. It also brought administration of public affairs and self-governance closer to citizens, in line with requirements of the governing principle of subsidiarity.

DECENTRALIZATION FOR SELF-GOVERNANCE VERSUS HIERARCHICAL DECONCENTRATION OF STATE POWER

Decentralization must be distinguished from a mere deconcentration of power in state¹. **Decentralization** provides space for self-governance at a lower level and closer to citizens than the level of the whole state. It allows people to vote for their deputies that decide over issues that concern an individual part of a country. The elected leadership manage the property of a smaller unit and most often provide for basic services to the inhabitants such as transportation, waste disposal, water distribution, and many others.

Statutory provisions at the state level also delimit certain space for self-governed regulations in which a decentralized unit can specify the rules for situations of public interest – for instance, as regards maintenance of clean public areas or securing of public order in connection with sport or cultural

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DECENTRALIZATION MUST BE DISTINGUISHED FROM A MERE DECONCENTRATION OF POWER IN STATE

events, and similar issues. However, self-governed units cannot lay down new duties for individuals unless they have a specific delegation in a statutory provision of the state to do so.

The self-governed rights of municipalities and regions are guaranteed in a specific section of the Czech Constitution². The state is allowed to intervene into self-governed issues only to protect the rule of law and only in a way that is stipulated in statutory provisions³. This could be seen also at the organizational level, where appointments of those who are responsible for decisions in the sphere of self-governance must be based on democratic elections (either direct or through directly elected deputies).

Self-governed decisions may vary between individual units. The result is a variety of self-governed rules and styles of property management that can be applied throughout the country. This variety reflects the very liberal approach to which it is expected that people can decide on the issues

¹ See also Dušan, H. et al. (2003) *Správní právo. Obecná část*, 5th edition. Prague: C.H.Beck, p. 372.

² Section seven (Article 99 to Article 105) of the Constitution of the Czech Republic, No. 1/1993 Coll., as amended.

³ Article 101 (4) of the Constitution of the Czech Republic.



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that concern them, such as the organization and availability of municipal public services, and securing of public order in the best way without the necessity of centralized decisions.

In contrast to decentralization, the concept of **deconcentration** represents only a way of internal organization of a state and division of responsibilities among its offices. The state need not operate only through its central offices (such as ministries with territorial authority over the whole country).

The state operates offices such as the state police or tax authorities, which are located all around the country and have a presence in almost every large town. These are, however, not self-governed entities with appointments based on local elections, but are units that are subordinate to the central offices of the state. Deconcentration can be a means of bringing administration of public affairs closer to the citizens, but at the same time one that keeps the control in the hands of the central authorities.

This clear-cut distinction between decentralization and deconcentration should not be blurred by various forms in which state power is deconcentrated. State deconcentrates its powers not only between its central and local offices (as is the case of tax authorities that are divided between central ministry and regional and district authorities responsible for specific territory), but it also delegates its powers to already existing offices in regions and municipalities.

These offices thus have two roles. First, they provide administrative support for self-governance tasks (e.g. managing property of a municipality) fully under the control of regionally or locally elected assemblies. At the same time, they also serve as offices performing tasks on behalf of the state. In the latter case, they must have the guidance of central state authorities, whereas the execution of these tasks is financed from the central budget.

LOCAL SELF-GOVERNANCE AND ITS CHANGES OVER TIME

The features of self-governance were introduced to the Czech lands – then a part of the Habsburg monarchy – for the first time in 1849 by the so-called Stadion's provisional municipal establishment⁴. The establishment was dominated by a modern principle under which "a free municipality is a foundation of a free state"⁵. The modern municipal regime that had been brought about by the revolutionary year 1848 was soon overshadowed by the decade of neo-absolutism and centralization under chancellor Alexander Bach⁶.

⁴ Janšová, M. (2001) *Historie územní samosprávy*, epravo.cz. Available [online]: <https://www.epravo.cz/top/clanky/historie-uzemni-samospravy-15359.html?mail>

⁵ Pavlíček, V. et al. (1998) *Ústavní právo a státověda: 1. díl – Obecná státověda*. Prague: Linde, p.332.

⁶ Zimek, J.(1998) *Ústavní vývoj Českého státu*. Brno: Právnická fakulta MUBrno, p. 12.



DECONCENTRATION CAN BE A MEANS OF BRINGING ADMINISTRATION OF PUBLIC AFFAIRS CLOSER TO THE CITIZENS, BUT AT THE SAME TIME ONE THAT KEEPS THE CONTROL IN THE HANDS OF THE CENTRAL AUTHORITIES

The self-governance features reappeared after the resignation of chancellor Bach and with the end of absolutism in the 1860s. Then, self-governance had been introduced also to a district level⁷, while a new constitution gave legislative powers over the municipal regime to assemblies of individual lands in the monarchy⁸.

The birth of a new Czechoslovak Republic in 1918 was connected with a broad reception of the established self-governed levels that already existed in individual parts of the new republic. In 1920, a new statute introduced a completely new partially self-governed

level of larger counties (*župy*) that consisted of several districts. These counties were assumed to have elected local assemblies which appointed permanent committees chaired by county governors who were installed by the central government⁹.

The counties' establishment became effective only in the Slovak part of the country. In the historic Czech lands (i.e. Bohemia, Moravia, and the part of Silesia that remained in the Czechoslovak Republic), their introduction was consistently postponed, and never become effective¹⁰. This was partly due to criticism of only limited self-governance rights and strong elements of bureaucracy¹¹.

It is, however, important to note that further approaches to divide the country into larger counties or regions existed, and that Bohemia under this system was supposed to be divided for administrative and self-rule purposes into nine counties, with county capitals in Prague, Pardubice, Hradec Králové, Mladá Boleslav, Česká Lípa, Louny, Karlovy Vary, Plzeň, and České Budějovice¹². Moravia should have consisted of five counties with seats in Brno, Jihlava, Olomouc, Uherské Hradiště, and Moravská Ostrava and the remnants of Silesia formed one county with capital in Těšín¹³. The historic Czech lands were supposed to be divided into fifteen counties. As mentioned previously, the reform did not become effective, and no political subject desired to spend political capital in support

⁹ Malý, K et al. (1997) *Dějiny Českého a Česko-Slovenského práva do roku 1945*. Prague: Linde, pp. 315–319.

¹⁰ Janšová, M. (2001) *Historie územní samosprávy*, epravo.cz. Available [online]: <https://www.epravo.cz/top/clanky/historie-uzemni-samospravy-15359.html?mail>

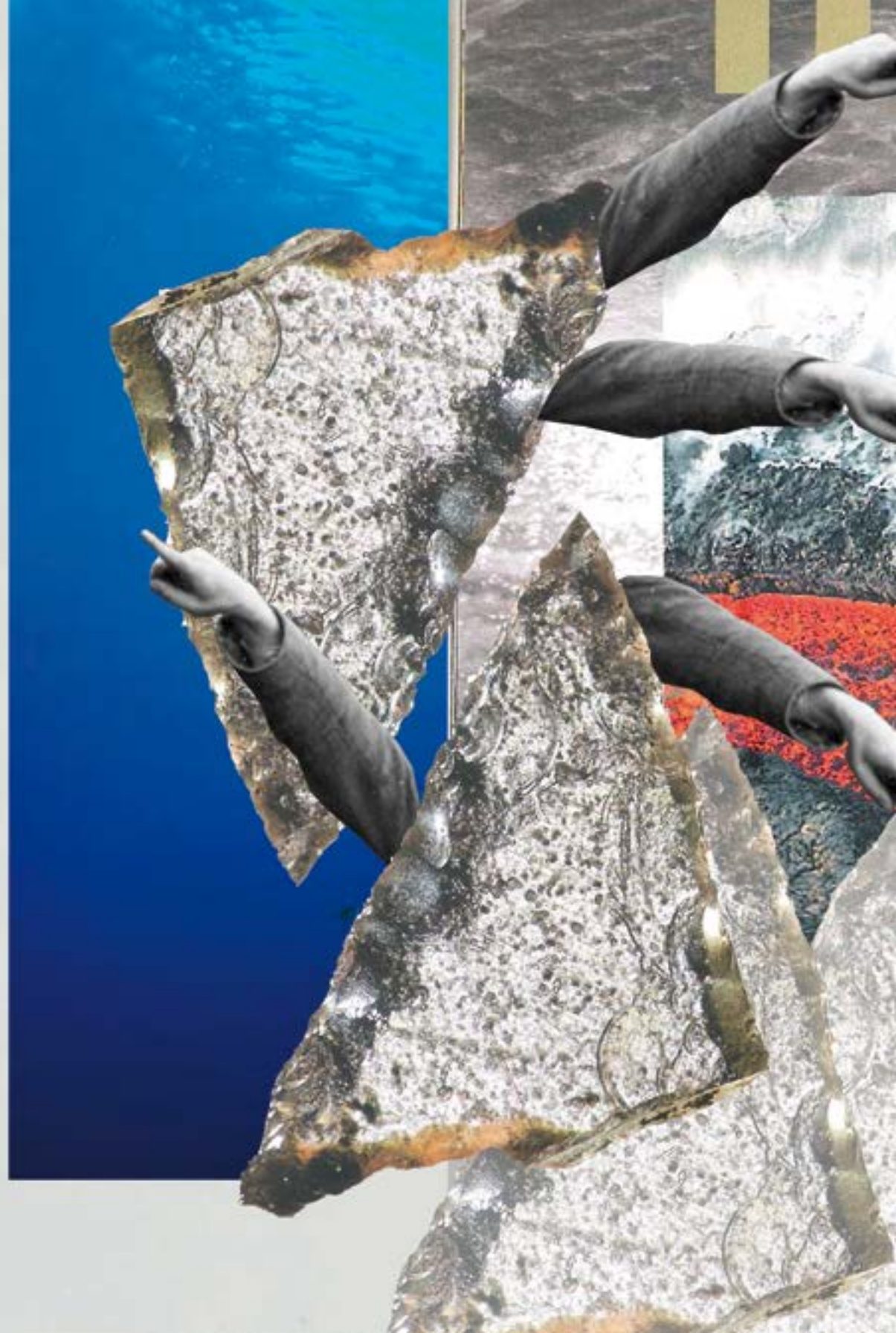
¹¹ Malý, K et al. (1997) *Dějiny Českého a Česko-Slovenského práva do roku 1945*. Prague: Linde, p. 319.

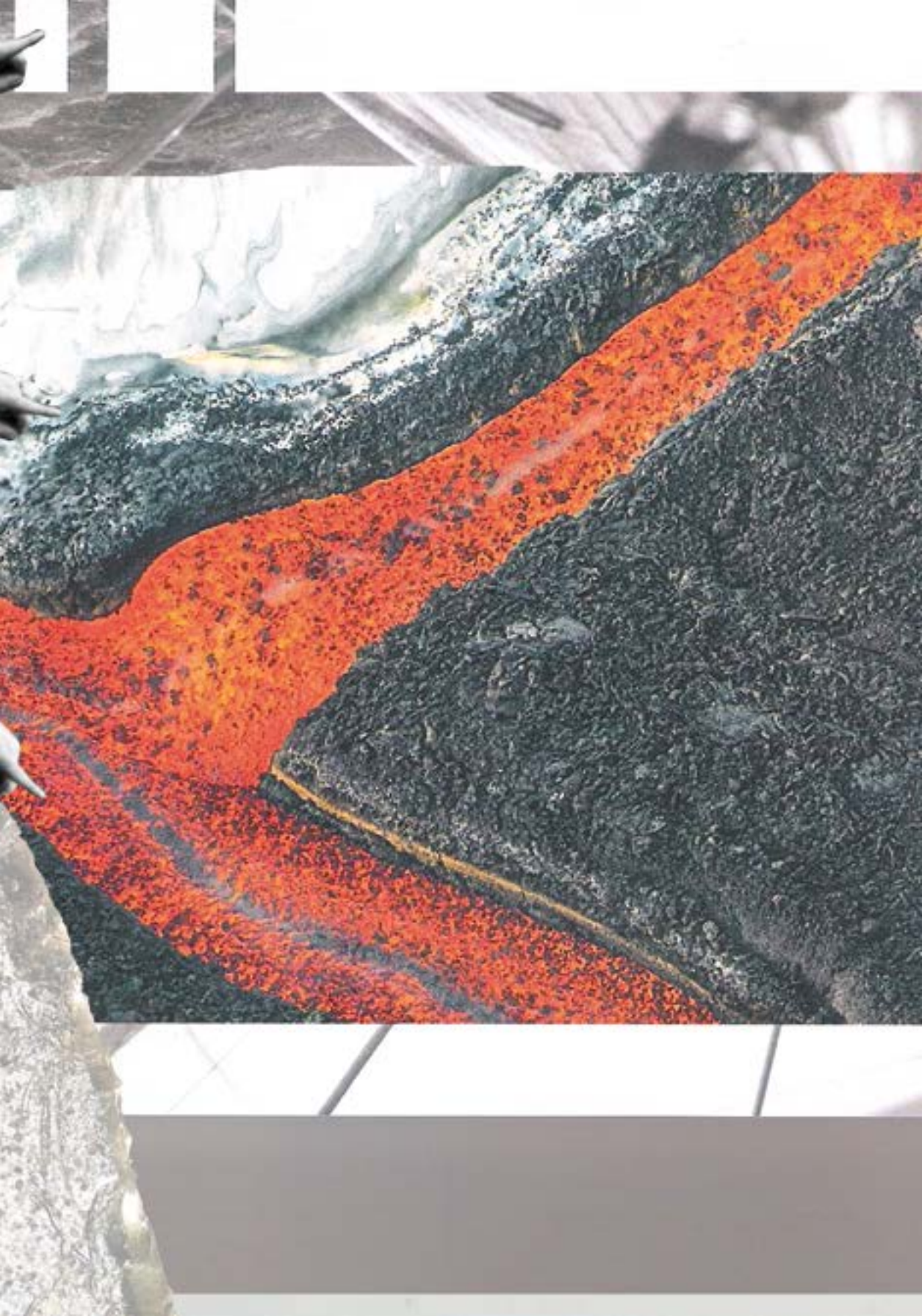
¹² Ibid, p. 317.

¹³ Ibid.

⁷ Pavlíček, V. et al. (1998) *Ústavní právo a státověda: 1. díl – Obecná státověda*. Prague: Linde, p. 332.

⁸ Janšová, M. (2001) *Historie územní samosprávy*, epravo.cz. Available [online]: <https://www.epravo.cz/top/clanky/historie-uzemni-samospravy-15359.html?mail>







MUNICIPALITIES – AS BASIC UNITS OF SELF-GOVERNANCE – WERE RECREATED IN THE CZECH REPUBLIC IN 1990

of the introduction of counties into the historic Czech lands. The reason why the reform was introduced only in the Slovak part of the republic may be that the counties served there as an additional layer of central control.

The German occupation of the historic Czech lands before the beginning of World War II brought the introduction of German authorities overseeing the remnants of the formally existing self-governing structures, which were finally demolished by the Heydrich administrative reform of 1942. In light of the reform, all previously autonomous parts of administration became centrally appointed and mayors in towns were substituted by German governmental commissioners¹⁴.

The post war years brought the introduction of the so-called *national committees* (*“národní výbor”*), which after 1948 lost any real self-governance character – despite formal elections that were still held under the Communist regime¹⁵. The system of national committees consisted of three layers: the municipal layer, the district layer,

and the regional layer. In 1949, the historic Czech lands were divided into thirteen regions.

This was changed in 1960, when the number of regions was reduced to seven plus one (with the capital city of Prague as a separate entity). Bohemia was divided into five regions. Moravia was divided into two regions. The part of Silesia that remained in the Czechoslovak Republic became part of the Northern Moravia region.

MUNICIPALITIES

Municipalities – as basic units of self-governance – were recreated in the Czech Republic in 1990. The whole territory of the Czech Republic is currently divided into districts of individual municipalities¹⁶. In accordance with the principle of subsidiarity, competence over self-governance issues is set as a primary for municipalities, while regions are charged with issues that are better governed for larger territories. Public transportation serves as a good example of this division. Connections within the territory of one town are organized at the municipal level while regional mass transportation between individual towns is organized at the regional level.

In the Czech Republic there are a considerable number (over 6,200) of municipalities. The average population is the lowest among all OECD countries¹⁷. Three quarters of municipalities have less than 1,000 inhabitants (and one quarter even less than 200 inhabitants) which leads the OECD to repeatedly mention that the Czech municipalities are too small to provide effective public services

¹⁶ The only exception to this rule is the territories that serve for military training purposes and thus are exempted from the system of self-governance.

¹⁷ OECD (2016) *Hospodářské přehledy OECD Česká republika*. Available [online]: <http://www.oecd.org/eco/surveys/Czech-Republic-2016-overview-hospod%C3%A1%C5%99sk%C3%A9-p%C5%99ehledy.pdf>, p. 38-39.

¹⁴ Zimek, J.(1998) *Ústavní vývoj Českého státu*. Brno: Právnická fakulta MU Brno, p. 74.

¹⁵ Pavlíček, V. et al. (1998) *Ústavní právo a státověda: 1. díl – Obecná státověda*. Prague: Linde, p. 332.

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and that their costs are higher than would be necessary with a smaller number of municipalities¹⁸.

The sustainability of the system with such a high number of small municipalities is provided by the authorized offices in larger municipalities with authority (e.g. Building Authority) not only for the municipal territory where the office is located, but also for territories of smaller municipalities in the vicinity. This system of authorization adds up to two more layers of public administration that exist between the smallest municipali-

ties and the level of regional authority. Thus, the system is costly but reflects the village landscape of the country. It is an outcome of a mixture of influences ranging from historical tradition of municipalities, to institutional path dependency strengthened by the fact that changes to the system could be challenged as an intrusion into the constitutionally recognized right for self-governance.

REGIONS

A comparison of the supposed fifteen counties from the statute from 1920 and country division under the communist regime (firstly into thirteen regions and later into seven plus Prague), shows that there was a trend of creating a shrinking number of larger regions. This trend was reversed when a regional level of self-governance was finally introduced to the Czech Republic in January 2000. The new setting of regions is a step back and closely resembles the territorial arrangement into thirteen regions that existed between 1949 and 1960.

Currently there are fourteen regions, including Prague as the capital city of the country. The regions that are on the border between Bohemia and Moravia include significant parts of both of these historical Czech lands. The remnants of Silesia form Morsvoskoslezský region together with the northern parts of Moravia. This is a strong aspect of the new regional setting as it blurs the historical division between Bohemia and Moravia, as well as remnants between Silesia and Moravia. It was one of the reasons for creating the thirteen regions in 1949, and this argument reappeared after the Velvet Revolution and together with regional lobbying gained ground in parliament when the new regional system was introduced¹⁹.

¹⁸ Ibid.

¹⁹ Jeřábek P. (2014) "Krajské uspořádání? Vadí i po čtrnácti letech", [in:] deník.cz. Available [online]: https://www.denik.cz/z_domova/krajske-usporadani-vadi-i-po-ctrnacti-letech-20140102.html

The relationship to the regional capital has been a significant issue in formation of identity for some of the regions. The creation of new regions was easily accepted where strong bonds to a regional capital existed. For instance, former Eastern Bohemia (Východočeský region) was dominated by two bigger cities – Hradec Králové and Pardubice – both having about 90,000 inhabitants. Former regional division allowed only Hradec Králové to be a regional capital, while the new regional setting allows both cities to keep proper administrative importance for themselves and their surroundings. On the other hand, Jihlava Region (named originally after its capital, Jihlava) had been renamed to Vysočina Region soon after its creation. The demand from its inhabitants brought the name of the mountain range located in the region into the region's name instead of the name of its capital. Five of the regions have names based on their geographical location, while the remaining regions bear the names of their regional capitals and biggest towns.

A disadvantage of introducing this new regional division is that in the minds of many people, the former division into seven regions (done for its geographic simplicity and four decades of existence) is still strongly imprinted. Apart from this, the state kept the former regional structure in the formation of its bodies, particularly for regional courts and regional state attorneys' offices. Thus, the people from Královéhradecký and Plzeňský region still have their regional courts in Plzeň, whereas those who live in Hrálovehradecký and Pardubický have theirs located in Hradec Králové. This is a disadvantage that still complicates the orientation of people in the structures of public authorities.

ELECTORAL TURNOUT

A regular electoral term in the Czech Republic lasts four years. The first free modern elections at the municipality level were



REGIONAL ELECTIONS IN THE CZECH REPUBLIC ARE OFTEN WON BY ONE DOMINANT POLITICAL PARTY

held in 1990, and since they took place right after the fall of the communist regime they proved highly popular with electoral turnout reaching 73%. Unsurprisingly, voter turnout decreased throughout the 1990s. Since the new millennium, it has become stable with turnout hovering between 40% and 50%²⁰.

The first elections in the regions were held in 2000 due to the deferred introduction of regions as a new self-governed level of administrative organization in the country. This means that every two years either regular, local or regional elections take place. A specific situation occurs in the capital city, Prague, which holds the regional and local elections together in time of the regular local election in the country.

The usual turnout in regional elections is between 30% and 40%. Regional elections thus attract less voters than the general or local elections but are still doing better when compared with elections to the upper chamber of the parliament, or elections to the European Parliament (which in 2014 had turnout of only 19.5%).

²⁰ This is behind the turnout in general elections to the lower chamber of the Czech parliament, which in the last decade was around 60%. Nevertheless, the local elections still have the second highest average turnout in the country.

Regional elections in the Czech Republic are often won by one dominant political party. The first elections were dominated by the Civic Democrats. Later, in 2008, the Social Democrats won in all regions and gained electoral victories in most regions in the next elections in 2012. In 2016, the political movement ANO 2011 came first in nine out of thirteen regions. This suggests a relatively flat diffusion of political moods in the Czech population with only minor regional differences, such as slightly higher support for Christian Democrats in the southern part of Moravia in comparison with the rest of the country, and slightly higher support for Communists in structurally impacted regions in the northern part of the country.

HOW MUCH DOES IT COST?

Self-governed units have various sources of income. The total income of municipalities reached CZK 282 bn (with a budgetary surplus of CZK 40.5 bn) in 2016²¹. Municipalities receive most of their income (about two thirds) as their share of tax revenue²².

The second biggest source of income for municipalities constitute monetary transfers from the state (the contribution on performance of state powers by offices of the municipalities and other subventions, e.g. from the Ministry of Education), from regions, or from EU funds.²³ The remaining income sources are revenues from municipalities' or regions' property (e.g. rents of real estate owned by municipalities) or their capital revenues²⁴.

²¹ Matej, M. (2017) "Financování obcí v ČR – současný stav a další vývoj RUD a dotací", [in:] *Deník veřejné správy*. October. Available [online]: <http://denik.obce.cz/clanek.asp?id=6743008>

²² Ibid.

²³ Ibid.

²⁴ Ibid.



THE REVENUE FROM TAXES PAID IN THE CZECH REPUBLIC IS DIVIDED BETWEEN THE STATE, THE REGIONS, AND THE MUNICIPALITIES

The revenue from taxes paid in the Czech Republic is divided between the state, the regions, and the municipalities based on a key that is specified in a specific statute²⁵. The share of the total revenue varies according to tax type. For instance, revenue from real estate tax is fully dedicated to a municipality where a specific piece of real estate is located. Municipalities can also set a specific coefficient that can increase or decrease real estate tax paid in their territory.

Regions and municipalities are not exempt from income taxation of legal persons. However, the revenue from such a tax is fully dedicated back to them. Most of the remaining tax revenues (VAT, various forms of income tax) are divided based on a key according to which 8.92% of tax revenue goes to regions, 23.58% of tax revenues goes to municipalities, whereas 67.5% remains in the state budget. The share of a specific level is further divided among individual regions and municipalities according to coefficients that reflect, primarily, the number of inhabitants and, secondarily, features such as the land area or the number of children in schools established by a specific municipality.

²⁵ See An Act no. 243/2000 Coll., as amended.

In 2017, tax revenues of municipalities amounted to CZK 206.3 bn²⁶, whereas the tax revenue of regions was CZK 64.43 bn²⁷. This part of income has been constantly increasing in time due to:

- a) a gradual increase of the share of regions and municipalities on the total tax revenue;
- b) improved tax collection, and;
- c) steady economic growth in the last several years²⁸.

In 2016, the overall debt of municipalities and regions in the Czech Republic reached CZK 98.6 bn, while, at the same time, the available financial assets of municipalities and regions amounted to CZK 197.8 bn (representing positive surplus of financial over debt of CZK 102.2 bn)²⁹. The financial situation of municipalities and regions may suggest very healthy finances and a high level of financial prudence of self-governed units in the Czech Republic. Nevertheless, it also shows a limited ability to invest in the development of much needed infrastructure.

CONCLUSIONS

The vertical division of powers and responsibilities for public affairs that has developed within the last three decades in the Czech Republic has resulted in a stable arrangement of public administration. However, this does not mean that suggestions of partial reforms are not a part of the general political and public discussions that are currently taking place in the country.

The most attention is given to such issues as introducing new features of direct democracy – including, for instance, direct elections of majors, issues of responsibility of elected deputies in municipal and regional representative bodies, or the never-ending dispute on a proper division of tax revenues between the state level, the level of regions, and the level of municipalities. A possible issue for the future is how to motivate self-governed entities to invest their financial surpluses into a sensible development of needed infrastructure.

The need of investments could become more imminent if economic performance in the country begins to slow down in the future. The surpluses of self-governed entities could be used for investments that might cushion such an economic development. Some way of further offsetting the situation with the large number of small municipalities (under 200 inhabitants) in the Czech Republic could also be a topic in case of economic recession. and scarcity of resources. ●

²⁶ Ministry of Finance of the Czech Republic (2018) *Vývoj daňových příjmů obcí a krajů 2005–2017*. Available [online]: <https://www.mfcr.cz/cs/verejny-sektor/uzemni-rozpocety/prijmy-kraju-a-obci/zakladni-informace/2018/vyvoj-danovych-prijmu-obci-a-kraju-2005-32304>

²⁷ Ibid.

²⁸ Ibid.

²⁹ Ministry of Finance of the Czech Republic (2017) *Zadluženost územních rozpočtů v roce 2016*. Available [online]: <https://www.mfcr.cz/cs/verejny-sektor/uzemni-rozpocety/zadluzenost-uzemnich-rozpocetu>



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KRYŠTOF
KRULIŠ

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State Decentralization in Poland Has Been Successful, but There Is Still Room for Improvement



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ALEKSANDER
ŁASZEK



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RAFAŁ
TRZECIAKOWSKI

State decentralization played an important role in the successful transition to a market economy in Poland. The title of the last World Bank publication on Poland accurately describes our success (*Lessons from Poland, Insights for Poland: A Sustainable and Inclusive Transition to High Income Status*). The authors of the report focused on the importance of state decentralization, pointing out that local governments are subject to increased political accountability, which helped to improve governance overall.

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DECENTRALIZATION
IN POLAND WAS
IMPLEMENTED IN TWO
STAGES – IN 1990
AND IN 1999

Decentralization in Poland was implemented in two stages – in 1990 and in 1999. The early reforms passed down central government tasks as well as some revenue-raising authority, giving it limited autonomy regarding real estate taxes, local fees, and other minor taxes. The second round of administrative reforms reduced the number of voivodeships, restored counties, and decentralized public programs and services to increase citizen involvement and improve public service delivery¹.

¹ World Bank Group (2017) *Lessons from Poland, Insights for Poland: A Sustainable and Inclusive Transition to High Income Status*. Washington, DC: World Bank. Available [online]: <https://openknowledge.worldbank.org/handle/10986/28960>

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THE MAJORITY
OF INTERACTIONS
BETWEEN PUBLIC
ADMINISTRATION
AND CITIZENS OCCURS
AT THE LOCAL LEVEL
OF GOVERNMENT

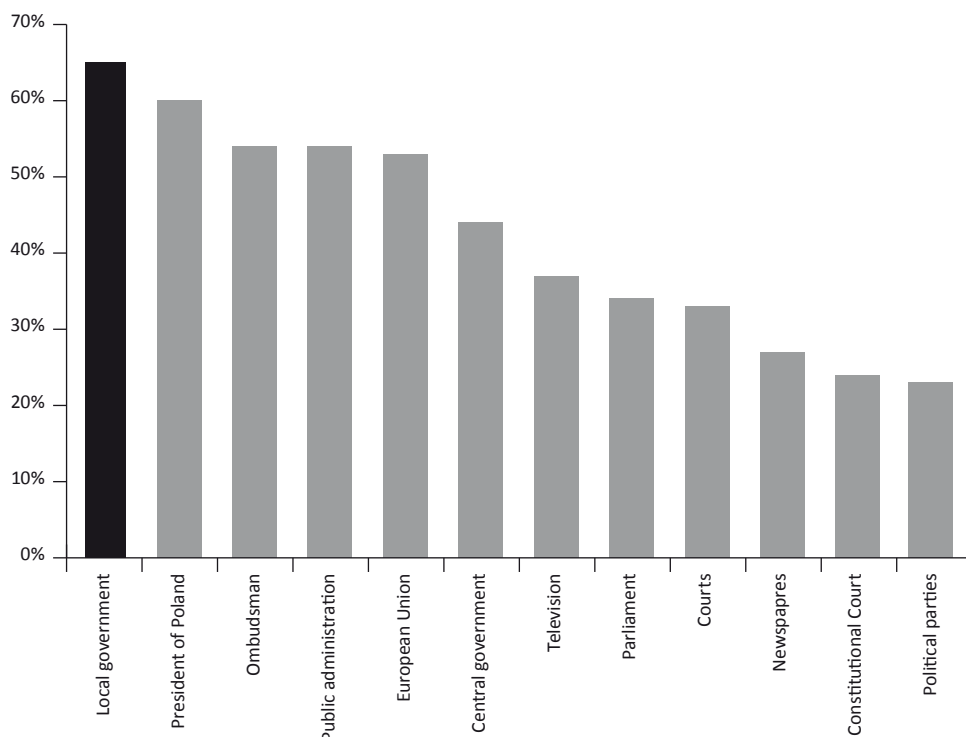
LOCAL GOVERNMENTS PLAY A SIGNIFICANT ROLE IN DELIVERING PUBLIC SERVICES

Besides tax issues, the majority of interactions between public administration and citizens occurs at the local level of government. As local government service the majority of administrative matters, they employ nearly 60% of the total number of people who work in public administration. They are also responsible for primary and secondary education, which – according to the PISA results – is of a high quality by European standards. While the central government supervises the curricula and grants money (the educational grant is a function of a number of students and teachers in a given community), it is local government that runs the schools directly.

In the case of the healthcare, the responsibilities of local government (which owns the majority of hospitals) and central government (which funds the entire sector) are less clearly divided. Moreover, outcomes are much worse than in education.

Overall, local governments spend around 30% of total general government expenditure, but their contribution to investment is much higher – in recent years, on average

Figure 1: Do you have trust in those institutions? (sum of % respondents who answered "I definitely do" and "I rather do")



Source: CBOS (2018) *O nieufności i zaufaniu*.

Available [online]: https://www.cbos.pl/SPISKOM.POL/2018/K_035_18.PDF (in Polish)

45% of public investment was conducted by local governments². Although there are discussions about the efficiency of certain projects (aqua parks and airports are the most hotly debated), overall improvement in infrastructure (local roads, sewers, public spaces) during the last 30 years was remarkable.

POLES HAVE TRUST IN LOCAL GOVERNMENT

In the recent survey conducted by CBOS, local governments ranked as the most trusted public institution – way ahead of central

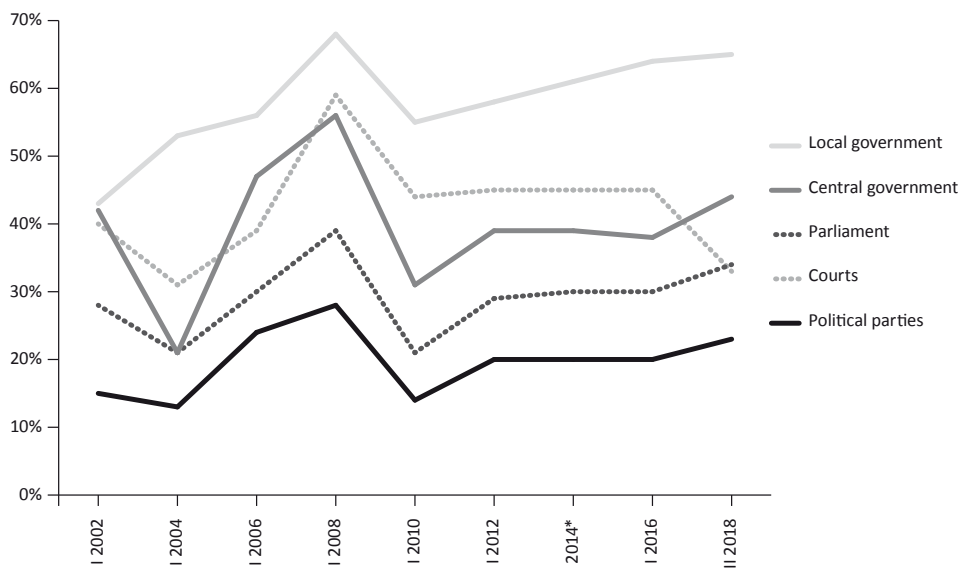
government and other remaining branches of government³. However, such results are nothing new – looking back at the surveys for more than the last 15 years, local governments have always been among the most trusted institutions, consistently ranking above central government and political parties [See Figures 1 and 2].

² See <http://ec.europa.eu/eurostat/data/database/>. Annual governmental finance statistics.

³ Local city and county governments are trusted by 65% of Poles, while the President by 60%, public administration offices by 54%, central government by 44%, parliament by 34%, courts by 33%, and political parties by just 23%. Even the media rank much lower, with 37% in the case of television and 27% of the press.



Figure 2: Do you have trust in those institutions? (sum of % respondents who answered "I definitely do" and "I rather do")



Source: CBOS (2018) *O nieufności i zaufaniu*.

Available [online]: https://www.cbos.pl/SPISKOM.POL/2018/K_035_18.PDF (in Polish)

Thus far, state decentralization in Poland has proved to be successful. Poles have trust in their local government, but there is still space for improvement. Although public expenditure has already been decentralized, tax autonomy of local government remains limited, creating bad incentives. The experience of other countries indicates that fiscal autonomy that encompass both the expenditure and revenue side is a much more desirable state.

INCREASING TAX AUTONOMY OF LOCAL GOVERNMENTS WOULD FURTHER IMPROVE ACCOUNTABILITY

Fiscal decentralization is a way to achieve a more efficient delivery of public services. The importance of local knowledge, the right of exit and generally gains from moving decision making closer to the citizen-level have long been recognized by

economists⁴. In general, central governments are not acquainted well enough with local matters to tailor their policies to varying circumstances on the local level, thus decentralization improves efficiency. Furthermore, decentralization puts local governments in the hands of their citizens, who can exercise their right to voice their opinions by voting and participate in public hearings, and – perhaps more importantly – by their right to exit, e.g. move to a neighboring county. Decentralization on the municipal level allows citizens to “vote with their feet” on the level of public services and taxes,

⁴ Hayek, F.A. (1945) “The Use of Knowledge in Society”, [in:] *American Economic Review* 35(4), pp. 519-530; Tiebout, C. (1956) “A Pure Theory of Local Expenditures”, [in:] *Journal of Political Economy* 64(5), pp. 416-424; Oates, W.E. (1972) *Fiscal Federalism*, Harcourt, New York; Brennan, G. and J.M. Buchanan (1980) *The Power to Tax: Analytic Foundations of a Fiscal Constitution*, Cambridge: Cambridge University Press.

thus pushing local governments towards a policy mix better aligned to voter preferences and leads to a more efficient system.

MOST COUNTRIES ARE DECENTRALIZED TO SOME EXTENT

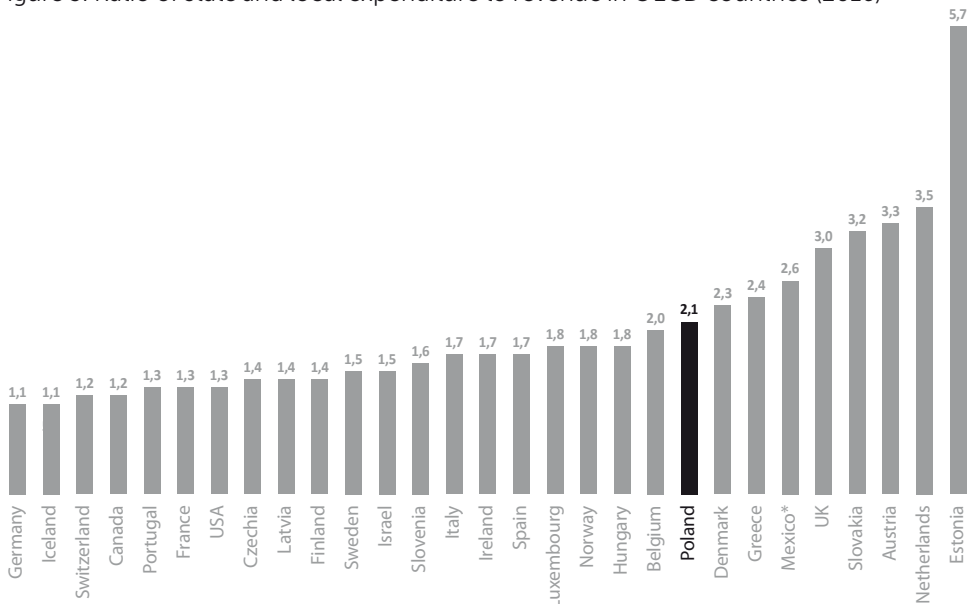
Most states channel expenditures and revenues through the local level of government to some degree. In general, local governments handle a much higher share of expenditures than revenues, as their revenues consist not only of own revenue, but also transfers from central and state governments [See Figure 3]. Polish local governments spend twice as much as they gather in own revenues, which is typical of highly unitary or small countries. This contrasts with state and local governments in neighboring Germany, which takes in almost as much as they spend in own revenue.



DECENTRALIZATION
ON THE MUNICIPAL
LEVEL ALLOWS
CITIZENS TO “VOTE
WITH THEIR FEET”
ON THE LEVEL
OF PUBLIC SERVICES
AND TAXES

Further tax decentralization in Poland and other countries with centralized revenues may enhance public sector efficiency and promote economic growth. A much

Figure 3: Ratio of state and local expenditure to revenue in OECD countries (2016)



Note: *Data for Mexico for 2015. Several countries have been omitted due to data limitations (e.g. the United States lacks aggregate data from the local level, partly due to a very high level of local autonomy)

Source: Own elaboration based on OECD data

higher degree of spending decentralization than tax decentralization is unfortunate, as the latter has a stronger positive impact on economic growth⁵. This is attributed to the fact that intergovernmental transfers weaken the incentives to develop an economic and fiscal base – lowering public sector efficiency. Incentives to create business-friendly conditions and provide high-quality public services are weakened when local government revenues depend on the central government instead of their citizens.

Thus, empirical findings show that spending covered by own revenue is growth-enhancing, while transfer-funded spending may be growth-dampening. Such a result is consistent with the findings from Italy, according to which low public-sector efficiency is also detrimental to private company productivity, as it may weaken the protection of property rights, lengthen administrative procedures, and increase the local tax and regulatory burden⁶.

Moreover, the dependence of state and local governments may create problems of moral hazard, especially if the central government cannot credibly commit to a no bailout rule. In Australia, Canada, Germany and the United States, markets punish state governments with higher bond spreads for taking on debt and deficit spending more when these states have a higher share of own revenues⁷.

⁵ OECD (2018) *Fiscal Decentralisation and Inclusive Growth*, OECD Fiscal Federalism Studies.

⁶ Giordano, R., S. Lanau, P. Tommasino, and P. Topalova (2015) *Does Public Sector Inefficiency Constrain Firm Productivity: Evidence from Italian Provinces*, IMF Working Paper 15/168.

⁷ Sola, S., and G. Palomba (2015) *Sub-National Government's Risk Premia: Does Fiscal Performance Matter?*, IMF Working Paper No. 15/117.



THE DEPENDENCE
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Conversely, if the share of own revenues is low and state governments are highly transfer-dependent on their central governments, markets expect them to receive bailouts from central governments and treat their bonds as close substitutes to sovereign bonds. This, in turn, lowers the incentive of state governments to run a responsible fiscal policy – the contrast is striking between Argentina, Brazil, and Germany on one side, and Canada and the United States on the other⁸.

A similar effect takes place in the case of municipalities, where a dollar of intergovernmental transfers increases expenditure more

⁸ Bordo, M.D., L. Jonung, and A. Markiewicz (2013) A Fiscal Union for the Euro: Some Lessons from History, [in:] *CESifo Economic Studies* 59(3), pp. 449-488; Rodden, J. (2005) *Achieving Fiscal Discipline in Federations: Germany and the EMU*, Fiscal policy in EMU: New Issues and Challenges Workshop Paper, European Commission, MIT.

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USUALLY, REVENUE
DECENTRALIZATION
IS IMPLEMENTED
WITH NO OR ONLY
LIMITED LOCAL TAX
AUTONOMY

than a dollar of own revenues⁹. In Poland this problem is minimized by submitting local governments to an expenditure rule, which limits their capability to take on debt. In effect, in 2017, despite a high central government deficit of 3.8% of GDP, local governments experienced a modest surplus of 0.1% of GDP.

LOCAL TAX AUTONOMY IS OFTEN LACKING

Usually, revenue decentralization is implemented with no or only limited local tax autonomy. The OECD measure of own revenue encompasses all revenue minus intergovernmental transfers from other levels of government. Unfortunately, this often encompasses a large amount of shared tax revenue. State and local governments have no discretion as to the rates and reliefs in case of such revenues, making tax competition effectively impossible. This is the case in Poland, where shared revenue from central government PIT and CIT taxes have a sum of over 20% of all local revenue.

Local governments in Poland collect less revenue from autonomous taxes and more from tax sharing schemes than in the rest

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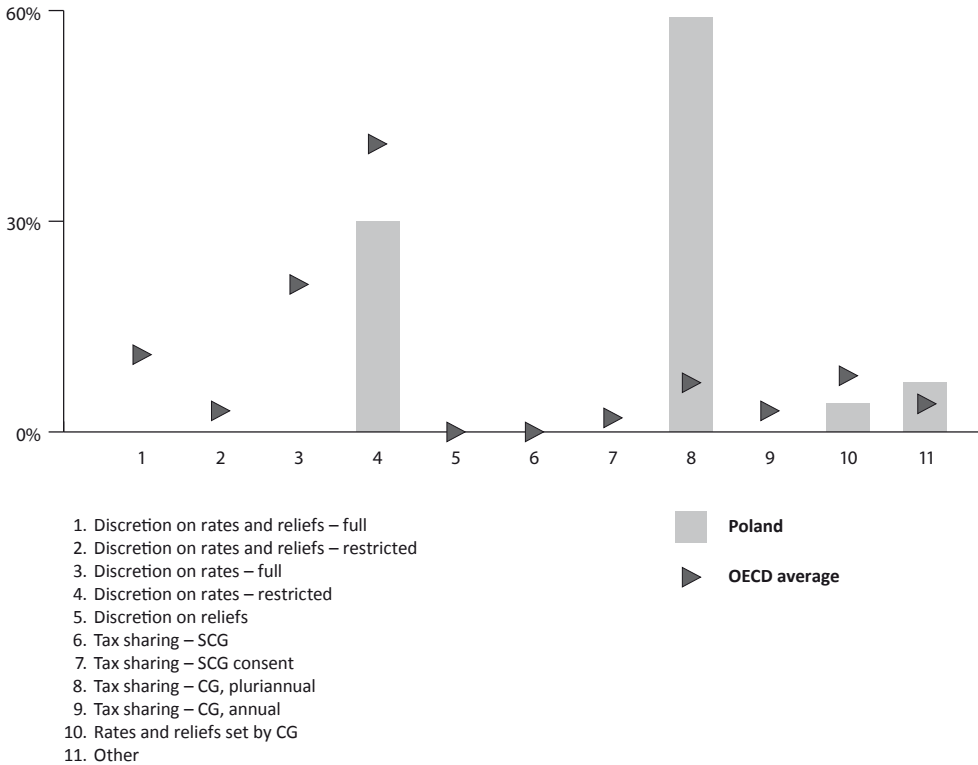
LOCAL GOVERNMENTS
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of the OECD countries. The OECD classifies state and local tax revenue into 11 groups with respect to the level of autonomy. For example, in highly federalized countries local governments can implement new taxes setting their rates and reliefs at will, while in Poland local governments have at most a limited discretion with respect to the rates of some taxes, e.g. on real estate, transport vehicles, and agricultural activity.

In the case of Poland, 3 out of 9 such taxes appear reflected in the OECD data, but this has no significant impact on the results as the remaining tax revenue remains rather small. We treat the sum of sub-central tax revenues, where state and local governments retain full or limited discretion with respect to rates or reliefs, as autonomous tax revenue. The comparison shows that Polish local governments hold some part of autonomy over only 30% of their tax revenues, while OECD countries hold on average 76% of their tax revenues. Furthermore, their autonomous local taxes are “more autonomous” as these municipali-

⁹ Martin-Rodriguez, M., and H. Ogawa (2017) “The Empirics of the Municipal Fiscal Adjustment”, [in:] *Journal of Economic Surveys* 31(3), pp. 831-853.

Figure 4: Structure of local tax revenues in Poland and an average of other OECD countries (2014)



Note: We refrain from showing exact shares as OECD data appears incomplete

Source: Own elaboration based on OECD data

ties often hold more discretion regarding rates and reliefs than the Polish ones [See Figure 4].

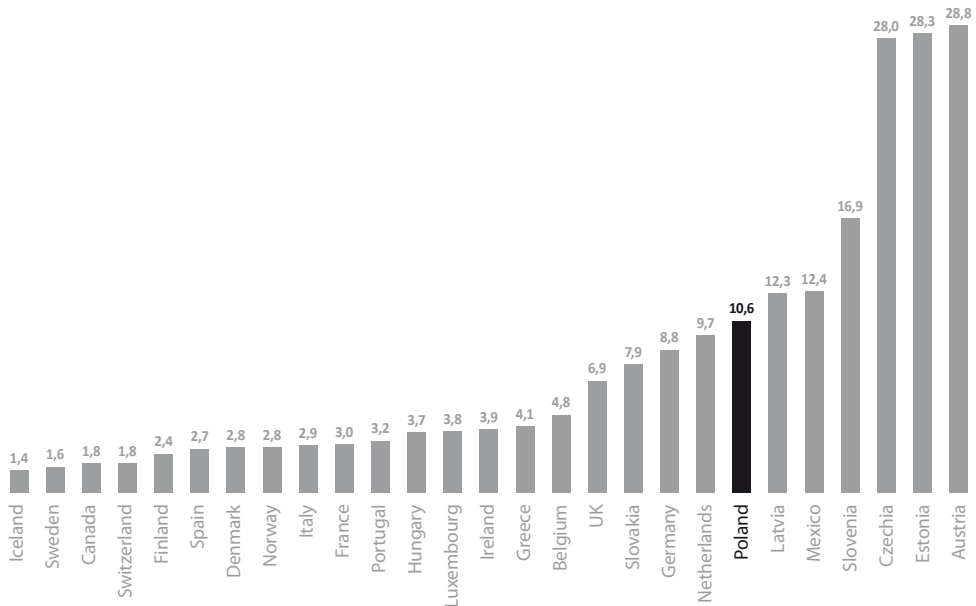
The ratio of state and local expenditure of autonomous revenue in Poland and other OECD countries is much higher than in the case of all local revenue. The OECD data has been used to show a ratio of autonomous revenue for state and local spending [See Figure 5]. The ratio in Poland deteriorates five-fold in comparison to the previously exhibited ratio. Germany scores almost as poorly on this measure. The Scandinavian countries, Canada, and Switzerland (and presumably other non-European Anglo-Saxon

countries for which there is no data) appear most decentralized as far as this measure is concerned.

EXTENDING TAX AUTONOMY WOULD BE BENEFICIAL

Revenue decentralization may be much more effective in aligning subcentral incentives to public welfare if state and local governments are given more tax autonomy. Vertical fiscal gap is the amount of spending on a given government level which is not covered by autonomous revenue on that level, but funded by intergovernmental transfers instead. A recent meta-analysis of available studies shows that vertical fiscal gaps lead

Figure 5: Ratio of state and local expenditure of autonomous revenue in OECD countries (2014)



Note: *Data for Mexico for 2015. Several countries have been omitted due to data limitations (e.g. the United States lacks aggregate data from the local level, partly due to a very high level of local autonomy)

Source: Own elaboration based on OECD data

to more fiscal profligacy in terms of debt and spending, higher tax burden, and lower public-sector efficiency¹⁰.

Singular studies also link higher vertical fiscal gaps to lower voter knowledge and per capita income. Lower voter knowledge is consistent with other findings, such as when municipalities are highly dependent on intergovernmental transfers, the ability of citizens to hold local governments accountable is limited and ignorance becomes rational.

In the case of Poland there remains ample space to expand the amount of autonomous tax revenue. As it has been shown previously, the ratio of autonomous local tax revenue to local spending is higher in Poland than

in most OECD countries. In fact, own revenue amounts to 49% of their revenues, while autonomous tax revenue amounts to only 11% [See Figure 6].

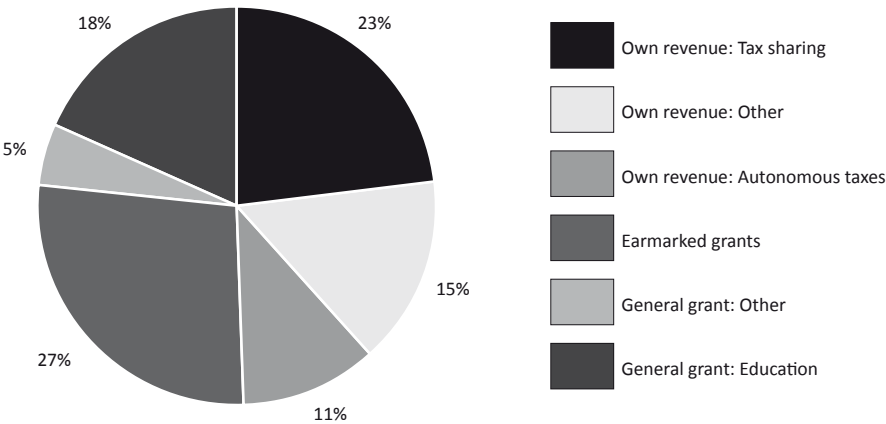
Polish localities have only a very limited ability to increase their tax sharing revenue from PIT and CIT taxes by incentivizing citizens to pay their taxes in a given county – e.g. Warsaw attempts to do that by providing public transportation discounts. This is not much different from the general grant, which consists mostly of the educational grant that finances public schools. This grant is not earmarked, and is calculated based on the number of pupils and teachers in a county. Some counties attempt to hold on to their populations so that their education grants will not be lowered – e.g. Jarocin, a town in central Poland, attempts to do this by partnering with the central government to provide subsidized housing.

¹⁰ Sorens, J. (2016) *Vertical Fiscal Gaps and Economic Performance*, Mercatus Working paper.





Figure 6: Structure of local government revenues in Poland (2017)



Note: Counties, poviats, cities with a poviat status, and voivodeships are included
Source: Own elaboration based on Ministry of Finance of the Republic of Poland data

Nevertheless, these remain only half-measures as citizens often pay their PIT and CIT taxes and use public services in different counties from the ones where they actually live, while the non-earmarked education grants have to be spent accordingly to teacher salaries and other school organization rules set by the central government. Even in the case of school manager selection, the central government has an equal share of votes as the local government: 3 representatives of ministry, 3 representatives of local government, 2 representatives of teachers, 2 representatives of parents, and 2 representatives of unions.

Even in countries with lower autonomous revenue shares than Poland, higher vertical fiscal gaps lead to more fiscal profligacy. It is worth noting that Austria, despite being formally a federation, has much higher ratios of local revenues and autonomous local revenue spending than Poland. Yet, even in the case of Austria, the municipalities with higher vertical fiscal gaps respond to incentives as expected by accumulating

more debt¹¹. This may be counter-intuitive as more “help” in the form of transfers from the central government leads to more deficit spending and debt.

In addition to tax autonomy, counties still lack autonomy from the central government in many prosaic matters (like county borders, names or even coats of arms). In some cases, local governments use their political influence in the central government to increase tax revenues by annexing the territory of neighboring counties. Such cases destroy any incentive to attract investment and citizens by improving the business environment and providing high quality public services. In a highly publicized case, the city of Opole, located in southern Poland, annexed a part of Dobrzeń Wielki county (which included a power plant and shopping center, both

¹¹ Köppl–Turyna, M., and H. Pitlik (2018) “Do Equalization Payments Affect Subnational Borrowing? Evidence from Regression Discontinuity”, *European Journal of Political Economy* 53(C), pp. 84-108.

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COUNTIES STILL LACK AUTONOMY FROM THE CENTRAL GOVERNMENT IN MANY PROSAIC MATTERS (LIKE COUNTY BORDERS, NAMES OR EVEN COATS OF ARMS)

generating high tax revenues)¹². As a result, the tax revenue per capita decreased in Dobrzeń Wielki from PLN 5,779 in 2016 to PLN 2,232 in 2017 according to the ranking of “Wspólnota”, a local government magazine¹³. The county dropped from the 16th place of the local governments with highest per capita tax revenue to the 1,537th place.

CONCLUSIONS

Decentralization played an important role in the success of the Polish transition from socialism to democracy and market economy. It has increased political accountability, which helped to improve governance, and today local governments provide the major-

ity of public services to local communities. This appears to have improved efficiency and is reflected in high levels of trust in local governments among their citizens.

Unfortunately, sub-central governments in Poland remain to a large degree, extensions of the central government. They deliver policies set by the central government and do it in a more efficient fashion, but actually have no significant power to run independent policies and to experiment. Any incentive of local governments to engage in a beneficial competition – and improve citizen welfare in the process – remains low. An improvement would come if the sub-central governments could be transformed more into laboratories of democracy, creating and testing new policies on the local level. The abovementioned research suggests a significant step in this direction would be to further decentralize revenues, giving localities more tax autonomy. •



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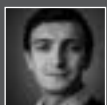
RAFAŁ
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¹² In Poland the central government holds the power to change borders of sub-central governments, merging and splitting them at will. The president of the city of Opole used his contacts in the central government to annex a part of the neighboring Dobrzeń Wielki county (and some other counties in the process). As mentioned in the article, this part included a power-plant and shopping center, both generating large tax revenues. The annexation went along despite widespread protests of inhabitants of Dobrzeń Wielki, which even gained national media coverage.

¹³ Świaniewicz, P. and J. Łukomska (2018) “Bogactwo samorządów. Ranking dochodów JST 2017”, [in:] *Wspólnota* 14/2018.

Centralization of Taxes, Decentralization of Competences: Is There a Way Out for the Local Government in Poland?



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MAREK
SZOLC

Creation of functioning local government in 1990 after a long period of centralized governance during the communist regime is considered to be a major achievement of the democratic transformation which took place after 1989. The Polish People's Republic had no real local government and façade institutions existing at that time enjoyed little to no autonomy from the state and party institutions. Local government, which was thoroughly reformed in 1999, played (and still plays) a key role in building a democratic society.

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MORE
THAN 60%
OF SURVEYED
INDIVIDUALS
DECLARED THAT THEY
TRUST THEIR LOCAL
GOVERNMENTS

One of the most pressing needs of the state after 1989 was decentralization and delegation of tasks in accordance with the principle of subsidiarity. Local government was entrusted with numerous competences and is responsible for providing vital public services and infrastructure. Available data and public perception suggest that it has been largely successful in these tasks. According to the Central Statistical Office, in 2017, more than 60% of surveyed individuals declared that they trust their local governments, which is a result to be envied by other public authorities in Poland (a mere

27.4% of Poles trust the parliament, while central government achieved only a slightly better result – 31.1%)¹.

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LOCAL GOVERNMENT
IS FACING MANY
CHALLENGES THAT
CAST DOUBT ON ITS
ABILITY TO CATER
FOR THE NEEDS
OF COMMUNITIES
ACROSS POLAND
IN THE FUTURE

However, despite its overall success, local government is facing many challenges that cast doubt on its ability to cater for the needs of communities across Poland in the future. The looming crisis is related in particular to the way it is financed.

The majority of income available to local government units is derived from funds redistributed by the state. Local government, which has only limited influence over its income, is increasingly burdened with additional tasks by the central government, even though additional funding is not always secured for them. At the same time, expectations on the local level are rising. Many services

¹ Central Statistical Office (2017) *Quality of Life in Poland 2017 Report*, p. 18. Available [online]: <https://stat.gov.pl/obszary-tematyczne/warunki-zycia/dochody-wydatki-i-warunki-zycia-ludnosci/jakosc-zycia-w-polsce-edycja-2017,16,4.html> [in Polish]

or facilities that used to be a luxury are now taken for granted, and people expect higher standards of services or more sophisticated needs to satisfy.

Aging population, migrations, increasingly difficult access to European Union (EU) funding, and structural deficiencies built into the design of public administration put additional pressure on the entire system. It is becoming evident that a major overhaul of the way local government is financed in Poland should take place.

The purpose of this article is to analyze the trend to centralize income from taxes or levies and decentralize competences or obligations that local government units have to fulfill. It will put emphasis on potential solutions that could address existing challenges and explain how decentralization of taxes may help finance local government in a sustainable, efficient way.

FINANCING LOCAL GOVERNMENT IN POLAND: A MIXED SYSTEM WITH MIXED RESULTS

Before discussing how local government is financed nowadays in Poland, it is necessary to briefly outline how it is organized in terms of type and number of its units, as well as competences assigned to its every level.

Local government in Poland has three tiers. There are 2,478 units on the lowest tier, called *gmina* (municipality), 314 units of the middle tier, called *powiat* (county), and 16 regional units called *województwo* (voivodeship).

MUNICIPALITY

Among municipalities, there are 302 urban municipalities, 621 mixed municipalities and 1,555 rural municipalities. Additionally, 66 major cities form special municipalities which are responsible for tasks delegated both to the municipal as well as the county

level. Municipalities vary greatly in terms of size, number of inhabitants, population density, and level of development. Local government is in consequence rather fragmented.

Municipality is the basic unit of local government. As per its definition under Polish law, it is a community formed by all inhabitants, covering a particular territory². Legislation and controlling competences are entrusted to a municipal council consisting of directly elected councilors, while directly elected mayors hold executive power.

In theory, municipality can engage in a vast number of tasks, since its role is to cater for the collective needs of the community that forms it. Municipality's tasks include all public matters on the local level, excluding those delegated to other authorities. In consequence, municipalities are the go-to authority in case of doubt as to which authority should act.

In practice, municipalities focus on spatial order, zoning and urban planning, real estate management (including social housing), management of municipal roads, streets, bridges and squares, management of local traffic, water supply, sewage treatment and disposal, maintaining order and sanitary facilities, municipal waste management, supply of electricity and heat, as well as protection of the environment, nature and water (to a limited extent). Municipalities also play a role in the field of healthcare, social aid, and family benefits distribution. In the field of education and culture, municipality is responsible for public lower-level education, libraries, and other cultural institutions, as well as monuments and heritage protection³.

² Arts. 1(1) and 1(2) of the Municipality Local Government Act of March 8, 1990, [in:] *Journal of Laws from 2018*, item 994.

³ Ibid., Art. 7(1).



COMPETENCES
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OR POORLY
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ON THE PART
OF ADMINISTRATION

COUNTY

County is the middle-level local government unit, between municipality and voivodeship. Each county comprises several municipalities and has its legislative and controlling body, the county council, as well as an executive body – county board.

Counties are responsible for tasks enumerated in relevant laws and are primarily in charge of: education and healthcare institutions not managed by municipalities (in particular those responsible for supporting people with disabilities), agriculture and forestry, social aid, nature and water protection, labor market and combating unemployment, flood protection, prevention of fires, as well as other extraordinary threats to life, health, and the environment.

In practice, competences of counties and municipalities overlap to a certain extent, which at times causes conflicts and delays and leads to inefficient or poorly coordinated action on the part of administration.

VOIVODESHIP

Voivodeship is the last level of local government, which comprises an entire region with multiple counties and municipalities. Similarly to counties, it carries out tasks stipulated in relevant laws and has a regional assembly (a legislative body) and a voivodeship board, which is its executive branch.

The main task of voivodeships are regional development and strategic planning, maintenance, and development of regional-level infrastructure, certain tasks in the field of education, social aid and health care, regional public transport and public roads, as well as some aspects of national defense and public security.

As was previously the case with municipalities and counties, there are areas where competences of voivodeships overlap with other levels of local government or are equivalent to certain roles performed by central government. Unsurprisingly, it gives rise to similar problems with effective administration, e.g. in the field of regional development⁴, conservation of nature and historical monuments⁵ or road infrastructure management⁶.

⁴ Właźlak, K. (2010) *Rozwój regionalny jako zadanie administracji publicznej*, Warsaw: Wolters Kluwer, pp. 243-244.

⁵ Fogel, A. (2015) "Kompetencje gminy w ustanawianiu form ochrony przyrody i ochrony zabytków", [in:] *Samorząd Terytorialny*, no. 11, pp. 32-33.

⁶ Uliasz, B. and E. Kruk (ed.) (2009) *Dziesięć lat reformy ustrojowej administracji publicznej w Polsce. Ogólnopolska konferencja naukowa, Łańcut, 12-14 czerwca 2008 r.*, Warsaw, p. 132.



DISPROPORTIONATELY LARGE PARTS OF LOCAL GOVERNMENT'S REVENUES ARE NOWADAYS DERIVED FROM THE STATE BUDGET SUBSIDIES THROUGH A RATHER COMPLICATED SYSTEM

Having outlined the sheer number of tasks that have been assigned to all tiers of local government, it is now necessary to describe in a greater detail how all these tasks are financed.

Different types of tasks which require different amounts of financial resources often have different sources of funding. These differences are the reason why disproportionately large parts of local government's revenues are nowadays derived from the state budget subsidies through a rather complicated system, where a large share of taxes collected by the state is firstly taken to the central level, and then redistributed to finance local public services.

REVENUES AND EXPENSES OF LOCAL GOVERNMENT IN POLAND

Ensuring that local government has adequate resources to carry out its tasks was perceived as a priority when fundamental laws regulating the Polish political system were being drafted. As a result, the Constitution enacted in 1997 contains provisions which states that local government has guaranteed access to sufficient funding.

The Constitution clearly outlines the basic rules governing how local government should be financed:

- **Article 167(1)** of the Constitution stipulates that units of local government shall be assured public funds adequate for the performance of the duties assigned to them.
- **Article 167(2)** states that the revenues of units of local government shall consist of their own revenues as well as general subsidies and specific grants from the state budget.
- **Art. 167(3)** further specifies that the sources of revenues for units of local government shall be specified by statute – which allows for a certain level of flexibility in this field.
- Lastly, **Art. 167(4)** makes it clear that alterations to the scope of duties and authorities of units of local government shall be made in conjunction with appropriate alterations to their share of public revenues.
- In addition, **Art. 168** stipulates that to the extent established by statute, units of local government shall have the right to set the level of local taxes and charges.

As a result of such constitutional regulation, sources of revenue of local governments are diverse and comprise: general subsidies from the state, specific grants from the state transferred to perform certain tasks delegated to the local government, and finally, local governments' own revenues, generated primarily through local taxes and shares of taxes like personal income tax (PIT) or corporate income tax (CIT) kept on a local level.

In 2017, local government as a whole reported revenue in the amount of approximately PLN 229.9 bn (EUR 53.7 bn)⁷. However, only

⁷ National Council of Regional Accounting Chambers (2017) *Report on the Activities of Regional Accounting Chambers and Budgets of Local Government Units in 2017*, pp. 170-171. Available [online]: under: http://www.rio.gov.pl/modules.php?op=modload&name=HTML&file=index&page=spr_sejm_2017 [in Polish]



IN 2017, EACH MUNICIPALITY WAS ALLOWED TO RETAIN 37.89% OF TAX REVENUE GENERATED THROUGH TAXING PERSONAL INCOME OF INDIVIDUALS REGISTERED AS TAXPAYERS IN THEIR TERRITORY

app. PLN 113.3 bn can be classified under Polish law as own revenues of local government. Apart from this, local government units received PLN 54.3 bn in the form of general subsidies and specific grants in the amount of PLN 62.3 bn⁸. This means that less than 50% percent of total revenue of local government came from its own sources of revenue and that a significant percentage of total tax revenue was firstly accumulated in the state budget and then redistributed among different units of local government.

The main source of tax income of local government is the share that units of all tiers receive from PIT and CIT. For example, in 2017, each municipality was allowed to retain 37.89% of tax revenue generated through taxing personal income of individuals registered as taxpayers in their territory. In 2017, total revenue from this source amounted to PLN 36.7 bn.

Apart from a share in PIT and CIT, local governments collect their own taxes. These include:

- a) **real estate tax** – a rather complicated and multifaceted tax paid by both individuals and businesses which possess land or property. The amount of tax to be paid depends on the area of a real estate subject to taxation. It is definitely the most important local tax, since it brings significant revenue (PLN 24.8 bn in 2017);
- b) **agricultural tax** – a special tax paid by individuals and businesses in possession of land classified as agricultural, paid in the amount which depends on the area, quality, and type of land; in 2017, the tax brought revenue in the amount of PLN 1.6 bn;
- c) **forest tax** – a tax paid primarily by the State Forests, the main owner of forests in Poland; the amount due from a taxpayer depends on the area of forests owned by the owner; the tax generated PLN 0.3 bn in revenue in 2017;
- d) **tax on the means of transport** – a tax imposed on all individuals and entities that possess a means of transport that is used for the purpose of business activity, in practice paid most often by owners of larger trucks and other vehicles; in 2017 the tax brought app. PLN 1.9 bn in revenue to local government;
- e) **tax card** – a special and simplified form of personal income tax paid by individuals who decide to subject their proceeds from individual economic activities they undertake to a different regime, better adjusted to their needs as entrepreneurs;
- f) **inheritance tax** – a tax imposed in an event of inheritance or donation taking place between individuals which are not close family members;
- g) **tax on civil law transactions** – a tax payable in case of a number of standard contracts, subject to numerous exceptions.

⁸ Ibid., p. 170.

In addition to taxes, some levies are also collected by local government. However, taken altogether with tax card, inheritance tax, and tax on civil law transaction, these generated only approximately PLN 3 bn of revenue in 2017.

Although in theory local government units in Poland are allowed to collect a large number of different taxes and levies (and they can adjust them to their needs to a limited extent), they remain heavily dependent on state budget funding. This situation is unfavorable for several reasons.

First of all, rigid rules on spending subsidies and grants obtained directly from the state take away a lot of freedom from local government units and prevent them from adjusting funding to local needs and implementing better-suited policies.

Secondly, local communities have less control over their tax money and find themselves increasingly detached and unable to understand the relationship between taxation and quality of public services.

Thirdly, every transfer and additional layer of intermediaries reduces transparency and creates additional obstacles for citizens willing to analyze financial data in more detail.

Lastly, large portions of revenue redistributed from the central level results in inefficiencies and inadequate funding. Regardless of its revenue, each local government unit has to comply with its obligations and carry out tasks that are within its own competence or that were delegated to it by the central government.

As a result, a gap appears between the financial needs of local government units and funds they receive from the state budget, and although it is difficult to estimate, its existence is rarely disputed. Despite



LARGE PORTIONS OF REVENUE REDISTRIBUTED FROM THE CENTRAL LEVEL RESULTS IN INEFFICIENCIES AND INADEQUATE FUNDING

the fact that these funds should be supplied by the central government, they are never made available, which forces local government units to cut funding for other activities or fall into debt.

These and other disadvantages were recognized by the Supreme Audit Office in a recent report, in which the office spoke in favor of transferring certain permanently delegated tasks (and the financing related to them) directly to local governments, since it would simplify all procedures and bring savings⁹.

The financing model described above might be prone to serious disruptions in the light of risks related to trends and changes taking place in Poland.

CHALLENGES AHEAD

As evidenced by the presented data, the system which is currently in place severely limits the flexibility of local governments and effectively makes it too dependent on decisions taken at the central level. With

⁹ Supreme Audit Office (2017) "Subsidising of central administration tasks delegated to the local government units", September. Available [online]: <https://www.nik.gov.pl/aktualnosci/nik-o-dotowaniu-zadan-zleconych-samorzadom.html> [in Polish]



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approximately 50% of local governments' revenue derived from the funds transferred through the state budget (and a dwindling percentage of revenues related to their own, separate sources) potential influence of central government is excessive and undermines the very idea of local government units political, organizational, and fiscal autonomy.

The model which is enforced in Poland will be tested as local government units are going to cope with a number challenges that can verify their fiscal stability.

Firstly, depopulation and migrations will pose a challenge for many municipalities. Even today, out of all Polish municipalities, merely 884 have more than 10,000 inhabitants, and 103 have less than 3,000. Providing high-quality public services to communities this small (which are also more often than not affected by structural unemployment, poverty, and social exclusion) becomes less and less economically viable. If services like

healthcare, education or public transport are to be maintained, a more sustainable model has to be found.

Secondly, and in parallel with depopulation, a rapid ageing will affect all local governments in Poland. In dynamic municipalities – especially large cities – challenges related to an increasing population of the elderly will be easier to overcome due to their resilience related to the attractive job market, positive migration rate, better infrastructure, and bigger revenue. Unfortunately, many other municipalities in at least several regions within Poland will be at the same time hit by a combination of low fertility, high mortality, significant emigration, and related lack of economic opportunities. As of now, municipalities which are at risk of total stagnation due to these factors are badly prepared to deal with this increasingly alarming issue.

Thirdly, local government might suffer from declining EU funding. In the period between 2014 and 2020, approximately PLN 82.5 bn of EU funds fueled and will still fuel investment and development in many areas, especially in regions lacking in infrastructure. However, it is likely that the next EU budget is going to be far less generous¹⁰, which will result in limited access to funding, which might also be subject to more stringent requirements and aimed at different areas than in the past. It remains to be seen how local governments in Poland will adjust its development policies to new priorities, but the investment boom witnessed in previous years will probably not continue – at least not on the same scale.

¹⁰ The likelihood of significant cuts in the EU Cohesion Funds was commented in the press. See for example <http://www.spiegel.de/international/europe/eu-considers-funding-cuts-for-poland-and-eastern-europe-a-1201082.html> and <https://euobserver.com/economic/141933>





Fourthly, at least part of local governments units will likely have to deal with excessive indebtedness. In 2017, 1,432 local government units reported a varying degree of deficit¹¹. Investments made by municipalities are the main driver of modernization of infrastructure and contribute to increasing social capital. Nevertheless, local government units constantly face the challenge of maintaining a safe indebtedness level and efficient debt management. Although they are bound by legally proscribed limits of debt¹², some will likely face an increasing risk of their debt spin-



NEW CHALLENGES CALL FOR A NEW APPROACH TO FINANCING ACTIVITIES OF LOCAL GOVERNMENT UNITS IN POLAND

ning out of control, partly as a result of poor debt management, and partly owing to over-investment resulting from easy access to EU

¹¹ National Council of Regional Accounting Chambers (2017) *Report on the Activities of Regional Accounting Chambers and Budgets of Local Government Units in 2017*, pp. 183. Available [online]: under: http://www.rio.gov.pl/modules.php?op=modload&name=HTML&file=index&page=spr_sejm_2017 [in Polish]

¹² The most likely consequence of constant and blatant infringement of debt regulations is suspension of a local government unit's executive body or nominating a commissioner by the Prime Minister in its place (Art. 97 of the Municipality Local Government Act). In case debt reaches unsupportable levels, a unit, together with its debt, can be dissolved and divided between neighboring units.

funds, but also due to a heavily centralized system of financing which leaves them with too little revenue they can freely decide on.

TOWARDS A BRIGHTER FINANCIAL FUTURE

New challenges call for a new approach to financing activities of local government units in Poland. The most effective way to empower local governments and break the absurd trend of placing more burdens while keeping control over funds necessary to deal with them would be to change the way tax income is distributed between local government units and state budget.

FINANCIAL CHANGES: TAX DECENTRALIZATION

The first step to reinvent the way local government is financed in Poland would be to ensure that a larger share of revenues from PIT is retained on a local level. The most feasible solution would be to transfer all revenue from the first income tax threshold and revenue from taxpayers subject to flat tax rate directly to local government units.

Simultaneously, the share of direct subsidies and grants could be significantly limited. Such an operation would have no direct financial consequences on taxpayers in the increase of paid tax and would be neutral for the state budget – it will simply cease to fund subsidies for local government that will be no longer needed, as all necessary resources become available directly for the local government.

Keeping the majority of tax money from every taxpayer would result in a number of other positive developments.

Firstly, it would most likely limit administration costs and burdens related to transfers, accounting, and control. Potential savings are difficult to estimate but reducing the number

of steps that funds have to go through before they reach their final destination should generate savings.

Secondly, it would significantly increase the fiscal and organizational autonomy of local government units, since finally the tasks they are responsible for would be financed with revenues they have full and direct access to.

Thirdly, it has the potential to revolutionize the way local governments cooperate with local communities. The awareness that taxes paid by every individual are used directly by a local government to finance local needs and that the local government has much more control over when and where to spend them should reengage citizens and give new impetus to become involved in local matters.

Fourthly, such an approach could (if other reforms in the field of access to public information are introduced in parallel, e.g. countrywide standardization of the Bulletin of Public Information) drastically improve transparency and understanding of how local budgets are managed.

Fifthly, increasing the percentage of total revenue dependent entirely on the number of taxpayers would encourage local government units to compete in terms of quality of provided public services. A larger share of tax retained on a local level may make it more important for units to persuade people to relocate to better managed local government units and foster positive competition, especially as far as essential services of healthcare, education, and transport are concerned.

Summarily, the decentralization of taxes should have positive effects far beyond these related only to reduction of a number of transfers required to place funds where they are needed.

The main issue that will have to be tackled if such an approach is adopted is how to financially support disadvantaged regions where poorer taxpayers will generate less revenue for local government units. In conjunction with solutions proposed in the next section, regarding reducing the number of tiers of local government and merging of small municipalities, this issue should be solved by establishing a financial mechanism aimed at supporting less developed municipalities.

This support model could take a variety of forms from direct subsidies to investment-based support. What is most important is the source of its funding. The simplest and most coherent solution would be to reserve tax revenues generated by the second income tax threshold for its purposes. The amount will suffice to finance a mechanism for all local government units that face structural exclusion, lag behind in terms of development or cannot provide opportunities attractive enough for their inhabitants. At the same time, it will not alienate wealthier citizens, since a large part of their income subject to the first income tax threshold will still remain as a financial contribution to the development of the municipality where they decide to live.

Secondly, it is essential for local government units to be able to regulate local tax rates to a certain extent. This would further boost competition between municipalities and encourage them to provide the best public services possible for the lowest cost they can achieve. The maximal and minimal scope of modification should be capped and probably allow for a 2-3% divergence from the basic nationally set rate.

STRUCTURAL CHANGES: LARGER UNITS, FLATTER STRUCTURE

A necessary component of the abovementioned tax decentralization reform would be a structural reform of the local government.



COMPETENCE OVERLAPS RESULTING FROM A THREE-TIER MODEL AND REGULATORY BURDEN PUT EQUALLY ON SMALL AND LARGE UNITS HAVE NEGATIVE IMPACT ON THEIR ABILITY TO PROVIDE HIGH-QUALITY PUBLIC SERVICES

As it has already been mentioned, local government units in Poland are highly fragmented. Even though the official reason behind it has almost always been the need to keep local government as close to the people as possible and shape it in accordance with the principle of subsidiarity, nowadays, it is becoming more and more evident that competence overlaps resulting from a three-tier model and regulatory burden put equally on small and large units have negative impact on their ability to provide high-quality public services.

In addition, as pointed out earlier, many municipalities in Poland are becoming too depopulated and too small to effectively carry out their tasks. It borders on the impossible for a community of 3,000 or 4,000 inhabitants to deliver everything it is obliged to – not to mention ensuring high quality of public services. Some experts argue that the optimal

size of a municipality is 20,000¹³ and while an exact number of inhabitants is still a matter of controversy, the issue whether to merge communities or not is going to become more and more pressing.

In consequence, fewer structures, reduced competence overlap, leaner administration, and larger municipalities financially capable of providing all services on their own without resorting to subsidies go hand-in-hand with tax decentralization. A reform of the financing system should be accompanied by an elimination of the worst-functioning and most under-financed county level units and a structured attempt at merging smaller municipalities into larger and self-sufficient entities¹⁴.

CONCLUSIONS

The current model of financing local government in Poland calls for a major overhaul. It is inadequate and unsustainable in the long run. Local government in Poland requires a system of financing which is better suited to its status and responsibilities, encourages good practices, and guarantees transparency.

Unfortunately, these much-needed changes are unlikely to take place. Firstly, central government is at best skeptical towards the idea of decentralization and so far, has been implementing changes that take both funds and power away from local governments. It is unlikely that this trend would change due to the political

¹³ Forum Od Nowa (2013) *Local Government 3.0 Report*, p.17. Available [online]: http://www.jawnosc.pl/wp-content/uploads/2013/11/Forum_Od-nowa-Raport_Samorzad_3-0.pdf [in Polish]

¹⁴ Counties were created as a result of a large reform of the local government in 1999, when previously-existing 49 voivodeships were merged into 16 larger regional units. The idea behind their creation was to prevent small- and medium-sized cities from experiencing negative consequences of losing the status of a voivodeship's capital. However, this strategy failed and while some of these cities witnessed continuous development (a result of successful management by talented mayors), the majority struggles to compete with large metropolises. Their status as a county's capital was thus a negligible factor.



THE CURRENT MODEL OF FINANCING LOCAL GOVERNMENT IN POLAND CALLS FOR A MAJOR OVERHAUL

environment in Poland. Although the ruling Law and Justice (PiS) party has an absolute majority in the parliament, it is far from dominating local governments (it has a majority in only one out of sixteen regional assemblies, has few mayors in large and medium cities and is often outnumbered by other parties and local committees in local assemblies or city councils). Thus, the central government has little incentive to grant more fiscal autonomy to local governments regardless of possible positive developments related to it. Reforms that at least partly incorporate solutions proposed in this article are only possible after a change in government, since electoral manifestos of the liberal and center-right opposition parties endorse them to a certain extent.

Secondly, there is strong opposition on the part of many local governments to the idea of merging municipalities and dissolving counties. Members of local political (and often financial) elites are often members of elected bodies that would no longer exist if municipalities were to be merged. Furthermore, possible reductions in the number of positions available in the local executive bodies and authorities would harm existing power structures, which are prone to cronyism and often have seen little democratic competition in the past years. Any attempt at structural changes will require significant political effort to overcome resistance on the part of many stakeholders.

Thirdly, a reform on a scale proposed in this article will only be possible after thorough and detailed preparations. A shift in the logic of financing local government will likely have a ripple effect on related areas. Greater transparency and more convenient public information systems should accompany these changes in order to achieve the desired effect of greater citizens' involvement in local matters. Direct, tax-based funding will allow more flexibility in term of how public services can be provided, but at the same time will create new challenges in terms of control and auditing. An entirely new system of internal transfers between wealthier and worse-off regions will have to be designed in order to prevent abuses of competitive edge many municipalities already enjoy over others. Preferably, in order to prevent further decline in disadvantaged, depopulated, and aging parts of the country, a set of more ambitious policies to prevent inequalities should be developed.

Nevertheless, despite the abovementioned obstacles, the trend to decentralize tasks and centralize taxes has to be reversed. It will increasingly hinder development on the local and regional level. In comparison to other conceivable models, ensuring that the largest possible amount of local taxes and levies remains to be spent on local level is most favorable. Most importantly, fiscal autonomy of local government in Poland will be secured. ●



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Elusive Road to Fiscal Decentralization in Bulgaria



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YAVOR
ALEXIEV

Fiscal decentralization is often viewed as a niche issue that mostly concerns administrative and regional development policies. However, it has broader social and economic implications, which are often overlooked, especially in countries with a heavily centralized government structure such as Bulgaria. For decades Bulgarian municipalities have been struggling to carry

given the right to set (within pre-defined limits) and collect a wide array of taxes, mostly related to movable and immovable property.

The period that followed has shown clearly that this step – while important at the time – has failed to lead to significant changes in the structure of municipal budgets. The additional tax powers that local governments received in 2007 have failed to produce the desired impact as the revenue of local governments (as % of GDP) has increased modestly – from 6.3% in 2007 to 7.3% in 2017.

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MUNICIPALITIES HAVE
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MANDATE

out their democratic mandate – to observe, identify, and resolve issues of importance to the local community, hindered by an evident lack of own resources.

THE STATE OF LOCAL FINANCES IN BULGARIA

While Bulgarian governments have a clear long-term commitment to pursue fiscal decentralization (as stated in the 2004-2015 and the 2016-2025 Decentralization Strategy¹), the last meaningful changes in this regard were undertaken more than a decade ago. In 2007, Bulgarian municipalities were

This share is more than two times lower than both the EU average (15.7%) and the euro area average (15.3%)². In fact, there are only 8 countries in which this share is lower than the one in Bulgaria. Among those are heavily centralized countries such as Greece, as well as countries that are significantly smaller both in terms of their population, as well as their territory (Luxembourg, Cyprus, and Malta).

With very few notable exceptions³, Bulgarian municipalities remain⁴ highly dependent on transfers from the central government, which has created conditions in which political favoritism has thrived. Examples of the latter are numerous, but none are more telling than the so-called Regional Development Fund of the PM Oresharski's government back in 2014. Under its operation, municipalities were invited to submit proposals for local projects that would be funded by the government. The results of this otherwise “transparent and project-based” approach were striking – municipalities,

¹ The Decentralization Strategy 2016-2025. Available [online]: <http://www.strategy.bg/StrategicDocuments/View.aspx?lang=bg-BG&Id=1155> (in Bulgarian).

² The cited figures include the revenue of both local and state governments (where such exist).

³ These exceptions include the capitol city of Sofia, as well as several resort municipalities, and municipalities with large concession deals.

⁴ The other countries with lower local government revenue to GDP are Slovakia, Hungary, Portugal, and Ireland.

PROS AND CONS OF FISCAL DECENTRALIZATION

A recent IMF study¹ shows that fiscal decentralization can lead to improved fiscal discipline, resulting in lower deficits and indebtedness, as well as more efficient and transparent allocation of public funds. In line with the principles of local governance and subsidiarity, local governments have an informational advantage² when it comes to determining local priorities, which can help them achieve higher effectiveness of public expenditures.

Makreshanska and Petrevski (2016) argue³ that fiscal decentralization creates conditions that encourage the implementation of innovative, resource-saving approaches to the provision of local administrative services, which suppress corruption practices and support the fiscal position by leading to higher expenditure efficiency and higher economic growth.

In theory, even factors such as the geographic proximity of those who pay the money and those who spend it influence the way in which the expenditure process is facilitated. In contrast, high dependence on common resources (such as transfers

from the central government) can lead to low stimuli for combating tax avoidance at the local level and a lack of clear political responsibility, which spurs deficit spending. When both local governments and their constituencies are aware that they are spending someone else's money, political and fiscal accountability issues are easier to overlook.

Most arguments against fiscal decentralization are based on the principle of achieving economies of scale, which are indeed easier to accomplish at the national level. In addition, some models of fiscal decentralization are rightly criticized for resulting in unnecessary multiplication of administrative bodies and procedures, or for creating more opportunities for lobbyist and rent-seeking practices at the local level.

¹ Sow, M. and I. Razafimahefa (2017) *Fiscal Decentralization and Fiscal Policy Performance*. IMF Working Paper WP/17/64.

² See Oplotnik, Ž. And M. Finžgar (2013) "EU Member States and Fiscal Decentralization – Empirical Comparison", [in:] *Innovative Issues and Approaches in Social Sciences*, Vol. 6, No. 3, pp. 39–68.

³ Makreshanska, S. and G. Petrevski (2016) *Fiscal Decentralization and Government Size across Europe*. MPRA Paper No. 82472.

controlled by the then ruling coalition⁵ were awarded several times more per capita funds in comparison to municipalities controlled by the opposition.

The lack of sufficient own revenues has led to increasing debts among Bulgarian municipalities, not least due to their efforts to provide co-financing for EU projects. The latter have gradually become

the only go-to option for realizing much needed (in some cases) capital investment, but their operation has exposed the seriousness of the issue with the own revenues of municipalities, as many of them have struggled to repay the loans that they have taken out in order to cover their share of the expenditures.

In late 2014, this issue led to some calls for government to fulfill its strategic engagement and provide municipalities with a new revenue stream – and in particular, to give them the right to a share of income taxes. Regret-

⁵ The ruling coalition at the time consisted of the Bulgarian Socialist Party (BSP) and the Movement for Rights and Freedoms (MRF).

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tably, the discussion was quickly turned on its head in two decisive moves by the central government.

First, it was proposed that instead of getting a share of the flat 10% income tax already collected, municipalities get the right to set up to 2% additional income tax rate on top of the existing rate. This proposal was loudly rejected by municipalities, but for the wrong reasons – local elections were just around the corner and no one wanted to be seen as supporting higher tax rates. The debate was then shifted, and the central issue was no longer the insufficient own resources of municipalities, but rather – their lack of fiscal responsibility.

It was evident that the central government had no desire to relinquish a larger part of the fiscal pie to municipalities. Furthermore, if the then proposed approach to fiscal

decentralization had been adopted, the negative outcomes would have probably outweighed any positives stemming from the increased revenue flow of local governments. In particular, this approach would have led to:

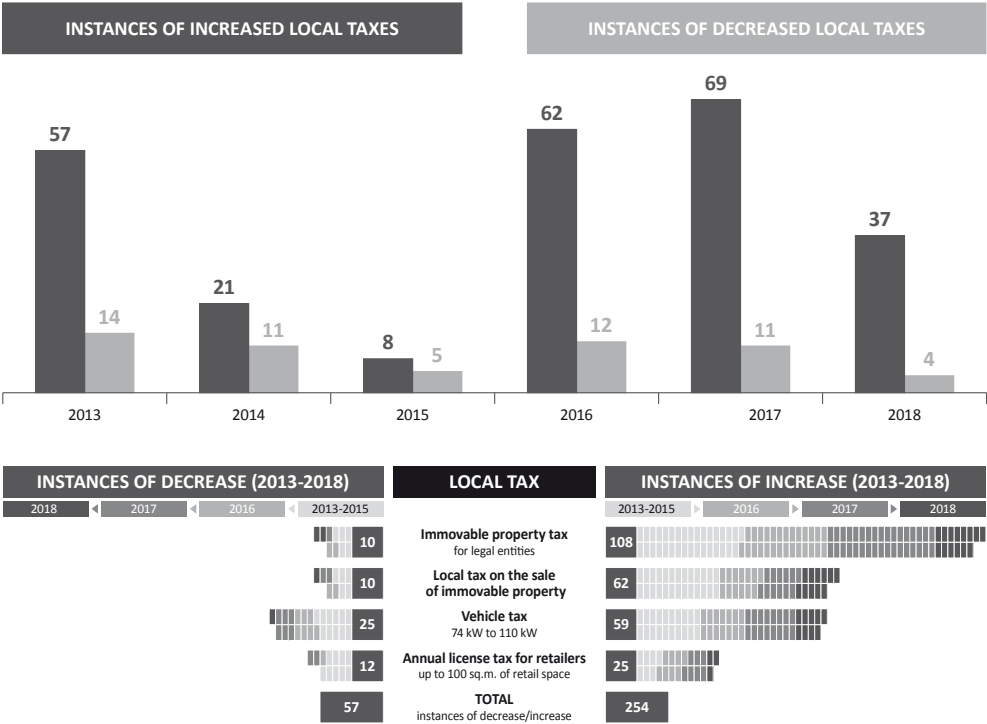
- loss of international competitiveness due to an overall increase in the tax burden of local businesses;
- limited capacity for further decentralization due to the precedent that would have been set – namely that decentralization is carried out not at the expense of central government revenues, but on top of the already existing tax burden;
- a more insignificant shift in the structure of public finances than would have been achieved if decentralization was carried out through sharing already established revenue streams;

In the wake of this discussion, a dedicated mechanism for support of municipalities with financial difficulties was established. As

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Figure 1: Instances of local tax increases and decreases (2013-2018)



Source: IME, based on requests for access to information under the Access to Public Information Act (APIA)

part of its operation, municipalities that do not meet a certain number of fiscal criteria are being put under financial supervision by the Ministry of Finance and are asked to put forward financial stabilization plans in order to receive interest-free loans from the central government, which can even be revoked under certain conditions.

It is no surprise that this instrument, which has arguably put certain municipalities under even stronger dependence from the central government, sparked a previously unseen race for rising taxes – in some cases as a reactive step for meeting requirements and receiving financial support from the government, and in others – as a pre-emptive step away from the scope of the mechanism.

IME has followed this trend closely, as we sent out 1,590 requests for information under the Access to Public Information Act (APIA) in the period between 2013 and 2018, which has allowed us to identify 254 separate cases in which a key local tax has been increased and just 57 cases in which a tax was decreased [See Figure 1]. Since there are many different forms of local taxation⁶, we have concentrated our efforts on four of the local taxes that bear the highest fiscal importance for municipalities, while also being related to the local business environment and living conditions.

⁶ For instance, while most passenger vehicles fall into the 74-110 kW bracket, there are separate tax rates for vehicles that fall in other ranges. The same is true for the annual license tax for retailers, which can vary depending on the village, town, city and even location within a given municipality.

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STARVED FOR CASH MUNICIPALITIES VIEW IMMOVABLE PROPERTY TAXATION AS THEIR MAIN SOURCE OF ADDITIONAL REVENUE

These are the annual immovable property tax for legal entities, the tax on the sale of immovable property, the annual vehicle tax, and the annual license tax for retailers.

As can be clearly seen in Figure 1, instances of tax increases reached 62 in 2016 and a record of 69 in 2017. It is, indeed, no coincidence that these are the two fiscal years that follow the introduction of the stabilization mechanism, nor is it surprising that the general trend has continued in 2018, with the latter being the year with fewest local tax reductions so far. It is evident that starved for cash municipalities view immovable property taxation as their main source of additional revenue – the annual immovable property tax and the sales tax on immovable property have been both the most frequently increased and the least frequently decreased local taxes in the observed period. None of these tax hikes, however, address the underlying issue of the structure of municipal budgets and their dependence on the central government.

THE ALTERNATIVE: FISCAL DECENTRALIZATION

IME has developed a number of recommendations in light of the deteriorating state of Bulgarian municipal finances and the in-

creasing concerns regarding the vitality of local democracies and the capability of local governments to carry out policies in support of the economic and social development of Bulgarian regions.

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SHARING PART OF THE INCOME TAX REVENUES WITH MUNICIPALITIES IS THE EASIEST, MOST STRAIGHTFORWARD, AND ECONOMICALLY VIABLE APPROACH TO FISCAL DECENTRALIZATION IN BULGARIA

The proposals are the result of a nearly decade-long work in the field of local finances and regional development, as well as of a six-year effort to monitor and evaluate local tax systems:

- **Sharing part of the income tax revenues with municipalities** is the easiest, most straightforward, and economically viable approach to fiscal decentralization in Bulgaria. While other models do exist⁷, most of them create incentives for tax arbitrage and creative accounting and are much harder to administer.

⁷ Most notably corporate taxes, but also in some cases taxes on turnover.

- **Income tax revenues** would continue to be collected and administered by the National Revenue Agency (NRA), but tax proceeds would be transferred back to municipalities depending on the permanent residence of the taxpayer (the so-called “money follows the ID” approach).

Our calculations show that sharing 1/5th of income tax revenue with municipalities would lead to an overall 30.4% increase in the own revenues of municipalities. In addition, this system would act as a natural cohesion instrument across regions.

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THE RESTORATION OF THE LINK BETWEEN TAXATION AND POLITICAL REPRESENTATION ON THE LOCAL LEVEL WILL HELP REVITALIZE LOCAL DEMOCRACIES

- The initial step would see **municipalities receive 1/5th of income tax revenue** that has been received by workers whose permanent address is within their borders. Municipalities will be able to use these revenues as they see fit, but a consolidation period of local finances and prioritization of debt service might be required in some cases.
- In the long run, once the share of **the income tax that municipalities receive is increased to, for instance, 50% of income tax revenues** (which equals 5% of an individuals' gross income after security payments), they could be given the opportunity to decide on the tax rate itself within the allowed boundaries. This will create conditions for real tax competition and could give less attractive regions the edge when it comes to attracting investment.

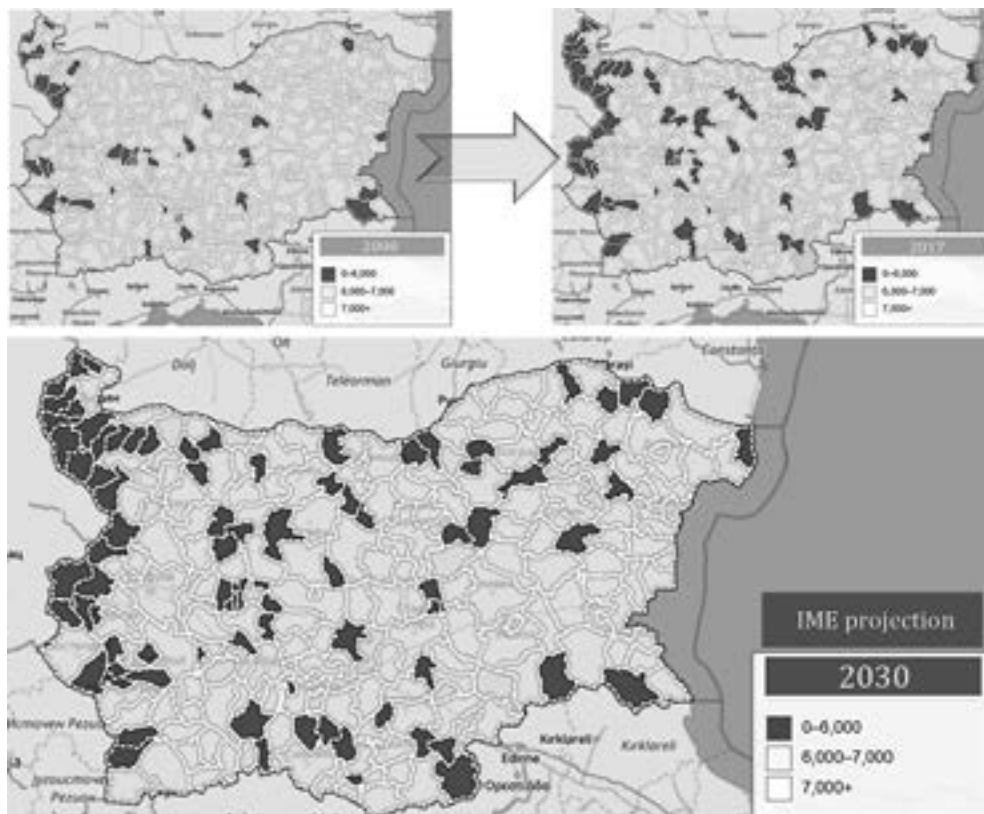
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THERE ARE MORE THAN 70 MUNICIPALITIES (OUT OF A TOTAL OF 265) WHICH DO NOT ADHERE TO ONE OF THE INITIAL RULES FOR THE CREATION OF A MUNICIPALITY – A POPULATION OF MORE THAN 6,000 PEOPLE

National Statistical Institute (NSI) data show that as a result of daily labor migration between Bulgarian municipalities, 71% of them are in fact net donors of workers, which means that they are likely to experience an even stronger positive fiscal effect from fiscal decentralization.

The 286 thousand Bulgarian workers that fall into the group of daily commuters between municipalities will see a share of their income taxes go back to the municipality in which they live and in which they vote in local elec-

Figure 2: Municipalities that do not comply with the 6,000 population rule



Source: IME, based on requests for access to information under the Access to Public Information Act (APIA)

tions. The restoration of the link between taxation and political representation on the local level will help revitalize local democracies by empowering both local governments and local citizens to identify and implement those policies that they feel are most important.

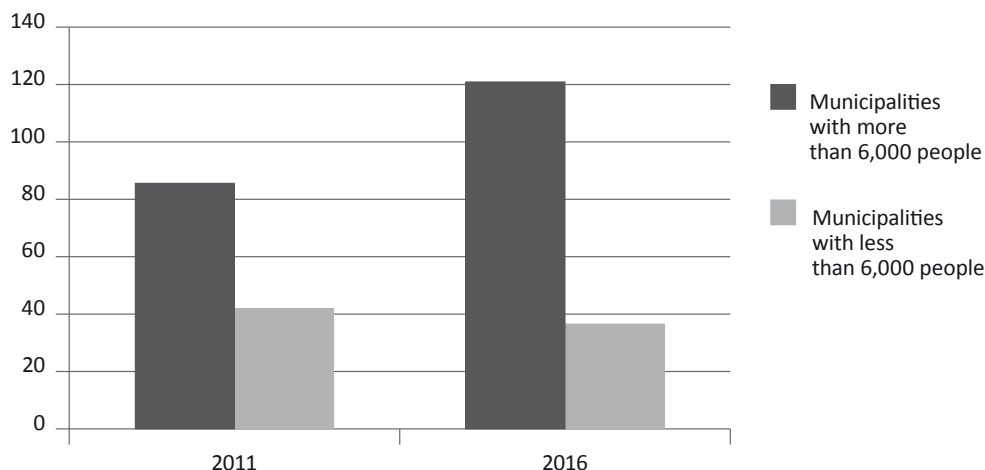
FISCAL DECENTRALIZATION AND TERRITORIAL ADMINISTRATIVE REFORM

The characteristics of Bulgaria's current territorial administrative division mean that even in the case of fiscal decentralization, there will be a number of municipalities that are unlikely to reach higher financial independence from the central government.

As of 2017, there are more than 70 municipalities (out of a total of 265) which do not adhere to one of the initial rules for the creation of a municipality – a population of more than 6,000 people [See Figure 2]. IME's projections, based on NSI's official data, show that by 2030 the number of such municipalities will be somewhere between 87 and 92, while an additional 18 to 22 municipalities would have a population of above 6, but below 7 thousand people. In other words, municipalities that do not adhere to the initial population requirement currently form about 25% of all municipalities and this share is expected to increase to more than 33% by 2030.



Figure 3: Local taxes revenue per capita (BGN)



Source: Municipal budgets, Ministry of Finance of Bulgaria, IME calculations

Most of the smaller municipalities are already struggling financially under the current tax system. In the 2011-2016 period, their per capita tax revenue actually decreased by 14% (from BGN 42 to BGN 36), while municipalities with more than 6 thousand people experienced a 42% increase (from BGN 85 to BGN 121) [See Figure 3].

Apart from the falling population, this is due to a wide array of issues; a low collection rate, the high share of the shadow economy and the non-existent market-to-market procedures, which means that immovable property in particular is significantly undervalued (due to the fact that most value assessments are 2-3 decades old) and thus revenues are low. In addition, a number of these municipalities report highly inadequate ratios of municipal workers to the local population. While in most municipalities there are 3-5 municipal workers per every 1,000 people (and under 2/1,000 in bigger municipalities), this share reaches 40/1,000 in Treklyano (a small municipality in the southwest of the country) and is above 10/1,000 in 40 of the country's 265 municipalities – mostly concentrated in the border regions and the north-west.

Bearing in mind the fact that many such municipalities consist primarily of small settlements inhabited by retirees, the effects of fiscal decentralization would most likely be limited, since the expected stream of own revenues (via the potential transfer of a part of income taxes) would not materialize to a meaningful extent. These municipalities will most likely continue to find it hard to function properly within the new system, which implies that most of them would have to be either included in the territory of larger nearby municipalities or will have to undergo some kind of consolidation. The latter is most likely to be the case in parts of the North-west and in some border regions, where compact clusters of such municipalities are mostly found⁸.

It is advisable that any such changes occur after the upcoming 2021 nationwide census, which will provide much needed information

⁸ Since these are areas with 6-7 neighboring small and fiscally powerless municipalities, including them to larger ones may be difficult, as there are none around. This is why we propose both: 1) merging small municipalities in distant areas together, and 2) merging small and distant municipalities.

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WHILE ACCURATE
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TO POSTPONE FISCAL
DECENTRALIZATION

regarding their actual demographic state. This is important because current demographic estimates are increasingly inaccurate as the distance to the latest census is growing.

However, there is a case to be made that while accurate demographic data is an important prerequisite to the long-term sustainability of administrative units, there is no practical reason to postpone fiscal decentralization until after the census results have been published. To the contrary – provided the government keeps up its current transfers to municipalities (most of which are for delegated policies anyway) and income tax revenues are an addition and not a substitution for existing transfers, the analysis of the resulting income tax revenue streams can be used as an important indicator for the formation of new territorial units.

For instance, it may well be the case that some small resort municipalities turn out to be capable of fiscal independence, despite

having fewer than 6 thousand people. Using income tax revenue data as a starting point, it would be possible to better match the administrative and the natural socio-economic boundaries of local communities.

CONCLUSIONS

Fiscal decentralization is a vital prerequisite for the sustainable development of Bulgarian regions. Sharing income tax revenues with municipalities will help reduce their dependence on transfers from the central government and revitalize local democracies by empowering municipal councils, mayors, and citizens to establish and pursue their own

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FISCAL
DECENTRALIZATION
IS A VITAL PREREQUISITE
FOR THE SUSTAINABLE
DEVELOPMENT
OF BULGARIAN
REGIONS

priorities. It will also support the general business environment by creating conditions for tax competition among Bulgarian municipalities, which can result in a lower overall tax burden on businesses and citizens.

Since local governments would in any case have a limited scope within which to determine the income tax rate (even if they receive all of it) and since intra-country mobility is quite high, municipal councils would have an incentive to try and widen their tax base, rather than keep taxes as high as possible.

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SHARING INCOME TAX REVENUES WITH MUNICIPALITIES CANNOT AND SHOULD NOT BE AN ISOLATED AND UNCONDITIONAL CHANGE IN THE TAX SYSTEM

IME's proposal as to how fiscal decentralization should be implemented addresses most of the possible negative effects of fiscal decentralization, such as the spread of bureaucracy. Since the administration of tax revenues would remain in the hands of the National Revenue Agency (NRA), there would be no need for additional administrative bodies, or even employees. This being said, sharing income tax revenues with municipalities cannot and should not be an isolated and unconditional change in the tax system.

Another important issue to be considered is tax collection, and control against tax evasion – potential sharing of responsibility between central and local governments may be considered with the increasing relocation of income taxes back to municipalities.

In light of widespread corruption practices (including at the local level) and the overall lack of traditions in civic participation, fears that in some instances decentralization may actually hurt rather than help local communities are not to be overlooked. This argument, however, is systemic in nature and in no way contradicts any of the established positives of fiscal decentralization itself.

Ongoing efforts aimed at the implementation of effective program budgeting at the local level should be strengthened in order to ensure higher expenditure efficiency and transparency (including municipal enterprises and the management of municipal property). ●



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Fiscal Decentralization in Ukraine: Is It Run Smoothly?



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OLEKSANDRA
BETLIY

The governance system at the local level in Ukraine for many years has had built-in conflict as it does not clearly define the responsibilities of elected local authorities and the local administrations, which are a part of the executive branch of power. The local government entities traditionally had little impact on their financing – both in regard to revenue and expenditures. Such a situation failed to create any real incentives for local authorities to be efficient and improve their performance.

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THE DECENTRALIZATION REFORM LAUNCHED IN 2014 AIMS AT INCREASING THE FINANCIAL AUTONOMY OF LOCAL GOVERNMENT ENTITIES PROVIDING MORE FINANCING, AS WELL AS MORE POWERS TO THE LOCAL LEVEL

The decentralization reform launched in 2014 aims at increasing the financial autonomy of local government entities providing more financing, as well as more powers to the local level. In Ukraine, decentralization in no way means federalization. By now, it basically combined two major pillars.

The first relates to **fiscal decentralization**, according to which the local authorities received more taxes, but with more responsibilities. The second refers to the **administrative issues of decentralization**, including the organization of amalgamated territorial communities. The latter, however, is not possible without the former. Through decentralization, local entities receive powers to carry out governance, healthcare, education, regional development, roads maintenance, etc. Overall, the decentralization reform is listed among one of the biggest successes of Ukraine's reforms in the last four years.

THE BACKGROUND OF THE REFORM

Between 1991 and 2014¹, the Ukrainian government did little towards strengthening the regions. Most decisions were taken at the central level, whereas local governments were fiscally dependent on the central budget.

Moreover, local government entities were (and still are) represented by local self-governance with little powers², while their executive branches (local administrations) are *de facto* the territorial subdivisions of the central government³.

About 60% of local revenues were received in the form of central fiscal transfers, while the share of tax revenues declined from 62% in 2001 to 30% in 2015⁴. Moreover, tax rev-

¹ Ukraine gained its independence in 1991.

² Local self-governance is conducted either directly, by local communities, or indirectly, by elected local councils (village, town, city, rayon, and oblast councils), which are formed primarily by elected local deputies and mayors. See <http://zakon0.rada.gov.ua/laws/show/280/97-%D0%B2%D1%80>.

³ The heads of local administrations are appointed by the President of Ukraine on the submission of the Cabinet of Ministers. See <http://zakon2.rada.gov.ua/laws/show/586-14>.

⁴ Such changes were partially explained by legal amendments, but also by low efficiency of local taxes. For details see OECD (2018) *Maintaining the Momentum of Decentralization in Ukraine*, OECD Multi-level Governance Studies.

venues were primarily comprised of shared taxes (personal income tax, excise, and environmental tax). Own local tax revenues are generated by use charges, administrative fees, revenues from assets, land tax, and property tax, among others.

As the administrative territorial reform was not introduced during the years of independence, in 2014, Ukraine was comprised of 24 oblasts and Autonomous Republic of Crimea, which were at the time divided into 490 rayons (districts). More than 11,000 communities (villages and towns) existed, while only about 1,000 local government entities received direct central fiscal transfers as the rest did not receive direct central fiscal transfers but received them indirectly through rayons' budgets. Several levels of transfer provisions and numerous key expenditure units resulted in high fiscal non-transparency as well as inefficiencies, which also reduced fiscal sustainability. Territorial disparities were high with little possibility of local government to impact the situation.

THE AIM OF THE DECENTRALIZATION REFORM IN UKRAINE

After the Euromaidan revolution in 2014, the new government identified decentralization as one of its top priorities. The decentralization reform was launched with several important decisions taken by the government very fast.

First, in April 2014, the government adopted the Concept of the Reform of Local Self-Government and the Territorial Organization of Power,⁵ which was followed by the approved Action Plan for its implementation. These documents envisaged the implementation of the broad-based decentralization

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aimed at strengthening the development of Ukraine and improving the well-being of the population.

Later, the decentralization and the reform of state governance were defined among the Top-5 priorities of the Strategy “Ukraine-2020”, which was approved by President Petro Poroshenko in 2015. The Government Action Plan until 2020 (adopted in 2016) also lists decentralization reform among the priorities. These two strategic documents define the decentralization as the fiscal decentralization. Meanwhile, the Association Agenda between Ukraine and the European Union (EU) focused primarily on the issue of the decentralization of power.

According to the Concept of the Reform of Local Self-Government and the Territorial Organization of Power, the major tasks of the decentralization reform included ensuring:

- the access to quality public services;
- optimal division of powers between local and central executive bodies;
- justification of territorial basis for activity of local self-governance and local administrations to ensure access to quality public services provided by them;

⁵ The Resolution of the Cabinet of Ministry, N°333-p from April 1, 2014. Available [online]: <http://zakon5.rada.gov.ua/laws/show/333-2014-%D1%80>

- creation of appropriate material, financial, and organizational conditions to ensure the implementation of own and delegated functions by local self-government bodies.

The decentralization is to be based on the transfer of powers (responsibilities) from the center to the lowest possible local level, the respective shift of financing resources, and supervision of local government entities by the central government.

According to the Concept of the Reform of Local Self-Government and the Territorial Organization of Power, the decentralization was planned to start with amendments to the Constitution, according to which the reform of powers of local councils and local administrations were to be streamlined. However, since the approval of amendments appeared politically unfeasible⁶, the reform has started on the basis of the old Constitution. Yet, the Parliament still approved the amendments to the Budget Code and the Tax Code, which changed the tax distribution between local and central governments. Furthermore, all essential legislation was approved for the implementation of the decentralization reform – including the mergers of territories, regional government policies, and provision of administrative services at local level.

The decentralization envisages the creation of administrative service centers at local government entities to enable the provision of most services locally. As of June 2018, 756 Administrative service centers have already been created (452 of them by rayon state administrations), which is a substantial progress in the fulfillment of the task of better access to administrative services for the population.

THE AMALGAMATED TERRITORIAL COMMUNITIES AS A CORNER STONE FOR FISCAL STRENGTHENING

One of the key steps within the decentralization reform are the voluntary municipal mergers, which started in 2015. The formation of capable basic level of local self-government was based on the Law on “Voluntary Amalgamation of Territorial Communities”⁷. It is aimed at the concentration of human capital, infrastructure, and land resource at a local level, which would strengthen communities. The capable community will then be able to provide quality public services (including education and healthcare) to the population.



THE COMMUNITIES
ARE STIMULATED
TO MERGE THROUGH
THE FINANCIAL
STIMULUS. IF THEY DO
MERGE, THEY RECEIVE
HIGHER REVENUES

“Amalgamated hromada⁸ is the unification of several settlements with a single administrative center. Any amalgamated hromada (community) with a city as an administrative center is an urban hromada, any amalgamated hromada with an urban-type settlement as an administrative center is a settlement

⁶ Jarábik, B. and Y. Yesmukhanova (2017) *Ukraine's Slow Struggle for Decentralization*. Available [online]: <https://carnegieendowment.org/2017/03/08/ukraine-s-slow-struggle-for-decentralization-pub-68219>

⁷ Law 333-2014 from April 1, 2014. Available [online]: <http://zakon5.rada.gov.ua/laws/show/333-2014-%D1%80>

⁸ *Hromada* is an amalgamated territorial community.

hromada, and any amalgamated hromada with a village as an administrative center is a rural hromada". (<http://decentralization.gov.ua>)⁹

The Law also introduced the institution of a starosta¹⁰ in the amalgamated territorial communities, who is to represent the interests of rural residents in community council¹¹.

According to the Ministry of Regional Development, Construction, Housing, and Communal Services of Ukraine (hereinafter referred to as the Ministry of Regional Development), as of June 11, 2018, 743 amalgamated territorial communities were formed by 3,443 communities with 6.4 mn residents (the number of residents in communities increased by about 5 times to about 8,400 per an amalgamated community)¹². If such trends continue, the number of communities is likely to decline from about 11,000 to around 2,400 communities¹³.

⁹ decentralization.gov.ua is a special official web-portal devoted to the issues of decentralization reform. It contains the information on the design of the reform, monitoring of its implementation as well as information on the assistance of international donors in the implementation of the reform.

¹⁰ *Starosta* is a local self-government official in villages forming part of an amalgamated territorial community (hromada). A village head is voted during elections and declared by the decision of the amalgamated community's council.

¹¹ As of June 11, 2018, 653 starostas have been elected and more than 1.8 thousand individuals are acting starostas.

¹² Ministry of Regional Development, Construction, Housing and Communal Services of Ukraine (2018) *Monitoring of the Process of Decentralization of Power and Local Self-Government Reform as of 11 June 2018*. Available [online]: <http://decentralization.gov.ua>

¹³ This is somewhat more than primarily expected 1,500 communities after the reform. See Carnegie Endowment's (2015) *Ukraine Reform Monitor*. Available [online]: <http://carnegieendowment.org/2015/10/05/ukraine-reform-monitor-october-2015/iik7>. Still, this might change if some of the remaining communities join already created amalgamated territorial communities.

The communities are stimulated to merge through the financial stimulus¹⁴. If they do merge, they receive higher revenues: in 2016, total budgets of communities that amalgamated in 2015 increased by 49%¹⁵, while in 2017, own revenues of 377 active amalgamated communities more than doubled. Moreover, such amalgamated communities become direct recipients of the central fiscal transfers – including healthcare, education, and infrastructural subventions (earmarked transfers from the central budgets).

Still, the evidence indicates that some communities lack fiscal sustainability. One of the reasons for this is that not all of them were created in accordance with the regional development strategies (in some oblasts such strategies were not approved)¹⁶. As a result, some of the amalgamated communities are too small to cope with their new responsibilities¹⁷.

The data indicates that the amalgamated territorial communities spent increasing revenues for financing primarily social and other infrastructure. Overall, education, healthcare, administrative services, roads, lighting, water, waste, landscaping, and safety currently belong to the competence of amalgamated territorial communities. The amalgamated territorial communities received more responsibilities in the area of architectural

¹⁴ The survey, conducted by the Center of Democratic Initiatives in 2016, showed that heads of local government entities became more interested in merging with other communities after they saw the additional financing received by first amalgamated communities. This also reduced the skepticism about the amalgamation among representatives of civil society.

¹⁵ <http://despro.org.ua/despro/Local%20Budgets%20of%20ACs.pdf>

¹⁶ Ukrainian Center for Independent Political Research (2017) *Decentralisation in Ukraine: Achievements, Expectations, and Concerns*, August.

¹⁷ OECD (2018) *Maintaining the Momentum of Decentralization in Ukraine*, IECD Multi-level Governance Studies.



EDUCATION,
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WASTE, LANDSCAPING,
AND SAFETY
CURRENTLY BELONG
TO THE COMPETENCE
OF AMALGAMATED
TERRITORIAL
COMMUNITIES

and construction supervision and inspections, which is expected to simplify the construction procedures. The communities also received more powers in the management of land resources. However, the evidence shows that some communities lack managerial competences¹⁸ and technical capacities. This is true especially for rural communities.

It was evident that some amalgamated territorial communities are more capable than others in dealing with new challenges and, thus, were expected to be more successful in using additional financing and new powers. To ensure knowledge sharing, the Law on "Cooperation of Territorial Communities"¹⁹ defined the mechanism of dealing with

common problems faced by communities. According to the Ministry of Regional Development, since the beginning of July 2018, 199 cooperation agreements have already been implemented and 861 communities have taken advantage of this mechanism²⁰. Such activities relate primarily to such issues as waste management and recycling or development of joint infrastructure.

FISCAL DECENTRALIZATION PATH

In the end of 2014, the government introduced steps for fiscal decentralization, which were aimed to increase the financing capacity of local government entities. Tax-sharing arrangements were changed, while the list of local taxes was modified (some were abolished, while others were created). Local governments' taxing power was extended, as they have received bigger freedom in setting tax rates and envisaging exemptions (even though the maximum rates have been capped).

Key taxes that fill local budgets (cities of oblast importance, rayons, and the amalgamated territorial communities) currently amount to:

- 60% of **personal income tax**, part of the excise tax (important source of revenues in 2015-2017)²¹;
- 100% of **unified tax** paid by the taxpayers under the simplified taxation system, and;
- 100% of **property tax** (property, land)²².

According to the official estimate, in 2018, these four taxes will account for 94.9% of total tax revenues of local budgets. As previously, tax revenues of local budgets are primarily comprised of shared taxes (personal income

¹⁸ Ukraine's Slow Struggle for Decentralization. Available [online]: <https://carnegieendowment.org/2017/03/08/ukraine-s-slow-struggle-for-decentralization-pub-68219>

¹⁹ The Law of Ukraine, №1508-18 from June 17, 2014, <http://zakon3.rada.gov.ua/laws/show/1508-18>

²⁰ <https://decentralization.gov.ua/en/about>

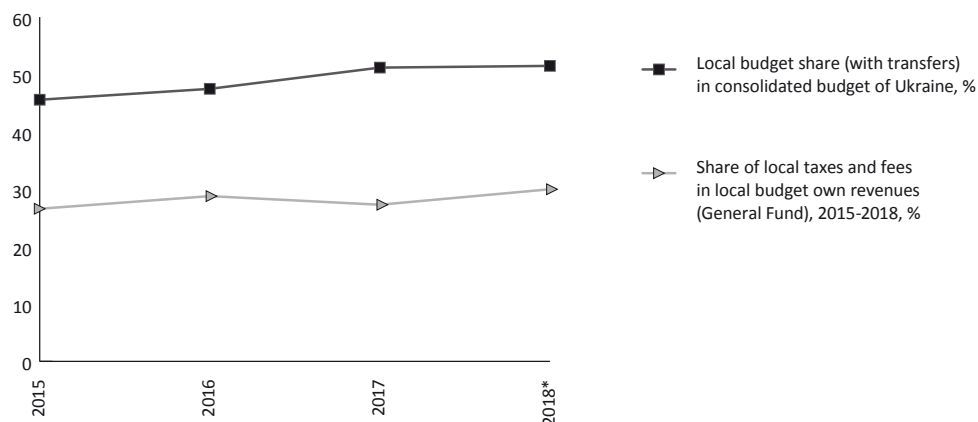
²¹ First, since 2015, the local budgets received excise on retail sales with the rate of 2–5%. In 2018, local budgets receive part of the domestic excise tax, excise of fuel, and part of the excise on retail sales.

²² The Budget Code of Ukraine . Available [online]: <http://zakon0.rada.gov.ua/laws/show/2456-17/conv/print1533816078654981>

tax and excise account for 69.2% of total tax revenues of local budgets²³), while own local tax revenues remain low. In particular, the revenues from property tax, which is perceived to be inefficient, remained low as some of the local government entities impose a zero percent rate for the tax. Still, local budgets received more powers in spending revenues from shared central taxes, which became a benefit of the reform.

In particular, oblasts and rayon administrations are still comprised of “deconcentrated and decentralized entities” and, thus, part of their budgets should be classified rather as “central government sector” according to the OECD methodology²⁵. In any case, the increase in the shares of local budgets and local taxes still indicate the strengthening of financial capacities of local budgets over recent years.

Figure 2: The Local budgets in 2015-2018



Note: * 2018 – official estimate

Source: The Ministry of Regional Development²⁶

Local budget own revenues (general fund) gradually increased from 5.1% of GDP in 2014 to 6.7% of GDP in 2017 and are expected to grow further to 7.1% of GDP in 2018²⁴. The share of local taxes and fees in local budget own revenues (general fund) increased over the last three years [See Figure 2]. Still, these numbers should be taken with caution while being comparing to other countries.

Furthermore, since 2015, the government has changed the policies in relation to transfers provided from central to local budgets. Before 2015, the government covered 100% of the fiscal gap, which did not stimulate local government entities to become more efficient. In turn, the revenues surplus of well performing local entities

²³ The State Treasury Report on the Budget execution for 6 months of 2018.

²⁴ Ministry of Regional Development, Construction, Housing and Communal Services of Ukraine (2018) *Monitoring of the Process of Decentralization of Power and Local Self-Government Reform as of 11 June 2018*. Available [online]: <http://decentralization.gov.ua>

²⁵ OECD (2018) *Maintaining the Momentum of Decentralization in Ukraine*, IECD Multi-level Governance Studies.

²⁶ Ministry of Regional Development, Construction, Housing and Communal Services of Ukraine (2018) *Monitoring of the Process of Decentralization of Power and Local Self-Government Reform as of 11 June 2018*. Available [online]: <http://decentralization.gov.ua>



IN 2017, THE LOCAL GOVERNMENT ENTITIES RECEIVED MORE FINANCING RESPONSIBILITIES

was withdrawn to the central budget. After the change, the government covers only 80% of possible fiscal gap, while well performing entities transfer to the central budget not the full amount of revenue surplus, but 50% of its size. The financing of healthcare and education was transferred to the rayon level and level of cities of oblast importance and is provided in the form of formula-based direct subventions (earmarked central budget grants). The amalgamated communities are direct recipients of these subventions.

The evidence suggests that in 2015-2016, local budgets spent additional revenues primarily for road construction. This was explained by the delay in the shift of powers to local government entities (which were not amalgamated). However, in 2017, the local government entities received more financing responsibilities. In particular, they became responsible for financing utility services (including heating) of health and education facilities, as well as payment of wages to non-pedagogical staff of secondary schools. The cities of oblast importance became responsible for financing vocational education schools. The provision of some privileges was also shifted to the local level.

The gap in time between the increased resources and transferred financing responsibilities might be considered as a drawback in the reform path. The local government

entities that increased their development budgets in 2015-2016 had to reduce them in 2017 with a risk of underfinancing already started projects.

Still, the evidence indicates that not all local governments can spend received resources effectively. In particular, some local governments keep part of the available financing at the Treasury or on banking deposits²⁷ instead of using them on the development (since 2015 local governments can keep unspent funds, while prior to that they had to return them to the central budget).

STATE SUPPORT OF REGIONAL DEVELOPMENT

- The decentralization and regional development were stimulated by the approved State Strategy of Regional Development of Ukraine until 2020²⁸. The Strategy defined three aims of its implementation:
- increased regional competitiveness;
- territorial, social and economic integration;
- effective state management in the area of regional development.

In the framework of the implementation of the Strategy, the Law on the "Fundamentals of State Regional Policy" was introduced²⁹. According to the Ministry of Regional Development, it resulted in a sharp increase in state support of regional development [See Figure 1]. Overall, it partially reflects the reduction in the support in the form of equalization transfers in fa-

²⁷ Financial and Economic Analysis Office at the Verkhovna Rada of Ukraine (2018) *Local Budgets' Deposits as of July 1, 2018* (inforeference). Available [online]: <https://feao.org.ua/products/local-budgets-deposits-july-1-2018/?lang=en>

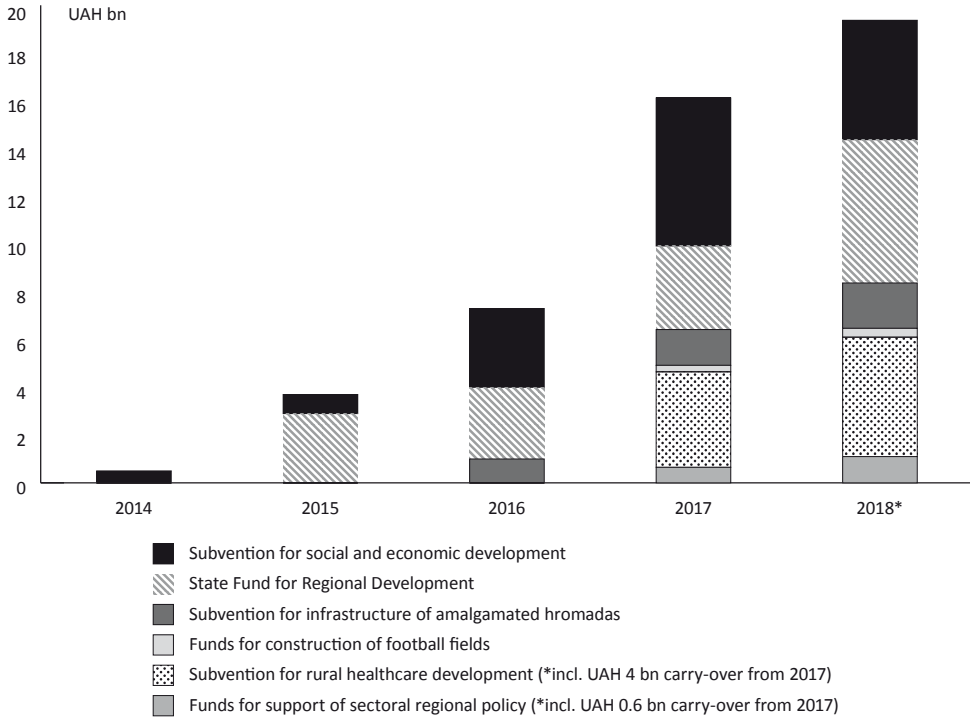
²⁸ Постанова КМУ (2014) Державна стратегія регіонального розвитку України (ДСРП) на період до 2020 року», №385 від 6 серпня 2014 р. Available [online]: <http://zakon2.rada.gov.ua/laws/show/385-2014-n/paran11#n11>

²⁹ Закон (2018) №157-19 від 5 травня 2018 року. Available [online]: <http://zakon1.rada.gov.ua/laws/show/157-19>





Figure 1: State Support of Regional Development



Note: * 2018 – official estimate

Source: The Ministry of Regional Development³⁰

vor of support through more transparent earmarked grants. The grants of the State Fund of Regional Development (SFRD) are distributed on a competitive basis.

Overall, the financing of the SFRD should be envisaged at 1% of forecasted central budget revenues (general fund), and the government envisages financing for the SFRD close to the benchmark when it is to be submitted to the Draft State Budget Law for the next fiscal year to the parliament. However, during the voting for the Budget in the parlia-

ment, people's deputies typically redistribute part of funds allocated for the SFRD in favor of non-transparent and inefficient social and economic subvention to regions³¹.

In 2018, the local governments are also expected to receive an earmarked grant (subvention) for construction, repair, and maintenance of local public roads with a total amount of UAH 11.5 bn, which is one of the biggest priorities of the government's policies in recent years. The provision of such

³⁰ Ministry of Regional Development, Construction, Housing and Communal Services of Ukraine (2018) *Monitoring of the Process of Decentralization of Power and Local Self-Government Reform as of 11 June 2018*. Available [online]: <http://decentralization.gov.ua>

³¹ Social and economic subvention is a central fiscal transfer to specific community typically lobbied by people deputies, often on the basis of political decisions. For details see Centre for Economic Strategy (2018) *Subvention for Socio-Economic Development: How to Stop Public Funds Allocation According to Political Preferences*. Available [online]: <https://goo.gl/RysRZN>

subvention constitutes also one of the steps in the framework of decentralization. Previously, this financing was conducted from the central level (first, by the Ukravtodor, and then by newly created State Road Fund).

In the framework of the implementation of the Law on the "Fundamentals of State Regional Policy", the Regional Development Agencies were created almost in all oblasts, whereas the Centers of Local Self-government Development were established in all oblasts.

SUPPORT OF DECENTRALIZATION REFORM BY INTERNATIONAL DONORS

The decentralization reform is among the focus of technical and financial assistance of numerous international donors³². Donors helped the government in the drafting of legislation as well as in the implementation of the changes. Several projects are aimed at the strengthening of capacities of local governments, especially in amalgamated territorial communities, to use increased financing efficiently and effectively, and fulfill responsibilities in an optimal way.

Currently, the largest project that supports the implementation of the decentralization reform is the EU financed U-LEAD³³. The project is implemented by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), German Corporation for International Cooperation (GmbH), and Swedish International Development Cooperation Agency (SIDA)). One of the components of the project foresees the creation of Decentralization



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IN THE DRAFTING
OF LEGISLATION
AS WELL AS
IN THE IMPLEMENTATION
OF THE CHANGES

Centers in all oblasts, while another one focuses on the establishment of Administrative Service Centers.

Several large projects were financed, and some are still financed by the U.S. Agency for International Development (USAID)³⁴. In particular, these are projects DOBRE and PULSE, which were highly evaluated by the Ministry of Regional Development.

Overall, the Ministry of Regional Development is very active in the cooperation with the international donors³⁵. The Ministry created the Council of Donors with the aim to ensure strategic coordination between the government and numerous international donors. The coordination is conducted on the basis of a created Matrix of Assistance, which clearly outlines the contributions and tasks of each project in the implementation of specific decentralization reform measures and steps.

³² There are 15 projects financed by a number of donors, including the EU, USAID, Canadian Government, governments of other countries. See <https://donors.decentralization.gov.ua/>.

³³ <http://donors.decentralization.gov.ua/project/u-lead/>

³⁴ USAID (2017) *Governance and Decentralization*. Available [online]: <https://www.usaid.gov/ukraine/factsheets/governance-and-decentralization>

³⁵ For details of the support by international donors see IER (2018) "Priorities of the EU'S Assistance to Ukraine: Beneficial Alignment", by O. Betliy, Y. Anhel, I. Kosse, V. Kravchuk, O. Krasovska, and I. Fedets., Available [online]: <http://www.ier.com.ua>

KEY CHALLENGES FOR THE FUTURE

The decentralization reform is among the biggest successes of Ukraine's reform path over recent years. It includes the financial strengthening of local government entities, which become more powerful while making decisions on territorial development. The establishment of amalgamated territorial communities in the framework of the fiscal decentralization reform is among crucial changes recently launched by Ukraine. It results in the creation of capable communities, as well as increased fiscal transparency.

The reform is also supported by the population. In 2017, 42% of the population supported the steps taken in the framework of decentralization reform, while 27% negatively evaluated the measures introduced by the government³⁶. According to the experts' survey, the decentralization reform is the second most successful reform³⁷.

However, the implementation of the decentralization reform still faces challenges³⁸. One of these relates to the lack of managerial competences of leaders of local government entities (especially of amalgamated territorial communities) to implement fiscally responsible policies³⁹. In particular, the evidence already shows that the performance of local government entities varies after they have received more financing. Some of them effectively finance infrastructural and social

³⁶ Survey of the population, conducted by the Ilko Kucheriv Democratic Initiatives Foundation on June 9-13, 2017: <https://dif.org.ua/article/gromadska-dumka-naselennya-shchodo-reformi-detsentralizatsii>

³⁷ The survey of experts was conducted by the Ilko Kucheriv Democratic Initiatives Foundation on June 8-13, 2018. See <https://dif.org.ua/uploads/pdf/9941662655b4882a3310fb8.05753855.pdf>

³⁸ Here, only several challenges are listed.

³⁹ The principles of fiscal responsibility in the framework of decentralization include greater transparency, monitoring, and reporting mechanisms at the local level.



THE ESTABLISHMENT OF AMALGAMATED TERRITORIAL COMMUNITIES IN THE FRAMEWORK OF THE FISCAL DECENTRALIZATION REFORM IS AMONG CRUCIAL CHANGES RECENTLY LAUNCHED BY UKRAINE

projects, while others have not improved the performance. As a result, the capacities of the leaders of local government entities impact the equity and quality of primary and secondary education and healthcare provision. The communities, especially in rural areas, lack professionals in many sectors – including public health, education, infrastructure, and energy efficiency.

The role of local authorities increases in provision of vocational and educational training (VET) as they are expected to coordinate the state order in VET schools with local employers. This is an essential prerequisite of the adaptation of skills, competences, and vocational qualifications to the needs of the local economy⁴⁰. Therefore, more capacities are needed at the local level in this area as well.

⁴⁰ ETF (2018) "Ukraine – Education, Training and Employment Developments, 2017", European Training Foundation.

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THE ANECDOTAL EVIDENCE SUGGESTS THAT CORRUPTION ACTUALLY BECAME A BIGGER ISSUE AT THE LOCAL LEVEL AFTER DECISION MAKING WAS SHIFTED FROM THE CENTRAL LEVEL

Another challenge defined in the OECD study relates to ensuring an enabling environment for the reform, which, in particular, relates to the corruption⁴¹. The anecdotal evidence suggests that corruption actually became a bigger issue at the local level after decision making was shifted from the central level.

The reform also indicates that the powers of the rayons and amalgamated territorial communities should be streamlined. In particular, this relates to a clear definition of the spending responsibilities between different tiers of administrative units.

The creation of the amalgamated territorial communities again indicated that there is a need for a broad administrative territorial reform. The current number of rayons (districts) is excessive. Moreover, the administrative division of other countries suggests that the oblasts might be also further merged.

This is likely to be a task for the new government, which will have a mandate for the continuation of the decentralization reform after the presidential and the parliamentary elections scheduled for 2019.

In any case, an essential point for the future is the effective communication of the importance of decentralization reform to the public. The government should clearly explain the plan (the sequence of measures) and expected results of the reform to the public to increase the support for the reform. Overall, such a road map of the decentralization reform really needs to consider the fact that it tightly interrelates with the education, healthcare, and tax reforms, which are high in the policy agenda. •



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OLEKSANDRA
BETLIY

⁴¹ OECD (2018) "Maintaining the Momentum of Decentralization in Ukraine", IECD Multi-Level Governance Studies.

Leading Research Fellow and Project Coordinator at Institute for Economic Research and Policy Consulting (Kiev, Ukraine)

No Freedom Allowed: Consolidation of Power in Hungary through Centralization



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MÁTÉ
HAJBA

Centralization, decentralization in Hungary. How to best approach the subject? How best to describe a country, which at the moment has no other long-term goal other than the consolidation and retention of power for the governing Fidesz party?

While I have buried myself deep in already existing analyses, research, and data, my phone suddenly blew up from all the notifications – one of the largest Hungarian TV stations, Hír TV, under its new management reverted to being pro-government.

The situation of the media in Hungary had been dire to begin with, but this was essentially a *coup de grace* to independent TV broadcast. Similar takeovers have afflicted the print and online media scene, so that the governing party can impose its views on the population, having majority control over the media.

The state's tendency to try to exert influence not only in the media, but also in education, administration, business, and politics. Therefore, it is currently more crucial than ever to have a comprehensive overview of what is happening in each of these sectors in order to be able to come up with a set of recommendations to counter the current trends.

Governmental takeovers and oligarchs acquiring monopolies are, in fact, are actually a means of centralization, with the sole purpose of consolidating power. This is done in two ways: through centralization either to do away with independent decision making, or in order to reward oligarchs for their loyalty.

This, however, will cause a democratic deficit and a surge in corruption, also any dissenting voice will have fewer platforms on which to voice their critiques. How did Hungary get here?

BRIEF HISTORICAL OVERVIEW

In order to gain an overview of current developments, we must first understand how the current government came into power, what attitudes existed back then, and what drove public opinion during that time.

The financial crisis of 2008 hit Hungary hard. Despite the country being relatively better off during the fall of communism than the neighboring countries facing democratic changes, an apparent fatigue with democracy and free markets blossomed into disappointment by 2009.

It is therefore the social attitudes, rather than the financial hardship (which obviously contributed to the former) that had more prevalent effects on politics. Radicalism flourished with the emergence of Jobbik, a party often dubbed back then as neo-Nazi.

People with hitherto no opinion on economics and policies started voicing their views; and underlying tensions that were not polite to mention, such as racism, exploded to the surface. The illusion nurtured during communism that such tensions do not exist shattered along with the belief many people held that democracy, free market economics, and the European Union (EU) will bring about prosperity.

Back then people only speculated whether these attitudes existed or if they were just the fleeting products of heated family arguments, but now we have the numbers.

According to PEW Research¹, in 2009, 94% of Hungarians were dissatisfied with the financial situation. Even though at the time MSZP (Magyar Szocialista Párt), the Hungarian Socialist Party (a direct descendant

¹ Pew Research Center (2010) *Hungary Dissatisfied with Democracy, but Not Its Ideals*. Available [online]: <http://www.pewglobal.org/2010/04/07/hungary-dissatisfied-with-democracy-but-not-its-ideals/>

of the communist party that ruled Hungary before the democratic changes), was in power, a relatively free market economic system was in place in Hungary, and no considerable party openly advocated for changing this.

Therefore, despite the fact that a lot of people were dissatisfied with the ruling party and the term *communist* was flying about in response to the MSZP policies, according to the same PEW research, 72% of the population claimed that people were better off during communism than at the time, while 16% believed they were about the same. Even more people (77%) were dissatisfied with democracy itself. Both of these ratios recorded for Hungary were the highest among the surveyed countries (including Ukraine, Bulgaria, Lithuania, Slovakia, Russia, the Czech Republic, and Poland).

Relying further on the PEW's data², while approval of democracy in Hungary stood at 74% in 1991, it fell to 56% by 2009. Similarly, the approval of change to capitalism has lowered from 80% in 1991 to 46% in 2009. This represents the largest change among the countries in question.

Among young people, who might be deemed more democratic by default, a study by Új Nemzedék Központ found that in 2008 only 41% of the youth thought that democracy is better than any other system, 31% claimed all systems are similar, and 14% deemed dictatorships better³. The study was repeated, and by 2016

55% declared democracy is the best system, 25% remained indifferent, and only 8% preferred dictatorship.

Dissatisfaction was further exacerbated in Hungary by the events of 2006. When the socialist party, MSZP, secured governing positions and Prime Minister Ferenc Gyurcsány's address to the party was leaked, in which he stated that in order to win they had cheated, stolen, and lied⁴. This caused great turmoil, with long-lasting protests and riots in the streets, leading to the Prime Minister's abdication, but only in 2009, by which time the trust in the party and the system had plummeted.

In the parliamentary elections of 2010, the landslide victory of the largest opposition party, self-proclaimed right-wing Fidesz, securing a two-third majority, which is the absolute majority necessary to implement any and all reforms the new government wanted.

Fidesz was in power before (between 1998 and 2002), when the Prime Minister and leader of the party was Viktor Orbán, who retains the same power ever since 2010. He and his party were hit hard by the defeat from the hands of MSZP in 2002, and currently, Orbán is working tirelessly to entrench his power and position ever further.

As the new government pledges, the constitution – which was essentially an updated version of the communist constitution – has been thrown out, a completely new one was voted in its place. This constituted the basis of the reforms the government could implement. In order to consolidate power, a lot of these measures were done with centralization in mind, serving the purpose of strengthening power and redistribution to oligarchs.

² Pew Research Center (2009) *End of Communism Cheered but Now with More Reservations*. Available [online]: <http://www.pewglobal.org/2009/11/02/end-of-communism-cheered-but-now-with-more-reservations/>

³ Új Nemzedék Központ (2016) *A Magyar Ifjúság Kutatás 2016: Az ifjúságkutatás első eredményei ezek a mai magyar fiatalok!* Available [online]: http://www.ujnemzedek.hu/sites/default/files/magyar_ifjusag_2016_a4_web.pdf [in Hungarian]

⁴ BBC News (2006) *Excerpts: Hungarian 'Lies' Speech*. Available [online]: <http://news.bbc.co.uk/2/hi/europe/5359546.stm>

WHAT IS CENTRALIZATION?

To understand the topic of centralization and decentralization it must be made clear what these terms mean. According to the online Oxford Dictionary, centralization is defined as “[t]he concentration of control of an activity or organization under a single authority”, whereas decentralization is “[t]he transfer of authority from central to local government”.

Interestingly, according to Google Ngram Viewer⁵, which searches for terms in the vast corpus of English sources on the search engine’s database, the word centralization saw an upward trajectory in the 1820s, while decentralization as a term started to pick up around 1850. Both of the terms peaked in usage in 1974–83 and showed a decline in frequency of usage ever since.

The greater the number of areas that are centralized, the less likely any surprises may arise for the ruling party. On the one hand, the government wants to have control over certain areas in order to influence the people (for instance through education), but on the other hand it all boils to what people deem as the role of the government. If voters think that the state should have more control and manage a plethora of sectors, the government will act accordingly.

According to research conducted in 2018 by Policy Solutions⁶, out of 14 economic policy questions Hungarians answered 10 with economically left-leaning answers, demanding more state intervention. Despite the fact that the current government has imposed a flat tax system, two-thirds of Hungarians (70% of the Fidesz’s voters) would like to see a pro-

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BY EDMUND BURKE

gressive tax be implemented. Luxury wealth tax is supported by 87% of Hungarians. With these statistics in mind, it is not surprising that the government can rather easily expand its powers.

As it has already been mentioned, Fidesz is a self-proclaimed right-wing party, but as it appeals to predominantly economically left-oriented people the government policies are also not economically strictly right wing. Centralization, however, should not be a part of a conservative party’s manifesto if the term *conservatism* is understood as it was by Edmund Burke. Moreover, in order for the state to capture certain areas and put them under its control, it is required to nationalize them, which certainly is against free market and economically right-wing principles.

Ironically, however, the current government attacks the EU due to it stripping away national autonomy from member states. The critique goes as far as opposing the European Union in so many cases and with regards

⁵ See Ngram for centralization and decentralization use throughout the years: <https://tinyurl.com/y9f5qfbq>

⁶ Policy Solutions (2018) *Szociáldemokrata értékek Magyarországon*. Available [online]: https://www.policysolutions.hu/hu/hirek/470/szocialdemokrata_ertekek_magyarorszagon [in Hungarian]



HUNGARY IS CONTENT WITH CENTRALIZATION AS LONG AS IT REMAINS WITHIN ITS NATIONAL BORDERS, BUT WHEN A HIGHER AUTHORITY WIELDS THIS POWER IT MUST BE FOUGHT AGAINST, LEST IT WEAKENS THE POSITION OF THE GOVERNMENT

to numerous values that the threat of launching Article 7 is looming ever so closely above Hungary. This phenomenon means that Hungary is content with centralization as long as it remains within its national borders, but when a higher authority wields this power it must be fought against, lest it weakens the position of the government.

This is why the government tries to control a wide range of areas, which in many cases are to the liking of people. However, in a society based on individualism, self-reliance, and responsibility, local communities are better off having a larger say in their own affairs as they know what is best for themselves.

For those wanting self-control over state control the best option remains to self-organize, and build local communities based on sharing and self-help. To come together, and take initiative fixing issues even

on the micro scale, such as repairing a fence, or painting a school, to show that it is possible and more beneficial than waiting for some faraway central authority to take care of it.

MAIN AREAS OF CENTRALIZATION IN HUNGARY

So far, the Fidesz government managed to take control over the media and education. Nevertheless, centralization has also occurred in administration, business, and politics. The effects in each of these areas differ, which shall be discussed in the next section.

EDUCATION

Education is an important aspect for every state, it can foster intelligent students with a critical approach who will be valuable to the economy, or with the lack thereof will not criticize the government and can be indoctrinated easily.

After the democratic changes had been introduced, the core curriculum was broadened⁷ and teachers gained freedom to teach it as they wished, which led to the emergence of a number of different schools, widening the gap of knowledge among students.

The first Fidesz government introduced common standards and requirements, which a student should be able to know by the time they take the matura exam, which is taken after twelve years of education. This exam was created as a substitute to university entrance exams.

The core curriculum has changed again during Fidesz's regaining power in 2010, with the aim that every teacher in every school

⁷ For a summary of education reforms until today see Sándor, J. (2018) "Elmúlt nyolc év: Permanens reform és kudarc az oktatásban", [in:] Index.hu. Available [online]: https://index.hu/belfold/2018/valasztas/2018/04/05/oktatas_fidesz_orban-kormany_elmult_nyolc_ev_klik_pisa_reform_nat_beremeles/?token=94b-889d9e9852cc510b474424fa0f6c6 [in Hungarian]

should teach the same. Mandatory religion courses were introduced, with an option to choose ethics instead.

The textbook industry has been completely nationalized, creating a centralized monopoly. At first, the government mandated that starting from the school year of 2013–2014, schools have to order all textbooks from Kello, a non-profit distributor, owned by the state. As the Budapest Beacon reports, before, schools could buy books from a publisher of their own choosing⁸. Needless to say, many of the books failed to arrive on time, forcing teachers to make photocopies of the existing copies.

Afterwards, the government nationalized the publishers as well. The textbook industry was privatized in 1985, before the fall of communism, and until the centralization publishers could compete, obliged only to follow certain mandated standards.

Not long after distribution has been taken over, according to the Budapest Beacon, the largest publishers, Nemzedékek Tudása Tankönyvkiadót, and Apáczai Kiadó were acquired by the state as well, which created a state monopoly⁹. This greatly affected the quality of textbooks, and many have been criticized for poor standards and erroneous content, see, for instance, in Magyar Nemzet¹⁰.

⁸ Nagy, É. (2013) "130,000 Hungarian Students Missing 600,000 Textbooks", [in:] *Budapest Beacon*. Available [online]: <https://budapestbeacon.com/130000-hungarian-students-missing-600000-textbooks/>

⁹ Kovács, Z. (2013) "Fidesz to Nationalize Textbook Industry" [in:] *Budapest Beacon*. Available [online]: <https://budapestbeacon.com/fidesz-to-nationalize-textbook-industry/>

¹⁰ Kiss, A. (2017) "Mit hozott az államosított tankönyvpiac?" [in:] *Magyar Nemzet*. Available [online]: <https://mno.hu/hetvegimagazin/mit-hozott-az-allamosított-tankönyvpiac-1381377>

According to The Hungarian Free Press blog, not only the textbook industry was criticized, but the upkeep of schools as well, which since been taken over from the municipalities by a centralized institution KLIK,¹¹. This has caused an instant problem for schools, which now lacked not only quality books, but, as the Budapest Beacon tells us, also such essentials as chalk and paper¹². After a couple of years of constant struggle, the centralized system had to be broken up into several smaller sections to enable better management of schools, according to a report published by Index¹³.

Government control has recently extended not only to basic, but also higher education as well. In order to find the reasons behind it, one has to examine the government's propaganda policy.

It has been a long-standing strategy of Fidesz to use Carl Schmitt's idea (see FEE for further details)¹⁴ of identifying an enemy, against whom they can protect voters. Sometimes it is communists, sometimes neo-Nazis, and at times the European Union. With the height of the refugee crisis, it has been immigrants, but as the number of people wanting to enter Hungary waned, the fo-

¹¹ Christopher, A. (2016) "Hungary's Government Is Traumatizing Teachers, Students and Parents" [in:] *Hungarian Free Press*. Available [online]: <http://hungarianfreepress.com/2016/02/08/hungarys-government-is-traumatizing-teachers-students-and-parents/>

¹² Budapest Beacon (2016) "Our Patience Has Run Out" Say Hungarian Teachers, Students and Parents Alike [in:] Available [online]: <https://budapestbeacon.com/our-patience-has-run-out-say-hungarian-teachers-students-and-parents-alike/>

¹³ Dull, Sz. (2016) "Indul az új oktatási rendszer: 59 darabra szedték a Klikeket" [in:] *Index.hu*. Available [online]: https://index.hu/belfold/2016/06/13/indul_az_uj_oktatasi_rendszer_59_darabra_szedtek_a_klikeket/

¹⁴ Palmer, T. G. (2016) "Carl Schmitt: The Philosopher of Conflict Who Inspired Both the Left and the Right" [in:] *Foundation for Economic Education*. Available [online]: <https://fee.org/articles/carl-schmitt-the-philosopher-of-conflict-who-inspired-both-the-left-and-the-right/>

cus of government propaganda has turned to Hungarian-born billionaire and philanthropist, George Soros, who has been branded by governmental propaganda as someone who intends to undermine the government, destroy Hungarian culture, and settle in immigrants.

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George Soros helps fund a private university in Hungary, Central European University (CEU), which, according to the University's webpage, is one of the best in the region¹⁵, and which offers U.S. and Hungarian degrees. The Hungarian government has attacked the university, passing a law according to which CEU has to have an actual

campus in the United States in order to offer an American degree, otherwise, as a Reuters report suggests, it will have to be shut down¹⁶. The law was tailor made for CEU. Another criticism against the university was that it teaches gender studies – a course dubbed by the government as not a real science – and undermines Christian values.

Negotiations with the university regarding its degree are ongoing, despite CEU having complied with all regulations. In the meantime, the government has recently banned the teaching of gender studies, which has also been discussed in *The Telegraph*¹⁷, meddling in yet another way in educational affairs.

The government has also gained some control over the country's highest academic body, the Academy of Sciences, by mandating that their finances are not provided by the state budget, but by the Ministry for Innovation and Technology, which can indicate what the funds may be spent on, according to the news site 444¹⁸.

The aim of the reforms in primary and secondary schools has been to counter the declining results in the PISA test. Nevertheless, according to Compare your Country by

¹⁵ CEU.edu (2017) "CEU Ranked Among Top 200 Universities in Europe by Times Higher Education". Available [online]: <https://www.ceu.edu/article/2017-06-21/ceu-ranked-among-top-200-universities-europe-times-higher-education>

¹⁶ Dunai, M. (2018) "Soros University Says It Plans Stay in Hungary" [in:] Reuters. Available [online]: <https://www.reuters.com/article/us-hungary-soros-ceu/soros-university-says-it-plans-stay-in-hungary-idUSKBN1JM-1QA>

¹⁷ Day, M. (2018) "Viktor Orban Moves to Ban Gender Studies Courses at University in 'dangerous Precedent' for Hungary" [in:] *The Telegraph*. Available [online]: <https://www.telegraph.co.uk/news/2018/08/13/viktor-orban-moves-ban-gender-studies-courses-university-dangerous/>

¹⁸ 444.hu (2018) "Az MTA főtákará szerint a kormány beavatkozása olyan hangulatot teremthet, hogy innen menekülni kell". Available [online]: <https://444.hu/2018/07/19/az-mta-fotitkara-szerint-a-kormany-beavatkozasa-olyan-hangulatot-teremthet-hogy-innen-menekulni-kell> [in Hungarian]

OECD, the ranking clearly shows that if anything, performance has shown a steeper decline¹⁹ in recent years.

The government's efforts to incorporate education under a single authority, to tighten its control over what can and cannot be taught, and from what textbook, resulted in a drop in the overall quality of education in the country. The governing party can define what is going on in all levels of education, every state-run kindergarten, primary and middle school, and university. While knowledge is being centralized in schools, another wave of centralization sweeps over the media industry, to control the information acquired by the rest of the population.

Education is the most basic level where large-scale changes can be made in a society. No country can flourish without a strong educational system, and as it is very difficult not to be part of the state school system, reforms would be needed. Unfortunately, no such reforms appear to take place any time soon.

MEDIA

One of the most internationally recognized areas of centralization in Hungary is the media sector. Controlling the media is a key aspect of winning re-election and maintaining power. Already in 2010, the Fidesz government passed legislation regulating media content, and established the Media Authority to oversee and enforce the new laws. The government is the one responsible for appointing the key members of this body, drawing criticism, for instance from the Hungarian Helsinki Committee that it is thus not independent²⁰.

Fidesz has also tried to increase its control over the media by introducing a putative tax tailored at targeting independent media by focusing on advertising revenues. In the end, however, the pro-government media empire of Lajos Simicska, an influential Hungarian oligarch and a close friend

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of Prime Minister Viktor Orbán, also fell under purview. The new law affected his media conglomerate as well, forcing Simicska to split with his former ally and change his right-wing media empire into a critical voice of the opposition.

This move forced the government to create another media empire, which was done through newly made oligarchs, and media platforms. According to Index, local newspapers were acquired and restructured, and now they feature the same propaganda content, oftentimes even featuring the same images²¹.

¹⁹ Available [online]: <http://www.compareyourcountry.org/pisa/country/hun?lg=en>

²⁰ Eötvös Károly Policy Institute (2012) "Media Regulation in Hungary", [in:] *Hungary Fact Sheet*, No. 6. Available [online]: <https://helsinki.hu/wp-content/uploads/Media-Regulation.pdf>

²¹ Bohus, P. (2018) "Ilyen a vidéki sajtószabadság, ha azt Mészáros Lőrinc szabályozza" [in:] Index.hu. Available [online]: https://index.hu/belfold/2018/valasztas/2018/04/07/ilyen_a_videki_sajtozabadsag_ha_azt_meszaros_lorinc_szabalyozza/?to-ken=16425623ea73ce07d3736d8a667ecab4

According to Direkt36, one of the first, but definitely not the last, large blows on media independence in Hungary has been the shutting down of *Népszabadság*²², the largest daily print national newspaper, back in 2016. The newspaper had been publishing since 1956. Initially, before the democratic changes, it served as the mouthpiece of the Communist Party, but later on it became an important part of the media scene, publishing left-wing opinions as well as independent voices and conducting investigative journalism.

The newspaper has been acquired by Austrian businessman Heinrich Pecina, who has since received a suspended prison sentence for embezzlement on a separate case, as reported by Portfolio²³. When *Népszabadság* published its investigative work on politicians spending more money than they should be able to, the media outlet was abruptly shut down without notifying the editors or staff. The reasoning behind it was that it operated at a loss. According to Reuters, the media company operating the newspaper was then sold to a Hungarian oligarch and a close friend of the prime minister, Lőrinc Mészáros²⁴. It is, however, clear that the oligarchic media serve political goals, rather than purely financial ones, and they are used as the government's mouthpiece.

Some other opposition newspapers are controlled through paid government advertisements (or rather, lack thereof), without which

media outlets cannot operate at a profit. This has happened in the case of the left-leaning *Népszava*. Although the newspaper is allowed to publish opinion pieces critical of the regime, no investigative articles have been appearing since the outlet is controlled through government advertisements, as reported by the Budapest Beacon²⁵.

In late 2017, a Hungarian online investigative portal, *atlatszo.hu*, published data on the situation of media in Hungary, revealing how much influence the pro-government outlets hold²⁶. According to the findings, 65% of the daily print national newspapers bought by readers were pro-government, including all regional newspapers. 90.5% of the weekly news magazines in circulation were also pro-government, as well as 37% of the average online readership. Within radio stations this ratio was 62%, and 55% for the audience of evening TV news programmes. 59% of the total reach of news media has been totaled by pro-government outlets.

Since then, the situation took a change for the worse as after the governing party, Fidesz, won the April 2018 parliamentary elections for the third consecutive term. The Hungarian Free Press reports that a conservative magazine, *Heti Válsz*, shut down, unable to operate in the Hungarian media landscape²⁷.

²² Fabók, B., Pethő, A., and A. Szabó (2016) "Inside the Killing of *Népszabadság*, Hungary's Biggest Opposition Paper" [in:] Direkt36.hu. Available [online]: <https://www.direkt36.hu/en/ilyen-volt-a-nepszabadsag-halala-be-lulrol/>

²³ Portfolio.hu (2017) "Heinrich Pecina Gets Suspended Prison Sentence". Available [online]: http://www.portfolio.hu/en/economy/heinrich_pecina_gets_suspended_prison_sentence.33977.html

²⁴ Reuters (2017) "Orban Ally Buys Stakes in Owner of Hungarian Media Group". Available [online]: <https://www.reuters.com/article/us-hungary-media-oligarch/orban-ally-buys-stakes-in-owner-of-hungarian-media-group-idUSKBN16A1PE>

²⁵ Novak, B. (2018) "Orbán Props Up "Opposition" Paper *Népszava* with State Advertising, Says 444.hu" [in:] Budapest Beacon. Available [online]: <https://budapestbeacon.com/orban-props-up-opposition-paper-nepszava-with-state-advertising-says-444-hu/>

²⁶ Bátorfy, A. (2017) "This Is How Government-Friendly News Outlets Dominate the Hungarian Media" [in:] *Atlatszo.hu*. Available [online]: <https://english.atlatszo.hu/2017/11/22/this-is-how-government-friendly-news-outlets-dominate-the-hungarian-media/>

²⁷ Christopher, A. (2018) "*Heti Válsz* — Another Opposition Publication Goes Out of Business" [in:] Hungarian Free Press. Available [online]: <http://hungarianfreepress.com/2018/06/06/heti-valasz-another-opposition-publication-goes-out-of-business/>

To further diminish the waning ranks of opposition media, according to the *Budapest Business Journal*, Lajos Simicska decided to sell his companies to Zsolt Nyerges, another friend of the prime minister. This included one of the largest news TV stations, Hir TV, which as soon as it changed ownership, reverted back to a pro-government stance²⁸.

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IT IS NOT SURPRISING THAT FREEDOM HOUSE LISTS HUNGARIAN MEDIA AS “PARTIALLY FREE” SINCE 2011

In light of all this, it is not surprising that Freedom House lists Hungarian media as “partially free” since 2011. In the latest 2017 report, the organization gave Hungary 44 points out of a 100 on media freedom (0 being the best, 100 the worst), a 4 point markdown since 2016²⁹. These results, however, were easily dismissed by the majoritarian government in Hungary – a government, which also has strict control over the media landscape in the country. When Freedom House identified Hungary as the least democratic country in the European Union, the government dismissed

²⁸ *Budapest Business Journal* (2018) “Hungary’s Hir TV Turns Pro-Government Again” (2018) [in:] Available [online]: https://bbj.hu/news/hungarys-hir-tv-turns-pro-government-again_152999

²⁹ Legal environment received 13 out of 20 points, political environment 17 out of 4, and economic environment 15 out of 30. See Freedom House (2017) *Freedom of the Press 2017: Press Freedom’s Dark Horizon*. Available [online]: <https://freedomhouse.org/report/freedom-press/2017/hungary>

the organization as being part of George Soros’ coordinated attack on Hungary, as the Budapest Beacon reports³⁰.

Unless local communities start organizing small voluntary news outlets, based on objective reporting rather than propaganda, residents will not be able to get any reliable news.

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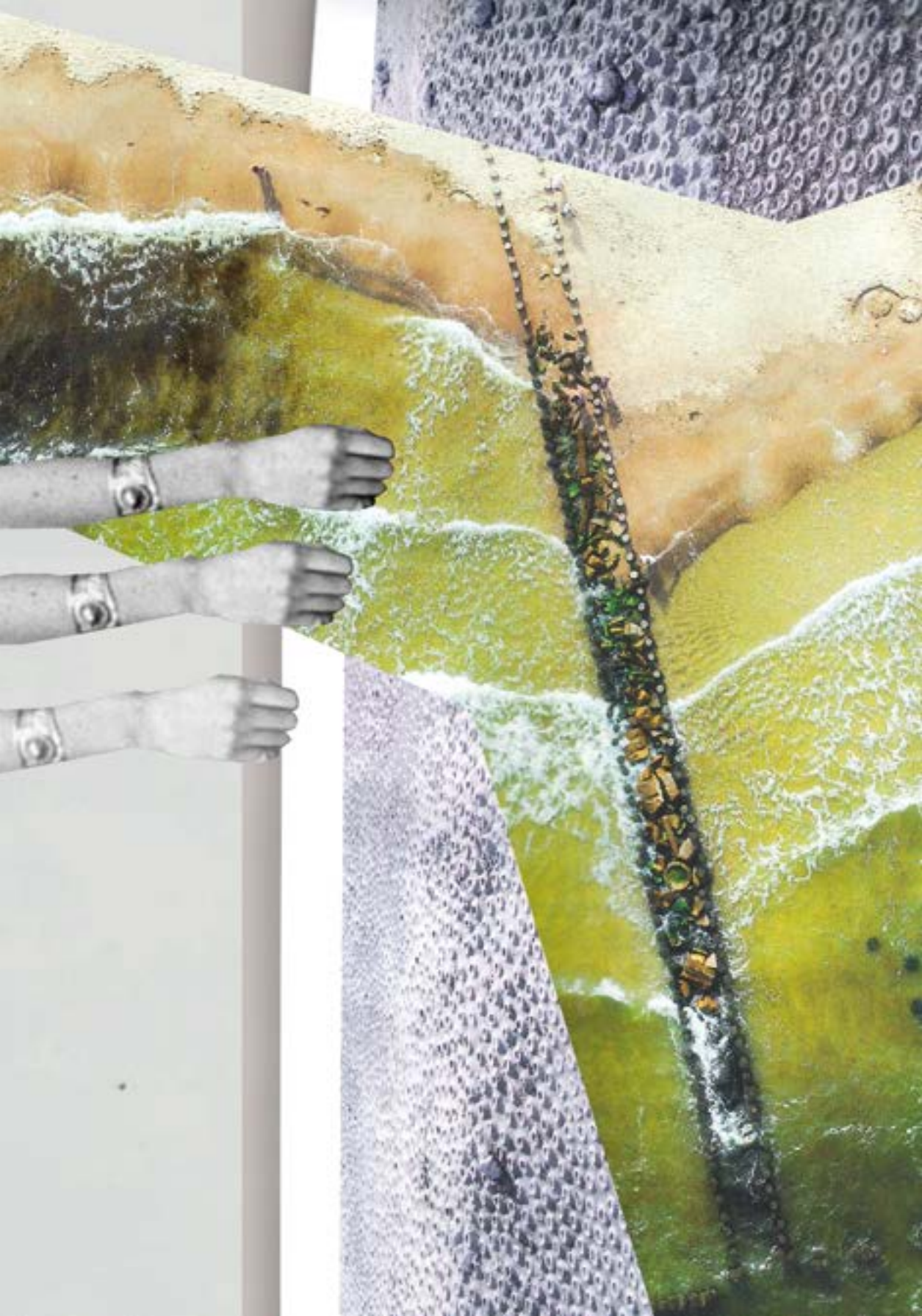
DECIDING ON HOW MUCH FUNDS RESPECTIVE LOCAL GOVERNMENTS GET IS AN IMPORTANT POWER IN THE HANDS OF THE CENTRAL GOVERNMENT


OTHER AREAS OF CENTRALIZATION: LOCAL GOVERNMENTS, LEGISLATIVE, AND NATIONALIZATION

Since 2010, the Fidesz government has restructured the local government system in Hungary. According to IPSA, local governments are given funds by the central government based on their activities, and they cannot have a deficit in their annual budget³¹. From a recent report by *Heti Világgazdaság*, it emerges that, for example, 2,000 local governments asked for a total of HUF 28 bn (app.

³⁰ Novak, B. (2018) “Kovács on Freedom House report: Soros!”, [in:] *Budapest Beacon*. Available [online]: <https://budapestbeacon.com/kovacs-freedom-house-report-soros/>

³¹ See http://paperroom.ipsa.org/papers/paper_36074.pdf



An abstract artwork featuring a large green area on the left, a yellow area in the middle, and a red and black striped area on the right. The green area has some white and dark spots, possibly representing water or a landscape. The yellow area is a solid, bright color. The red and black stripes are diagonal and appear to be part of a larger composition.

EUR 80,350,000) for repairs, and in the end 500 of them received the support worth HUF 5 bn (app. EUR 15,457,000)³².

Deciding on how much funds respective local governments get is an important power in the hands of the central government. It could serve as an incentive for the inhabitants of certain towns and villages to vote for a governing party's candidate in order for the municipality to receive sufficient, and much needed, funding.

The pretext for having a tight-fisted approach in the financing of municipalities was that by the end of 2010 the local governments had accumulated HUF 1,154 bn in future commitments. The government has consolidated the debt accumulated during the years 2002-2008. It is also reflected in the 38% drop in the amount allocated to local governments from the central budget, while in 2010, HUF 3,900 bn (app. EUR 12,039 bn) had been given to them, while in 2014, this amount was HUF 2,400 bn (app. EUR 7.4 bn).

Another change implemented by Fidesz to further extend the power of the central government and to weaken the system of checks and balances was constituted by the reforms of the Constitutional Court, which have limited its authority to review laws on the central budget, according to the Human Rights Watch³³. Moreover, as the Hungarian Helsinki Committee reports, since the reform, the majority party is the one to appoint justices without the need to receive

³² hvg.hu (2018) 28 milliárdnyi támogatást kértek az önkormányzatok, 5 milliárdot osztottak szét közöttük. Available [online]: http://hvg.hu/gazdasag/20180811_28_milliardnyi_tamogatast_kertek_az_onkormanyzatok_5_milliardot_osztottak_szet_kozottuk [in Hungarian]

³³ hrw.org (2013) *Wrong Direction on Rights*. Available [online]: <https://www.hrw.org/report/2013/05/16/wrong-direction-rights/assessing-impact-hungarys-new-constitution-and-laws>



A STRONG
CENTRALIZED
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IS FREE TO SHAPE
THE BUSINESS SECTOR,
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TO THE GOVERNMENT

the approval of the opposition³⁴. This results in a complete and unchecked control over the central budget for the governing party.

Centralization has also been present in the business sector, through nationalization. According to the Budapest Business Journal, the government nationalized utility companies, such as gas and electricity companies, to create central agencies³⁵. According to a Reuters report, it also emerged that the government aimed to have at least 50% of the banking sector in Hungarian hands³⁶.

³⁴ Hungarian Helsinki Committee (2015) *Hungary's Government Has Taken Control of the Constitutional Court..* Available [online]: <https://www.helsinki.hu/en/hungarys-government-has-taken-control-of-the-constitutional-court/>

³⁵ Keszthely, Ch. (2014) "Hungary's Government to Continue Nationalization" [in:] *Budapest Business Journal*. Available [online]: https://bbj.hu/politics/hungarys-government-to-continue-nationalization_81981

³⁶ Than, K. (2014) "UPDATE 1-Hungary's Orban Sees Two-Thirds of Banks in Domestic Hands" [in:] Reuters. Available [online]: <https://www.reuters.com/article/hungary-banks-idUSL6NOT41RF20141114>

A strong centralized political will, with complete control over legislation, is free to shape the business sector, giving awards to those loyal to the government. This is evidenced by the infamous case of the tobacco shops in Hungary, when the government passed legislation which mandated that only specially licensed shops can sell tobacco. The government then gave a large portion of the licenses to friends and cronies of Fidesz, according to the Financial Times³⁷.

The current government also awards public procurement bids to its cronies, creating wealthy oligarchs. According to Hungarian Spectrum, Lőrinc Mészáros³⁸, a close friend of Prime Minister Viktor Orbán, is on his way to become the world's richest person by 2024 if his wealth continues to increase in the way it has been, Portfolio speculates³⁹.

The government's efforts to exercise power in a variety of areas and to award businesses to its friends is reflected in the growing corruption in the country. According to Transparency International's Corruption Perception Index, Hungary scores 45 out of a 100 in 2017 – 10 points worse than in 2012, making it the second most corrupt country in the European Union (with Bulgaria coming last)⁴⁰.

³⁷ *Financial Times* (2013) *Hungary's Tobacco Scandal*. Available [online]: <https://www.ft.com/content/a0a593f8-d878-3d28-bc01-f6a11aef353a>

³⁸ *Hungarian Spectrum* (2018) "The Spectacular Business Career Of Lőrinc Mészáros". Available [online]: <http://hungarianspectrum.org/2018/01/21/the-spectacular-business-career-of-lorinc-meszaros/>

³⁹ Portfolio.hu (2018) *PM Ally Mészáros Already 2nd Richest Person in Hungary*. Available [online]: <http://www.portfolio.hu/en/economy/pm-ally-meszaros-already-2nd-richest-person-in-hungary.36196.html>

⁴⁰ Transparency International (2018) "Is Hungary's Assault on the Rule of Law Fuelling Corruption?". Available [online]: https://www.transparency.org/news/feature/is_hungarys_assault_on_the_rule_of_law_fuelling_corruption

The centralization in Hungary is aimed at gaining control – not only to further exercise power, but also to have the unchecked ability to reward loyal oligarchs.

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THE CENTRALIZATION
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RECOMMENDATIONS

It is not an easy task for any one person to fight centralization. However, it is by no means impossible. In order for the Hungarian education system to foster critical thinking, independence and initiative, a lot has to change.

In the meantime, children either brave the state-run education, or, if their parents can afford the astronomical prices, move to private education. There is, however, a third, more affordable way, which is certainly much better than the indoctrinated public education aimed at teaching centrally planned curricula. Homeschooling might be a viable option for those who value their children's mental well-being as well the need to focus on practical skills rather

than theory. Homeschooling is often done in small groups to help foster their skills and interests. However, there is a great need to liberalize education, to give control back to municipalities, to privatize, to foster competition among teaching methods, and textbooks, and to focus on the students rather than ideologies.

As for countering the growing influence of the government-controlled media, the answer lies in local communities. People are interested in their surroundings and large media outlets are not going to concern themselves with local news, as this would simply not be feasible. Self-organized news networks made up of volunteer journalist might also help provide an alternative to government propaganda. With widening internet access as well as volunteer printing efforts (the Nyomtasz te is movement), as some Hungarians had to resolve to⁴¹ – not unlike when distributing banned material during communism – news can spread through local communities. It is easy to set up blogs and Facebook pages, to sit down with neighbors, or to simply call friends. Those who speak English could translate an article, others could share the small minority of objective reports in the news.

The solution to government control over towns and villages, administration, business, and politics also lies in localism. Grassroots and self-helping communities should be organized, so they can help solve issues locally, by means of crowdfunding or from their own pockets. Fixing roofs of schools, cutting grass, these activities may seem petty, but they build communities, teach self-reliance and independence. This could plant the seed of long-needed change in Hungary. Unfortunately, there are no plans for decentralization on the horizon,

⁴¹ See <http://nyomtaszteis.hu/a-kezdemenyeyesrol/>

and the opposition's efforts are easily dismissed by the supermajority of the government.

CONCLUSIONS

Since Fidesz began its rule in 2010, the party has been bent on consolidating its power. It has been done very effectively by extending control over key areas. The government realized that creating a dependence, by stripping people of alternatives, initiative, and incentive in order to win elections over and over again can be achieved through the concentration of power in a central authority.

To achieve this, the government needed administrative changes, such as the weakening of checks and balances, the opposition, and the constitutional courts. It also required a new framework, which was provided in the form of the new Constitution.

Educational reforms centralized the schooling system, so the state could exercise tight control over what students learn, who they get their textbooks from, and who manages schools. Although the centralized authority had to be broken into several sections as it has been unsustainable, still, education needs to be liberalized much further, to enable competition between different methods of teaching, textbooks, and to some extent curricula.

The situation of the media has shown a steep decline ever since the government took power in 2010. First, authority was laced above the free media to regulate content, then insubordination has been dealt with by punitive taxation. The government was forced to create its own media empire from scratch, and it started a hostile takeover of the local and national media, shutting down opposing voices. The latest elections saw further erosion of media freedom. Currently, the Fidesz government controls

the overpowering majority in the press market. Hungary has been stripped of its free status, and for years running media freedom is listed as partially free.

Self-organized local media outlets could pose an alternative to governmental propaganda, which is issuing forth from the majority of the media.

Furthermore, Fidesz enjoys rewarding its local friends and oligarchs for their loyalty to the party and central government. In order to do so, it needs control over businesses as well, so through political will the right people could acquire them. This tendency leads to a growing amount of corruption in Hungary.

In conclusion, the government has been expanding its power over the key areas of education, the media, businesses, local governments, among others. It has been a pragmatic, rather than an ideological move, as it does not fit into the conservative values Fidesz claims to hold. Local communities, however, are a glimmer of hope against centralized power in Hungary. •



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MÁTÉ
HAJBA

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President of Free Market Foundation in Hungary

MEMBERS OF 4LIBERTY.EU NETWORK

Free Market Foundation (Hungary) is a think tank dedicated to promoting classical liberal values and ideas. The organization's projects focus on advocating a free market economy and fighting racism. The Foundation's activities involve education, activism, and academic research alike, thus reaching out to different people.

Liberální Institut (Prague, Czech Republic) is a non-governmental, non-partisan, non-profit think tank for the development, dissemination, and application of classical liberal ideas and programs based on the principles of classical liberalism. It focuses on three types of activities: education, research, and publication.

The Lithuanian Free Market Institute (Vilnius, Lithuania) is a private, non-profit organization established in 1990 to promote the ideas of individual freedom and responsibility, free markets, and limited government. The LFMI's team conducts research on key economic issues, develops conceptual reform packages, drafts and evaluates legislative proposals, and aids government institutions by advising how to better implement the principles of free markets in Lithuania.

The F. A. Hayek Foundation (Bratislava, Slovakia) is an independent and non-political, non-profit organization, founded in 1991, by a group of market-oriented Slovak economists. The core mission of the F. A. Hayek Foundation is to establish a tradition of market-oriented thinking in Slovakia – an approach that had not existed before the 1990s in our region.

IME (Sofia, Bulgaria) is the first and oldest independent economic policy think tank in Bulgaria. Its mission is to elaborate and advocate market-based solutions to challenges faced by Bulgarians and the region face in reforms. This mission has been pursued since early 1993 when the institute was formally registered as a non-profit legal entity.

The Academy of Liberalism (Tallinn, Estonia) was established in the late 1990s. Its aim is to promote a liberal world view to oppose the emergence of socialist ideas in society.

INESS (Bratislava, Slovakia), the Institute of Economic and Social Studies, began its activities in January 2006. As an independent think tank, INESS monitors the functioning and financing of the public sector, evaluates the effects of legislative changes on the economy and society, and comments on current economic and social issues.

Projekt: Polska (Warsaw, Poland) comprises people who dream of a modern, open, and liberal Poland. It is those to whom a democratic, effective, and citizen-friendly government is a key goal, and who help accomplish this goal while enjoying themselves, forming new friendships, and furthering their own interests.

Liberales Institut (Potsdam, Germany) is the think tank of the Friedrich Naumann Foundation for Freedom dedicated to political issues such as how liberalism can respond to challenges of the contemporary world and how liberal ideas can contribute to shaping the future.

Fundacja Liberté! (Lodz, Poland) is a think tank created in Łódź in 2007. Its mission is to promote an open society, liberal economic ideas, and liberal culture, and to organize a social movement around these ideas. Among the foundation's most recognizable projects are: Liberté!, Freedom Games, 6. District. The foundation is coordinating the 4liberty.eu project on behalf of Friedrich Naumann Foundation.

Republikon Institute (Budapest, Hungary) is a liberal think tank organization based in Budapest that focuses on analyzing Hungarian and international politics, formulating policy recommendations, and initiating projects that contribute to a more open, democratic, and free society.

Civil Development Forum (FOR) (Warsaw, Poland) was founded in March 2007 in Warsaw by Professor Leszek Balcerowicz as a non-profit organization. Its aim is to participate in public debate on economic issues, present reliable ideas, and promote active behavior. FOR's research activity focuses on four areas: less fiscalism and more employment, more market competition, stronger rule of law, and the impact of EU regulations on the economic growth in Poland. FOR presents its findings in the forms of reports, policy briefs, and educational papers. Other projects and activities of FOR include, among others, Public Debt Clock, social campaigns, public debates, lectures, and spring and autumn economic schools.

Visio Institut (Ljubljana, Slovenia) is an independent public policy think tank in Slovenia. Aiming for an open, free, fair, and developed Slovenia, the Visio Institut is publishing an array of publications, while Visio scholars regularly appear in media and at public events.

COOPERATING PARTNERS FROM EASTERN PARTNERSHIP COUNTRIES

The Institute for Economic Research and Policy Consulting (Kiev, Ukraine) is a well-known Ukrainian independent think tank, focusing on economic research and policy consulting. IER was founded in October 1999 by top-ranking Ukrainian politicians and scientists, and a German advisory group on economic reforms in Ukraine, which has been a part of Germany's TRANSFORM program. Its mission is to provide an alternative position on key problems of social and economic development of Ukraine.

Svetilnik (Ljubljana, Slovenia) is a non-profit, non-governmental, and non-political association. Its mission is to enlighten Slovenia with ideas of freedom. The goal of the association is a society where individuals are free to pursue their own interests and are responsible for their actions.

New Economic School – Georgia (Tbilisi, Georgia) is a free market think tank, non-profit organization, and NGO. Its main mission is to educate young people in free market ideas. It organizes seminars, workshops, and conferences for education and exchanges of ideas. NESG was founded by Georgian individuals to fill the knowledge gap about the market economy in the country and the lack of good teachers and economics textbooks.zw

JIRÍ NOHEJL

INFORMAL INSTITUTIONS AND DECENTRALIZATION OF GOVERNANCE

Incentive structures affect societal structures and mental models of individuals. Given the fact that human brain structures are not infinitely elastic, and become even less elastic with age, inertia of mental models can play an important role in institutional change. Historical events which formed the mental models of individuals are therefore important in understanding why there may exist barriers of progress towards cooperation, decentralization, and free society.

ARTO AAS

LOCAL GOVERNMENT REFORM IN ESTONIA

PAGE 40

The carrying out of the administrative reform concerned nearly all Estonian local governments and a large part of the population. Before, 80% of the old local governments did not meet the criterion of 5,000 residents. The later results showed that the majority of local governments merged voluntarily.

SIMONA KUKOVIČ

PLANNING FOR SHRINKAGE? BATTLE BETWEEN THE SLOVENIAN STATE AND THE MUNICIPALITIES

PAGE 56

Due to the unwillingness of the state to give up its powers, the division of powers causes disagreements and tensions. The
s by the state in the previous two decades were mostly non-essential. At the same time, the state was not willing to increase the municipal competencies in certain other areas, such as spatial planning, agriculture, small industries, etc.

MAREK SZOLC

**CENTRALIZATION OF TAXES, DECENTRALIZATION OF COMPETENCES: IS THERE A WAY OUT
FOR THE LOCAL GOVERNMENT IN POLAND?**

PAGE 98

The system which is currently in place severely limits the flexibility of local governments and effectively makes it too dependent on decisions taken at the central level. With approximately 50% of local governments' revenue derived from the funds transferred through the state budget (and a dwindling percentage of revenues related to their own, separate sources) potential influence of central government is excessive and undermines the very idea of local government units political, organizational, and fiscal autonom

YAVOR ALEXIEV

ELUSIVE ROAD TO FISCAL DECENTRALIZATION IN BULGARIA

PAGE 112

In light of widespread corruption practices (including at the local level) and the overall lack of traditions in civic participation, fears that in some instances decentralization may actually hurt rather than help local communities are not
ever, is systemic in nature and in no way contradicts any of the established positives of fiscal decentralization itself.

MATE HAJBA

NO FREEDOM ALLOWED: CONSOLIDATION OF POWER IN HUNGARY THROUGH CENTRALIZATION

PAGE 138

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