COUNTRY STUDY: CZECH REPUBLIC
BUILDING FISCAL CAPACITIES

Robert Jahoda, Jitka Pekova, Jan Selesovky[1]

Chapter 1: Introduction

The Czech Republic is the outcome of the **split of the former Czechoslovakia** to two independent states in 1993. Administrative structure of the Unitarian state has been specified in the Constitution of the Czech Republic since. **The Constitution specifies three levels of government** of the Czech Republic with separate budgets. The top level is represented by Central Government, which controls Regional Governments. The lowest level is represented by Municipal Governments (Councils).

Until 1998 the Constitution was not fully implemented in this point. The Government failed to create the regional level administration and thus the only administrative levels working at that time included Central Government and Municipal Councils. In addition there still were territorial state administrative units – districts – dating back to the year 1950. The district administrative offices were mere elements of the central administration with the absence of self-government features. Districts were governed by heads of the district offices, appointed by and dismissed by, and reported to, the central government (Minister of Interior). The task of the district offices was implementation of the central state policy on the local level and legal supervision over municipal political activities in the area of delegated powers.

In 1998 the new government resulting from the respective parliamentary election declared the programme of preparation and implementation of the Reform of State Administration, still in progress now. The core element of the Reform was creation of the intermediate level government – regional governments. A team of experts was established in the Ministry of Interior to prepare the Concept of Public Administration Reform. The Concept was submitted to the Parliament for discussion in 1999. The Concept defined three basic variants of public administration. The Parliament later decided for the **combined model** (combining "delegated" responsibilities and "own" responsibilities on the regional as well as municipal level2). The 2000 administrative act (no. 129/2000 Coll.) implemented 14 self-governing regions and towards the end of the same year the first election to regional governments was held. Regional governments have effectively functioned since 2001. The district offices, not considered in the accepted model, were closed by the end of 2002 (see Table 1).

Table 1: Numbers of Government Entities

Year	Central Government	Regions	Districts	Municipalities		
				Total	Delegated	with extended powers
1993	1	-	76	6 191		
1996	1	-	77	6 228	383	
2000	1	-	77	6 246	383	
2001	1	14	77	6 241	383	
2002	1	14	77	n.a.	383	
2003	1	14	-	n.a.	381	205

Municipalities have been the basic administrative units from the beginning of the independent Czech state. Citizens elect municipal representatives and the municipal representatives indirectly elect members of the Municipal Council – executive element of the self-government system. Mayor selected from among members of the Council heads municipal offices. Intergovernmental expenditure assignments in the Czech Republic conform to conventional general principles, mainly the principle of subsidiarity. Municipalities are responsible for expenses within **"own" and "delegated" responsibility**. The scope of "own" responsibility is specified in the Municipality Act (no. 128/2000 Coll.). Pursuant to the act the municipalities control operation of nursery and elementary schools, culture and recreation, safety and order, sanitary services, street lighting, water distribution and sewerage systems, site planning etc. Delegated responsibilities include activities in civil registry (birth, marriage, and death), building codes, regulation and enforcement of laws pertaining to the environment, transportation, sanitation, and so on. The widest range of delegated responsibilities before 2000 were performed by 383 selected municipalities, with authorised district offices governing the remaining municipalities.

[1] Robert Jahoda and Jan Selesovsky are from Masaryk University Brno, Faculty of Economics and Administration. Jitka Pekova is from Economics Univerzity Prague, Faculty of Economics and Public Administration, Czech Republic

2 at a municipal level, the combined model, is exercised since 1990

Responsibilities of the closed district offices were taken over by the extended power municipalities (205 selected towns). Since 2003 these selected towns (sometimes called "designated" municipalities) have executed the greatest portion of state administrative tasks, such as issue of identity cards, passports, trading certificates, crisis management acts, social work etc.

Chapter 2: Local Government at a Glance

The following Tables 2 and 3 describe the share of local finance in GDP and in total public expenses. The share of expenses in GDP has been stabilised at 7.4 – 8.0 % recently, with the exception of the years 2000 – 2002. Those years represented increased expenses as a consequence of increased capital income in the years 1998 – 2000 (see Table 4). With a view to this the increased expense share is only temporary and will terminate as soon as the reserves are used up. Another reason for increased expenses may be an ongoing reform of public administration and the related transfer of responsibilities of district offices onto municipal councils.

Comparability of statistical data of local finances is partly biased by interpretation of district office budgets as part of the state line of public administration of the Czech Republic. Before 2000 these budgets were not part of the state budget and were included in local finance together with municipal budgets. In 2001 until closing of the district councils their budgets were part of the state budget.

Table 2: Public Sector Expenditure and its components in bln. CZK

	1994	1995	1996	1997	1998	1999	2000	2001	2002[p]	2003[b]
GDP	1183	1381	1567	1680	1839	1902	1985	2157,8	2268	2400
Public Sector Exp.	518,8	593,9	660,5	700,8	752,7	796,4	867,9	963,9	1084,5	1127
State Budget	374,3	431,8	466,8	503,5	546,8	580,6	626,9	671,2	714,1	788
District offices	19,5	20,8	21,6	20,9	19,4	19,8	20,3			
Regional offices								14,4	38,2	91,3
Municipalities	92,6	110,3	122,8	129,2	136,3	147,1	164	195,5	206,9	192,7

Note1: Components of Public Sector Expenditures are not fully consolidated.
Note2: Health Care Expenditures and expenditures of other (central) state purpose funds are not in the table.
Note3: Exchange rate is stable for the whole period around 33 CZK (± 10%) for 1 €.
Source: State Final Account for 1993-2001, State Budget 2003, Macroeconomic prediction CR (February 2003)

In 2001 Regional Councils took over responsibilities of the **closed district offices**, including certain responsibilities transferred onto the new regional governments from the central state administration (such as secondary school management, apprentice schools, 2nd and 3rd class roads, hospitals, social institutes etc.). The last three years have seen soaring expenses of the regional councils, in 2003 to already represent half of the regional budgets. Most of the expenses are derived from delegated responsibility areas, such as secondary schools, representing in 2003 nearly 70% of all costs. Regional governments are currently financed from earmarked subsidies, in 2003 forming 85 % of the overall income of the regions, the remaining 15 % consisting of tax revenues (13 %) and non-tax revenues (2 %). Allocations of tax revenues take the form of general subsidies serving as provisional solutions. Since 2004 a legislative change is to be implemented reversing the ratio of subsidies and tax revenues in favour of tax revenues.

Table 3: Distribution of Expenditures Between the Levels of Government

	1994	1995	1996	1997	1998	1999	2000	2001	2002[p]	2003[b]
As a percentage of GDP										
Public Sector	43,9	43,0	42,2	41,7	40,9	41,9	43,7	44,7	47,8	47,0
State Budget	31,6	31,3	29,8	30,0	29,7	30,5	31,6	31,1	31,5	32,8
District offices	1,6	1,5	1,4	1,2	1,1	1,0	1,0			
Regional offices								0,7	1,7	3,8
Municipalities	7,8	8,0	7,8	7,7	7,4	7,9	8,3	9,1	9,1	8,0
As a percentage of total PSE										
Public Sector	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0
State Budget	72,1	72,7	70,7	71,8	72,6	72,9	72,2	69,6	65,8	69,9
District offices	3,8	3,5	3,3	3,0	2,6	2,5	2,3			
Regional offices								1,5	3,5	8,1
Municipalities	17,8	18,6	18,6	18,4	18,1	18,8	18,9	20,3	19,1	17,1

See Notes and Sources to the table 2.

Chapter 3: Local Government Finance: An Overview

For income and expenses of municipalities see the below Table 4. The table shows that the share of expenses in GDP has been relatively stable, with the volume of income corresponding to the volume of expenses. Economies of municipalities are in deficit, but the balances are relatively low. The overall indebtedness of municipalities shows a moderately increasing trend. For more details of the deficit and the indebtedness see below section.

Table 4: Consolidated balance LG's budgets [in % GDP]

	? **1994-96**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**budget	**2003**budget
I. Tax revenues	3,9	3,9	3,9	4,0	4,2	4,2	4,4	4,5
II. Non-tax revenues	1,3	1,3	1,3	1,3	1,2	1,1	1,0	1,0
III. Capital revenues	0,4	0,6	0,7	1,9	0,8	0,5	0,5	0,4
Own revenues	**5,6**	**5,7**	**5,9**	**7,2**	**6,3**	**5,7**	**5,9**	**5,8**
IV. Transfers	1,7	1,6	1,4	1,7	1,9	2,9	2,7	1,6
other	0,3				0,2	0,4	0,2	0,2
Revenues	**7,6**	**7,3**	**7,3**	**8,9**	**8,2**	**8,5**	**8,9**	**7,7**
V. Current expenditures	4,7	4,8	4,8	5,2	5,4	6,0		
VI. Capital expenditures	3,2	2,9	2,6	2,7	2,8	3,0		
Expenditures	**7,9**	**7,7**	**7,4**	**7,9**	**8,3**	**9,1**	**9,1**	**8,0**
Balance	**- 0,3**	**- 0,4**	**- 0,1**	**+ 1,0**	**- 0,1**	**- 0,5**	**- 0,3**	**- 0,3**
Debt	**1,8 %**(1996)	**2,0**	**2,1**	**2,1**	**2,1**	**2,2**	n.a.	n.a.

Source: State Final Account for 1993-2001, State Budget 2003

Let me note the remarkable fact that capital expenses represent more than a third of total municipal expenses. That is the result of low level of investment until 1989 and the consequent necessity of repairs of existing municipal property (buildings, infrastructure, public spaces etc.). Capital expenses were to a certain extent affected by capital income. As a substantial drop in capital income is expected in the following years a corresponding decrease in capital expenses may reasonably be assumed. The volume of capital expenses is further affected by sources provided by the central government for financing of infrastructure, housing or environmental policy. The government provides purpose subsidies and beneficial loans, which create dependency of the municipalities on these sources. The purpose of the loans thus limits the level of independent decision making on the part of the municipalities.

One particular area of interest is whether there are disadvantages for smaller municipalities because of their inability to realize economies of scale in the production and delivery of services. This should be particularly evident in administration-related costs. For example, for 1995 municipalities with less than 200 inhabitants spent 35 percent of their funds on internal administration. This went down to 25 percent for slightly larger municipalities (those with 500 to 1,000 inhabitants) and continued to decline with the size of the municipality. For those municipalities with populations over 500,000, internal administration represented 11 percent of total expenditures. This argument, together with **lack of economic and legal experts** in small municipalities has led Central Government to the effort aimed at consolidation of the number of municipalities in the Czech Republic. This effort currently manifests itself in tax revenues allocations to individual municipalities. For more details concerning this issue see the following chapter.

The volume of tax revenues has been relatively stable since 1993, with certain increases in the years 2002 (preliminary information), and 2003 (estimate of the Ministry of Finance). While tax revenues show a slightly growing trend, the non-tax revenues keep moderately decreasing. This does not encourage the trend of responsibility transfer onto municipalities. These two incomes together, however, represent a relatively stable source. Capital income is expected to drop in the following years, but as this income grew significantly towards the end of the 1990s (as a consequence of sales of shares allocated to municipalities in the period of privatisation), some municipalities then created substantial reserves today dissolved in stages into capital investment.

More than a fifth of all municipal sources in the Czech Republic come from the state budget **subsidies**, from state funds, and from other programmes, such as EU financing programmes (via the National Fund). Certain transfers may also be received from regional budgets.

Subsidies in the Czech Republic are classified on the basis of various criteria, such as **current and capital subsidies** (for investment activities). Particular events are subsidised with **purpose subsidies**, conditioned by the principles of the state policy of subsidising. The funds allocated in this way may exclusively be used for the given purpose and the purpose together with a detailed breakdown of expenses must be reported to the state budget (unused sources must be returned). This applies to both investment and non-investment subsidies. General (global) subsidies defined as **non-purpose** subsidies are allocated without specification of the purpose of their application. Municipalities may use them at their own discretion, to a certain extent. General subsidies include for example contributions to execution of state administration.

Another possible classification of subsidies is classification into eligible and non-eligible subsidies. **Eligible subsidies** are related to specified public functions performed by municipalities. This type of subsidy is granted automatically under certain predefined terms and conditions. **Non-eligible subsidies** must be applied for. Their allocation is conditioned with a wide range of conditions to be met by the municipality to become eligible for that particular type of subsidy.

The new sources recently made available for the Czech Republic and applicable on the communal level include **pre-structural funds of EU**. These funds complement the system of subsidies, grants and projects implemented in the Czech Republic. The available funds include the **PHARE project**, established by European Union in favour of transforming countries. The PHARE programme includes for example the Small Project Fund, the Small Infrastructural Project Fund, the Cross-Border Cooperation Program etc. Towns and municipalities (or voluntary groups of municipalities) may participate in some of these programmes on condition of being able to prepare corresponding projects in compliance with the programme requirements.

Since 2000 two more pre-structural funds in addition to PHARE have been made available to the Czech Republic by EU **– ISPA and SAPARD**. EUR 23.7 M of the SAPARD Fund, oriented towards pre-accession assistance to agriculture and country development, was allocated for the Czech Republic in 2002. Following the flood in 2002 a lot of EU programmes were modified to incorporate preferential assistance to support programmes for the flood-stricken municipalities. At the same time the newly established **Solidarity Fund** allocated EUR 129 M for remedy of consequences of the floods, including assistance to municipalities.

Chapter 4: Tax Revenues as Own Revenues?

Table 4 clearly shows that the volume of tax revenues of municipalities in the last 10 years has moderately increased from 3.9 % to 4.5 % of GDP. The level of authorities of municipalities in the area of taxation, however, is very low, as most taxes allocated to them municipalities can affect neither the tax base nor the tax rate. A limited variety is allowed in the area of real estate tax and local fees. Certain indirect effect of the municipalities on PIT (personal income tax) revenue was represented by support to business activities in their respective areas of influence, deprived from them in 2000 by the RUD (tax sharing system) Act (see below). For tax revenue history see Table 5.

Table 5: Tax Revenue of local governments in bln. CZK

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
PIT	38,2	48,0	41,1	44,0	47,4	48,8	51,4	26,1	30,0	33,0
from wages	25,1	33,2	25,3	28,2	30,7	31,9	34,7	16,3	19,4	21,6
from self-employment	13,1	14,8	15,8	15,8	16,7	16,9	16,7	8,2	9,3	10,2
from other incomes.								1,6	1,3	1,2
CIT	0,6	3,2	14,1	13,3	16,2	18,8	23,5	23,5	26,7	28,8
non-municipality			11,8	10,3	11,9	13,6	12,9	17,3	20,5	22,1
municipality[1)]	0,6	3,2	2,3	3,0	4,3	5,2	10,6	6,2	6,2	6,7
Property Tax	3,8	3,8	4,0	3,9	4,1	4,3	4,4	4,5	4,5	4,5
Administrative and local fees (tax)	3,1	3,2	3,3	3,4	3,6	3,2	3,6	3,8	3,7	4,0
VAT								31,3	30,8	32,7
Other Taxes	0,1	0,3	0,2	0,8	0,8	0,6	0,7	0,7	3,8	3,9
Total	**45,8**	**58,5**	**62,8**	**65,4**	**72,1**	**75,7**	**83,6**	**89,9**	**99,5**	**106,9**

[1)] Municipalities retain all CIT paid by their "own commercial activities"
Source: State Final Account for 1993-2001, State Budget 2003

Tax revenues of municipalities can be divided into **local tax revenues** (property tax, administrative and local fees), **transferred tax revenues** (legal entity income taxes paid by municipalities owning the respective legal entities) and **shared tax revenues**, where however the principles of sharing between the state and the municipalities have changed. In the past years there were two substantially different rules applied to allocation of revenues to municipalities. First there were the rules applicable in the period 1993-2000, and these have been followed by the rules applicable since 2001 (see Table 5).

Before 2000 the method of budget allocation of taxes was based on the **principle of allocation of district generated tax revenues** to municipal budgets3. This system later got into conflict with certain principles of the ideal allocation system, and funding (tax revenues) of the newly established regions needed to be decided, too. Leaving aside the necessary changes following from the Public Administration Reform the following were the **major objections** against the previously applied allocation rules:

? existence of unjustifiable differences between revenues of individual municipalities within districts and between revenues of individual districts themselves;

? concentration of tax payer cash registers in big cities and the consequent transfer of tax revenues onto the cities;

? speculative moves of self-employment (? tax revenue transfers);

? in consequence of extensive fragmentation of the municipal sector in the Czech Republic (6245 municipalities in 2000) ineffective use of finances by certain municipalities (especially the smallest villages);

? different dynamics of tax revenues into state and municipal budgets.

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3 The characteristic features of the period 1993-95 included the fact that tax revenue of PIT represented the largest tax revenue of municipalities. Municipalities and districts shared tax revenues from wages within the territory of the district. Municipalities shared 40 % (1993), 50 % (1994) and 55 % (1995) of the revenue, allocated among the individual municipalities of the district depending on the population, the rest remaining with the district office. 100% of income tax revenues from self-employment remained with the municipality in which the self-employer registered its seat. These rules were partly amended towards the end of 1995, mainly for the reason of different elasticity of the various tax revenues. While the PIT grew rapidly, the CIT (corporate income tax), allocated to the state budget, stagnated. This meant in practice quicker development of municipal sources and slower growth of the state source basis. The reform in 1995 took away from municipalities part of the revenue from wage tax, replacing it with part of the PIT. In the years 1996-2000 wage tax revenues were shared between municipalities (30 %), district offices (30 %) and the state (40 %). For increased motivation of municipalities in tax revenues and for support of local business activities 10 % of the tax revenues were allocated to the place where the taxpayer paid his tax and the remaining 20% were allocated on the basis of the population of the municipalities of the district allocating the revenues. There were municipalities where the 10% revenue was higher than the 20% revenue share. To compensate for the relocated part of the PIT 20% of the CIT was allocated to municipalities on the basis of the municipal to total state population ratio.

The above facts are mutually correlated. The progress of information technologies and the consistent pressure towards cost reduction were forcing companies to concentrate their wage accounting departments (e.g. a company with five branches will concentrate accounting department into headquarter). The departments (cash registers of taxpayer contributions) were moving from small municipalities to centres – for example to district capitals. Thus employee tax revenues of district capitals were increasing, the same revenues of smaller towns and villages going down correspondingly.

Another fact affecting the system of tax revenue allocation was the varied employment structures in individual municipalities and districts. There were regions affected by structural unemployment more than others. Regions with a higher percentage of structural unemployment enjoyed lower number of tax payers. This at the same time decreased the average wage in the district, which means lower taxes paid by individual tax payers, considering the progressive tax policy applied in the country. To sum this up: regions with higher unemployment had fewer employment tax payers and these taxpayers paid lower taxes, which meant lower wage tax revenues of the region. Practical experience has clearly demonstrated the above-described correlation between the level of unemployment in the region and the PIT revenues of the same region. In 1999 the physical person tax revenues of municipalities ranged from CZK 500 to CZK 50,000 per capita. The question has to be posed whether the difference was not a little too high considering the virtually equal level of service required from the individual municipalities.

Before 2001 self-employment showed a high fluctuation rate, too. Municipalities competed by "stealing" entrepreneurs – income tax payers - from each other. The reason was that self-employment tax revenue pertained to the municipality in which the entrepreneur had permanent residence. Some municipalities therefore promised refunding of part of the paid tax (which was enabled by the effective legislation in the context of the policy of private business support). This trend was in direct contradiction to the requirement of stable tax revenue and tax equity (tax should be paid where public municipal assets are being used by the tax payer – technical infrastructure, security, lighting…).

The Government reacted to these trends by development of new rules of tax revenue allocation to individual municipalities. The new system was based on the assumption that similar municipalities provide a similar range of public services and therefore their tax revenues should be correspondingly similar. The Government classified similarity between municipalities by their population. This criterion is very simple and transparent, which has its advantages as well as disadvantages.

The last factor significantly affecting the changed rules of tax revenue allocation was the high number of small villages. The existence of such a high number of small villages was the way of expression of their inhabitants will to govern their affairs independently, which in turn resulted in the villages being very active in settlement of their own issues and extensive motivation of their representatives. On the other side, however, there were the high administrative costs of the decentralised model, consuming majority of the municipal income. This posed the question of effectiveness of the municipal spending. The fact of limited financial resources even led to unwillingness of part of the municipal population to participate in political life of their municipalities. These municipalities then got under the rule of another, larger municipality. Under such conditions there was virtually no reason for the independence. In 2000 the Czech Republic has 584 municipalities with population under 100 and 1163 municipalities with population between 100 and 200. With such a large number of municipalities it was also difficult to achieve good coordination between state and self-administration.

The result was the **new state-imposed tax allocation act** (no. 243/2000 Coll.), effective since 1 January 2001. The new act substantially changed the principle of tax sharing between the central government and local self-administrations[4]. The new system combined **sharing of overall revenues** from three main tax sources (PIT, CIT and VAT), allocating the revenues to municipalities on the basis of their population, with application of modifying coefficients[5]. The new system thus attempted at creating conditions for voluntary merges of small municipalities (see Table 6).

4 Proportion between state and local government tax revenue remains same, at the same time reform significantly changes allocation principle for municipalities.

5 This act is often criticised for entire absence of factors motivating municipalities for increase of tax revenues. In reaction to the criticism the Parliament passed a novella in 2001 including a tax revenue increase motivation element for municipalities. We believe, however, that the less than CZM 1 billion motivation factor is insignificant for municipalities.

Table 6: Impact of the new tax sharing system act [in CZK]

Size of municipality		Old rule - 2000				New rule - 2001		
From	to	number of inhabitants	number of municip.	average tax rev. per inhab.	dispersion	average tax rev. per inhab.	dispersion	**coefficient**
0	100	41 286	584	6 498	33 633	5 135	6 703	**0,4213**
101	200	173 411	1 163	4 947	5 456	5 424	4 371	**0,537**
201	300	214 772	876	5 304	10 177	5 442	3 286	**0,563**
301	1 500	1 828 622	2 785	4 797	2 434	5 403	1 775	**0,5881**
1 501	5 000	1 467 776	572	5 193	2 368	5 453	808	**0,5977**
5 001	10 000	928 534	133	5 905	3 214	5 840	777	**0,615**
10 001	20 000	937 508	67	6 370	1 620	6 956	1 241	**0,7016**
20 001	30 000	697 378	28	5 878	1 100	6 602	620	**0,7102**
30 001	40 000	349 267	10	6 464	1 778	7 343	1 338	**0,7449**
40 001	50 000	227 765	5	8 091	3 221	8 368	1 099	**0,8142**
50 001	100 000	1 247 257	17	6 916	1 510	7 793	981	**0,8487**
100 001	150 000	103 015	1	7 220	0	9 170	0	**1,0393**
150 001	1 000 000	872 366	3	12 995	1 611	13 152	131	**1,6715**
Praha		1 186 855	1	20 693	0	21 566	0	**2,7611**

Source: Own calculation

In the context of the public administration reform the process of fiscal decentralisation was commenced in the Czech Republic. The process broke down into several stages. The change in the tax revenue allocation system eliminated most of the past system negatives. The new system at the same time exerted certain pressure on the smallest municipalities (up to 100 inhabitants) to merge. The positive outcomes of the reform certainly include the fact that the amount of tax revenues is today much less affected by the economic condition of municipalities and the differences in tax revenues between similar size municipalities has been significantly reduced (see Table 6). On the other hand, municipalities cannot affect their tax revenues in a way other than change of population. In certain respects **tax revenues are becoming more and more non-purpose subsidies**.

Chapter 5: Local Government Borrowing

Self-administrative units of the Czech Republic for funding communal public investments usually use refundable resources. Small municipalities with small budgets may get into difficult financial situation in the beginning of the year, having no reserves from previous periods and forced to use borrowings, often for provisional financing of operational costs.

Local governments may make use of:

? **refundable financial assistance and loans,** for example from the state budget or from state funds, or from the budget of another municipality, or from the regional budget, either interest-free or in the form of low interest bearing loans;

? **short-term credit loans,** refundable in one year time, or by the end of the respective budget year;

? **medium-term credit loans,** refundable in four years, or sometimes in five year time, and

? **long-term credit loans,** refundable in ten years, or sometimes in fifteen year time;

? or, under certain terms, the municipality may **issue securities** for financial source acquisition (this variant involves additional costs of the bond issuing – issue procurement etc., reducing the net revenue from the issue).

Credit loans, and therefore indebtedness, must be **approved by the municipal authority. Loans are provided on the basis of loan agreements concluded with a bank and approved payment schedules** – refunding of the body of the loan and the interests from the municipal budget. The banks provide loans to municipalities against collateral (capital, future income, securities).

After 1990 a number of municipalities faced the problem of inability to realistically estimate acceptable level of annual debt service and its impact on future economy. The reasons included absence of experience in long-term budget planning and changing conditions of municipal economy – rules for tax revenue allocation, rules of subsidy provisions from the state budget etc. **Analysis of history of budgeting of the municipality** was easy.

What was much more difficult, or nearly impossible under the existing conditions, was compilation of a medium- or long-term **future economic prognosis** for the whole period of the credit refunding.

Municipal self-administrative authority should loan refundable financial means **up to the amount corresponding to annual debt service equal to the lowest positive current budget excess assumption** (i.e. the difference between regular income and regular expenses) for the period of the loan refunding. The need for realistic planning of the amount is more than obvious. **This represents a problem, especially for smaller municipalities**.

Not all municipalities were always able to realistically assess the purpose of the investment covered with a refundable financial source (loan), especially in the cases of financing of the so called profit investments from credit loans, when very often the planned profit to be used for the loan refunding did not reach the levels assumed in the beginning – this was particularly the case of certain small villages – such as **Rokytnice nad Jizerou**[6]. Municipalities often underestimated business risks of their enterprises.

Another negative impact on municipal debts was represented by local business credit loans with the business risks taken over by the municipalities without appropriate weighing of the risks. When a businessman failed to refund the loan the municipality as the guarantor had to take over the responsibility for the loan refunding.

Following the applicable legislation the **Czech state takes no responsibility for liabilities of local governments.** In the past ten years the state either did not regulate use of refundable resources and indebtedness of municipalities at all or paid insufficient attention to the regulation[7]. Indirect regulation of municipal indebtedness by the state was represented by the 15 % indicator of maximum debt service share in regular municipal income in the case of applications for non-eligible subsidies from the state budget. We can speak about state regulation in the case of communal bond issues. The regulation was first exercised through granting (or refusing) the obligatory approval of the Ministry of Finance with the issues. In late 1990s the regulation took the form of approval by the Securities Commission.

The positive aspects include the fact that as a rule municipalities used borrowings with refunding deadline exceeding one year for financing of capital costs of investment, mostly into local public sector. The reasons included mainly the poor technical infrastructure in towns and villages. In the latter half of 1990s the municipal budget deficits increased (see Table 4 and 7), accompanied with dynamic growth of the total municipal debt of the Czech Republic. The debt increase rate only dropped after 1997. However, towards the end of 1990s small municipalities began to increase their debts. **Debt service** represents a significant **burden for budget economy** of over-indebted municipalities.

Table 7: Development of the municipal debt (in bln. CZK)

Debt Item	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Loans	2,5	4,9	8,7	11,6	13,5	18,0	17,6	18,4	22,6
Bonds	0	7,6	8,5	11,9	13,2	11,9	10,9	10,1	13,3
Others	0,9	1,8	3,1	4,8	7,7	9,1	11,5	12,5	12,4
Total	**3,4**	**14,3**	**20,3**	**28,3**	**34,4**	**39,0**	**40,0**	**41,0**	**48,3**

Source: State Final Account for 1993-2001

Further **increase of municipal debt is assumed in 2002 to reach over CZK 53 billion**, which on average represents nearly one quarter of the municipal budget volume. The image of municipal indebtedness is somewhat

6 The town of Rokytnice nad Jizerou is a model warning example of failure to manage **debt management.** In addition to a loan for the municipal wastewater treatment plant (CZK 70 M), issue of communal bonds (CZK 120 M) the town provided collateral for construction of a funicular (CZK 145 M). The investment into the funicular was not as profitable as expected, the debt of the town increased and Rokytnice nad Jizerou became unable to refund the debt. The Consolidation Agency, taking over the debt in the meantime, ordered the first forced auction of municipal property (2002). The auction was to serve as a warning for other municipalities that the state would not perform the role of the "last instance guarantor". There are more municipalities, however, reported in the press to be approaching this state of affairs. Representatives of all municipalities should take a lesson from these cases.

7 Last year the Parliament passed an act regulating municipal indebtedness – however, counter-proposals raised in the Parliament caused ambiguity of the selected indicator and resulted in subsequent cancellation of the regulation by amendment to the act. Therefore the state again does not regulate municipal indebtedness at all today.

distorted by the debts of big cities (Prague, Brno, Ostrava and Plzen). Indebtedness excluding these cities is shown in Table 8.

Table 8: Development of the municipal debt without four biggest cities (in bln. CZK)

Debt Item	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Loans	3,8	6,3	9,9	12,7	14,4	12,9	13,4	14,3
Bonds	0,3	0,9	1,6	1,6	1,4	0,9	0,5	0,0
Others	1,4	2,7	4,2	6,5	7,6	9,8	10,2	9,8
Total	**5,5**	**9,9**	**15,7**	**20,8**	**23,6**	**23,6**	**24,1**	**24,1**

Source: State Final Account for 1993-2001

Chapter 6: Enhancing Local Capacity and Democratic Accountability

Local administration in the Czech Republic is accountable for the **local tax rate applied by municipalities,** as well as for the **utility use rate** in the form of modified price for mixed local and regional public goods. The price is defined as modified for the reason of the mixed goods not subject to traditional market pricing and priced by local authorities alone. For example local administrative authority, including provision of the service by a private transport company, decides the price of public transport tickets. Decision-making of elected authorities is strongly affected not only by their voters – users of public utilities – but also by political parties, frequently including vested interest groups and bureaucracy.

Collective decision-making of local administrative authorities brings about lack of individual responsibility for effective provision of the charged public goods. In fact the citizens cannot exert much pressure on their elected representatives, even if they were interested in doing that at all.

Revenue from Net Public Goods – Tax Price

Net local or regional public goods costs should be funded from tax revenues, for individual share of each citizen in their consumption cannot be accurately determined. This fact is called tax price. Following the assumption that citizens of individual municipalities should contribute with their local or regional taxes to financing of local public goods, as the consumption of the goods is limited to them, then the obvious conclusion is that revenues from local and regional taxes should be sufficient to cover the costs, which may vary by region. This at the same time implies that municipalities, or regions, **should be endowed with a certain amount of powers for imposing taxes** to be able to affect the imposed tax rates for the purpose of achievement of equality between the revenues and the production costs. On the other hand, extensive taxation powers reduce pressure on reduction of costs of production of public goods. At the same time the high number of municipalities in the Czech Republic (over 6000) disables effective implementation of tax competitiveness in the period when tax bases are becoming increasingly mobile.

Municipalities in the Czech Republic are allowed to charge **local fees (taxes)**, most of them of tax nature. As for construction of these local fees the taxation powers of the municipalities are very low. Although no serious research has been made it can be assumed that these local taxes, whose contribution to the budget is permanently very low, cannot cover the costs incurred for provision of public goods[8]. Thus the costs have to be permanently subsidised from other incomes.

The municipality decides introduction of local taxes. The local taxes cannot be any, their types are limited to those specified in the relevant legislation. Unlike income and other taxes, unified across the Czech Republic, the local tax rates – within the legislatively specified local tax types and rate limits – may vary significantly by municipality, for the municipality may or may not apply the maximum rate applicable to the relevant tax type.

Local taxes must be announced in the form of a generally binding public notice and are **administered directly by the municipality itself,** unlike income and other taxes administered by the Financial Office, where the municipalities only receive the specified percentages of the revenues. Current Czech municipalities may therefore charge local fees of the following types[9] dog owner tax, recreation tax, spa tax, public space use tax, admission tax, accommodation tax, motor car access tax, gambling machine operation tax, connection to civils tax, waste collection, transport, sorting, recycling and disposal tax[10].

8 Research has indicated that administrative costs of local tax collection are in many cases higher than the revenues themselves.

9 Act no 565/1990 Coll., on local taxes.

10 In addition to local taxes the municipalities collect **administrative fees** in the context of delegated responsibility, without the ability to affect the rates, which are specified by law. Even these fees, however,

Budgeting furthermore usually does not include purpose-specific links between specific types of income and specific types of cost. This makes comparisons of local and regional tax revenues and utility costs for matching extremely difficult.

Revenues from Mixed Public Utility Service – User Fees

Mixed public goods, especially those representing facultative consumption, **are provided to citizens against user fee, representing modified price for unit consumption** by the citizens. Application of user fees to use of mixed public goods assumes the possibility of **accurate measurement of consumption** of the public good in question. In such case the user fees are **non-tax revenues**. **If a particular good consumption cannot be accurately measured**, or is not measured for the reason of extremely high transaction costs of the measurement, the **lump user fee** is de facto a tax (see for example the Czech communal waste disposal fee-tax).

The effectiveness approach would welcome user fees and taxes covering 100% of the calculated costs of production of mixed public goods. These costs will be subject to geographical differences, for both objective and subjective reasons (lying especially in the area of management quality). Therefore the mixed good consumption fee rates vary by municipality, or by region.

User fees need not necessarily go directly into the municipal budget. In some cases they do, if the municipality is the direct provider of the service to the citizens. As other subjects also provide these services, the revenues usually go directly to the providers. Nevertheless, the municipality invariably decides the rates. In addition, municipalities collect "rents" on housing and charge tariffs on water and other utilities owned by them. However, the prices ("rents" and "tariffs") are still regulated by the central government. This has had a significant impact on local budgets, especially in the case of rents on housing.

Let me make a note about construction of user fee for mixed public good provided by the communal entity itself. Generally speaking the unit costs of mixed public good – and thus the user fee rate (for the presumed 100 % cost coverage) depends on the number of users of the utility, i.e. on the use of capacities reflecting in the overall costs of production in the form of fixed expenses. The fixed cost flow is different from other cost flows. If for example a municipality attempts at maximum use of the capacity of a device producing a mixed public good by joining a neighbouring municipality and providing the good to its inhabitants too then fixed costs per unit may be reduced radically, which may either allow reduction of the user fee or prevent its increase (despite inflation pressures affecting increase of other costs), or generate profit in the eventual run.

Municipal Property Management in the Czech Republic

Municipal property in the Czech Republic consists of real estates (land and buildings), movables (furniture, motor cars, computers, machinery, devices etc.), intellectual property (industrial rights, registered trade marks etc.), also including property rights (claims), securities and monies. Property ownership is one of the basic attributes of self-government and is therefore accentuated in the Constitution of the Czech Republic as well as in the Municipal Act11. Self-administration units such as autonomous legal corporations may dispose with their property **independently** of state intervention within the limits of powers and responsibilities specified by the Constitution and other applicable legislation.

Municipalities were returned their property after 1989 by transfer from **state property**.12 The property included historic property and property of the former national committees, including forests, agricultural and, building plots, buildings, residential fund etc. Municipalities by transfer from the closed district offices acquired other property.

A special part of property acquired by municipalities from the state was represented by **securities**. Municipalities acquired those by free transfer in the context of the privatisation process. The securities included shares of

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represent municipal revenue. The class of communal taxes also includes **environmental tax**. Environmental tax is close to administrative fees and the revenue resulting from its collection is usually distributed between the State Environmental Fund and the respective collecting municipality. This tax comprises the fee for air pollution, and exemptions from agricultural or forest land. Fees for mining areas and revenues from mined materials are shared between the state and the respective municipality.

11 See Act no. 1/1993 Coll., Constitution of the Czech Republic, section 7, and Act no. 128/2000 Coll., on municipalities municipal administration).

12 See Act no. 172/1991 Coll., on transfer of specific property by the Czech Republic onto municipalities.

infrastructure producers and distributors of power, heat, water and sewerage. Municipalities thus acquired for example 34 % of shares of gas and power companies and 80 – 90 % of shares of water management companies.

The scope and structure of property returned or transferred to municipalities **not always corresponded** to their needs. That is why municipal property needed restructuring in many cases. In the former half of 1990s **significant municipal property sales** took place, especially including real estates. In the late 1990s many municipalities "got rid of" shares, thus acquiring substantial one-off income supporting their budgets.

It is difficult to make objective comments on the real estate and security sales outside the context of the role of municipalities and their newly acquired property. It is certainly impossible to positively view sales increasing regular budget revenues and thus consumed in the course of the year. Many municipalities, however, took over real estate property with maintenance costs largely exceeding revenues from the ownership, which was one of the frequent and logical motives for the sales (see the previous section – user fee – and problem of rents on municipal houses).

As for security sales the criticism may be sharper, for the original intention was to use transfer of shares in power network service providers onto municipalities to achieve municipal control over the respective branches of industry, especially preventing natural monopolies. Acquisition of securities by municipalities therefore was a political decision. Their holding by municipalities was to become expression of public control and a potential instrument of economic control exercised by local authorities. However, most municipalities, pushed by the limited disposable income and the necessity to provide the services required by the citizens, needed quick financial means for construction and modernisation of communal infrastructure. Where the revenues from security sales were used for capital investment there they can be accepted.

One of the main features of "healthy" economy is **maintenance and extension of property**. What follows from this is that the principal criterion of good economy of a self-administration unit is not only balanced budget but also extended (reproduced) property base. Municipal authorities must develop clear investment strategy, outspoken **priorities** supported by knowledge of preferences of the citizens. The order of implementation of individual investments should generally be included in the accepted development strategy. This means that consensus should be reached between the authorities and political parties whether the highest preference should be given to construction of a public water supply system, a sewerage branch, a sports stadium or a swimming pool. This is the only way to maintain **budget stability**, for demanding project implementation may exceed one term of office. Under normal circumstances, unless an emergency occurs (flood, etc.) the priorities cannot be changed overnight and construction projects cannot be discontinued without negative impact on the budget as well as on the life of the municipality.

Most municipalities and their authorities are thoughtful about their property management, giving preference to leases over sales, expanding municipal property by their activities. Municipalities have mainly invested in long-term material assets, such as construction of new infrastructure including water pipelines, sewerage, wastewater treatment plants etc.

Chapter 7: Conclusion

We suppose, that the first stage of building municipal financial system is in the Czech republic done. For almost ten years are municipalities operating with own property, they have extensive expenditure authority, whereto are allocated adequate incomes. In case of (large) investments, when revenues are insufficient to planned expenditures, municipality has the right to borrow on the capital market, either bonds issue or loan from bank.

Important task, that municipalities are facing nowadays, is the insignificant degree of autonomy of local authorities over their own revenue sources. This adversely affects efficiency and accountability. If we pass over subsidies, majority of own incomes has the shape of non-purpose transfer. We are talking about shared tax revenues, which are allocated to municipalities according to number of their inhabitants. This situation is the outcome of the reform of tax revenue assignment, which was done in the year 2000. Municipality has a few possibilities how to affect size of the revenues (whether tax or non-tax). That is, why we make a suggestion, that present reform and future changes would be made with intention of boosting municipal revenue autonomy. This will improve budgetary predictability and the accountability of local authorities. We propose, that the government may consider following **suggestions in the field of revenue assignments**:

? revising the adopted adjustment coefficient for the tax-sharing distribution, in order to introduce a clear economic rationale to it

? finishing of the deregulation of prices for some public goods, so local government could set user fee accordingly to the price for providing of such services
? providing more local autonomy and restoring tax-effort incentives by reassigning the personal income tax (PIT). This could have shape as the right of the municipalities to impose their own flat-rate (proportional) PIT local surcharge (piggybacking on the national adjusted progressive PIT rate) within a bandwidth of rates,
? increasing the predictability of local budgets by defining the local tax law (e.g., bandwidth of local tax rates, local tax base and exceptions) with liberal powers for municipalities,
? increasing of impact of property (buildings) tax (start to exercise value-based tax instead of size-based tax) and transfer administration of this tax to municipalities,
? introducing obligatory certificated educational modules for local officials and administrators, which will upgrade their skills. Such courses should cover basics of public finance, performance budgeting, European structural policy, etc.

At the same time, we have identified **several arguments**, which could work **against the process of increasing LG's fiscal autonomy** or at least reduce **political willingness** to perform such changes:

? so far not finished process of decentralization and de-concentration of competencies in the public sector (to individual stages of territorial administration) prohibits strengthening of own revenues. At the same time it leads to increasing of subsidies (the full dependence of the new regional administration on the state budget),
? preparation of Public finance reform (first step) prevents to anticipate (with sufficient accuracy) impacts of reform steps both to fiscal capacity of local governments and to available tools of budgetary policy at the municipal and regional level,
? non-professional decision of elective bodies and executive management causes (mainly in small municipalities) non-effectiveness with spending of scarce budgetary sources. When talking about municipalities – about 60 thousands municipal representatives determine 9 % of GDP- they are rarely economically educated,
? high number of municipalities – over 6 thousand, when there exists fully independent villages with less then 50 inhabitants. Transfer of some tax competencies to municipalities could cause a mess,
? problem with improvement of effectiveness of local and regional public sector – necessity to introduce of norms, indexes and standards of public services. Simple increasing of fiscal competencies could be followed by boosting of ineffectiveness in spending
? low quality of fiscal control, both expert and lay public control. Citizens do not play active role in public affairs management – needed feedback is absent.

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