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An Overview of Intergovernmental Fiscal Relations in the Baltic States

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FOREWORD

This paper presents an overview of recent changes in intergovernmental fiscal relations in the Baltic republics. Local governments in Estonia, Latvia and Lithuania are asserting themselves increasingly as autonomous components of the larger government structure. With the same goal of decentralization, each of the three Baltic states have been following home grown paths in redefining intergovernmental relations. The discussion concentrates on four main issues: the vertical structure of governments, expenditure assignments, revenue assignments (including intergovernmental transfers) and local public sector borrowing in the Baltics.

In recent years, the assignment of expenditure responsibilities has become more explicit and stable. The assignment of revenues and the system of transfers continue to evolve but local governments still lack autonomous sources of revenues. Subnational governments in the Baltics have started to borrow without much central government supervision. The needs for capital investment remain enormous. Differences among the three countries in the design of intergovernmental relations may sometimes be traced to different historical backgrounds. Other differences simply show that there exists more than one "best" solution to issues of intergovernmental design. In other cases, some of these three countries have pursued policies that appear to be inferior. This is often the case in revenue assignments and the design of transfers. Overall, Lithuania has made little progress since the Soviet era, while Estonia and Latvia have taken bigger steps toward a decentralized system of government finance.
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AN OVERVIEW OF INTERGOVERNMENTAL FISCAL RELATIONS IN THE BALTIC STATES

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I. INTRODUCTION

The break-up of the former Soviet Union has presented us with the opportunity to observe a natural social experiment in intergovernmental fiscal relations. In 1991, the Baltic republics of Estonia, Latvia and Lithuania broke away from the Soviet Union and independently pursued policies to achieve deep and meaningful government decentralization. With a common history of Soviet occupation, these three republics started their paths to decentralization with virtually identical economic structures.

This paper will present an overview of recent changes in intergovernmental fiscal relations in the republics of Estonia, Latvia and Lithuania. Each of these three countries has often chosen a different approach in dealing with the decentralization of government finances. Several explanations account for these differences. First, differences in historical institutional development and affinity for Western neighbors have exerted influence over decentralization

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*This paper is based on several field reports prepared for the World Bank on Estonia and Latvia [J. Martinez-Vazquez and Ilona Castro "Intergovernmental Finances in Latvia" May 1994, J. Martinez-Vazquez "Revenue Needs and Resource Constraints in Latvia" March 1995, and J. Martinez-Vazquez "Intergovernmental Finances in Estonia" June 1995]. Most of the information on Lithuania was provided by Mats Anderson and David Sewel "Lithuania's Municipal Finances," processed April 1995. The views expressed in this paper are solely those of the authors.

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policies in the three republics.¹ Second, the intergovernmental issues that these countries are facing in some instances may be solved in more than one "right" way, allowing each to choose a different --yet correct-- approach. Lastly, different policies may result, of course, from the fact that some policies are superior and others inferior in achieving identical goals.

This paper is organized as follows: The next section provides a summary of the vertical structure of governments in Estonia, Latvia and Lithuania. Overviews of the issues involved in expenditure assignments, revenue assignments (including intergovernmental transfers) and local public sector borrowing are presented in sections three, four, and five, respectively. The last section contains summarizing comments and reflections.

II. THE VERTICAL STRUCTURE OF GOVERNMENT

In all three of the Baltic states, the 50 years of Soviet occupation were characterized by tightly centralized finances. Subnational governments were merely an extension of the central government. Two tiers of local governments were maintained under the Soviet system. In each of the Baltic countries several hundred municipalities were active in the provision of local public services at the lowest level of government. At the intermediate level --between the central government and the municipalities-- operated rayons or counties. Many larger cities gained the status of "Republican Cities" which combined the functions of both municipal and district

¹Estonia has been closer to Finland while Latvia has been more inclined to follow the example of Denmark.
government. Beyond providing certain public services, rayon governments were often also responsible for enforcing central government regulations at the municipal level.

**Changing Government Structures**

As a reaction to the tightly centralized system during the socialist era, after independence local governments clearly wanted to be free from interference from higher levels of government. One of the consequences of this focus on autonomy has been the abolition of the intermediate bureaucratic layer of government in both Estonia and Lithuania. The intermediate level of government has purposefully been kept in Latvia where this level of government appears to be more firmly rooted historically, predating Soviet occupation. The importance of fiscal and political decentralization is reflected by the high pace at which legislation to this effect was introduced after independence from the Soviet Union. Yet, each of the Baltic nations took a very different approach in restructuring intergovernmental relations in the post-Soviet era.

In Estonia, the *Law on Local Government Organization* of 1993 changed the status of the rayon governments, making them regional administrative units of the central government. Lithuania, on the other hand, opted to consolidate its two tiers of local governments into 56 large municipalities through the *Law on Administrative Units and their Boundaries* of 1994. In addition, ten regional administrations were scheduled to be established in 1995 as deconcentrated units of the central government. Latvia’s parliament is currently discussing a draft for the *Law on Local Self Government*. This law calls for the maintenance of the status quo in the number

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2Latvia and Estonia had seven and six Republican Cities, respectively; Lithuania had 11 such Republican Cities, called "miestai." Latvia has maintained these Republican Cities despite recent reforms in the structure of intergovernmental relations.
and structure of jurisdictions in Latvia, but does seek the elimination of six autonomous government districts within the city of Riga.

The question of optimal jurisdiction size, and in particular how to address the problems raised by very small jurisdictions, does not appear to receive a unique answer in the Baltic republics. The optimal size of jurisdictions attempts to balance the benefits of increases in efficiency and political accountability associated with smaller size of government against the losses of economies of scale, increases in bureaucracy and more complex coordination also associated with smaller government size. Lithuania’s choice to consolidate local government into 56 jurisdictions was undoubtedly facilitated by the relative ethnic homogeneity of its populace.\(^3\) Forced mergers of small jurisdictions do not appear to be likely in Latvia and Estonia, although in these two countries a majority of municipalities have a population of less than 5000. Instead, Latvia has chosen to rely on keeping the intermediate level of government to mitigate some of the problems associated with suboptimal jurisdiction size. Estonia, on the other hand, is relying on several other mechanisms to address the issue of suboptimal size, including the contracting among local governments with explicit compensation arrangements, other cooperative solutions, and privatization of the delivery of services. Both Estonia and Latvia are considering avenues to facilitate the voluntary consolidation of small jurisdictions. None of the three countries has so far considered the possibility of creating special service districts. This is a flexible and attractive solution to capture economies of scale with little interference, but one that lacks tradition in Eastern Europe.

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\(^3\)In 1989, ethnic Lithuanians comprised 79.6 percent of Lithuania’s population; these ratios are 52 percent for Latvia and 61.5 percent for Estonia. (Susanne Oxenstierna, "Labour Market Policies in the Baltic Republics," *International Labour Review* 130(2):255-274, 1991.)
Vertical Imbalance of the Fiscal Structure

Although there appears to be a genuine desire to decentralize government functions in the Baltic states and an intense demand for devolution by local governments, the central governments have been cautious in giving subnational governments full responsibility over the local budget. In particular, local governments have little or no authority to impose taxes and collect fees independently except in narrowly specified cases, and often only with central government approval. Subnational governments in all three countries face restrictions on their ability to attract financing for local capital investment projects. As a result of the absence of significant own fiscal resources, local authorities are largely dependent on shared revenues and transfers from the central government. Since transfers and both the base and rate of shared revenues are determined by the central government, this has caused a vertical inequality in the balance of fiscal responsibilities.

Vertical balance is said to exist when there is a broad correspondence between the expenditure responsibilities assigned to each level of government and the fiscal resources available to them to carry out these responsibilities. Although revenue sharing and transfers are designed to redress this imbalance, they give the central government disproportional control over the subnational budget process. A "coefficient of vertical imbalance" is calculated as one minus the share of the subnational government expenditures that are financed from sources not controlled by subnational governments.\(^4\) By construction, the coefficient takes a value between zero and one, with values closer to zero indicating a larger fiscal imbalance. Table 1 presents

a comparison of the coefficients of vertical imbalance for the Baltics with those computed for a selected number of Western European countries. There is disagreement on how exactly to define revenue sources controlled by a higher level of government. Therefore two different versions of the coefficient are computed: the first only considers own local revenues as controlled sources, while the second definition also considers revenue from tax sharing as locally controlled sources.

Latvia overall achieves a low score under this measure of vertical imbalance. For Estonia, the first coefficient indicates a significant degree of vertical imbalance. Yet, when revenue sharing is added, the situation in Lithuania and Estonia is more comparable to that in other countries. However, as Table 1 shows, even in federal countries such as Germany the vertical imbalance indices do not reach high marks.

III. EXPENDITURE ASSIGNMENTS

Subnational government spending accounts for an important share of public sector expenditures in the Baltics. Relative shares of fiscal expenditures by the subnational sector are presented in Table 2. These relative shares are not unlike those in other former Soviet republics. For a selected group of transitional economies, subnational budget expenditures on average accounted for 24.8 percent of the consolidated national budget in 1993. The relative share of the subnational budget may change in these transitional economies when expenditure responsibilities are shifted between central governments and lower levels of government.

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The unweighted average was calculated using data from Bulgaria, Hungary, Poland, Romania, Russia and Ukraine. See Bird, Ebel and Wallich, "Fiscal Decentralization: From command to market" in Decentralization of the Socialist State, The World Bank, 1995.
Assignment of Expenditure Responsibilities

Decentralization of public finances in the Baltic states has enhanced efficiency by letting local governments be more responsive to the needs and preferences of the population. By decentralizing certain government services, services that are only of local concern can be provided at the local level to those who benefit from, and pay for, these services. Current assignments of expenditure responsibilities are presented in Table 3. In all three of the Baltic republics the assignment of expenditure responsibilities has been in flux since independence due to continued decentralization. For a number of services, confusion exists about the assignments of responsibility. For example, in Estonia different laws assign responsibilities to different levels of government for fire protection and emergency services. In Lithuania, ambiguity surrounds the exact responsibilities of the newly established regional administrative units. Yet failure to have a concrete assignment of expenditure responsibilities may lead to instability in intergovernmental relations and to the inefficient provision of public services.

An important example of the ambiguity in expenditure assignments is the case of primary and secondary education. In all three Baltic countries, the responsibility of education is shared by central and local authorities. Teacher salaries are paid from central government funds, while local expenditures on education include heating, non-teaching personnel and building maintenance. Unifying the responsibilities for education at the local level of government would allow for better cost management and increase government's responsiveness to voter preferences. Confusion on other responsibilities is due to the fact that major sectoral reforms are underway in the Baltic states. Such is the case with health services.

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6In Estonia, the central government also funds the purchase of textbooks.
Budgeting Autonomy

Departing from the Soviet command system where local budget discretion was minimal, subnational governments in the Baltics now experience much greater freedom in the budget process. Due to the rapid reforms in intergovernmental relations, local governments in all three Baltic republics have now achieved budgetary independence. In Estonia, the Law on Local Government Organization of 1993 granted municipalities the right to make independent, autonomous budgets. Although unfunded mandates are prohibited by the same and other laws, in practice a large number of laws and central government regulations are still in effect that assign expenditure responsibilities to local governments outside the Law on Local Government Organization without due compensation from central government funds. Local governments in Latvia also have complete discretion over their budget with the exception of mandated minimum expenditures for health care and the allocation of specific central government grants. As of 1995 municipalities in Lithuania are also free to allocate their funds as they wish, although restrictions remain on the use of these funds for salary payments. However, Lithuania continues the tradition of earmarking revenues from selected sources; certain shared revenues, municipal service fees and other local user fees are kept completely outside the regular budgetary process.

Capital Expenditures

Perhaps the most important concern that remains in the area of expenditure assignments in the Baltic states is that while local governments have been assigned the responsibility for capital investment in many service areas, most local governments lack the capital funds or the

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7Mandated minimum expenditures for health care are Ls 21 per capita.
financial ability, weight and sophistication to borrow for these purposes. It is a generally accepted principle of public finance that borrowing is the proper way to finance long-lived capital expenditures. By gradually repaying debt incurred for capital expenditures, the cost of a project will be borne by those who benefit from it. Local public sector borrowing is discussed in detail in section V of this paper.

During the first years of economic transition, capital investments for infrastructure and public utilities have suffered heavily in the expenditure crunch that went along with the overall downsizing of government. This is true to a greater or lesser extent in each of the three countries. The lack of funds for capital investment purposes has put the entire subnational sector at an impasse. Problems of low capacity and the consequent overload of existing facilities remain in water supply, sewage, heating and solid waste disposal. If this pattern of neglect of capital expenditures were to continue, damage to the existing stock of public infrastructure could be irreparable. While similar problems exist in the education and health sectors, they are present to a lesser extent due to previous over-investment and decreases in population (the migration of ethnic Russians), especially in Estonia and Latvia. Giving priority for funding to rehabilitation projects, rather than entirely new construction, should mitigate the shortage of funds. Unfinished projects, however, should not receive a blanket priority status. This practice, now followed in many countries in transition, ignores the questionable economic justification of many projects initiated by the socialist state.

Privatization of Enterprises

Municipal enterprises and public utilities continue to impose a burden on local budgets. Efforts in each of the Baltic states to run public enterprises with full cost recovery have met with
varying degrees of success. Local governments and utilities in all three of the Baltic republics have been given the authority to raise user fees and utility rates to reflect operating costs, depreciation and investments. Despite increases across the board in user charges, local governments in the Baltics continue to subsidize utility companies and housing services.

Since 1992, local governments in Estonia have embarked on the privatization of commercial activities and have significantly reduced subsidies for public housing and public utilities. Despite these efforts most of the housing in Estonia is still owned by local governments. While municipalities receive a rent subsidy from the central government for poor households, these housing allowances appear to be insufficient. As a result, many local governments continue to burden their budgets with subsidies to private housing.

In Latvia, little progress has been made in the area of publicly-owned housing. Rents are still far from reflecting maintenance and operating costs. Cost recovery will be a critical step for reducing local government expenditures in this area. Transportation and trade are other areas in which public spending could be reduced through privatization. Tariffs for public utilities have been raised by local councils, but revenues still fall short of full cost recovery.

Most municipal enterprises in Lithuania are subsidized to a greater or lesser extent by local government. Public transportation poses a burden especially on the budgets of several larger local governments. Subsidies for district heating, formerly the responsibility of the local governments, have primarily been taken over by the central government. Although user charges have been substantially increased for municipal services, subsidies from municipal governments continue to be needed for maintenance, depreciation and investments.
An issue unique to the transition economies of former socialist countries is the divestiture of the social responsibilities of enterprises. State enterprises in the former Soviet Union traditionally played a major role in the provision of public services. With the process of economic readjustment and privatization, state enterprise responsibilities in the social sector have either been transferred to the government sector or they have been discontinued. In Latvia and Estonia the process of divestiture of social responsibilities by (former) state enterprises has ended. By 1995 the number of preschool establishments in Latvia had dropped to 647, little more than half the number of such establishments in 1992. Lithuania and Estonia also experienced the closing of a large number of kindergartens, health clinics and other facilities, previously the responsibility of state enterprises. Although the divestiture of social responsibilities by state enterprises has affected all local governments, those that have been most affected are jurisdictions that in the past benefitted from the presence of state enterprises. They have been "cursed" during the transition with higher levels of unemployment and greater burdens on local budgets because of the divestiture of social services by state enterprises.

Despite the progress to date with the privatization efforts in the Baltics, the real danger remains that public officials in these countries in transition see their direct involvement in the economic development of the area as one of their responsibilities. This attitude not only puts the local budget at risk, but it also continues to deter genuine private sector development.

IV. REVENUE ASSIGNMENTS

The relative importance of the three sources of subnational revenue in the Baltics (own revenue, shared revenue, and transfers) is presented in Table 4. The goal of revenue assignments is to reach some broad correspondence between the expenditure responsibilities assigned to local
governments and the revenue available to these jurisdictions. Among the Baltic nations, different solutions to the issue of revenue assignments have arisen. While Estonia and Latvia have made considerable progress in this area, the revenue assignment in Lithuania, as we will see, remains clearly inferior.

**Own Source Revenues**

Own source revenues are defined as sources of revenue over which local authorities have a certain degree of control, be it by setting the rate or base of the tax or the level of the fee. Own local revenues in the Baltics are confined to several local user fees, income from local fines and certain narrowly defined local taxes. The combined revenue from these sources covers only a small part of the revenue needs of the subnational governments, reaffirming the reluctance of the central governments to confer significant autonomy upon the subnational sector.

In Estonia, the *Law on Local Taxes* of 1994 provides local governments with nine different taxes over which they have a certain degree of discretion. These taxes included a capitation ("poll") tax, a piggy-back local corporate income tax, a local sales tax, an insurance premium tax and five minor "nuisance" taxes. Yet only a handful of municipalities have actually implemented one or more of these taxes. In Lithuania local authorities have control over the rate of the land tax;\(^8\) the revenue of which is fully assigned to the local budget. However, revenues from this tax are minor. Local charges and fees in Lithuania are currently not a significant source of local revenue either, and as a rule are considered extrabudgetary revenue. In Latvia the property tax and the land tax, formerly central government taxes fully assigned to local

\(^8\)The maximum rate for the land tax is set at 4 percent by the central government.
government, have recently been made local taxes with the same discretion for local government to set rates. But again, these two taxes have only minor revenue raising capacity. User fees and other revenues accounted for only 1.2 percent of total subnational revenues in Latvia for 1994.

Granting local governments the capacity to vary the level of services and to charge residents of the community for these services is a key feature of true decentralization. It enhances responsible fiscal behavior, and it establishes a strong link for accountability of local officials to voters. However, central governments in the Baltic nations (and elsewhere in the former communist states) have been apprehensive about assigning more tax autonomy to the local level. Among other reasons, central governments fear that by assigning taxing power to subnational governments, they will lose control of fiscal policy as a macroeconomic policy instrument. Similarly, continued interference or complete control in setting the level of user fees is often justified by the central government’s goal of social stability. While the traditional local taxes, property taxes, vehicle taxes and user charges are obvious candidates for providing local tax autonomy, these taxes do not seem to be capable of generating sufficient revenue. The only alternative with considerable revenue-raising ability at the present time is a local personal income tax, either as a surtax on the national personal income tax (PIT) or as a separate tax. Many of the small local taxes recently introduced can be considered nuisance taxes and should be discontinued. The choice of other taxes such as the local corporate tax and the insurance tax premium in Estonia, for example, are not appropriate tax handles for local government because of apportionment problems.
Revenue Sharing

As own local sources have consistently fallen short of providing an adequate revenue base for local government activities, tax sharing has been continually used in post-Soviet years to address the growing revenue needs of subnational governments. Tax sharing has for the most part been on a derivation basis. This has intensified geographical disparities in the provision of local public services. Below we review to what extent intergovernmental transfers have helped to reduce these disparities.

In the Baltic countries, different approaches are taken with respect to revenue sharing. A summary of which taxes are shared in the Baltics for 1994 is presented in Table 5. It should be kept in mind that in each of the Baltic countries the mechanisms of revenue sharing have been subject to frequent changes. Sharing rates and decisions on which taxes to share are changed virtually every year. In all three countries the process of revenue sharing is heavily influenced by pressure placed on the central governments by individual, and groups of, local governments. While Estonia and (recently) Latvia arrived at a fixed rate structure of revenue sharing, in Lithuania politically negotiated solutions have resulted in a differential rate structure.

Clearly, some of the Baltic countries have a better structured system of revenue sharing than others. Estonia has arrived at a stable and well-structured system of revenue sharing. Four groups of taxes are shared at fixed rates between the central government and local authorities. Subnational governments received 52 percent of personal income tax collections, 50 percent of the land tax and fixed shares of various natural resource taxes. For 1996 there appear to be quite definite plans to assign 100 percent of land tax revenues at the local level. The corporate profit tax and the value added tax (VAT) are fully assigned to the central government. These
arrangements follow generally desirable principles of tax assignment. The personal income tax and the property tax are the most appropriate candidates for revenue sharing and have the potential of suitably developing into genuine local taxes.

In Latvia, the allocation of shared revenues has been in a continuous state of change in recent years. Significant improvements have been made in the system of revenue sharing. After experimenting with several combinations of differential or "regulating" sharing rates, Latvia used a system of uniform fixed sharing rates for all local jurisdictions for 1994. A dramatic overhaul of the system of revenue sharing and transfers took place again the following year. For 1995, 100 percent of the individual income tax has been assigned to subnational governments. Republican cities get the entirety of the tax, and rayon governments and municipalities share on a 15/85 percent basis. The property tax and the land tax were also fully assigned to the local level and in 1995 they became local taxes. Local governments further receive 75 percent of the natural resource tax and 30 percent of the forest cutting fees. The value added tax and the company profit tax are assigned for 100 percent to the national level. A unique element of the Latvian system of revenue sharing is that part of the revenue from the income tax, the land tax and the property tax is shared among local governments, in an effort to reduce some of the disparities caused by derivation-based revenue sharing. To this effect, subnational governments contribute to, or receive from the Equalization Fund, an amount based on 50 percent of the difference between the average per capita collections for all local governments and the per capita collection for the individual government. Expenditure needs are determined by a combination of negotiations and a "coefficient of local government need," which is a weighted index based on population share, the share of children under six, the share of youths aged 7-18, and the share
of the total pension-aged population within each jurisdiction. The central government, as discussed in the next section, finances a significant portion of the Equalization Fund through direct transfers.

Practices in Lithuania are in sharp contrast to the approaches taken in Estonia and Latvia. The value added tax and the personal income tax are shared with local governments on an annually negotiated basis. Lithuanian local governments also receive a fixed share of corporate income tax collection, although the sharing rates differ by type of enterprise (municipal, state, joint stock). The negotiated sharing rates deprive local governments of any revenue certainty and discourage local tax effort and expenditure efficiency. An identical allocation of resources between local governments can be achieved without differential rates by adopting a system of uniform sharing rates combined with an appropriate set of revenue equalizing transfers funded by the central government, or a fraternal revenue equalization system. In addition, the VAT is a poor vehicle for revenue sharing because of administrative headaches from the debiting and crediting of the tax in different jurisdictions. The corporate income tax is not a good candidate for revenue sharing either because of the difficulties arising from apportioning income from enterprises working in different local jurisdictions. Sooner or later this will become a serious problem.

The continued use of revenue sharing in the Baltic republics is an important tool for achieving a closer correspondence of local revenues and expenditures, and will continue to be an important source of subnational revenue for the intermediate run. Yet the discretion enjoyed by the central government in determining both what taxes are shared and the sharing rates rule out revenue sharing as a solution to the lack of revenue autonomy, and therefore accountability,
at the local level. Instead, options such as a truly local property tax, a piggyback personal income tax, vehicle taxes, and increased reliance on user charges at the local level can assist in giving local governments a greater degree of autonomy. It is unclear at the present time what the chances are of these reforms actually taking hold.

**Intergovernmental Transfers**

Under the old Soviet system revenue sharing and intergovernmental transfers were used as accounting tools to balance local budgets, while the size of these budgets was determined by planning norms. As such, transfers were used in a highly discretionary way, guided more by political considerations than by any economic principle. The overall level of transfers was politically negotiated, and transfers were used to provide local governments with the required funding for the minimum expenditure budget. Although the discretionary use of intergovernmental transfers as a source of revenue for subnational governments continued in the Baltics after independence from the Soviet Union, in recent years these countries have made progress in their efforts to allocate intergovernmental transfers in less discretionary ways. Intergovernmental transfers constituted roughly 15 percent of local government funding in Estonia and Lithuania in 1994, while conditional and unconditional grants in Latvia made up approximately half of all subnational revenues. The size of these transfers is determined of course by the degree of revenue sharing that is taking place and the expenditure responsibilities assigned to local governments, but also by the emphasis on equalization of subnational government funds.

Intergovernmental transfers in Estonia are regulated by the *Law on the Correlation between Municipal and Town Budgets and the State Budget* that entered into force January 1,
1994. This law establishes the general principle that the overall level of transfers from the central government is decided in negotiations between the central government and local government representatives, including the unions of local governments. Five different categories of transfers are specified in the law; within each category different assignment criteria or allocation formulas are delineated. As more than half of the total grant budget is used for equalization purposes, intergovernmental transfers have achieved a considerable degree of equalization in Estonia. Yet, certain concerns with respect to the system of transfers still remain. Most notably, certain categories of transfers are still largely based on bargaining and discretionary allocation instead of allocation rules or formulas. The Estonian system is also excessively complex, lacks transparency and can potentially be discouraging to local tax efforts.

In Latvia, the draft Law on the Equalization Fund is awaiting final approval by parliament. Yet, for 1995 the assignments of shared revenues and intergovernmental transfers were already for the most part calculated according to the mechanism set forth in the draft law. This law intends to end years of politically negotiated, discretionary transfers. The policy objective of the Latvian government is to keep the share of the local government sector in the consolidated public sector budget at the same level it has been over recent years, roughly between 23 and 24 percent. The Equalization Fund introduced by this law implements both revenue and expenditure equalization simultaneously for cities, rayon and municipal governments. Payments into, and receipts from, the equalization funds are formula driven, although parts of the equalization process retain an element of political negotiation. A weakness of the new Latvian system of transfers is that the system equalizes revenues rather than capacity which could discourage local tax effort. However, little tax autonomy exists at the present time. Until local
revenue autonomy is developed, the sensible approach is to continue equalization on the basis of personal income tax revenue over which local governments have no discretion. Property taxes and local tax revenues now at the discretion of local governments should be excluded from the equalization base to avoid adverse effects on local tax effort. Also, most of the equalization of expenditures is done \textit{a priori} by fixing expenditure norms for the three groups of local governments (Republican Cities, rayons and municipalities), thus ensuring significant differences across local governments rather than equalizing them.

The system of intergovernmental transfers in Lithuania is highly discretionary and based on political negotiations. As such, it has not evolved much from the transfer system of the former Soviet Union. Municipal expenditure "needs" are established based on the previous year's expenditures, adjusted for inflation and other indices. As a means of expenditure equalization, local governments are divided into six groups based on certain characteristics. Those municipalities that have below-average "needs" compared to their group get assigned the group's average "needs". Based upon these needs, after own source revenues are taken into account, sharing rates for the PIT and VAT are determined for each municipality. If after full assignment of these shared revenues imputed local government needs still exceed revenues available to the municipality, the difference is covered by a "subsidy" to the local government.

A tool of public finance that has been underutilized in the Baltic republics is the conditional (or matching) grant, which should be considered a valid method for central governments to pursue national policies for functional responsibilities assigned at the local level. It allows the central government to correct for inefficiencies at the subnational level caused by spill-overs and other externalities, while adhering to the goals of consistency and transparency.
A system of matching grants would also help in reaching a balance between local autonomy and accountability while ensuring national standards. Of fundamental importance, however, is not to overburden the transfer system with matching categorical grants. The fundamental objective of budgetary autonomy implies that most of the revenue should be of a block grant nature.

V. LOCAL PUBLIC SECTOR BORROWING

As discussed in the section on capital expenditures, subnational governments are severely restricted in borrowing ability, either by law or because of financial constraints. Although local operating budgets ought to be balanced, it is appropriate to finance long run capital investments through borrowing. Indeed, in all three Baltic nations operating budgets are to be balanced by law. However, these same central governments have failed to provide an adequate legal and financial framework for subnational borrowing for capital investments. Central governments seem to be hesitant to relinquish borrowing power to local governments. In particular, they may fear the loss of control over monetary policy and the objective of economic stability if local governments are allowed to borrow for capital investment purposes.

Direct access to capital markets is not a realistic proposition to address the capital financing needs of most local governments in the Baltics. Some large cities are already borrowing funds and are likely to continue to do so. However, it is unlikely that smaller governments will have direct access to capital markets any time soon. For these local governments the best chance for access to financial markets is the creation of a financial intermediation program that allows local governments, especially small ones, to borrow on the basis of strict criteria. Financial intermediaries for the local public sector have operated successfully in many Western European countries. Practices there and elsewhere offer examples
of errors to be avoided and successful features to be emulated in the development of these financial intermediaries. The most important key to success has been to keep financing and subsidization of poorer local governments as entirely separate activities. The financial intermediary should be kept independent of the central government and it should be given adequate means to provide funds.

In Latvia, the Cabinet of Ministers can set maximum amounts for borrowing by local governments and the issuance of guarantees, as stated by the *Law on Budget and Financial Management* of 1994. So far these regulations have not been issued, nor is there a borrowing mechanism in effect for subnational governments. Local governments in Lithuania did not obtain the right to borrow for the purpose of capital expenditures until 1995. Currently, the central government is acting as borrower for municipal investments. The new *Local Government Law* permits municipalities to borrow from private capital markets and foreign sources.

Borrowing by local governments in Estonia is regulated by the *Law on Local Budget* of 1993. Local governments are allowed to borrow and issue bonds for capital investment purposes. Tallin and several larger cities have already issued bonds. So far there has been little control of this borrowing through registration with the Ministry of Finance. Most local governments, however, will lack direct access to the capital markets for financing long-term capital investments.

**VI. SUMMARY**

While merely an extension of central control in the era of Soviet occupation, local governments in the Baltic states are asserting themselves increasingly as autonomous components of the larger government structure. With the same goal of decentralization, Estonia, Latvia and
Lithuania have followed their own paths in redefining intergovernmental relations. The
assignment of expenditure responsibilities is now more stable, while the assignment of revenues
and the system of transfers continue to evolve. While some differences in policy approaches may
be traced to different historical backgrounds, other differences indicate that more than one "best"
solution is available for policy dilemmas. In other cases, some Baltic countries have pursued
policies that are inferior. This is especially the case in the assignments of shared revenues and
transfers. In particular, Lithuania has made little progress since the Soviet era, while Estonia and
more recently Latvia have made bigger steps toward greater local control over revenues.

Several challenges remain for intergovernmental relations in the Baltic region. Expansion
of the own revenue capacity of local governments should be a dominant concern in restoring
some balance between the expenditure responsibilities assigned to local governments and the
fiscal resources available to them. Clarification of (exclusive or shared) expenditure assignment
responsibilities should also be a priority. Further, enabling local governments to borrow for
capital investment purposes would prevent further erosion of the infrastructure and allow public
utilities to provide services at adequate levels. Overall, with some exceptions, the Baltic
countries are better off and have made more substantial progress in decentralization policy than
most of the former Soviet Union and East European countries. The level of policy concerns
should move on from basic principles of expenditure and revenue assignments to improving the
actual mechanisms of implementation of general policy principles. This will call for more
detailed work on the design of fiscal management systems and of the formulas used for the
systems of transfers.
TABLE 1
MEASURES OF VERTICAL FISCAL IMBALANCE FOR THE SUBNATIONAL SECTOR:
AN INTERNATIONAL COMPARISON, 1991

<table>
<thead>
<tr>
<th>Country</th>
<th>Coefficient #1</th>
<th>Coefficient #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia(^1)</td>
<td>0.088</td>
<td>0.686</td>
</tr>
<tr>
<td>Latvia(^1)</td>
<td>0.069</td>
<td>0.491</td>
</tr>
<tr>
<td>Lithuania(^1)</td>
<td>0.111</td>
<td>0.869</td>
</tr>
<tr>
<td>Austria(^2)</td>
<td>0.186</td>
<td>0.717</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.156</td>
<td>0.512</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.172</td>
<td>0.611</td>
</tr>
<tr>
<td>Finland(^3)</td>
<td>0.191</td>
<td>0.654</td>
</tr>
<tr>
<td>Germany(^2)</td>
<td>0.244</td>
<td>0.794</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.288</td>
<td>0.345</td>
</tr>
</tbody>
</table>


\(^1\) Based on 1994 fiscal data. Land and property taxes are not included in the definition of shared revenue.
\(^2\) Subnational sector includes Länder as well as local governments.
\(^3\) Coefficients calculated using 1990 local expenditure data.

The coefficients of vertical fiscal imbalance were calculated, following J.S.H Hunter, Federalism and Fiscal Balance, 1977:

\[
\text{Coefficient } #1 = 1 - \left( \frac{\text{Revenue Sharing} + \text{Untied and Conditional Transfers}}{\text{Total Local Expenditures}} \right)
\]

\[
\text{Coefficient } #2 = 1 - \left( \frac{\text{Untied and Conditional Transfers}}{\text{Total Local Expenditures}} \right)
\]
### TABLE 2
CENTRAL AND SUBNATIONAL GOVERNMENT EXPENDITURES, 1994

<table>
<thead>
<tr>
<th></th>
<th>Estonia (million EEK)</th>
<th>Latvia (millions Lats)</th>
<th>Lithuania (billion Litas)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government Expenditures</td>
<td>6904.1</td>
<td>497.27</td>
<td>2.46</td>
</tr>
<tr>
<td>Subnational Government Expenditures</td>
<td>2174.3</td>
<td>183.47(^1)</td>
<td>1.85</td>
</tr>
<tr>
<td>Subnational Budget as Percent of Consolidated Budget</td>
<td>25.9</td>
<td>26.9</td>
<td>43.1</td>
</tr>
</tbody>
</table>

Sources: Ministries of Finance of Estonia, Latvia and Lithuania.

\(^1\) Includes central government grants and teacher salaries paid by the central government.
<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>Primary and secondary schools&quot;</td>
<td>Shared responsibility for primary and secondary schools&quot;</td>
<td>Primary and secondary schools&quot;</td>
</tr>
<tr>
<td>Health</td>
<td>Polyclinics, municipal hospitals and primary care</td>
<td>Tertiary care, polyclinics, medicine and some primary care</td>
<td>Primary health care, ambulance service</td>
</tr>
<tr>
<td>Social Security</td>
<td>Care for the elderly and other social assistance</td>
<td>Shared responsibility for homeless, disabled and orphans</td>
<td>Temporary social benefits, day care, care for elderly, handicapped and homeless</td>
</tr>
<tr>
<td>Police and Fire</td>
<td></td>
<td></td>
<td>Municipal police&quot; and fire protection</td>
</tr>
<tr>
<td>Housing</td>
<td>Housing maintenance and communal services</td>
<td>Financing, building, maintenance and subsidies.</td>
<td>Rental and sale of municipal housing stock</td>
</tr>
<tr>
<td>Public Transportation</td>
<td>Local Public Transportation</td>
<td>City Transportation</td>
<td>Local Public Transportation</td>
</tr>
<tr>
<td>Roads</td>
<td>Maintenance of local networks and town streets</td>
<td>Maintenance and construction</td>
<td>Urban and rural roads</td>
</tr>
<tr>
<td>Sanitation</td>
<td>Garbage collection and street cleaning</td>
<td>Shared responsibilities for garbage collection and street cleaning</td>
<td>Garbage collection, cleaning of streets and parks</td>
</tr>
<tr>
<td>Public Utilities</td>
<td>Water and Sewage</td>
<td>Water, sewage and heating</td>
<td>Water and Sewage, some district heating</td>
</tr>
</tbody>
</table>

Sources: Ministries of Finance of Estonia, Latvia and Lithuania.

* New establishments of schools, medical facilities and social institutions are assigned to the regional Administrative Unit.

** Salaries for teachers and medical staff paid by the central government.

*** Shared responsibility of local and central authorities.
<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own Source Revenues</td>
<td>17.2(^1)</td>
<td>7.3(^1)</td>
<td>11.3</td>
</tr>
<tr>
<td>Shared Revenues</td>
<td>54.3</td>
<td>42.0</td>
<td>75.7</td>
</tr>
<tr>
<td>Intergovernmental Transfers</td>
<td>28.5</td>
<td>50.7</td>
<td>13.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Sources: Ministries of Finance of Estonia, Latvia and Lithuania.

\(^1\) Includes category "other revenues," which may not at all be controlled by local government.
<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
<th>Latvia (1995)</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Income Tax</td>
<td>52</td>
<td>100</td>
<td>Negotiated</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>0</td>
<td>0</td>
<td>30/50/100</td>
</tr>
<tr>
<td>Value added Tax</td>
<td>0</td>
<td>0</td>
<td>Negotiated</td>
</tr>
<tr>
<td>Land and Property Tax</td>
<td>50</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Nat. Resource Taxes</td>
<td>Various</td>
<td>75/30</td>
<td>Not Shared</td>
</tr>
</tbody>
</table>

Sources: Ministries of Finance of Estonia, Latvia and Lithuania.

1 Shared between rayons and municipalities on a 15/85 percent basis.
2 Sharing rates differ by type of enterprise.
3 Essentially a local tax.
4 Local governments receive 75 percent of Nat. Resource Taxes and 30 percent of cutting fees.
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