



Reforming intergovernmental fiscal relations in the Czech Republic

Intergovernmental fiscal reforms are complex—they cannot be implemented in one fell swoop.

The Czech Republic has largely overcome the challenges associated with its legacy of socialism, the 1993 breakup of Czechoslovakia, and its transition to a market economy. In addition, the country's evolving approach to intergovernmental fiscal relations has addressed crucial issues, including the prospect of joining the European Union and the need to increase public sector efficiency.

Features of the Czech system

During the 1990s the Czech system of intergovernmental fiscal relations suffered from two long-standing problems: a growing vertical imbalance against the central government and increasing horizontal imbalances among municipalities. The vertical imbalance reflected slower growth in central government revenue from nonshared taxes (such as customs duties and excise and value added taxes) relative to shared taxes (especially individual income taxes). Horizontal fiscal imbalances resulted from rising disparities in growth levels and social and economic conditions across local governments and from the fact that shared taxes were essentially distributed based on a derivation principle. Because the Czech Republic lacks equalization grants, local spending reflected the uneven distribution of regional tax capacity.

In 2000, to support EU accession and advance fiscal decentralization, the Czech Parliament approved reforms of intergovernmental fiscal relations. The reforms replaced the state's deconcentrated territorial administration, based on 77 districts, with 14 inter-

mediate self-governing regions run by elected representatives. These regions were intended to be fiscally autonomous and directly accountable to their citizens. In addition, the system for sharing tax revenue between the central government and municipalities was restructured by shifting distribution from a derivation to a per capita basis. This change was expected to diversify the pool of shared taxes, distribute them more equitably, and stabilize tax revenue for all levels of government.

Municipalities have generally followed responsible spending patterns. Although district-level variations in per capita spending increased somewhat between 1997 and 1999, disparities were lowest for basic services—such as education and water—and highest for “economic functions”—such as telecommunications and financial operations.

Challenges ahead

Despite these improvements in intergovernmental fiscal relations, significant challenges remain in overcoming municipal fragmentation, strengthening municipal borrowing, and promoting transparency, autonomy, and accountability. Managing implementation of the reforms will also require considerable effort, including transferring fiscal powers to the self-governing subnational units, equalizing fiscal opportunities, and restoring incentives for local taxes.

Overcoming municipal fragmentation

Most (87 percent) of the Czech Republic's 6,254 municipalities have fewer than 1,500

Czech reforms to ease fiscal imbalances show great promise—but challenges remain

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inhabitants, and many (42 percent) have fewer than 300. This fragmented administrative structure has critical political and efficiency implications. From a political perspective this structure may be justified on the grounds that it may foster strong democratic representation and horizontal accountability. The downside (as also observed in Poland and some Baltic countries) arises from the financial weaknesses and economic inefficiencies associated with small communities, which cannot benefit from:

- Fiscal autonomy, because their tax bases are insignificant.
- Local technical and administrative capacity, because they are unable to retain qualified staff.
- Economies of scale in public service delivery, because privatization and outsourcing of local services are underdeveloped and municipal cooperation in service delivery is limited.

Four options may mitigate municipal fragmentation. The first is mandatory amalgamations of local governments—often considered the most expedient solution. But the Czech Republic has rejected this approach as being politically impractical. Strong local opposition stems from experiences with forced amalgamations of local governments in the 1960s and 1970s that were perceived as arbitrary and unrepresentative.

The second option is voluntary amalgamation. This approach can avoid social tensions and may be more economically efficient because it reflects residents' preferences. But this option may require costly financial incentives that could undermine the central government's fiscal balance, and it may be too slow or, ultimately, ineffective.

The third option is for the central government to encourage the formation of municipal associations or special districts to deliver services with significant economies of scale. This option is also likely to take a long time to mature.

The final option is asymmetric assignment of responsibilities (and resources) to local governments. This approach could be achieved, for example, by delegating most responsibilities now assigned to small com-

munities to “designated” or “statutory” towns or to the new self-governing regions. Resolving municipal fragmentation in the Czech Republic may require some combination of these options.

Strengthening municipal borrowing

Complete, transparent information on municipal debt is not readily available in the Czech Republic. Still, available data indicate that such debt increased rapidly during the 1990s. Excluding implicit contingent liabilities, municipal debt reached 24 percent of total municipal revenue in 1999, up from 5 percent in 1993. As a share of tax revenue, municipal debt grew from 11 percent to 53 percent during the same period. These increases reflect the fact that local government borrowing is unregulated and municipalities' access to credit is not formally restricted.

In practice, however, municipal debt is restricted. The Ministry of Finance controls the supply of credit to municipalities through moral suasion over the financial system. In addition, the Commercial Code restricts the use of collateral by municipalities, limiting their creditworthiness. Moreover, small municipalities have limited revenue capacity, restricting their access to capital markets.

The Czech government is considering ways to promote responsible subnational borrowing and to increase municipalities' access to capital markets for infrastructure financing. But among other things, the government must first establish regulations that increase transparency and competition, as well as preserve market incentives and hard budget constraints. These regulations should:

- Set clear limits on municipal debt and debt service obligations.
- Strengthen bank supervision, drawing on internationally recommended prudential rules.
- Draft a bankruptcy law or fiscal responsibility law (or both) to govern municipalities and regions.
- Develop public and private institutions (including private credit rating agencies) to ensure proper monitoring and avoid moral hazard.

Promoting transparency, autonomy, and accountability

During the Czech Republic's transition to a market economy, local authorities were given substantial discretion over spending decisions. Yet these authorities have little autonomy over revenue, limiting their accountability. Moreover, predictable and transparent preparation of local government budgets has been limited by lack of synchronization with the central government budget, uncertainty about basic budget parameters, and insufficient information on central government guarantees and contingent liabilities. Although there have been no major disruptions in local budget execution, budget control and performance evaluation remain weak.

Increasing transparency and accountability at the subnational level will require:

- Empowering local authorities to set rates (within defined ranges) for meaningful local taxes, such as property taxes.
- Lifting central controls on rents and tariffs.
- Increasing local freedom to mix factors of production in the most economical ways.
- Publicizing all approved and executed transfers and guarantees.

Budgets would be more predictable if basic parameters (including tax sharing arrangements and transfer or grant formulas) were defined in organic laws rather than the annual budget law.

When the Czech Parliament eliminated districts, the oversight function of municipalities (including the audit function) was left undefined. Addressing this issue may provide an opportunity to expand audits of subnational governments beyond legal and procedural aspects (the input approach) to include program and performance evaluation (based on measurable outcomes).

Managing implementation of the reforms

The government set a two-year transition period to implement the new system of inter-governmental fiscal relations. To avoid overspending, fiscal imbalances, and unfunded mandates, additional time has been taken beyond the two years to ensure that revenue sources assigned to the new regions are con-

gruent with new (delegated) and existing responsibilities. New spending responsibilities must be defined for the regions—and unlike in many unsuccessful experiences elsewhere, the Czech government will not assign revenues until spending responsibilities have been well defined. In the meantime, regional government operations will be fully financed by the central budget.

Among the issues to be resolved in the interim is the possibility that the administrative structure of the new regions (including new staff and facilities) might grow uncontrollably. That could severely threaten the country's structural fiscal balance, and could prove difficult to reverse.

There is a risk that the 2000 reforms will only slightly modify the state's previous territorial administration. The reforms made line ministries responsible for defining the functions to be transferred to the new regions, but it is unclear whether the central authorities are prepared to relinquish fiscal decisionmaking powers to lower-level authorities.

In addition, it is unclear whether the central government and Parliament are committed to transferring significant revenue and spending autonomy to regional and local authorities. Nor is there a clear commitment to promoting private participation in the financing and provision of public services at the local level—especially housing and education. Private participation could help small Czech communities benefit from economies of scale in service delivery.

One of the government's main goals is to provide all citizens with access to public services (health, education, water, sanitation, and so on) of similar standards, regardless of where they live. But the current decentralization system may not facilitate this objective because it lacks an explicit mechanism for equalization grants. The equal per capita distribution of shared revenues among local governments, introduced in the 2000 reforms, does not reflect the varying social and economic conditions among regions—and so does not properly address disparities in spending needs and revenue capacities. Implementing a true

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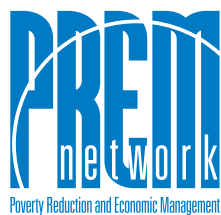
equalization scheme thus remains a major challenge for the near future.

The 2000 reforms practically eliminated incentives for local governments to bolster their tax efforts. But there appears to be wide consensus on the need for and possibility of restoring incentives to mobilize local revenues—without undermining the central government budget. One way is through property taxes, by better defining and expanding their base and by providing regional and local authorities with limited discretion to establish property tax rates. A second possibility is to introduce a regional or local individual income tax, with a proportional rate that piggybacks on the national (progressive) individual income tax.

The challenges created by the Czech Republic's reforms of intergovernmental fiscal relations indicate that fiscal decentralization should be conceived as a process rather than as a one-time event—and that continued reforms are needed to ensure that initial objectives are met.

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