PROBLEMS OF THE FUNCTIONING OF LOCAL SELF-GOVERNMENT

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SELF-GOVERNMENT FINANCE – LOCAL DEVELOPMENT – NEW CHALLENGES

1. Introduction

In a democratic country, public expenditure is of great interest to local communities. It is desirable that inhabitants of self-governing municipalities, districts, boroughs and counties have the possibility to observe and evaluate how public money is spent. Furthermore, local communities can influence the process of raising and spending public funds through their democratically elected representatives.

May 1990 saw the reinstatement of local self-government at its most important level, *i.e.* municipal. At the beginning of 1999 new units of local (district) and regional (county) self-government were established as part of the so-called second phase of the self-government reform. As some time has already passed since those epoch-making changes, we can now begin to form opinions and make observations. Since these changes have both territorial and, in terms of public finance, financial aspects, it is reasonable to look at 'Polish self-government' in the context of self-government finance and local development.

2. Self-government finance

The changes in the system of governing the country have started a new era in managing public funds, mainly as a result of the following developments:

– nearly 2,500 municipal budgets, which are independent of the state budget, have been created;

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– sources of municipal revenue (local taxes and charges, as well as a share of the national revenue from income tax) have been allocated to municipalities;

– rules of providing municipalities with regular additional revenue from the state budget (general subsidies that can be used freely) have been developed;

– principles of allocating government funds to municipalities to finance specific tasks have been defined. Such earmarked grants, or *specific-purpose funds*, can only be used for clearly specified purposes and are subject to detailed inspection and settlement of accounts. Earmarked grants allocated to municipalities are designed to finance tasks that have been delegated by central government or to co-finance tasks which a particular municipalities cannot perform due to insufficient income.

Like municipalities, districts and counties are also free to manage their budgets, which are drawn up by executive boards (local governments) and passed by district and county councils.

Looking at these epoch-making changes from a statistical perspective, we could define the existing system of self-government finance as:

– a system of interrelations reflecting the fact that state revenue from taxation and other sources has been divided between central government and local authorities,

– a set of general principles that regulate the functioning of the public sector and the distribution of the state revenue.

The development of self-government depends upon strong and stable regulations for managing public money. The current rules of financial management play an important role in the performance of public tasks at all levels of self-government. The process of giving self-government bodies clearly defined powers and responsibilities, as well as funds that match these powers and responsibilities, has a very positive effect on the allocation of financial resources and is a very effective incentive to increase the revenue that will be spent to satisfy local needs.

We have to bear in mind, however, that the degree of decentralisation in the distribution of public funds in Poland is still quite low when compared with other countries. For example, local budgets form 32.5% of total public revenue in Denmark, 31.0% in Finland, 30.3% in Sweden and 15.3% in Poland. This divergence results from the interaction of different political, economic and social goals.

Undoubtedly, the transition period intended to adjust our country to market conditions, together with social and economic difficulties experienced by many municipalities, has an impact on the degree of decentralisation in the distribution of public funds. A significant proportion of local authorities are not able to solve complex local economic and social problems by themselves. In order to be effective in supporting local authorities, government needs to engage public funds. At the moment, local finance shows a relatively low level of decentralisation and its scope varies significantly.

The basic system of supplying funds to municipal budgets is still evolving. This is connected with economic changes and the tasks performed by local authorities. Development subsidies and support grants for carrying out task, allocated to lower-income communes, are not sufficient to eliminate the disproportion resulting from differences in economic development. Each municipality's revenue depends mainly on locally generated income and tax revenue supported by central government funding.

These increasing differences reflect the differing abilities of municipalities to attract funds for the performance of their tasks. The disproportion in the level of income and in the income growth rate observed in practice is caused, to a large extent, by the instability of the local finance system:

– subsidies, related mainly to newly delegated tasks of local authorities (*e.g.* primary schools), constitute an increasing proportion of local budgets,

– revenue from income tax, local income and grants constitute a decreasing proportion in local budgets.

The decline in the income derived by a municipality is a negative phenomenon. This income (except for earmarked grants) can be freely allocated by municipalities and ensures them security in the performance of their tasks. Due to the condition of public finance in 2002, subsidies to local authorities were cut by 10%. Undoubtedly, this will reduce the investment capacity of municipalities. This, in turn, will make the problems of local labour markets even worse than they are today. These negative financial effects will have the greatest impact on small municipalities, where subsidies constitute a significant proportion of their revenues.

Such differences in locally generated income as a proportion of total revenue are observed throughout the country and they do not seem to be related to the kind or size of particular municipalities or their development. This is evidence that the disproportion in the amount of local income the local income growth rate greatly depends on the policies of local authorities, as well as the diverse structure of local income and tax reductions and exemptions. Local income is thus an important element of competition between municipalities (which is allowed), although it can be dangerous (resulting in serious financial problems) in the long run.

By and large, territorial differences in the sources of local income result from the natural environment, the development of communications and industry, population density, etc.

One of the main factors that determine the development of a municipality is demand for investment aimed at changing the municipality's environment, so that social and economic needs can be satisfied. Municipalities deal with such needs after they have performed their day to day tasks. The needs and capacity for municipal investment vary greatly throughout the country. The amount allocated for investment depends mainly on a municipality's total revenue and the level of its day to day expenditure, as well as on the amount of funds raised by running into (public) debt. In general, we can observe a sharp decline in investment expenditure, especially in municipalities with relatively small populations, both in city and rural areas.

The main reasons for the decline in the investment expenditure of municipalities are:

1. The growth rate of total expenditure is faster than the growth rate of investment expenditure. Most funds are spent on day to day expenses related to the performance of tasks assigned to local authorities. Therefore, we can conclude that the development of local investment activities depends largely on internal factors, *i.e.* the financial strength and policy of a municipality.

The impact of central government's policy to give preference in the form of grants or preferential loans to small municipalities is clearly felt. This policy focuses on rural municipalities that have a low income and is one of the factors that determine the investment capacity of a municipality.

2. The existing legal restrictions: The Public Finance Act of 26th November 1998, which became effective in January 1999, has limited the total amount of debt that a municipality can incur to 60% of its annual revenue and stipulated that the total amount of debt repayment cannot exceed 15% of the revenue budgeted for a particular year. Due to these restrictions, many municipalities that show good financial management and those that have access to low-interest-rate loans, *e.g.* from the Environmental Protection Fund, are not free to use all the financial instruments that are available to them. This restriction is particularly unfavourable to small municipalities that have a small income, as it makes it impossible for them to use such an important instrument of local development.

3. Ineffective usage of the capital market for local development, which results from the inertia of the banking sector, which is unable to make attractive offers. This is a very serious barrier to local development in

many municipalities, as the construction of local infrastructure cannot be financed by the current assets of local authorities, especially when municipalities are facing a continuous decline in locally generated income. Long-term loans should be an important investment instrument for local government and local authorities which, aware of local interests, should be ready to take investment risks.

4. An increase in the funding received from central government. This reduces the proportion of locally generated income as a percentage of a municipality's total income. On average, 75% of this income is allocated to investments. Observing a continuous decline in business activity, Polish municipalities are not certain whether they will receive the funds promised by central government and whether it would lead to insolvency if they do not. Therefore, giving local authorities instruments that not only enable them to increase locally generated income, but also ensure income stability, could be a milestone in stimulating investment growth in municipalities.

In general, the financial situation of a municipality reflects its competitive strength, which is closely related to the development of technical infrastructure. An unfavourable interrelationship between these factors may hinder the development of some regions, since it calls not only for the development of technical infrastructure which may be many years behind other regions, but also for attracting investors who are ready to start or develop non-agricultural businesses.

Local development calls for stimulating policy that supports various kinds of activities. It also requires funds that can be allocated to improving the competitiveness of a municipality. In the present weak financial situation of municipalities, however, this is very difficult. Development is related to changing the way municipalities are financed, which basically means actions designed to:

– broaden the possibilities for municipalities to raise their own funds, including locally generated income;

– reduce the dependence of the income of a municipality on funds received from central government;

– rationalise the existing system of subsidies and grants;

– ensure a wider range of non-government funds and better conditions for attracting them.

The state of Polish self-government provides conclusive evidence that local authorities' access to sources of finance is in conflict with the need to ensure basic social justice (municipalities have in practice been split into those which enjoy good financial standing and those which are weak). Not only is this a lasting situation, but also a worsening one. Rich municipalities are getting richer and the weak ones remain poor.

Undoubtedly, there is not a 'golden rule' for distributing government funds well, but this does not mean that it is impossible.

The protection of financially weaker local authorities calls for setting up financial procedures, which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burdens they must support. This is provided by Article 9 (Paragraph 5) of the European Charter of Local Self-Government (ECLSG). In Poland, general subsidies and earmarked grants are, in a sense, in accordance with the provisions of this charter. However, most of this support is earmarked, thus limiting local authorities' freedom of decision-making with regard to the allocation of such funds.

Considering the current structure of their financial resources, local authorities do not have much freedom to decide about their expenditure. The funds raised by local authorities represent the greatest share in their total budget, often as much as 50%, at the municipality level. However, such funds sometimes constitute as little as 4% of a local authority's budget, which is often the case at the district level. Therefore, it must be clearly emphasised that the resources received by local authorities for the performance of the tasks delegated by central government administration are usually insufficient. The expected change (favourable to local authorities) in the subsidy and grant provision system may give local communities a genuine chance to implement their development strategies.

In order to develop reasonable scenarios of managing their current and future financial resources, local authorities must first prepare reliable income forecasts. The structure and level of municipal revenue are determined mainly by political and legal factors. Municipalities do not enjoy full financial autonomy because the (basic) system of their revenue is formed by central regulation. Although local authorities have been given some powers to determine the rates of local taxes and charges (so-called taxation power), these powers are actually limited to rather insignificant sources of income.

Power to make local laws with regard to some taxes and charges is one of the fundamental principles underpinning the financial system of local self-government. In this respect, Polish municipalities have been given statutory powers to adopt resolutions with regard to local taxes and charges. The taxation power given to communes means that the level of some local taxes and charges (such as property tax, vehicle tax, dog tax, market-place charges, administrative charges, agricultural tax and forest tax) depends partly on decisions made by local authorities, although it must remain within the limits laid down in the relevant regulations.

The power to determine the rates of local taxes and charges is given exclusively to municipal councils, in compliance with Article 9 (Paragraph 3) of the European Charter of Local Self-Government, which states that: at least part of the financial resources of local authorities shall derive from local taxes and charges, whose rate they have the power to determine within the limits of the statute.

The income raised by local authority (derived from so-called taxation power) is only 18–20% of their total revenue. This means that the powers of municipalities to adopt resolutions with regard to taxes and charges are significantly limited. On the one hand, municipalities levy taxes and charges. On the other hand, however, they grant reductions, deferrals, exemptions, etc. Local authorities, recognised as 'the legitimate landlords at the local level', sometimes have a policy of maximum reductions in the local fiscal burdens (mainly on individuals), thus giving up a significant proportion of potential revenue from taxation (such reductions are estimated to be about 5% of a municipality's own revenues). Taxation power has not been given to local authorities at the district and county levels of self-government.

In the light of the European Charter of Local Self-Government, taxation power should be treated and recognised as the right to implement a rational local taxation policy, which will be more precise and purposeful than a central policy. The same power, however, may also be interpreted as the right to reduce fiscal burdens, and then the burden of collecting public tribute is, automatically, shifted to the central level of decision-making, thus forcing changes in the existing rules governing the distribution of 'public money'.

Bearing in mind the importance of local taxation as a reflection of the provisions laid down in the ECLSG, we can conclude that:

– taxes and local authorities' taxation power have to be recognised as a socially accepted and indispensable element of a democratic system;

– tax rates result from a compromise reflecting economic reality at national and local levels, local communities' expectations and local authorities' strategic goals.

The existing system of financing local authorities has produced the following effects:

– the concentration of public revenue in various centralised forms other than the state budget has grown;

– local authorities have become more dependant on central government and its agencies;

– earmarked subsidies, granted on a discretionary basis, have been maintained.

The experience gained in the last few years in managing public finance has revealed both many weaknesses and many positive elements in these historic reforms. In a general assessment, showing both the strengths and the weaknesses of financial management at each level of self-government, we can make the following observations:

– a relatively clear structure of central administration and local self-government authorities has been created throughout the country (there is sometimes a difference of opinion with regard to the necessity of the district level);

– the new self-government structure has made it possible to delegate powers (including financial management ones) to the relevant levels of self-government, but this possibility has not been fully utilised yet;

– central government administration has delegated several responsibilities to local authorities, but is still the main provider of public finance;

– the management of public finance in the new dimension of the self-government sector has not become clearer. There has been a formal decentralisation of power in the management of Poland, but without the necessary simultaneous changes and processes leading to broader (as compared with previous years) decentralisation in the management of public finance;

– there have not been (since 1999) any explicit rationalising effects of the self-government reform with regard to the system of providing public finance or to the effectiveness of public spending;

– there is no balance between the central government level and the local self-government structure. The responsibility for local development and local communities has been assigned to the lowest levels without appropriate decision-making powers or adequate financial resources. According to Article 9 (Paragraph 6) of the ECLSG, local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them. Practice confirms that this provision is not (fully) implemented in compliance with the intentions of the signatories to the ECLSG;

– the responsibility for regional policy has been allocated to county authorities without their adequate participation in the distribution of public finance (this item has not yet been provided for in the State budget), hence the achievement of strategic goals has become practically impossible;

– limiting local authorities' initiative is dangerous, because it will lead to reduced entrepreneurship and a lack of interest in improving the effectiveness of financial management. A specific example of such limitation is the current tendency, seen at the level of central government administration, to accumulate powers of distributing assistance funds granted by the European Union;

– in many municipalities, inspections carried out by regional chambers of accounting have revealed financial management malpractice that affect local revenues and expenditure. The most common examples of such malpractice are: municipal councils' failure to adopt resolutions on tax rates before the start of a fiscal year, wrongly determining due taxes, lack of information flow with regard to the communalisation of property and revenue generated from such property, conclusion of contracts resulting in liabilities that exceed the amounts fixed in municipal budgets, provision of grants to public institutions whose value is different from that provided for in the relevant municipal council resolutions, selection of improper public procurement procedures, failure to calculate and collect default interest on overdue payments of taxes, etc.

– the Public Finance Act effectively eliminates local authorities' abilities to raise debts. The activation of local communities predicted seems quite doubtful, due to the lack of adequate conditions and motivation to promote investment activities;

– local authorities' budgets should tend to be balanced (expenditure should not exceed revenues). The practice of financial management at the local self-government level confirms that many municipalities adopt a so-called conservative approach, *i.e.* are careful about investments (therefore they sometimes may have a temporary surplus in their budgets), wait for a favourable situation, etc. Bearing in mind the gap between Polish municipalities and European Union standards, local budget deficits, which result from the implementation of investment programmes, should not form the basis for negative assessment of municipal councils and their executive boards.

There is no difference of opinion with regard to the new district and county authorities' budgets: the funds that have been allocated to local authorities at these levels do not guarantee the complete fulfilment of the responsibilities assigned to them. It is also difficult to predict the financial situation at various levels of local self-government, since the current Local Authorities' Revenues Act is only a temporary law. Therefore, a new act, which will regulate the issues of the revenue of municipal, district and county authorities after 2002, must reflect the recommendations included in Article 9 of the ECLSG and ensure that the income generated by local authorities enables them to be independent and that the funds that they receive from the central government do not limit their decision-making powers. Financial management at the municipal level is at the beginning of a long road. The experience gained so far shows that financial management at this level is based upon finding an equilibrium between strengths and weaknesses. The next few years should bring local communities many favourable changes in this field.

Although the decentralisation of public authorities started twelve years ago, some key issues concerning the finances of local authorities have not yet been solved. In particular:

– there is no balanced division of public revenue between local authorities and central government administration;

– a rational division of tax revenues has not yet been implemented or designed;

– the sources local authorities can use to generate income have not been clearly specified;

– objective instruments for financing the statutory tasks local authorities have not been defined;

– the goals and rules of subsidising 'socially sensitive areas' have not been defined and stabilised;

– uniform principles for allocating earmarked grants financed by public funds have not been codified;

– the principles of and the procedures and criteria for subsidising local authorities' have not been stabilised.

The next few years should see an increase in the strength of the local self-government structure. A lot will depend upon the new Local Authorities' Revenues Bill that is being drafted.

3. Local development

In the theory and practice of local self-government in Poland, local development is understood as a process that is basically stimulated by effective usage of the financial, human and natural resources available in order to create jobs and achieve favourable social standards in a given local situation. These processes should be designed to equalise the effectiveness in managing local means of production and, consequently, to reduce the differences between self-government communities and make local environments more attractive. An element that plays a particularly important role in this approach is the financial situation of a municipality, which results from its statutory obligation to perform public tasks that develop living and working conditions in compliance with an approved and adopted budget. These factors determine, to a large extent, the development of local communities.

Poland has entered a new phase of making decisions that concern local development. The decentralisation of power in Poland has become a fact and, not surprisingly, most attention is focused on local development, which is widely recognised as a strategic element of a country's social and economic development. Consequently, there are numerous new challenges that reflect the social expectations of meeting many Western European standards in a short time.

Depending on a researchers' approach or political needs, local development can be seen, both at the central government level and at the local self-government level, in a social, cultural, environmental and/or economic perspective. These needs are reflected in development programmes that are part of the strategy of an individual local authorities. However, the difficult financial situation observed in many municipalities is becoming an increasingly serious barrier to development, including the development of infrastructure, which is necessary for both business and non-profit activities. The present condition of public finance at the local level does not ensure a solid capital and social basis for encouraging economic initiatives. These issues are especially important to organisations and institutions that make an effort to create new jobs and continue structural changes in the municipalities that are open to innovation.

The continuously modified mechanisms of financing local authorities ensure gradually increasing funds, which municipalities have at their disposal. It is commonly believed that this decentralisation of public finance is too slow in giving municipalities financial independence in accordance with the European Charter of Local Self-Government. Although municipalities have the right to fix local tax rates and charges, this does not actually determine their local development. The strategic role and decision-making powers in this field are still vested by the main provider of public finance.

In the present financial and legal situation, central government is obliged to play an active role in supporting local development. The government can adopt two regional policies:

– a policy to support regional development of counties through financing the implementation of projects that have been included in county development strategies and, possibly, in the so-called regional contracts;

– a policy to implement the government's own regional plans through agreeing with the relevant authorities that their regional strategies and contracts should include projects that are important in the light of the country's development priorities and, as such, will be financed totally by the central government administration.

One of the spin-offs produced by the concept of local development (under the provisions of the Regional Development Support Principles Act, 2000) is a contract concluded between the Council of Ministers and county authorities. This contract covers such issues as: the scope of and the procedures and conditions for the performance of tasks resulting from county programmes that have received the support of central government and the tasks that fall under the supervision of competent ministers and are also supported by local authorities. This arrangement puts local authorities in the position of an applicant applying for support from the 'Centre'.

A regional contract is not a business contract in legal terms, but a form of allocating central finance to projects that are, in most cases, within the formal responsibilities of local authorities, but no adequate sources of income generated by local authorities have yet been assigned to the fulfilment of those responsibilities. In this way, local authorities' powers, laid down and referred to in the system statutes, cannot be exercised without financial support from central government. This enables the government to intervene successfully in nearly all development projects that are carried out by county authorities.

For county authorities, a contract with central government should constitute a solid basis for planning the financing of the county development strategy. Therefore, what becomes extremely important in this 'contracting' is the cohesion between the county strategy and individual district and commune development strategies.

In order to be effective, the contracting procedure for negotiating the conditions of co-operation and the financing of regional development calls for action to:

– ensure that municipal and district authorities also have access to grants for long-term development programmes by introducing uniform principles of receiving grants designed to co-finance long-term investment programmes for all local authorities;

– adopt a rule that will give precedence in the allocation of grants for long-term investment programmes to projects that are supported by more than one local authority (regional and interregional contracts);

– define the rules and procedures for allocating earmarked grants designed to co-finance the long-term investment programmes of local authorities;

– define the rules and procedures for claiming any grants that an individual local authority is entitled to under a contract with the central government;

– ensure stable co-financing principles for projects listed in a contract with the government when such a contract covers the long term programmes of local authorities or central government.

Local development will always be a topical issue, as the needs of local communities are continuously growing rather than diminishing. It is reasonable to solve the existing dilemmas at least partially, if not fully, because it will gradually adjust our local communities to European standards.

4. New challenges

1. Self-government finance is a very important strategic element in achieving the growth rate expected both at local and at national level. The financial situation of local authorities should improve in the nearest future to enable them to implement the development plans that have been included in their strategies. A constant concern at each level of self-government should be the systematic growth of the proportion of the income generated by a local authority as a percentage of its total income. The greater the share of such revenue in financing expenditure, the greater the independence and the chances of implementing ambitious development programmes.

2. The Polish system of self-government is only 12 years old. Having developed the key segments of self-government in the Republic of Poland, *i.e.* municipalities, districts and counties, we have to focus on improving them, as well as on co-operation and partnership between them, which is necessary for carrying out EU programmes, and also on ensuring financial independence at all levels of local self-government.

3. Practically, the most difficult issue and greatest challenge for the political elites is to set a constitutional standard for the adequacy of local authority revenue to carry out set tasks.

4. The system of self-government finance has a lot of weaknesses, not only in the opinion of authorities. Therefore, it requires structural changes that should be based upon the following assumptions:

- it is necessary to extend local authority income from taxation and, in particular, increase the proportion of local taxes in the total revenue of district and county authorities;
- local authorities should receive, as a source of income, the revenues of central institutions that perform or finance local tasks;
- earmarked grants, as well as other mechanisms enabling administrative control over the structure of local authorities' expenditure, should be reduced to the lowest possible level.

5. Due to the requirement that projects have to be co-financed, local authorities' ability to use EU funds depends, to a large extent, upon their financial situation. Expanding the possibilities to carry out programmes could ensure co-operation between local authorities and other non-business institutions, such as local agencies, trade unions, non-government organisations, etc.

6. Many achievements of local communities (made in spite of financial difficulties) deserve great respect. All prejudice against local authorities must be eliminated. The distrust which is often created is rooted in the belief that social and economic transition requires a strong, highly

centralised control system to monitor public expenditure at the individual levels of local self-government.

7. The implementation of local development strategies, equal standards of infrastructure in the whole public sector, realisation of the duties of a local authority, both assigned by central government and set by the authority itself, as well as getting closer to the model described in the European Charter of Local Self-Government, are only some of the most important challenges that will require, in the nearest future, a lot of support from local authorities, central government, research centres, institutions, businesses and people who care for local development.

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