

FISCAL DECENTRALIZATION IN THE PUBLIC SECTOR OF LITHUANIA: POSSIBILITIES OF DEVELOPMENT

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Abstract

The article deals with the possibilities to develop fiscal decentralization and the important part - the local tax authority in Lithuania. General principles of tax distribution on the state and local government levels are discussed. The situation in the sphere of the fiscal decentralization in Lithuania and the budget's structure of Lithuanian municipalities from the point of view of fiscal decentralization is analyzed. The analysis showed, that non-tax income, which can be mostly influenced by local governments, comprises, but an insignificant share of all local governments income and its significance is not great. The local taxes do not play an important role in municipal budgets too, because these taxes comprise but a small share of municipal budgets. The volume of state subsidies for budgets of local authorities comprises more than a half of their total revenues. This fact testifies rather a low level of fiscal decentralization in the country. Similar situation is in the level of individual municipalities. The comparative analysis budget structures of the Vilnius and other capitals of Baltic countries showed that situation in Vilnius, Tallinn, Riga municipalities is similar and characterizes by low degree of financial independence of municipalities.

Keywords: *Fiscal decentralization, public sector, Lithuania.*

JEL Codes: *H2, H7*

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1. Introduction

The main principle of democracy - the right of citizens to participate in public affairs - can be most effectively realized by means of local self-government. The self - government means, that local government have the right and ability within statutory limits to run a certain part of public affairs following the interests of local residents, assuming the full responsibility. The significance of independent activities the self-government to modern democracy is also emphasized by the European Charter of Local Self-government (1985), stating that “the institutions of self-government are the basis of any democratic system”. These principles correspond to the modern tendencies in the countries of western democracy that causes processes of decentralization both in the spheres state governance and economies.

Development of local finance of municipalities are one of the major conditions of fiscal decentralization, as well as extension of independence of self-government. Fiscal decentralization - is the process through which specific levels of government decision-making and implementation responsibilities in public finance redistributed to lower levels of government fiscal autonomy upward toward.

In the countries of EU or any other countries of western democracy the institution of local finances is developed enough. In Lithuania this problem is still waiting for the solving. The problems, connected with the local finances, were considered by both foreign, and the Lithuanian scientists, basically in the fiscal decentralization aspect. Between of foreign and Lithuanian authors it is worth mentioning (Astrauskas and Strizkaite, 2003; Baskaran, 2011; Baskaran, Feld, 2013; Beer, 2009; Bird, 1998; Blöchliger, 2013; Chen, Groenewold, 2013; Chu and Zgeng, 2013; Davulis, 2007, 2008, 2009; Gemmell, Kneller, Sant, 2013; Musgrave, 1989; Oates, 1993; Rosen, 1998; Rimas, 2005; Stiglitz, 2000; Staciokas, 2003; Szarowska, 2014), etc. The general problems of fiscal decentralization and state local finances are considered in (Adam, Delis, Kammas, 2014; Aisyah, 2012; Baltuskiene, 2004; Begg, 2009; Bell, Ebel, Kaiser, Rojchaichanthorn, 2007; Buskeviciute, 2008; Daflon, 2002; EOCED, 2013; Gomes , 2012; Grisorio and Prota, 2015; Rimas, 1999).

The article deals with the possibilities to develop fiscal decentralization and the important part - the local finances of municipalities in Lithuania and

analyzes the structure of the Lithuanian municipal budgets in terms of fiscal decentralization.

2. Fiscal decentralization principles

The process of decentralization in the economy of public sector is getting a form of so-called fiscal decentralization, which expresses financial independence and form. Perhaps the most important function of the state public sector, which also includes municipalities, is a provision of public goods to the population. Such activity requires appropriate financial resources, which are provided in the national budget. Fiscal decentralization is perceived as a rising of financial independency of a local government, delimitating the local and central government functions in the public sector of economy and, therefore, allocating financial resources to carry out these functions. The economic justification for such decentralization is an improvement of the efficiency in public sector of economy, decentralizing the economic functions of this sector. A centralized provision of standard goods, regardless of the specifics of individual regions of the country and the variety of the needs of the society groups, determines their inadequacy to the social needs. The decentralization of the public sector promotes economic efficiency, creating favourable conditions to provide such public goods that are mostly appropriate for the consumers (Davulis, 2007, 2008, 2009).

The fiscal decentralization can be implemented in a smaller or larger extent in different countries. In the first case, it is a transfer of financial power to the local institutions, which may be subordinate to the central government completely or only partly, but in both cases accountable to it. In the other case, the decentralization is implemented by transferring the financial management functions to the local government. In the latter case, the local government gets some autonomy, thus becoming accountable not so much to the central government, as far as to the local electors, that is more similar to the principles of European local government (European Charter of Local Self-Government).

The European Charter of local government states that the financial resources of various levels of government have to be proportionate to the Constitution and statutory obligations. Thus, based on the concept of fiscal decentralization, which justifies the separation of the central and local governments, there has to be formed such public financial structure, in which each of state government level would gain adequate revenue resources in order

to perform all the assigned functions. This financial structure usually provides the assignment of taxing sources and financial grants to the local budgets, as well as an ability of local authorities to borrow (Beer-Toth, 2009).

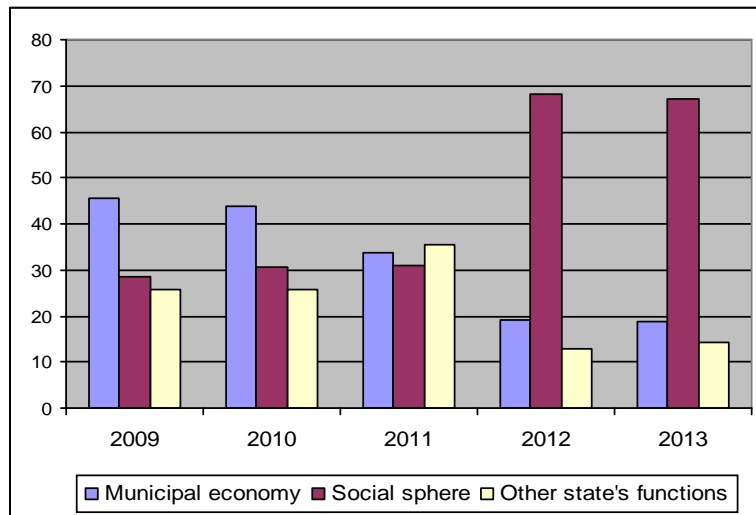
The tax distribution between the central and local levels of government is based on the fact that the provision of all of the major part of taxing powers to the central government is not effective, thus limiting the fiscal autonomy and responsibility of the local government. The European Charter of local government notes that “the local authorities at least a part of financial resources receive from local taxes, which are determined by themselves, following the statute”. On the other hand, the grant of too broad autonomy to the local authorities may be unacceptable from the viewpoint of macroeconomic stability and effective distribution of public resources. These are the main principles, according to which the taxes are divided into state, belonging to the central management level, and local, belonging to the local management level. The latter goes to the local budget. The most proper local taxes are those of which the base is evenly distributed in the country. Otherwise, the taxes are assigned to the states (e.g. taxes for the use of natural resources). It is important, that the local tax rate would be equivalent to the benefits, which are accrued by the local area residents. It is considered that such equivalence motivates taxpayers to pay voluntarily and correctly. Local taxing and maximum rates are usually determined by the central government, but the local authorities have an ability to change the tax rates, not exceeding the determined maximum size (EOCD, 2013).

3. Expenditure and revenue analysis of local authorities budgets in Lithuania

The dynamics of local authorities budget expenditure in the period of 2009 – 2013 according to indicators in shown in Figure 1.

The largest share of municipal financial means is allocated to the municipal economy from 2009 till 2010. During 2012 – 2013 about 60 – 70 % of municipal budget expenditure were allocated for socio-cultural institutions and measures thereof. The biggest share of financial means allotted for the social sphere is allocated for social protection. Less expenditure was allocated for other spheres and municipal economy and its shares in municipal budget are rather constant.

Figure. 1: Expenditures of municipal budget (%) in 2009 – 2013



Source: www.stat.gov.lt

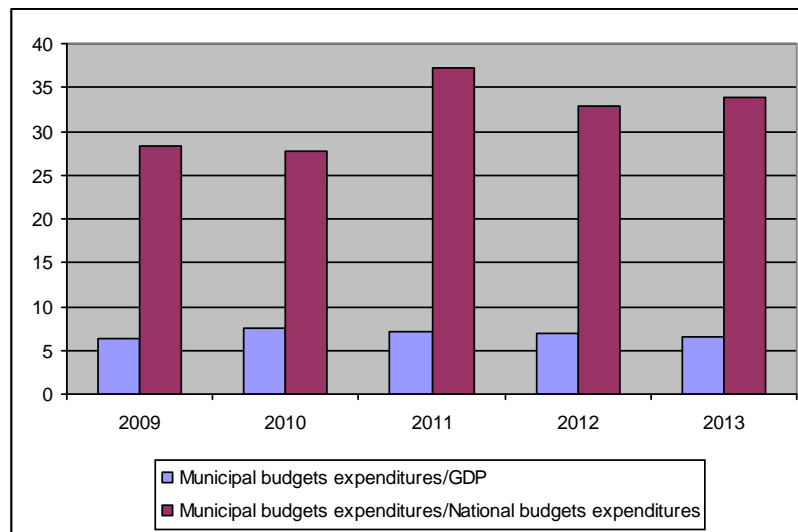
One of the indicators that show the degree of fiscal decentralization is local authorities expenditure in the National budget and in the gross domestic product (GDP) of the country. As the expenditure analysis of municipal budget in Lithuania has shown in Figure 2, local government budget expenditure in the period of 2009 – 2013 comprised comparatively not a small share of national budget expenditure, namely, on the average about 40 %. Indeed, this share was different in different years in 2011 – 2013 the municipal expenditure share in national budget was greatest and amounted up to 30 %, however it was consistently diminishing and in 2009 - 2010, in line with the expenditure plan, it should make up only about 27 %.

Thus, these data testify to sufficient financial independence of local authorities. It would be a mistake, however, to draw a conclusion that Lithuanian local authorities are strong financially and that financial resources are sufficient to perform preassigned function, because in recent years local government budget expenditure compared to GDP have been decreasing and on the average comprise only 10 % of GDP.

Thus, if one estimates the fiscal decentralization degree by the ratio of expenses between local government budgets and National budget, Lithuania can be attributed to considerably decentralized states. However, if we estimate the

ratio of expenditure between local government budgets and GDP, we shall see that, in this respect, a low decentralization degree is characteristics of Lithuania of late.

Figure 2: Proportion of expenditures of municipal budgets with GDP and with expenditures of national budget (%) during 2009 – 2013 in Lithuania.

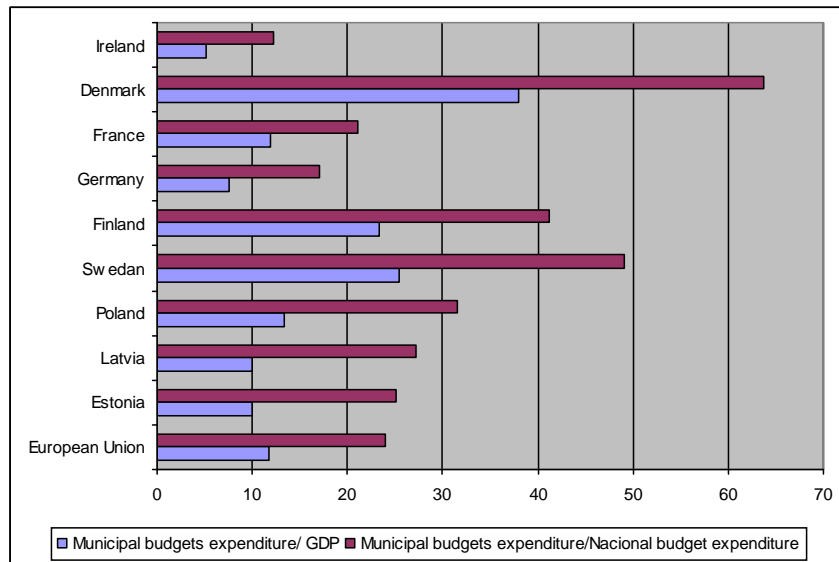


Source: www.stat.gov.lt

As the expenditure analysis of local government budget in Ireland, Denmark, France, Germany, Finland, Sweden, Poland, Latvia, Estonia and EU has shown in Figure 3.

Local government budget expenditure in 2013 comprised comparatively a small share of GDP, namely, on the average about 11,8 % of EU. Indeed, this share was different in different countries, the municipal expenditure share in GDP was greatest and amounted up to 20 % of Denmark, Sweden and Finland, but Baltic countries (Latvia, Lithuania and Estonia), it should make up only about 10 %. The same situation with local government budget expenditure and national budget expenditure - the biggest share is in Denmark Sweden and Finland (more than 40 %).

Figure 3: Proportion of expenditures of municipal budgets with GDP and with expenditures of national budget (%) during 2013 in European countries



Source: Eurostat

The main part of financial resources of local authorities is counted up in their budgets. Legal acts set the following kinds of budgeted receipts for local authorities:

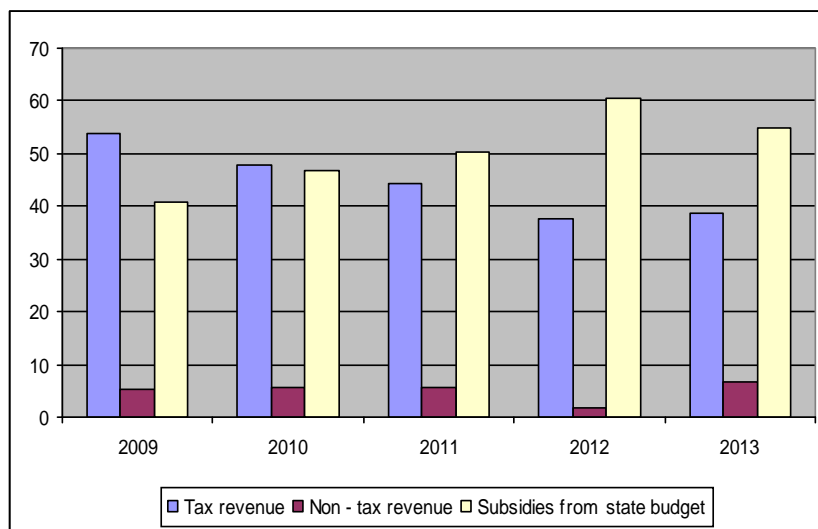
- tax revenue comprised of taxes assigned to local authorities and a part of common taxes set by law,
- non-tax revenue received from the property of a local authority, local charges, fines, and other non-tax sources,
- subsidies and grants of the state budget.

The first two kinds of income can be relatively called as the own income of local authorities. The ratio between the own income of local authority and state subsidies characterizes the independence degree of the local authority. Contrary to foreign countries where the own resources completely depends on the decisions made by local government, Lithuanian local authorities have limited possibilities to control this kind of resources.

All the three kind of income - tax income, non-tax income, and subsidies – in local government budgets have a different comparative weight. Tax income

and subsidies comprise the largest share of municipal budget income. Meanwhile non-tax income, which can be mostly influenced by local authorities, comprises but an insignificant share of all the income of local authorities and its significance is not great. Up till 2010, the largest share of municipal income was comprised of tax income which in 2009 totaled about 53 % of the total budget income of local authorities (Figure 4).

Figure 4: The dynamic of revenues of Lithuanian municipal budgets (%) in 2009 – 2013

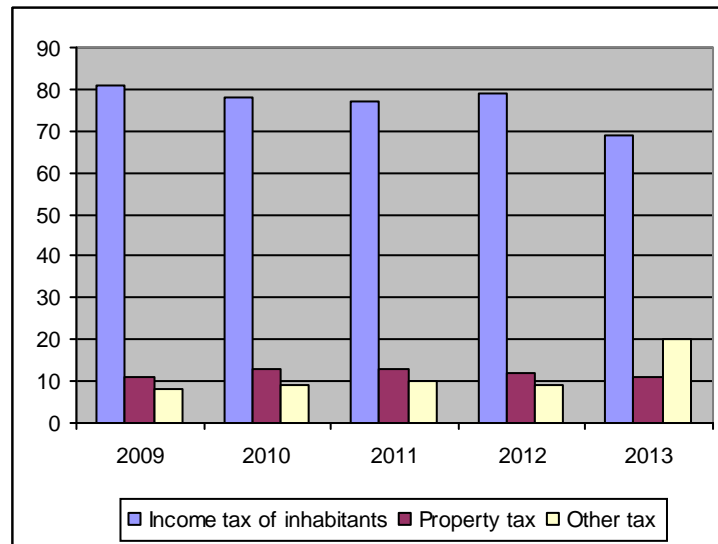


Source: www.stat.gov.lt

Having changed the state policy in the financial sphere and passed the appropriate legal acts, since 2010 the share of tax income in municipal budgets has considerably diminished (up to 10 %), whereas the share of state budget subsidies has grown almost up to 50 % of the total local government income. Since subsidies are related with more rigid obligations of local authorities, we can state that financial independence of local authorities has decreased, and fiscal centralism of the country increased.

The income tax of inhabitants makes up the largest share (over 65 %) of the aggregate tax income of all local government budgets (Figure 5). The other taxes, i.e. local taxes, do not play an important role in municipal budgets, because these taxes comprise but a small share of municipal budgets.

Figure 5: Tax revenues in Lithuanian municipal budgets (%) in 2009 – 2013

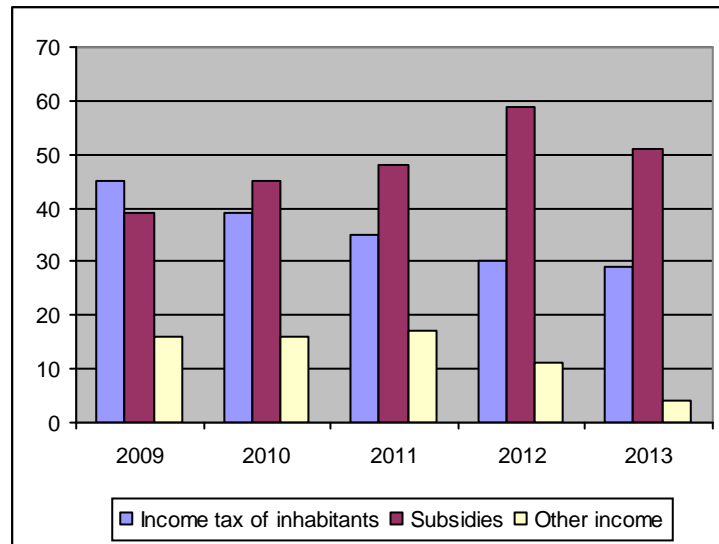


Source: www.stat.gov.lt

Lithuanian municipalities have a greater influence on establishing the amount of local charges. Though according to the law on charges, municipal councils have the right to determine eleven types of local charges, the institute of local charges is poorly developed. Incomes from local charges approximately comprise only 1% of all the municipal budget revenue. In accordance with the Law of charges, the common council has a right to set local charges in its territory for giving permissions.

Thus income tax of inhabitants and subsidies comprise the largest share (over 80 %) of municipal budget income. Meanwhile other income, which can be mostly influenced by local governments, comprises but an insignificant share of all local governments income and its significance is not great. The volume of state subsidies for budgets of local authorities comprises more than 40 % of their total revenues. This fact testifies rather a low level of fiscal decentralization in the country (Figure 6).

Figure 6: The dynamic of revenues of Lithuanian municipal budgets (%) in 2009 – 2013



Source: www.stat.gov.lt

Thus as it is shown in the works (Davulis, 2007, 2008), the degree of financial independence of local governments and level of development of the institution of the local taxes in Lithuania are insufficient and lag behind the European level. So, after integration of Lithuania into the European Union, it is necessary to strengthen and develop the institution of local taxes.

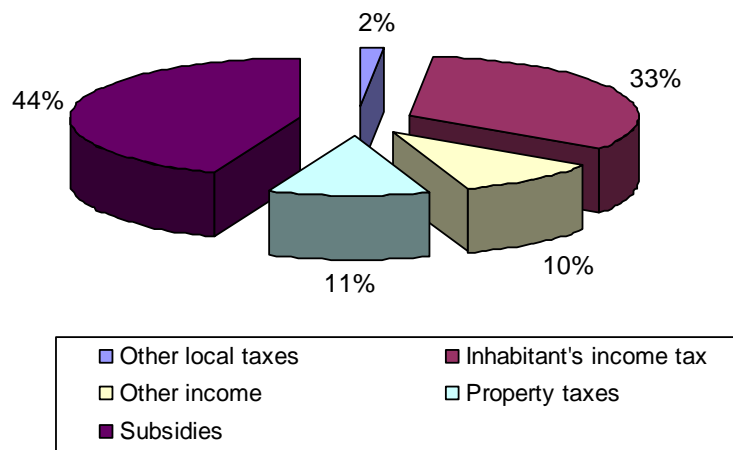
4. The comparative analysis budget structures of the Vilnius city and other capitals of Baltic countries

The budget of the Vilnius municipality is the largest of all the budgets of municipalities in Lithuania, however, in terms of financial independence the situation in this municipality is analogous to other Lithuanian municipalities. Let us analyze the budget structure of the Vilnius municipality and compare it with that of other Baltic countries municipalities – Riga and Tallinn – in terms of fiscal decentralization and local taxes. The statistical data of Vilnius, Riga and Tallinn municipalities are used for the analysis. The degree of financial independence of municipalities is shown by the volume of subsidies from the state budget. The high level of grants in the total income structure means a

relatively lesser financial independence of local governments, because state budget grants are associated with concrete obligations. Structure means a relatively lesser financial independence of local governments, because state budget grants are associated with concrete obligations.

The analysis shows (Figure 7), that both - subsidies of state budget (44 %) and inhabitants' income tax (33 %) make up a considerable share of the Vilnius municipality budget revenues.

Figure 7: Budget revenue structure of the Vilnius municipality in 2013



Source: www.stat.gov.lt

Meanwhile, the non-tax revenue that can be influenced by the municipality at most as well as local taxes (i.e., taxes attributed by laws to local governments) makes up a very small share in the total budget revenues. This fact indicates that financial independence of the Vilnius municipality is rather limited.

We see that subsidies and inhabitants' income tax that cannot be influenced by the municipality make up 77 % of all income of budget. Only 23% of budget revenues can be influenced by the municipality to a larger or smaller extent. The main taxes, attributed to local governments by laws that can be treated as local, included real estate, ground and inherited property taxes as well as the one on state natural resources and environment pollution. The share of all property taxes (real estate, ground, inheritance) in the Vilnius budget 2013

made up 11% of the total budget revenues. Thus the share of all rest local taxes in Vilnius budget in 2013 comprised only 2% of the total budget revenue.

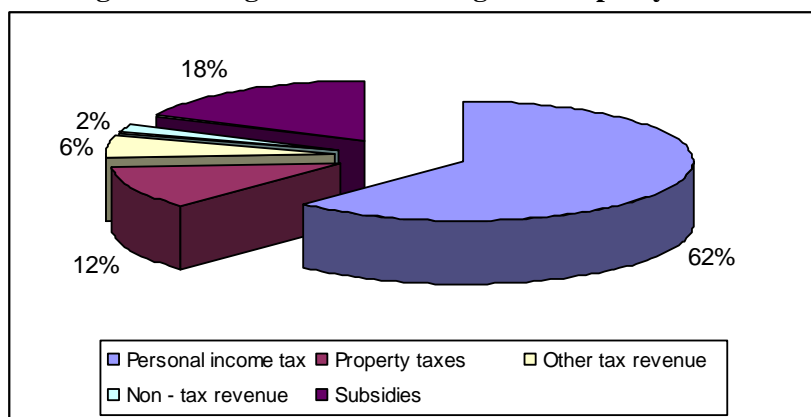
Lithuanian municipalities have a greater influence on establishing the amount of local charges. Though the common council of a local government makes their own decision on local charges and approves the rules, the institution of local charges is poorly developed in Lithuania. Income of Vilnius municipality from local charges constantly grow, however, their share in budget revenue does not exceed 2%. Thus, this income plays an insignificant role in increasing financial independence of Vilnius municipality.

The following financial resources comprise budget revenues of Riga municipality:

- personal income tax;
- property tax;
- other tax revenue;
- non – tax revenue;
- subsidies.

As it can be seen in Figure 8, the personal income tax and property tax made up the largest share, - more than 70 % of the total budget revenues of Riga in 2013. Subsidies make up not a small – about 18 % of the total budget revenue of Riga. And non – tax revenue makes up a small share of income, - only 2 % of the local budget revenues.

Figure 8: Budget structure of Riga municipality in 2013



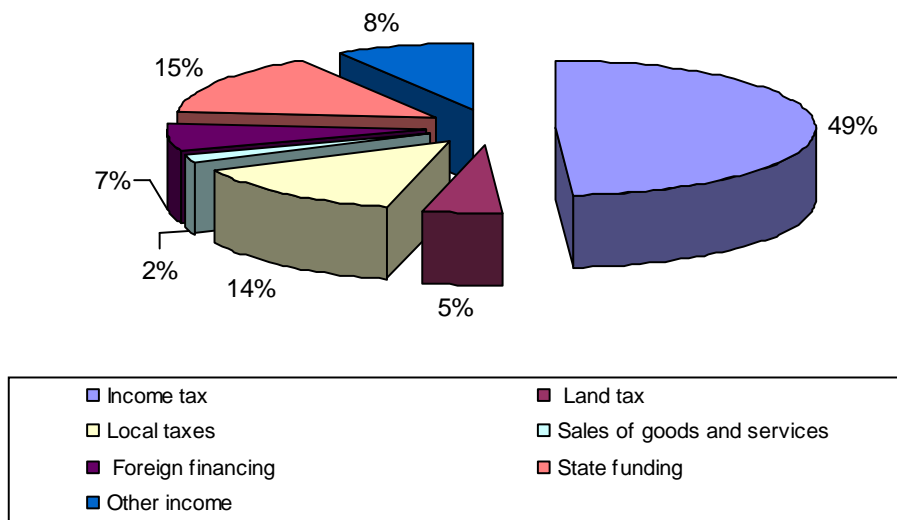
Source: www.riga.lv

Tallinn's city budget is another budget, which will be comparing with Vilnius city budget. The following financial resources comprise budget revenues of Tallinn municipality:

- income tax;
- land tax;
- local tax;
- subsidies;
- other income.

As it can be seen in Figure 9, more than half of Tallinn budget revenue comes from tax revenues (about 68 %.), of which the importance of income tax is 49 % of the total budget revenue. And only 14 % comes from local tax. Subsidies make up not a small – about 15 % of the total budget revenue of Tallinn in 2013.

Figure 9: Budget structure of Tallinn municipality in 2013



Source: www.tallinn.ee

Consequently, the financial independence of the Riga, Dublin and Tallinn municipality are similar like a Vilnius city.

5. Opportunities to develop the institution of the local taxes in Lithuania

As it has been shown in the modern democratic countries the institute of local taxes is developed enough. Local taxes in the budgets of local government of foreign countries make up a significant part of income, and taxes are legalized by the laws. Meanwhile in the laws of Lithuania there is no definition of the concept of local taxes. On the other hand, a certain part of tax income is assigned to local budgets by the laws of the Republic of Lithuanian and other legal acts. The taxes assigned to local governments (with exception the income of inhabitants tax) can be treated as local in the some sense, but the rights of the self-government to influence their amounts are not great.

We think that strengthening of the institution of local taxes needs to be started from the legalization of local taxes, passing the corresponding law. Today there are all conditions for the property tax to become basic local tax in Lithuania (including the ground). As it has been shown by expert, the taxation of the real estate of the inhabitants used only for business had no big influence. Therefore it is necessary to expand the base of taxes and to change the tariffs. To this end, it is necessary to charge all the property belonging, both to legal, and natural persons under the property right. On the other hand, it is necessary to determine the maximum ceiling of nontaxable property in order that inhabitants having the small or average property could avoid the tax. With the growth of the living level, this ceiling could be reduced. The value of property, exceeding the nontaxable amount, is taxed by decision of the council of the local government. As local taxes it would be expedient to introduce taxes on property of juridical persons and luxury property of inhabitants as local taxes. Realization of these proposals would not refer to the majority of inhabitants, but it would have a positive effect on the income of budgets of local governments. On the other hand, these means would also have a positive side effect – they would help to settle the market of the real estate that today is obviously distorted in Lithuania.

In the light of experience of the countries of modern democracy, it would be expedient to treat a part of the inhabitants' income tax, transferable to the budgets of local governments as a local tax with the established the right of the local government to change the tariffs within the limits set by laws. Since the part of the inhabitants' income tax, transferable to the local government, makes

up a significant part of income of their budgets, such local taxes would essentially expand the financial independence of the local governments.

6. Conclusion and Recommendations

The analysis budget structures in Lithuanian municipalities showed that subsidies and inhabitants' income tax, which can be treated as state subsidies of a special kind, comprise the largest share of municipal budget income. Meanwhile the other taxes and non-tax income, which can be mostly influenced by local governments, comprises but an insignificant share of all local governments income. Similar situation is in the level of individual municipalities. The comparative analysis budget structures of the Vilnius and other capitals of Baltic countries showed that situation in Vilnius, Riga and Tallinn municipalities is similar and characterizes by low degree of financial independence of municipalities.

Thus being integrated into the European Union further Lithuania should develop the institute of local taxes as one of the major elements of fiscal decentralization. We propose such means to develop the institute of local taxes in Lithuania: legalization of local taxes by means of the corresponding law, legalization of the real estate tax as the main local tax expanding its base and the rights of the local government to set its tariff in greater limits, introduction of the part of the inhabitants' income tax into local budgets as a local tax, authorizing local governments to set its own tariffs within the statutory limits, legalization of new local taxes, for example, the taxes on property of legal persons and on luxury property of natural persons, as well as the tax on the means of transport that would make a useful by-effect, apart from fiscal effect.

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