

**42nd Congress of the European Regional Science Association**  
**"From Industry to Advanced Services -**  
**Perspectives of European Metropolitan Regions"**  
**Dortmund 2002**

**Fiscal federalism in the Baltic countries**

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**Abstract**

In the democratic societies local government handles many functions typical of the welfare states. In the Baltic countries new public institutions and economic infrastructure are being created to establish the foundations for a pluralist and democratic society. Extensive political and fiscal decentralization of local governments is now under way in all these states as a reaction to the overcentralization during the Soviet past. Today main problems in all three Baltic countries is that many local governments are limited with financial resources, their administrative capacity is often inadequate and activities restricted by the central authorities. Therefore, the most important goal of the fiscal reforms is to enhance the administrative capacity of different level of governments, democratization of decision making process and giving public spending programs the required transparency.

The main purpose of the article is to describe the design of fiscal systems and intergovernmental fiscal relations in the Baltic countries; profile of sub-national revenues and expenditures, particularly grant systems.

## Introduction

Definition of fiscal federalism by a regular textbook is specified as division of economic responsibilities between different levels of government. Like other post communist countries, Baltic States inherited from the past extremely centralized administrative system<sup>1</sup>. After excessive centralization there emerged clear pressure to decentralize and devolve a number of expenditure functions and revenue sources to lower levels of subgovernment. The democratization process logically led to increasing subnational governments, in fiscal activities particularly. The delegation of fiscal responsibilities to subnational levels of government is likely to increase efficiency in service delivery, reduce information and transaction costs associated with the provision of public goods and services and enlarge municipalities tax autonomy.

In Baltic countries, the euphoria of (re)establishing new local administrative units in early 90-ies was soon after followed by serious problems. Underprovisions of many public services, growing disparities in standards among municipalities, unbalanced regional growth, social degradation in the low-income areas are just few most striking outcomes. Common understanding prevails that municipalities fiscal capacity is not adequate to act in accordance with function stipulated by laws. Municipalities' fiscal autonomy is still limited and varies regionally very noticeably.

Considering that, this paper focuses on fiscal situation description in Baltic countries during the last decade. Our main interest is to analyze local municipalities revenue level and structure, expenditure composition and fiscal autonomy conditions. Particularly is considered government grants-in-aid systems.

As potential members of European Union, Baltic countries have to follow ideas of European Charter of Local Self-Government. Its article 9 states visibly: "Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law" (European Charter of Self-Governments).

Often subgovernments' revenues from its own taxes and user-charges are insufficient to finance efficient level of their expenditures. Theoretically, in a system of multi-level on governments, budgetary balance (inclusive of any debt issues) is not required at each level or unit of government. Revenues at one level of government, for example, can fall

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<sup>1</sup> Estonia, Latvia and Lithuania

short of spending, if the difference is made up intergovernmental transfers from other level of governments. This provides underlying principle for central government to issue grants to local authorities with respect to such services.

In reality, central governments may also issue grants for reasons other than allocative efficiency, most notably equity. The European Charter of Local Self-Government supports the idea: “The protection of financially weaker local authorities calls for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of unequal distribution of potential sources of finance and of the financial burden they must support” (European Charter of Self-Governments).

Central government may wish to restrain the level of local taxes, it may support local public services, especially benefiting low-income groups or compensating local authorities relatively high expenditure needs per capita (Bailey).

In terminological aspects the author uses the terms ‘subnational governments’, ‘local governments’, ‘municipalities’ and ‘local communities’ as synonymous. For the description of particular details in fiscal situation are mainly used OECD Country Reports ” Fiscal Design Across Levels of Government 2000” for Baltic countries.

## **I Local governments’ revenue and expenditure**

### **1.1 Administration division and size**

Baltic countries are often considered as one area with similar economic situation, with common political and social values. As geographically and historically closely related, (particularly during the Soviet past), the development of the societies of all three nations is analogous and have a lot in common. But there are as well remarkable differences in many aspects of local administrative system and finance.

In all three Baltic countries after regaining independence the local administrative units have followed bath to democratization and became real representatives for local inhabitants. But there are obvious limitations in their fiscal capacity and accordingly fulfilling functions put on them.

First, during the period after regaining independence in early 90-es, in the developing of new administrative systems, main emphasizes was put to restoring the historical situation before the World War II. The mixture of nostalgia to the past and economic

naiveness led to the (re)establishing of numerous low populated and fiscally weak municipalities, particularly in Estonia and Latvia. As a result, municipalities revenue base is often very limited and therefore their fiscal capacity extremely weak. Despite there is wide consensus on the importance of improving municipalities' fiscal capacity, however limited progress has been made implementing the local government reform agenda.

Second, subgovernments fiscal situation differ regionally very significantly. Such disparities lead to municipalities' competition problem and cause "Tiebout economy" like movements. Tiebout argued that individuals choose to live in the local community whose provision of local public goods and tax levels best satisfies their preferences (Tiebout). In the Baltic countries this practice means discarded population migration flows with economic activities concentration to capital city areas and continuous impoverishing of rural areas.

Third, fiscal relations between the central government and local municipalities are far from optimal and efficient. There is a clear mismatch in Estonia and Latvia between local expenditures and the corresponding revenues. The adequate funds and grant-in aid provisions do not often cover municipalities' tasks.

Fourth, municipalities elected councils and their local administrators still lack of experience on fiscal administration and budget management. Their administrative capacity is often limited; their political and fiscal dependency from the central government remains still high.

In following Table 1, the Baltic countries administrative division in 1999 is described. The number of subgovernments changes periodically due to continuous administrative territorial reform.

<b>Table 1. Administrative division of Baltic countries, 1999</b>			
	Estonia	Latvia	Lithuania
Rural authorities	205*	472*	60
Towns	42*	73* + 7 big cities	
Regional government (county)	15	26	10
Total number of subgovernments	247	578	60
*Same administrative status			
Source: Fiscal Design Across levels of Governments: OECD Country Reports, 2001			

As the table shows, there is much bigger number of municipalities in Estonia and Latvia compared to Lithuania due to differences in local administrative reform processes.

Estonia and Latvia instead of using the old Soviet administrative system with big rayons and towns quickly established an impressive number of local municipalities, whereas in Lithuania the process was slower and the number of subgovernments is growing gradually.

Rural authorities and towns governments in the Baltic countries are local administrative bodies to which representatives are elected by citizens (residents) and they fulfill the functions delegated to them by laws. Considering democratic principles, local governments initiate other activities in the interest of inhabitants and in accordance with country's laws and their financial capability.

Regional (county) government representatives are appointed by the central governments and approved by local municipalities elected bodies within their jurisdictions. County governments carry out mainly general regional tasks and implement state policy in the spheres of social maintenance, education, culture and health. In Latvia a regional government is formed by elected mayors from local authorities and its functions are wider than in its other Baltic neighbors.

In following Table 2 subnational governments are distributed by their composition by size and proportion of the whole population in municipalities within the population range.

**Table 2. Baltic countries municipalities composition by population size, 1999**

Number of inhabitants	Estonia		Latvia		Lithuania	
	Municipalities proportion by population size	Population proportion within population range	Municipalities proportion by population size	Population proportion within population range	Municipalities proportion by population size	Number of inhabitants
Less 999	10%	1%	32%	6%		
1,000-1,999	39%	10%	39%	13%		
2,000-4,999	36%	19%	20%	13%		
5,000-9 999	9%	10%	4%	7%	0.3%	Less 10,000
10,000-49,999	4%	12%	4%	15%	7%	10,000-30,000
50,000-99,999	1%	12%	1%	9%	28%	50,000-100,000
More 100,000	1%	36%	0.4%	37%	8%	100,000-200,000
					32%	More 200,000
Capital city and population*	Tallinn (411,000)		Riga (764,000)		Vilnius (554,000)	
Total population*	1,445,000		2,397,000		3,542,000	
* Statistical Offices in relevant countries, rounded						
Source: Fiscal Design Across levels of Governments:OECD Country Reports and author's calculations						

In Estonia and Latvia the majority of municipalities are relatively small by population, there 85% and 91% of municipalities respectively have less than 5,000 inhabitants. Lithuanian municipalities are clearly bigger by population, for example only 7% of communities have population less than 10 thousand inhabitants.

As was said earlier, local administrative reform in the Baltic countries proceeded differently. In Lithuania the number of municipalities still remains limited and will grow consolidated up to 93 in 2003 (Fiscal Design Across Levels of Government: Lithuania).

As later will be demonstrated, big number of low population municipalities increases need for grant-in-aid from central government to keep up their revenue level. Otherwise, municipalities that are large by population and territory, carry a risk that there exists a discrepancy between interests of local population and elected by them sub government.

Another apparent difference from Lithuania is that in Estonian and Latvian population is concentrated to big (capital) cities as show population proportion within population range. In addition, during economic and social restructuring large centres in Baltic countries have developed faster than mainly rural areas. As expected, their inhabitants have higher income level that transfers to solid tax base for municipalities. High incomes attract new settlers from poorer regions, which weakens the low-income areas even more. In the result, the disparities on revenue basis between capital areas and particularly low-density rural municipalities became extremely wide (Raus).

## **1.2. Municipalities revenue composition**

In following Table 3 data of revenue composition and fiscal autonomy ratios of local municipalities in Baltic countries is given. Separately is presented central and local governments' data and share of local governments in total consolidated budgets<sup>2</sup>.

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<sup>2</sup> Consolidated budget includes different type of governments budgets and centrally established social funds

**Table 3. Baltic countries municipalities revenue structure, 1999, million**

	Estonia				Latvia				Lithuania			
	CG	LG	LG revenue composition	LG on consolidated budget	CG	LG	LG revenue composition	LG on consolidated budget	CG	LG	LG revenue composition	LG on consolidated budget
No of column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
<b>Tax revenue</b>	<b>13,712</b>	<b>4,037</b>	<b>68%</b>	<b>16%</b>	<b>662</b>	<b>222</b>	<b>61%</b>	<b>17%</b>	<b>6,009</b>	<b>2,823</b>	<b>91%</b>	<b>22%</b>
Income, profit, capital gains	4,509	3,661	62%	45%	161	171	47%	52%	361	2,576	83%	65%
Property		347	5%	100%	1	47	13%	99%		247	8%	100%
Taxes on goods and services	9,203	29	0%	0%	484	4	1%	1%	5,434		0%	0%
<b>Non-tax revenue</b>	<b>1,135</b>	<b>538</b>	<b>9%</b>	<b>32%</b>	<b>148</b>	<b>72</b>	<b>20%</b>	<b>32%</b>	<b>587</b>	<b>150</b>	<b>5%</b>	<b>20%</b>
Operating surplus	279	215	4%	44%	20	0	0%	2%	329	12	0%	3%
Fees, fines	856	312	5%	26%	106	28	8%	21%	231	129	4%	35%
Other		11	0%	37%	23	44	12%	61%	27	9	0%	23%
<b>Grants</b>		<b>1,328</b>	<b>22%</b>	<b>100%</b>		<b>71</b>	<b>20%</b>	<b>100%</b>		<b>128</b>	<b>4%</b>	<b>100%</b>
<b>Total revenue</b>	<b>148,747</b>	<b>5,903</b>	<b>100%</b>	<b>22%</b>		<b>365</b>	<b>100%</b>	<b>24%</b>	<b>6,596</b>	<b>3,102</b>	<b>100%</b>	<b>23%</b>
<b>Sub-national tax revenue as % of total tax revenue</b>		<b>16%</b>				<b>17%</b>				<b>22%</b>		

Code: LG – local government; CG- central government

Source: Fiscal Design Across levels of Governments: OECD Country Reports and author's calculations

Subnational governments receive majority of revenues from taxes, there revenue from the income tax is the biggest (column 3, 7 and 11). In Lithuania the tax revenue is high as 91% of total revenues. Share of local governments' tax revenues in their total revenues is also named as tax autonomy level. In Estonia and Latvia personal income tax is centrally established, well collected and eventually shared between central and local governments. For that reason income from personal tax indicates tax autonomy level only partially. In Lithuania the personal income tax is totally collected by local municipalities.

There are no local taxes established in Latvia. In Estonia, despite the 9 different local taxes, their sum in municipalities' total revenues is insignificant.

Another main tax in revenues is property tax, mainly land tax, with the highest share in Latvia (13%). Land reform still continues in the Baltic countries, thus land market is clearly underdeveloped and there is difficult to establish foundation for taxation. Mostly often the land is undervalued and in addition, municipalities elected bodies are not enthusiastic to impose taxes which burden lays on their direct electorate. Municipalities' non-tax revenues consist incomes from their economic activities, fees, fines and user charges. Those incomes cover less than fifth of all revenues in Latvia and only 5% in Lithuania. In Estonia and Latvia local municipalities receive substantial part of their incomes in form of grants from central government or special equalization funds. Share of transfers and grants from the central budget in local governments' total revenues often described also as a vertical imbalance or mismatch between municipalities own revenues and relevant expenditures. Such a vertical imbalance is highest in Estonia and very low in Lithuania.

Grants-in-aid serve for equalization in per capita revenues among municipalities and maintain necessary expenditures, but it increases municipalities' political dependency from central authorities and support funds size. Similar to world practice, the grant transfer schemes are criticized in Estonia and Latvia because that equalization adversely affects localities' effort to collect own (tax)revenues. Otherwise, with limited fiscal capacity fiscal decentralization is unlikely to foster municipalities' competition to raise revenue by means of more grants and transfers from the central government. In more detail the grants systems will be considered below.

Columns 4, 8 and 12 in Table 3 show the local governments share in consolidated budgets. Baltic countries municipalities share of total revenues varies. Local governments are collecting 22% of all taxes in Lithuania and 32% of non-tax revenues in Estonia.

### **1.3 Municipalities expenditures**

What are the municipalities' functions and composition of expenditures? In Table 4 Baltic municipalities' expenditure level, structure and share in total consolidated budget is given.

Budget structure in general indicates municipalities' tasks and obligations, put on them by law and most of expenditures are common for all three Baltic countries.

As Table 4 indicates, expenditures structure varies by the countries. The biggest expenditure in all three countries belong to education, which covers from 41% Estonia up to 56% in Lithuania municipalities budgets' cost. Municipalities' educational expenditures in Estonia will grow significantly in 2001 when sums for schoolteacher's salaries are transferred from central budget to local ones. All other expenditures cover much smaller proportion in total revenues.

General public services have bigger proportion in Estonia and Latvia than in Lithuania. The reason is that such expenditure includes also administrative cost, which is proportionally higher if the municipalities' budget size is small as it is in low population subgovernments in Estonia and Latvia. Therefore the decreasing expenditures for administrative purposes are strong argument in these countries for municipalities' consolidation.



**Table 4. Baltic countries local governments' expenditures and structure, 1999, million**

Expenditure	Estonia			Latvia			Lithuania		
	LG expenditure, EEK	Expenditure structure	LG share on consolidated budget	LG expenditure, LVL	Expenditure structure	LG share on consolidated budget	LG expenditure, LTL	Expenditure structure	LG share on consolidated budget
General Public Services	725	14%	38%	41	13%	38%	125	5%	21%
Public order and safety	19	0.4%	1%	6	2%	6%	21	1%	3%
Education	2,191	41%	49%	154	50%	65%	1,510	56%	68%
Health	66	1%	2%	4	1%	2%	13	0%	1%
Social Security & Welfare	672	13%	7%	25	8%	4%	432	16%	9%
Housing	556	10%	98%	36	12%	79%	213	8%	100%
Recreational, cultural and religious affair	485	9%	41%	18	6%	43%	133	5%	36%
Fuel and services	52	1%	100%	0	0%	50%	85	3%	94%
Agriculture and Forestry	4	0.1%	1%	0	0%	1%	0	0%	0%
Transportation	295	5%	18%	13	4%	18%	92	3%	15%
Other economic affairs	91	2%	39%	1	0%	4%	1	0%	2%
Other functions	207	4%	27%	14	4%	29%	59	2%	6%
<b>Total</b>	<b>5,364</b>	<b>100%</b>	<b>20%</b>	<b>310</b>	<b>100%</b>	<b>21%</b>	<b>2,682</b>	<b>100%</b>	<b>21%</b>

Code: LG – local government

Source: Fiscal Design Across Levels of Government: OECD Country Reports and author's calculations



## **II Grants in the Baltic countries**

### **2.1 Grants in general**

In everyday practice most developed countries have implemented at least some supporting mechanisms for subnational governments, mainly in form of grants. Intergovernmental grants are used by central government as a measure to expand services, to equalize municipalities' incomes and make greater use of central government tax base by the subnational governments.

Theoretical aspects of grant transfers are extensively provided in economic literature (Oates). The approach to grant payments varies from "how much money is thrown for incapable municipalities" to "unconditional support of every single community".

In general, there are economic, political and institutional reasons for grants. The first rationale justifies the benefit spillover aspect. The general idea is that not all of the benefits of a local expenditure are captured within the community and therefore central government acting as agent for other communities in carrying out specified tasks.

A second justification for grants considers in a simple way redistribution of income (Gramlich). Supporting low income communities allow provision of education, health, public safety and other services on the same level or cost as in richer communities. Intergovernmental grants support low-income municipalities because their revenue bases are limited. Often the regional income varieties are discussed, the measures for equalizing are considered narrowly as part of regional policy programs. In practice, as precisely mentioned by researchers, transfers to local municipalities are powerful instrument for motivating local economies (Mønnesland). For example, total grants size to Estonian municipalities exceeds more than 10 times funds within regional policy allocated to the local municipalities (Estonian Ministry of Internal Affairs).

### **2.2 Latvia**

Latvia is dominated by municipalities with extended territories, but often with small number of inhabitants on them and accordingly with weak financial revenue base.

During the administrative reforms, functions have been added to the rural district and town municipalities as their independence and responsibility increased. But the problem is that increased number of tasks is not packed with sufficient financial resources and

municipalities' decision-making power is still limited. As a result, financially weaker and less populated municipalities often cannot efficiently execute their functions. At the same time, local municipalities deputies and officials perceive any efforts to consolidate subgovernments as a pressure from the central authorities and are against the amalgamation of municipal territories (Fiscal Design Across Levels of Government: Latvia).

Tax system is totally centralized and there are no local taxes in Latvia. Therefore municipalities cannot impose local taxes, set tax rates or give tax exemptions, with few exception of real estate tax. All taxes are set by the central government despite some of the taxes are allocated directly to local governments' budgets.

The revenue of local governments is generated from the shared state taxes on personal income and real estate, respectively 71.6% and 100% from total collection of those taxes. In addition, municipalities receive fines and duties and service fees. The local government has very limited possibilities for adjusting revenues to meet expenditure needs by increasing own revenue collection. Similarly with Estonia, local governments' revenue basis in Latvia has significant differences by regions. Some local authorities, particularly closer to capital city area, have up to 10% more tax revenue per capita than others.

To support weaker municipalities and equalize revenue base, there is grant-in-aid system in Latvia. Also, for specific purposes, the central government transfers earmarked grants for municipalities to extend provision of public services or carry on specific tasks assigned to them under the laws. Those earmarked grants cover salaries of teachers; supporting special schools; salaries of cultural workers; investments; supporting implementation of development plans. Grants size for subnational governments in Latvia is given in Table 5.

Year	Specific Grant		General grant	
	Standard Cost	Actual cost	Without own tax effort	With own tax effort
1999	65.4	0	5.8	0

Source: Fiscal Design Across Levels of Government: OECD Country Report, Latvia

Table 5 indicates, that majority of grants from the central government are transferred as specific grants and general grants size is significantly smaller.

In addition, municipalities receive general grants from local government equalization fund. Such a system of redistribution of incomes is typical for Nordic countries, but not for other Baltic states (Söderström). The equalization fund revenues accumulated from local government contributions. In 1999 the equalization fund was 30.1 million lats, of them 80% were local governments donations. The amount of the donations to be paid to the equalization fund is calculated as difference between the sums to be paid from the equalization fund and actual contributions paid to the fund by local governments. The local authorities with higher revenues than 10% more than calculated expenditure needs, contribute to the fund 45% of that surplus. The local municipalities with a revenue below 90% calculated expenditure level receive a grants from equalization fund to bring them up to given standards of revenue and accordingly as well expenditure.

In general, grant aid system definitely supports revenue base equalization among Latvian municipalities. The system secures predictable transfers and municipalities can plan their financial activities for longer periods. In opposite, redistribution of incomes among municipalities might lessen the incentive to increase their own revenue level and efficiency of expenditures.

### **2.3. Lithuania**

As described earlier, there are much less administrative units of subgovernments in Lithuania than its Baltic neighbors have; municipalities are bigger by population and financially less dependent from the central government.

By law, state supports local government independence and self-governance. Municipalities have the right to approve their own budgets, establish local duties and taxes, freely and independently regulate and manage public affairs to meet the needs of local residents according to laws.

Majority of Lithuanian municipalities revenues come from taxes, which cover more than 91% of municipalities' incomes as presented in Table 3. The biggest tax revenues come from natural persons income tax (after 30% deduction for the Health Insurance Fund) and profits tax. Differently from other Baltic countries, income tax is solely revenue for local municipalities and not shared with the central government. Taxes on property include land tax and real estate taxes, imposed on undertakings and organizations.

In addition to ones own revenues, municipalities receive support from central government in form of different grants which allocation is presented in Table 6. The amount of general grants is based on standardized expenditure volume of municipalities and their own revenue collection accordingly.

Year	Specific Grant		General grant		Total
	Standard Cost	Actual cost	Without own tax effort	With own tax effort	
1997	485.9	39.5	327.2	852.6	1,705.2
1999	16.3	41.8	70.3	128.4	256.8

Source: Fiscal Design Across Levels of Government: OECD Country Report, Lithuania

Majority of grants Lithuanian municipalities receive as general grants what is apparent difference from other Baltic countries where the specific grant payments are prevailing.

The total grants size has decreased during the period 1997-1999 more than 6 times. Municipalities revenues have been increased more than municipalities' expenditures, therefore the amount of general grants has decreased accordingly. In addition, the decrease of specific grants is the result of Lithuanian central government policy to cut such a grant payments.

#### **2.4. Estonia**

In Estonia the local municipalities fiscal situation is rather similar to Latvian conditions. There are relatively big number of low populated municipalities and extreme (regional) differences among them in revenue basis per head of population.

Table 7 gives more detailed overview of Estonian local municipalities revenue level and structure in 2001.

**Table 7. Estonian local municipalities revenue (total), 2001, thousand**

Revenues	EEK	Structure of revenues
Taxes	4,414,722	40.4%
Personal income tax	3,942,133	36.1%
Land tax	397,451	3.6%
Other local taxes	74,715	0.7%
Income from assets	1,619,112	14.8%
Revenue from economic activities	323,955	3.0%
Transactions and grants	3,515,864	32.2%
General grants or support fund	951,802	8.7%
Specified grants for education	1,397,438	12.8%
Loans	738,016	6.8%
Other	321,268	2.9%
<b>Total revenues</b>	<b>10,932,938</b>	<b>100.0%</b>

Source: Ministry of Finance of Estonia

Municipalities receive majority of their incomes from taxes (40.4%) and other internal sources as financial and asset income, revenue from the economic activity and other (17.8%). About 90% of the tax revenues the governments receive from personal income taxes. That tax is collected by the central government and shared afterwards with local governments on proportion 44% and 56% accordingly.

Land tax is established by central government but transferred directly to local municipalities budgets. Local municipalities have right to establish tax rates within the limits, which are set by the central government.

As the table 7 shows, municipalities' revenue from local taxes revenue is extremely low, despite the fact that there are several local taxes. In reality, such taxes do not play any significant role in generating local income because municipalities express a little incentive to collect them. Only to give some reasons behind that – often-local tax basis is extremely limited, local taxes are difficult to administer, tax revenues is hard to forecast and imposing local taxes is unpopular (Fiscal Design Across Levels of Government: Estonia).

Transactions and grants constitute also important source of revenues for Estonian subnational governments. As in other Baltic countries, these transfers are specified or general-purpose grants. The municipalities can fulfill specific tasks with specified

grants like support education, culture activities or healthcare<sup>3</sup>. These funds are transferred to local communities accounts as transfers from ministries and their use is exactly defined. The biggest part of transfers from ministries comes for social benefits payments and expenditures for education.

General grants purpose is to equalize revenue level and support poorer municipalities to finance their spending to reduce regional disparities in public sector provision. These transfers and grants also vary significantly across municipalities, depending on subgovernments' revenue-mobilization capacity. In many cases, local governments tax base is very narrow and municipalities are often unable to mobilize resources locally to finance spending in their jurisdictions.

“Modern type of grants” history in Estonia began in 1993, when to the central budget records was added “Local Budget Support Fund” – funds relocation from central budget to local ones. Overview of grants transferred to Estonian municipalities on the selected years on Table 8.

	<b>2001</b>	<b>2000</b>	<b>1996</b>
Total transactions and grants	3,515,864	1,778,695	3,399,205
General grants (“Support fund”)	951,802	866,500	729,327
Educational expenditure*	1,397,438	-	-
Shared income taxes	-	-	2,404,059
Total local budget revenues	10,932,938	7,857,804	5,048,309
Total grants in revenues	32%	22%	67%
General grants in total revenues	27%	49%	21%

Source: Ministry of Finance of Estonia and authors calculations

As the table shows the nominal sum of the general transfers has fluctuated during the period significantly due to grants including different elements . In 1996 total grants exceeded 67% of all revenues, during following years their share stabilized between 22-25% of total revenues. In 2001 share of grants again sharply increased to compare with previous year then the amount of total grants doubled due to including major part of educational expenditures from central to local budgets. Amount of teachers' salaries

<sup>3</sup> In 2001 different specific grants include subsidies for local transport, maintenance of elderly homes, food provision in schools and other functions.

was then transferred from central to local municipalities accounts and indicated as specific grants.

The total size of the support fund is determined annually as an agreement between representatives of local authorities and central government and receives a power as part of central budget. In principle, the amount of support fund should reflect the resources deficit by local governments to fulfill the functions obligatory on them. The purpose is that the differences in revenues should be at least 90% of the municipalities' average level.

Estonia is not using any redistribution systems among municipalities like in Latvia, so there is no explicit competition and conflict of interests among municipalities.

In practice, general grants definitely have supported municipalities' revenue base and expenditure equalization per capita. Despite that, significant and persistent disparities on municipalities tax basis remains and there are evidence that grants have supported sustainable growth in own revenue base in weaker municipalities (Trasberg).

Estonian subnational governments as a whole are small, except the capital city of Tallinn. In accordance, subgovernment revenue and tax collecting abilities are often very limited in many cases to take an advantage even from their bigger fiscal autonomy. As similar to Latvia, Estonian territorial-administrative reform is obliged to optimize the size of municipalities and their functions to meet public requirements within their jurisdictions.

## **Conclusions**

In all three Baltic countries a new administrative system is being developed to establish the foundations for pluralist and democratic society. Despite the similarities in their social and economic structure, municipalities' fiscal situation and tax autonomy level differs significantly in those countries.

One of the main problems in Estonia and Latvia is a big number of low populated municipalities, which leads to their inadequate (tax) revenue capacity. In addition, municipalities' revenue level per capita varies extremely by different regions. Eventually, municipalities are considerably dependent from central government grants-in-aid and equalization schemes, which afterwards limits their fiscal autonomy.

Lithuanian municipalities are less dependent from grants from central governments due to larger population and bigger tax capacity in their jurisdictions.

Despite that the grants help to finance municipalities' activities, their size is often difficult to predict and grants allocation may support inefficient expenditures.

Therefore, the most important goal of administrative territorial reform is to enhance the fiscal base of municipalities through their amalgamation and optimization of their functions and responsibilities.

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