MUNICIPAL FINANCE EQUALIZATION PROCESS IN LATVIA

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Abstract

The municipal finance equalization calculations in Latvia presently take into account the demographic indicators, but they do not depict accurately the municipal finance requirements; in order to precisely determine these numbers, other consequential criteria should be accounted for as well, such as infrastructure or other aspects characterising the peculiarities or needs of a certain territory. Inclusion of these new criteria in the process of determining the need for financing could serve as the basis for improvements to the existing system.

The purpose of this article is to analyze the municipal finance situation in Latvia, starting with 1998, to show the differences in their income and expenditure and point out the trends that would materialize in case the system remains unchanged.

Keywords: municipalities, municipal finance equalization.
JEL Classification: G38, O16, R51.

Introduction

In Latvia, just as in many other European Union countries such as Denmark, the UK, Germany, Sweden, Poland, Estonia and Lithuania, there are significant differences between municipalities in terms of income and expenditure. The reasons are various, from the municipality's geographic position to the demographic situation to a beneficial economic environment, which may foster increased revenues. There are both wealthy and poor municipalities in Latvia, some of which cannot ensure their functions with their own income only. In order to reduce these differences and enable every municipality to perform its legally required functions, the municipal finance equalization has been enforced, which partially covers up the gaps between municipal income in favour of those where the income is smaller than necessary to ensure their functions.

The **aim** of this article is to analyze the municipal finance situation in Latvia, starting with 1998, to show the differences in their income and expenditure and point out the trends that would materialize in case the system remains unchanged.

The **subject** of the study refers to municipalities in Latvia.

The **methodological** basis for the article is made up of the laws, regulations, and guidelines of the Republic of Latvia as well as works of foreign authors, and research carried out by the authors.

The listing of literature provides references to works of Latvian authors, and sources of publicly available information.

Municipal finance situation in Latvia

By June 2009, there were 41 municipalities, 424 rural territories, 50 district towns, 7 republic-scale cities and 26 regional municipalities (a total of 548 municipalities) in Latvia, operating on two administrative levels. The competencies of municipalities, regional towns and rural territories did not differ, and they were called local municipalities, while districts had the status of regional municipalities and the republic cities had the competencies of both types of municipalities at the same time. As a result of the administrative and territorial reforms that were concluded by the time of municipal election in June 2009, one-level municipalities were created, and currently there are 119 municipalities operating in Latvia, 110 of which are regional municipalities and 9 of which are republic-scale.

The structure of local government income and expenditure varies in different countries, and so does the level of budget autonomy, mainly characterized by the local governments' rights to establish their own taxes, tax rates, other income, proportion of their own income, and the right to make decisions regarding their expenses (Vaidere *et al.*, 2001, 2006).

Budget income of Latvian republic-scale cities and municipalities is formed by deductions from the national taxes and duties, municipality duty, state budget subsidies and targeted subsidies, grants from the municipal finance equalization funds, payments to municipality budgets, payment for services, deductions from enterprise profits, income from renting municipal property, property sales, and other income defined by

legislation (Law on Municipality Budgets, 1995).

Distribution of municipality income structure in percentage is depicted in Figure 1. The biggest part of the municipality budget income in 2010 was contributed by taxes, responsible for more than half of the total municipality income.
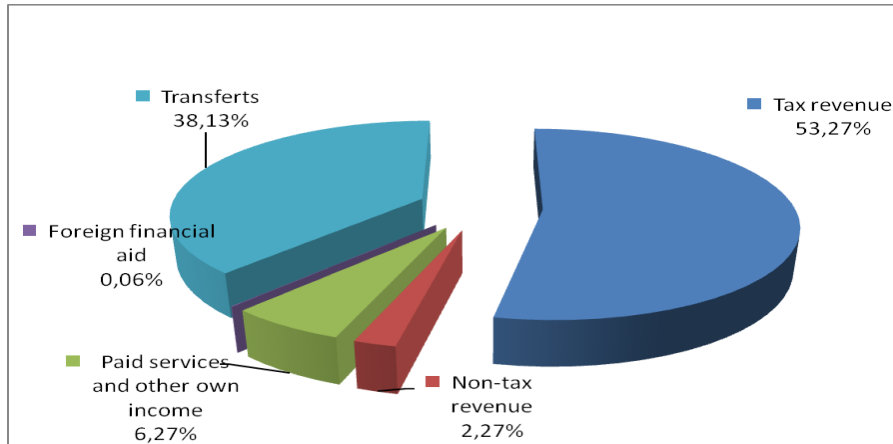

Figure 1. Distribution of municipality income structure in percentage, 2010
Source: National common budget execution report 2010 - Summary of municipality general budget execution

Local governments do not have the legal authority to impose taxes in Latvia. Only the national-level government has the power to set taxes. The local government shares revenues from four state taxes as follows:

- Personal income tax (PIT) (share going to local governments was 83 percent in 2009 and 80 percent in 2010);
- Real estate tax (100 percent share);
- Lottery and gambling tax (25 percent share of gambling taxes, and 100 percent share from local scale lottery); and
- Natural resource tax (60 percent share in special budget for pollution, 30 percent share for radioactive waste tax, and 100 percent share for burning of dangerous waste and for mineral deposits) (Latvia From Exuberance to Prudence A Public Expenditure Review of Government Administration and the Social Sectors, 2010).

The two biggest contributors to the municipality tax income are the individual income tax and real estate tax (Figure 2). The real estate tax is, according to the law On Real Estate Tax, collected independently by municipalities to its full extent or 100% of the property in the territory of the municipality, while only a part of the individual income tax (80% of the total individual income tax revenue in 2010) is transferred to the municipalities by the state treasury, based on the amount of tax collected in the respective territory. The income from both these taxes is used in the municipality finance equalization fund (MFEF) calculations.
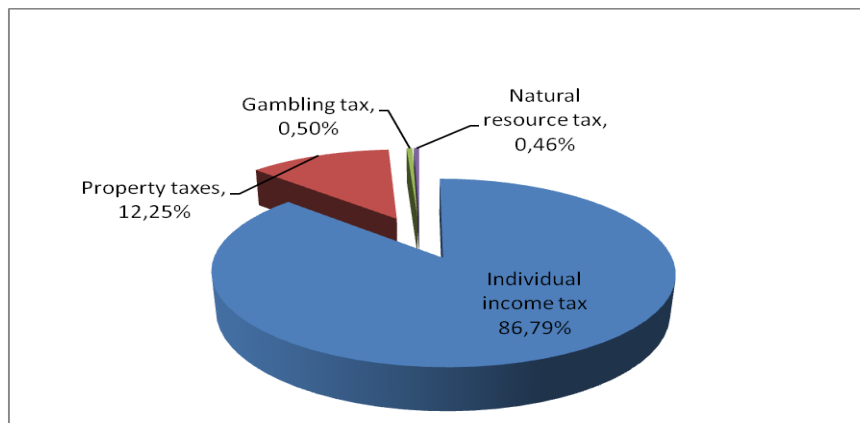

Figure 2. Distribution of municipality income structure, execution in 2010
Source: National common budget execution report 2010 - Summary of municipality general budget execution

Municipality expenditure made up 23.5% or 1268.2 million LVL of the total consolidated national budget in 2010, which is 519.1 million LVL less then in 2008. The proportion of municipality budgets in the consolidated budget decreased from 28.5% in 2008 to 23.5% in 2010. Regardless of expenditure decrease or increase, the proportions did not undergo any rapid changes in the years in question and remained around the level of 26% (Figure 3).
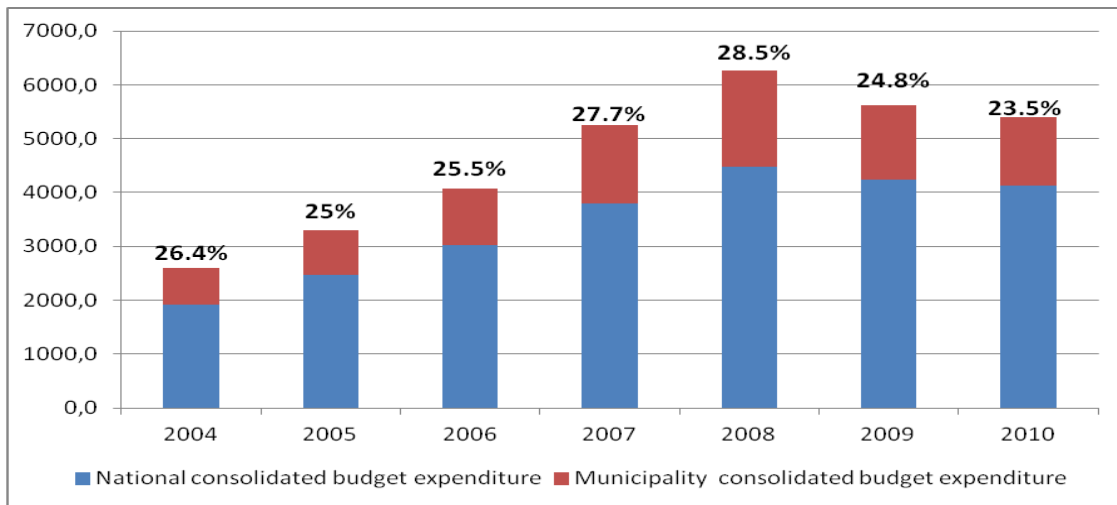

Figure 3. General government and local government consolidated expenditures
Source: Annual reports on national consolidated budget execution 2004-2010

In terms of functional categories, it can be seen that the most part of municipality expenditure both in 2009 and 2010 went to education. This included not only maintenance and operation costs of educational facilities, but also teachers' salaries, which are financed from a specific subsidies from the national budget. The second largest municipal expenditure category in 2010 was economic activity - 13.8%, followed by expenditure for general government offices - 13.4% (see Figure 4).
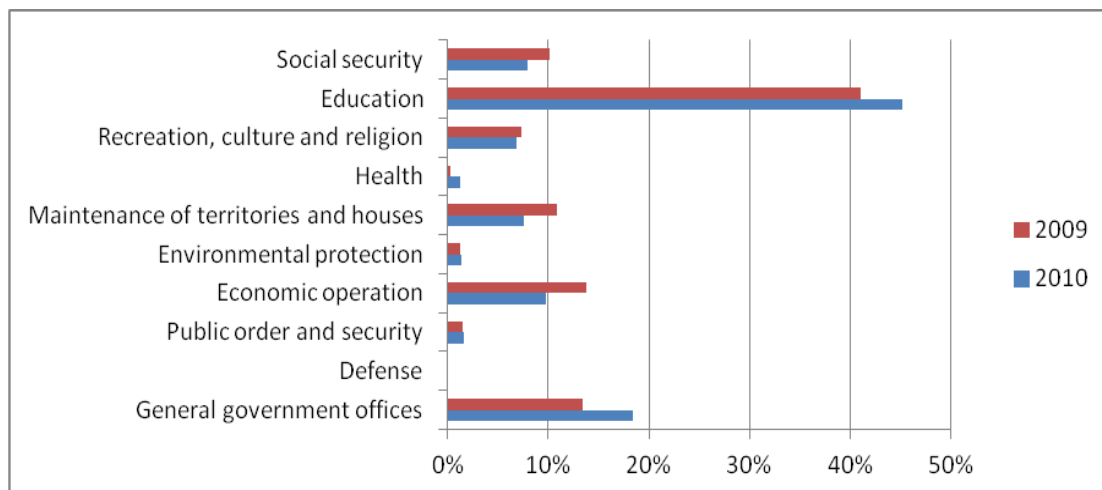

Figure 4. Functional classification of local government expenditures
Source: Annual report on national consolidated budget execution 1998-2011

The revenue and expenditure of the municipality consolidated budget have been growing year-on-year since 1998, until in 2008 they reached their highest up to date. The end of 2008 marked the beginning of the global economic recession, followed by a rapid decline in the municipality revenue and expenditure. In 2009, the municipality consolidated budget revenue had decreased by 20.7% compared to 2008, and expenditure - by 22%. The decrease in revenue and expenditure repeated two years in a row, in 2009 and 2010, but began to increase in 2011 and reached 2.6% and 10% respectively. The municipality consolidated budget changes year by year reveal that its size had grown fast from 2001 to 2008, reaching its year-on-year peak in 2007, when the revenue grew by 38.7% and expenditure by 40.3%. The proportion of municipality consolidated

budget revenue and expenditure in the state consolidated budget demonstrates that their interrelationship over the years in question fluctuated in income from 25.2% to 29.4%.
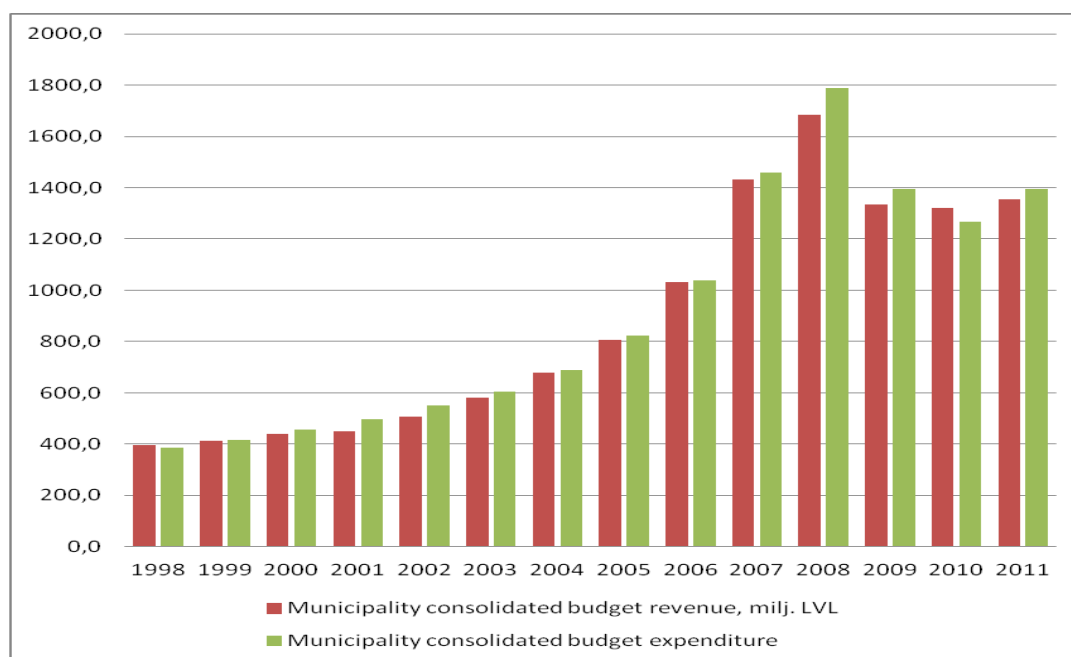

Figure 5. Municipality consolidated budget revenue/expenditure (1998-2011)
Source: Annual report on national consolidated budget execution 1998-2011

Municipal finance equalization process in Latvia

The theoretical principles of financial equalization were developed as early as 1992, based on Denmark's experience, and in 1994 the first equalization steps were taken, but it was only in 1995 that the first law on municipality finance equalization (MFE) for one year was adopted. This new system changed the municipality object financing substantially - the financing of infrastructure objects within a municipality's territory was replaced by financing on the basis of social and economic conditions in the municipality. Yearly laws were approved again for 1996 and 1997 (Assessment of the Latvian local government finance equalization system, 2007). As of 1998, the LR Saeima has adopted a long-term law On Equalization of Local Government Finances, but the system has been working practically unchanged since 1995, which could be regarded as its biggest advantage, but it also signifies a certain stagnation (Law on Municipality Budgets Equalization, 1998).

The first and second paragraph of the Law on Equalization of Local Government Finances demonstrate the essence of the law:

(1) The law defines the order in which the local government finance equalization shall be implemented to provide local governments with equal opportunities to perform their functions as foreseen by legislation, taking into account the social and economic differences of local governments.

(2) The local government finance equalization anticipates partial equalization of the finances, to foster local government initiative and independence in the forming of their financial resources and ensure protection of the financial activities of local governments.

The MFE is very important and should continue to exist in one form or another, but considering the opinions of many municipal administrators regarding the shortcomings of this system, it is vital to analyze these comments in greater detail.

The municipal finance equalization calculation stages according to the law, on 2011, are as follows:

- assess the forecasts of each municipality's assessed income;

Based on execution data, one year before the calculations local government income estimates are made with regard to the real estate tax and the part of individual income tax indicated in the law on annual national budget.

- assess the common municipality financing requirements;

The total minimal financial needs of local governments for the operational year are determined by the preparation process of the law on annual national budget and included in the minutes of annual discussions of the municipal association established by article 96 of the law On Local Governments and by the Cabinet of Ministers, and the grounds for this are:

1) total financial needs of local governments planned for budget preparation year;
2) national macroeconomic indicator forecasts for the operational year;
3) function distribution between local governments, and between local governments and the state, in the operational year;
4) priorities set for the operational year. (Law On Equalization of Local Government Finances, 1998).
- calculate each municipality's financing requirements;

In line with the calculations of total financial needs of local governments, the financial needs of each local government are assessed according to criteria characterizing the tasks related to execution of municipal functions. The assessment is done for each local government separately within the respective municipal group. The proportion (relative value) is established for every expenditure-related criterion in the total expenditure of the local government. (Law On Equalization of Local Government Finances, 1998).

- calculate the contributions to and grants from the equalization fund;

Equalization of financial revenue and expenditure is done based on the financial needs of all local governments as compared to the revenue. The local governments having assessed income that exceeds by more than 10% the calculated upper bound of financial needs not subject to equalization, **make payments** to the local government financial equalization fund, to the extent of 45% of the exceeded amount but not more than 35% of the local government's income from individual income tax and real estate tax. Whereas the local governments having income of no more than 95% of the financial needs lower bound **receive** a subsidy from the MFEF. The necessary amount of subsidy is calculated as the difference between the assessed income and lower bound that is beyond equalization.

- calculate the necessary state budget grants.

The state subsidy amount was unchanged from 2001 to 2010 and amounted to 7.2 milion LVL, but in 2011 the state subsidy increased to 7.9 million LVL and in 2012 to 8.4 million LVL. Since the assessed income and the total financial needs established by the law are reviewed during discussions at the Ministry of Finance and local governments, it has become a tradition to arrange the calculations so that the total needs and assessed income calculations depend on the state subsidy amount. (Assessment of the Latvian local government finance equalization system, 2007)

Equalization is vertical when the policy is conducted by the central government and financed out of the central budget. Equalization is horizontal when it is done by subnational government units at the same level, through monetary transfers from units with high capacity to units with low capacity, however capacity is defined (Boadway, 2006).

The total amount of MFEF is formed by local government contributions and a subsidy from the national budget, the graph shows the contribution structure by years.
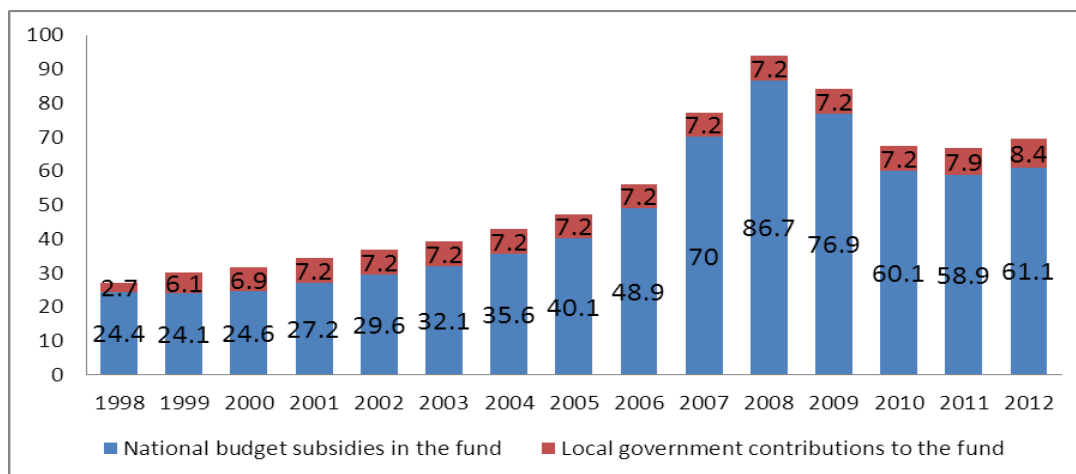

Figure 6. Amount of local government finance equalization fund milj.LVL (1998-2012)
Source: Law on National Budget 1998–2012, Regulations on local government finance equalization fund income and their distribution in 1998–2012, graph prepared by the authors.

The size of the fund over the 1998-2011 period changed similar to the local government budget revenue and expenditure - it grew up to 2008 and then decreased during the period of 2009 to 2011; this correlation is very close and it can be ascertained by comparing graphs 5 and 6. A positive development is the slight increase in the national budget subsidy portion in the fund in 2012. The unchanging amount of national budget subsidy in the MFE fund and the decrease of its proportion up to 2008 were some of the drawbacks pointed out by foreign experts in the existing studies of equalization in Latvia. The importance of vertical equalization is stressed by the European Council as well, and having assessed the priority of services that are the responsibility of the local governments, in the general framework of public expenditure, the Council recommends indexation of the national budget contribution taking into account the increase in the consolidated national budget revenue (Assessment of the Latvian local government finance equalization system, 2007). The national budget subsidy was until 2008 considered to be symbolic, as its proportion in the total MFEF revenue was decreasing year by year up to 2008, but it regained its significance after the economic decline, and there is a chance that the government officials in charge will listen to the experts and provide for subsidy indexation, like in 2012.

At the end of 2008, the LPS (The Latvian Association of Local and Regional Governments) collected the local government opinions on potential changes in the finance equalization system, and currently there is an opportunity to verify the influence of the suggested changes, in case the suggestions were supported. One of the offered changes was to attach the total financial needs of local governments to the national budget tax income, so that the total financial needs would not be less than 17.2% of the national budget tax income. Analysis of the data from 2009-2011 suggests that implementing the idea in 2010 would not change anything for local government or national budgets, since the calculated financial needs exceed the 17.2% of total budget tax income plan by 67.2 million LVL (Table 1). However, the situation in 2011 shows that the difference is just the opposite, and this means that the state would have to compensate the lacking resources of MFEF. Such a situation would cause complications because the unplanned rapid changes in the national budget subsidies would not be easily ensured.

Table 1. Comparison of total national budget tax income proportion to the total financial needs of local governments (2010-2011), milj.LVL

Year	Total national budget tax income proportion (A)	(A) * 17,2%=(B)	Total financial needs of local governments (C)	(B) - (C) = (D)
2011	3630,4	624,4	603,3	21,1
2010	3307,1	568,8	636,0	-67,2
2009	3593,3	618,0	630,4	-12,4

Source: Tax income forecasts of the Ministry of Finance (2010-2011), calculation of the total financial needs of local governments, by the Ministry of Finance

The other suggestion was related to the cancellation of the first MFE criterion, which envisages distributing the financial needs of the cities and municipalities as 47% to 53%. The republic-scale cities support removal of this criterion, as the resources are distributed based on demographic criteria. The cities contain more than a half of Latvia's population, but they receive only 47% of the MFEF funds, while local governments, which accommodate less than a half of population, receive 53% of the fund resources. Consequently, if the MFEF amounts were viewed without that criterion, for instance in 2011, the cities would be richer, and the municipal governments - poorer by approximately 2.7 million LVL.

The third idea for changes envisaged reducing deductions in MFEF fund for the local governments where the estimated income would exceed the upper bound of equalization, thus reducing it to 30% instead of the current 45% and at the same time increasing the national budget subsidy to 50% of the fund amount. This solution would satisfy both cities and municipal towns, but it should hardly be supported by the Ministry of Finance or government. If the reduction of municipality contributions to the fund would not increase the state subsidy, then the local governments the income of which are based mainly on the MFEF subsidy would find themselves in great complications and could arrive at the threshold of those requiring stabilization.

Conclusions

Looking at the suggestions from local governments, there is a clear desire among the local governments to increase the national budget proportion in the MFEF fund. At present the municipality finances are equalized mainly in a horizontal fashion, since the biggest contribution is provided by local governments of the same level as those receiving the financing. However, if the national budget subsidies to fund would increase, we could talk about increase in the significance of the role of vertical equalization. What is important is that the system itself does not encourage MFEF increase, and these potential changes would not lead to bigger income. Each of the suggestions found its supporters, but none of them could be called beneficial to a central governments

Implementation of the opinions mentioned by the article could harm the future operation of the law On Equalization of Local Government Finances, since they would decrease its flexibility in the face of changes in the economic situation of Latvia.

The authors believe that future amendments to the law on FME require first acknowledging the common national priorities and directions of development. MFEF could become an efficient means of development of certain territories, therefore it is vital to see the common national priorities and directions of development. At this point great hopes are laid on the National Development Plan, currently under active development.

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