POSITIVE AND NEGATIVE EFFECTS OF THE INTRODUCTION OF RADICAL LOCAL MUNICIPALITIES FINANCE EQUALIZATION SYSTEM MODEL

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Abstract

In the article there is the suggestion to introduce new and radical model of local municipalities finance equalization system. This model includes the change of redistribution system of personal income tax among local municipalities. At present distribution of this tax among local municipalities is very unequal, because the main criterion, which is used to distribute personal income tax, is base of the tax – taxable incomes of population declared in local municipalities. It means that local municipalities, that are located in the economically active regions of the country, can receive considerably more income compared to those municipalities that are located in the less developed regions. This problem can be solved in two ways: it is necessary to change distribution of personal income tax among local municipalities: one part of incomes (approximately 50%) would be distributed using the existing mechanism (using base of tax), but the other part would be distributed based on the costs criterion. In this case local municipalities finance equalization fund with local municipalities payments is not formed. The aim of subsidies from central government budget would be the second stage finance equalization – extra subsidy to those municipalities, in which incomes from personal income tax are considerably less then the average of the country; it is necessary to change the procedure how the part of personal income tax is shifted to local municipalities. The part of personal income tax is shifted no to the local municipalities budgets, but directly to the local municipalities finance equalization fund. In the next stage local municipalities finance equalization fund will distribute resources maximally objective, based on the latest data about the number of population. At the end of the article the strengths and weaknesses of the suggested radical model of local municipalities finance equalization system are analyzed and evaluated. There is also conclusion about the introduction effectiveness of the model in case of Latvia.

Key words: taxes, finance equalization, municipality, fund, model.

Introduction

As the result of administrative territorial reform, there are 119 local municipalities (110 counties and 9 republic cities) in Latvia. Before the reform, till July 2009, there were 26 districts and 522 parishes in the country. New municipalities are very different if we are going to consider their area, population, distribution of population, nature, location, cultural and historical conditions, as well as socio-economical situations, development possibilities, legal capacity, financial resources, quality and efficiency of local government work and other factors.

One of the most important regional development instruments, which are used to decrease unfavourable difference among municipalities, is local municipalities finance equalization system. Equalization of local municipalities finances have been realized through finance equalization fund, which takes into consideration differences in tax revenues and different needs of local municipalities that depend on demographical structure. Resources of this fund consist of contributions of municipalities and subsidy from national budget.

Till 2008 incomes of local municipalities finance equalization fund increased and in 2008 they reached the maximum – 93,8 millions lats. But, from 2009 incomes of local municipalities finance equalization fund decreased. In Latvia subsidy from national budget is calculated based on the law "About local municipalities finance equalization". From 1998 till 2000 subsidy from national budget increased from 2,7 millions lats to 6,9 million lats, but in the period from 2001 till 2010 the subsidy didn't change and it was 7,2 millions lats. Only in 2011 subsidy from national budget increased to 7,9 millions lats. In the Figure 1 it is possible to see that subsidy from national budget makes considerably small part of total local municipalities finance equalization fund incomes. The biggest part is contributions of local municipalities.

It would be optimal to provide regular increase of subsidy from national budget and to fix its changes to the trend of GDP or tax revenues. Or it is also possible to define minimal increase of national budget subsidy taking into consideration the forecasted level of inflation during next year. But this problem in Latvia still is not solved.
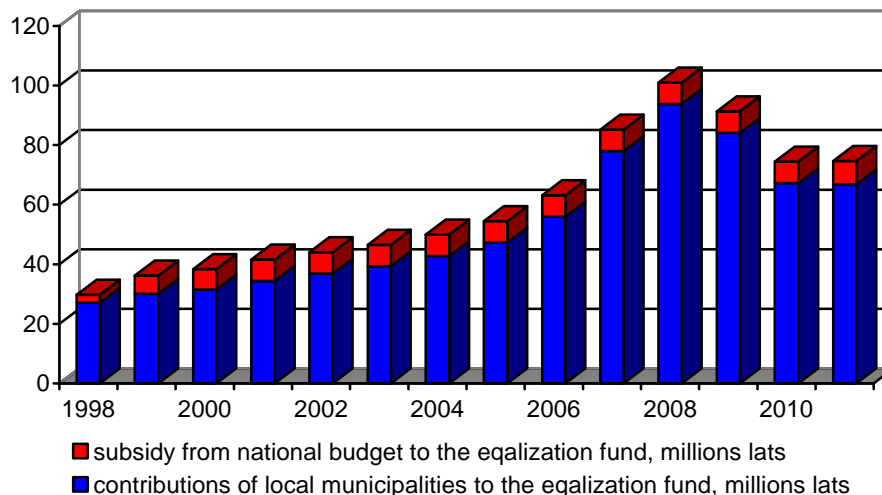
Fig. 1. Trend of local municipalities finance equalization fund incomes 1998-2011 (made by authors after [1])

1. Local municipalities finance equalization at regional level

In Latvia to calculate local municipalities finance equalization, local municipalities finance capacity is characterized by revenues of two taxes - personal income tax and real estate tax. The value of local municipalities' contributions in the local municipalities finance equalization fund is calculated only for those municipalities, which estimated revenues exceed the highest non-equalized margin of finance necessity. It means that estimated incomes are 10% higher than finance necessity of the local municipality. These local municipalities pay in the local municipalities finance equalization fund allocations to the tune of 45% from the exceeded value of estimated revenues that are higher than the highest non-equalized margin of finance necessity. But the revenues do not exceed 35% of the local municipality estimated incomes.

Subsidies from the local municipalities finance equalization fund is given to those municipalities which estimated incomes are less than the lowest non-equalized margin of finance necessity. It means that estimated incomes are 95% lower than finance necessity of the local municipality.

Local municipalities, which estimated incomes exceed the lowest non-equalized margin of finance necessity or which estimated incomes are lower than the highest non-equalized margin of finance necessity, do not pay contributions to the local municipalities finance equalization fund and do not receive the subsidy from the fund [2].

Already in the second part of 1990-ies started the formation of five regions – Riga, Vidzeme, Kurzeme, Zemgale and Latgale. They were confirmed in the government in 2003. These regions were made to plan and coordinate regional development, as well as to provide cooperation of local municipalities. The most local municipalities are in Riga region (30), then follows Vidzeme region (26), Zemgale region (22), Latgale region (21) and Kurzeme regions (20).

In the beginning of 2011 the population of Latvia was 2 millions and 230 thousands, nearly half of them – 48,9%, lived in Riga region. In other four regions the population was about 10-15% from the total population of Latvia.

Riga city local municipality's contributions to the local municipalities finance equalization fund are the biggest during all the years. In 2011 its contribution was 45,5 millions lats, it was 77,24% from total local municipalities contributions to the local municipalities equalization fund. Data about finance equalization at regional level show that in 2011 eighteen local municipalities paid contributions to the local municipalities equalization fund: five of nine Republic cities municipalities (Jelgava, Jurmala, Riga, Valmiera and Ventspils), and 13 counties municipalities. It is interesting, that all local municipalities, which pay contributions to the fund, are from Riga region, it means, that they are located in the economically active area of Latvia.

11 local municipalities do not pay contributions to the fund and also do not receive subsidies from this fund. One of them is Republic city

municipality (Liepaja) and others are counties municipalities. Seven of them are from Riga region, two are from Zemgale region (Aizkraukle county and Ozolnieku county) and one is from Vidzeme region (Cesu county).

90 local municipalities receive subsidies from the local municipalities' equalization fund. Three of them are Republic cities municipalities (Daugavpils, Jekabpils and Rezekne), 8 county municipalities from Riga region, almost all county municipalities from Vidzeme and Zemgale regions, and quite all county municipalities from Kurzeme and Latgale regions. The data are summarized in the Table 1.

Table. 1. Latvia's local municipalities financial relations to the local municipalities equalization fund in 2011 / made by authors after [1]

Local municipali-ties	Pay con-tribu-tions	Do not pay contributions and do not receive sub-sidies	Receive subsi-dies
Republic cities	5	1	3
Riga region	13	7	8
Vidzeme region	-	1	24
Kurzeme region	-	-	18
Zemgale region	-	2	18
Latgale region	-	-	19

These data show that local municipalities finance equalization system is necessary for Latvia. Thanks to this system all local municipalities will be able to provide, that in the democratic state all people, paying similar taxes, in their living place can receive similar state and local government services.

Despite of necessity to support economically weaker local municipalities, the most important problem is to promote development of all regions. Therefore it is necessary to revise and improve the existing finance equalization system in Latvia. In the article there will be offered and analyzed new and radical models of local municipalities finance equalization system, as well as evaluated their strengths and weaknesses and made a conclusion about the introduction effectiveness of those models in the existing economical situation in Latvia.

2. The possible models of local municipalities finance equalization system

One of the most important local municipalities incomes are personal income tax revenues. They make more than a half of local municipalities incomes. And local municipalities by themselves can make decisions how to spend this money. Personal income tax revenues are included in the budget of the local municipality of payer place of residence and in the national budget according to the distribution, which is defined in the annual law of national budget. In 2011 82% of personal income tax goes to the local municipality budget and 18% - to the national budget [3]. The main essence of the calculation algorithm of radically new local municipalities finance equalization model is to change the distribution procedure of personal income tax among local municipalities. It can be explained by the fact, that due to different socio-economical development of local municipalities, distribution of personal income tax among them is very unequal.

At present criterion used to distribute personal income tax revenues among local municipalities, is base of the tax – revenues of taxable incomes of population declared in local municipalities. Revenues of personal income tax in local municipalities' budget are very dependent on the location of the municipality – is it located in the economically active area with high population density or is it located in the economically passive area with considerably low population density. In 2011 personal income tax revenues among Republic cities municipalities varied from 5,7 millions lats in Jekabpils to 245.1 millions lats in Riga. The difference is more than 43 times. In the counties municipalities group personal income tax revenues varied from 0,2 millions lats in Baltinava county to 10,8 millions lats in Ogre county. The difference is 54 times. These differences are shown in the Table 2.

Table. 2. Differences of personal income tax revenues in local municipalities budgets in 2011 (made by authors after [1])

Indicators	Republic cities	Counties
The highest, millions lats	245,1	10,8
The lowest, millions lats	5,7	0,2
Differences in times	43	54

To decrease so drastic differences of personal income tax revenues in local municipalities' budgets, the new algorithm is offered. It would provide to change the distribution of personal income tax revenues among local municipalities.

According to the new algorithm one part of personal income tax revenues would be distributed using the existing mechanism (using base

of tax), but the other part would be distributed as following: based on the natural values of local municipalities' expenditures criterion the part of each local municipalities' expenses as share of total state government expenses is defined. At present in the same way proportion of each local municipality's finance necessity is defined. In this case there is no local municipalities finance equalization fund with local municipalities' contributions to it. The goal of national budget subsidy would be the second stage equalization – extra subsidy to those local municipalities, in which incomes from personal income tax are considerably less then the average of the country. If the real estate tax is also included in this finance equalization system, this will substantially complicate the system. To realize such algorithm of financial equalization system, there would be necessary to change the law "About personal income tax" and the law "About local municipalities' finance equalization".

The authors of the article have a view, that it would be necessary to evaluate and analyze one more possible algorithm of the model of local municipalities' finance equalization system. It provides to pay part of personal income tax revenues not in the local municipalities budgets, but directly to the local municipalities finance equalization fund. In the next stage the local municipalities finance equalization fund, on the bases of the current data about the population of local municipalities from the Office of citizenship and migration affairs, would maximally objective and well-founded distribute personal income tax revenues among local municipalities. The goal of subsidy from national budget, like in the previous algorithm, would be the second stage equalization. And to introduce this algorithm there will also be necessary to make changes in several normative documents.

The advantages of both local municipalities finance equalization models - they do not provide donors and distribution of personal income tax revenues is simply.

The most significant disadvantages are:
- local municipalities can not accept the algorithms of the models, because they considerably differ from the existing model of local municipalities finance equalization. Local municipalities have used it during the long time;
- local municipalities from economically active areas can not accept the new models, because they provide, that part of

the existing main revenues will not be available in the future;
- there is very high sensitiveness of the models to the changes of personal income tax rates ;
- the importance of real estate tax in the local municipalities finance equalization system is decreased or totally excluded;
- if the real estate tax will be included in the models and for each model their own equalization mechanism will be made, then the models would be very complicated.

So this is very important to consider and evaluate the compliance of the both offered models of local municipalities finance equalization system to the economical situation of Latvia, to analyze advantages of each model, as well as provide the transition period for introduction of the chosen new local municipalities finance equalization system model.

3. Characteristic of the possible local municipalities finance equalization system models

The improvement of local municipalities finance equalization system using new algorithms, like in the existing algorithm, is made in the context with the development processes of local municipalities system. Only, the new algorithm provides to use various current data, for example, the current data about population of local municipalities. The existing local municipalities finance equalization system needs to verify data, but it is still not done.

In the new local municipalities finance equalization system, like in the existing system, the subsidy from national budget is provided. It can be explained by the fact, that after administrative territorial reform still there are counties with very different number of population in Latvia. Because personal income tax revenues are included in the budget of the local municipality, in which the payer has declared his place of residence [4], the local municipalities' incomes differs a much. For example, in data, which were used to calculate local municipalities finance equalization in 2011, there were the following differences in population of counties – 26 468 people in Jekabpils and 709 145 people in Riga in the group of Republic cities municipalities, 1 365 people in Baltinava and 38 944 people in Ogre in the county group. Obviously, the differences in the number of population are more than

26 times in the Republic cities group and more than 28 times in the counties group.

The goal of local municipalities finance equalization system is at least partly compensate differences of local municipalities finance capability, thereby to increase revenues of financially weaker local municipalities. In the same time to decrease differences of their expenses, providing more revenues to those municipalities, which have more or extra responsibilities or to those municipalities, which have bigger expenses to provide their responsibilities due to their geographical location, demographic situation or other reasons. Therefore, the local municipalities finance equalization system must make equalization, taking into consideration revenues and expenses. This principle is included in the existing algorithms and will be left in the new algorithms, too.

One more common feature of the existing algorithm of local municipalities finance equalization system and new algorithms is the fact, that both models take into consideration only objective parameters, that do not depend on the local municipality activity, because local municipalities finance equalization system need not to compensate differences of the local government work efficiency, as well as differences of those costs, that appear in the result of local governments realized functions of local politics.

The offered new local municipalities finance equalization system, like the existing system, is maximally objective, because the calculation algorithm and data sources, necessary for local municipalities finance equalization precisely will be defined in the law.

The existing finance equalization system in Latvia is also positively evaluated abroad, because there are important role of negotiations of central government and local governments, in which both sides talk about the results of the previous year finance equalization system and about main directions of the next year activities, as well as they come to the agreement about necessary amount of national budget subsidy. And also in the new local municipalities finance equalization system is provided such discussions directly about the amount of national budget subsidy.

As mentioned before, model of local municipalities finance equalization system and calculations must be simply, understandable and transparent. The existing model does not always meet these requirements, but it is used for a long time and is well-known and habitual. The new model, even if it is transparent, could be unacceptable and difficult, because it provides separate equalization mechanism for personal income tax and real estate tax. The attention must be paid to the fact, that the new model is very sensitive to the changes of the personal income tax rates. Radical decrease of personal income tax rate can lead to the crash of the system.

The existing model and the new model provide not only horizontal, but also vertical equalization, because they provide not only redistribution of local municipalities' incomes, but also subsidy from the national budget.

The important positive feature of the new model of local municipalities finance equalization system is, that it is necessary to provide in the legislation regular increase of subsidy from the national budget. For example, by indexing it with some indicator, which is used to determine national budget increase – increase of GDP, increase of tax revenues, determining minimal increase of national budget subsidy, compared with the previous year, the same as the forecasted level of inflation. The existing model of local municipalities finance equalization system is notorious, because during 2001 till 2010 the subsidy from the national budget did not change and it was 7,2 millions lats. During 10 years in the negotiations between Ministry of Finance and Latvian Association of local and regional governments the tradition was to take into consideration the above mentioned amount of subsidy in the determining the amount of estimated incomes and total financial necessity. It must be evaluated negatively.

The local municipalities finance equalization system must be made in such way, that the sum, which is paid by local municipalities – donors in the horizontal income redistribution, will not be so large, that could keep back them from the growth of local municipalities income base. The local municipalities' equalization mechanism must not to turn down motivation to increase tax revenues. In the existing local municipalities finance equalization system the local municipalities – donors have no reason to say, that it is not necessary to strive to improve their activity and to promote increase of incomes, if in such way there are larger contributions in the local municipalities finance equalization fund. Such expressions are not well-founded, because the contributions to the local municipalities finance equalization fund are calculated taking into con-

sideration only incomes from two taxes. It means that increase in all other revenues is local government disposable income. The differently situation is with local municipalities, that receive subsidies. They have not financial motivation to increase tax revenues. In the new local municipalities finance equalization model the local municipalities – donors have no reason to be dissatisfied, because in the result of the changes in the distribution of personal income tax revenues among local municipalities, the inside equalization is happening. Concerning the local municipalities, which receive subsidies from the fund, the subsidy distribution mechanism must be connected with the motivation. If it will be like the existing mechanism and will provide the local municipalities incomes till the definite level, then also in the new model local municipalities – receivers will not have motivation to increase their revenues.

In the local municipalities finance equalization system, in the equalization process of local municipalities expenses, it would be necessary maximally to take into consideration functions of local municipalities, especially those, that are very important, or those, that are obligatory and are defined by law. In the existing local municipalities finance equalization system are taken into consideration only demographical parameters, which, unfortunately, do not solve different features of all functions [2]. In the new model the wider parameter range is worked out, which meet the requirements of European Council. The European requirements define, that it is necessary to characterize not only demographical differences, like in the existing model, but also geographical, socio-economical or infrastructural differences among local municipalities [5].

The expenses of local municipalities must be evaluated mainly based on objective and measurable parameters, which are not directly controlled by local municipalities. There must be few parameters in the local government finance equalization calculation formulas to guarantee, that they will be easy understandable and will provide transparency, but in the same time the formulas must be all-inclusive and detailed. The relative weights, used in the formulas, must be well-founded. In the existing local municipalities finance equalization system the relative weights for parameters, that characterize demographical differences, are defined in the law "About local municipalities finance equalization". In the new model, to make it more all-inclusive and more

objective, the number of parameters must be increased, the relative weights of the parameters must be based on structure of local municipalities expenses, the expert evaluation and political corrections must be include.

The existing local municipalities finance equalization system has not be changed more than 10 years and it has some features of stagnation. The local governments also recognize that it is necessary to make fundamental changes in the existing system. It would be optimal to make the improved local municipalities finance equalization model for period of 4-5 years, to guarantee regular supervision and evaluation, as well as response mechanism for unexpected crisis. It is also important to foresee and develop activities for the transition period of introduction of the new local municipalities finance equalization model. It is necessary to furnish local municipalities with information about the new local municipalities finance equalization system, because local governments do not want to introduce the system, which is understandable.

Conclusions

Considerable local municipalities finance equalization system is precondition for the success of finance decentralization and stable local municipalities, as well as economical stability and success of balanced sustainable regional development policy. The objectivity of local municipalities finance equalization system will be increased by its regular evaluation accordingly to the real situation, as well as regular verification of used data.

In the process of improvement of local municipalities finance equalization system it is necessary to avoid from unclear formulations, the most important must be principles of simplicity and objectivity. At present in Latvia as the equalization parameters are used only demographical indicators, which are one-sided. The new local municipalities finance equalization model provides improved and more connected to the real situation local municipalities finance equalization system, in which there will be indicators, that characterize not only demographical, but also geographical, socio-economical differences and differences in infrastructure expenses among local municipalities.

If we evaluate local municipalities finance equalization system from the aspect of regional development, it is possible to conclude, that this system provides the decrease of regional dispari-

ties, because within the framework of this system the support is given to those local municipalities, which are less developed. But, at present, together with local municipalities system improvement, urgent problem is revision of the existing local municipalities finance equalization system and introducing of new model, because, despite necessity to support less developed local municipalities, the most important is to promote development of all regions.

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