

## FISCAL FEDERALISM

Marina KESNER-ŠKREB, MSc  
Institute of Public Finance, Zagreb

Glossary\*

Fiscal Federalism characterises the fiscal relations between central and lower levels of government, that is, the financial aspects of the devolvement of authority from the national to the regional and local levels. Fiscal federalism covers two interconnected areas. The first is the division of competence in decision making about public expenditures and public revenue between the different levels of government (national, regional and local). The second is the degree of freedom of decision making enjoyed by regional and local authorities in the assessment of local taxes as well as in the determination of their expenditures (in aggregate and detailed senses).

The level of these competences depends on the real degree of decentralisation of some state in both a political and an administrative sense. How much authority is enjoyed by local government units<sup>1</sup> depends upon:

- the range of public services that they finance;
- the sufficiency of the revenues for the financing of public services;

- the extent of the authority that local government units have in the allocation of budgetary resources;
- the extent of authority in the determination of the rates of local taxes and user fees.

*Public expenditures* that are financed at the level of local government are determined differently in individual countries. In most countries local government units are responsible for the financing of the communal services: local roads and street lighting, water supply and sanitation, waste collection, parks and sports facilities, social housing and the like. There is a particularly diverse approach to the degree of the local financing of social services such as education, health care and social assistance. In some countries these services are financed from the central government budget, in others the costs are shared among the levels of local government, while in others again local governments shoulder the entire cost of social services.

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<sup>1</sup> The concept of local government below covers regional and local government together. For example, in the Croatian system of local government and self-government are the counties, cities and municipalities.

Local public expenditures are financed with local taxes, user fees and intergovernmental transfers. Local government can also take on debt in the financial market.

*Local tax revenue* can be formed from two sources: first, from the division of tax revenue among the different levels of government (shared taxes) and secondly, autonomously, with each local unit determining the local taxes, setting the tax base, the rate and the tax exemptions independently.

Local taxes are divided into three categories: taxes on property, taxes on corporate and personal income, and sales tax.

*Taxes on property* are the most common form of local taxes. These taxes have certain advantages, which contribute to making local revenue more stable. The basis of this tax is the real estate located in the area of the local government, and hence it is quite unambiguous that the revenue from that tax does belong to that unit of local government. Apart from that real estate cannot be concealed in the underground economy and is thus a sure tax base for the local budget. The drawback of these taxes is in the lengthy and complex determination of the base, which includes evaluation of the real estate and updating values along with price changes. Apart from this, such a tax is collected directly from the taxpayer, which makes every change in this especially political sensitive for local government.

*Personal income tax* is the most productive local tax. The rates of local income tax are usually determined as the rates of surtax on top of the national personal income tax. In some countries local government also participates in resources from corporate income tax. But in recent times, the importance of corporate income tax has declined in the local budgets of European countries. For the tax base for corporate in-

come tax is very mobile, and it is difficult to determine which part of this tax belongs to the local government.

*Sales taxes* are characterised in most European countries by a national value added tax and excises, while local consumption taxes constitute just a small part of the local budgetary revenues.

*User fees* are the autonomous revenues of local units that have a purpose set in advance. The main user fees are charges with which the local infrastructure is financed, such as the water supply, sewage and public transport systems. Local units themselves set the rate of user fees quite independently, and also look to the collection of them.

*Intergovernmental transfers* from the national government level to the local government units are carried out by sharing tax revenues and by grants. The sharing of tax revenues is carried out according to some formula that can for example include a *per capita* criterion, that is, the tax is shared according to the size of the population, or a territorial criterion, i.e. the tax belongs to the local unit on the area of which it is collected. Grants can be targeted, i.e. when they are meant for the coverage of a precisely defined expenditure (for example, welfare payments or education), or untargeted, which can be used at the discretion of local government units.

The purpose of intergovernmental transfers to local government units is that *horizontal and vertical equalisation* be carried out. Vertical equalisation is meant to close the gap between the costs for services that local governments have to provide and the direct resources that they can collect. Horizontal equalisation is used to equalise the *per capita* revenues or expenditures of given units of local government.

Local government units can borrow over the long term by taking out loans in

order to finance large capital investments that cannot be covered from the annual revenue. But the ability to pay off principal and interest, i.e. the debt servicing capacity of local units has to be secured from future revenue. Usually, European countries set limits in order to avoid excessive local government indebtedness and excessive public sector debt growth.

#### LITERATURE

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