Fiscal federalism in the Baltic countries: from Soviets to EU

Viktor Trasberg
Lecturer, Ph.D.
Institute of Economics
Faculty of Economics and Business Administration
University of Tartu
Lossi 3, 51003 Tartu, Estonia
Tel: +372 7 375 647
E-mail: viktor.trasberg@ut.ee

Abstract

The Baltic countries' local governments have been functioned during the last decade in a permanently changing environment. Like other transition countries, they inherited from the past extremely centralized administrative system.

Along with radical reforms, administrative system was decentralized and various functions were devolved from central to lower levels of government. Despite that, municipalities are still fiscally strongly dependent from central authorities. Often their fiscal capacity is not adequate to act in accordance with functions stipulated by laws. Many local governments' revenues from taxes and user-charges are insufficient to finance efficiently their expenditures. Disparities in municipalities' fiscal situation are correlated with unbalanced regional growth, social degradation in the low-income regions and growing differentiation by municipalities' residents on access to education and healthcare.

Membership of the European Union brings new tasks and responsibilities for the Baltic local governments. Municipalities should increase their economic sustainability and enhance administrative capacity to explore EU accession funds and implement EU policies.

Considering the above-mentioned problems, the paper focuses on current fiscal situation of local governments in the Baltic countries. The main interest is to analyze local municipalities' revenue level and structure, expenditure composition and fiscal autonomy conditions.

I Introduction

During the last decade, Baltic countries have established democratic type of local governments and improved their functioning. During the Soviet period, sub-national governments' countries existed only formally. Local governments were subordinate to the centralized administrative and bureaucratic structure and their role was to implement state plans for economic and social development on their territory (Vanags and Vilka 2000). After obtaining independence on early 90-ies, the countries put foundations to new organizational principles of public administration. Despite all three Baltic countries developed their own system of local governments; however, there are lots of common reform issues and similar problems.

As a reaction to over-centralization, the priority of the administrative reform was to establish new and democratic local jurisdictions, define their functions and sources of fiscal revenues. Local government reformers in Baltic countries were clearly impressed about Nordic countries type of municipalities - with their large autonomy and numerous different functions[1]. In similar way, in the Baltic countries were devolved many formerly central government functions to the local governments' jurisdiction. Also improvement of central-local authorities' fiscal relations, as part of decentralization process, have been continuously discussed and restructured in practice.

If the first period of sub-governments reforms main attention was focused on local government democratization issues, then the last years most important concern has been municipalities' operational efficiency and their fiscal viability (Vanags and Vilka 2002). Despite the increase of municipalities' autonomy, as well certain serious problems have become more evident. Some of the below listed problematic matters are more general and worry local governments in many countries, but some Baltic countries municipalities' difficulties are specific transitional issues and inherited from their Soviet past[2].

One of the main problems is related with "unfunded mandates". Straightforward giving up by central government its functions to sub-national governments has not followed by adequate financial sources to implement those new tasks. Mismatch between responsibilities and revenues declines municipalities functional abilities to provide high quality and suitable variety of public goods. Therefore all Baltic governments have

[1] Detailed analyses about Nordic municipalities is given by Mønnesland (2003)

[2] Municipal finance issues in Central and Eastern European transitional countries are analysed by Nam and Radulescu (2003) and Trasberg (2003)

declared as strategically important purpose to increase of municipalities' activities fiscal viability.

The second serious problem of Baltic countries municipalities is related with growing revenue disparities among them. Municipalities' disparities are approaching as regional differences. For example, agricultural sector, which dominates in Estonian and Latvian numerous small and sparsely populated remote municipalities, is in stagnating conditions and generates low incomes. Small personal incomes are limiting eventually also local governments' revenue base. Differently, municipalities where modern industries and service sectors dominate, are able to collect significantly more revenues to local budgets. Despite there are developed revenue equalization schemes, particularly in Estonia and Latvia the disparities in revenue level per capita among municipalities have remained manifold.

Scope of optimal revenue equalization is limited due to inadequate fiscal resources by central governments. Also surprisingly, in post-communist societies the redistribution initiatives are often opposed due to negative experience of extreme equalization in the nearest past. Nevertheless, the Baltic countries have to decrease municipalities' regional revenue disparities to avoid significant regional differences on service level and quality.

The third range of municipalities' problems is related with their operational efficiency. All three countries recognize a need for serious improvements in performance of local authorities, particularly on the frames of European Union. Municipalities' organizational efficiency, their administrative competence and capability is often weak. Particularly, Baltic municipalities should be technically and fiscally capable to allocate EU structural funds and explore them efficiently. As many EU policies are implemented on sub-national governments' level, they should be able to put those policies into operation. Therefore, the EU has a direct concern over efficient functioning of sub-national governments in the new member countries.

Considering the above-mentioned problems, the article gives general survey of Baltic local governments and their fiscal activities. There are focused on municipalities' fiscal reform issues and particularly are considered their fiscal autonomy perspectives.

2. Size of local governments'

As an important purpose of administrative reform, new local administrative units were established in all Baltic countries. If Estonia and Lithuania eventually established single level sub-governments, then in Latvia two-tier sub-national government system was developed (local and regional level).

Main emphasizes on the early reform period in Baltic countries was focused on institutional build-up and legal aspects of municipalities functioning. Municipalities' fiscal viability and their optimal size by population were not enough seriously considered. Actually, in the situation of underdeveloped tax system, high inflation and economic recession the reliable revenue planning was almost impossible.

The process of establishing local governments in the Baltic countries was different. Estonia and Latvia mainly resembled as close as possible municipalities, which existed before the World War II. Despite intensive urbanization process during the half a century had significantly modified population territorial settlement and economic activities location, those changes were not taken into account. As a result, numerous sparsely populated (rural) municipalities were established within the historical borders. Many of those small municipalities soon after faced serious fiscal problems due to limited tax revenue base.

Another situation existed in Lithuania, where establishing new sub-governments' had different path. During the Soviet period existed regional administrative units (rayons) were just renamed and were given new functions. In the result, average municipalities' size by population is today highest among European Union countries. As municipalities are still large by population and territory, the government is planning to increase number of sub-governments. Smaller municipalities are expected to satisfy better local preferences on public goods and will make easier local residents access to administrative institutions.

The number of sub-governments periodically changes in Baltic countries due to continuous administrative territorial reforms. In following Table 1, the Baltic countries administrative division in is given.

Table 1. Administrative division of the Baltic countries

	Estonia (1.01.2003)	Latvia (2003)	Lithuania (1.1.2003)
Rural authorities	202	459	44
Towns, cities	39	81*	16
Total number of local governments	**241**	**540**	**60**
Regional government (counties, rayons)	15	26	10

Source: Statistical Department of Estonia www.stat.ee
Latvian Local Government Information Network http://lps.logincee.org
Lithuania Statistical Office www.std.lt/web/
* includes so-named amalgamated municipalities

As Table presents, there is a much bigger number of sub-governments in Estonia and Latvia than in Lithuania. The reason behind such a situation was mentioned earlier. In Lithuania the number of municipalities still remains too small, but will grow on the course of administrative reform (Fiscal Design Across Levels of Government: Lithuania 2001).

Local administrative structure is similar in Estonia and Lithuania but different in Latvia. Regional (county) government representatives in Estonia and Lithuania are appointed by the central governments and approved by local municipalities' elected bodies within their jurisdictions. County governments still carry out mainly general regional tasks and implement state policy in the spheres of social maintenance, education, culture and health. In Latvia, elected representatives of local authorities form regional governments and their functions are wider than in other Baltic countries (Fiscal Design Across Levels of Government: Latvia 2001).

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

Table 2. Baltic countries municipalities composition by population size

	Estonia (1.1.2003)		Latvia (31.03.2000)		Lithuania (1.01.2003)	
Number of inhabitants	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	Population proportion within population range
Less 999	14%	2%	33%	6%	0	0
1,000-1,999	41%	11%	39%	13%	0	0
2,000-4,999	28%	16%	19%	13%	2%	0.1%
5,000-9 999	11%	13%	4%	7%	2%	0.2%
10,000-49,999	5%	17%	3%	15%	67%	37%
50,000-99,999	0.4%	5%	1%	9%	22%	24%
More 100,000	0.8%	37%	0.4%	37%	8%	40%
Capital city and population (rounded)	Tallinn (397,200)		Riga (764,300)		Vilnius (553,200)	
Total population	1,353,500		2,377,400		3,462,600	

Source: Statistical Offices in relevant countries and author's calculations

In Estonia and Latvia exists vast number of low populated municipalities, respectively 83% and 91% of municipalities have less than 5,000 habitants. Lithuanian municipalities are clearly bigger, by average number of habitants more than 60,000 on them. Here only 2% of communities have population less than 5 thousand inhabitants. Another apparent difference from Lithuania is that in Estonian and Latvian population is concentrated to one big (capital) city region. In Lithuania the population location by municipalities' size is more balanced.

Low populated municipalities in conditions of Estonian and Latvian local administrative system create inefficiencies. Their revenue base tends to be limited and operational cost per capita is higher than in bigger municipalities. Small municipalities often provide insufficient volume and quality of public services and they do not have adequate financial resources to maintain and develop technical and social infrastructure (Vanags and Vilka 2002).

Therefore, Estonian and Latvian administrative-territorial reforms are focusing on amalgamation of low populated municipalities with other jurisdictions and thus making them fiscally more viable. Theoretically, bigger municipalities are able to explore economies of scale in public provisions and cut down administrative cost. Despite the discussions and several reform strategies, actual progress of jurisdictions' amalgamation is still slow. Central authorities in both countries have abandoned the idea to merge municipalities in authoritarian way. Instead, the are supporting voluntary amalgamation and providing fiscal bonuses to merged municipalities.

Another way, about 70% of Estonian and Latvian population lives in jurisdictions bigger than 5 thousand habitants. Accordingly, only a minor part of residents lives on low populated and sparse municipalities, which considered to be too small to provide public services (schools, healthcare, other) efficiently. Therefore, amalgamation of jurisdictions may not give expected results in terms of cost-efficiency. In opposite, considering restructuring related expenses; longer distances to reach the administrative offices; risk of lessening democracy and other aspects may cause even bigger burden on society, then to maintain current a number of local governments. As presents Lithuanian experience, municipalities that are too large by population and territory, will face the problem of discrepancies among residents' preferences within jurisdictions.

During economic and social restructuring, capital city areas in the Baltic countries have developed faster than rural agricultural or declining industrial regions (North-East

Estonia, Eastern part of Latvia, other). Faster growth in capital cities is based on several reasons – better infrastructure (roads, ports, other), skilled labor force, attractive cultural and living environment and many other factors. Capital city and closely surrounding areas residents' incomes have grown faster than regions were dominate agricultural activities. Eventually, local residents' good incomes form solid tax base for capital region municipalities and surrounding jurisdictions budgets.

High incomes attract new settlers from poorer regions, which weaken the low-income areas even more. In the result, the disparities on revenue basis between capital areas and particularly low-density rural municipalities became very significant.

3. Composition of Baltic municipalities' functions and expenditures

Municipalities' expenditures structure and level depicts sub-governments functions. Public recourses allocation between central and lower level governments' measure also scope of public sector decentralization. In general, new EU member countries municipalities in average are still far less decentralized than in the EU present member states (OECD, 2002). Table 3 presents composition of Baltic municipalities' functions and compares them to EU average.

The Baltic municipalities carry on quite a similar functions comparing with EU countries, but share of particular expenditures is somehow different from EU average. As the table indicates, biggest part of expenditures is related to education, which covers from 42% in Estonia up to 57% in Lithuania. In average, EU countries municipalities' educational expenditures cover only one fifth of all spending (OECD 2002). Other main spending issues in Baltic countries are - different economic affairs (Estonia), housing (Latvia), social security and welfare (Lithuania).

In comparison, European Union countries municipalities' the mean spending percentages seem much higher for public order and safety; health; social security and welfare. However these high EU means are also influenced by anomalies in individual countries (OECD 2002).

Table 3. Baltic countries local governments' (LG) expenditures and structure, million EUR

Expenditure	Estonia (2002)		Latvia (2001)			Lithuania (2000)			EU mean for sub-national expenditure
	LG expenditure	LG structure	LG expenditure	LG structure	LG share on total government budget	LG expenditure	LG structure	LG share on national budget	
General Public Services	62,360	9%	98,631	11%	40%	46,476	5%	21%	7.0%
Public order and safety	6,543	1%	11,111	1%	5%	7,740	0.8%	3%	4.5%
Education	321,153	45%	395,933	42%	68%	560,424	57%	69%	19.6%
Health	9,338	1%	12,612	1.3%	3%	3,972	0.4%	2%	8.4%
Social security & welfare	62,822	9%	67,825	7%	6%	143,204	15%	43%	26.9%
Housing			137,728	15%	82%	69,429	7%	100.0%	12.2%
Recreational, cultural &religious affair	74,392	10%	64,158	7%	56%	44,661	5%	39%	5.0%
Transportation			44,914	5%	25%	22,258	2%	58%	4.5%
Other economic affairs	175,646	24%	26,029	3%	39%	313	0.0%	2%	1.7%
Other functions	5,973	1%	76,824	8%	19%	55,184	6%	15%	8.1%
Total	718,227	100%	940,594	100%	25%	977,810	100%	34.5%	100%

Source: Estonian Statistical Office, Latvian Ministry of Finance: Lithuanian Department of Statistics, OECD (2002)

Education, housing and community services are common local authority activities because they have limited spill-over effects and offer little economies of scale arguments to point to central provision (OECD 2002).

As was said earlier, in the Baltic countries municipalities' functions can vary significantly among local governments due their fiscal abilities. During the last decade municipalities have obtained additional functions and their abilities on providing public goods have increased.

Certainly, in coming years a great impact on Baltic municipalities activities will have actual economic integration and convergence processes with EU structures. Such a development requires improving democratic principles of self-governance, wider transparency, accountability and other local authorities' activities[3].

Ultimate short-term importance in local governments' activities is going to be their capability to utilize of EU structural funds. As a pre-requisite, sub-national authorities have to spend additional resources to implement EU policies. Therefore, possibility to receive EU accession funds will modify as well Baltic municipalities' functions and activities structure.

General public services, which include also administrative cost, cover from 5% in Lithuania up to 11% in Latvian municipalities' expenditures. In average, administrative expenditures are higher in Estonia and Latvia, due to numerous tiny municipalities. Therefore, cut of expenditures for administration is strong argument for municipalities' consolidation in these countries.

3. Baltic municipalities' revenues

Principles of Baltic municipalities' revenue formation have been continuously under discussions during the last decade. Despite the fact that debates main issue - increase jurisdictions' tax autonomy - is generally accepted, there are several obstacles, which keep fiscal decentralization process on the slow path. One of the reasons is that central governments are concerned about macroeconomic stability of the national economy and

[3] General principles on self-government activities are fixed on *European Charter of Self-Governments*

monetary system. Particularly in Latvia and Estonia, where the few municipalities' present significant part of entire economy, the macroeconomic risks are very high if those jurisdictions collapsing in balancing their budgets.

Table 4 presents Baltic municipalities' revenue level and composition. Local governments' are receiving about one fourth of all consolidated government sector revenues. Municipalities' revenue size compared with GDP level has slightly increased during the last decade and is about 10 % in Estonia and Latvia, respectively 7% in Lithuania. Local governments' tax revenues are from 13-22% of consolidated government taxes. Actually, the share of municipalities' revenue capacity indicates their fiscal autonomy only partially. Majority of revenue sources are strictly controlled by central authorities and local governments have low revenue discretionary power.

3.1 Tax and non-tax revenues

Tax revenue is the biggest income source for all three Baltic countries. In Lithuania the total tax revenue is as high as 87% of total revenues in 2001, respectively in Estonia it about half and in Latvia 55% of total municipalities' incomes.

At the same time, municipalities' actual sovereignty to establish taxes and control tax base in extremely limited. As a matter of fact, there are no any local taxes or discretionary power in Latvian and Lithuanian municipalities. In Estonia, despite the 9 different local taxes, their sum in municipalities' total revenues is insignificant. Local taxes base is defined by the central government very narrowly and in reality such taxes do not play any noteworthy role in generating local income.

Majority of tax revenue in Latvia and Estonia is generated from the shared taxes on personal income. In Latvia respectively 71.6% and in Estonia 56% of total collection of that tax is transferred to municipalities' budgets. In Lithuania the personal income tax was until 2002 solely local municipalities' revenue source, but became also shared between central and local governments thereafter.

Table 4. Overview of Baltic municipalities' (LG) revenue level (millions EUR*) and structure (%)

	Estonia (2002)			Latvia (2002)			Lithuania (2001)		
	LG expenditure	LG revenue composition	LG on consolidated budget	LG expenditure	LG revenue composition	LG on consolidated budget	LG expenditure	LG revenue composition	LG on consolidated budget
Tax revenue	310.0	46.1%	13.0%	451	54.4%	17.2%	815.0	86.7%	22%
Personal income tax	278.0	41.3%	55.7%	372	44.8%	71.0%	730.1	77.7%	100%
Property and land tax	29.9	4.4%	100.0%	77	9.2%	100.0%	82.7	8.8%	100%
Taxes on goods and services				3	0.4%	0.3%			
Other	2.1	0.3%	0.2%			0.0%	2.2	0%	
Non-tax revenue	109.4	16.3%	34.9%	41	4.9%	18.4%	34.1	4%	11%
Self-earned revenue	0.0	0.0%		45					
Foreign aid	0.6	0.1%	1.8%			0.0%			
Grants and transfers	252.5	37.5%		290	34.9%		88.1	9%	73%
of which transfers from other central government budgets	241.9	36.0%		229	27.6%				
Other revenue (self earned)	0			3	0.4%		3.0	0%	26%
Total revenue	672.6	100.0%	24.6%	830	100.0%	27.0%	940.1	100%	22%
Revenue in GDP, %	9.9%			9.7%			6.7%		

Source: Estonian Ministry of Finance Homepage; Latvian Ministry of Finance Homepage Lithuanian Ministry of Finance Homepage and authors calculations
*includes also regional level
**Exchange rates (31.12.2002): 1EEK=0.064 EUR; 1LVL= 1.78EUR ; (31.12.2001) 1LTL=0.299EUR

The lack of tax autonomy continues to be the most significant shortcoming of intergovernmental fiscal relations. However, the problem is not as simple as just to widen local authorities' taxation power. Many municipalities' revenue base is often so limited that even increase of tax autonomy does not allow them fulfill their statutory tasks. In addition, there is a risk that differences of tax base will lead to increasing disparities among municipalities on public goods provision. Also, stronger municipalities have competitive advantage to attract population (taxpayers) from other jurisdictions, which weakens poor regions municipalities' tax base even more.

Second biggest tax revenue for Baltic municipalities is from property and land taxes. There is only single land tax in Estonia, but other Baltic countries municipalities receive part of property taxes also from real estate related taxes. In Latvia and Lithuania the property tax rates are set by central authorities, but administered locally. In Estonia the central government establishes the land tax rate range, within that municipalities can choose the "right one". Land tax is administered by the central government, but transferred to local budgets.

Municipalities' non-tax revenues cover about 16% all revenues in Estonia and less than 5% in Latvia and in Lithuania. Non-tax income is coming mainly from municipalities' economic activities, different fees, fines and user charges. Partly non-tax revenues are received from sales of municipal property (municipal companies' shares, real estate and land on the territory of their jurisdictions) in the course of privatization process. Nevertheless, privatization revenues are not long-lasting and permanent source of income. Even more, they are depending on fluctuations of economic activities and real estate price levels. For example, too substantial reliance on such revenue has created serious short-term fiscal problems in some Estonian municipalities.

In general, level of non-tax revenues is expected to grow in all Baltic countries, despite the decline of privatization receipts. In the situation of limited tax autonomy, local governments' tend to widen provision of public services (education, healthcare, other) on fee basis. As consumers see clearly the link between service received and payment made, user charges considered as fair source of local government revenue. Increase of purchasing power of population support expansion of fee based services supplied by the municipalities.

3.2 Grants and transfers

Substantial part of their incomes all three countries municipalities receive in form of different transfers and grants. Generally, intergovernmental grants are used by central governments as a fiscal tool to provide its services through sub-governments and equalize municipalities' revenues. Share of transfers in municipalities budgets is often named as a vertical imbalance or mismatch between municipalities own revenues and relevant expenditures.

By the Table 4, such a vertical imbalance is highest in Estonia and Latvia, but still relatively low in Lithuania. In the following years, due to local budget reforms, share of grants will considerably increase as well in the Lithuanian municipalities' budgets. Majority of Estonian and Latvian sub-governments are low populated and accordingly, their tax collecting abilities are often limited to meet their responsibilities.

In Estonia total amount of transfers and grants to local governments have increased continuously during the last decade and cover about 38% of municipalities' revenues. Majority of transfers are different earmarked grants to finance functions stipulated by the central authorities. Biggest earmarked transfers are received to finance local educational activities, namely to cover schoolteachers salaries cost.

General grants transferred to local budget mainly on the revenue equalization purposes. The total size of the equalization or support fund is determined annually as an agreement between representatives of local authorities and central government. The support fund is financed solely from the central budget. Each municipality receives transfers from support fund on the basis of formula, which takes into the consideration both revenue level and normative expenditure needs. Normative expenditure level for certain municipality will be calculated on the basis of various demographic and specific geographical factors. Subsequently, the needed expenditure level is compared with potential own revenues and a gap between them will be partly covered by the general support grant. Despite positive impact of equalization grant transfers to local budgets, in many cases objectives set for use of grants did not give expected results (Trasberg 2002). The fiscal disparities among municipalities still remain high and grants are not motivating jurisdictions to increase their own revenues. Also total amount of grants is too limited to guarantee for municipalities' adequate financing. Therefore, Estonian central government purpose is to reduce amount of general grants. Instead, prevailing

understanding is that municipalities' own revenue capacity should be strengthened after territorial-administrative reform and increase of local governments' fiscal autonomy.

In Lithuania, municipalities are at least formally less financially dependent from the central government transfers. The grants share on the municipalities' total revenues in 2001 was significantly lower than in its other Baltic neighbors, covering only about 10% of total revenues (Table 4). Nevertheless, transfers from the central government will grow as a result of change in Lithuanian local government revenue principles. Similarly to the other Baltic neighbors, personal income tax will be shared between local and central governments. Since 2002 it was solely local government revenue. To compensate decline of local governments' revenues, the central government will increase the unconditional grants size.

By the Lithuanian legislation, grant transfers are divided into compensation grants, specific grants and equalization support (Fiscal Design Across Levels of Government: Lithuania 2001). The Lithuanian municipalities receive majority of transfers in form of general grants, differently from the other Baltic countries, where the specific transfers are prevailing. Earmarked grants are transferred to support provision of social benefits payments, also to finance capital investments and civil servants salaries. Similarly to Estonia, there is only single system of vertical transfers from central to sub-governments. Municipalities' revenues are not redistributed to pool funds for the different equalization purposes.

In Latvia the grant system is more complicated. Beside central government transfer to the municipalities as well the horizontal redistribution revenues exists among municipalities. Such an equalization system through redistribution of municipalities' revenues is typical for Nordic countries, but still not in use in other Baltic states (Mønnesland 2003).

Earmarked grants in Latvia cover salaries for teachers; supporting of special schools; salaries of cultural workers; investments and support financing other different activities. General grants transferred to the local governments are mainly donations from the equalization funds. The system of equalization is based on the several principles, which considers demographic and social characteristics of particular local government. The estimated revenue level is based on expected incomes from shared income and property taxes. The sources of equalization funds are coming from allocations of central

government and also form contributions, made by local governments themselves. (Fiscal Design Across Levels of Government: Latvia 2001).

Surveys point out, that equalization system in Latvia should be estimated positively - the system supports the less wealthy local authorities, contains an expenditure need calculation and revenue equalization, the revenue equalization is not too high for the incentives to create wealth within the local areas (Fiscal Design Across Levels of Government: Latvia 2001).

4. Summary: local governments' reforms ahead

Despite the Baltic countries have done radical changes towards democratization and decentralization, still major reforms are expected for implementation. Particularly in the situation there local governments are obliged to implement EU policies and administer accession funds, the reforms agenda became more urgent.

To be more general – local governments should be capable to fulfill their statutory functions and provision of public goods and services should be more equal among municipalities. Both of the main issues are related with sub-governments' inadequate fiscal capacity.

During the last decade a number of municipalities' functions have increased in all three Baltic countries. Baltic central governments' have added new functions on municipalities without backing up them with adequate fiscal resources to execute those responsibilities. Particularly, many low populated municipalities' in Latvia and Estonia have clearly inadequate tax base to finance properly variety of statutory functions. In the situation, where local governments' tasks and responsibilities are not very clearly defined, number of actual activities varies widely among local municipalities and depending heavily from their fiscal abilities.

Therefore, municipalities' fiscal stabilization is considered as most important reforms purpose. In that situation increase of municipalities' fiscal autonomy is seen as the ultimate goal of the Baltic municipalities' fiscal development. Theoretically larger fiscal autonomy will lead to a better reflection of local preferences, enhanced tax collection

and wider fiscal capacity[4]. As a result, the task of providing public goods and services and other public sector functions can be shared more efficiently across levels of government. Nevertheless, currently almost all tax revenue sources and taxes are controlled by central authorities and municipalities still suffer from fiscal over-control.

Unfortunately meaning of fiscal autonomy often considered as municipalities' unlimited power to establish taxes or borrows funds. But such „autonomy" ignores the situation, there municipalities' tax base is often very limited and differs drastically by regions. In reality, a possibility to increase fiscal autonomy in small and low income jurisdictions by expanding taxation power is very questionable. Widening municipalities' fiscal autonomy may increase disparities differences even bigger. Eventually "too large" fiscal autonomy may contradict national macroeconomic goals and social balance.

Therefore, increase of fiscal autonomy in the Baltic countries requires certain pre-conditions. Necessarily that means stable and adequate own revenue base for the most of municipalities and balancing (optimizing) their functions with finances available. Increase of fiscal autonomy inevitably requires also improving revenue equalization mechanisms.

Decisive aspect for larger fiscal autonomy is forming municipalities' adequate tax base. In Estonian and Latvian situation that means proceeding with an administrative-territorial reform. The goal of the reform is to create administrative territories with local and regional governments, which would provide qualitative services to the inhabitants and which are capable of ensuring economic development (Vanags and Vilka 2002). Amalgamation of many smaller municipalities to bigger units will assure them with more stable tax base. In practice, the municipalities' amalgamation has been strongly opposed by the local authorities. To avoid direct opposition with local jurisdictions, the governments fiscally support amalgamation on voluntary basis. However, limited progress has been made on recent years on implementing the administrative-territorial reform agenda.

[4] Recent developments in fiscal decentralization in Europe are analyzed by Darby J., Muscatelli A., Roy G. (2003) and OECD: Fiscal decentralization in EU Applicant States and Selected EU Member states (2002)

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