Financing local authorities

Analysis of the revenue and expenditure of local authorities and summary of the results of a survey of local authorities.
Is the revenue designated by the state divided evenly between local authorities?

Summary of the results of the overview

What did we investigate?

In the course of preparing an overview, the National Audit Office of Estonia analysed the financial information of local authorities as of 2008, investigating the revenue and expenditure of local authorities both by areas and in different local authorities. The survey of local authorities revealed the opinion of local authorities on financing – which decisions of the state have affected them the most, which changes in the financing of local authorities are they expecting from the state in the course of the administrative reform; it was also examined which functions in addition to mandatory functions the local authorities are performing, how much money they are spending on it and which functions they are short of money for in their own opinion. The National Audit Office of Estonia also investigated the state's plan to change the financing of local authorities.

By autumn, the administrative division of Estonia will be completely different than today – Estonia comprising primarily small rural municipalities with a thousand or a few thousand residents will become Estonia comprising significantly larger local authorities – local authorities will not only have new borders, but they will also have to reorganise their substantive activities. No decisions have yet been made regarding the exact functions of the local authorities and how they will be financed in the future. In order to make a decision on which changes to make, we need to know the current situation of the local authorities. The general principle is that, irrespective of the functions carried out by the local authorities, financing has to be sufficient to perform all functions and must not become unfavourable unexpectedly or without a reason, considering the opportunities arising from the location of the local authorities and the needs associated with the population. The overview foremost looks into how even are the financial opportunities of local authorities. The overview does not analyse whether local authorities have enough funds to perform their functions, because no standards have been established for assessing thereof.

Why is this important to taxpayers?

Each person has the right to receive local services irrespective of where they live. Local authorities also receive funds for offering services from the person's wages; e.g. local authority of residence of a person receives 116 euros a month from the monthly gross wages of 1000 euros, which amounts to nearly 1,400 euros a year.

What did we observe and conclude on the basis of the study?

Local authorities cannot affect their revenue much, as the majority of revenue is dependent on the decisions of the state. Funds that local authorities receive from the state on uniform grounds is divided unevenly between local authorities. If the principles of financing are not significantly amended, the gaps between local authorities will remain almost the same even after larger local authorities are established.

The main conclusions regarding the revenue and expenditure of local authorities drawn from the study are the following:

- **Only 17% of the revenue of local authorities is of the size, which the local authority has the ability to affect to some degree.** 83% of revenue is subject to the decision of the state.

- **Funds allocated to local authorities on uniform grounds regarding which the local authority can make an independent decision on using and that is not associated with a specific purpose of use or basic revenue is divided unevenly between local authorities when calculated per resident.** Due to the principles of allocating funds, a small share of local authorities (37 local authorities, i.e. 17%) have a higher than average basic revenue per resident; the basic revenue per resident of the majority of local authorities remains lower than the average (176, i.e. 83%). There are nearly twice as many (62, i.e. 29%) local authorities whose basic revenue per resident is more than 10% lower than the average than there are local authorities with a higher than average basic revenue.

- **Local authorities with a higher than average basic revenue have nearly double (45%) the financial means** than other local authorities (the difference with local authorities with up to 10% smaller than average basic revenue is 42% and with local authorities with more than 10% smaller than average basic revenue is 53%).

- **Assuming that following the administrative reform, local authorities will be financed similarly to how they are financed currently, the gap between the financial means of local authorities will remain great in the new local authorities as well.** The share of local authorities where basic revenue per resident is higher than average would increase by 7%, there would be 17 of them (24% of local authorities). There would be approx. three-thirds (76%) of local authorities with a lower than average basic revenue. Basic revenue would remain up to 10% lower than the average in half of the local authorities and basic revenue would remain more than 10% lower than the average in approx. one-quarter of the local authorities. The difference per resident would, however, decrease – basic revenue per resident in a local government with a higher than average basic revenue would be approx. one-third higher (34%) than in other local governments (the difference with local authorities with up to 10% lower than average basic revenue is 31% and difference with local authorities with more than 10% lower than average basic revenue is 40%).

- **Equalisation fund whose objective is to even out the financial means of local authorities isn't doing it sufficiently.** There are several reasons for this. Firstly, the balance of expenditure accounted for in the equalisation fund is based on the expenditure of local authorities at the turn of the century. For example, the share of expenditure associated with children in the expenditure of local authorities has significantly increased, which is why the funds received from the equalisation fund do not cover the expenditure of local authorities with a larger number of children. Secondly, the equalisation fund does not account for the higher expenditure need per person of small local authorities and local authorities situated away from centres (peripheries). In 2016, 173 local authorities received funds from the equalisation fund, but approx. 40% of these funds were distributed between 8 major cities. The third bottleneck is that the equalisation fund does not finance the investment needs of local authorities.

- **The opportunity of local authorities to earn revenue themselves is limited.** Local tax revenue comprises an average of 1% of the revenue of local authorities. In 2015, local authorities earned a total of approx. 13 million euros from local taxes, while the highest tax revenue was accrued from parking charge (53%) and advertisement tax (33%). Land tax (3–4% of the revenue of local authorities) accrued by local authorities still relies on the results of the land assessment of 2001, although the market value of the land has increased 5–6 times during that period. If the land tax price was based on the market price of the land, land tax could be estimated to be up to 7 times higher, approx. 600 million euros, exclusive of tax exemptions and incentives.

- **Local authorities with higher basic revenue earn less money per resident for services than the other local authorities.** Analysing the sale of services per resident, it is revealed that irrespective of the fact that the average kindergarten fee per resident is higher in local authorities with higher basic revenue, the revenue per resident remains smaller in comparison to the other local authorities.

- **Expenses per resident are nearly one-fifth higher for local authorities with a higher than average basic revenue than for the other local authorities.** Compared to the others, local authorities with higher basic revenue can for example spend, on average, 50% more on housing and environmental protection, 45% more on economy and 41% more on general governmental sector services per resident. Additionally, such local authorities grant, on average, approximately one and a half times more allowances per resident than the other local authorities.
- **Payroll in local authorities with a higher than average basic revenue per employee is, on average, 12% higher than in other local authorities.** Differences by areas are even greater – in 2015, for example, labour costs per employee for local authorities with a higher than average basic revenue were, on average, 37% higher in pre-school education and 36% higher in the area of social protection than in other local authorities. Due to the economic crisis, local governments were forced to cut down on the number of employees in 2009, but the number of employees in local authorities with higher basic revenue has now increased a little in comparison to the pre-crisis period, while the situation is the opposite in other local authorities – the number of employees has decreased approx. 9% in comparison to the pre-crisis period.
- **The investment capability of local authorities with a higher than average basic revenue will remain approx. three times higher if financing is not amended.** Local authorities with higher basic revenue have invested significantly more own funds in the upkeep of fixed assets than other local authorities who have been dependent on grants.
- **Local authorities with a higher than average basic revenue spend, on average, twice as much per resident on voluntary functions than other local authorities.** Presuming that the majority of costs associated with voluntary functions concern the area “free time, culture and religion”, the average expenditure of these functions constitutes 13% in the local authority. Irrespective of the level of basic revenue, local authorities generally perform similar voluntary functions, but local authorities with a higher than average basic revenue perform, on average, more voluntary functions – 9 functions, while the other local authorities perform, on average, 6 voluntary functions. A big share of voluntary functions is paying various allowances that are not dependent on the size of the person’s income.
- **Although the state has to compensate local authorities for expenses associated with performing state’s functions, this has still not been done with regard to some of the functions.** If local authorities are not compensated for the expenditure of state’s functions, this will also affect other functions, because these costs are covered at the expense of performing the local authority’s own functions. Many local authorities have volunteered to perform the state’s functions that residents are in serious need for but that the state cannot perform at a satisfactory level all over Estonia by itself. Because local authorities have not received compensation for it from the state, they have been forced to demand compensation through court. There have been cases where the court has ordered compensation to some local authorities for performing a state’s function, but the state has not voluntarily compensated similar expenses to other local authorities and is continuing with court actions that require time and money. One of the reasons for this situation is that the functions of local authorities have still not been analysed in a way that enables determining all the state’s functions.

The results of the survey of local authorities indicate that local authorities would like to have more funds. Two-thirds of local authorities also outlined the amount of money they would like to have in addition when providing answers to the survey. It was revealed that local authorities with a higher than average basic revenue who are of the opinion that they do not have enough funds to perform all the mandatory functions would like to have the most additional funds. If we compare the amount of money that local authorities with higher basic revenue believe to need in order to perform mandatory functions to the amount of money that they are, on average, spending on performing voluntary functions, it is revealed that the latter would cover the majority of the need for funds. The other results of the survey can be summarised with the following observations and conclusions:

- **The majority of local authorities noted that they are not satisfied with the negotiations held between the representatives of the state and the local authorities with regard to financing local authorities.** Local authorities believe that annual negotiations have become formalistic and the state has rather made decisions from its position of power. To demonstrate their attitude, the representatives of local authorities have not signed the minutes of negotiations in several years as of 2010. Upon providing answers to the survey, local authorities proposed how to act in the event that an agreement is not achieved in the course of negotiations.

- **Leaving aside revenue cuts of local authorities arising from the economic crisis in 2009, local authorities find that the most unpredictable field of financing has been education**, where they have not been given time to adapt to different changes over the years (e.g. confusion regarding financing support specialists from the support fund, abolishing wage subsidies for kindergarten teachers). Financing the maintenance of local roads was also unpredictable when it was separated from the accrual of excise duty on fuel.

- **Local authorities want more funds foremost for local roads and education.** Irrespective of the size of the basic revenue of a local authority, the areas that they require additional funds for are the same – economy, i.e. foremost local roads and education. At the same time, these are areas that the state has supported the most, but the funds granted for which are restricted with a specific purpose of use. This connection may indicate that **targeted support strips the local authorities of the option to use their funds in a flexible manner and does not motivate the local authorities to contribute to the support using their own revenue.** Both OECD and the National Audit Office of Estonia in its earlier audits have drawn attention to the problem.

- **Local authorities with a smaller than average basic revenue highlighted more areas that they would like more funds for:** in addition to local roads and education, they want additional funds for social protection, housing and the area of general governmental sector services in the amount of at least 53 million euros.

- **Local authorities would change the procedure of financing.** The majority of local authorities supported the distribution of **personal income tax** differently by regions. Distribution of income tax between the local authorities of the person's work and residence or several residences was supported by only a few. More than half of the local authorities (65%, whereas the opinion was shared both by those who receive funds from the equalisation fund and those who do not receive funds from the equalisation fund) would like to amend the principles of allocating funds from the **equalisation fund**. They foremost wanted the equalisation fund to account for the peripheral local authorities and the actual expenditure need of local authorities and that it would not be reduced if a local authority earns more revenue in some years. Restructuring of the **support fund** and distributing its funds to local authorities by way of increasing the share of income tax and the equalisation fund was supported by more than one-third of the local authorities. There were, however, more of those local authorities who opposed this in fear of the funds decreasing. Although local authorities have had problems with distributing the so-called **protection money** (funds are allocated for activities that are not in accordance with the development needs of the local authority or it brings about unforeseen expenses), they have made proposals for amending the distribution of protection money.

- **Local authorities have conflicting positions with regard to amending the principles of land tax accrued in the budget of local authorities** – approx. half of the local authorities would turn it into a local tax and replace state's incentives intended for residential land with local incentives. Probably thinking about the increase of tax burden for residents, more than half of the local authorities do not support taxing land on the basis of the market price – less than one-third of the local authorities wants this.

- **Local authorities want more revenue to accrue to them.** Local authorities want to additionally receive funds from dividend income and corporation tax. One-third of local authorities would like to receive revenue from new local taxes, preferring real estate tax (some would want that together with land tax), heavy goods vehicle tax and tourism tax the most. In the opinion of national unions of local authorities, establishing local income tax would have the greatest effect. The Congress of Local and Regional Authorities of the Council of Europe (CLRAE) has also made the same recommendation to Estonia.

By 2020, the Government of the Republic is planning to increase the share of income tax accrued by local authorities and the equalisation fund by a total of 55 million euros. In the opinion of the National Audit Office of Estonia, however, simply allocating more funds would not resolve the problem for those local authorities where basic revenue per resident is significantly lower than in other local authorities. The gap between the financial means of local authorities deepens if in addition to distributing the equalisation fund, the principles of distributing the primary source of revenue for a local authority – personal income tax – are not amended so that it would be divided more evenly between local authorities. The Ministry of Finance has discussed a solution where part of income tax is distributed between all local authorities proportionally to the number of residents. The fact that the funds of no local authority would decrease because revenue would be evened out between local authorities gradually at the expense of income tax speaks in favour of this solution.