Strengthening the financial independence of local and regional governments

Policy analysis and recommendations

Council of Europe

Centre of Expertise for Good Governance

in cooperation with the Slovak NGO MESA10

Authors: Gábor Péteri, Council of Europe expert
Martin Valentovič, MESA10

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Acronyms

BVT	Business Value Tax
BA	Bratislava
CEGG	Centre of Expertise for Good Governance
CIT	Corporate Income Tax
HTU	Higher Territorial Unit (regional self-government)
JMO	Joint Municipal Office
MoF	Ministry of Finance
MoI	Ministry of Interior
NKU	National Audit Office
PIT	Personal Income Tax
SCG	Sub-central Government
SR	Slovak Republic
VAT	Value Added Tax

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Executive Summary

Objectives

This report has been prepared at the request of the Slovak Government to the Council of Europe Centre of Expertise for Good Governance to prepare a policy advice on the local and regional governments' financial independence, which could also improve their financial management capacities. It focuses on the revenue raising options and methods for an improved local fiscal autonomy.

The main goal of the report is to support the development of policies in the context of a potential structural and territorial-administrative reform, which could be designed as per the relevant Council of Europe recommendations prepared in the framework of the project. These reports targeted some of the local public financial management issues and due to project limitations, they will not be discussed here. This policy advice specifies the financing mechanisms for a future iterative policy design process.

Principles, conditions

The key principles in this policy advice are based on the local finance provisions of the European Charter of Local Self-governments, the subsequent recommendations[1] and the lessons learnt from climate change mitigation and the pandemic. They target increased local accountability for more efficient and effective public service management. In Slovakia, having extremely small average size of municipality, the different types of municipalities require diverse funding models. In practice, the interconnected national and local government functions can hardly be separated as original and delegated. Tax policy reforms should target environmental protection and climate change mitigation while minimising the additional tax burden for supporting economic growth and development. A fiscal decentralisation reform program should be started immediately to prevent lost opportunities in the fragmented municipal system and to avoid the high risks of re-centralisation with further delays in addressing the current problems of the local self-government.

Proposals

The municipalities in Slovakia are financed by a balanced set of traditional own source revenues (20.0%), shared personal income tax (36.6%), grants and transfers (31.8%), supplemented by the revenue from financial operations (11.6%). The regional self-governments are financed predominantly by the shared PIT (47.6%) and by grants and transfers to a lesser degree (30.7%). In European comparison, Slovakia belongs to the group of countries with low own source municipal revenues.

a) Options for own-source revenue raising are, as follows:

(i) *real estate tax* regulations that allow sufficient municipal autonomy in assessing the tax base and setting the rate. Property tax revenues can be increased by raising the default rate, combined with local autonomy in deciding tax allowances and exemptions, incorporating the property quality in assessing the tax base, providing support to local property tax administration. Low-income taxpayers should be protected by an income compensation mechanism.

(ii) *introduction of property value capture* techniques for sharing the financial burden of public investments with the local property owner.

[1] Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities (CM/Rec(2005)1), Recommendation of the Committee of Ministers to member States on the funding by higher level authorities of new competences for local authorities (CM/Rec(2011)11)

(iii) *introduction of a motor vehicle tax* as a widely used local tax elsewhere in Europe. By levying the average tax on cars for business purposes (EUR122/car), the proposed municipal motor vehicle tax on all private cars would result in a revenue of EUR 298 Million. It is proposed as a municipal revenue but, depending on the allocation of road maintenance responsibilities, it might also be a regional tax.

(iv) *Business Value Tax* levied by the regional self-governments would directly connect the local economic potential to the region's budget. Assuming that a business value tax finances 10% of the regional governments' budget, EUR 272 Million might be raised by the regional self-governments with this new revenue source.

b) Improvements in revenue sharing

Currently, the Personal Income Tax allocation is exclusively formula-based and is mostly shared by the population number. The present PIT sharing mechanism can be improved in two ways, by:

(i) *incorporating additional national budget revenues in the pool of shared taxes*. Combining the relatively stable VAT revenue (15%) and the more volatile PIT (70%) into a joint fund for revenue sharing would create a predictable local revenue source and will not decrease the national budget revenues.

(ii) *refining the revenue sharing rules* to reallocate a portion of the PIT by its place of origin. This derivation-based PIT allocation method can further increase local autonomy when municipal or regional self-governments are authorised to levy surtaxes on the national tax base.

c) Grants and transfers

The *largest delegated municipal services* by expenditure size are the public education (41.5% of municipal budgets) and the administrative services (general public services: 22.0%). Beyond the national budget transfers received, local governments also contribute to the service costs from their locally controlled revenues. The legislative concept followed in Slovakia is to separate original, devolved municipal services from delegated, state functions. However, assignment of own revenues versus earmarked transfers to finance them, can be hardly implemented in the practice.

As local and central functions cannot be strictly isolated, the actual past costs should be the basis of financing the delegated services. These grants and transfers should follow the average service costs of municipalities of similar size and type. Incentives for service efficiency improvements and savings can be supported through *performance-based grants*, as an alternative, supplementary method.

d) Equalisation

More own-source revenues and greater financial autonomy will further differentiate the local revenue potential, which would demand for an effective fiscal equalisation mechanism. The proposed options are as follows:

(i) Municipalities with origin-based PIT revenues (per capita) *below a minimum threshold* receive contribution from municipalities with higher PIT base. This equalisation scheme provides grants only up to a certain level (e.g. 90% of the average) of the per capita PIT revenue.

(ii) *A two-step allocation scheme* authorises the regional self-governments to adjust the nationally set grant allocation rules (weights, coefficients) according to the local conditions. Direct intervention by regional self-governments to specific municipal affairs should be prohibited.

e) Bratislava City-region

The proposed Bratislava City-region model joins the present Bratislava City magistrate and the Bratislava self-government region into one new metropolitan entity. It would change the relations between this upper and the lower (city parts and municipality) government tiers. The revenue reform options proposed here will produce significant new resources in the Bratislava City-region which will raise the need for modified internal revenue sharing and reallocation practices.

Revenue options by territorial-administrative models

The proposed techniques for increased financial independence should be adjusted to the various territorial-administrative reform models, summarised in the table below.

Financing options by territorial-administrative models						
Financing options	*Territorial-administrative models*					
	a) present two-tier local government system	*b) inter-municipal cooperation*	*c) amalgamated, large size municipalities*	*d) regional self-governments*	*e) Bratislava City-region*	
					lower tier	*upper tier*
(i) improved municipal real estate taxation	x	x	x		x	
(ii) property related value capturing	x	x	x	x	x	x
(iii) motor vehicle tax	x	x	x	x		x
(iv) Business Value Tax				x		x
(v) taxpayers' residence-based PIT share		x	x	x	x	x
(vi) per capita PIT- based revenue equalisation		x	x	x	x	x
(vii) two-step equalisation by the regions	x	x	x			

These specific reforms related to the local government financial independence are conditioned by several *common actions*:

- limiting the financial impact of revenue restructuring on businesses or individuals and minimising the increase of overall tax burden;
- introducing new models for fiscal equalisation on the revenue side of the budget and authorising the regional self-governments to reallocate some parts of grants;
- developing joint decision-making mechanisms and internal rules on revenue allocation for the sub-municipalities (districts, city parts) in the large size municipalities and the lower metropolitan tier in the capital city-region;
- ensuring an accurate population registry with permanent addresses combined with taxpayer identification and private car ownership, for the purpose of proper tax administration.

Objectives and background

The Slovak Government has requested the Council of Europe Centre of Expertise for Good Governance to prepare a policy advice on the local and regional governments' financial independence. This report aims to respond to this request by proposing solutions to the detected shortcomings of the local revenue autonomy. It focuses on the local revenue raising options for strengthening the financial independence of the local and regional governments in Slovakia.

Related financial management aspects of fiscal independence, such as issues of revenue administration or local borrowing are discussed partially. Some other components of public financial management were targeted by other CEGG policy advice reports (e.g. on the assignment of local functions) (see Ionita 2021; Trutkowski, 2022). Assessment of broader local public financial management issues (e.g. budgeting, fiscal transparency, audit, management of municipal service organisations) would go beyond the limits of this analysis and policy advice.

The analytical reports prepared by the EU - Council of Europe joint project "Delivering Good Governance in Slovakia" already formulated various development and reform options[2]. The overall directions of the administrative and territorial reform strategy have been identified and some proposals on local finances were outlined. Following the discussions with all the major local stakeholders, the present report aims to make those draft policies more operational, while assessing their impact or testing their feasibility. Additional local finance reform proposals are also formulated.

More specifically the main goal of this policy advice is to design those methods of fiscal independence, which support the already presented strategies and the structural, territorial-administrative reform proposals.

Structural and local competence reform options

Without prioritising the options presented by the above-mentioned Council of Europe policy advice documents, the following basic models should be considered in the context of local financing reforms:

1) *Improvements in the present local government structure with unchanged functions*

The powers and functions of municipalities, the self-governing regions (called higher territorial units, HTUs) and Bratislava will not change. The financing options aim to make this highly fragmented, two-tier local government system with moderate level of devolution more efficient and equitable.

2) *Inter-municipal cooperation-based model*

Widespread Joint Municipal Offices create the basis of this model. JMOs are established for numerous local services and presently 82% of municipalities participate at least in one form of cooperation[3]. The New Community Management proposal (ZMOS, 2021) plans to build on the voluntary cooperation agreements.

3) *Diverse amalgamated models are developed*

The numerous small size municipalities are combined into larger, more viable local entities. The proposed reform options might create larger municipalities of different sizes and forms by following diverse amalgamation processes (voluntary, gradual, mandatory). The new municipal structures organised along city regions might affect the intermediary tier of government by creating metropolitan zones. In the larger

[2] Two Peer Review Reports (Koutalakis, 2021; Trutkowski, 2022), the policy advice reports and strategies (Ionita, 2021; Swianiewicz, 2021, Allio, 2022; Orlando, 2022) represent the administrative and structural bases of the present financial reform proposals.

[3] See Tomečko, 2021

amalgamated entities, the remaining role and powers of the sub-municipal entities should be also regulated.

4) Regions with strengthened self-governing characteristics

Keeping the present eight higher territorial units while the accountability of the self-governing regions is improved by further revenue decentralisation.

5) Bratislava City-region

The future of the capital Bratislava, as a potential City-region was designed, as well. The proposed city authority for metropolitan cooperation is planned by merging the two higher tier territorial units (the City and the Region Self-government).

These five main models require specific local financing mechanisms. They are critical conditions for successful administrative-structural changes; therefore, they should be *planned in coordination with the territorial reforms* and reallocation of government functions.

The following specific local financing reforms for enhanced local autonomy will be elaborated below:

1. possibility for levying new taxes and ensuring higher autonomy in own source revenue raising;
2. creating wider own revenue base and new type of tax sharing under the amalgamated model and for the self-governing regions;
3. improved fiscal equalisation mechanisms, both on the revenue side of the budget and for the expenditures;
4. drafting specific financing mechanisms in the future capital City-region.

Strengthening local finances: principles and conditions

Based on the local finance provisions of the European Charter of Local Self-government, the subsequent recommendations of the Council of Europe[4], and the lessons learnt from climate change mitigation and the pandemic, the following key principles should be in the centre of new policies for enhanced financial independence of local governments in Slovakia:

Higher fiscal autonomy for increased accountability

Fiscal autonomy of local governments results in an *increased accountability* of local decision makers *for more efficient and effective public service provision*. The financial independence of the local government is enhanced by higher own source revenues, greater autonomy in setting these revenues and higher discretion over the shared and transferred national budget revenues. It should be accompanied with new forms of administrative accountability (e.g. towards the line ministries) and strengthened social accountability mechanisms of inclusion, citizen participation and empowerment.

Diverse funding for different types of municipalities

The local government system in Slovakia is highly fragmented: 38% of municipalities are with population below 500. (Table 1[5]) However, despite the large number of small municipalities, the population affected by the fragmented system is not significant. Only 5% of the population lives in these 1,116 small municipalities (with population less than 500) having an average annual budget of EUR 206 thousand. The fiscal weight of these tiny municipalities is even lower because less than 4% of all municipal revenues are raised here.

Therefore, following the subsidiarity principle, the models for financing the *extremely small municipalities might be different* from the resource allocation model regarding larger towns, cities and Bratislava. The *regions* as intermediary local governments are closer to the problems of these small municipalities, thus they should have a *greater role in the financial equalisation*.

[4] Beyond the key Council of Europe standards on local finances (e.g. *CM/Rec(2005)1 - Recommendation for good local financial resources of local and regional authorities, Recommendation CM/Rec(2011)11 of the Committee of Ministers to member States on the funding by higher level authorities of new competences for local authorities*) there are several other standards on local finances, which specify the fiscal conditions of good democratic governance. They are specified by comprehensive reports and documents on fiscal autonomy, intergovernmental fiscal relations in the new era of multiple crises (climate change and pandemic): e.g. Boex, *et al*, 2021, Farvaque-Vitkovic – Kopanyi, 2014; GOLD reports of UCLG Global Observatory on Local Democracy and Decentralization; OECD, 2021; World Economic Forum, 2022

[5] See the sources of financial and statistical data among the references.

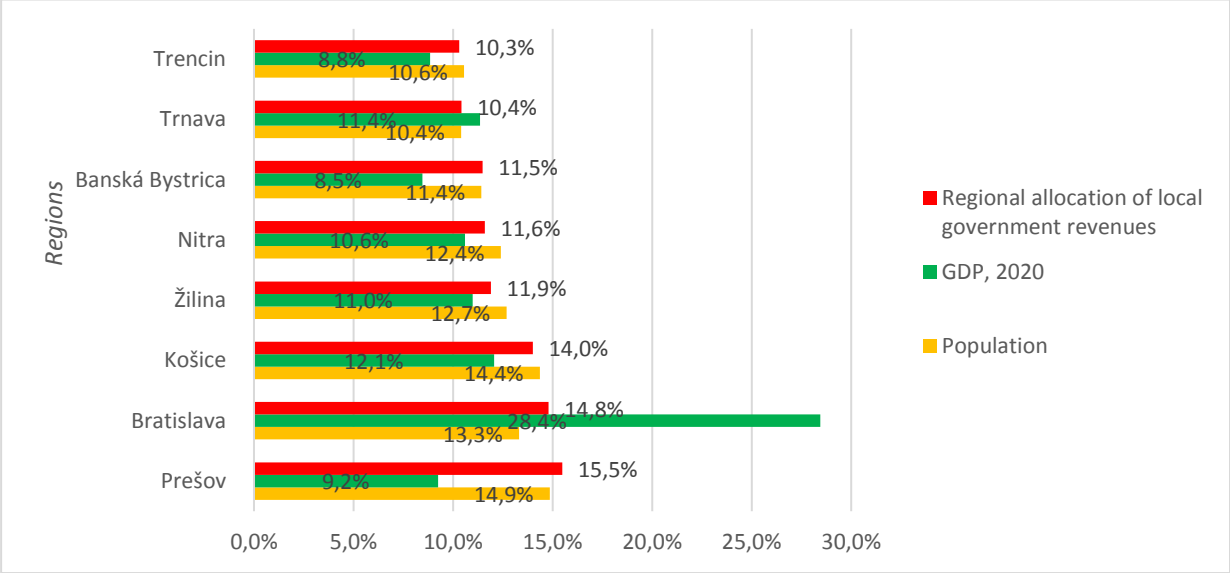
Table 1: Number and size of municipalities

Population group	*Number of municipalities*	*Average municipality population*	*Average revenue, EUR 1,000*
Bratislava Capital	1	475 503	428 106
Bratislava Districts	17	27 971	17 739
Bratislava, total	18	26 417	40 537
Košice	1	229 040	252 128
50,000<	7	70 436	85 631
20,000-49,999	35	28 055	27 096
5,000-19,999	102	9 319	10 860
1,000-4,999	890	1 929	2 087
500-999	757	709	665
<500	1 116	264	206
Total	**2 926**	**1 941**	**2 129**

Need for incentives combined with revenue equalisation

The current formula-based PIT sharing is a powerful equalisation mechanism, even though it *creates little financial incentive* to increase local revenues by promoting economic growth. Chart 1 below shows that local (municipal together with HTU) revenues by region follows mainly the population number and less the economic power of the region. Moving away from this formal equity by creating greater reliance on own source revenues will require *more effective forms of equalisation* on the revenue side of the budget.

Chart 1: GDP, population number and local revenues by regions: population number driven formal equity



However, during fiscal reforms at the local level it should be kept in mind, that *one financing instrument serves only one objective.* It cannot be expected that a revenue collection technique can solve multiple and often competing problems. Different fiscal mechanisms should be used in parallel for creating incentives for revenue raising, to ensure basic, minimum services and for revenue equalisation.

Government functions are interconnected

Allocation of financial *resources should be harmonised with the functions* assigned to the responsible government tier. In Slovakia the key issue is that additional municipal and regional own (or locally

managed shared) resources are needed for financing the transferred government tasks. It shows that strict separation of original (devolved) and delegated local competencies is hardly manageable. They are interconnected and also the devolved functions always have national and local components. Consequently, in a joint, multilevel system of governance the *financing resources of central and local governments supplement each other*.

Revenue policies for protecting the environment

The overall goals of environmental protection and climate change mitigation should be incorporated in the local revenue policy reforms, as well. Sub-national governments *have important roles in promoting sustainability*, as they manage major sources of pollution (e.g. housing stock, public transportation) and have effective instruments for climate change mitigation (e.g. urban planning, construction regulations, waste management practices). Intergovernmental finance mechanisms such as taxing powers, administrative fees and user charge settings, should be adjusted to these new requirements of sustainable development.

Re-grouping fiscal burden

Re-allocating tax burden among primary income owners (citizens, businesses) can make the local government revenue structure more balanced. Local governments should be financed by diverse resources ensuring budget stability and buoyancy. However, additional tax burden on companies should be *minimised for supporting economic growth and development*.

Risks of delayed fiscal decentralisation reforms

Decentralisation is a highly political reform process as it effects the power relations, the administrative structures and financial competencies. However, further delayed actions concerning widely known problems should count with the *systemic risks of postponed reforms.* The “do nothing” option in the local government sector misses regional development opportunities in rural parts of Slovakia and it might lead to abrupt centralisation actions. In local public service provision, promising simplified solutions to complex problems might easily get popular political support. But they will not achieve the expected results and might lead to likely worsening of the local governments’ position.

Targeting revenue autonomy

Local government fiscal and financial management autonomy is determined by various factors. On the expenditure side of the budget, the local functions and the devolved service management authority define *what local governments can do*. The wide spectrum of public financial management actions influences the local scope of manoeuvre - that is *how local governments operate*: fiscal planning, accounting and reporting regulations, control over service organisations, transparency in decision making, etc. Therefore, the revenue autonomy is a key condition, as it determines the *access to public resources* through taxation, allocation of intergovernmental fiscal transfers and by setting the local revenue raising powers.

This policy analysis and the reform proposals target revenue autonomy. The following three main areas of fiscal autonomy within the revenue decentralisation framework are discussed:

1. raising of own source revenues,
2. mechanisms for sharing of revenues and
3. allocation of transfers.

Evidence are collected for evaluating the feasibility of the above-mentioned territorial-administrative reform options from financing point of view. *Several aspects* of the proposed municipal and regional government revenues and financing mechanisms will be assessed: how they influence fiscal autonomy, what financial incentives they create, what is their impact on service efficiency, what is their administrative viability and how they affect equity and fairness in local service provision.

Both tiers of local government, *municipalities and regional self-governments* as higher territorial units, are subject of this policy advice. Bratislava as the capital city with its own two-tier urban administration is discussed separately.

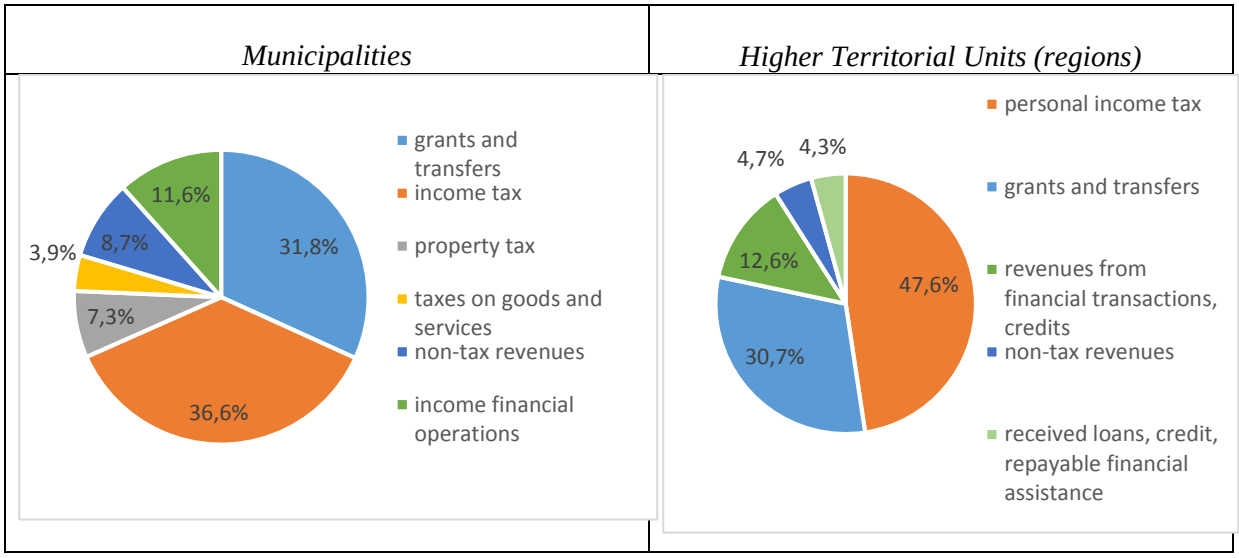
Local government revenue structure

Municipalities have the major role in financing local government responsibilities and public services: on the average 75% of local budgets are controlled by municipalities. HTU's role in financing local functions ranges from 18% (Bratislava region) to 28% (Banská Bystrica, Trenčín regions).

Municipalities are financed by a balanced set of revenues (see Chart 2). They include: the traditional own source revenues, the taxes and fees (20.0%) and shared personal income tax under local control (36.6%), the grants and transfers (31.8%) and the revenue from financial operations (11.6%).

The *regional self-governments*, as Higher Territorial Units are financed predominantly by the shared PIT (47.6%). The grants and transfers for financing delegated functions have 30.7% share in the HTU budgets, similarly to the municipalities. However, the regions have no real own source revenue raising powers, as they do not levy taxes. The non-tax revenues (fees, rents, business revenues, asset sale, etc.) represent less than 5% in their budget.

Chart 2: Major local government revenue sources, 2021



In comparison to the European countries, Slovakia belongs to the group of countries with *lower own source municipal revenues*. According to this categorisation, only locally levied taxes and charges are considered as own resources whereas the shared taxes belong to a different group. The higher dependency on national budget revenues is caused by the significant role of shared PIT in financing both tiers of sub-central governments.

Dependency on national budget revenues (PIT and transfers) is decreasing as the population size rises: larger municipalities have significantly higher share of own source revenues. (Table 2) More than one quarter of local budget revenues are raised from local taxes, fees and non-tax revenues in cities with population above 50 thousand, while this ratio is decreased to 16% in municipalities with population below 5,000. These small municipalities with population between 500 and 5,000 inhabitants, represent the lowest level where state administrative services are delegated: here the transfers to the deconcentrated organs of the ministries are the highest (above 33%).

The highly fragmented local government structure is reflected by the differences in revenue raising potential and in the composition of locally provided public services. These *diverse conditions determine the reform options* for increasing local fiscal autonomy. Larger municipalities are supported by the higher own source revenue raising powers, while the smaller ones need more equalisation funds, combined with autonomy in using the resources allocated to municipalities.

Table 2: Municipal revenue structure by population size, 2021

Population group	*Own source revenues*	*PIT*	*Grants and transfers*	*Financial operations*	*Total*
BA Capital	26,0%	41,4%	21,0%	11,5%	100,0%
BA Districts	30,1%	28,0%	30,6%	11,3%	100,0%
Bratislava, total	27,7%	35,9%	25,0%	11,4%	100,0%
Košice	26,1%	40,0%	22,3%	11,7%	100,0%
50,000<	24,4%	37,8%	22,9%	14,9%	100,0%
20,000-49,999	20,6%	37,8%	29,5%	12,1%	100,0%
5,000-19,999	19,3%	36,4%	32,6%	11,6%	100,0%
1,000-4,999	15,8%	34,7%	39,6%	9,9%	100,0%
500-999	16,7%	37,8%	33,1%	12,4%	100,0%
<500	19,6%	40,2%	26,0%	14,2%	100,0%
Total	**20,0%**	**36,6%**	**31,8%**	**11,6%**	**100,0%**

Own source revenue raising

According to the standard categorisation of sub-central government revenues, own resources are considered only those in which cases the local government has the power to *define the tax base, the rates and the allowances*. This means that the shared PIT does not belong to this group of fully locally controlled revenues, despite the fact that municipalities and regions are autonomous in spending that PIT.

In comparison to other economically developed countries, the *revenue raising autonomy* of all local governments (municipalities and HTUs) in Slovakia is *low*. (Table 3) The OECD average of local government taxes compared to the total tax revenues is 10.1% (excluding from the comparison the state governments of the federal countries, where this ratio is much higher). Among the four Visegrad countries, Slovakia, similarly to the Czech Republic, lags behind: only 1.8% of general government tax revenues are local. However, in the case of the devolved revenues, municipalities have high autonomy. They can set the revenue rates within limits (90.0% of all local taxes) and they have additional discretion in setting tax allowances (8.9%).

Table 3: Taxing power of sub-central governments, 2018

	SCG tax as % of total tax revenue	*Local discretion on rates*	*Local discretion on rates, reliefs*	*Central rates; revenue split; other*	*Total*
Poland	12.7	25.6	0.0	68.8	100.0
Hungary	5.8	96.4	0.1	3.6	100.0
Slovakia	1.8	90.0	8.9	0.1	100.0
Czech Republic	1.0	99.9	0.0	0.1	100.0
OECD, local avg.	*10.1*	*61.8*	*12.1*	*25.1*	*100.0*

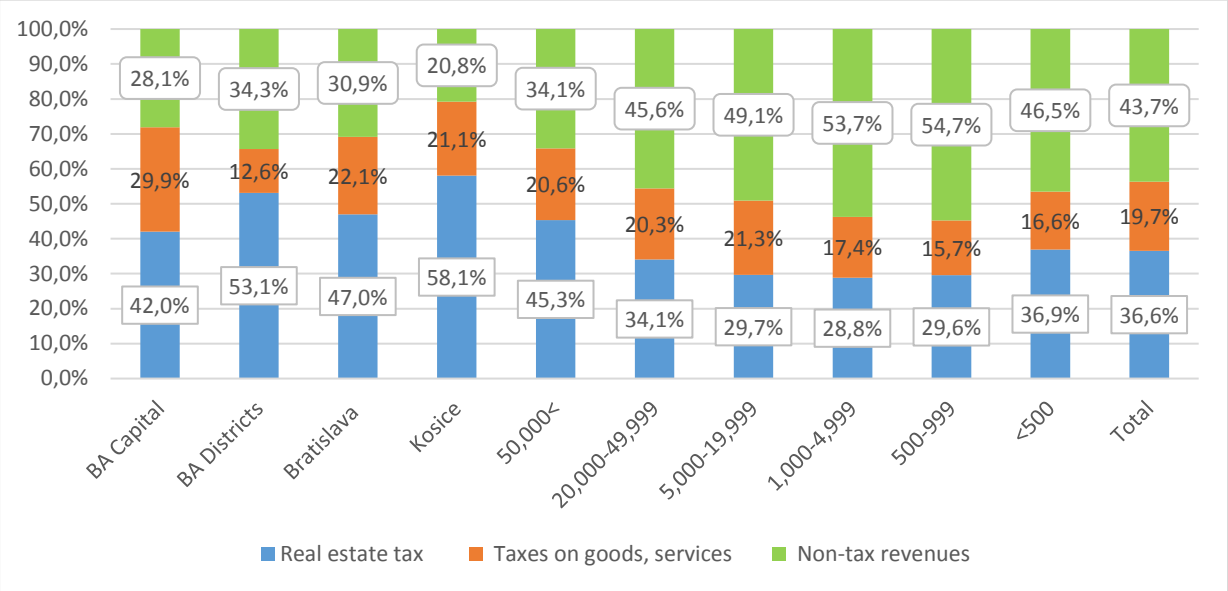
Source: OECD Fiscal Decentralisation Database

In Slovakia, the municipal own-source revenues are dominated by the *non-tax revenues*, which are mostly administrative fees and property revenues, such as rent (43.7% of all own-source revenues). The property tax on land, buildings, apartments is also significant (36.6%). The rest are other taxes on goods and services (e.g. dog tax, tax on tourism, vending machines) (19.7%).

The importance of these main types of own source revenues is *different depending on the size and type of municipalities*. (Chart 3) The large cities with population above 50 thousand collect more than two-thirds of own source revenues from local taxes, mainly from property tax. The smaller towns and villages with population of 500-5,000 rely more on the non-tax revenues, being administrative service fees and rent.

This group of small municipalities represents more than half of all municipalities in the country. Here, the delegated public services are the most important local tasks. The administrative fees collected with these delegated services are strictly regulated and they are connected to the services produced. They supplement the transfers received, so these non-tax revenues leave rather limited autonomy for municipal councils.

Chart 3: Composition of municipal own source revenues



Therefore, the revenue raising options should be found in other types of own revenues or by introducing new ones. Slovak local own source revenues can be increased by collecting more property related revenues (real estate, motor vehicle) and taxing other primary income earners, that is the local businesses. The proposals discussed below are based on the principles of good local taxation (see summary in Annex 1.).

Real estate tax

Property taxation is relatively developed in Slovakia and the real estate tax is a major municipal own revenue source. Regulations on property tax base and tax rates leave sufficient powers to the municipalities in developing their own revenue policies. The real estate tax regulation targets three types of asset categories: l) land (23% of property tax revenues in 2021), 2) buildings (69%) and 3) residential apartments (including non-flat areas in apartment buildings) (8%). Details on real estate tax regulation are summarised in Box 1.

Box 1: Municipal property taxation

Land tax is value based with nationally set tax rate of 0.25%. Municipalities can increase or decrease this tax rate set by law and differentiate tax rates for different location zones and for land categories. There are five land tax categories with the following maximum tax rate limits:

a. arable land, hop-fields, vineyards, orchards, permanent grassland – maximum 1,25%;
b. gardens – maximum 5-fold of minimal land tax rate in the municipality;
c. built-up areas, courtyards and other areas – maximum 5-fold of minimal land tax rate in the municipality;
d. forest lands on which there are farmed forests, fish ponds and other economically exploited expanses of water – maximum 2,5%;
e. construction land – max 5-fold of minimal land tax rate in the municipality. Lands connected with the construction of nuclear facility have a special maximum land tax rate of 25%

In each municipality (and sometimes in each part of the municipality) the average land value for *arable land and grass land* is administratively set by the national regulations. Those values are based on soil quality categorisation, and they vary from 0 (in city centres) to EUR 1.1674/m^2 for arable land and EUR 0,3014/m^2 for grass land. Municipalities are authorised to increase their zero rates up to maximum 50% of the value set administratively for the district in which municipality located.

The administratively set value of *gardens, build-up areas and construction land* is differentiated by the size of the municipality and the administrative status. Property value of gardens, build-up areas ranges from EUR 1.32/m^2 in municipalities with population below 1,000 to EUR 5.97/m^2 in Bratislava and

construction land between EUR 13.27/m^2 and EUR 59.74/m^2. The value of forest lands, fish ponds and water expanses is not regulated, but it is assessed by expert reports.

Municipalities are not obliged to follow administratively the set values for lands. A municipal decree can define local price maps which can set the tax base if the property owner does not object it by presenting his own expert opinion on the property value.

Tax rate on buildings is set at EUR 0,033/m^2 of land under the building. This rate can also be increased or decreased by specific rules based on the building category and zone. The law sets nine categories of buildings (e.g. non-commercial buildings, such as garages, glass-houses, chalets and also other residential buildings) The maximum tax rate is limited at ten times of the minimal tax rate on buildings. Municipalities are authorised to tax each floor separately in multi-floor buildings under the same rules. They may also decide upon different tax coefficients (with maximum value of 10) on non-maintained buildings in order to prevent deteriorated or dangerous, unstable buildings.

A special category is the **tax for apartments** (including non-apartment parts in apartment buildings) and the tax rate is EUR 0,033/m^2. The tax base is calculated on the area of occupied land (m^2), but with extra surcharges for floors above the ground. Municipalities can also increase or decrease this tax based on zones, respecting ten-fold difference between the lowest and highest apartment tax rates.

Tax exemptions are allowed for certain property categories, which are mandatory for some, while voluntary for others.

Source: Act No. 582/2004 Local taxes and local fee for communal waste and small construction waste

The real estate tax represents 7.3% of all municipal revenues (Table 4). In the smaller towns and villages this ratio is below 5%, while in the large cities more than double, around 11% of municipal revenues. The municipal property tax revenue per capita is EUR 80, which represents only 1% of the net income[6].

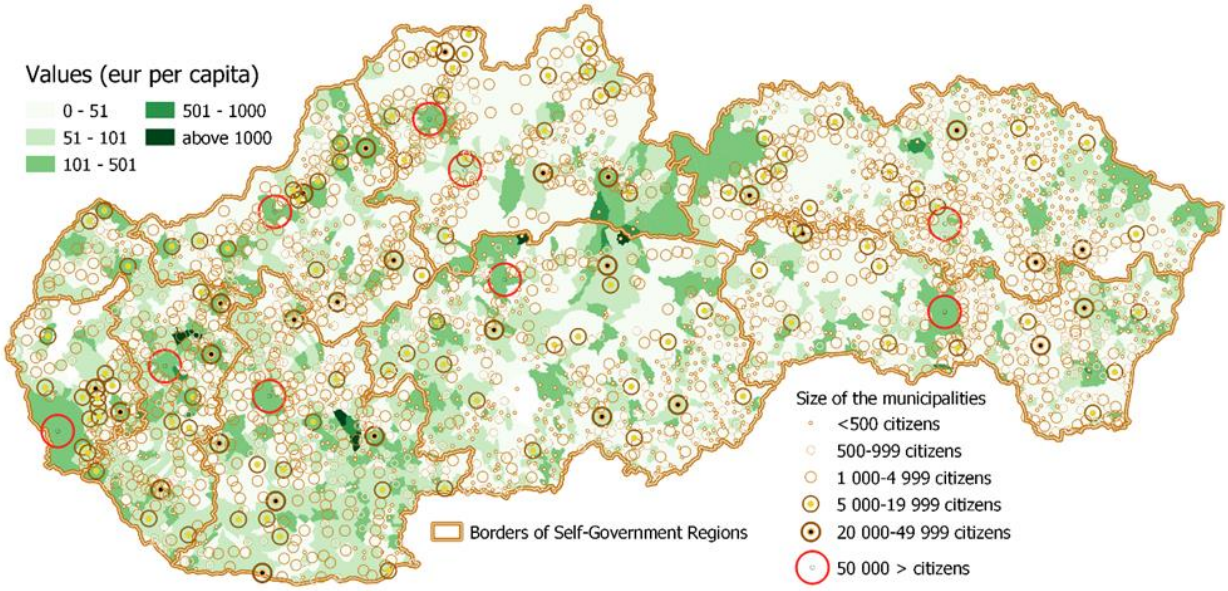
Table 4: Local real estate tax revenue, 2021

	Real estate tax as % of municipal revenues	*Real estate tax per capita, EUR*
BA Capital	10,9%	98
BA Districts	16,0%	101
Bratislava	13,0%	200
Košice	15,1%	167
50,000<	11,1%	135
20,000-49,999	7,0%	68
5,000-19,999	5,7%	67
1,000-4,999	4,6%	49
500-999	4,9%	46
<500	7,2%	56
Total	**7,3%**	**80**

There are large differences in utilising the real estate tax potential (Map 1). Tax revenue of five municipalities exceeds EUR 1,000 per capita. They are in an exceptional position: three of them have nuclear plant on their territory (Pečeňady, Kalná nad Hronom, Jaslovské Bohunice) and two are popular tourist ski resorts in Lower Tatras (Donovaly, Jarabá).

[6] Median equivalised net income, Statistical Office data, 2021

Map 1: Real estate tax revenues by municipality size (EUR per capita, 2021)



Source: Authors' design, with data from of SR Ministry of Finance and SR Statistical Office

Revenues from local real estate per capita tends to be higher in the *Western part of Slovakia*. This regional pattern follows the differences in economic development and municipality size, as Eastern and South-Eastern parts of the country are less developed and have even more fragmented territorial organisation. Some of the exceptionally high per capita real estate tax revenues are collected in the popular, but scarcely populated tourist regions or national parks. Here, the real estate is often owned by non-residents, who are politically easier to tax.

Municipality might use real estate tax policy as an instrument for promoting local economic development. Nevertheless, data show that *social goals* have a much higher priority in local tax policies. The average rate of taxing commercial areas was 9.2 times higher than the rate of taxing residential units (ZMOS, 2022). In 2020, the municipalities collected only EUR 53.7 Million of real estate tax on all residential buildings and flats of 226.7 million m^2, while levied only EUR 92,4 Million from commercial buildings with taxable area of only 200.5 Million m^2.

In land taxation, municipalities have some autonomy and high flexibility by setting not only tax rates but by defining the property value in the local regulation. They have the authority to identify the assessment areas within their territory, however these zones should not target specific property owners. The number of real estate units in a group of property (zone) cannot be less than 5% of all properties. This rule is a serious limitation and it creates an obstacle to use other land value capture methods (discussed later).

Proposed changes

Property taxes might have a greater role in financing municipal budgets. The following changes of the present tax regulations are needed for better utilising this potential local revenue source:

a) *increase of default rate.* Higher rates, combined with better proxies of property value make the real estate tax more progressive and fairer. An increased default rate set by the law – despite being only indicative targets - together with the ten times ratio of the maximum limit will produce more municipal revenues. More taxpayers will be subjects to the property tax at the upper end of ranges. It is justifiable, because the owners of the same size real estate with better quality property should pay higher taxes. The property tax will represent lower share in their income, as it is presumably higher compared to the income of the owners of lower quality units. They probably also use more municipal services, so their contribution to the public expenditures should be higher, as well.

b) *incorporating the quality of the property when calculating the base of the real estate tax*. Beyond the city zones, other characteristics of the property should be taken into account in the assessment of the tax base. The age of the building, materials used, access to utilities and specific amenities will help to

differentiate the area-based tax by making it more progressive and subsequently will increase the local tax revenues.

c) *ensuring local autonomy in deciding tax allowances and exemptions*. Introduction of a minimum real estate tax rate should be combined with the local autonomy to decide on a preferential tax treatment. There might be cases where real estate owners should be compensated for the environmental hazards that might affect them, such as in the vicinity of a nuclear power plant or waste treatment facility. Municipalities can balance these losses by other taxes levied on the potential pollutants.

d) *compensation of low-income taxpayers.* Local decisions on the property tax rate increase the burden on homeowners and local businesses. Setting the maximum ratio of property tax in percentage of household income will prevent pensioners and the less affluent families from excessive local tax burden (the mechanism is called "circuit breaker"). Similar allowances might be used for businesses by making their property tax deductible from the corporate income tax or by setting its maximum ratio.

e) *supporting the administration regarding the local property tax.* Moving towards *ad valorem* property taxation requires additional and new administrative capacities at the local level. Even basic indicators of the quality of the property can be specified by only additional information collected in the field or from parallel registries and information sources. It will require larger local tax administration and greater efforts to assess the tax base accurately. Local governments should be supported by information, equipment, training and other forms of capacity development. This one-time initial investment will make significant returns of higher municipal tax revenues.

New forms of capturing increase in property value

Higher property tax revenues and incorporation of quality in assessing tax base would open new possibilities for municipalities to increase their own source revenues. There are several property-based instruments which help to recover the costs of building public infrastructure. They all aim to capture the increase in property value as a result of public investments and re-zoning. Recently these *land value capture mechanisms* are more often used for financing infrastructure. They collect a portion of the increased value of properties (land or buildings) for the municipal budget. (Walters, 2013; World Economic Forum, 2022)

Various forms of property value capture techniques are based on a similar logic. The municipality builds the infrastructure or makes other public investments by sharing the financial burden with the property owners of the area, which benefitted the most from these improvements. Under this scheme, the new water system, the extended lighting network or public transportation system (e.g. metro line) is financed upfront by the municipal budget, but the costs are partially allocated to the property owners. These residents, commercial and manufacturing businesses affected by the public investment contribute to the municipal expenditures by paying higher property taxes. In these special assessment districts (areas) the benefits received will be proportional to the costs charged on the taxpayers. The actual payments could be made through surcharges on the property tax or as a temporary increase in tax rates.

The municipalities in Slovakia have sufficient financial management autonomy to plan and to implement these techniques for *raising the property related own source revenue*. The tax zones are decided locally, which will allow to identify the affected property owners who should contribute to the public investment. The regulatory limitation on minimum number of taxed units (5%) should be modified. This provision aimed to avoid targeted selective taxation of businesses. A mechanism for preventing corruption or extortion of individual property owners can be introduced by setting the absolute number of taxpayers in a specific zone (e.g. minimum 50). But a proper municipal tax policy with strategic goal aiming at long term development, will not put excess burden on businesses. They are relatively mobile and might move to other jurisdictions in a competitive environment.

Theoretically, the real estate transfer tax serves similar purposes, i.e. to generate local revenues for infrastructure development. But together with the tax on inheritance and the tax on gifts it was abolished in Slovakia in 2005. Despite its benefits, it is not recommended by this policy advice, because it does not fit into the overall national tax policy which aims to support economic growth and labour force mobility by not taxing property transfers.

Motor vehicle tax

With the decentralisation reform in 2004, the former road tax was transformed into a tax on motor vehicles used for commercial purposes. The regional self-governments were authorised to levy this circulation tax from the owners of motor vehicles used for business purposes. The tax base was the vehicle weight for utility vehicles and buses, and engine capacity for the personal vehicles. The tax rate was not regulated centrally. Diverse rates differentiated regional tax revenues (Gnap-Konecny, 2015). Later, since 2016, the regions were deprived of the motor vehicle tax, causing them a loss of this own source revenue, but they were compensated by the shared PIT.

There was a substantial amendment to the national motor registration tax in 2012. The former flat rate for new vehicle registration (EUR 33) was increased in an interval of EUR 33-3,900dependent on different engine power categories, whereas as a green tax - the electric cars pay only EUR 33.

The main argument for transferring the local motor vehicle tax back to the national budget was that the collected amount did not correspond regionally with the use of road infrastructure. Vehicles are registered usually in the region where the company headquarter is located, while they are used elsewhere. This administrative problem was not solved, instead a proper local environmental tax was centralised.

However, there is an increasing *need for environmental taxes* in Slovakia. The regular country report of the European Commission also proposes that "road taxes and vehicle registration fees could better reflect emission intensity by increasing them for polluting vehicles". (European Commission, 2022). Re-introduction of the local motor vehicle tax would serve exactly these objectives.

It is a widely used municipal tax elsewhere in Europe, because the tax on both passenger and commercial vehicles represents a relatively stable local tax base, the revenue is connected to the municipal services (road maintenance, environmental protection) and its administration is relatively inexpensive. The national tax or transport administration in Slovakia should be able to connect car registration to the owner's actual place of residence.

Motor vehicle taxation follow various models in Europe. Usually, the ownership of a passenger car is taxed by the motor capacity (engine power), the weight of the car, the CO_2 emission or the combination of these factors. Motor vehicle taxes are further differentiated by fuel type and age of the passenger cars. It is regarded as a progressive tax, because heavier cars or vehicles with larger engine capacities are usually owned by wealthier residents. (Country examples of taxes on car ownership are summarised in Annex 2.)

Table 5: Estimated motor vehicle tax revenue

Region	*Number of private cars*		*Potential revenue, EUR*
	City functional area (actual)	*Total, estimate*	
Bratislava	283 928	283 928*/	34 639 216
Košice	125 742	331 581	40 452 935
Banská Bystrica	40 329	289 549	35 325 035
Nitra	69 895	317 221	38 700 938
Prešov	56 155	364 467	44 465 014
Žilina	58 686	315 490	38 489 839
Trnava	58 237	268 821	32 796 117
Trenčín	45 308	268 928	32 809 199
Total	***738 280***	***2 439 986**/***	***297 678 292***
Average tax			122

*/*actual*
Source: DATAcube

The projected total motor vehicle tax is EUR 298Million, which would be equal to *one quarter of the present municipal own source revenues*. (Table 5) The motor vehicle tax might be allocated to regional self-governments as well. The decision on decentralisation depends on how road maintenance and transportation functions are shared between the two sub-national government tiers.

As a municipal revenue source, the potential motor vehicle tax in Slovakia was projected by multiplying the average tax (EUR 122/car) with the estimated number of private cars. These estimates are based on the reported number of cars by urban areas, the cars in total and the number of inhabitants by regions. The number of cars outside the urban areas was allocated by the share of population in a particular region.

Local business tax

There is a relatively *weak linkage* between local government budgets and business outputs located in a municipality or a region in Slovakia. The personal income tax, as a revenue shared mostly by the number of inhabitants is vaguely and only indirectly connected to the local economic potential. The argument saying that population-based PIT allocation is in accordance with the local employment and subsequently defines the infrastructure needs (e.g. in transportation) is only partially valid. Modern businesses claim more complex services (e.g. clean environment, qualified labour, vibrant urban life, culture) from the host local governments, where they are based. Improvement of these local functions need broader revenue base, not only revenues shared by the population number.

Businesses pay property tax but it *only partially reflects the taxpayers' financial capacity* (turnover, profit). It might correlate with the companies' economic potential in the traditional sectors, but the more labour-intensive services and high-tech industries are driven by other production factors, as well (e.g. see the difference in real estate value of a warehouse vs. software house). Taxing only real estate does not connect properly the payments made to the local services received. It makes the taxes less fair as companies in different financial positions will contribute to the local budget with similar – asset based – amount.

All these factors make the financing of local budgets rather single-sided in Slovakia. Here, municipal and regional governments rely predominantly on revenues from citizens, as private individuals. Taxing local businesses at the sub-central level will broaden the financial basis of devolved public services. A balanced revenue structure makes the local budgets more stable.

European models of taxing local businesses

The European models of local business taxes are built on two types of economic indicators: financial output (value added) and the assets of taxed business or the combination of these methods. (see details of the discussed country cases in Annex 3).

In *Germany,* the local business tax (Gewerbesteuer) is mandatory for all companies. It is legislated by the federal government, but local governments are authorized to increase the minimum rate within the framework set by state level regulations. The tax base is the corporate income, although some costs might be deducted. It is paid only above a minimum income. The tax base is allocated among municipalities by the labour costs.

In *France,* a new local business taxation was developed in 2010 by supplementing the former „tax professionnelle". In addition to the rental value-based property tax component, a local tax based on the company's added value was introduced. The tax rate is progressive along the bands of added value. The total amount is limited in the percentage of the total value added of the company. The revenues from the two components of the local business tax is shared between the municipalities (they receive the property value based portion) and the higher territorial units (which benefit from the value added component).

The local business taxes in *Italy* and *Hungary* follow similar principles: they both charge the net turnover of companies. In Italy, the basic tax rates are differentiated by the type of business (financial institutions pay more) and the local government can top-up these rates below a nationally set limit. In Hungary, the maximum tax rate is also regulated, however, there is no minimum business tax rate. These local business taxes passed the test of the European Court, so they are not regarded as local VAT, which is prohibited in the EU.

These country examples prove that the local business tax is a proper local government revenue source. By moving towards a broader tax base with lower rates, it makes the *business value tax politically more acceptable* (Bird, 2014). It meets most of the requirements of a good local tax. The local business tax contributes to a broad range of local services which in turn helps the economic development. The business value tax economic distortion effect is low as the burden does not fall on a one single production

factor. It is more stable revenue than the profit tax. It attracts the companies with higher value added to the municipality or region. The tax administration might be shared with the national tax authority, which will decrease the local costs of tax collection.

Following the 2008/2009 economic crisis, national tax policies usually targeted lower tax burden and aimed to stimulate economic growth. Limits on local business taxes can support these goals and excessive taxation of companies can be avoided by compensating them with lower national taxes.

Concentration of tax revenues can be limited by levying the business tax in larger jurisdictions, assuming that accountability is still ensured. This characteristic of a local business tax makes it *more acceptable as a regional government resource*. The natural geographical differences in business locations are equalised within the larger territorial unit.

The Council of Europe report on the regional governments in Slovakia also argued that regional finances should be connected to the "…*actual economic output produced and consumed in the region. The current criteria … lead to misalignments between financial transfers, actual expenditures and attractiveness of regions and municipalities to businesses, workers, and consumers*". (Allio, 2022)

Introducing regional business value tax in Slovakia

All these arguments call for the introduction of a *local business tax, as a regional self-government revenue*. Assuming that a business value tax would finance 10% of the regional governments' budget, EUR 272 Million might be allocated by this new revenue source. It could replace some of the shared PIT and will open up new own-source revenue raising options for the regions. It should not create a new tax burden on the companies and other businesses, if the aggregate PIT revenue is decreased.

However, it will definitely *change the allocation pattern* of the regional self-governments' shared revenues. (Table 6) Data are available on regional GDP and compensation of employees, which can be used as proxies of potential business value added. These two indicators showed similar regional patterns, so here regional GDP was used for estimating local BVT.

Compared to the present revenue sharing, two regions (*Bratislava, Trenčin)* might gain with the business value tax. The other regions' share of GDP is lower than their population weight, with the highest losses in the regions of *Banská Bystrica, Prešov, Košice.*

Table 6: Business Value Tax projection: 10% of regional self-government revenues[*/]

Regions	*GDP share*	*BVT estimated by regional GDP shares, EUR Million*	*Estimated BVT as % of HTU revenue*[**/]
Bratislava	28,4%	77,4	34,8%
Trnava	11,4%	30,9	13,6%
Trenčín	8,8%	24,1	10,2%
Nitra	10,6%	28,8	11,6%
Žilina	11,0%	29,9	11,4%
Banská Bystrica	8,5%	23,0	8,7%
Prešov	9,2%	25,1	7,9%
Košice	12,1%	32,8	11,4%
Total	**100,0%**	**272,1**	**13,2%**

**/ total RSG revenues (financial transactions included)*
***/ estimates of HTU revenues (excluding financial transactions)*

These figures indicate the revenue structure of regional business value tax only at the beginning, in the year of its introduction. By empowering regional self-governments with revenue raising authority,

different tax policies with diverse tax rates and allowances will follow. Subsequently these territorial proportions might change in the future and the total collected amount can become higher.

Further refinement of business value tax regulation will limit the concentration of the tax revenues in the municipality (region), where the company's headquarters is located and the business is registered. There are methods to *reallocate BVT among the actual locations of economic activities* by sharing the tax base with the help of measurable indicators, such as number of employees and/or asset value.

The estimated high share of BVT in the Bratislava region's budget shows the present concentration of businesses in the capital city and its vicinity. The projected Business Value Tax would represent 34.8% of the budget revenues in the region surrounding Bratislava. Under the proposed scenario of the Bratislava City-region, the share of BVT would be only 6.3% of the budget revenues in the newly created metropolitan area.

Revenue sharing

Personal income tax is a major municipal revenue: it represents more than one third of the total revenues. In Slovakia, it is an own-source local revenue although it does not meet the criteria of a proper locally controlled revenue. It should be regarded more as a shared revenue because the central government sets the tax base, rates and tax reliefs, and the SCG has no control over these critical components of the national tax. This is the reason why international fiscal reports and statistics never categorise Slovak local PIT as an own source revenue.

Present PIT sharing practices

Table 7: Shared PIT allocation criteria

Municipality		*Region*	
Residents	23%	Residents	15%
Height (elevation)	Population 57% is recalculated by the altitude coefficient	Population 15-18	15%
Population size	32%	Elderly population	32%
Pupils	40%	Reverse density	9%
Elderly population	5%	Length of the roads	20%
Total	***100%***	**Area**	**9%**
		Total	***100%***

Following a decade long learning and adjusting period, presently the *total amount* of personal income tax is allocated to local governments (with 70:30 ratio shared between municipalities and regions). Earlier, the revenue sharing rule was different as some part of the actually collected PIT was kept by the national budget. It aimed to compensate local governments for the national grant revenues lost and the costs of newly delegated services. This centrally kept portion of the PIT was 6.2% in 2004 and 12.7% in 2012[7]. In 2004, the regions received only 23.5% of the total amount collected, while municipalities kept 70.3%. After the economic crisis, when the centralised ratio increased, both the municipal share (65.4%) and the regional self-governments' portion (21.9%) were lower. The municipalities' advantage vanished in 2015 when the regional self-governments had to be compensated for the centralised motor vehicle tax. The national fiscal regulations influence the actual amount of local PIT. The recent decision on income tax bonuses decreased the PIT amount planned for municipalities and regions.

[7] See MoF website on fiscal decentralisation and the country fact sheet in SNG WOFI report, 2019

The indicators used for PIT allocation follow local government functions, that is they are *proportional to the needs and costs of municipal services*. (Table 7) In the case of municipalities the main indicator is the number of permanent residents, the pupils and the elderly population. The regional self-governments share is also determined primarily by the population number, taking into account the services needed for two specific age groups (secondary school age and elderly population). In addition, the length of roads, the area and population density (preferring sparsely populated regions) are used as allocation criteria.

In addition, the urban and regional differences in service costs are also built into the complex PIT sharing formula. Coefficients by municipality size (higher in larger municipalities) and elevation (favourable multipliers for municipalities located in higher altitudes), try to respond to the differences of the demand for services in urban centres and heating costs.

Due to the population number dominated sharing formula, the PIT is rather *equally apportioned* among the municipalities. (Table 8) On the average 36.6% of local revenues is financed by the PIT and the differences are minimal among the municipalities of different sizes. Dispersion is 15.2%, which is low even in relative terms. The PIT ratio ranges between 34.7% in the group of municipalities between population 1-5 thousand and the maximum of 40% in Košice.

Table 8: Personal income tax revenues

	Income tax as % of local revenues	*Income tax per capita*	*Income tax per municipality, EUR 1,000*
BA Capital	41,4%	373	177 324
BA Districts	28,0%	177	4 964
Bratislava	35,9%	550	14 539
Košice	40,0%	440	100 740
50,000<	37,8%	459	32 359
20,000-49,999	37,8%	365	10 234
5,000-19,999	36,4%	424	3 955
1,000-4,999	34,7%	376	725
500-999	37,8%	354	251
<500	40,2%	314	83
Total	**36,6%**	**401**	**779**

The income tax revenue per capita (EUR 401 on the average) follows the *urban slope*. The PIT per capita is highest in cities with population above 50 thousand and lowest in the small municipalities (EUR 314 in municipalities with population below 500), mainly as a result of size coefficients in the formula[8]. The income tax distribution method results minimal revenues in the group of the smallest municipalities (only EUR 83 thousand per municipality). There are exceptions to this urbanisation driven trend: towns of 20-50 thousand have lower PIT per capita and the smaller towns of 5-20 thousand benefit more from these allocation rules. These differences are explained partially by the *high weight of number of pupils* (40%) in the formula.

Regional differentiation of per capita PIT revenues is also explained partly by the urban structure and geography. The municipal PIT per capita revenue outside Bratislava is highest in the Žilina (EUR 432) and Prešov (EUR 430) regions. While the predominantly flat Nitra region (EUR372) and in the Košice region (EUR 319) with numerous small municipalities the shared PIT revenue is low.

[8] Population size coefficient is defined by number if inhabitants, as follows: 0.89 for 1-1,000 inhabitants, 0.9 for (1001-5,000), 0.91 (5,001-10,000), 0.94 (10,001-50,000), 1.13 (50,001-100,000), 1.50 for Košice City, 2.35 for Bratislava Capital City.

Options for improving PIT sharing

Specific rules of PIT sharing and allocation in Slovakia meet three of the four criteria used for defining a proper shared revenue. (Blöchliger-Petzold, 2009). Firstly, the PIT revenue is fully shared with local governments, so they *bear the risk of tax revenue fluctuation*. Secondly, the use of PIT is unconditional, which means that municipalities and regions have *high autonomy in spending* the tax revenue shared with them. It is exclusively allocated by a formula and the tax sharing *rules are set by law*[9] without any changes during the year or being rarely modified between fiscal years. This formula-based allocation results in a horizontal distribution of the PIT with a strong equalisation affect. Lastly, the condition not met is that the shared revenue is *not connected to the PIT generated in the territory* of the local government. The lack of this origin-based portion of the shared tax makes the allocated PIT closer to a grant.

In summary, the PIT allocation in Slovakia has several positive characteristics and also some disadvantages. A summary evaluation of the PIT sharing system will help to identify the directions of future correction and reforms. (Table 9)

Table 9: Summary characteristics of PIT sharing

Positive, favourable	*Negative, disadvantageous*
Shared PIT is a significant local revenue	Single shared revenue base is volatile, fluctuating
Rules of revenue sharing are regulated by law	Annual change of tax legislation makes the local shared revenue less predictable
Allocation formula takes into account the service needs and some cost factors	PIT is only indirectly connected to local wealth, citizens' income
Allocation criteria are objective and measurable	It correlates mostly with the quantity of local services, quality is not taken into account
Allocation formula supports mainly the formal revenue equalisation	Allocation formula does not support the effective utilisation of local PIT potential. It creates very weak local incentives for increasing PIT revenues
Pupil number based component stabilises the school network, as it reinforces the existing structure in education	Pupil number based allocation component does not create incentives for school network rationalisation
The formula is simple, it is clear, understandable for the decision makers	The accuracy of municipal population numbers is questionable

The current PIT sharing mechanism can be improved in two ways, by

- incorporating more national revenues in the pool of shared taxes
- refining the rules of revenue sharing.

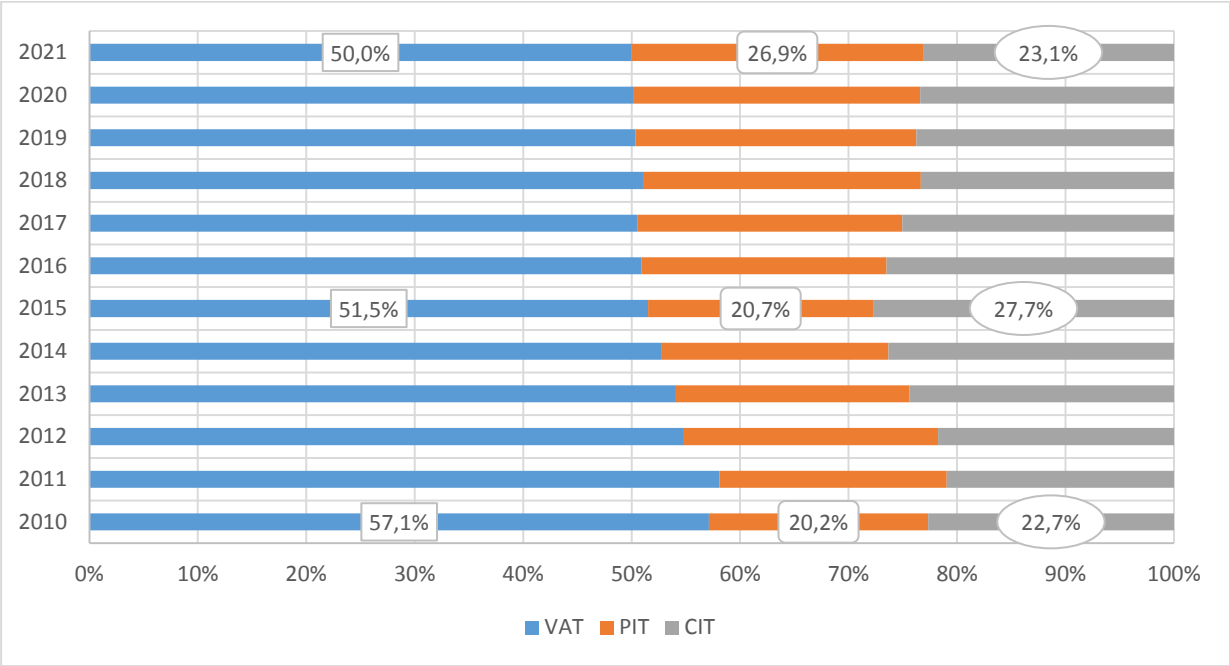
Broadening shared revenue pool

Three main taxes usually establish the revenue basis of national budgets: the Value Added Tax, the Personal Income Tax and the Corporate Income Tax. In Slovakia, they represent more than one third of the total budget revenues. Among these three taxes, the VAT is the largest one, amounting to half of these major taxes. The PIT proportion is increasing and by now it reached 27% of the three taxes. The CIT's weight is 23%, although it was higher in the middle of the decade, during the period of economic recovery. (Chart 4)

[9] Only the overall sharing ratio of 70:30 is regulated by the law, the actual PIT distribution formula is stated in a government decree.

Despite all the criticism, in the long run *local governments benefitted from the present PIT based revenue sharing regulation*. Following the 2008/2009 economic crisis, the weight of the PIT increased among the main taxes: from 20.2% (2010) to 26.9% in 2021. Both the PIT and CIT showed significant fluctuation in this period.

Chart 4: Composition of major general government tax revenues , 2010-2021

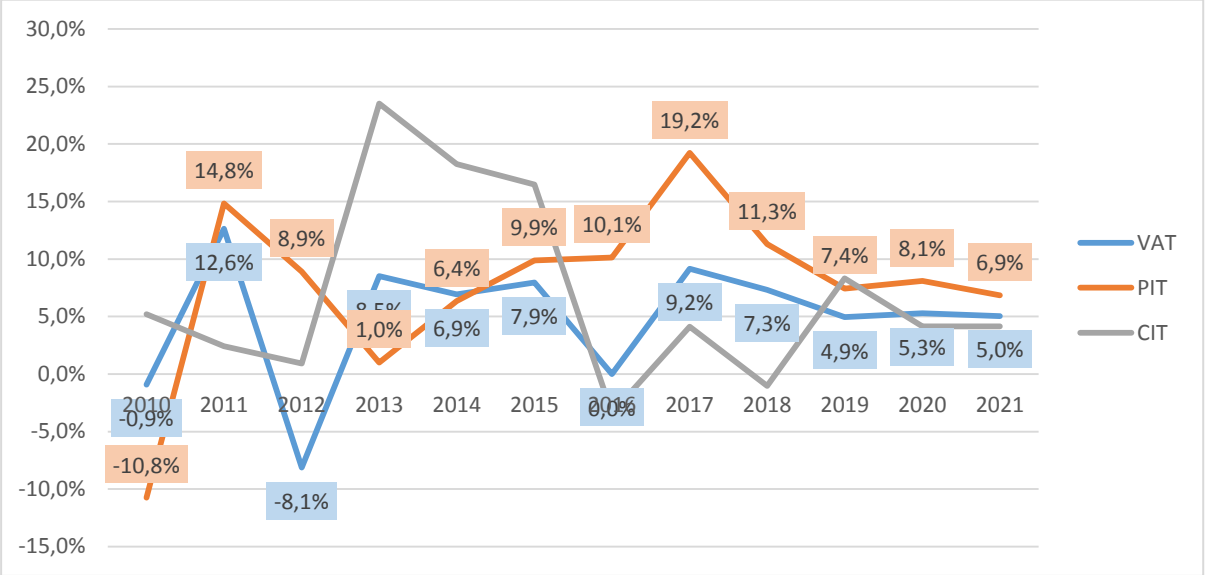


However, annual *changes of the VAT were less drastic* and its variation was high only in the period of the crisis recovery in 2011-2012. (Chart 5) The direction of changes of these three major tax revenues often neutralise each other: annual high increase of PIT either coincides with VAT decline or its lower growth. Volatility of personal income tax is caused also by the fictitious employment and underreported PIT revenues (NKU, 2022). The dynamics of the three tax revenues has been stabilised only during the past three years.

The volatility of PIT and VAT revenue trends argue for combining the two major taxes into a *joint fund for revenue sharing*[10]. For example, allocating 70% of the PIT and 15% of the VAT into a common revenue pool for sharing will not change the central and local budget relations at the aggregate level. It will only decrease the shared PIT by EUR 1.1 Billion and supplement the shared taxes with the same amount from the VAT. So, the impact on total local and national budgets will be neutral.

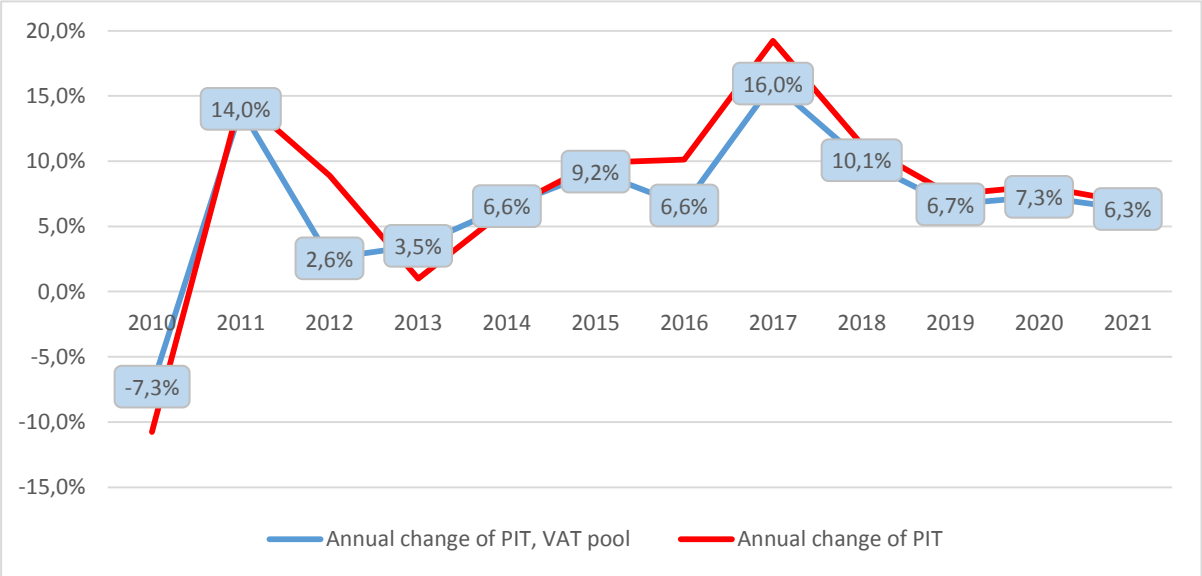
[10] A similar method was followed in the 2023 budget by combining the CIT with the PIT in the pool of shared revenues. It has increased the amount of shared taxes by 33% and represent 25% of the total amount allocated by formula.

Chart 5: Fluctuation of major tax revenues (annual change, %)



However, in the long run, the two taxes will create a *more stable base* for the financing of the local government shared revenue. Annual changes of these two combined revenues are lower than the fluctuation of the PIT. (Chart 6). The blue line of the combined revenue pool in the chart is always closer to the horizontal axis than the red line of PIT. Lower fluctuation of the shared revenues will stabilise this revenue source and will make the aggregate local financial resources more predictable.

Chart 6: Annual change of proposed larger pool of shared taxes and PIT



Sharing PIT by place of origin

The present revenue allocation criteria are proxies of the need for locally provided services. The revenue sharing model is dominated by the population number and similar indicators of service needs. Only the pupil-based PIT sharing follows a different logic - when the actual demand is measured by the number of enrolled pupils (adjusted by education service and institution type). The foundations of tax sharing formula can be hardly improved in the present highly fragmented territorial-administrative municipal system of Slovakia. Further refinement of the present system might be implemented, but conceptually new indicators, such as the school age population number at municipal level, would endanger the stability of municipal finances.

However, municipalities and regional self-governments would benefit from diversifying the methods of the PIT sharing. Beyond the present formula-based reallocation, a set portion of the PIT might be *allocated by its place of origin*. Direct connection of shared PIT to the local budget, where the taxpayer lives, has various benefits. Firstly, increase of residents' income creates new opportunities for local service improvements. Secondly, local governments should respond on the local taxpayers' needs by providing better or different types of services. It will improve accountability as citizens become more interested in following municipal decisions and monitoring the way how their taxes are spent.

This derivation-based PIT allocation method can further increase local autonomy, when local governments have the authority to *add a local tax on the national tax*. This surtax is levied on the same income tax base and the additional local rate is limited by law. This model is preferred in the Scandinavian countries, but it is used also in Croatia and Montenegro. It connects even more directly the locally paid PIT and the services received. It makes the revenue sharing more effective by enhancing the fiscal autonomy by allowing a partial local control over a major tax revenue. This surcharging method can be used for municipalities and regions in parallel.

Critical condition of the origin-based PIT sharing method is *proper information on the taxpayers' place of residence*. In Slovakia, the personal tax identification number presently does not have a code on permanent residence. However, the Tax Office registers might be connected to the place of residence through the nationwide Personal Identification Numbers. Regardless of the form of tax reporting (self-declaration or the employer declaration), the physical address can be merged with the information on the tax paid. Alternatively, the taxpayer might declare his/her tax residence if it is different from the permanent address.

Under this type of PIT sharing method, local governments will urge local taxpayers to register in the municipality where they mostly stay. According to a local estimate there are approximately 130 thousand people - 5% of all taxpayers without permanent residence. (There are no estimates on the number of citizens living in a municipality, which is different from their place of registration.) With this information on the actual place of residence, the PIT can be directed by the Tax Office to the right municipality or region simply by transferring quarterly the income tax collected.

A rough simulation of the origin-based PIT sharing is summarized in Table 10. These estimates *allocate 10% of the PIT by the amount of compensation to employees*. Data are available on the compensation of employees by regions, which are good proxies of personal income tax revenues. Allocating the EUR 227.8 Million (10% of municipal PIT) by the regional proportions of employee compensation, the impact of origin based PIT can be assessed. At least the directions of changes by regions are measurable (see the last column of Table 10).

Table 10: Estimated impact of origin based municipal PIT allocation

Regions	*Compensation of employees (EUR M)*	*Regional location of employee compensation*	*10% of municipal PIT allocated by employee compensation (EUR M)*	*10% of PIT shared by formula (EUR M)*	*Differences of origin and formula based 10% PIT allocation (EUR M)*	*Differences of origin and formula based 10% PIT allocation (%)*
Slovak Republic	40 218,4	100,0%	227,8	227,8	0,0	0,0
Bratislava (NUTS 2)	11 440,0	28,4%	64,8	35,9	28,9	80,5%
Trnava	3 863,1	9,6%	21,9	21,3	0,5	2,6%
Trenčín	4 113,3	10,2%	23,3	23,0	0,3	1,2%
Nitra	4 200,5	10,4%	23,8	25,2	-1,4	-5,5%
Žilina	4 679,1	11,6%	26,5	30,0	-3,5	-11,7%
Banská Bystrica	3 721,9	9,3%	21,1	25,4	-4,3	-17,1%
Prešov	3 601,6	9,0%	20,4	34,8	-14,4	-41,4%
Košice	4 598,9	11,4%	26,0	32,2	-6,2	-19,1%

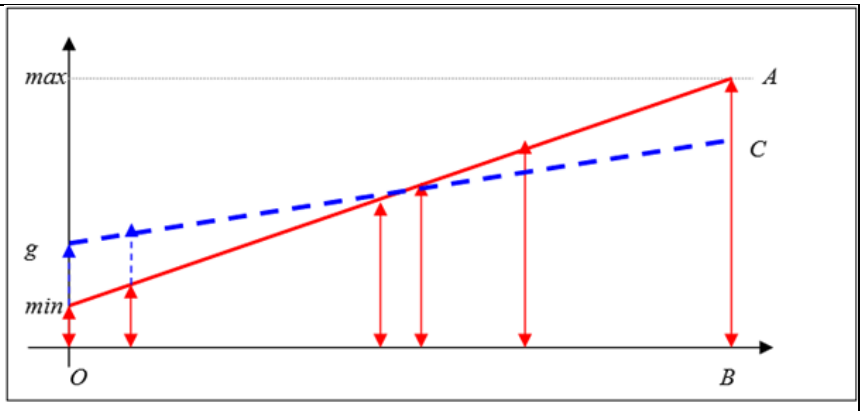
The municipalities in the area of Bratislava region (including the Capital and the city parts) would benefit the most from this origin-based PIT sharing. Compared to the present PIT allocation by formula, these local governments will receive 80% more. It is explained by the higher salaries and the concentration of better paid employees in the city and the surrounding towns, villages. Municipalities in three regions (Trnava, Trencin, Nitra) will remain in the same financial position. The remaining four regions would lose because the origin-based PIT is lower than what they get through the formula: Žilina (-11.7%), Banská Bystrica (-17.1%), Košice (-19.1%) and Prešov (-41.4%).

These estimates are regional aggregates and show only the impact of the first year of introduction, while the municipal differences are definitely higher. With active municipal development programmes, the local personal income tax base and consequently the amount of derivation-based PIT shares will increase. During the reform, the shocks of sudden revenue losses might be minimised for the "losing" municipalities. In a transitionary period, they might receive a gradually declining amount which compensates the difference of the PIT shared by formula and portion allocated by taxpayers' residence.

The origin-based PIT allocation will not only diversify the local revenue base, but it will *open up new possibilities for revenue-based equalisation*. Municipalities with high PIT revenues (per capita) might contribute to the budgets of municipalities with very low PIT revenues (per capita). There will be many municipalities in between these two extreme groups. They are in a neutral position, that is, they do not pay to or receive compensation from the PIT equalisation fund[11]. They will be further incentivised to increase the local income tax base.

This method of revenue equalisation follows the overall rationale of fiscal equalisation, already known since the start of the fiscal decentralisation reform program in Slovakia (see Box 2.)

Box 2: Fiscal equalisation within the local budget framework



The authors of the fiscal decentralisation reform in Slovakia have developed an equalisation scheme both for municipalities and the regional self-governments. It is based on that internal equalisation approach, which does not change the relative position of the "richer" and "poorer" local governments. Only the difference between them will be lower. As it is presented in the chart below there is a guaranteed minimum funding for the least affluent local government (point "g" on the vertical axis). The red line represents the position of local governments before equalisation (ranked from poorest to the richest along the horizontal axis). The blue line is the position of the same local government after equalisation. In this equalisation scheme, the national government decides the "guaranteed minimum" revenue of the poorest self-government, which is the only input to the equalisation formula. The changing component is the slope of the line representing the financial position of the municipalities (or HTUs). This way, any of them is always motivated to increase its revenues, because even after the equalisation each additional earned euro will make the municipality or the HTU better off by a certain percentage of the euro collected.

Source: Nižňanský – Valentovič, 2002

[11] A similar per capita income tax equalisation method is used for example in Serbia, where the two largest cities contribute to the numerous municipalities with PIT per capita below 90% of the national average (called Robin Hood method).

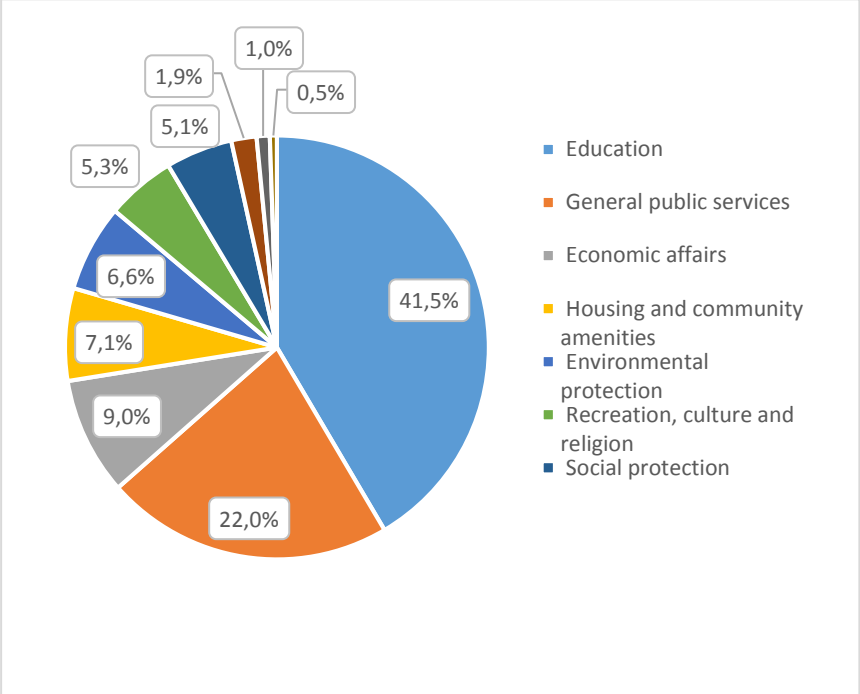
Grants and transfers

A possibility of transferring selected local state administration tasks to municipalities or HTUs when the state covers the costs, is enshrined in the Slovak Constitution. This mechanism increased service efficiency by terminating the former local deconcentrated state administration (called district offices). At the same time, with this transfer of competencies, the former state district office services come even closer to the citizens. It also means that not the municipalities, but the state is responsible for the execution of each transferred task.

Municipalities implement these services for the state and in the name of the state.

The largest *municipal services* by expenditure size are the public education (41.5% of municipal budgets) and the administrative services (general public services: 22.0%) (Chart 7).

Chart 7: Municipal expenditures by services, 2021



The fully or partially *transferred local competencies* are, as follows: public education, implementation of construction law, local roads and communications, housing in relation to the state support program, registrar (in some municipalities only), residency registry, organising elections and referendum, state water management, environment protection, protection against floods.

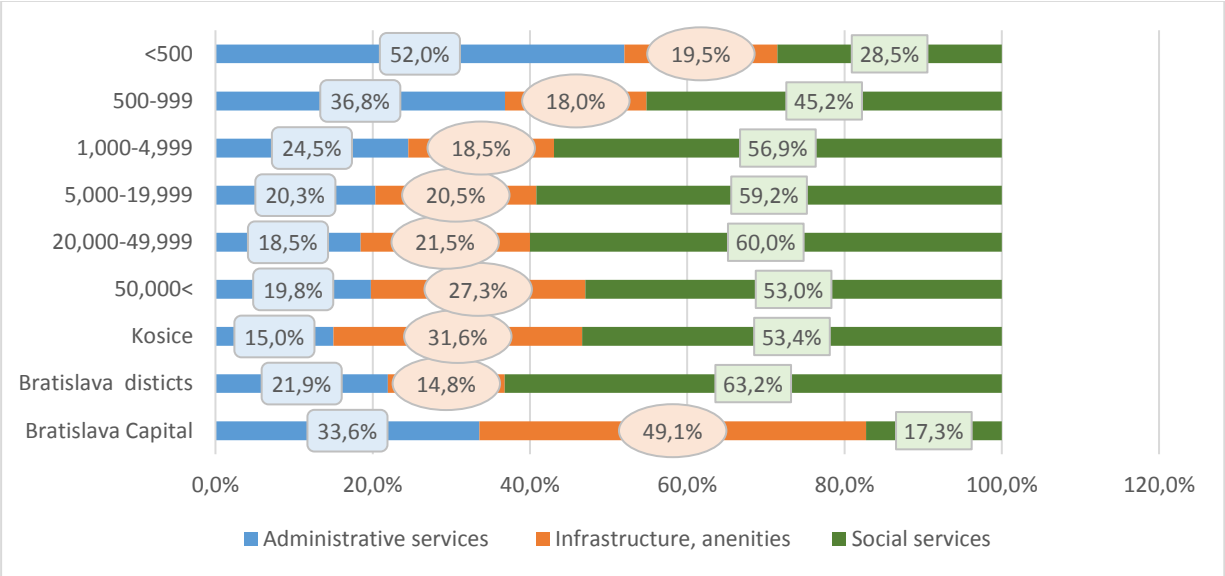
Delegated competencies are different from all other municipal "original" or "self-government" tasks. Only these self-government tasks are executed under the responsibility of the municipality and funded from municipal own sources. Because at the time of decentralisation, the own sources (such as local taxes) were not sufficient to cover all original municipal tasks, the shared taxes supported these purposes, as well.

In the case of education such operational activities, such as the maintenance of school canteens, clubs and specific education activities (language schools, elementary art schools, re-education centres, leisure centres, etc.) are not guaranteed by the constitution. They are regarded as original municipal competences financed by municipal own resources (local and shared taxes, but not the transfers).

Grouping the municipal functions into three major categories, Chart 8 below shows the differences in spending responsibilities by population groups. The *social services combined* (health care, education, social protection, culture) have the highest share in the budgets of those municipalities where the institutions operate. They are typically municipalities above population 1,000. *Administrative service*

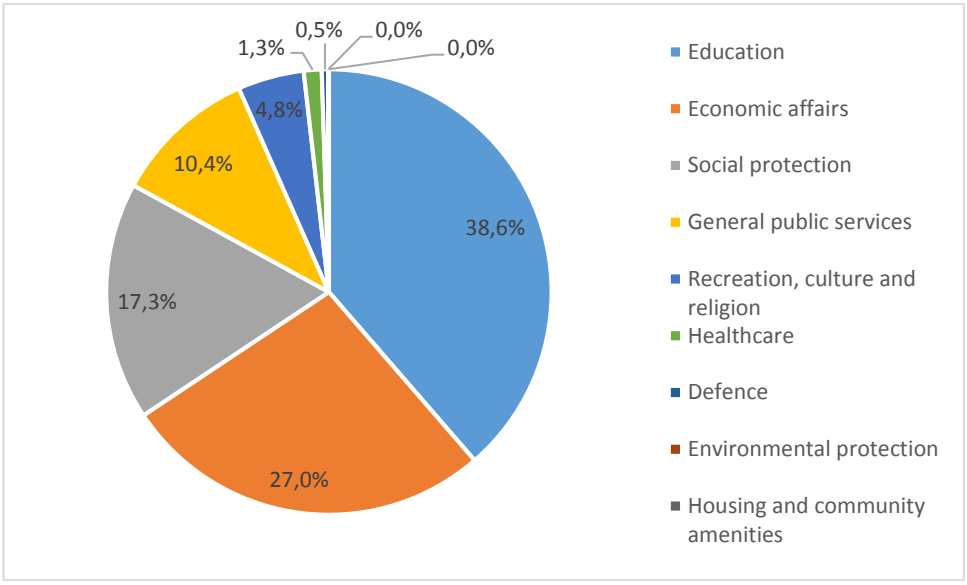
expenditures dominate the local budgets of the small municipalities (below population 500: 52%, in population group 500-1,000: 37%). *Infrastructure services* represent roughly one fifth of the expenditures in all types of municipalities, with a slightly increasing share in the larger cities.

Chart 8: Services by municipal population size, 2021



Administrative services: General public services, Defence, Public order and safety
Infrastructure, amenities: Economic affairs, Environmental protection, Housing and community amenities
Social services: Health, Recreation, culture and religion, Education, Social protection

Chart 9: Expenditures of HTUs by services, 2021



The *Higher Territorial Units* have different service responsibilities. *Secondary education* is the largest budget item in the regional self-government's budget (39%), it is followed by the *economic affairs* (27%) and *social protection* (17%). These are typical services organised for larger areas (e.g. transportation, social institutional services). Compared to these costly public services, the administration (10.4%) represents a relatively low part in the HTU budget.

Transfers to municipalities

National budget grants and transfers are provided primarily for the delegated municipal services. Grants and transfers are the second largest municipal revenue source. In 2021 they represented 31.8% of the municipal budget revenues (see Chart 2. above). These current budget subsidies and capital transfers are higher among the local budget revenues in smaller municipalities, which have limited own source revenues. In the group of small towns and villages with population between 1,000-5,000, the grants and transfers have the most significant role: they finance 39.6% of the total budget (see Table 2 above).

Grants and transfers are important pillars of self-government funding in the present system of intergovernmental finances in Slovakia. The majority of grants and transfers (85%) received by the municipalities were domestic current transfers. (MoF, 2021) Of that, 61% were transfers from the state budget aimed at covering costs of so called "transferred execution of the state budget".

Different ministries are involved in formulating and implementing the transferred services, in accordance with applicable legal regulations. The transfers for covering the costs of delegated competencies also *flow from various national government entities* (ministries, agencies). A further complication is that not all the activities are implemented and thus funded every year, or the transferred competence targets only a sub-group of municipalities.

For example, in the year of the census, the Statistical Office can issue a decree for funding particular activities to be realised by the municipalities. It should give an exact definition of what services are paid by that particular state budget transfer to cover the costs of this delegated responsibility. The state may also delegate its responsibilities to only selected municipalities to overcome problems of fragmentation. This was implemented in the case of "registrar offices", which were not delegated to all municipalities. Only the larger ones (971 municipalities + 2 military districts) in micro regions of "registrar districts" manage this specific service.

Transferred competencies might offer a solution to the problem of municipal fragmentation. In the case of these state services, when the implementation and funding is a state responsibility, the optimal service networks are defined by the state (e.g. in the case of joint citizen registrars). The "forced co-operation" via financial mechanisms would not be against local autonomy. In principle funding of these "joint administrative offices" should be arranged in a way that the host (gestor) municipality costs are fully covered by the national budget transfers, and it is not obliged to use its own sources for the benefits of the neighbouring municipalities, serviced by the central one.

Ministerial specific grants, subsidies

Transfers for these delegated services (registry, education, construction permit, social housing, environment, forestry, etc.) are financed through the relevant line ministry budgets as earmarked transfers. In 2023, EUR 1,302 Million were budgeted for municipalities and EUR 588 Million for HTUs as grants and transfers. Most of these funds (98,2% in the case of municipalities and all for the HTUs) come from the Ministry of Education's chapter to cover the costs of transferred educational competencies. The rest is budgeted through chapters of the Ministry of Interior and the Ministry of Transport[12].

These grants are allocated by objective criteria, for example as the transfers for state administrative services from MoI (see Table 11 below). Since the competent ministry sets the grant allocation rules, the MoF has no direct influence on the amount received by a municipality. The grant allocation for these transferred competencies follows the sector specific territorial-administrative structures. However, many of them are combined into the 48 State Administrative Offices under the MoI.

Public education, as the largest municipal and regional expenditure, is financed through three main channels (Kascak, 2021, Santiago, *et al*, 2016). Municipalities, as founders of schools get direct transfers from the national budget (through the Ministry of Finance) for the primary schools, compulsory pre-

[12] State Budget Law for 2023 (No 526/2022 Z.z.)

primary education[13] and other educational services. The secondary education is provided by the regional self-governments, which receive funding through the Ministry of Finance and the Ministry of Education. The national budget grants are standardised by the number of pupils. These per pupil transfers are differentiated for salaries and for operational expenditures. In both cases, these normative grants are further refined by school type and by specific coefficients for diverse education services (e.g. special needs, programmes).

Beyond these national education transfers, local governments also subsidise education from their own source revenues and the shared PIT. Significant part of the shared municipal PIT is allocated by number of pupils in local schools (40% of PIT) and by the secondary age population in the higher territorial unit (15%).

The delegated *state administrative services* are financed partially by the subsidies from the Ministry of Interior's budget. (Tomecko, 2021) These transfers are provided primarily for the registration offices, which manage citizen registration, changes of addresses, etc. The total amount allocated by the ministry was EUR 11.5 Million (2020). It is allocated by the standardised number of employees, that is, ultimately by population number. In the case of address registration, the actual number of administrative actions in the previous year is the basis of grants. (Table 11)

Table 11: Subsidies transferred to perform state administration service

Section	*Subsidies*		*Method of municipal subsidy calculation*
	2019	*2020*	
Registrars	8 249 615	9 075 447	Number of full-time employees in the section, derived from the number of inhabitants and the number of operations in the municipality.
Reporting of citizens' stay, registration of inhabitants	1 796 167	1 798 576	Number of inhabitants of the municipality: EUR 0.33 per inhabitant
Address register	142 837	139 853	Number of actions taken by the municipality in the given section in the past year: EUR 1.6 per action + a flat rate of EUR 18 for each municipality
Environment	508 805	517 766	Number of inhabitants in the village
Total	*10 697 422*	*11 531 642*	
Expenditures on municipal general public services, 2021		1 246 852 684	

Source: MoI Report on public administration, 2020, MoF municipal fiscal database

These MoI grants and transfers finance only a *marginal part of the local administrative service costs.* Municipal expenditures accounted under the general public services is significantly higher than the subsidies received (EUR 1.3 Billion vs. EUR 11.5 Million). This difference is caused by the fact, that the original municipal competencies, such as operation of executive and administrative bodies, foreign relations, foreign aid, statistical services, are all accounted under the category of general public services.

Options to improve transfer allocation methods

This lack of precise information on the costs of delegated services is not caused by improper financial administration or by shortfalls of the accounting system. The legislative concept to separate original devolved municipal services from delegated state functions and to assign own revenues versus earmarked transfers to finance them can be hardly implemented in the local practice[14].

[13] Attendance of children in pre-school facility one year prior to entering primary school in order to get used to the school conditions.

[14] The Peer Review Report of this CEGG program also concluded, that "sometimes transferred competences can be redefined as municipal own ones". (Trutkowski, 2022). It was also in the center of criticism from the Congress of

Firstly, because *local and central functions are not strictly isolated*. There is often local pressure on services under national control (for improved client relations, or when local schools claiming additional staff with special qualification, etc.). Secondly, the standardised subsidies are *not able to cover the specific costs of delegated services in each and every municipality* (e.g. where registry offices manage mixed central and local tasks). Even the most refined service costing methods cannot provide reliable information which is agreed by all parties. Often, the service performance standards are not quantifiable, either.

These characteristics of delegated local services are reflected by the fact that local governments do supplement the state grants. There is always need for additional local revenues to finance the delegated services. So instead of further refinement of cost sharing and the calculation of the central portion of combined municipal-state services, the *historic costs should be the basis* of financing the delegated services.

This approach acknowledges the imperfect pricing of delegated functions. It accepts that public budgeting methods always aim to build upon the past expenditures. These characteristics of fiscal planning promote stability in public service provision and incremental budgeting helps to negotiate the future appropriations.

Subsequently, the contribution of the central government to the locally provided delegated services should *follow the standard (average) expenditures*. However, the changes in the quantity of services or introduction of new delegated services can be properly costed because these marginal expenditures are measurable.

The population number is widely used for grant allocation because the volume of service needs, different in the service quality (e.g. due to complexity of administration, access), is connected to local population size. So adjusting the delegated service subsidies to the *average costs in municipalities of similar size and type* will simplify the grant allocation. The use of actual (historic) costs for grant allocation will make the standard expenditure-based model more acceptable by the recipient municipalities.

Incentives for service efficiency improvements and savings can be supported through other transfer schemes. An alternative to the present grant allocation methods is the *performance-based grant.* (Lee *et al*, 2022, UNCDF, 2009) It supplements the average cost-based approach by forcing recipient local governments to either modernise the delegated services or to lower the costs. The logic of performance-based grant is simple: once a municipality meets the set minimum service requirements, then it receives additional funding. These conditions might be rather diverse: capital investments, improved service management techniques, higher quality, sophisticated fiscal planning, greater own source revenues, etc.

Successful implementation of prerequisites should be monitored and evaluated externally. It will require a transparent reporting system supported by timely provision of information and cost assessment methods. In the case of administrative services, the performance indicators are not only the number of cases, but additional information, such as processing time, unit costs, number of complaints, customer relations, etc. The performance-based grant system can be introduced only if local governments have sufficient financial and management autonomy.

Equalisation

The highly fragmented municipal structure and the major regional differences in Slovakia require effective fiscal equalisation techniques. The present PIT sharing method *mostly supports uniformity*. The *per capita based tax sharing formula* reinforces the financial position of similar size municipalities. The multipliers, coefficients adjust the per capita shared revenues to the potential cost differences (in heating costs by municipality elevation, greater costs in larger cities with more complex services). However, these revenue allocation techniques do not take into account the differences in revenue raising potential and cannot properly follow the specific municipal conditions in diverse regions.

Local and Regional Authorities on the Article 9, of the European Charter of Local Self-governments (Pereira-Verbeek, 2016)

In this regulatory environment, equity and fairness of municipal finances can be enhanced in two ways: a) incorporating the own resource potential and revenue raising effort in the grant allocation or tax sharing and b) introducing a two-step equalisation practice in the intergovernmental transfer system.

Revenue equalisation

Once the origin-based PIT sharing system is introduced, it can serve as the basis of revenue equalisation. Municipalities with *per capita PIT revenues below a minimum threshold* receive contribution from municipalities with higher PIT base. The small but numerous poor municipalities will receive supplementary funds from the wealthy municipalities. This municipal solidarity scheme keeps the equalisation funds within the overall municipal budget. It prevents the local government sector from external budget cuts and restrictions.

The minimum level of equalised per capita shared PIT should be defined well below the national average. Only those municipalities which are really poor and can hardly increase their PIT revenue base, will benefit from this equalisation mechanism.

An alternative revenue equalisation method is *based on the own source revenues* (e.g. real estate tax, the proposed regional business tax). This model is built on the standard (average) tax rate levied on the estimated tax base. The tax rate averages are differentiated by municipalities' size and type.

Municipalities below the calculated standard own source revenue receive equalisation grants up to a certain level (e.g. 90% of the average). Thus, they will remain interested in collecting more own source revenues either by broadening the tax base, through higher tax rates or with more effective tax collection.

Two-step expenditures equalisation by the HTUs

Differences in service costs, diverse objective local needs and the variation of revenue raising capacities claim for fiscal equalisation. In the highly fragmented municipal system of Slovakia, the specific expenditure or revenue conditions of the small municipalities cannot be followed from the centre. National budget equalisation grants and revenue sharing methods are usually based on standardised methods, while the *local differences require precise targeting of equalisation grants.*

The present outstanding practice of prohibiting direct intervention into municipal budgets by higher territorial unit should be kept in the future. However, a *two-step grant allocation* might be considered, especially in the regions with large number of small municipalities. Regional self-governments are better informed within their territory about the municipal problems and needs, than the national government.

Under this scheme, the regional self-governments would be authorised to reallocate a part of the national equalisation grants or adjust some of the revenue sharing criteria. This way the elected regional government partially takes over the burden of equalisation from the national government (the ministries) by differentiating and further refining pre-set group of allocation criteria. All eligible municipalities will receive the equalisation grant. Political favouritism or misuse of regional funds is minimised by the standardised, normative method. The region's intervention will be rule based, but at the same time the regional self-government will target more precisely in its territory the equalisation grants available for the municipalities.

For example, a special national equalisation fund is allocated firstly to the HTUs by selected criteria for regional development (for example population size, number of elderly people, level of urbanisation, municipal structure, regional GDP, unemployment ratio, etc.). The standard re-allocation criteria are also set by regulation (e.g. in the annual budget law or a government decree), such as population, age groups, own source revenues, shared tax by origin, current budget deficit). But the actual formula of reallocation within a region is defined by the HTU.

Bratislava capital city and region

Metropolitan governments are faced with the dual problem of (i) the need for establishing effective *devolution within large cities* and (ii) the pressure for *coordination in urban areas* for efficient public service provision. Following the subsidiarity principle, city districts and suburban towns, villages should be responsible for the basic municipal services, to be financed partially by their own revenues. However,

as these municipalities are interconnected urban entities, there is a need for harmonisation of the regional, network-based services, primarily transportation and public utilities. These diverging forces are balanced by diverse political mechanisms, administrative-territorial structures, and financial schemes. (Sud-Yilmaz, 2013)

An analysis of the capital Bratislava proved that the city has similar problems and is not an exception to this rule. (Orlando, 2022) Local autonomy should be strengthened with safeguards for the powers of Bratislava's city-parts[15]. A capital-city region model was proposed by combining the two territorial administrative entities (the Bratislava capital city and the Bratislava self-government region[16]).

The importance of the proposed new entity, named as *Bratislava City-region* would not be exceptionally high in Central-Eastern European comparison. Approximately 14% of the country's permanent population is registered in the 89 municipalities of the region with a similar share in total local government revenues. Within the existing Bratislava region, two thirds of the total population of 720 thousand inhabitants, live in the capital and the rest are located in the agglomeration belt of the Bratislava metropolitan area. (Table 12)

Table 12: Local governments in the Bratislava region

	Local governments	*Population*		*Total expenditures*	
		number	*%*	*EUR M*	*%*
Bratislava capital	*1*			*397,7*	*35,8%*
Bratislava city parts	*17*			*275,1*	*24,8%*
Bratislava (city + city parts)	18	475 503	66,1%	672,8	60,6%
Municipalities within Bratislava self-government region	71	243 887	33,9%	235,8	21,2%
Bratislava HTU	1			201,7	18,2%
Total	**91**	**719 390**	**100,0%**	**1 110,2**	**100,0%**

The majority of the EUR 1,1 Billion worth combined budget expenditures of the local governments is controlled by Bratislava capital, the Bratislava city parts and the surrounding municipalities (82%). However, the Bratislava capital city and the Bratislava self-governing region, as Higher Territorial Unit jointly manage more than half of the local government expenditures (54%).

These proportions are in line with the services presently assigned to the different types of local governments. Expenditures of the Bratislava city parts and the surrounding municipalities, Bratislava HTU are dominated by *education* spending, while in the capital city the *economic functions (mostly transportation)* have the highest share among the expenditures[17].

The revenue structure of Bratislava city and the HTU is *in line with these service obligations*. (Table 13) Due to the mostly population and pupil-based PIT sharing rules, the personal income tax is the largest revenue source of the Bratislava capital city (41%) and the Bratislava HTU (49%). The regional self-government has no own-source taxes.

[15] In this report, the administrative categories and geographical terms are used in parallel. The administrative categories are Bratislava capital and Bratislava city parts (17), plus municipalities (71) in the territory of Bratislava self-government region (HTU). The urban structures are named as Bratislava city as capital, the suburban towns and villages in its vicinity, the agglomeration belt. All these entities are parts of the Bratislava region or metropolitan area.

[16] This report on finances does not deal with the issue of metropolitan city-region natural boundaries. The present Bratislava self-governing region is accepted as it is, even the region might be considered an artificial unit, limiting its development in South-East direction.

[17] Bratislava HTU current budget expenditures are concentrated on three major programs in 2022: education (45% of current budget), social services (20%) and transportation (13%). (*Draft budget of the Bratislava self-governing region for the years 2022-2024*)

Table 13: Local government revenues in the Bratislava region

	Revenues per capita, EUR	*Other taxes*	*Personal Income Tax*	*Non-Tax Revenues*	*Grants, Transfers*	*Financial Transactions*
Bratislava capital	*900*	*18,7%*	*41,4%*	*7,3%*	*21,0%*	*11,5%*
Bratislava city parts	*634*	*19,8%*	*28,0%*	*10,3%*	*30,6%*	*11,3%*
Bratislava city	1 535	19,2%	35,9%	8,6%	25,0%	11,4%
Municipalities within Bratislava self-government region	1 128	16,6%	35,3%	8,5%	28,0%	11,5%
Bratislava HTU	309	0,0%	48,7%	4,5%	35,1%	11,7%
Total	**1 705**	**15,1%**	**38,1%**	**7,8%**	**27,5%**	**11,5%**

There are set allocation rules within Bratislava where the property tax and the parking fees are equally shared between the Bratislava capital and its city parts. Bratislava city parts administer the land development fee, so its majority remains in their budgets (68%), while the other city-wide service revenues (e.g. 90% of waste disposal fee) or the revenues from property sale (90%) are in the budget of Bratislava capital city.

The proposed Bratislava City-region model, which would join the present Bratislava city magistrate and the Bratislava self-government region into one local government, will create a new metropolitan entity. It will have more balanced internal budget proportions. Assuming that the functions of the first tier (city parts and municipalities) and the second tier (Bratislava capital plus HTU) of the local government will remain unchanged, the new upper tier, metropolitan government will control 54% of expenditures and the rest (46%) will be the lower tier governments' responsibility.

The above discussed revenue reform options will have diverse impact on the proposed Bratislava City-region:

1. Moving towards value-based property taxation will increase the own source municipal revenues. The property tax base is the highest in the capital city and in its vicinity, so *all municipalities in the region will benefit from these changes*. Joint property tax administration might decrease the costs of tax collection. However, the present equal sharing of property taxes (50:50) will result in losses in the suburban municipalities which should be compensated for the shared property tax. This internal equalisation mechanism might be built on higher property tax revenues.
2. Municipalities and city parts in the metropolitan area will benefit from the proposed new motor vehicle tax, to be moved from the state budget to the first tier of local governments. The concentration of private cars in the city functional area will result in significant new local revenues. As in large cities typically the *higher tier local governments* are responsible for road maintenance, the new municipal motor vehicle tax should be also shared between the two tiers.
3. Similarly, the business value tax is an important own source revenue. According to our estimates, *one third of BVT would be raised in the territory of the Bratislava region*. It might be subject to regional equalisation, because 28% of the country's GDP is concentrated in this region. The business value tax is a typical regional government revenue, but in this large city the BVT should be shared between the upper local government tier and the municipal/city part governments.
4. The present 68:32 PIT sharing rule within the capital city might not be kept under the new City-region model. It will create significant losses for the municipalities outside Bratislava, which presently have full access to all shared PIT. New sharing ratios should be designed after the functions of the upper tier metropolitan government is decided and their costs are estimated. However, the proposed origin-based PIT sharing should be also taken into account, as it will generate new resources for the municipalities. An origin-based PIT sharing will further increase the revenue concentration in the Bratislava region, which will be subject of revenue equalisation. The Bratislava capital City-region will be a net contributor under this future revenue equalisation mechanism.

Conclusions and recommendations

Increasing revenue autonomy

The previous proposals for the enhancement of local governments' financial independence focused on the revenue side of the budget. They are categorised into five groups:

1. ***New own source revenue raising options***
   - real estate tax: increased default rate, incorporating quality in tax base assessment, support to tax administration
   - property related value increase capturing mechanisms
   - motor vehicle tax
   - Business Value Tax

2. ***Improved revenue sharing techniques***
   - broader base of shared revenues
   - origin-based PIT sharing

3. ***Modernisation of grant and transfer allocation***
   - average costs-based planning practices of transfers
   - performance-based grants

4. ***Introduction of new forms of equalisation***
   - revenue equalisation using origin-based PIT allocation
   - two-step equalisation by the regions

5. ***Establishing Bratislava City-region***
   - modified nationwide regulations and internal revenue sharing

Some of these proposed options for raising local government revenues might be introduced without major overhaul of the tax system in Slovakia. That means a gradual implementation is possible. While others (e.g. the regional Business Value Tax, origin-based PIT sharing) are subjects to a comprehensive tax policy reform. They should be adjusted not only to the future territorial-administrative changes, but their fiscal and financial implications have to be taken into account.

Common issues

There are common elements of the recommendations on local financial independence, which are critical conditions of future successful reforms:

Changes in national tax regulations

The financial independence of local governments is enhanced by introducing new municipal and regional taxes. More local revenues with higher local taxing autonomy will increase the local tax burden on businesses or individuals. In order to limit the impact of this public revenue restructuring, compensation mechanisms should be introduced to *minimise the increase of the overall tax burden*. Taxpayers can be compensated by the lower national taxes or revenue restructuring should be combined with decentralisation of tasks and responsibilities.

The proposed broadening of the shared revenue pool will have implications on national budget. According to this proposal a portion of the VAT will be also shared with local governments by the formula. This revenue loss for the national budget should be compensated by recentralising the same amount from the personal income tax. As both amounts should be defined as a percentage of the VAT and PIT revenues, the *national budget might lose (or gain) from the new sharing rule*.

For example, based on 2021 data, if 15% of the VAT is shared with local governments, then 30% of the PIT has to be centralised for compensating the national budget. So, if these ratios are kept in the future (70% of the PIT plus 15% of the VAT is shared with the municipalities and regions), the total amount of national budget revenues might change with the fluctuation of the two tax revenues.

Need for new equalisation methods

Higher local taxes and greater revenue raising autonomy will result in more diverse own-source revenues. A decrease in the shared tax, allocated by formula based on the population number, will further restrain the formal equity of municipal budget revenues. Both of these changes raise the *need for new types of fiscal equalisation*, focusing on the revenue side of the budget and thereby enhancing the role of regional self-governments.

As it was proposed, fiscal equalisation might target both the revenue and the expenditure differences. The new local revenues and the greater revenue raising autonomy present new forms of revenue equalisation. A transfer of the PIT revenues from the municipalities with high income tax revenues to the municipalities with lower tax base will keep the redistributed amount within the local government budget. The *per capita PIT shared by origin* is a good indicator of the municipal revenue potential and it can serve as basis of revenue equalisation.

An alternative model is to authorise the HTU to manage the national equalisation fund by strictly following the rule of no direct intervention in the municipal level decisions. However, the regions are better informed about the scope and causes of the municipal budget differences (both costs, needs and revenue potentials) in their territories. The regional self-government will have limited authority - it might only *adjust the nationally set allocation criteria* to the local conditions by changing the weights or multipliers in a grant allocation formula. This will limit political favouritism, will prevent municipalities from biased fund allocation and support of a particular municipality.

To avoid the direct intervention by the HTU in the lower government tier's decisions, this two-step equalisation mechanism has to be properly standardised with institutional guarantees.

Improved municipal internal decision-making

Under the municipal cooperation-based model there is a need to develop *joint decision-making mechanisms* for the own revenues. The overall local government taxing powers and fee setting methods should be adjusted to the specific conditions of the inter-municipal cooperation. The rules and procedures of budgeting, council decisions and revenue administration should be balanced between the member municipalities and the joint authority of the cooperating entities.

Both in the municipal cooperation-based model and in the amalgamated system, the *internal rules of revenue allocation s*hould be agreed. The key requirements are to keep the decision-making authority of the elected bodies and to preserve the unity of local budgets at the cooperation or the amalgamated municipality level. However, during the planning and revenue design process, the tasks should be shared between the joint municipal office (council) and its members. In the amalgamated model, the sub-municipal entities should have control over some parts of the municipal budget revenues.

Accurate population registry and taxpayers' identification

The implementation of revenue-based proposals for financial independence is conditioned also on changes in the financial administration. An important common issue of the proposed revenue options is the resident population registry and its combination with taxpayers' information.

Making the *permanent residence registry reliable* will improve the population-based revenue sharing and grant allocation schemes. Despite the high daily commuting, an accurate number of municipal residents and up-to-date information on the size of local age groups will help to target these revenues better.

The origin-based PIT sharing will introduce conceptually new financing methods into the present formula-based revenue sharing system. However, it can be implemented only if the *personal income tax declaration is connected to the taxpayer's permanent residence*. Otherwise, the shared PIT cannot be transferred to the right beneficiary municipality or the HTU. The simplest way to go about this is to incorporate a municipal code in the taxpayer ID.

The proposed municipal motor vehicle tax requires the car owner's *permanent residence incorporated in the registration of private cars*. The system of car registration was changed recently, so the region on the licence plate does not indicate any more the actual residence of the owner. However, the connection works in the other way: car registration is linked to the owner's name and address, so it will produce information on the location (the municipality), where the car is used the most.

Options by territorial-administrative models

Beyond the common elements of financial independence, the mechanisms for strengthening local fiscal autonomy will be different by the main territorial-administrative models. The recommendations should be adjusted to the specific conditions of these models. Not only the possible new assignment of functions will influence the financing (revenue) options, but the decentralisation reform models will also determine which one can be introduced. For example, the two-step regional equalisation scheme can be introduced under the present fragmented system, while less compensation is needed for the larger, financially stronger municipalities under the amalgamated model.

Table 14: Financing options by territorial-administrative models

Financing options	*Territorial-administrative models*					
	a) present two-tier local government system	*b) inter-municipal cooperation*	*c) amalgamated, large size municipalities*	*d) regional self-governments*	*e) Bratislava City-region*	
					lower tier	*upper tier*
(i) improved municipal real estate taxation	x	x	x		x	
(ii) property related value capturing	x	x	x	x	x	x
(iii) motor vehicle tax	x	x	x	x		x
(iv) Business Value Tax				x		x
(v) taxpayers' residence based PIT share		x	x	x	x	x
(vi) per capita PIT based revenue equalisation		x	x	x	x	x
(vii) two-step equalisation by the regions	x	x	x			

Developing the specific methods of revenue based financial independence require further preparations and planning. The specific revenue policy design will be an *iteration process* through simulations and impact assessment of the various techniques. As a start, the above discussed recommendations are grouped here along the following decentralisation reform options:

a) actions *under the current system* with small municipalities;
b) revenue options for financing the *inter-municipal cooperation* model;
c) new financing methods of the *amalgamated, large size municipalities*;
d) increasing the accountability of *regional self-governments* by new financing mechanisms;
e) changes for financing the *Bratislava City-region.*

a) Present system of fragmented, two-tier model

The present system of first tier local governments can be made more efficient through increased municipal own source revenues. Higher local revenues and greater revenue autonomy will make municipalities more accountable towards taxpayers, primarily the citizens. In the fragmented local government territorial structure, higher municipal revenues should be supported by more effective fiscal equalisation methods. The proposed specific changes are, as follows:

(i) enacting an updated set of *municipal property taxes* as per the recommendations above to increase the default tax rate, which would automatically set the benchmark higher and open up the possibility to levy higher rates.

Further incorporation of real estate quality in the tax base (value) assessment will move some of the taxed units to the higher bands, where more taxes are collected.

The expected greater property tax revenues will make municipalities more interested in investing in the local tax administration. Computerisation and joint tax offices will lead to more effective tax collection.

(ii) supporting the use of *property related value capturing mechanisms* will offer new revenue options for municipalities of all sizes. However, there are more municipal investments in larger towns and cities and there the property related value capturing mechanisms will produce more revenues. Under the present territorial-administrative model, the opportunities for identifying these external resources are more limited.

(iii) re-directing the *motor vehicle tax* to the municipal budgets will have several advantages. It not only increases the local revenue base, but it offers a new financial regulatory tool for improving the quality of the environment and to mitigate the effects of the climate change. It is a local environmental tax which is directly connected to the municipal tasks and responsibilities.

(iv) new own-source revenue options will further differentiate the financial position of small municipalities. Therefore, grant allocation should be better targeted through the proposed *two-step regional equalisation mechanism.*

b) Cooperation based model

A comprehensive municipal cooperation model will require joint decision-making rules for own source revenue raising (taxation, fee setting) and procedures for internal fund allocation. The own-source revenues and tax sharing arrangements in these larger local government entities are, as follows:

(i) cooperating municipalities will benefit more from the recommended *municipal property taxes.* Increased default tax rate will automatically widen the scale of tax rates and open up the possibility to levy higher rates. Further incorporation of real estate quality in the tax base assessment will move some of the taxed units to the higher bands, where more taxes are collected. The expected greater property tax revenues will make municipalities more interested in investing in local tax administration. The tax administration is usually more efficient in larger cooperating municipalities. Common tax offices can share the administrative tasks of tax collection and enforcement, combined databases and inventories can provide more comparable information on the tax base, and the routine tasks of informing taxpayers i.e. mailing can be easily outsourced in larger quantities.

(ii) inter-municipal cooperation does not offer significantly more revenues through the *property related value capturing mechanisms.* But it might create more investment opportunities in larger municipalities and cooperation can help to share value capturing methods among the partner municipalities. The larger territorial entities have greater municipal capital investments with more opportunities to attract external sources.

(iii) re-directing the *motor vehicle tax* to the municipal budgets has advantages under all forms of administrative reforms. It does not only increase the local revenue base, but it offers a new financial regulatory tool for improving the quality of the environment and mitigating the effects of the climate change. It is a local environmental tax which is directly connected to the municipal tasks and responsibilities.

(iv) *an origin-based tax sharing* will produce new revenues for the more affluent member municipalities. The internal revenue equalisation mechanisms of the cooperating municipalities will be more targeted and will lower the need for country-wide financial compensation of municipalities with lower shared revenues.

(v) however, there will still be a need for having a *revenue equalisation scheme* and the proposed *two-step regional equalisation mechanism.*

c) Amalgamated model with large size municipalities

Local governments with larger revenue base and more complex economic background can rely more on own source revenues. The amalgamation will especially increase municipal fiscal autonomy through the following specific revenues:

(i) larger municipalities will benefit more from the recommended changes of the *municipal property taxes:* a higher default tax rate will automatically widen the scale of tax rates and open up the possibility to levy higher rates. Further incorporation of real estate quality in the tax base assessment will move some of the taxed units to the higher bands, where more taxes are collected. The expected greater property tax revenues will make municipalities more inclined to invest in modernisation of the local tax administration. Similarly to the cooperation based model, tax administration will be more efficient in larger amalgamated municipalities. The tax office can manage the administrative tasks of tax collection and enforcement at a lower cost, the combined databases and inventories provide more comparable information on tax base, the routine tasks of informing taxpayers i.e. mailing can be easily outsourced in larger quantities.

(ii) larger municipalities with increased investment opportunities offer more revenues through the *property related value capturing mechanisms.* The municipal administrative capacity to design the property related value capturing schemes is also more developed.

(iii) re-directing the *motor vehicle tax* to the municipal budgets has advantages under all forms of administrative reforms. It does not only increase the local revenue base, but it offers a new financial regulatory tool for improving the quality of the environment and to mitigate the effects of the climate change. It is a local environmental tax which is directly connected to the municipal tasks and responsibilities.

(iv) *an origin-based tax sharing* will produce new revenues for the more affluent member municipalities. Even the more sophisticated sharing method to levy surtax on the national PIT base can be introduced in the amalgamated municipalities.

(v) a larger tax base will lower the need for country-wide revenue equalisation. However, the proposed *two-step regional equalisation mechanism* might still be used.

d) More effective regional self-governments

Some of the proposed methods for improving municipal financial independence can be introduced for the regional self-governments, as well:

(i) larger entities with increased investment opportunities offer new revenue raising options through the *property related value capturing mechanisms.* The regions' administrative capacity to design the property related value capturing schemes is also more developed than the municipal ones.

(ii) *motor vehicle tax* might be alternatively re-directed to the regional self-governments. Depending on the allocation of road maintenance and transportation responsibilities, the regions' revenue base should be increased. An additional argument for the regional motor vehicle tax is that it contributes towards the protection of the environment.

(iii) *Business Value Tax* is typically used for large local entities, such as the regional self-governments. Their economic base is more balanced and the regional administration has effective tools to improve the business climate in its territory;

(iv) the HTUs can also benefit from the *origin-based tax sharing.* Even the more sophisticated sharing method to levy the regional surtax on the national PIT base can be introduced.

e) Bratislava City-region

(i) municipalities of the new city-region will significantly benefit from the proposed changes in *property taxation* (move towards value-based taxation, increased lower tax rates, efficient common tax administration). However, the present internal revenue sharing rules should be adjusted to the revised allocation of tasks and responsibilities.

(ii) *property related value capturing mechanisms* will offer especially enhanced municipal revenue options in the Bratislava Capital City-region. Depending on the investment opportunities, both local government tiers (City-region and city parts, municipalities) can raise these revenues separately or together.

(iii) The Capital City-region will benefit from the *new motor vehicle tax* because of the high concentration of private cars in the city. Sharing of motor vehicle tax between the city-region and the municipalities, city parts should follow primarily the assignment of the road maintenance tasks.

(iv) *Business Value Tax* is an important regional revenue source. In the Bratislava City-region it might be lowered because of the need for nationwide equalisation. The BVT should be shared between the higher local government tier and the municipal/city part governments.

(v) the proposed *origin-based PIT sharing* will further increase the revenue concentration in the Bratislava region, which will be subject of revenue equalisation. The Bratislava City-region will be net contributor in the country and new internal sharing rules should be designed, as well.

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Databases and information sources

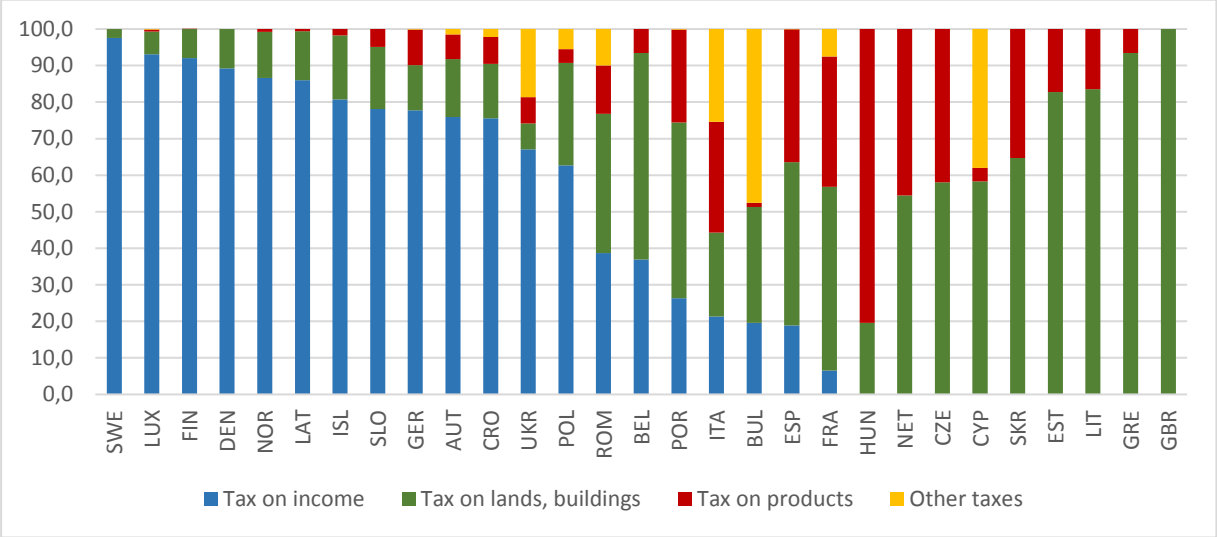
Association of Self-governing Regions
DATAcube
Eurostat
Ministry of Finance
OECD Fiscal Decentralisation Database
Statistical Office, Regional database

Annexes

Annex 1. Good local taxes

1. Local taxation aims to connect the services and other benefits received to the local payments made in the form municipal revenues. This way a good local own revenue system increases accountability, as municipal leadership faces the consequences of its decisions on revenues and service priorities and performance. Financial accountability works the best, when the revenue base, the rate and preferably the exemptions are defined locally usually within a nationally set legal framework.
2. A good municipal own source revenue is significant in size, has a broad base and it is not costly to administer (e.g. not movable, such as real estate). It should be aligned to the changes in the economy that is the tax base follows the variations in economic development (e.g. income). This requirement of buoyancy should be balanced with the condition of being relatively stable (e.g. levied on business turnover, instead the volatile profits).
3. A good own source revenue should be acceptable to the local society, so traditions and taxation culture matter. In Europe there are two basic approaches: (i) countries primarily with property taxes such as in the Anglo-Saxon countries and France; (ii) income tax-based models in Scandinavia and Germany. Local taxes are not always collected by the municipalities; the national tax administration might work more efficiently. However, local incentives for more effective collection are usually higher.
4. Among the various taxes which meet most of these criteria, the widely used municipal taxes are levied on property, certain commodities, business value and personal income. Other taxes, such as corporate income tax, value added tax, natural resource taxes are not preferred options, although some of them might be subject to tax sharing between national, regional or lower government tiers.
5. Local taxation of real estate is widely used primarily because of the immobile tax base, the relative stability of the tax revenues and that the tax base is well connected to the local service performance. The value-based taxation makes property taxes more progressive. The costs of tax administration might be optimised with various proxies of property value and by using a banded system of property assessment. From among commodities, the locally consumed products and the motor vehicle tax are used widely as municipal revenues. They are easily localised and collectable revenues, which are also linked to municipal functions, such as environmental protection, road maintenance in the case of vehicle tax.
6. Business value tax works as a general benefit tax, which is paid by the companies for the use of local infrastructure. Local tax burden can be exported, as products are usually sold outside the boundaries of a municipality. When it is levied by regional governments the differences in tax base might be equalised in the larger territorial units. Personal income tax is typically a national tax, but it might be shared with local governments through surcharging mechanism (that is a municipal rate is levied on the national tax or tax base).
7. Beyond these technical requirements of good local taxation, other conditions should be taken into account. The broader economic and social environment also influences which taxes will work the best at local level. In Slovakia with diverse urban structure beyond taxes on citizens, properties, both on tangible and movable assets, such as motor vehicles, plus local business taxes might create a sound revenue base for municipalities.
8. In the transforming economic environment, new local taxes should not disproportionally increase the financial burden on the private sector. So even with revenue decentralisation businesses pay more for the locally provided public services, the central-local ratio of public services is modified and more functions are managed locally. Another way of minimising the financial burden is to make municipal business tax deductible from the nationally paid taxes (or at least from the tax base).

Composition of local government taxes in the EU countries



Annex 2. Types of motor vehicle charges

(tax on passenger car ownership)			
Country	*Base*	*Charge/fee calculation*	*Comment*
Engine power, capacity			
Austria	Engine power (kW based formula), 3 categories by age Weight for lorries	passenger car: EUR 0.62-0.75 per kW EUR 1.55/t-1.9/t	minimum and/or maximum rates are set zero emission cars are not taxed
Hungary	Capacity (kW) differentiated by age; (weight for lorries)	EUR 0.3-0.8/kW (lower for older passenger car)	Earlier municipal revenue recently moved entirely to national budget
Slovakia	Engine capacity (cm^3)	EUR by cm3 ranges	Only commercial vehicles, cars used for business purposes
Weight, combined with emission			
Netherlands	Weight, fuel type, CO_2 emission	differentiated by provinces	exemption for cars without CO_2 emission, hybrid cars pay the weight tax, diesel surcharge
Emission			
Denmark	emission: ranges of CO_2/km weight tax (6 categories)	Green owner's tax (1:35) weight tax DKK 1.1-4.2	additional equalization tax on diesel cars
Germany	CO_2 emission and cylinder capacity	EUR 2-4 by CO_2 categories; EUR 2/100cm^3	Differentiated rates by age

Source: ACEA tax guide, 2022

Annex 3. Local business tax in selected countries

Subject of Taxation	*Base of tax*	*Tax rate, concessions*
Germany: ***Trade income tax (Gewerbesteuer)***		
All commercial businesses	Taxable corporate profit (after deductions)	3.5% of taxable profit with municipal multipliers (at least 2, w/o upper limit)
France: ***Territorial Economic Contribution (CET)***		
Two component tax	Asset and value added	Tax relief for CET above 3% of added value
Component 1: Companies Land Contribution (CFE)		
Companies	Rental value of assets	Reduction by 30% for industrial plants; differentiated rates by towns up to 1.3% in the highest band
Component 2: Companies Added Value Contribution (CVAE)		
Enterprise with turnover above EUR152,500 declare	Value added	Progressive rate above turnover EUR 500,000 (up to 1.5%)
Italy: ***Regional Production Tax (IRAP)***		
Sales and manufacturing companies. Different rules for banks, financial institutions.	Net income before tax. Tax base is apportioned by labor costs.	3.9% after deduction of labor costs, interest and bad debt. Regions might modify the rate by ±0.92%.
Hungary: ***Local business tax***		
Any entrepreneurial activity in the municipality	Net turnover, deducting cost of purchased materials, services up to a declining set percentage.	Tax rate is 2% of tax base or USD 16/day for temporary businesses. Local tax allowances are only general, for all businesses