

## FINANCING OF LOCAL SELF-GOVERNMENT ON DIFFERENT CONTINENTS – CASE STUDY

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### **Abstract:**

According to the European Charter of Local Self-Government of 1985, local self-government denotes the right and the ability of local authorities, within the limits of law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of local population. Local self-government takes care of this matter and provides key elements for the functioning of local and regional communities. It complements and also becomes a type of a counterweight to state power. Financial resources are necessary for the operation of local self-government. These financial resources can come from various sources, for example: subsidies, taxes or issued bonds. It is worth a closer look at this issue from a perspective of countries located on different continents. The article will have a form of a case study. The objective of the article is to present and compare the structure of local self-government and its financing sources on three continents: Europe, Africa and South America, each represented by one country: Poland (a leading economy in East-Central Europe), Nigeria (MINT) and Brazil (BRICS). The conclusion of the article will be that indicated countries have diversified sources of local self-government financing.

*Keywords: Local self-government, revenue, financing, Poland, Nigeria, Brazil*

## 1. INTRODUCTION

The modern idea of local self-government was established in the late eighteenth century during the French Revolution. The objective of self-government was the implementation of the tasks entrusted to it by the state and performed for the benefit of local communities (Niewiadomski, 2013). Over time, the concept of self-government has evolved from a naturalistic theory (self-government is independent from the state) to the state theory (self-government performs sovereign powers ceded by the state). A major contribution in this field has been provided by local self-government of Germany.

Today, in accordance with the European Charter of Local Self-Government of 1985, local self-government denotes the right and the ability of local authorities, within the limits of law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of local population. It complements and also is a kind of counterweight to state power. This is reflected in the decentralization theorem advanced by Oates (Oates, 1972). According to this theorem: "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision". This has an impact on many practical aspects of local self-governance: local self-governments understand the concerns of local residents; local decision making is responsive to the people for whom the services are intended, thus encouraging fiscal responsibility and efficiency; unnecessary layers of jurisdiction are eliminated; interjurisdictional competition and innovation are enhanced (Shah, 2006).

Financial resources are necessary for the functioning of local government. These financial resources can be obtained from sources, e.g., such as: subsidies, taxes or issued bonds. This issue merits a closer look from a perspective of countries located on different continents.

The aim of the article is to present and compare the structure of local self-government and its financing sources on three continents: Europe, Africa and South America, which will respectively be represented by these countries: Poland (a leading economy in Central and Eastern Europe), Nigeria (MINT) and Brazil (BRICS).

## 2. SOURCES OF FINANCING LOCAL SELF-GOVERNMENTS

The European Charter of Local Self-Government identifies a series of elements that should be present in terms of financing local communities (art. 9). First of all, local authorities shall have adequate financial resources of their own, which they may manage freely within the framework of their powers. Having said that, at least a part of financial resources of local authorities shall derive from local taxes and charges which are subject to their power with regard to determining their rate. Additionally, financial resources available to local authorities shall be of sufficiently diversified and flexible nature in order to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks. Financially weaker local authorities should benefit from support in the form of equalization procedures and equivalent measures. As a consequence, included in the scope of financing can be also a variety of subsidies. However, you should also remember to provide governments with access to a national capital market.

The role of subsidies and grants in the financing of local self-government depends on a model of public finances adopted in the country and, thus, their degree of decentralization (Oates, 1999). Beside being a general or purposeful, grants can also be unconditional or conditional and their design can be based on principles of co-financing of both restricted and unrestricted type. In addition, the way each of these grants is prepared may be based on the profitable capabilities of the subsidized unit in question or their own financial needs (Guziejewska, 2007). Among the systems based on objectified criteria there are two types of grants: lump-sum grants, e.g. the transfers transmitted in proportion to the number of inhabitants and, secondly, matching grants which means that the more funding the local government unit provides independently, the more funding it can obtain (Guziejewska, 2007). Transfers to local self-governments perform several key functions. Among them, we can distinguish among the following (Shah, 1994): troubleshooting fiscal gap (when the cost of the tasks imposed on local self-government is higher than its own revenues), equalizing the financial situation between the various levels of local self-government, achieving the objective important from the state point of view. At the same time, local self-governments can access the capital market. For this purpose, they have the ability to acquire returnable funds through loans, credit or debt securities issues (Misterek, 2009).

### **3. SELECTION OF SAMPLED STATE**

The total area of Poland is over 300 000 km<sup>2</sup>. This country is inhabited by 38.5 million people and it is estimated that GDP in 2016 will amount to 630 billion USD<sup>1</sup>. According to a study by Ernst & Young undertaken in 2009, in the opinion of investors, Central and Eastern Europe was going to become the most attractive region for investment (Ernst & Young European Attractiveness Survey, 2009). However, after a few years, the situation has changed. The region's attractiveness was lost in the eyes of investors and now it was given the fourth place in the ranking of the most attractive regions for establishing operations in 2014 (after Western Europe, North America and China). In spite of that, for Central and Eastern Europe there is still quite a good perspective ahead. Poland is maintaining its leading position among the countries of Central and Eastern Europe in terms of the attractiveness of investment (Ernst & Young European Attractiveness Survey, 2014).

The total area of Brazil is nearly 8 516 000 km<sup>2</sup>. This area is inhabited by 205 million people and it is estimated that GDP in 2016 will amount to 2 468 billion USD. Brazil belongs to a group of countries collectively known as BRICS. This name comes from the first letters of countries – group members, i.e. Brazil, Russia, India, China and South Africa. All countries belonging to this group are characterized by large, fast-growing economies. Thanks to its potential they can significantly affect both the regional and global affairs. The term "BRIC" was coined in 2001 by Jim O'Neill who used it in his publication "Building Better Global Economic BRICs".

The total area of Nigeria is over 923 000 km<sup>2</sup>. This area is inhabited 182 million people and it is estimated that GDP in 2016 will amount to 702 billion USD. Nigeria is one of the MINT countries. This name, as is the case with BRICS, comes from the first letters of the member states, namely, Mexico, Indonesia, Nigeria and Turkey. Also, as in the case of BRICS, it was Jim O'Neill who popularized the name. In 2011, it was argued that these countries were the most promising and had the biggest potential. Two factors were key in this regard: working-age population measure compared to the general population and the most favorable forecasts for GDP per capita growth.

### **4. FINANCING LOCAL SELF-GOVERNMENTS ON THE EXAMPLE OF SELECTED STATE**

#### **4.1. Poland**

The current system of local self-government was created in Poland after the political changes of the late twentieth century. It assumed its final shape at the beginning of 1999 when a three-tier organization of local self-government was introduced. At the regional level there are 16 voivodeships. Poviats, the second-tier units, are smaller and in Poland there are 314 of them. The basic unit of local self-government is gmina or municipality, which is also the only form of organizational self-government guaranteed by the Constitution (art. 164 of the Polish Constitution of 2nd April 1997.). The total number of municipalities is 2 478. It is also worth mentioning the specific form of the municipalities – that is, the cities with poviat status. These are 66 large cities, which perform both the tasks of municipalities and those of poviats as well.

The revenues of local self-government units in Poland can be divided into the following: own revenues, general subsidies, grants from the state budget, funds from foreign non-recoverable sources (Kornberger-Sokołowska, 2010; Wójtowicz, 2008).

In own revenues we can include: taxes (property tax, inheritance tax, agricultural tax, forest tax, stamp duty, vehicle tax and fees (market, local, resort, from the ownership of dogs, fiscal, operational), participation in state-level taxes, income from the properties of the local government, income from local government economic activity and capital income.

General subsidies and specific grants are forms of non-repayable funds transferred to local governments from the state budget or other local government units. The grants are allocated for a predetermined use and are designed to finance specific tasks carried out by the local government unit.

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<sup>1</sup> Data from: <http://www.economywatch.com/economic-statistics>

While, on the other hand, allocation of subsidies is determined by the beneficiary of the subsidy. Subsidies are divided into three parts: compensatory, balancing and educational.

Funds from foreign sources and non-refundable funds from the European Union budget. They are transferred to local government units in accordance with the procedures contained in an international agreement or in agreement signed with the unit that is responsible for transmitting these funds. They can also be transferred from the state budget as development subsidies in the context of a development policy. Foreign funds may come from resources of institutions, such as, the World Bank, the European Bank for Reconstruction and Development or these may also funds from the European Union educational programs (e.g. Socrates) or other EU funds (per-accession funds, structural funds, etc.) (Czerski, Hanusz, Niezgodna, 2009).

In 2013, the total revenues of local self-government units amounted to 183 458 281 000 PLN. Own revenues accounted for 50% of total revenues (21.1% of income tax, 13.3% of revenues from taxes and fees, 3.8% of income from assets), the general subsidies were responsible for 21.5% of total revenues and targeted subsidies for 22%. At the same time, 14 533 114 000 PLN came from the European Union funds (Krajowa Rada Regionalnych Izb Obrachunkowych, 2014)

An overall difference between incomes of the different levels of local self-government manifests itself in a much broader scale (which takes into account the income tax) of the sources of income attributable to the municipal level, a bit differently shaped criteria for calculating general subsidies for the municipal level and first- and second-tier levels of local government, a diversified range of grants and various degrees of participation in state income taxes (Kornberger-Sokołowska, 2010).

## **4.2. Brazil**

Brazil is a highly decentralized, federal country. It is a type of a union between the central government, states and local governments – municipalities. As established by the Constitution of 1988, currently there are local governments. These include 26 provinces, a federal district and also 5 570 municipalities (Afonso, 2006). All Brazilian municipalities have the same legal status (Souza, 2002).

Brazilian municipalities have two important sources of revenue: federal and state transfers, and self-generated revenues (Ikeanyibe, 2014). A complex system of transfers has been introduced to equalize the differences between municipalities. The structure of local tax allocation is divided into three parts: local taxes, service tax (ISS), urban property tax (IPTU), frontage tax, property transfers (ITBI), federal transfers (22.5% of income tax, 50% of rural property tax, 25% of tax on industrial products [IPI], 70% of tax on financial operations on gold) and state transfers (25% of value-added tax [ICMS], 50% of motor vehicle registration tax [IPV]). In addition, municipalities which are the producers of minerals, oil and natural gas are entitled to a proportional share of a tax collected by the federal government (Souza, 2002).

Federal transfers from income tax (IR) and tax on industrial products (IPI) form the Municipal Participation Fund (FPM). It is a type of a compensation fund. This solution is beneficial for the municipalities with smaller populations (Souza, 2002).

In addition to the constitutional fiscal transfers from the state and federal governments, the Brazilian municipalities also receive fiscal grants or discretionary transfers from higher levels of government, particularly the Federal Government, as means of creating a national minimum standard (Ikeanyibe, 2014).

The most important among the local taxes is the service tax. The second most important tax is urban property tax (IPTU). Municipalities have a lot of flexibility in determining procedures for establishing the tax levels. Usually among the main criteria there are: the value of the property, its location and size (Souza, 2002).

Local tax system has specific weaknesses. Firstly, the focus of the tax system is taxation on production, sales and consumption – none of which are the subjects of the jurisdiction of local governments. Secondly, some taxes (e.g. urban property tax) require detailed records that must be updated frequently (Souza, 2002).

Municipalities can also get funds from loans. However, each loan has to be approved by the legislature of the council, the central bank of the country and, finally, the senate (Adu, Igbalajobi, 2015).

### 4.3. Nigeria

The local government as a third tier of the administrative structure in Nigeria was established in 1976. The whole country is divided into 774 local government areas.

We can distinguish two main sources of local self-government revenue in Nigeria: internally generated revenue, which is revenue generated within the local government area of administration (local tax or community tax, poll tax, tenement rates, user fees and loans) and externally generated revenue, which refers to the local government funds generated outside the local government area of administration. It should also be emphasized that local self- governments derive the biggest share of their funding from fiscal transfers and loans dedicated to local self-governments (Alo, 2012).

Local self-government can also be financed by grants from the central government or state. In Nigeria these are known as grants and statutory allocations. The federal government and the state governments are required to provide 10% of their income to local self-government. Despite the constitutional regulations, the central government is reluctant to provide funds to individual local government units (Alo, 2012; Adu, Igbalajobi, 2015).

On the other hand, in the case of internal sources, the growing disproportion between the level of funding and the number of tasks entrusted to local self-government is highly conspicuous. Special attention should be paid here to two sources: poll tax or community tax and property tax or tenement. The first is levied on every citizen who meets its criteria. The second is an excellent source of income, especially for local governments which have administrative control over industrialized areas (Alo, 2012).

## 5. CONCLUSION

When we analyze the forms of financing local self-governments of Poland, Brazil and Nigeria we can see “big picture” similarities. In each case, we are dealing with external and internal sources of income. Furthermore, at least a part of the funds is generated from local taxes and fees (with particular emphasis on broadly defined property tax). The focus is also placed on the attempts to minimize the differences between the local government units located in different regions of each country.

However, the closer we look at the various methods of financing used in different countries, the more clearly we see significant discrepancies. These differences relate even to the diversity in the proportion of revenues generated from different sources. There are different taxes from which local government units derive income. The most significant variations can be found in the way of operation of the systems of subsidies and grants distributed by the central government. In addition, it is worth noting that in many cases local governments have difficult access to the domestic capital market.

The diversity of local government funding cannot be regarded as a negative phenomenon. In the longer time frame, different methods can yield equally good results in different national and cultural environments. Undoubtedly, the local government has a key role to play in supporting the proper functioning of local communities. Hence, it is crucial not only how local governments will be financed but also whether the funds acquired by them will be sufficient so they are able to perform the tasks entrusted to them.

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