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Municipal budgets in the Czech Republic: Accuracy, transparency and accountability

Lucie Sedmihradská, University of Economics, Prague, Czech Republic, sedmih@vse.cz

The Czech Republic is a unitary state. The constitution from 1993 establishes two levels of local governments: regions (14) and municipalities (about 6250). Municipalities are autonomous self governing entities which gained substantial independence in the decision-making about their expenditure priorities, budget and the way how they deliver public services during early 1990's. At the same time their autonomy regarding the revenues is remaining very low: municipalities heavily rely on intergovernmental transfers and shared taxes distributed among the municipalities based on a formula (see Sedmihradská, 2007 and 2008). Simultaneously borrowing is limited only indirectly. In this environment municipalities exercise budgetary process similar to those in western democracies.

Municipal management adheres to the municipal approved by the municipal council. The budget contains estimated revenues and approved expenditures for a budget year. During the budget year several changes can occur both on the revenue and expenditure side of the budget. These changes can be both expected (e.g., grant allocation) or unexpected (e.g., natural disaster). Comparison of approved and actual municipal budgets shows, that a significant share of realized revenues and expenditures was not included in the approved budget. On average the revenues were underestimated between 1997 and 2007 by 25% and the expenditures by 15 % with little variance in the individual years.

The objectives of the paper are to analyze the difference between approved and actual municipal revenues and expenditures, to discuss its impacts and to propose measures for the potential improvement.

In the first part of the paper the results of the comparison of approved and actual municipal budgets is presented and the magnitude of the inaccuracies in the Czech municipal budgets are examined. First, the aggregate data for all Czech municipalities in the period 1997-2007 are analyzed. Second, analysis of 277 individual municipalities for the budget year 2004 is undertaken. These are municipalities which responded to a questionnaire on budgetary process realized in 2004 (see Sedmihradská, 2007). The size of the municipalities is between 671 and 101,624 inhabitants and all of them are municipalities with authorized municipal office.

In the second part of the paper the current legal provisions ensuring transparency and accountability of municipal budgets and budgetary process are listed and issues risen by significant underestimation of the approved budgets are challenged. Finally recommendations for improvement are proposed.

Budget inaccuracy

Municipal budget is above all one a year financial plan of a municipality. This plan is prepared in advance and is based on forecast of the future development. It is thus subject to uncertainty. Therefore the approved budget can be inaccurate to some extent.

Budget inaccuracy is the difference between the approved (estimated) and actual revenues or expenditures. In the paper the following budget inaccuracy indicator is used:

$$BI_x = \frac{B_x - A_x}{A_x} \cdot 100, \text{ where}$$

x = analyzed budget segment (revenues, expenditure or a line of them)

BI = budget inaccuracy in %

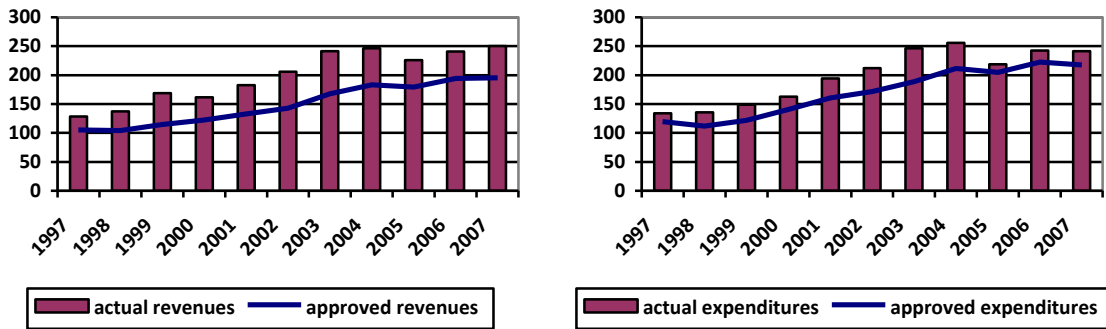
B = approved (estimated) amount

A = actual amount

The inaccuracy can be either in the form of overestimation, i.e., the approved revenues (or expenditures) exceed the actual revenues (or expenditures) and $BI_x > 0$ or underestimation, i.e., the estimated revenues (or expenditures) are lower than the actual ones and $BI_x < 0$.

Figure 1 shows the comparison of approved and actual revenues and expenditures between 1997 and 2007.

Figure 1: Budgeted and real revenues and expenditures (1997-2007, billions CZK)



Source: ARIS, own calculations

Table 1 reports the budget inaccuracy indicator for total revenues and total expenditures. Budget inaccuracy for expenditures (in absolute value) is considerably lower than the budget inaccuracy for revenues.

Table 1: Budget inaccuracy (in %)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Revenues	-17,9	-24,1	-32,2	-24,3	-27,2	-30,6	-30,5	-25,5	-20,6	-19,4	-22,0
Expenditures	-10,4	-17,4	-18,3	-13,6	-17,4	-19,0	-23,3	-17,4	-6,4	-8,1	-10,0

Source: ARIS, own calculations

The following table 2 shows the budget inaccuracy of individual revenue and expenditure types. Comparison of the individual revenue sources shows that the most difficult to predict are the intergovernmental transfers, as their volume depend on decision of other subjects. These decisions are mostly taken during the budget year and are very difficult to predict in advance. Regarding the capital revenues, municipalities plan in advance to sell a property, however they are not sure about the actual price and are cautious in their estimates. On the other hand the non-tax revenues (mostly user fees and rental incomes) are fully in hands of the municipality. We can see here a positive trend as the budget inaccuracy is decreasing over the years. The trend is even statistically significant. Thus we can believe that municipalities learn from their experiences and improve.

In contrary to this development is the budget inaccuracy of the tax revenues. The major part of the tax revenues is formed by shared income taxes and value added tax distributed among the municipalities based on a formula (see Sedmihradská, 2008). The tax sharing system has

changed since 2001, but the budget inaccuracy does not grow in this year. Although one would think that municipalities can easily derive their estimates of these revenues from the estimates of the total proceeds of the shared taxes provided by the Ministry of Finance which are more accurate (the average budget inaccuracy of revenues from income taxes and value added tax in 2001-2007 was -4,75%), this is not happening. The reason can be the so-called motivation enhancements, which form only a small part of the total shared revenues but are more volatile and thus more difficult to predict.

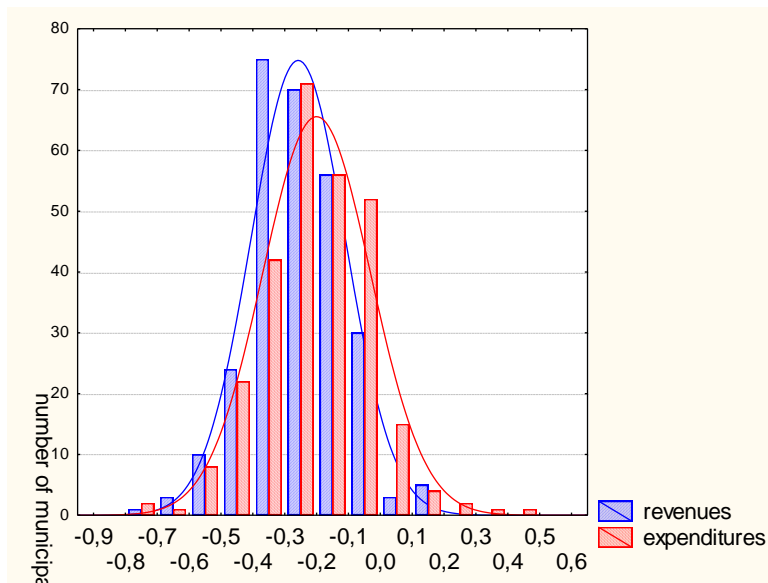
Table 2: Budget inaccuracy (in %)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	mean	st. dev.
Tax revenues	-1,1	-12,0	-7,9	-12,8	-8,0	-12,5	-10,6	-8,9	-12,6	-7,0	-8,1	-9,2	3,3
Non-tax revenues	-23,5	-18,1	-19,2	-16,1	-17,8	-17,8	-16,8	-12,5	-14,5	-16,4	-9,1	-16,5	3,5
Capital revenues	-31,9	-36,3	-76,7	-47,4	-27,3	-19,1	-29,1	-18,4	-31,2	-30,3	-30,4	-34,4	15,3
Intergov. grants	-44,6	-53,2	-47,8	-45,4	-58,8	-61,7	-55,3	-49,7	-37,4	-40,5	-51,7	-49,6	7,1
Current expenditures	-4,8	-7,6	-9,6	-9,9	-19,4	-16,3	-20,1	-14,6	-2,3	-4,4	-6,4	-10,5	5,9
Capital expenditures	-20,5	-35,5	-35,4	-20,9	-13,2	-25,0	-31,2	-24,0	-15,4	-15,7	-18,5	-23,2	7,5

Source: ARIS, own calculations

The availability of the data of individual municipalities allows a more detailed inquiry. Figure 2 shows the frequency of a revenue and expenditure inaccuracy among the 277 observed municipalities in 2004.

Figure 2: Frequency of budget inaccuracy (277 municipalities, 2004)



Source: ARIS, own calculations

The comparison of municipalities with a certain approved and actual budget balance is presented in Table 3. Only a minority (less than 3%) of municipalities approve a budget surplus but more than a half (53%) actually close the accounts with a surplus.

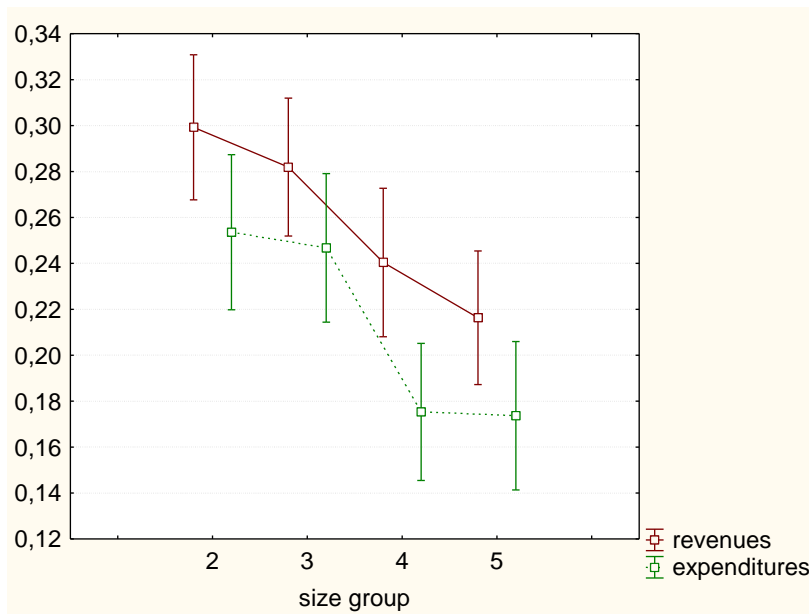
Table 3: Budget balance

		Real		total
		deficit	surplus	
Approved	deficit	112 (40,4%)	85 (30,7%)	197 (71,1%)
	surplus	13 (4,7%)	67 (24,2%)	80 (28,9%)
total		125 (45,13%)	152 (54,87%)	277

Source: ARIS, own calculations

Budget inaccuracy (in absolute value) decreases with the size of the municipality (see Figure 3, which shows the average budget inaccuracy in four different size groups). This can be explained by two factors: first the bigger municipalities can afford more specialized staff and, second, bigger municipalities have in general more stable revenues than the small ones.

Figure 3: Conditional means of budget inaccuracy in different size groups



Source: ARIS, own calculations

Note: 1) group 2: less than 5000 inhabitants, group 3: 5000-10000 inhabitants, group 4: 10000-50000 and group 5: more than 50000 inhabitants

2) the difference in the conditional means is statistically significant at the 95% level

The results presented in Tables 1 to 3 and Figure 2 lead to presumption that municipalities consider their own revenue estimates conservative and expect that some additional revenues appear and therefore approve higher expenditures than would probably approve otherwise. The budget process is revenue driven and the budget constrain for Czech municipalities is quite hard so it is unlikely that municipalities would approve expenditures which they would not be able to finance.

This doing is a case of moral hazard. How will the approved expenditures be funded if no additional revenues arrive or even if it appears that the revenues were not underestimated but overestimated? When will the officials realize that they are playing quite a different game than they have played for years? This can be a very dangerous situation because the officials many recognize the real situation quite late. The data prove that the described praxis is widespread. Therefore in case of an adverse economic development most of the municipalities will have to cope with sudden revenue shortage. This praxis jeopardizes thus not only municipal management but can have severe macroeconomic implications.

Budget transparency and accountability

Accountability is a process when the public agencies and the public officials are accountable to the public either directly or through the elected representatives for the realization of the public policy, financial management and administrative decision making (Wright and Nemeč 2003). In regard with the budget and budgetary process it means transparency to the citizens about what budget decisions have been made so that the citizens know what their money is going to be used for and that it will be spent well (Rubin 2000). At the municipal level the accountability is exercised indirectly, through the council, and directly, through the citizens, who can participate in the budget debate.

Provisions of three laws (law on municipalities, budgetary rules for local governments and law on free access to information) ensure that the public dispose of information on prepared and approved budget and the results of the budget management and that it can take part in the budget debate. Exactly:

- 1) The municipal council meetings are public and the scripts of these meetings are made public (on the public notice or on Internet),
- 2) The budget bill has to be published 14 days before its debate by the municipal council and citizens can submit their proposals either in writing or orally during the municipal council meeting,
- 3) Municipalities are required to publish on Internet information on the approved budget and all its changes and information about the budget management in the past year, and
- 4) Municipal accounts are subject to regular audit. At the same time municipalities have to submit monthly their accounting data to the regions.

The approved budget is a result of political decision with direct civic participation about the budget is the decision about the way how the estimated available resources will be used. The major resource is the expected revenues supplemented with accumulated surplus from the previous years or borrowing ensured by contract. The estimate of the expected revenues influences not only the volume of the approved expenditures but also their structure, i.e., the allocation efficiency.

In case of overestimation of the revenues it will be necessary to cut expenditures during the fiscal year or to ensure resources for financing of a higher than approved budget deficit.

Therefore prudence is necessary when forecasting budget revenues. However sizable or systematic underestimation of the revenue estimates leads to decrease of the reliability of the budget as a binding document because it is changing too often and too much and it is a reason for forced savings or delays in investment.

At the same time the unity of the budget process is violated as the decision making process about the additional resources is realized through the mechanism of budget amendments. This limits the accountability, because citizens cannot participate directly in the decision making process and even the role of the municipal council is limited. Budget amendments up to a certain limit are approved by the municipal commission or the mayor not the council. The meetings of the municipal commission (the executive body of the municipality, elected from and by the council members) are closed to the public in contrary to the council meetings, which are open. This different decision making mechanism can promote interests of narrow groups.

Unfortunately, frequent budget amendments decrease the transparency too. Although the municipalities are based on the decree accompanying the law on free access to information obliged to publish the approved budget and its later amendments this is rarely happening. It is probably because the extent and deadline of this information is not specified. The public thus knows only the approved budget but not the amended one.

The main reason of the current state is, without any doubts, the setting of the relations among the individual public budgets. This is caused by the fact that the fiscal year is the same for all the public budgets and that a significant part of local government revenues form intergovernmental transfers. The exact volume of these transfers is determined by the approval of the state or regional budget or during the budget year, when the specific grants are assigned.

Conclusions and recommendations

Significant underestimation of municipal revenues and expenditures is a widespread praxis in the Czech Republic and it severely limits accountability, transparency and allocation efficiency of the municipal budgetary process.

Partial improvement of the current state can be realized through either one or more of the following measures:

- 1) Obligation for municipalities to publish in a regular and consistent manner all the approved budget amendments on Internet together with the approved budget. Based on the law on budget rules for local governments all the budget amendments are registered in chronological order. This should make the control of the completeness of the published information easy.
- 2) Introduction of a regular approval of the amended budget, for example in the half-year. The amended budget would be published 14 days before the meeting of the municipal council and the public would have the possibility to submit proposals in the same way as during the debate of the budget proposal.
- 3) Improvement of revenue estimates which would include careful usage of revenue forecasts provided by ministry of finance, usage of new revenue forecasting techniques and interconnection of the annual budgetary process with multiannual budget outlook.

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