

## **Municipal finance and budgeting in the Czech Republic**

Lucie Sedmířadská, University of Economics, Prague, Czech Republic

The Czech Republic was established 1 January 2003, when the former Czechoslovakia was divided into two separate countries. According to the constitution the Czech Republic is a unitary state with two tiers of local governments: municipalities (about 6250) and regions (14). Due to the fact that regions started to work only in 2002 and their revenue and expenditure assignment is still developing this paper deals only with one tier of local government: municipalities.

The goal of this paper is to summarize basic facts about Czech municipalities and their competencies, to describe municipal revenues, to characterize the budgetary process and to discuss some new budgeting tools used by the municipalities.

Information presented come from various sources: Czech legal acts (see the complete list at the end of the document, secondary sources both Czech and international (the main sources in English language are also in the list), financial data provided by the Ministry of Finance and primary research of current budgeting practices which was realized in the framework of a postdoctoral research project “Municipal budgetary process” supported by the Czech Science Foundation in the period 2003 – 2005. Information on the different steps of the budgetary process and the used budgeting tools were obtained through a questionnaire which was mailed to all 377 budget officers in municipalities with designated local authority in April 2004. We received back 272 questionnaires, i.e., 72.1%. The return rate was very similar across size groups or regions. The questionnaire contained in total 15 questions. For more detail about the research results see Sedmířadská and Klazar (2006).

The paper is structured as follows: first municipalities, their structure and competencies are described, than the municipal revenues are analyzed, next the budgetary process, its regulation and main steps are outlined and finally the use of new budgeting tools is evaluated.

### **1. Municipalities in the Czech Republic**

The Czech Republic is a unitary state. The Constitution from 1993 establishes two levels of local governments: regions and municipalities.

Municipalities are basic territorial self-governing communities, i.e., public corporations acting sui juris in the legal relations, responsible for the results of these relations. They were

established in the early 1990s with the same boundaries as the previous local administrative units. There are currently about 6,244 municipalities. Table 1 shows details about municipal size structure.

**Table 1: Municipal size structure (2005)**

Size of the municipality	number of municipalities	number of inhabitants
less than 300	2,568	279,222
301--1500	2,833	1,854,138
1501--5000	587	1,506,011
5001--10,000	130	896,863
10,001--20,000	68	961,888
20,001--30,000	27	675,620
30,001--40,000	10	354,678
40,001--50,000	4	184,887
50,001--100,000	17	1,225,713
100,001--150,000	1	102,246
more than 150,001	3	853,050
Praha	1	1,160,118
Czech Republic	6,249	10,204,275

Source: Ministry of Finance

The 14 regions were established in 1997, first regional representatives were elected in November 2000, and the regional governments work since January 1, 2001. Region is a public corporation, which acts in legal relations on own behalf and carries responsibility resulting from these relations. It cares for general development of its territory and needs of its citizens, especially in the field of social care, environmental protection, transportation, education, culture, and security.

Until December 31, 2002 there existed also 76 districts, i.e., deconcentrated branches of the national government in the Czech Republic. Their existence came to an end as a part of the public administration reform.

The role of municipalities is defined in the Law on Municipal Establishment (Act # 128/2000 Coll.) and the Law on the Capital Prague (Act # 131/2000 Coll.). Municipalities (and regions as well) operate independently on the central or regional level of government. Municipal council is elected in popular elections which take part every four years. The mayor and the vice-mayor(s) are elected by the council from the council members. The municipal manager is

appointed by the mayor and the appointment (or removal) must be approved by the director of the regional office.

A basic municipalities' right is to own a property. Property has been returned to municipalities within two waves. The first wave went on in 1991 and the municipalities received back most of their property. The second wave took place in the framework of the process of regions creation in 2000 and the decay of districts in 2002 and the subsequent transfer of their responsibilities on the municipalities. The property represents possible rent incomes. Above all it is an asset-reserve that can be used in the financial and budgetary distress (property sale). The property can be also used as a credit deposit (especially the real estates).

Municipal responsibilities are dividend into two groups: independent competencies and delegated powers. For independent competencies municipalities can realize their own policy. According to the Act on municipalities the independent competences include for instance management of the municipality, formulation and approval of the municipal budget and final account, establishing of legal persons and organizational bodies, organization, management, personnel and material arrangement of the municipal office publishing of generally binding regulations of the municipality, local referendum, municipal police force, imposing penalties for administrative offences, program of development of the municipal cadastral district, municipal cadastral plan and regulation plan and cooperation with other municipalities.

Independent competencies represent for the municipality both right and duty. There are defined services, which a municipality must provide in the self-administration provision, e.g., elementary schools, kindergartens, children's homes, rest homes and social housing, theatres, libraries and museums, free-time activities facilities, water quality and delivery, gas and electricity delivery, public space cleaning, cemeteries, public roads provision, public lighting, public transport, municipal policy, firemen etc. Municipalities must finance services of the self-administration from their own revenues especially from the tax revenues.

For the delegated powers municipalities are executing central government policy. Because of the very fragmented municipal structure not all municipalities exercise all types of delegated powers. Currently the municipalities are divided into five categories (see Table 2). The scope of the state administration is determined together with the grants for its provision. These grants are drawn from the state budget. The provision of the state administration theoretically

should not financially burden the municipality, however, in reality the grants finance only a part of the total expenses.

**Table 2: The different levels of delegated powers in municipalities**

Type of municipality	Number of municipalities
Basic delegated powers ( <i>e.g.</i> emergency management)	6,243
Municipalities running population registration <sup>1</sup>	1,226
Municipalities providing building permits <sup>1</sup>	617
Municipalities with authorized municipal office	388
Municipalities of extended activity	205

Note: There is no definitive structure for the more minor delegated powers and no strict hierarchy. For example some municipalities with building permit offices do not run the population register. The geographic boundaries of the networks of smaller services do not necessarily line up with those of the municipalities of second type and municipalities of extended scope.

Source: Hemmings (2006), str. 13

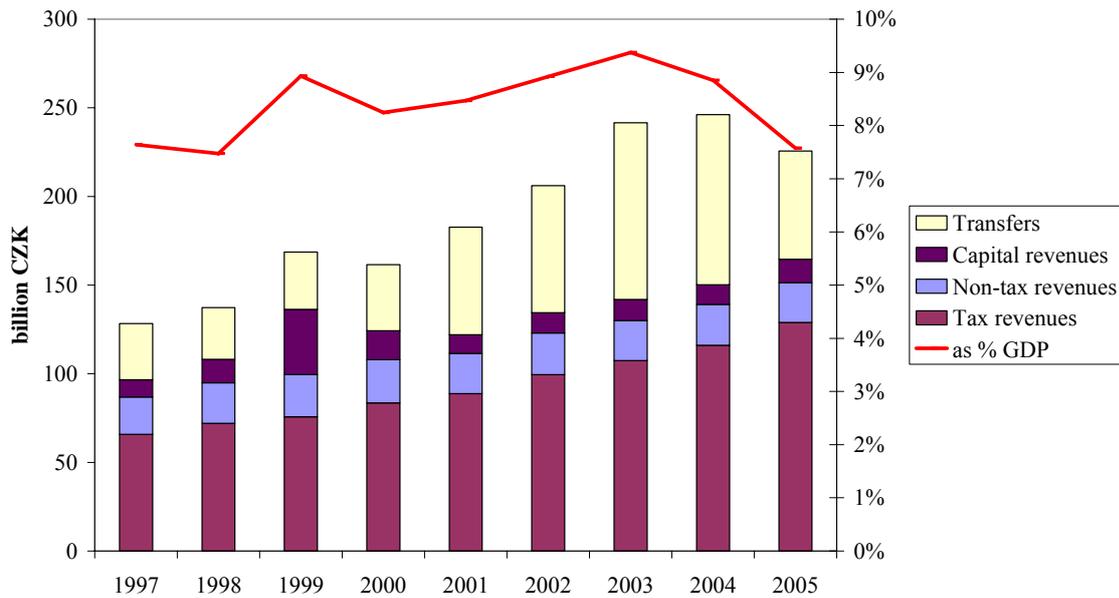
## 2. Municipal revenues

Municipal revenues are specified in two laws: the act on Budgetary Rules for Territorial Entities (Act # 250/2000 Coll.) lists all municipal revenues and the Law on Tax Assignment (Act # 243/2000 Coll.) specifies the revenue- sharing formula.

Figure 1 shows the development of the four main revenue sources in the last almost decade. We can observe stable nominal growth of the total municipal revenues with two exceptions: first the one-shot increase in 1999 which was the result of municipal sale of the shares they had held in utility companies which took place over the period 1998 – 2000, peaking just in 1999. Second, the decrease in 2005 was caused by the change in the mechanism of financing primary education, i.e. the grants are now distributed to the individual schools by the regions instead of the municipalities.

The growth of the municipal revenues as a share of the GDP in the period 2000 – 2003 is connected with the public administration reform, which consisted of abolition of districts and transfer of their responsibilities to the municipalities. This shift of responsibilities was accompanied with new transfers.

**Figure 1: Municipal revenue sources 1997 – 2005 (in millions of CZK)**



Source: Ministry of Finance – ARIS

The most important revenue source is the tax revenues (56,4 % of total municipal revenues in 2005). However, closer look at the structure of the tax revenues shows, that municipalities are very limited when influencing the volume of their tax revenues. Using the OECD system of classification regarding own taxes of sub-national governments (OECD, 2001) and the 2005 data (MFČR 2006), 94.2% of tax revenues fits into group d.3 (the revenue-split is fixed in legislation and may be changed unilaterally by the central government, i.e., shared taxes and other fees than local fees), 3.9 % into group b (for which the municipality sets only the tax rate, i.e., real estate tax) and only 1.9% into group a (for which the municipality sets both the tax rate and the tax base, i.e., local fees).

The tax sharing system was introduced in 1993 and has been changed twice since that time. Until 1996, municipalities received the entire proceeds from the personal income tax (PIT). Revenues from the PIT levied on dependent incomes were distributed among the municipalities based on the place of work; the distribution of revenues from the PIT levied on the incomes of the self-employed was based on the residence criterion. This assignment had several weaknesses: it led to harmful competition as municipalities attempted to attract the self-employed, it created vertical fiscal imbalances and it was inefficient and unfair. This injustice is a result of the fact that people consume more services where they live than where they work (see de Carmo Oliveira and Martinez-Vazquez 2001).

The system was adjusted in 1996: 30% (rather than 100%) of the PIT from dependent incomes and 20 % of the corporate income tax (CIT) was received by the municipalities. As CIT revenues declined, another change was instituted in 2000 when the value added tax (VAT) was committed to revenue sharing. Currently, municipalities receive 20.59% of the revenues from these three taxes based on the number of inhabitants (with coefficients that favor the larger municipalities). There are, however, two “motivation enhancement” areas: 30% of the PIT receipts of municipalities from the incomes of the self-employed is based on the residence of the self-employed; 1.5% of the PIT receipts of municipalities from dependent incomes is based on the number of employees. Revenues from shared taxes (i.e., the CIT, PIT and VAT) represented 113 billion CZK (49.3% of total municipal revenues) in the municipal budgets of 2005.

Since 1993 municipalities have received revenues from the real estate tax. The law on real property tax (Act # 338/1992 Coll.) provides only minimal decision-making power to the municipalities on the tax rate and none on the measurement of the tax base, *i.e.*, municipalities have no discretion over the tax on land, they can only select the coefficient (ranging from 0.3 % to 4.5 %, as specified by national law according to the size of the municipality) by which the tax rates on buildings are multiplied. Revenues from the real estate tax were 5 billion CZK (2.1 % of total municipal revenues) in 2005.

The tax revenues also include various fees: local fees, environmental and administrative fees, which in total amount to 11.3 bill. CZK (4.9 % of total municipal revenues) in 2005.

The Law on Local Fees (Act # 565/1990 Coll.) authorizes municipalities to impose local fees, which from the point of view of economics are taxes on goods and services. Municipalities have discretion over the fee base, and fee rate, which has to respect upper limits given by the law. Local fees are collected by the municipalities.

The municipal council must approve the fees levied in the municipality by an ordinance. This ordinance contains the fees, their rates, due dates for payments, compulsory registration, the beginning and ending dates of the payment duty, and any exemptions or relief from the payment obligation. Local fees are administered by the municipality.

Currently there are nine local fees, six of them (*i.e.*, Dog fee, Resort and Recreation Fees , Fee on the use of public space, Fee on entry tickets, Fee on recreational units, Motor Vehicle Entry Fee) have been in force since 1990, three were introduced later (*i.e.*, Fee on Operating Gambling Machines (since 1998), Fee on Standard Waste Collection and Treatment (since

2002), Fee on Appreciation of Building Land by the Provision of Water and Sewage Connections(since 2002)) and another three fees were abolished (i.e., Advertisement Fee (until 1994), Dislocation Fee (until 1993) and Fee on the Sale of Alcoholic Beverages and Tobacco Products (until 1994).

Revenues from payments for particular types of environmental pollution or damage Municipalities share with other public budgets:

- 1) The air pollution fee. Municipalities levy and collect fees on small polluters, they set the rates within a given limit. The proceeds are earmarked for environmental purposes. Fees on large polluters accrue to the State Environmental Fund.
- 2) The levy on the withdrawal of land from agriculture and the levy on the withdrawal of land from forestry: the rates and base are set by the central government, which also collects the fee. The proceeds collected in the area of the municipality are distributed between that municipality (40 %) and the State environmental fund (60 %). There is no specific earmarking of the revenues.
- 3) The charges for waste deposition in landfills: these consist of a basic charge, which is paid for every type of waste and is a revenue of the municipal budget and a risk charge, which is paid only in the case of hazardous waste and is a revenue of the State Environmental Fund. The charge is paid by the producer of the waste. The rates per ton of the waste are specified by central law.

Administrative fees are regulated by the Act on Administrative Fees (Act # 368/1992 Coll.) and are paid by natural persons for various administrative services listed in the scale of fees, which is a part of the law. The municipality receives the fees for services it administers. The fee rates are given either by a fixed amount or by a percent of the fee base.

The non-tax revenues amount to about 10 % of municipal revenues and are composed mainly of rental incomes, incomes from own activity and incomes from interests. Capital revenues amount to about 6% municipal revenues and their majority comes from property sale.

The grant system is quite complex. Grants are mostly provided for a specific purpose and their usage is monitored. Some of them require matching funds. Current grants are usually formula-based. The formulas are stable, the increases in the parameters are approved in the law on the state budget. Capital grants are allocated using a more case-by-case approach. A special grant is provided to partly cover the cost of providing central-government services.

### **3. Municipal Budget Process: regulation and main steps**

The municipal budgetary process in the Czech Republic is mainly regulated by the Budgetary rules for territorial entities (Act # 250/2000 Coll.), which next to the municipalities applies also to 14 regions. The roles different subjects play in the budgetary process are specified in the Law on municipal establishment (Act # 128/2000 Coll.). The municipal management is also regulated by the Law on audit of local government units (Act # 420/2004 Coll.) and the Law on financial control in the public administration (Act # 320/2001 Coll.). The main elements of the regulation are presented in Table 3.

### **Table 3: Municipal Budget Process Regulation**

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#### **Fiscal year**

The fiscal year is given by law and it is equal to the calendar year for all public budgets.

#### **Budget**

Annual budget contains both current and capital operations.

#### **Balanced budget requirement**

Budget should be prepared as balanced.

Deficit is allowed only if it can be covered by either surplus from previous years or from repayable resources, guaranteed by contract, which will be repaid in the future.

#### **Budget classification**

Uniform budget classification applies for all public budgets.

Economic, functional and, optionally, organizational classifications are used in municipal budgets.

#### **Accounting standard**

Cash accounting is used and the double entry system is required for all municipal governments.

#### **Multi-annual outlook**

It contains basic summary data on revenues, expenditures, debts, financial resources and needs for the period of two to five years.

#### **Budget preparation**

Preparation of the budget draft must reflect the relations to the other public budgets.

The draft budget must be available to the public. Citizens can submit their comments in writing or orally at the council session.

#### **Budget approval**

Budget is approved by the municipal council, i.e., the majority of all council members.

#### **Amendments**

Amendments are obligatory in case of any changes in financial relations with other public budgets, at the legal level of control or in case of danger of deficit rise.

Amendments include changes in revenues and expenditures, which do not lead in change of the budget balance and blocking of budgetary funds.

#### **Audit**

Audit of financial and legal compliance is obligatory for all municipal governments. It is provided by private firms or in case of municipalities with less than 5000 inhabitants by the regions.

#### **Financial reporting**

Municipalities submit through the regions monthly reports on uniform basis to the Ministry of Finance.

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Source: Budgetary rules for territorial entities (Act # 250/2000 Coll.) and Law on municipal establishment (Act # 128/2000 Coll.)

The central regulation leaves significant space for municipalities to choose how they will proceed preparation and debate of the draft budget. It only requires that the draft budget is available to the public for comments and that it is approved by the council.

The preparation, debate and approval of the municipal budget take several months. The preparation of the draft budget starts mostly in September or October, the smaller municipalities may start later. As the law requires, that municipal budget reflects financial relations with state and regional budget, therefore some (especially smaller) municipalities start the budget preparation after the approval of these budgets and for the first months of the year have only a provisional budget. The other municipalities have to amend and approve their budgets as soon as the financial relations with the other public budgets are approved.

The budget officer, i.e., the person responsible for the preparation of the draft budget, is in almost 90 % of the municipalities the head of financial, economic or similar department either alone or with some other subjects. In the remaining municipalities the budget officer is mostly the mayor or a member of the council. In only 6 % of the municipalities the budget officer prepares the draft budget alone, in the vast majority of municipalities he cooperates with other department heads of the municipal office.

The budget officer first sends instructions and tables to the department heads. The extent to which the budget officer limits the department heads by preparation of the departmental budgets influences the centralization of the budgetary process: less centralized (department heads have to fulfill only the deadline) to the most centralized (they have to follow given expenditure limits). The major part of the municipalities (exactly 58.9%) does not fall to any of the extremes. The degree of centralization was similar across the size groups.

The budget officer prepares the revenue estimates. Then the department heads submit their requests and the property or investment departments prepare the capital budget. Next the budget officer discusses the requests with the department heads, adjusts them, prepares a draft budget and compiles summary tables.

The draft budget is discussed by various subjects, in almost 80 % it is discussed by commission, mayor, financial committee and council. The commission is a municipal body elected in bigger municipalities by and from the council members.

After the internal discussion the draft budget is published. The Law that the draft budget is available to the public at least 14 days before the budget debate in the council, so that the citizens to participate in the budget debate. They citizens can submit their comments in writing or orally at the council session, when the budget is debated.

Municipalities use three ways of publication of the draft budget: public notice, local paper or the Internet. The most common is the publication at the public notice (268 municipalities, i.e., 98.5%). Second is publication in the local paper (137 municipalities, i.e., 50.4%). Internet

states little behind; it is used in 48 municipalities, i.e., 17.6%. The use of the local paper grows with the size of the municipality; the differences in the use of the Internet are very small across the size groups.

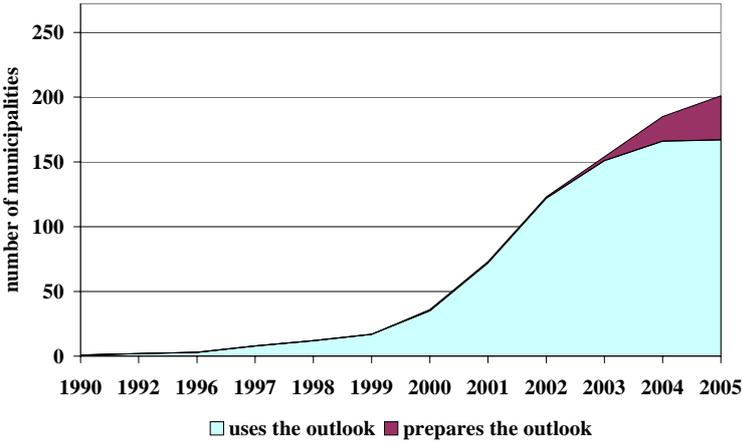
Finally the council approves the budget.

**4. Use of new budgeting tools by municipalities**

The Budgetary rules for territorial entities introduced from the beginning of 2001 the multi-annual budget outlook. According to the law the budget outlook is used for municipal planning and it should contain basic summary data on revenues, expenditures, debts, financial resources and needs for the period of two to five years. The budget outlook is not binding. Until the amendment of the Budgetary rules for territorial entities in 2003 there was unambiguous opinion about the compulsoriness of the budget outlook. At the same time the ministry of finance did not prepare any explanation decree or recommendation for the preparation of the budget outlook.

The following figure shows that the introduction of the multi-annual budget outlook was quite slow and that four years after its legalization the budget outlook was used by 173 municipalities (i.e., 63.6 %) and that another 36 municipalities (i.e., 13.2 %) are preparing it. Its usage grows with the size of the municipality.

**Figure 2: Use of the budget outlook in different years**



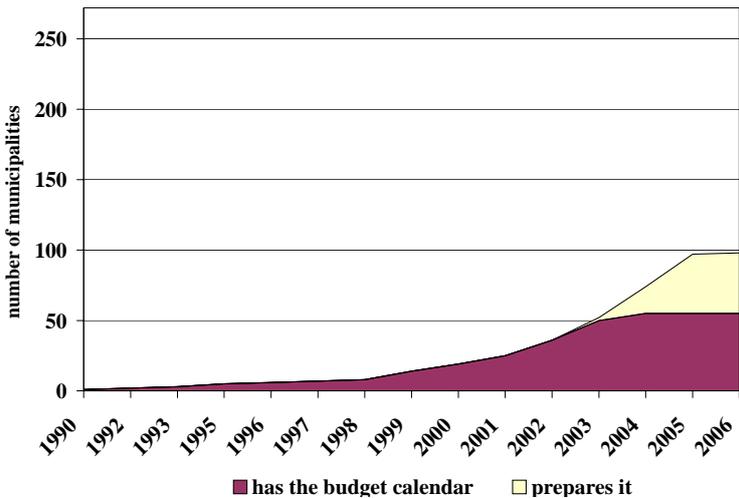
At the central government level the multi-annual budget outlook was introduced also from the beginning of 2001, however, in 2004 it was accompanied with the multi-annual budget framework, i.e., ceiling of the central government expenditures for the subsequent two years

approved by the Chamber of Deputies which is binding for the government when preparing the state budget for the particular years. Therefore since the state budget for the fiscal year 2006 the mechanism of fiscal targeting is used in the Czech Republic. In contrary at the municipal level only a few municipalities benefit fully from the interconnection of the annual budget and the multi-annual budget outlook, mainly because of lack of knowledge of the local officials.

Budget calendar is a timetable of the various steps that are necessary to prepare, review and adopt a budget and it assigns responsibility for each step. Budget calendar lists next to each other all steps of the budgetary process, their deadlines and all the participants (see Campbell and Glick, 1998, p. 155). The binding budget calendar at the central government level was established in 2004. There is no obligation for municipalities to approve a binding budget calendar; however it is a useful management tool.

The budget calendar must be compiled at the beginning of the budgetary process, either annually or the same budget calendar can be used in different years. Out of the 272 researched municipalities, 4 municipalities compile the budget calendar annually. 61 municipalities use the same calendar every year and 45 municipalities are currently preparing their budget calendar. The usage grows with the size of the municipality. The number of municipalities using the budgetary calendar grew fast in the last years as shown in Figure 3.

**Figure 3: Use of the binding budget calendar in the different years**



There is some relationship between the usage of the two tools: municipalities which use the binding budget calendar use also the multi-annual budget outlook, except of only 13 municipalities (i.e., 4.8%). 96 municipalities (i.e., 35.3%) use or prepare both the multi-

annual budget outlook and the binding budget calendar and 112 municipalities (i.e., 41.2%) use or prepare only the multi-annual budget outlook. 43 municipalities (i.e., 15.8%) do not use any of the analyzed tools.

## **Conclusions**

Municipalities in the Czech Republic are independent, self-governing entities whose powers and responsibilities are granted by laws of the national parliament. Basic municipal rights are to own property, to act on own behalf (i.e., independent competencies) and to manage responsibilities on behalf of the national government (i.e., delegated powers).

Major municipal revenue source are the shared taxes (with some simplification 20,59% of the total national personal and corporate income tax and the value added tax proceeds) which amount to 56 % of municipal revenues, the other own sources, i.e., property tax, local, environmental and administrative fees, non-tax revenues and capital revenues amount for 23 % revenues. The rest is composed of various current and capital grants from other public budgets.

Municipal budgetary process is regulated only to some extent. The central regulation leaves significant space for municipalities to choose how they will proceed preparation and debate of the draft budget, it only requires that the draft budget is available to the public for comments and that it is approved by the council.

Results of our research showed that the budget officer is in nearly 90% municipalities the head of financial or similar department and that only in less than 6% municipalities the budget officer prepares the draft budget alone without cooperation with heads of other departments. Instructions for the department heads contain more than the deadline in 76% of the municipalities. The department heads have to respect the expenditure limits in nearly 24 % of the municipalities.

Participants and procedures of the budget debate differ significantly across the municipalities, however in the majority of municipalities at the debate participate the commission and/or the mayor, the council and the financial committee.

Central government legislation requires that the municipalities prepare the multi-annual budget outlook, however, this requirement was not accompanied with any specifications, recommendations or methodological advice. This lack of either support or information

substantially limits the potential this tool has. Therefore despite the requirement only about 77% of the municipalities compiled the multi annual budget outlook in 2004.

In contrary , the example of the binding budget calendar (used by 40 % of the municipalities), which is not compulsory, shows, that municipalities are in general interested in adoption of tools which may improve their procedures.

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## **Czech laws**

Law on administration fees (Act # 368/1992 Coll.)

Law on budgetary rules for territorial entities (Act # 250/2000 Coll.)

Law on local fees (Act # 565/1990 Coll.)

Law on municipal establishment (Act # 128/2000 Coll.)

Law on tax assignment (Act # 243/2000 Coll.)

Law on the Capital Prague (Act # 131/2000 Coll.)