Theoretical Dimensions of Fiscal Illusions in Local Government Finance

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***Abstract*—The aim of this paper is to assess the financing system for the local government in Poland from the perspective of the origin of fiscal illusions. The notion of fiscal illusions rarely appears explicitly in the literature in the context of decentralization as it is mostly analysed in the context of taxation problems. In the financing system of the local government units, it is most frequently associated with the paradox of the flypaper effect. However, the phenomenon is gaining more economic, political and social importance due to the politicization and the ongoing decentralization of public finance. The share of transfer revenues such as the general purpose grant, earmarked grants and shares in PIT and CIT in the system of local government finance is on the increase. On the basis of a positive analysis, the main sources of fiscal illusions resulting from the present system of financing local government in Poland have been identified.**

***Index Terms*—Decentralization, fiscal illusions, local government finance, public finance.**

I. Introduction

Apart from many unquestionable benefits, the decentralization of public finance also results in various negative consequences. Paradoxically, it may lead to some problems with the rational management of public funds and an incorrect assessment of the processes involved. Fiscal illusions, which, in the theory of economics, are traditionally associated with tax policy, have long appeared implicitly in the context of the ongoing decentralization of public revenues and expenditures resulting in progressively complex fiscal relations between the central budget and the budgets of local government units [1]-[3]. After 2008, these complex relations coincided with the consequences of the global financial crisis both at the central and local tiers [4], [5].

The aim of this paper is to present the concept and areas of fiscal illusions in the system of public finance with particular emphasis on its decentralization. On the basis of a positive analysis, the main sources of fiscal illusions resulting from the present system of financing local government in Poland have been identified. They can be treated as some stylized facts before the empirical investigation in the following steps.

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II. The Concept of Fiscal Illusions in the Theory of Public Finance

The concept of fiscal illusions is related to the problem of any illusion observed in psychology and social life. In broad terms, an illusion is a false belief (about something that is not present in reality) or an erroneous, distorted interpretation of things and phenomena. In the field of economics, there are such illusions as 'money illusions' and 'fiscal illusions' which are discussed here. The foundations for the study of fiscal illusions were laid by an Italian economist, A. Puviani and later by M. Fasiani. The public finance theory that originated in Italy emphasised the role of the structure of political institutions in the state. According to Puviani, fiscal instruments are part of the institutional and political order which is used by the ruling group in order to minimize the resistance of taxpayers to excessive tax burden. That is why the ruling class creates fiscal illusions suggesting to the taxpayers that the level of taxation is lower than it really is, and that the real value of goods and services of which they are beneficiaries is higher [6]. The critics of the theory point out that A. Puviani's analysis of fiscal illusions concerned the state where a certain group held a monopoly of power and that it cannot refer to democratic states. This is, however, highly debatable as in the conditions of democracy and the decentralization of public finance, fiscal relations between individual tiers of public authorities and territorial communities become increasingly complex, which leads to false interpretations of economic and social phenomena. As a result, while many psychological aspects of fiscal policy are still present, other, new illusions are currently created regarding such financial instruments as, for example, intergovernmental transfers. Grants for the territorial self-government constitute a major element in the theory of fiscal federalism. Their composition, functions and importance for local autonomy and accountability have raised much controversy over the years [7].

The illusions that accompany the levying and use of taxes also appear in the English version of the discipline. In these studies, while less emphasis is placed on the structure of political institutions themselves, more attention is directed towards the consequences of fiscal illusions in the form of a constant increase of public expenditure. The increase also results from the preferences of politicians and administration officers whose jobs and careers strengthen the projects which increase public expenditure. Fiscal illusions are defined as the process where governments conceal the real tax costs of incurred public expenditures by using, first of all, indirect taxes or inflation phenomena to diminish the real value of tax reliefs and exemptions or to freeze tax thresholds etc. Such a situation is the reason why the taxpayers–voters are not aware

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of the real costs of public services and consequently voice a higher demand [8]. Growing public expenditure is a consequence of the illusion that the costs of services provided by the public sector are substantially lower than they really are. Also the big problem is the nature of indirect taxes which are, as if, hidden in the price of goods and services purchased by consumers [9].

A synthetic definition of fiscal illusions in the scope of our interest was provided by Dollery and Worthington [10] who stated that: 'The concept of fiscal illusion revolves around the proposition that the true costs and benefits of government may be consistently misconstrued by the citizenry of a given fiscal jurisdiction'. Mueller [11], in turn, analyses fiscal illusions linking them to the system of subsidies for local government, relations between the sources of revenue and expenditure policy and maximization of the politicians' chances of election.

III. System of Financing Local Government Units in Poland

The present system of financing local government units in Poland is an outcome of over twenty years of evolution which coincided with the construction of market economy and civil society. Local government has a three-tier structure consisting of municipalities (*gminy*), counties (*powiaty*) and regions (*województwa*). The system of financing local government is based, first of all, on the Act on Local Government Revenues of 13 November 2003 [12]. The principles of state financial management are stipulated in the Act on Public Finance of 27 August 2009 [13] and the composition of local taxes and charges are governed by many separate acts of law.

In short, the system of local government finance in Poland is characterized by the following: the dominant role of real property tax in the tax revenues of municipalities; counties and regions being deprived of typical tax revenues; the use of the so-called shared taxes in the vertical distribution of tax revenues; transfers from the central budget that have been based on the general grant which, in the financial aspect, is dominated by the part of a performance character, the so-called educational part; a large increase in local government debt which is caused by the co-financing of EU projects.

As a result of the vertical distribution of tax revenues, municipalities have received some relatively less efficient taxes: real property tax, agricultural and forest tax, transport vehicles tax, tax on civil law transactions, inheritance and donation tax and lump-sum tax in the form of the so-called 'tax card'. Real property tax plays the key budgetary role in local taxes. Supramunicipal local government units (counties and self-governing regions) do not hold typical local taxes. The vertical distribution of revenues also takes into account the shared taxes: personal income tax (PIT) and corporate income tax (CIT). As a result, local government shares in PIT and CIT are of a great importance in the system of financing. The local government sector has a share of over 50 per cent in PIT (of which municipalities - 39.34 per cent, counties - 10.25 per cent, self-governing regions - 1.6 per cent), and of 22.86 per cent in CIT (of which municipalities - 6.71 per cent, counties – 1.40 per cent and regions – 14.75 per cent). In practice the share in PIT is below 50 per cent because the law provides additional conversion factors.

It is debatable if local government shares in the state taxes should be formally, statutorily classified as own revenues. In counties and regions, such shares are the primary source of own revenues. It would be difficult, however, to classify them as own tax revenues as local government units do not exert any direct influence on their amount or composition.

Similarly to other countries, transfers from the state budget constitute an important source of revenue for all the local government tiers in Poland. The general grant plays the key role here whereas earmarked grants for the implementation of delegated tasks are of less importance. The general purpose grant consists of three parts: equalizing, balancing and educational, and in the case of regions: equalizing, regional and educational. The method of calculation is highly complicated, which obscures the functions they are supposed to perform.

As a result of such a composition of the financing system, the level of fiscal autonomy and independence, as has been stated before, varies considerably at different tiers of local government. Data on the share of local government expenditure in GDP point to the expansion of decentralization at all the tiers of local government in Poland. However, statistical indicators fail to assess the real fiscal autonomy of self-government. High level of local government expenditure is not indicative of high fiscal autonomy if it is covered by external revenues, for example, by earmarked transfers from the state budget. The share of own revenues as a source of financing seems to be a better indicator. However, also in such a case, what should be taken into consideration is the categories of revenues which belong to the so-called own revenues. It is debatable to classify shares in PIT and CIT in Poland as own revenues. The more so as they constitute a considerable source of financing. Local government units enjoy total autonomy in expenditure in this case, in the same way as in the case of the general purpose grant. The composition of a specific source of financing and the differentiation between revenue and expenditure independence are of considerable importance in the assessment of the real degree of local government fiscal autonomy. This is also extremely important in international comparisons as every system has its specific traits which have been derived from national and historical contexts.

A high level of external funds from the central budget does not necessarily lead to local government fiscal dependency especially when the grants are of general character and the goals they are put to are defined by local authorities. This is due to the fact that, in the conditions of the growing scope and costs of communal tasks, such a solution may be more advantageous than a system of small, inadequate local taxes and charges. In such a situation, the principles of calculating the total amount of the transfer in each year and the criteria for its allocation among local government units become important. In Polish conditions, the problem has gained importance as the vital role is played by revenues from intergovernmental transfers. These include: the general purpose grant, earmarked grants and shares in PIT and CIT. As has been underlined before, in Poland, the shares are a significant source of own revenues. In the theory of fiscal federalism, shares in state taxes are regarded, however, as transfers, general grants, from the central budget.

IV. Sources of Fiscal Illusions in the Decentralized Systems of Public Finance: Stylized Facts

The main thesis of the article is that the source of fiscal illusions about the system of financing local government lies in the fact that it is largely based on revenues from intergovernmental transfers. In such a system, the positive effects of the accountability of politicians to the citizenry disappear. Close relations among those who pay charges and use public goods which are financed by these charges enhance allocation of public funds. In the light of the theory of fiscal federalism, a large portion of local government expenditure should be covered by local taxes which should, in turn, be characterized by territorial explicitness, constant spatial relation of the tax base and universality of tax burdens. This allows for more rational management of public goods and finance, prevents inefficient localization, inefficient migrations and externalities [14]-[18].

The problem of optimal composition of the sources of financing local government has been closely observed and analysed by economists for some time now. They have pointed to the growing scope of transfers from the central budget which is not justified by the equalization policy as it leads to less accountability for local tax policy, stimulates an increase in local public spending and local government debt [19].

In practice, there are so many types of false perceptions and interpretations of fiscal phenomena that it should be enough to list just a selection of fiscal illusions associated with the decentralization of public finance. The most important illusions that spring from the system of financing local government in Poland can be quoted as follows:

- The division of local government in Poland into three tiers gives an impression of a wide range of financial decentralization. The fact is that the two upper tiers of local government, counties and regions, are deprived of own revenues in the form of taxes and the redistribution function of the state seems to be too strong. In recent years, transfers from the central budget to local government budgets (general purpose grant and earmarked grants) represent over 22 per cent of the central budget expenditure.
- A proliferation of taxes at the municipal level does not guarantee effective income from own revenues. In many municipalities, the income from such taxes as, for instance, agricultural tax, forest tax, inheritance and donation tax constitute but a symbolic source of budget revenue.
- The fact that inheritance and donation tax and 'tax card' are administrated by the state revenue offices creates a situation where taxpayers regard these taxes as a source of state budget revenue. Additionally, this false opinion is strengthened by the fact that there are no elements of municipal taxation power in this case.
- Knowing that primary and secondary schools are financed from local budgets, many citizens do not realize, however, how high the costs of financing education are as they do not feel particularly excessive local tax burden. This is due to the fact that educational tasks are financed from the educational part of the general purpose grant.
- In general, knowledge of the amount of grants and subsidies from the central budget to local budgets (their economic functions and meaning) is very low. What prevails is the demanding attitude which ignores the fact that the central budget funds come from the taxes that contribute to that budget.
- Traditionally seen as state taxes, PIT and CIT are in fact typical shared taxes. At present, half of the revenues from PIT goes into the local government budgets. In this way, taxpayers finance the expenditures from town and municipal budgets, of which they are not aware. That in itself constitutes a kind of fiscal illusion.
- In the situation where the revenues from intergovernmental transfers (alongside grants and subsidies, shares should be included in such revenues) are of great importance as a source of financing communal budgets, there is the danger that people may not be aware of the real level of costs of the services financed by the budgets at the decentralized level.
- What is often overlooked in both the literature and the public debate in Poland is the fact that decentralization as such is followed by financial expenses. Decentralization has been fetishized as it has paralleled the rise of democracy and market economy.

Paradoxically, the most trivial fiscal illusion in connection with decentralization seems to be the assumption that decentralization is the necessary and sufficient condition for a more rational spending of public funds. A simplified and uncritical approach to the benefits of delegating tasks and funds to the local government tiers is dangerous as we can easily expect a waste of public funds both at the central and local levels. It is important to realize that it is the local government tier where the indicators of public tasks can be put to use. They may be difficult to use for the expenses on national defence, diplomacy or the judiciary. Task indicators can perfectly fulfil their role in the case of most communal services.

The transfer of fiscally inefficient taxes and limited taxation powers to the local government tier and the complex system of subsidies may become, in certain systems and solutions, sources of many fiscal illusions. Numerous taxes of low revenue efficiency appear to be a frequent problem of local finances. Particularly, in unitary countries, high decentralization of taxation powers is avoided so that the system and tax burden should stay uniform across the country. As a consequence, a large portion of expenditures of a local government unit is financed by transfers from the central budget. Such a situation produces a false impression that the costs of communal services are lower than they really are as the tax burden at the local government tier is relatively low. In practice, it is often the case that the policy of local authorities is to demand higher grants from the state budget instead of financing the programs from their own revenues. As a result, the flypaper effect appears. The effect has been widely described in the literature and it has been a subject of many empirical studies [19]-[25].

V. Conclusions

Complex fiscal relations between the central and local governments and new fiscal illusions appear as a result of the decentralization of public finance. The definition of fiscal illusions in the context of decentralization requires a two-faceted approach. In the narrow and traditional approach, fiscal illusions conceal the real level and nature of taxes and their spending goals. To refer fiscal illusions to the decentralization of the administration and public finance requires a wider approach which would take into account both the gist of the traditional approach to all kinds of fiscal illusions and the specific character, goals and consequences of decentralization itself.

Taking into account the problems of the decentralization of public finance, we should define fiscal illusions as: concealment of the real level and nature of taxes and their spending goals at all the tiers of public authorities; ignorance or misinterpretation of fiscal instruments which result from the relations and interdependency between the central budget and the local government budgets.

The system of financing local government in Poland favours the formation and consolidation of fiscal illusions. The main reason for this is the fact that the system of financing communal budgets has been based on the revenues from intergovernmental transfers and little fiscal independence and autonomy of local governments. It is impossible in Polish conditions to properly study the flypaper effect due to a short period of local government experience, the ongoing decentralization and gradually introduced systemic reforms. Nevertheless, the legal and financial analysis shows the shortcomings of the system. The systemic errors cause the deterioration of the local government financial situation and conflicts between the central and local governments. From the social perspective, this situation is alarming in the context of efficient finance management, and consequently efficient and optimal catering for the needs of citizenry. The difficult financial situation of local governments is, of course, the aftermath of the global financial crisis, the economic slowdown and the difficult situation in the whole of the public finance sector. It also results from the local government borrowings to co-finance investment. In this case, however, tight budgetary constraints should be expected in the future. It is all the more important, therefore, to foster local fiscal autonomy and accountability of local politicians to their voters. It would be desirable to strengthen the Wicksell connection, the connection between the level of charges and the use of communal goods and services. It is necessary to confine the demanding attitudes among both the citizenry and their representatives – local councillors. The demanding attitudes of the local government which call for a compensation of the loss in revenues (instead of a comprehensive systemic reform) are all too present in the proceedings of the joint commission of the central and local governments and the national unions and associations of local governments. Although it would be difficult to disagree with the criticism of the central government practices to delegate tasks without an adequate increase in revenues, it seems that direct compensation of the loss in revenues is not an optimal solution. There is a need for a reform of the system of financing local government which would increase local government own revenues, first of all, local taxes and charges. Local government bodies should have a greater say in shaping the composition and level of taxes and charges. They should be held accountable for their decisions to the voters, who should be more often enquired about their preferences with regard to taxes and public expenditures. This is the problem of public consultations which are widely criticized in Poland as they do not fulfil their role or function particularly at the local government level.

The assumption that the decentralization of public finance contributes to the origin and consolidation of fiscal illusions raises the question of a remedy for this situation. In practice, it is difficult to find the optimal scope of decentralization that would counteract such illusions. Finding a solution is not easy as own revenues are fetishized and the system of financing local government units has been based on transfers from the central budget.

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