

# State Decentralization in Poland Has Been Successful, but There Is Still Room for Improvement



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State decentralization played an important role in the successful transition to a market economy in Poland. The title of the last World Bank publication on Poland accurately describes our success (*Lessons from Poland, Insights for Poland: A Sustainable and Inclusive Transition to High Income Status*). The authors of the report focused on the importance of state decentralization, pointing out that local governments are subject to increased political accountability, which helped to improve governance overall.

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THE MAJORITY OF INTERACTIONS BETWEEN PUBLIC ADMINISTRATION AND CITIZENS OCCURS AT THE LOCAL LEVEL OF GOVERNMENT

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DECENTRALIZATION IN POLAND WAS IMPLEMENTED IN TWO STAGES – IN 1990 AND IN 1999

Decentralization in Poland was implemented in two stages – in 1990 and in 1999. The early reforms passed down central government tasks as well as some revenue-raising authority, giving it limited autonomy regarding real estate taxes, local fees, and other minor taxes. The second round of administrative reforms reduced the number of voivodeships, restored counties, and decentralized public programs and services to increase citizen involvement and improve public service delivery<sup>1</sup>.

<sup>1</sup> World Bank Group (2017) *Lessons from Poland, Insights for Poland: A Sustainable and Inclusive Transition to High Income Status*. Washington, DC: World Bank. Available [online]: <https://openknowledge.worldbank.org/handle/10986/28960>

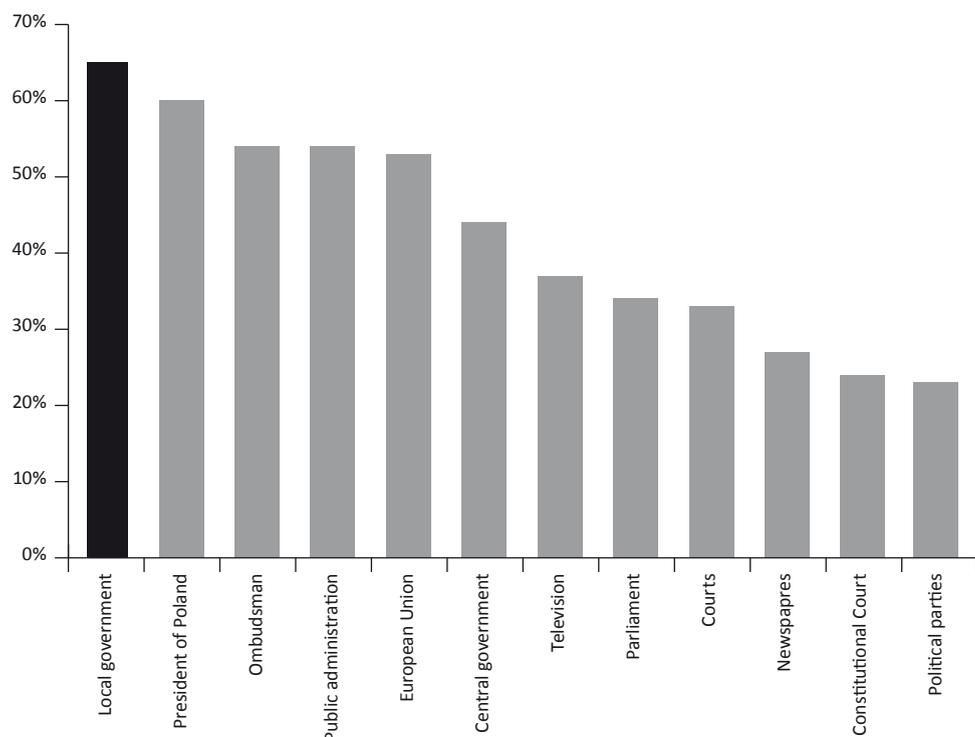
## LOCAL GOVERNMENTS PLAY A SIGNIFICANT ROLE IN DELIVERING PUBLIC SERVICES

Besides tax issues, the majority of interactions between public administration and citizens occurs at the local level of government. As local government service the majority of administrative matters, they employ nearly 60% of the total number of people who work in public administration. They are also responsible for primary and secondary education, which – according to the PISA results – is of a high quality by European standards. While the central government supervises the curricula and grants money (the educational grant is a function of a number of students and teachers in a given community), it is local government that runs the schools directly.

In the case of the healthcare, the responsibilities of local government (which owns the majority of hospitals) and central government (which funds the entire sector) are less clearly divided. Moreover, outcomes are much worse than in education.

Overall, local governments spend around 30% of total general government expenditure, but their contribution to investment is much higher – in recent years, on average

Figure 1: Do you have trust in those institutions? (sum of % respondents who answered "I definitely do" and "I rather do")



Source: CBOS (2018) *O nieufności i zaufaniu*.

Available [online]: [https://www.cbos.pl/SPISKOM.POL/2018/K\\_035\\_18.PDF](https://www.cbos.pl/SPISKOM.POL/2018/K_035_18.PDF) (in Polish)

45% of public investment was conducted by local governments<sup>2</sup>. Although there are discussions about the efficiency of certain projects (aqua parks and airports are the most hotly debated), overall improvement in infrastructure (local roads, sewers, public spaces) during the last 30 years was remarkable.

### POLES HAVE TRUST IN LOCAL GOVERNMENT

In the recent survey conducted by CBOS, local governments ranked as the most trusted public institution – way ahead of central

government and other remaining branches of government<sup>3</sup>. However, such results are nothing new – looking back at the surveys for more than the last 15 years, local governments have always been among the most trusted institutions, consistently ranking above central government and political parties [See Figures 1 and 2].

<sup>2</sup> See <http://ec.europa.eu/eurostat/data/database/> Annual governmental finance statistics.

<sup>3</sup> Local city and county governments are trusted by 65% of Poles, while the President by 60%, public administration offices by 54%, central government by 44%, parliament by 34%, courts by 33%, and political parties by just 23%. Even the media rank much lower, with 37% in the case of television and 27% of the press.

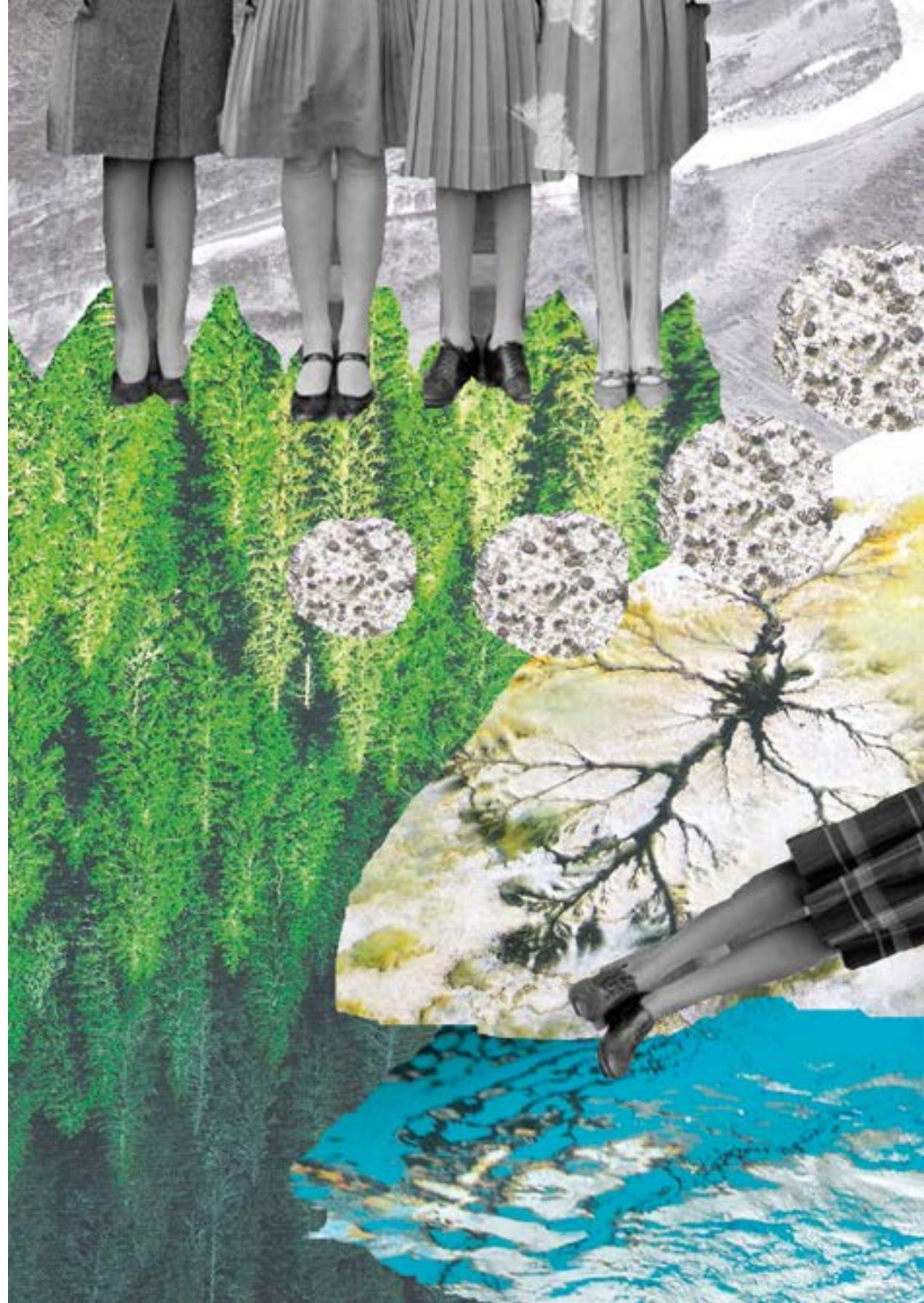
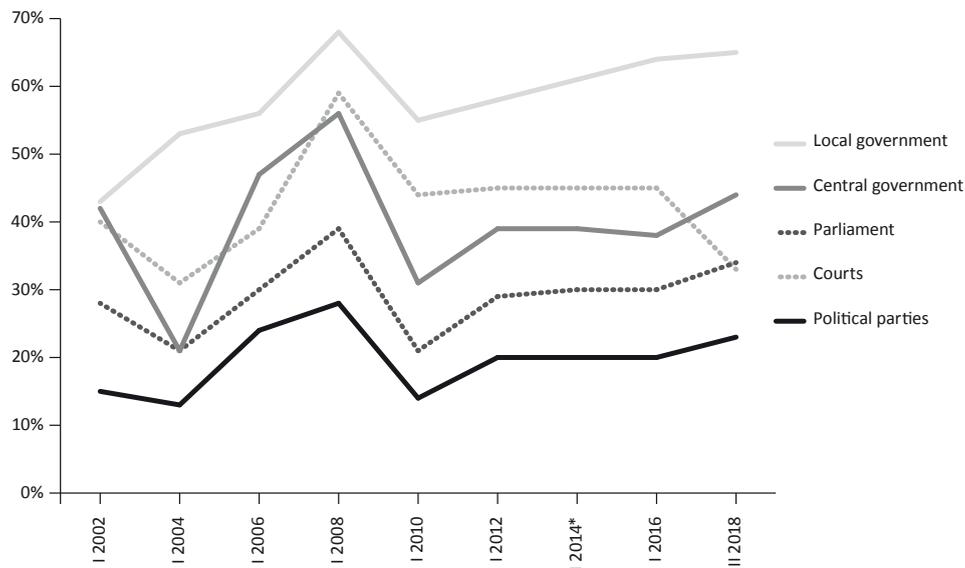


Figure 2: Do you have trust in those institutions? (sum of % respondents who answered "I definitely do" and "I rather do")



Source: CBOS (2018) *O nieufności i zaufaniu*.

Available [online]: [https://www.cbos.pl/SPISKOM.POL/2018/K\\_035\\_18.PDF](https://www.cbos.pl/SPISKOM.POL/2018/K_035_18.PDF) (in Polish)

Thus far, state decentralization in Poland has proved to be successful. Poles have trust in their local government, but there is still space for improvement. Although public expenditure has already been decentralized, tax autonomy of local government remains limited, creating bad incentives. The experience of other countries indicates that fiscal autonomy that encompass both the expenditure and revenue side is a much more desirable state.

### INCREASING TAX AUTONOMY OF LOCAL GOVERNMENTS WOULD FURTHER IMPROVE ACCOUNTABILITY

Fiscal decentralization is a way to achieve a more efficient delivery of public services. The importance of local knowledge, the right of exit and generally gains from moving decision making closer to the citizen-level have long been recognized by

economists<sup>4</sup>. In general, central governments are not acquainted well enough with local matters to tailor their policies to varying circumstances on the local level, thus decentralization improves efficiency. Furthermore, decentralization puts local governments in the hands of their citizens, who can exercise their right to voice their opinions by voting and participate in public hearings, and – perhaps more importantly – by their right to exit, e.g. move to a neighboring county. Decentralization on the municipal level allows citizens to “vote with their feet” on the level of public services and taxes,

<sup>4</sup> Hayek, F.A. (1945) “The Use of Knowledge in Society”, [in:] *American Economic Review* 35(4), pp. 519-530; Tiebout, C. (1956) “A Pure Theory of Local Expenditures”, [in:] *Journal of Political Economy* 64(5), pp. 416-424; Oates, W.E. (1972) *Fiscal Federalism*, Harcourt, New York; Brennan, G. and J.M. Buchanan (1980) *The Power to Tax: Analytic Foundations of a Fiscal Constitution*, Cambridge: Cambridge University Press.

thus pushing local governments towards a policy mix better aligned to voter preferences and leads to a more efficient system.

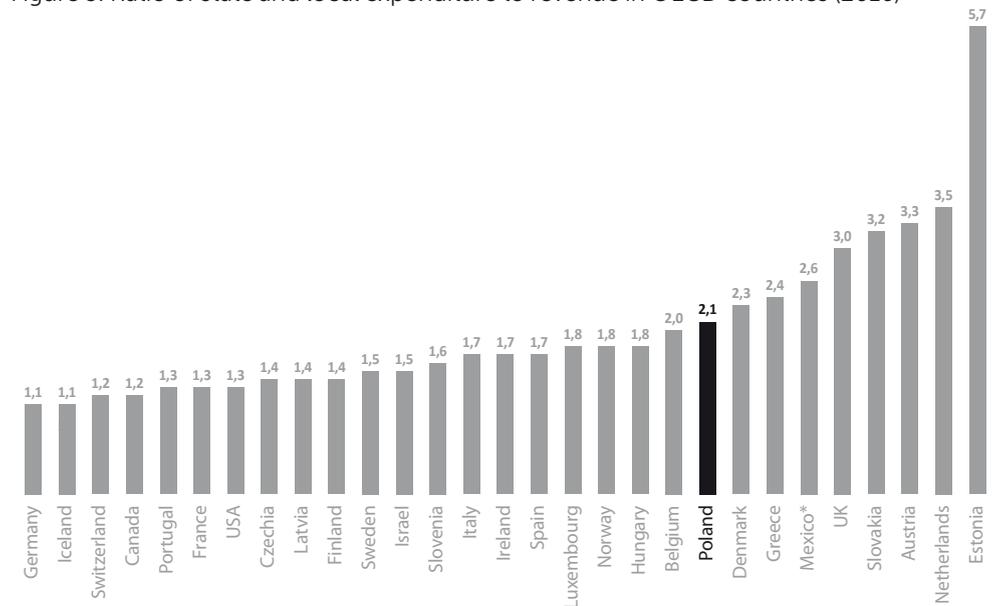
### MOST COUNTRIES ARE DECENTRALIZED TO SOME EXTENT

Most states channel expenditures and revenues through the local level of government to some degree. In general, local governments handle a much higher share of expenditures than revenues, as their revenues consist not only of own revenue, but also transfers from central and state governments [See Figure 3]. Polish local governments spend twice as much as they gather in own revenues, which is typical of highly unitary or small countries. This contrasts with state and local governments in neighboring Germany, which takes in almost as much as they spend in own revenue.

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DECENTRALIZATION ON THE MUNICIPAL LEVEL ALLOWS CITIZENS TO “VOTE WITH THEIR FEET” ON THE LEVEL OF PUBLIC SERVICES AND TAXES

Further tax decentralization in Poland and other countries with centralized revenues may enhance public sector efficiency and promote economic growth. A much

Figure 3: Ratio of state and local expenditure to revenue in OECD countries (2016)



Note: \*Data for Mexico for 2015. Several countries have been omitted due to data limitations (e.g. the United States lacks aggregate data from the local level, partly due to a very high level of local autonomy)

Source: Own elaboration based on OECD data

higher degree of spending decentralization than tax decentralization is unfortunate, as the latter has a stronger positive impact on economic growth<sup>5</sup>. This is attributed to the fact that intergovernmental transfers weaken the incentives to develop an economic and fiscal base – lowering public sector efficiency. Incentives to create business-friendly conditions and provide high-quality public services are weakened when local government revenues depend on the central government instead of their citizens.

Thus, empirical findings show that spending covered by own revenue is growth-enhancing, while transfer-funded spending may be growth-dampening. Such a result is consistent with the findings from Italy, according to which low public-sector efficiency is also detrimental to private company productivity, as it may weaken the protection of property rights, lengthen administrative procedures, and increase the local tax and regulatory burden<sup>6</sup>.

Moreover, the dependence of state and local governments may create problems of moral hazard, especially if the central government cannot credibly commit to a no bailout rule. In Australia, Canada, Germany and the United States, markets punish state governments with higher bond spreads for taking on debt and deficit spending more when these states have a higher share of own revenues<sup>7</sup>.

<sup>5</sup> OECD (2018) *Fiscal Decentralisation and Inclusive Growth*, OECD Fiscal Federalism Studies.

<sup>6</sup> Giordano, R., S. Lanau, P. Tommasino, and P. Topalova (2015) *Does Public Sector Inefficiency Constrain Firm Productivity: Evidence from Italian Provinces*, IMF Working Paper 15/168.

<sup>7</sup> Sola, S., and G. Palomba (2015) *Sub-National Government's Risk Premia: Does Fiscal Performance Matter?*, IMF Working Paper No. 15/117.



THE DEPENDENCE OF STATE AND LOCAL GOVERNMENTS MAY CREATE PROBLEMS THAT ARE MORALLY HAZARDOUS, ESPECIALLY IF THE CENTRAL GOVERNMENT CANNOT CREDIBLY COMMIT TO A NO BAILOUT RULE

Conversely, if the share of own revenues is low and state governments are highly transfer-dependent on their central governments, markets expect them to receive bailouts from central governments and treat their bonds as close substitutes to sovereign bonds. This, in turn, lowers the incentive of state governments to run a responsible fiscal policy – the contrast is striking between Argentina, Brazil, and Germany on one side, and Canada and the United States on the other<sup>8</sup>.

A similar effect takes place in the case of municipalities, where a dollar of intergovernmental transfers increases expenditure more

<sup>8</sup> Bordo, M.D., L. Jonung, and A. Markiewicz (2013) *A Fiscal Union for the Euro: Some Lessons from History*, [in:] *CEifo Economic Studies* 59(3), pp. 449-488; Rodden, J. (2005) *Achieving Fiscal Discipline in Federations: Germany and the EMU*, Fiscal policy in EMU: New Issues and Challenges Workshop Paper, European Commission, MIT.



USUALLY, REVENUE DECENTRALIZATION IS IMPLEMENTED WITH NO OR ONLY LIMITED LOCAL TAX AUTONOMY

than a dollar of own revenues<sup>9</sup>. In Poland this problem is minimized by submitting local governments to an expenditure rule, which limits their capability to take on debt. In effect, in 2017, despite a high central government deficit of 3.8% of GDP, local governments experienced a modest surplus of 0.1% of GDP.

#### LOCAL TAX AUTONOMY IS OFTEN LACKING

Usually, revenue decentralization is implemented with no or only limited local tax autonomy. The OECD measure of own revenue encompasses all revenue minus intergovernmental transfers from other levels of government. Unfortunately, this often encompasses a large amount of shared tax revenue. State and local governments have no discretion as to the rates and reliefs in case of such revenues, making tax competition effectively impossible. This is the case in Poland, where shared revenue from central government PIT and CIT taxes have a sum of over 20% of all local revenue.

Local governments in Poland collect less revenue from autonomous taxes and more from tax sharing schemes than in the rest

<sup>9</sup> Martin-Rodriguez, M., and H. Ogawa (2017) *The Empirics of the Municipal Fiscal Adjustment*, [in:] *Journal of Economic Surveys* 31(3), pp. 831-853.

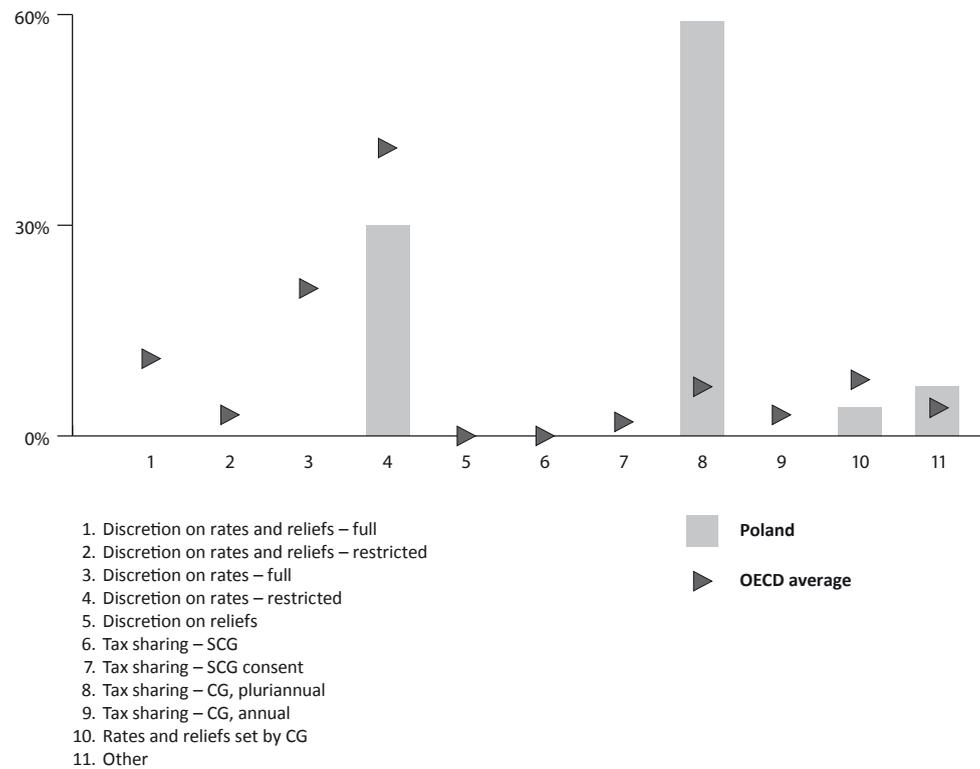


LOCAL GOVERNMENTS IN POLAND COLLECT LESS REVENUE FROM AUTONOMOUS TAXES AND MORE FROM TAX SHARING SCHEMES THAN IN THE REST OF THE OECD COUNTRIES

of the OECD countries. The OECD classifies state and local tax revenue into 11 groups with respect to the level of autonomy. For example, in highly federalized countries local governments can implement new taxes setting their rates and reliefs at will, while in Poland local governments have at most a limited discretion with respect to the rates of some taxes, e.g. on real estate, transport vehicles, and agricultural activity.

In the case of Poland, 3 out of 9 such taxes appear reflected in the OECD data, but this has no significant impact on the results as the remaining tax revenue remains rather small. We treat the sum of sub-central tax revenues, where state and local governments retain full or limited discretion with respect to rates or reliefs, as autonomous tax revenue. The comparison shows that Polish local governments hold some part of autonomy over only 30% of their tax revenues, while OECD countries hold on average 76% of their tax revenues. Furthermore, their autonomous local taxes are “more autonomous” as these municipali-

Figure 4: Structure of local tax revenues in Poland and an average of other OECD countries (2014)



Note: We refrain from showing exact shares as OECD data appears incomplete

Source: Own elaboration based on OECD data

ties often hold more discretion regarding rates and reliefs than the Polish ones [See Figure 4].

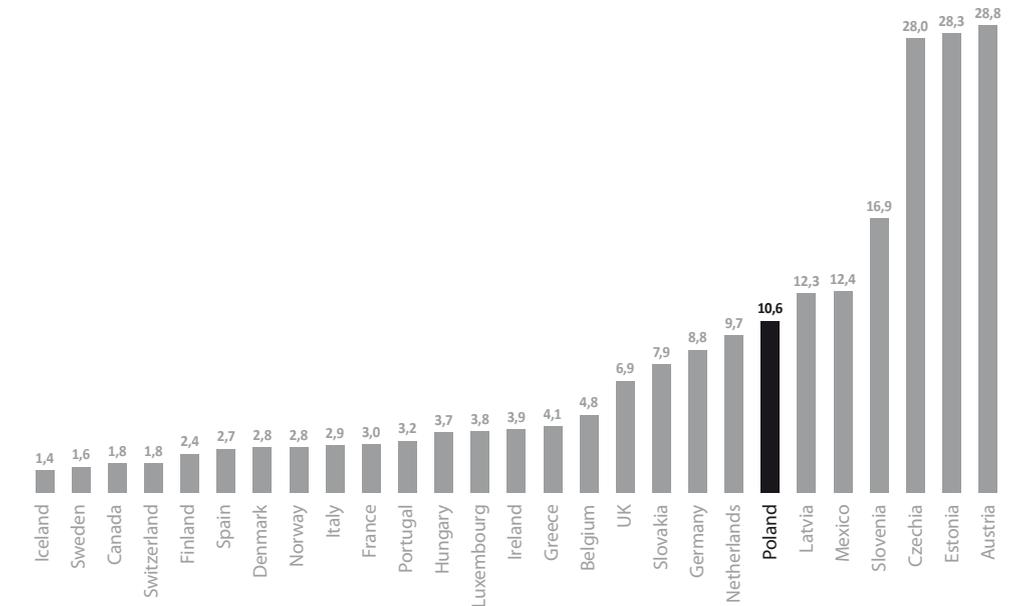
The ratio of state and local expenditure of autonomous revenue in Poland and other OECD countries is much higher than in the case of all local revenue. The OECD data has been used to show a ratio of autonomous revenue for state and local spending [See Figure 5]. The ratio in Poland deteriorates five-fold in comparison to the previously exhibited ratio. Germany scores almost as poorly on this measure. The Scandinavian countries, Canada, and Switzerland (and presumably other non-European Anglo-Saxon

countries for which there is no data) appear most decentralized as far as this measure is concerned.

#### EXTENDING TAX AUTONOMY WOULD BE BENEFICIAL

Revenue decentralization may be much more effective in aligning subcentral incentives to public welfare if state and local governments are given more tax autonomy. Vertical fiscal gap is the amount of spending on a given government level which is not covered by autonomous revenue on that level, but funded by intergovernmental transfers instead. A recent meta-analysis of available studies shows that vertical fiscal gaps lead

Figure 5: Ratio of state and local expenditure of autonomous revenue in OECD countries (2014)



Note: \*Data for Mexico for 2015. Several countries have been omitted due to data limitations (e.g. the United States lacks aggregate data from the local level, partly due to a very high level of local autonomy)

Source: Own elaboration based on OECD data

to more fiscal profligacy in terms of debt and spending, higher tax burden, and lower public-sector efficiency<sup>10</sup>.

Singular studies also link higher vertical fiscal gaps to lower voter knowledge and per capita income. Lower voter knowledge is consistent with other findings, such as when municipalities are highly dependent on intergovernmental transfers, the ability of citizens to hold local governments accountable is limited and ignorance becomes rational.

In the case of Poland there remains ample space to expand the amount of autonomous tax revenue. As it has been shown previously, the ratio of autonomous local tax revenue to local spending is higher in Poland than

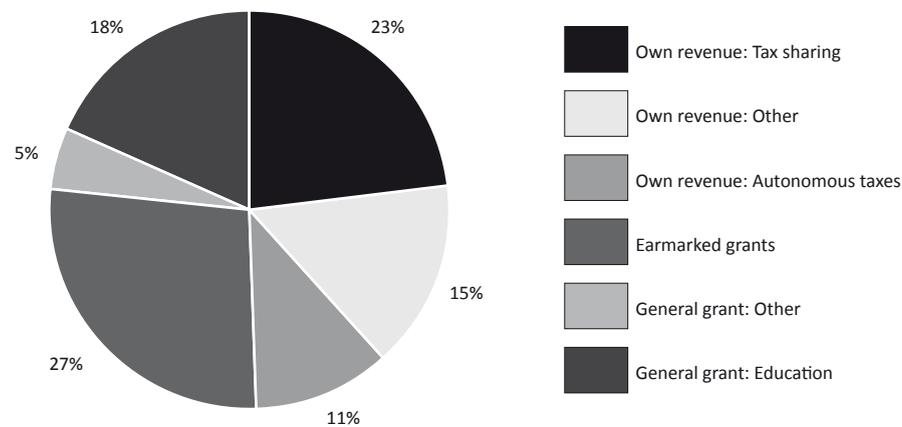
in most OECD countries. In fact, own revenue amounts to 49% of their revenues, while autonomous tax revenue amounts to only 11% [See Figure 6].

Polish localities have only a very limited ability to increase their tax sharing revenue from PIT and CIT taxes by incentivizing citizens to pay their taxes in a given county – e.g. Warsaw attempts to do that by providing public transportation discounts. This is not much different from the general grant, which consists mostly of the educational grant that finances public schools. This grant is not earmarked, and is calculated based on the number of pupils and teachers in a county. Some counties attempt to hold on to their populations so that their education grants will not be lowered – e.g. Jarocin, a town in central Poland, attempts to do this by partnering with the central government to provide subsidized housing.

<sup>10</sup> Sorens, J. (2016) *Vertical Fiscal Gaps and Economic Performance*, Mercatus Working paper.



Figure 6: Structure of local government revenues in Poland (2017)



Note: Counties, poviats, cities with a poviat status, and voivodeships are included

Source: Own elaboration based on Ministry of Finance of the Republic of Poland data

Nevertheless, these remain only half-measures as citizens often pay their PIT and CIT taxes and use public services in different counties from the ones where they actually live, while the non-earmarked education grants have to be spent accordingly to teacher salaries and other school organization rules set by the central government. Even in the case of school manager selection, the central government has an equal share of votes as the local government: 3 representatives of ministry, 3 representatives of local government, 2 representatives of teachers, 2 representatives of parents, and 2 representatives of unions.

Even in countries with lower autonomous revenue shares than Poland, higher vertical fiscal gaps lead to more fiscal profligacy. It is worth noting that Austria, despite being formally a federation, has much higher ratios of local revenues and autonomous local revenue spending than Poland. Yet, even in the case of Austria, the municipalities with higher vertical fiscal gaps respond to incentives as expected by accumulating

more debt<sup>11</sup>. This may be counter-intuitive as more “help” in the form of transfers from the central government leads to more deficit spending and debt.

In addition to tax autonomy, counties still lack autonomy from the central government in many prosaic matters (like county borders, names or even coats of arms). In some cases, local governments use their political influence in the central government to increase tax revenues by annexing the territory of neighboring counties. Such cases destroy any incentive to attract investment and citizens by improving the business environment and providing high quality public services. In a highly publicized case, the city of Opole, located in southern Poland, annexed a part of Dobrzeń Wielki county (which included a power plant and shopping center, both

<sup>11</sup> Köppl–Turyna, M., and H. Pitlik (2018) “Do Equalization Payments Affect Subnational Borrowing? Evidence from Regression Discontinuity”, *European Journal of Political Economy* 53(C), pp. 84–108.



## COUNTIES STILL LACK AUTONOMY FROM THE CENTRAL GOVERNMENT IN MANY PROSAIC MATTERS (LIKE COUNTY BORDERS, NAMES OR EVEN COATS OF ARMS)

generating high tax revenues)<sup>12</sup>. As a result, the tax revenue per capita decreased in Dobrzeń Wielki from PLN 5,779 in 2016 to PLN 2,232 in 2017 according to the ranking of “Wspólnota”, a local government magazine<sup>13</sup>. The county dropped from the 16<sup>th</sup> place of the local governments with highest per capita tax revenue to the 1,537<sup>th</sup> place.

### CONCLUSIONS

Decentralization played an important role in the success of the Polish transition from socialism to democracy and market economy. It has increased political accountability, which helped to improve governance, and today local governments provide the major-

<sup>12</sup> In Poland the central government holds the power to change borders of sub-central governments, merging and splitting them at will. The president of the city of Opole used his contacts in the central government to annex a part of the neighboring Dobrzeń Wielki county (and some other counties in the process). As mentioned in the article, this part included a power-plant and shopping center, both generating large tax revenues. The annexation went along despite widespread protests of inhabitants of Dobrzeń Wielki, which even gained national media coverage.

<sup>13</sup> Swianiewicz, P. and J. Łukomska (2018) “Bogactwo samorządów. Ranking dochodów JST 2017”, [in:] *Wspólnota* 14/2018.

ity of public services to local communities. This appears to have improved efficiency and is reflected in high levels of trust in local governments among their citizens.

Unfortunately, sub-central governments in Poland remain to a large degree, extensions of the central government. They deliver policies set by the central government and do it in a more efficient fashion, but actually have no significant power to run independent policies and to experiment. Any incentive of local governments to engage in a beneficial competition – and improve citizen welfare in the process – remains low. An improvement would come if the sub-central governments could be transformed more into laboratories of democracy, creating and testing new policies on the local level. The abovementioned research suggests a significant step in this direction would be to further decentralize revenues, giving localities more tax autonomy. •



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