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# Significance of local taxes for Lithuanian local government finance

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### Abstract

The article deals with the local taxes as one of major conditions of fiscal decentralization in the public economy of a country. The concept of local taxes and its place in the state is considered. The experience of modern democratic states in the sphere of local taxes is presented. The budget structure of Lithuanian municipalities is analyzed from the point of view of local taxes in the period of global crisis. The analysis of budget structures of the Vilnius municipality before and after crisis is made. The means are proposed that will enable us to develop the institution of local taxes up to the European level, i.e. the taxes allocated to the self-government to legalize as a local tax, rendering an opportunity to set its tariffs within the statutory limits and some new local taxes could be legalized.

## 1. Introduction

Local taxes, i.e. taxes attributed by laws to local government, are one of the major conditions of fiscal decentralization, as well as extension of independence of self-government, because they are set and regulated by a local government and are collected to municipality budgets directly. The significance of independent activities of the self-government to modern democracy is also emphasized by the European Charter of Local Self-government (1985), stating that "the institutions of self-government are the basis of any democratic system". In the countries of EU or any other countries of western democracy the institution of local taxes is developed enough. In Lithuania this problem is still waiting to be solved. The problems, connected with the local taxes, were considered by both foreign, and the Lithuanian scientists, basically in the fiscal decentralization aspect. It is worth mentioning. (Bird 1998; Musgrave 1989; Oates 1993; Rosen 1998; Stiglitz 2000; Astrauskas, Strizkaite 2003; Davulis, 2007, 2008, 2009; Staciokas 2003; Staciokas, Rimas 2004), etc. The general problems of fiscal decentralization and state local finances are considered in (Daflon 2002; Fiscal federalism and state local finance 1998; Baltuskiene 2004; Buskeviciute 2008; Raipa, A., Backūnaitė, R. 2004).

In this article, the situation in the sphere of local taxes in Lithuania and the foreign experience in this sphere are discussed. The article offers a solution to improve this situation, with regard to a further integration of Lithuania into the European Union.

The objective of the article is the situation in the sphere of local taxes in Lithuania. The problem, considered in the article is how to increase the role of local tax institution in the Lithuanian local government finance. The tasks of the article are to consider the principles of tax distribution between levels of state governing, the role of institution of local taxes in democratic states, to determine the significance of local taxes in the Lithuanian municipality budgets and to investigate the opportunities to develop the

institution of local taxes in Lithuania. The methodology used for investigating these tasks, is systematic analysis of scientific literature, legal acts and statistic data.

## **2. The Principles of Tax Distribution between the Levels of State Governing**

The major function of the state public sector is to provide public goods for the inhabitants of the country both on the state level and that of local governing. However, to realize these activities, the adequate resources are necessary on both levels. The main principle of distribution of financial resources at different levels of governing is expressed in the rule of fiscal decentralization. Thus, based on the concept of fiscal decentralization that justifies the separation of the central and local government, we should build such a structure of the public finance, in which each level of government would have sufficient resources of income to fulfil the functions entrusted to it. This financial structure includes allocation of tax sources both to the central and local governing level. The taxes assigned to the local governing level, are treated as local taxes. This principle corresponds to the European Charter of Local Self-government (1985), in which it is underlined that financial resources for governing should be proportional to the obligations established by the Constitution and laws. The economic basis of such decentralization is an increase in the efficiency of the public economic sector by means of the optimum distribution of economic functions in the economy of public sector. Actually, a centralized provision of the standard public goods, disregarding the specificity and variety needs of public groups in different regions of the country, causes its inadequacy to the social needs. Therefore, decentralization of the public sector helps to increase the economic efficiency by establishing better conditions for providing public goods that correspond to the needs of consumers.

The distribution of taxes between the central and local government levels is based on the fact that commission of the most part of rights to the central government is inefficient, because fiscal independence and responsibility of the local government is limited. On the other hand, commission of too extensive autonomy to local authorities can also be unacceptable from the point of view of macroeconomic stability and effective resource allocation. These are the main principles on the basis of which taxes are assigned to the state governing level and to the local governing level. Income from the latter taxes falls to the local budgets. Taxes, the basis of which is equally distributed in the territory of the country are most suitable to treat as local taxes. Otherwise, taxes are assigned to the state level governing (for example, the taxes of natural resources). It is important that the size of local taxes correspond to the benefit received by the inhabitants of the district in the form of public goods. It is considered that such conformity induces the tax payers to pay

taxes voluntarily and correctly. Taxes, the basis of which is mobile, are assigned to the state level, because their ranking to the local level can cause the so-called Tiebout effect. The taxes, the basis of which can be transferred to the territory of other jurisdiction, are not assigned to local taxes. One more important issue, connected with local taxes, is their administration. The most reasonable principle could be as follows. If local taxes were easily administered, then an institution, authorized by the local government, could collect the taxes.

On the contrary, it is more reasonable that an institution controlled by the central government, collect taxes, because it has greater administrative abilities to collect taxes than the local government and, consequently, tax collection costs are lower. That is the effect of scale economy in the administration of taxes. So, the taxes the base of which is easily established, equally distributed and steady, cannot be transferred to other administrative territory, they are easily administered and are best for local taxes.

Usually the taxes, giving the greatest income, are assigned to state taxes, because the central government does not wish to lose financial weights. The European Charter of Local Self-Government states that "the local government receives a share of financial resources from the local taxes and charges, the size of which is set by them on the basis of the status". Despite that, as usual the central government does not grant full autonomy to the local government to form their incomes due to the mentioned objective and subjective reasons. The order of taxation of local taxes is established by the central government. The autonomy of local governments is confined by an ability to choose the tax rates within the limits set by laws only.

## **3. Institution of Local Taxes in Contemporary Democratic States**

The institution of local taxes is well developed in foreign countries. Local taxes are legalized there. Though the local authorities have some power in setting the size of local taxes and their basis, however, in the majority of countries with modern economy, the central government limits the power of local authorities in this sphere. Note that, among all kinds of taxes, the local taxes are growing most rapidly. In the structure of local budgets of foreign countries, local taxes make up quite a large part, sometimes reaching almost half the income at the budget or more (Staciokas, 2003). In different countries there can be a different structure of local taxes. In some countries, one local tax is established, in others, some local taxes are combined. In the case of self-government where the public sector is more developed, some local taxes are usually introduced. In self-government with a less developed public sector, where the level of responsibility is minimal, it suffices one kind of local taxes. In order to determine which system of local taxes suits this or that local government better, it is necessary to take into account many

factors: capability of local authorities to administer local taxes, the volume of providing public services financed by local taxes, and even the conventional culture of tax payment.

In foreign countries we can distinguish three basic kinds of local taxes providing the greatest part of incomes in budgets of the local government: a profit tax, a property tax, and a tax on economic activities. In different countries these taxes are of different significance. The profit tax is quite widespread as one of the major financial sources for local authorities. This tax dominates, for example, in the structure of local taxes in the Scandinavian countries. The income related to those taxes makes up from 40 percents (Norway) to 60 percents (Sweden) of the total amount of all financial resources. On the other hand, in the countries such as France, Ireland, the United Kingdom and Holland profit taxes are attributed to the central government. In the Anglo-Saxon countries including Australia, the USA, Holland and others, the property taxes dominate in the structure of local taxes. Income of local budgets of these taxes ranges from 5 percents (Holland) up to 20 percents (Germany) of the volume of all revenues. The tax on economic activities dominates in the structure of local taxes of Austria, France, and the USA.

The analysis of the structure of local taxes of some countries confirms the statements mentioned above. In Canada the local authorities are entitled to use only one local tax, the property tax, the basis of which consists in the real estate. The minimum tax tariff is 0.5 - 1 percent of the property value, but for some kinds of activities the local government may establish much higher tariffs (for example, for manufacturing alcohol - 140 percent of the value of real estate). The tax is not applied to some kinds of the real estate (educational institutions, churches, public hospitals, etc.) Though the local governments have the right to set the amount of the property tax, they are obliged to adhere to the requirements established by the federal government.

In the structure of local taxes of the Northern European countries (Sweden, Norway, Finland, and Denmark) only one local tax dominates, for example, in Sweden - a profit tax. Local taxes are collected by the central government which allocates them to the local governments. The tax system of Germany is widely developed. Therefore revenues of local government budgets are obtained from different sources. The most important taxes are the tax on economic activities, the income tax on natural persons, and the property tax. The tax on dogs which can be large enough is specific, and it goes to local budgets.

In England only one tax falls into the local budgets - the property tax, tariffs of which differ in different areas, depending on the requirements of financial resources. Apart from the above tax, local authorities have the right to collect other taxes as well. In Italy the basic local tax is the profit tax and its size is set by the central government. Inheritance and donation property taxes are also paid to the local budgets. Tax revenues in local budgets reach about 24 percent.

The most important local tax generating the greatest income to the budget of the local government in Spain is the property tax. Apart from it, taxes on economic activities and

on mechanical means of transport are paid too. There are obligatory local taxes. There are other local taxes, so-called freely chosen taxes. The size of taxes on the economic activities is set by the local government within the limits established by the state. The amount of taxes on mechanical means of transport and their base is set by the state, depending on the type of the means of transport and power of the engine. The tax system of France is controlled centrally. Here the clearly separated taxes are collected in the state and local budgets. The taxes on professional activities, as well as the profit and property taxes dominate in the local budgets. The tax system in Japan is original. Local taxes are higher, but budgets of the local government are formed only of their own means, except for poorer local governments that receive additional revenues. The most important local taxes include the property taxes, the taxes on income of inhabitants and the urban planning of municipality taxes.

The analysis of local taxes in foreign countries (Davulis, 2009) has shown that there is no local tax that would be preferred in all countries. Which local tax (or taxes) would be most suitable for any country also depends on the economic situation, the power system and traditions. Quite weighty arguments can be to consider the property tax as the basic local tax because it meets the requirements of a good tax, for example, its base is easily determined and rather stable. On the other hand, the profit tax can be taken into account as well. Both the profit tax and that of economic activities have good properties from the fiscal point of view. Both taxes are paid not only by the local residents, but also by the arriving people. The taxes are flexible and they can be easily administered.

#### **4. The Institution of Local Taxes in Today's Lithuania**

As it has been shown in the modern democratic countries, the institution of local taxes is developed well enough. Local taxes in foreign countries make up a significant share of income in local budgets, and are legalized by the laws. Meanwhile in the regulation in Lithuania there is no a clear concept of local taxes. On the other hand, a certain share of tax income is given to local budgets according to regulations and other legal acts in the Republic of Lithuania. Taxes aimed at local governments (except the inhabitants' income tax), in some sense, can be treated as local, but the right of self-government to influence their amounts is not great. The state tax institutions collect the inhabitants' income tax and distribute it between the state and local budgets in compliance with the rules set by laws. The local authorities do not have possibilities to influence this tax. Thus the inhabitants' income tax cannot be treated as a local tax.

The following taxes and payment are connected with local budgets by laws and other legal acts in the Republic of Lithuania:

- the inhabitants' income tax
- the tax on pollution of environment

- the taxes on state natural resources
- the tax on lottery and gambling games
- the tax on income obtained from hunted animals
- the tax on the incomes received from any activity that requires business certificates
- the real estate tax
- the inherited property tax
- the ground tax
- the taxes on sale and lease of the state ground that is not used for agriculture
- the payment for the lease of the state ground and reservoirs of the state water fund
- charges.

The local government can set the tax on the incomes received from activities that require business certificates, charges, real estate tax, the state land lease tariffs within the limits set by laws or decisions of the Government. Lithuanian municipalities have a greater influence on establishing the amount of local charges. Though according to the law on charges, municipal councils have the right to determine eleven types of local charges, the institution of local charges is poorly developed. Incomes from local charges approximately comprise only 1% of all the municipal budget revenue. In accordance with the Law of charges, the common council of a local government makes its own decision on local charges and approves the rules. By a specific decision, a local government may index the size of charge once a year, in the case the annual price index of commodities is larger than 1,1. In all other cases the local government can reduce the tariff of the tax or, in general, refuse the tax by covering the financial losses by means of the budget. On the other hand, these taxes and payment attributed to local governments make up a small share of income of the local budgets.

A local government has no rights for imposing taxes on the income of inhabitants, on pollution of the environment, and on natural resources of the state. These taxes are so-called distributive ones because incomes from these taxes are divided between the state and local government budgets in proportions set by the laws. In accordance with the law of taxes on natural resources of states a fixed share (70 percent) of income, obtained from hunted animals, and the same share of income, obtained from the tax on pollution of the environment, are attributed to local budgets. In accordance with the Law of the tax on lottery and gambling games only incomes from small lotteries are attributed to local budgets. All taxes except the payment for the lease of the state ground, which directly goes to the local budget, are collected by the state tax inspectorates. Territorial state tax inspectorates transfer all the tax revenue attributed to them to municipal budgets.

Meanwhile transfer of the shared inhabitants' income tax is more complex. In accordance with the Law on the municipal budgetary revenue estimation methodology, different amounts of distributing the income tax, collected from inhabitants, are applied in each municipality. Before transferring a certain percentage of the inhabitants' income tax to the municipal budget, county tax inspectorates transfer

a certain share of this tax to the budget of the Compulsory Health Insurance Fund and to State budget in proportions set by the Law on the approval of financial indicators of the state budget and municipal budgets of the year concerned. County tax inspectorates then transfer to the municipal budgets a certain percentage of income tax of residents, indicated in the Law on the municipal budgetary revenue estimation methodology. Municipalities of Vilnius, Kaunas, Klaipėda, and the Mažeikiai region, where the revenues, received from the income tax of residents for one person, are higher than average one, the deducted share of the income tax of residents is transferred to the State Treasury. Other municipalities receive 100 % of the tax.

After signing the Association agreement, Lithuania is committed to observe the recommendation of the Committee of Ministers of the Council of Europe on "The Equalization of Resources of Local Authorities". It is most important to establish a system of local government financing which would allow us to equalize financial capacities of local governments in order to enable them to provide services of the same level, scope, and quality. Financial recourses, transferred to the State Treasury by the municipalities – donors, i.e. the municipalities of Vilnius, Kaunas, Klaipėda, and the Mažeikiai region, are used to equalize fiscal recourses of municipalities. Municipalities, which receive lower revenues than average from the income tax of residents for one person, get a support through the inhabitants' income tax which is in the State Treasury as state subsidies. Thus, the local governments have no possibilities to influence the income tax of inhabitants because this tax can be treated as state subsidies of special kind.

## 5. Analysis of the budget structure of Lithuanian municipalities

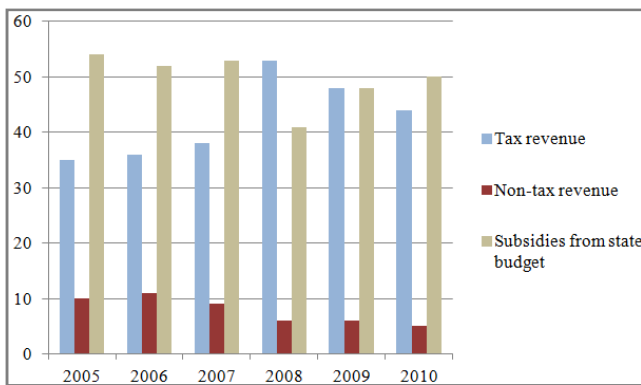
The main part of financial resources of local authorities is counted up in their budgets. Legal acts set the following kinds of budget receipts for local authorities:

- tax revenue comprised of taxes assigned to local authorities and a part of distributive taxes set by law,
- non-tax revenue received from the property of a local authority, local charges, fines, and other non-tax sources,
- subsidies and grants of the state budget.

The first two kinds of income except the distributive taxes can be relatively called as the own income of local authorities. The ratio between the own income of a local authority and state subsidies characterizes the independence degree of the local authority. Contrary to foreign countries, where the own resources completely depend on the decisions made by the local government, Lithuanian local authorities have limited possibilities to control this kind of resources. Thus, the own resources of Lithuanian local authorities do not quite correspond to their conception.

State subsidies to local budgets are indispensable so that financial resources of local governments were adequate to the functions assigned to be performed by them. Subsidies are

attracted directly and are divided into the common and purposive ones. The order of attracting subsidies is regulated by the law of the Republic of Lithuania on the methodology for municipal budget income estimation. A common subsidy of the state budget is attracted to local budgets to equalize differences between income and expenditure structures, determined by the factors not dependent on local governments. Purposive subsidies to municipal budgets are attracted in order to perform state functions prescribed to them, as well as to realize the programs approved of the Seimas (Parliament of Lithuanian Republic) and Government. Amounts of subsidies for local governments are approved by the law on state and municipality budget financial indices of the corresponding budgetary year. Obviously, state subsidies, especially the purposive ones, are related with more rigid obligations of local authorities. So, if the state subsidies increase, the financial independence of local authorities decreases.

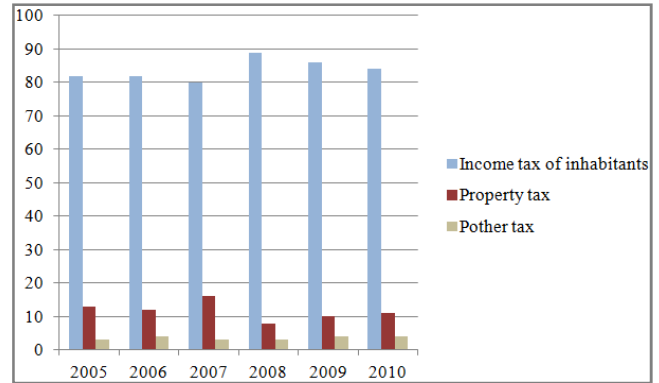


Source: <http://www.stat.gov.lt>.

Figure 1. Dynamic of revenue of Lithuanian municipal budgets (%) in 2005 – 2010

Let us analyze the tendencies in the budget structure of the Lithuanian municipalities before and during the global crisis. All the three kinds of income: tax income, non-tax income, and subsidies – in local government budgets have a different comparative weight (Fig 1). The tax income and subsidies comprise the largest share of the municipal budget income, while the non-tax income, which can be mostly influenced by local governments, comprises but an insignificant share of all local governments income each year of the considered period. This fact testifies rather a low level of fiscal decentralization in the country, too.

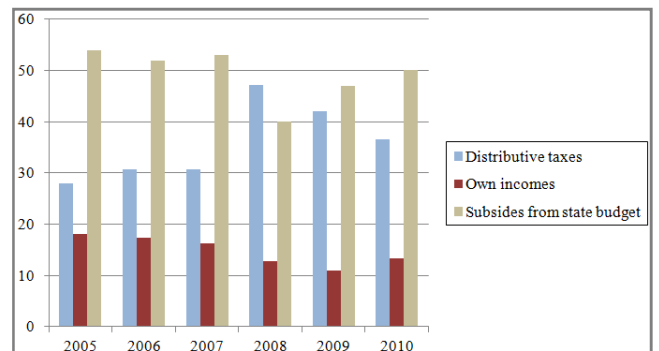
The income tax of inhabitants makes up the largest share (over 80 %) of the aggregate tax income of all local government budgets (Fig 2). The other taxes, i.e. local taxes, do not play an important role in municipal budgets, because these taxes comprise but a small share of municipal budgets. The property taxes comprise the largest share of local taxes – in 2007 about 17 percent of all tax revenue of Lithuanian municipal budgets. In 2008, with the onset of the crisis, the property tax income in municipal budgets considerably decreased, but later it increased insignificantly.



Source: <http://www.stat.gov.lt>.

Figure 2. Tax revenues in Lithuanian municipal budgets (%) in 2005 – 2010

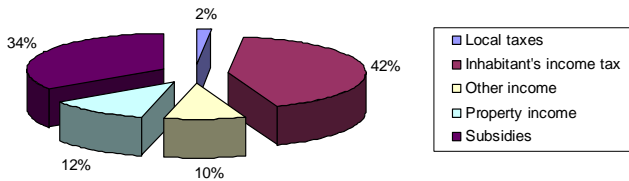
The own income (without distributive taxes) in municipal budgets characterizes the financial independence of a local government. The share of the own income in all revenues of municipal budgets can be used as an indicator of the financial independence of a local government. The analysis shows that the financial independence of local government in Lithuania is low (Fig. 3), especially in the crisis years.



Source: <http://www.stat.gov.lt>.

Figure 3. Distributive Taxes, State Subsidies and Own Income in Municipal Budgets (%) in 2005 – 2010

The budget of the Vilnius municipality is the largest one among all the rest budgets of municipalities in Lithuania, however, in terms of financial independence the situation in this municipality is analogous to other Lithuanian municipalities. Let us analyze the budget structure of the Vilnius municipality in the years before and after the crisis. The analysis shows that both subsidies of the state budget (34 %) and inhabitants' income tax (42 %) make up a considerable share of the Vilnius municipality budget revenues. Meanwhile, the non-tax revenue that can be influenced by the municipality at most as well as local taxes (i.e., taxes attributed by laws to local governments) makes up a very small share in the total budget revenues. This fact indicates that the financial independence of the Vilnius municipality is rather limited. The budget structure of Vilnius city in 2010 is represented in Fig. 4 (in percentage).

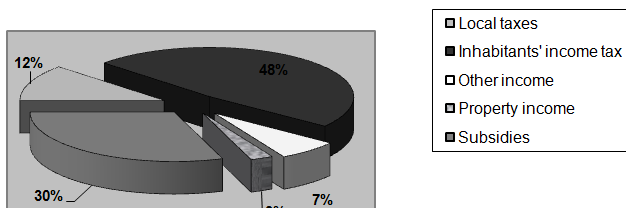


Source: <http://www.vilnius.lt/newvilniusweb/index.php/233/?itemID=1098>

**Figure 4.** Budget revenue structure of the Vilnius municipality in 2010

We see that subsidies and inhabitants' income tax that cannot be influenced by the municipality make up 76% of all income of budget. Only 24% of budget revenues can be influenced by the municipality to a larger or smaller extent. The main taxes, attributed to local governments by laws that can be treated as local, include real estate, ground and inherited property taxes as well as that state natural resources and environment pollution. The share of all property taxes (real estate, ground, inheritance) in the Vilnius budget in 2010 made up 12% of the total budget revenues. Thus, the share of all the rest local taxes in the Vilnius budget in 2010 comprised only 2% of the total budget revenue.

Comparing the structure of Vilnius municipality budget in 2010 and 2007 (Fig. 4 and Fig. 5) we can see that the budget structure in principle insignificantly differs before and after the economic crisis. Subsidies of the state budget (30 %) and inhabitants' income tax (48 %) make up a considerable share of the Vilnius municipality budget revenues in 2007, too.



Source: <http://www.vilnius.lt/newvilniusweb/index.php/52/?itemID=29>

**Figure 5.** Budget revenue structure of the Vilnius municipality in 2007

## 6. Opportunities to Develop the Institution of Local Taxes in Lithuania

As it has been shown in the modern democratic countries, the institution of local taxes is developed enough. Local taxes in the budgets of local governments of foreign countries make up a significant share of income and are legalized by the laws. Meanwhile, in the laws of Lithuania, there is no definition of the concept of local taxes. On the other hand, a certain part of tax income is assigned to local budgets by the laws of the Republic of Lithuania and other legal acts. The taxes assigned to local governments (excepting the income of inhabitants' tax) can be treated as local in some sense, but the rights of self-governing to influence their amounts are insufficient.

We think that strengthening of the institution of local taxes

needs to be started from the legalization of local taxes, passing the corresponding law. Today there are all conditions for the property tax to become the basic local tax in Lithuania (including the ground). As shown by an expert, taxation of the real estate of inhabitants used only for business had insignificant influence. Therefore, it is necessary to expand the base of taxes and to change the tariffs. To this end, it is necessary to charge all the property belonging, both to legal, and natural persons under the property right. On the other hand, it is necessary to determine the maximum ceiling of the nontaxable property in order that inhabitants, having a small or average property, could avoid the tax. With the growth of the living level, this ceiling could be reduced. The value of property, exceeding the nontaxable amount, is taxed by decision of the council of the local government. It would be expedient to introduce taxes on the property of juridical persons and luxury property of inhabitants as local taxes. Realization of these proposals would not refer to the majority of inhabitants, but it would have a positive effect on the income of budgets of local governments. On the other hand, these means would also have a positive side effect – they would help settle the market of the real estate that is obviously distorted today in Lithuania.

In the light of experience of the countries of modern democracy, it would be expedient to treat a part of the inhabitants' income tax, transferable to the budgets of local governments, as a local tax with the right of the local government to change the tariffs within the limits set by laws. Since the share of the inhabitants' income tax, transferable to the local government, makes up a significant share of income of their budgets, such local taxes would essentially expand the financial independence of the local governments.

The input of some smaller-sized taxes is possible today. The taxation of vehicles, parked in the streets and court yards, even in the largest cities of Lithuania would be useful in many cases. Such a tax would not only supplement the income of budgets, but also allow us to solve the problem of transport congestion in cities without any expensive projects as well as would reduce the air pollution and noise. Thus, the living conditions in the cities would improve in this way and affect the health of inhabitants positively.

Thus, the present conditions in Lithuania allow us to solve the problem of financial independence of self – governance in principle by consolidating and expanding the institution of local taxes corresponding to the European level. On the other hand, the degree of such independence should also depend on some specific conditions. The financial independence of a local government is only a condition for an increase in the efficiency of economy of public sector. The fulfillment of this condition also depends on how effectively the financial resources of the local government are used, which also means that qualification of local government workers and the level of corruption are important as well.

## 7. Conclusions

The analysis of budget structures in Lithuanian

municipalities has showed that subsidies and inhabitants' income tax comprise the largest share of municipal budget income. Meanwhile, the local taxes and non-tax income comprise but an insignificant share in the total municipality budgets revenues. Such a situation displays a low degree of financial independence of the Lithuanian municipalities in comparison with other democratic states of Western Europe.

The institute of local taxes in Lithuania can be developed and strengthened by legalization of local taxes by the corresponding law, legalization of the real estate tax as the main local tax by expanding its base and the rights of local governments to set their own tariffs within statutory limits, and legalization of new local taxes, for example, the taxes on the property of legal persons and on the luxury property of natural persons.

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