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# The Financial Guarantee of Local Government and Possibilities for its Protection

## 1. Introduction

Themes related to the financial guarantee of local government (LG) tend to be ‘evergreen’ both in Estonia and more broadly. One can here refer to the words spoken a full 20 years ago by P. Galina, then mayor of the Italian city of Cesena and vice-president of the National Association of Italian Municipalities: ‘The reform of local finances in our country, centring on the provision of independent resources, is another *fata morgana*: despite the new regulations, municipal bodies are still obliged to operate under conditions of uncertainty as to the financial resources actually available.’<sup>1</sup> Cuts made in the basis for LG income and lack of clarity surrounding determination and funding of LG units (LGUs) represent the situation in which on 16 March 2010 the highest judicial authority of the Estonian state—the Supreme Court acting *en banc* in Constitutional supervision procedure—made an important decision declaring unconstitutional the failure to adopt such legislation of general application as would

- 1) Stipulate what obligations imposed on LGUs by law are of a local character and which are of a national character, and
- 2) Distinguish between the funds allocated to LGUs for deciding on and organising the addressing of local issues from the funds allocated for performance of national obligations and provide for funding of the national obligations imposed on LGUs by law out of the state budget.<sup>2</sup>

These conclusions of the Supreme Court have not lost their relevance.

The author’s aim is to proceed from the Constitution of the Republic of Estonia<sup>3</sup> (CRE), European Charter of Local Self-Government<sup>4</sup> (ECLSG), valid legislation, case law of the Supreme Court, and relevant legal literature<sup>5</sup> to give answers to the following main questions:

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<sup>1</sup> Conference on the European Charter of Local Self-Government (Barcelona, 23.–25.1.1992). ‘What have you done with the European Charter of Local Self-Government?’ Legislation and Jurisprudence. Standing Conference of Local and Regional Authorities of Europe. Studies and Texts, No. 27. Council of Europe Press 1993, p. 86.

<sup>2</sup> Supreme Court *en banc* decision of 16.3.2010, 3-4-1-8-09. – RT III 2010, 13, 97 (in Estonian). English text available at <http://www.nc.ee/?id=1122> (most recently accessed on 20.3.2012).

<sup>3</sup> Eesti Vabariigi põhiseadus. – RT 1992, 26, 349; RT I, 27.4.2011, 1 (in Estonian).

<sup>4</sup> Euroopa kohaliku omavalitsuse harta. – RT II 1994, 26, 95.

<sup>5</sup> There is a scarcity of relevant legal writings on this particular subject in the Estonian language. The following ones can be mentioned: Eesti Vabariigi põhiseadus. Kommenteeritud väljaanne. Teine, täiendatud väljaanne (Constitution of the Republic of Estonia. Commented Edition. Second, Revised Edition). Tallinn: Juura 2008; T. Kolk. Millist kohaliku omavalitsuse rahastamise süsteemi nõuab põhiseadus? (Which Funding System is Required by the Constitution?). – Riigikogu Toimetised

- 1) What purpose does financial guarantee of LG serve as a whole? (The role of a financial guarantee within the whole structure of the Constitutional guarantee of LG.)
- 2) Which levels (elements) are included in the financial guarantee, and what is their purpose within the structure of this guarantee?
- 3) How can the financial guarantee be protected?

In the interests of better coverage of the income basis for Estonian LGs, the following breakdown is presented:

#### Sources of municipal revenue, 2003–2009<sup>\*6</sup>

|   | 2003        | 2004        | 2005        | 2006        | 2007        | 2008        | 2009        |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Taxes <sup>*7</sup>                       | 46.48%      | 47.57%      | 47.66%      | 46.85%      | 52.49%      | 54.62%      | 53.55%      |
| Grants                                    | 39.77%      | 35.56%      | 35.16%      | 33.23%      | 33.21%      | 32.32%      | 32.31%      |
| Sales of goods and services               | 8.39%       | 10.94%      | 10.43%      | 9.03%       | 8.87%       | 9.66%       | 10.77%      |
| Sales of tangible and intangible property | 3.22%       | 4.04%       | 4.80%       | 8.56%       | 2.86%       | 0.94%       | 0.89%       |
| Revenue from property                     | 1.44%       | 1.53%       | 1.23%       | 1.65%       | 2.03%       | 2.02%       | 1.98%       |
| Other income                              | 0.71%       | 0.37%       | 0.71%       | 0.68%       | 0.54%       | 0.44%       | 0.50%       |
| <b>Total</b>                              | <b>100%</b> |

## 2. The concept and structure of the guarantee of local government

Under the guarantee of LG, a complex of rights at the level of Constitutional law can be understood to be provided to each LGU, with a view to its formal and substantial existence within a system of public administration. The guarantee functions as a structural principle of state organisation as well.<sup>\*8</sup> Municipal self-management (right to exercise discretion upon taking decisions and making choices when resolving and managing local issues) as a basic guarantee of LG is provided in §154 (1) of the CRE, according to which all local issues shall be resolved and managed by LGs, which shall operate independently pursuant to law.

2011 (23), pp. 71–80; Ü. Madise. Kohaliku omavalitsuse garantii Eesti Vabariigi 1992. a põhiseaduses (The Guarantee of Local Self-government in the Estonian Constitution of 1992). Master's thesis. Tartu 2001.

<sup>6</sup> OECD Public Governance Review, Estonia: Towards a Single Government Approach. 2010, p. 52. Available at [http://www.valitsus.ee/UserFiles/valitsus/et/riigikantslei/uldinfo/dokumendiregister/Uuringud/OECD\\_Public%20Governance%20Review\\_Estonia\\_full%20report.pdf](http://www.valitsus.ee/UserFiles/valitsus/et/riigikantslei/uldinfo/dokumendiregister/Uuringud/OECD_Public%20Governance%20Review_Estonia_full%20report.pdf) (most recently accessed on 20.3.2012).

<sup>7</sup> Local budgets receive money from state taxes as follows: 1) without taking into account the deductions provided for in Chapter 4 of the Income Tax Act (tulumaksuseadus. – RT I 1999, 101, 903; RT I, 28.12.2011, 1 (in Estonian)), 11.4% of the taxable income of a resident natural person (§5 (1) 1)) and 2) 100% of land tax (Land Tax Act (maamaksu seadus), §6. – RT I 1993, 24, 428; 2010, 22, 108 (in Estonian)). Local taxes, which generally are of marginal importance in LG budget incomes, are the following: advertisement tax, road- and street-closure tax, motor vehicle tax, animal tax, entertainment tax, and parking charges (Local Taxes Act (kohalike maksude seadus), §5 5)–10). – RT I 1994, 98, 1169; RT I, 29.12.2011, 1 (in Estonian)).

<sup>8</sup> See Eesti Vabariigi põhiseadus. Kommenteeritud väljaanne (Note 5), Chapter 14, introduction, p. 722; Madise (Note 5), p. 12; Supreme Court Constitutional Review Chamber decision of 29.9.2009, 3-4-1-10-09, paragraph 19. – RT III 2009, 41, 305 (in Estonian). English text available at <http://www.nc.ee/?id=1067> (1.3.2012) (in Estonian); Supreme Court *en banc* decision 3-4-1-8-09 (Note 2), paragraph 51. There exists also an approach in the legal literature according to which a particular complex of provisions can be qualified as a guarantee of LG. See E. Schmidt-Aßmann, H.-Chr. Röhl. Kommunalrecht. – R. Breuer *et al.* Besonderes Verwaltungsrecht. E. Schmidt-Aßmann, F. Schoch (Hrsg.). 14., neu bearbeitete Auflage. Berlin: De Gruyter Recht 2008, pp. 22–23. The author of this article has followed the terminology of the Supreme Court's case law.

Constitutional guarantee cannot be defined as a fundamental right of the LGU.<sup>\*9</sup> It applies neither to relations between LG and private persons (wherein LG should, according to §14 of the CRE, observe common rules) to be applied by public administration nor to lower-level units of the LGU (rural or city districts). A LGU cannot refuse to fulfil the obligations conferred upon it by law, basing its refusal on its Constitutional guarantee.<sup>\*10</sup>

The guarantee of LG involves the following levels:

- 1) Guarantee of institutional legal personality
- 2) Guarantee of institution of objective law
- 3) Financial guarantee
- 4) Guarantee of independence from a local budget
- 5) Guarantee of subjective legal status.<sup>\*11</sup>

### 3. The nature of the financial guarantee

Financial guarantee is established in §§ 154 and 157 (2) of the CRE as well as in Article 9 of the ECLSG.<sup>\*12</sup> From these provisions of Constitutional law, certain rights arise for the LGU in relation to its economic capability to perform public tasks (related to local issues (see §154 (1) of CRE) and national obligations (see §154 (2) of CRE)). Financial guarantee serves as the basis for arrangement of funding of LGUs, consisting, on the one hand, of the system for funding LG functions and, on the other, of provisions regulating the funding of national duties imposed on LGs by law.<sup>\*13</sup> It proceeds from §154 of the CRE that the establishment of a system of funding for LGs to guarantee them sufficient financial resources is a responsibility of the state.<sup>\*14</sup>

The financial resources of LGUs must be commensurate with the responsibilities provided for by the Constitution and the law.<sup>\*15</sup> An LGU must be able to resolve and manage all local issues independently under the law and should not have to use the finances meant for the handling of local issues for the performance of duties of the state imposed on it by law.<sup>\*16</sup> Thus, financial guarantee goes beyond the right of self-management of an LGU. At the same time, the rights related to the financial guarantee are, when compared to the right of self-management, of a secondary nature and oriented to the creation of necessary conditions for its exercise.<sup>\*17</sup>

It is up to the legislator to decide whether the receipt of funds shall be guaranteed by imposition of local taxes, by payment of state taxes directly into local budgets, or by allocations from the state budget.<sup>\*18</sup> Funding of national obligations must, pursuant to §154 (2) of the CRE, proceed from the state budget. Hence, the possibilities of the state in forming a system of funding to provide a sufficient income base for LGUs are more diverse in cases of local issues than in relation to national obligations to be imposed upon LGUs by law.

<sup>9</sup> Supreme Court Constitutional Review Chamber decision of 19.3.2009, 3-4-1-17-08, paragraph 25. – RT III 2009, 14, 100 (in Estonian). English text available at <http://www.nc.ee/?id=1010> (most recently accessed on 1.3.2012); Supreme Court Constitutional Review Chamber decision of 19.1.2010, 3-4-1-13-09, paragraph 18. – RT III 2010, 5, 33 (in Estonian).

<sup>10</sup> Supreme Court Constitutional Review Chamber decision of 9.3.2005, 3-11-139-04, paragraph 15. – RT III 2005, 10, 94 (in Estonian).

<sup>11</sup> See also Supreme Court Constitutional Review Chamber decision of 21.2.2003, 3-4-1-2-03, paragraph 12; Supreme Court *en banc* decision of 19.4.2004, 3-3-1-46-03, paragraph 20. – RT III 2004, 11, 128 (in Estonian). English text available at <http://www.nc.ee/?id=403> (most recently accessed on 1.3.2012); Supreme Court *en banc* decision 3-4-1-8-09.

<sup>12</sup> Two main directions can be differentiated within the framework of Article 9. One of them is of a quantitative nature and has to do with the extent of the finances to be managed by LGUs. In the other one there appears a qualitative dimension, which results from independence of LG and is aimed at its financial power. – B. Schaffarzik. Handbuch der Europäischen Charta der kommunalen Selbstverwaltung. Stuttgart, Munich, Hannover, Berlin, Weimar, Dresden: Boorberg 2002, p. 505.

<sup>13</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 61.

<sup>14</sup> Supreme Court *en banc* decision 3-3-1-46-03, paragraph 21.

<sup>15</sup> Article 9 (2) of ECLSG.

<sup>16</sup> Supreme Court Constitutional Review Chamber decision of 9.6.2009, 3-4-1-2-09, paragraph 43. – RT III, 18.6.2009, 31, 227 (in Estonian). English text available at <http://www.nc.ee/?id=1038> (most recently accessed on 1.3.2012).

<sup>17</sup> *Ibid.*

<sup>18</sup> Supreme Court *en banc* decision 3-3-1-46-03, paragraphs 24, 28.

Article 9 (4) of the ECLSG requires diversity and buoyancy of the system of funding of LGs. Diversity means proceeds of various nature, buoyancy—*inter alia*—that, upon allocation of funds to LGs, it should be possible to take into account all revenue received by an LG, including extraordinary revenue.<sup>\*19</sup>

Article 9 (5) establishes that the protection of financially weaker LGs calls for the institution of financial equalisation procedures or equivalent measures that are designed to correct the effects of the unequal distribution of potential sources of financing and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility. This article does not prescribe criteria a state must take into consideration when equalising financial resources. It is important that the measures a state takes should equalise the differences upon unequal distribution of potential sources of financing and expenditure.<sup>\*20</sup> Local authorities must be consulted on the way in which redistributed resources are to be allocated to them (i.e., they have a right to a hearing).<sup>\*21</sup> As far as possible, grants to LGs should not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of LGs to exercise policy discretion within their own jurisdiction.<sup>\*22</sup> The requirement of clarity as to which particular national duties will be financed from the state budget is not in contradiction with Article 9 (7) of the ECLSG.<sup>\*23</sup>

Financial guarantee is not unlimited any more than is the right of self-management. With respect to delimitation, it is the legislator who must decide on all major restrictive measures.<sup>\*24</sup> Less intensive restrictions may also be imposed by the executive through regulation based on an accurate and clear provision delegating authority whose intensity is in line with the restriction.<sup>\*25</sup> It is not in accordance with the principle of the rule of law to balance possible prejudices of the financial guarantee of LG with ostensible measures (e.g., illusory possibilities for savings).<sup>\*26</sup>

## 4. The structure of financial guarantee

The financial guarantee of LGUs includes

- 1) The right to sufficient funds for performance of LG functions,
- 2) The right to the stability of the system of funding for LG functions,
- 3) The right to full funding from the state budget of national duties imposed by law,
- 4) The right to levy local taxes and to receive revenue from charges, and
- 5) The right to assume debt obligations.<sup>\*27</sup>

<sup>19</sup> Providing buoyancy of the system is also the aim of §25 of the Local Government Financial Management Act (kohaliku omavalitsuse üksuse finantsjuhtimise seadus. – RT I 2010, 72, 543; RT I, 23.12.2011, 1 (in Estonian)), which, though not itself offering a provision at the level of financial guarantee, establishes that if decreases in budget income and increases in budget expenses of an LG occur during the current budgetary year on the basis of legislation enacted by the Riigikogu or the Government of the Republic after the beginning of the budgetary year of the LG, the state shall compensate for such impacts of legislation to the same extent or proportionally decrease the obligations imposed on the LG.

<sup>20</sup> Supreme Court *en banc* decision 3-3-1-46-03, paragraph 30. Financial equalisation cannot, however, lead to overcompensation of differences in financial capability. A result of this kind would practically abolish responsibility of the LGU for results of its policy.

<sup>21</sup> Article 9 (6) of the ECLSG.

<sup>22</sup> Article 9 (7) of the ECLSG. See in this respect, for example, the 1998 report entitled 'Limitations of local taxation, financial equalisation and methods for calculating general grants', by the Steering Committee on Local and Regional Democracy (CDLR), prepared with the collaboration of Jørgen Lotz (Local and Regional Authorities in Europe, No. 65) from Council of Europe Publishing.

<sup>23</sup> Kolk (see Note 5), p. 77.

<sup>24</sup> Supreme Court Constitutional Review Chamber decision of 4.11.1993, III-4/1-4/93. – RT I 1993, 72/73, 1052 (in Estonian). English text available at <http://www.nc.ee/?id=487> (most recently accessed on 1.3.2012).

<sup>25</sup> Supreme Court *en banc* decision of 3.12.2007, 3-3-1-41-06, paragraph 22. – RT III 2007, 44, 350 (in Estonian). Available at <http://www.nc.ee/?id=883> (1.3.2012); Supreme Court *en banc* decision 3-4-1-8-09, paragraph 160.

<sup>26</sup> Supreme Court *en banc* decision of 3-4-1-8-09, paragraph 112.

<sup>27</sup> Supreme Court Constitutional Review Chamber decision of 9.6.2009, 3-4-1-2-09, paragraph 61.

#### 4.1. The right to sufficient funds for performance of local government functions

The right to sufficient funding for local government functions follows from §154 (1) of the CRE and subsections 1 and 2 of Article 9 of the ECLSG.

Subsection 154 (1) requires of the system of funding of LG functions that

- It be clearly distinguishable which funds are earmarked for performance of LG functions and what funds are meant for performance of national functions imposed on the LG by law<sup>\*28</sup>;
- As a whole, it not be disproportionately dependent on one-off allocations by the state, and it adequately mirror the overall economic situation; and
- It takes into account differences in the social, demographic, geographic, and economic situations of LGs.<sup>\*29</sup>

Although the legislator has extensive discretion in formation of the state's economic and tax policies<sup>\*30</sup>, funding of LG functions (both compulsory ones and voluntary functions to be reasonably expected from LG) must be provided at least at the minimum level necessary for performance of these functions.<sup>\*31</sup> In choosing between compulsory and voluntary functions of LG, only the latter need not be performed. Although voluntary LG functions can differ from one LGU to the next, it is incorrect to maintain that the state has no obligation whatsoever to fund this group of functions to a certain extent.

The minimum level of local functions that need to be performed and whose funding must be ensured arises, above all, from §154 (1), §28 (4), §37 (2), etc. of the CRE and from the local functions imposed on the LG by legislative acts. The need for financing of local functions arising from law is directly affected by various requirements established in relation to the performance of these functions in acts and in lower-ranking legislation.

It follows from §14 of the CRE that lack of funds must not bring the level of the local public services provided by the LGU substantially below the general level of similar services in other LGUs in Estonia.<sup>\*32</sup> Among other things, this presupposes (more) effective regional policy of the state and systematic reform of existing LG organisation.<sup>\*33</sup>

Article 9 (1) of the ECLSG places a LG's right to sufficient funds within the framework of the state's economic policy. If necessary, the state may also reduce the funding of LG functions, to the minimum extent necessary.

For establishment of an infringement, it is not sufficient that the contested provision be only capable of rendering performance of the LG functions more difficult: it actually must have this effect<sup>\*34</sup> (e.g., the state decreases the income of LGUs or increases the volume of mandatory local functions without allocating additional financial resources).

Violation of said right can arise only from such provisions (or failures to adopt them) as regulate (or that, because of failure to adopt, do not sufficiently regulate) the system of funding LG functions. These include provisions—or their absence—as a result of which the funding of local functions proves insufficient in the specific LGU in question. However, it is not a provision making performance of some local function compulsory for the LGU that may violate the right to sufficient funds for performance of LG functions but

<sup>28</sup> Supreme Court *en banc* decision of 3-4-1-8-09, paragraph 72.

<sup>29</sup> *Ibid.*, paragraph 66.

<sup>30</sup> For example, when collecting tax arrears, the state should not, in any case, prefer the taxes accrued for LGs over the taxes retained by the state. See Supreme Court Constitutional Review Chamber decision of 26.6.2009, 3-4-1-4-09, paragraph 26. – RT III 2009, 37, 280 (in Estonian). English text available at <http://www.nc.ee/?id=1040> (most recently accessed on 1.3.2012).

<sup>31</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 66.

<sup>32</sup> *Ibid.*, paragraph 67.

<sup>33</sup> See, e.g., 'Assumptions for provision of public services in small and remote local authorities'. Available at <http://riigi-kontroll.ee/Suhtedavalikkusega/Pressiteated/tabid/168/ItemId/626/amid/557/language/en-US/Default.aspx> (most recently accessed on 1.3.2012); Kohaliku omavalitsuse üksuste võimekuse indeks 2010. Metoodika ja tulemused (Index of Capability of Local Government Units 2010. Methodology and Results). Tartu: Geomedia 2011. Available at [http://www.siseministeerium.ee/public/KOV\\_voimekuse\\_indeks\\_Geomedia.pdf](http://www.siseministeerium.ee/public/KOV_voimekuse_indeks_Geomedia.pdf) (most recently accessed on 1.3.2012) (in Estonian). Also see Note 6.

<sup>34</sup> Supreme Court Constitutional Review Chamber decision of 9.6.2009, 3-4-1-2-09, paragraphs 48, 50.

the legislation regulating the funding of local functions, to the extent that it does not provide the LGU with funds for performance of local functions at least to the minimum extent required.

It is possible that the state, finding that the funding of local functions cannot be increased for the purpose of eliminating the violation, may reduce the requirements arising from law in relation to performance of local functions.<sup>\*35</sup> This is not, however, a common solution.

To comply with the requirements of §154 (1) of the CRE, a system of funding of LG functions must allow evaluation of the level of sufficiency on a case-by-case basis. Otherwise, it becomes impossible to identify whether the LG's right to sufficient funding has been violated or not<sup>\*36</sup> and consequently for the LGU to seek efficient judicial protection against the insufficiency of funding for local functions.<sup>\*37</sup> Therefore, there must be clarity as to whether a particular public task is of a local background or not.<sup>\*38</sup>

## 4.2. The right to the stability of the system for funding of local government functions

A right to the stability of the system for funding LG functions follows from the principle of legitimate expectation in combination with §154 (1) of the CRE and specifies it in relationships between LGUs and the state in matters concerning funding.<sup>\*39</sup>

A stable and foreseeable system of funding allows LGUs to draft more accurate development plans and implement them more effectively.<sup>\*40</sup> A stable funding system, while an auxiliary element of financial guarantee, is unavoidable for independent decision-making on and management of any and all local issues.<sup>\*41</sup>

LGUs need to be able to act in reasonable expectation that the regulation established for funding their functions remain stable and not suddenly be made less favourable for them, especially in the middle of the budgetary year.<sup>\*42</sup> Any legal act decreasing funding restricts the right to the stability of the funding system even if it does not result in insufficiency of funding for LG functions.

Adverse amendment of legislation regulating LG functions is not precluded.<sup>\*43</sup> The right to stability of the funding system may, similarly to other rights arising from §154 (1) of the CRE, be limited on the same terms and conditions as is the right to self-management.<sup>\*44</sup>

In the event of major changes to the funding system, LGUs must be granted the right to be heard.<sup>\*45</sup>

The right to stability of the system of funding for LG functions means also that a reasonable period for adaptation (*vacatio legis*) must be granted to LGUs.<sup>\*46</sup> It need hardly be said that the evaluation of adequacy has to be carried out case-specifically.

<sup>35</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 69.

<sup>36</sup> *Ibid.*, paragraph 70.

<sup>37</sup> *Ibid.*, paragraph 71.

<sup>38</sup> On problems of qualification of public tasks, see V. Olle. Kohaliku omavalitsuse poolt täidetavate avalike ülesannete struktuur ja liigitamiskriteeriumid (Structure and Classification Criteria of Local Government Functions). – *Juridica* 2002/8, pp. 523–531 (in Estonian); K. Merusk, V. Olle. On assignment of local government tasks to the private sector in Estonia. – *Juridica International* 2009 (XVI), pp. 34–35; Kohustuslike kohaliku omavalitsuse ülesannete ja kohaliku omavalitsuse üksuste täidetavate riiklike ülesannete piiritlemise juhend (Instruction on Delimitation of Compulsory Local Government Functions and National Obligations Performed by Local Authorities). Available at [http://webcache.googleusercontent.com/search?q=cache:ynOcJOiGFMUJ:www.siseministeerium.ee/public/SiM\\_juhend.rtf+Kohustuslike+omavalitsuse+%C3%BClesannete+piiritlemise+juhend&cd=1&hl=et&ct=clnk&gl=ee](http://webcache.googleusercontent.com/search?q=cache:ynOcJOiGFMUJ:www.siseministeerium.ee/public/SiM_juhend.rtf+Kohustuslike+omavalitsuse+%C3%BClesannete+piiritlemise+juhend&cd=1&hl=et&ct=clnk&gl=ee) (most recently accessed on 1.3.2012) (in Estonian).

<sup>39</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 78.

<sup>40</sup> Supreme Court *en banc* decision 3-3-1-46-03, paragraph 25.

<sup>41</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraphs 79, 110.

<sup>42</sup> *Ibid.*, paragraph 79.

<sup>43</sup> *Ibid.*, paragraph 81.

<sup>44</sup> *Ibid.*, paragraph 82.

<sup>45</sup> Article 9 (6) of the ECLSG.

<sup>46</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 83.

### 4.3. The right to full state-budget funding for national duties imposed by law

From the second sentence of §154 (2) of the CRE arises the right for the LGU to full funding from the state budget of national duties imposed by law or administrative contract.<sup>\*47</sup>

This particular right protects the LGU against having to use funds earmarked for performance of LG duties for performance of national duties.<sup>\*48</sup> It should be noted that the purpose of this right is not to empower LGUs to interfere substantively in the resolution of some state affair.<sup>\*49</sup>

National duties imposed by law upon LGUs must be funded in a manner that allows for evaluation of whether the state actually covers from the state budget all the expenses incurred in the national duties imposed by law. Also, an LGU must have the opportunity to protect itself in court in the event of insufficient funding for national duties imposed by law.<sup>\*50</sup> Once again, there appears a necessity for clear delimitation of national duties and local functions as well as of funds to be provided for performance of these two groups of public tasks.

The second sentence of §154 (2) of the CRE establishes specific requirements associated with allocation of money to LGUs for performance of national duties.

Expenditure related to national duties imposed by law on LGUs must be funded from the state budget.<sup>\*51</sup>

Under the principle of universality (set forth in §115 (1) of the CRE), the state budget must include any and all revenue and expenditure of the state and, consequently, also recognise the expenses of the state that, according to the second sentence of §154 (2) of the CRE, arise upon covering of the expenses related to the national duties imposed on LGUs. The principle of transparency arising from the same Constitutional enactment requires at least that the costs of performance of national duties imposed on LGUs be recognised as function-based state budget entries. This means that the state budget must clearly specify how much money is allocated for performance of one or another national duty imposed on LGUs. How the money to be allocated for performance of some national duty is divided among LGUs does not have to be indicated directly in the state budget. That may be specified in legislation on the basis of the state budget.<sup>\*52</sup>

The second sentence of §154 (2) of the CRE forbids the LGU using the funds allocated to it for some national duty without any legal basis for performance of other national duties or LG functions. However, in legal acts regulating the allocation of funds to LGs, terms and conditions may be provided whereby the LGU may use the funds obtained for performance of a national function for financing other national duties or LG functions.<sup>\*53</sup>

The second sentence of §154 (2) of the CRE also requires that the funding of the duties of the state imposed on an LG be cost-oriented. The income-oriented funding of some national duties need not be excluded, but, as a whole, income-oriented funding of duties of the state is not in conformity with §154 of the CRE.

Cost-oriented funding has, in principle, two levels. It must be

- 1) Clearly and transparently stated in the annual budget how much money is required for the fulfilment of any given national duty, and
- 2) Determined how much money each LGU would need for the fulfilment of these duties.<sup>\*54</sup>

<sup>47</sup> Supreme Court Constitutional Review Chamber decision of 8.6.2010, 3-4-1-1-10, paragraph 75. – RT I 2010, 32, 166 (in Estonian). English text available at <http://www.riigikohus.ee?id=11&tekst=22252846> (most recently accessed on 1.3.2012).

<sup>48</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 74.

<sup>49</sup> *Ibid.*, paragraph 132.

<sup>50</sup> *Ibid.*, paragraph 74.

<sup>51</sup> Also a model of funding under which an LGU first bears the expenses and then ‘presents the bill’ to the state agency for compensation is in conformity with the Constitution. See Kolk (Note 5), pp. 76–77.

<sup>52</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 76.

<sup>53</sup> *Ibid.*, paragraph 77.

<sup>54</sup> See, for example, the report ‘Methods for estimating local authorities’ spending needs and methods for estimating revenue’, by the Steering Committee on Local and Regional Democracy, prepared with the collaboration of Professor Jens Blom-Handsen and adopted by the CDLR at its 26th meeting, on 4.–6.12.2000. Local and Regional Authorities in Europe, No. 74. Council of Europe Publishing 2001.

Cost-oriented entries are necessary for fulfilment of the requirements of §§ 115 and 154 of the CRE. For compliance with clauses 1 and 6 of §65 of the CRE, the possibility must exist for Parliament to check the funding of national duties imposed on LGUs by its actions.<sup>\*55</sup>

#### 4.4. The right to levy local taxes and to receive revenue from charges

From the above-mentioned §157 (2) arises the right of an LGU to levy and collect taxes on the basis of law. Article 9 (3) of the ECLSG establishes that at least some of the financial resources of LGs shall be derived from local taxes and charges whose rate they have the power, within the limits set forth by statute, to determine. Charges may be determined for the use of various public services provided by an LGU. The exercise of political choice in weighing the benefit of the services provided against the cost to the local taxpayer or the user is a fundamental duty of local elected representatives. It is accepted that central or regional statutes may set overall limits to LGs' powers of taxation; however, they must not prevent the effective functioning of the process of local accountability.<sup>\*56</sup> The right of an LGU to levy and collect taxes is placed under legal reservation in the CRE. The same requirement applies to other financial obligations under public law. Therefore, an LG council shall not levy any local tax or other financial obligation under public law without legal basis.<sup>\*57</sup> With respect to local taxes, such a legal basis is established in the Local Taxes Act; however, the respective catalogue of taxes is permanently decreased therein.<sup>\*58</sup>

The legislator cannot delegate its competence in regulating any main elements of local taxes (the establishment of the nature of local taxes, etc.) to the executive power.<sup>\*59</sup>

#### 4.5. The right to assume debt obligations

Subsection 154 (2) of the CRE includes also a right to decide independently on assumption of debt obligations. Pursuant to Article 9 (8) of the ECLSG, LGUs shall, for the purpose of borrowing for capital investment, have access to the national capital market within the limits of the law.

Assumption of debt obligations (loan, financial lease, issue of bonds, etc.) allows LGUs to make investments necessary for performance of their functions, against future revenue. At the same time, it influences the development of the budget deficit of LGUs.

The state is obliged to refrain from establishment of legislation that prevents LGUs from obtaining funds from the capital market. This means that the state does not have to act as LGs' creditor or guarantee their obligations.<sup>\*60</sup>

The right to assume debt obligations may be limited on the same conditions as the right of self-management arising from §154 (1) of the CRE.<sup>\*61</sup> The Supreme Court has declared the Constitutionality of terminal limitation of the right of LGUs to assume debt obligation (1.3.2009–31.12.2011), established by the legislator for fulfilment of the obligations arising from the founding treaties of the EU, which essentially forbade LGUs from assuming any debt obligation, though certain clearly delimited exceptions in line with the aim of the obligations were provided.<sup>\*62</sup>

<sup>55</sup> Dissenting opinion to Supreme Court *en banc* decision 3-3-1-46-03 of Justice Jüri Põld, joined by Justices Tõnu Anton, Indrek Koolmeister, Jaak Luik, and Harri Salmann.

<sup>56</sup> Explanatory report on the European Charter of Local Self-government, Article 9 (3). Available at <http://conventions.coe.int/treaty/en/Reports/Html/122.htm> (1.3.2012).

<sup>57</sup> Supreme Court Constitutional Review Chamber decision 3-4-1-11-98, Section V. Available at <http://www.nc.ee/?id=455>.

<sup>58</sup> On 1.1.2012, the sale tax and boat tax were abolished by respective amendment to the Local Taxes Act.

<sup>59</sup> Supreme Court Constitutional Review Chamber decision III-4/1-4/93.

<sup>60</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 63.

<sup>61</sup> *Ibid.*, paragraph 64.

<sup>62</sup> *Ibid.*, paragraphs 135–151; Supreme Court Constitutional Review Chamber decision of 1.4.2010, 3-4-1-7-09. – RT III 2010, 15, 103 (in Estonian).

## 5. Options for protection of the financial guarantee of local government

Under §15 (1) of the CRE, everyone whose rights and freedoms are violated has the right of recourse to the courts. Everyone has the right, while his or her case is before the court, to petition for any relevant law, other legislation, or procedure to be declared unconstitutional. According to Article 11 of the ECLSG, local authorities have the right of recourse to a judicial remedy in order to secure free exercise of their powers and respect for such principles of LG as are enshrined in the Constitution or domestic legislation. It proceeds from this (i.e., the guarantee of subjective legal status) that an LGU must have a right to apply to an independent court or tribunal for protection against unsubstantiated limitations of elements of its Constitutional guarantee. It must have an opportunity to contest legislation of general application, individual acts, and administrative measures.

An LGU may, depending on the nature of the legal dispute, bring a case against the state or one or more other LGUs before an administrative court or, on the basis of §7 of the Constitutional Review Court Procedure Act<sup>\*63</sup> (CRCPA), directly to the Supreme Court.

Since 1 July 2002, §7 of the CRCPA has allowed an LG council to submit a request to the Supreme Court pertaining to an act that has been proclaimed but has not yet entered into force or a regulation of the Government of the Republic or a minister that has not yet entered into legal effect, in which it asks for declaration of said act or regulation to be in conflict with the Constitution or for repeal of an act that has entered into force, a regulation of the Government of the Republic or a minister, or a provision thereof if it is in conflict with Constitutional guarantees of the LG. Thus an LG council can contest in a Constitutional supervision procedure such items as a formula for calculation of support allocated from the support fund of the state budget to the budget of an LGU.<sup>\*64</sup>

With respect to an LG council and application of Constitutional review proceedings for contesting of failure to pass legislation of general application, the CRCPA does not provide the LG council, within the scope of abstract norm control, with such a competence for the realisation of its Constitutional guarantees.<sup>\*65</sup>

It should be noted that, when the request submitted by the LG council on the basis of §7 of the CRCPA is granted by the Supreme Court, that judgement will not in itself provide the LGU with the money necessary for performance of any particular public tasks. However, by resting upon this judgement, the LGU can, if necessary, in an administrative court procedure claim from the state the funds needed for a particular task. Since the LGU has no right to neglect any duty arising from law, grounding this refusal in its Constitutional guarantee means that a violation of a financial guarantee grows sooner or later into causing of damage to the LGU (a national duty left without proper funding from a state budget should be financed from the LGU's own resources; in cases of insufficiency of funding of LG functions, loans should be taken out and, consequently, interest paid etc.). In the case of damage caused to an LGU by violation of its financial guarantee, direct patrimonial damage, not a loss of profit, is conceivable.<sup>\*66</sup>

When, through a failure to pass legislation of general application, sufficient funds for performance of LG functions are not provided or sufficient funds are not allocated from the state budget for performance of national duties, and also in cases when such a failure has caused damage to an LGU in some other way, the LGU can submit a claim for compensation for damage arising from §14 (1) of the State Liability Act (SLA) to a first-instance administrative court and demand that the absence of such regulation be declared to be in conflict with the Constitution. Subsection 1 of §9 and §15 (1) 2<sup>1</sup>) of the CRCPA are interrelated with §14 (1) of the SLA, and, consequently, were intended for application only in relation to claims for compensation for

<sup>63</sup> Põhiseaduslikkuse järelevalve kohtumenetluse seadus. – RT I 2002, 29, 174; 2010, 19, 101 (in Estonian).

<sup>64</sup> Supreme Court *en banc* decision 3-3-1-46-03.

<sup>65</sup> Supreme Court *en banc* decision of 21.5.2008, 3-4-1-3-07, paragraph 30. – RT III 2008, 34, 228 (in Estonian). English text available at <http://www.nc.ee/?id=920> (most recently accessed on 1.3.2012).

<sup>66</sup> An exemplary list of direct patrimonial damages is provided in §128 (3) of the Law of Obligations Act (*võlaõigusseadus*. – RT I 2001, 81, 487; RT I, 8.7.2011, 6 (in Estonian)). It should be decided on a case-by-case basis whether in cases of compensation for damage, provisions of the Law of Obligations Act may be applied or, on account of the particular feature of legal relationships under public law, damages should be compensated for to an extent different from this (§7 (4) of the State Liability Act (*riigivastutuse seadus*. – RT I 2001, 47, 260; RT I, 13.9.2011, 9 (in Estonian))).

damage caused by failure to pass legislation of general application.<sup>\*67</sup> In cases wherein the legislator's failure to act is declared to be in contradiction with the Constitution, the Supreme Court can set a reasonable term for Parliament's correction of the situation.<sup>\*68</sup> It probably would have been reasonable to include such a term also in Supreme Court judgement 3-4-1-8-09.

The principle that an LGU alleging violation of its right to sufficient resources must also show which of the functions it might fail to perform on account of lack of finances is relevant both in Constitutional supervision and in administrative court procedures.<sup>\*69</sup> In consideration of the complexity of the LGU proving unconstitutionality of the valid system of funding, the burden of proof on the LGU may be eased and partially or fully transferred to the state.<sup>\*70</sup> It is quite probable that the future will see such a transfer take place in most cases of this kind.

When the violation of financial guarantee stems from an omission by an administrative authority (e.g., failure of the Tax and Customs Board to transfer income tax paid by resident natural persons or land tax to the local authority), an LGU may submit a claim under which the state is to take a measure of allocating money.<sup>\*71</sup> A claim for annulment of an administrative act of the state<sup>\*72</sup> (e.g., an administrative act entailing refusal to allocate funds) together with a claim in compliance with which the state is required to take a respective measure, is conceivable also, as is a request for non-application of the act or other legislation of general application on which the relevant administrative act is based and that is in conflict with the Constitution (§152 (1) of the CRE; §158 (4) of the Administrative Court Procedure Act). If the court of first instance or the court of appeal has declared in the resolution of the judgement that a piece of legislation of general application or refusal to issue an instrument of legislation of general application is in conflict with the Constitution, it will forward the judgement or ruling to the Supreme Court, thereby initiating the Constitutional review court procedure (§9 (1) of the CRCPA).

Section 171 of the new Administrative Court Procedure Act<sup>\*73</sup> (ACPA) allows interim judgements and partial judgements, which can also be used in the interests of procedural economy in complicated fiscal disputes between the state and an LGU in administrative court proceedings.

It cannot be excluded that a legal dispute takes place between an LGU and the state over the funds necessary for performance of a certain public task while at the same time the LGU (in the form of its council) has submitted a request in the Constitutional review procedure for declaration of non-conformity with the Constitution of the act or other legislation of general application that established the legal basis for the disputed administrative act or measure. In this case, the administrative court may, pursuant to §95 (3) of the ACPA, suspend a proceeding for the duration of adjudication of the Constitutional review matter in the proceedings of the Supreme Court. Subsection 95 (2) of the ACPA allows also a suspension of the administrative court proceeding until entry into force of a judgement on another administrative matter, where the matter in question lies in interpretation of a provision having decisive effect for the settlement of that proceeding to be suspended. Prerequisite for this is that at least 10 similar cases be pending with the court.

As an alternative to the court procedure, the challenge proceeding on the basis of provisions of Chapter 14 of the Administrative Procedure Act<sup>\*74</sup> (APA) is available to an LGU. It may submit various primary claims against an administrative act or measure of the state (in line with Chapter 2 of the SLA) and, under §17 (1) of the SLA, claim for compensation for damage caused by an administrative activity of the administrative authority.

Also, the President of the Republic (§107 of the CRE) and the Chancellor of Justice (§142 of the CRE) should be mentioned as institutions of indirect protection of the financial guarantee of LG.

<sup>67</sup> Supreme Court *en banc* decision 3-4-1-3-07, paragraph 29; Supreme Court *en banc* decision 3-4-1-8-09, paragraph 74.

<sup>68</sup> Eesti Vabariigi põhiseadus. Kommenteeritud väljanne (Note 5), §152 (comment 5.3.2), p. 716.

<sup>69</sup> Supreme Court *en banc* decision 3-3-1-46-03, paragraphs 35–36; Supreme Court Constitutional Review Chamber decision 3-4-1-2-09, paragraph 50.

<sup>70</sup> Supreme Court *en banc* decision 3-4-1-8-09, paragraph 98.

<sup>71</sup> Section 6 of the SLA; §37 (2) 2) of the Administrative Court Procedure Act (halduskohtumenetluse seadustik. – RT I 23.2.2011, 3; RT I, 28.12.2011, 1 (in Estonian)). See Supreme Court Administrative Law Chamber ruling of 10.5.2001, 3-3-1-24-01, paragraph 1. – RT III 2001, 16, 172 (in Estonian); Supreme Court Administrative Law Chamber ruling of 12.6.2008, 3-3-1-29-08, paragraph 10. – RT III 2008, 30, 208 (in Estonian).

<sup>72</sup> Section 3 of the SLA; §37 (2) 1) of the ACPA.

<sup>73</sup> Halduskohtumenetluse seadustik. – RT I, 23.02.2011, 3; RT I, 29.06.2012, 56 (in Estonian).

<sup>74</sup> Haldusmenetluse seadus. – RT I 2001, 58, 354; RT I, 23.2.2011, 3 (in Estonian).

From the perspective of protection of the financial guarantee of LG, the procedural guarantees related to the ECLSG are also certainly relevant. The standard of control of the charter, however, does not reach the level of the European Convention for the Protection of Human Rights and Fundamental Freedoms.<sup>\*75</sup> According to Article 14 of the charter, each party thereto forwards to the Secretary General of the Council of Europe (CoE) all relevant information on legislative provisions and other measures taken by it for the purposes of compliance with the terms of the charter.

The emphasis of the supervision activity of the Congress of Local and Regional Authorities of Europe (CLRAE) lies in *ex officio* control (with application of a thematic approach and an approach related to a particular country). In some instances, control on the basis of a municipal complaint may take place also.<sup>\*76</sup>

Resolutions and recommendations are drafted on the basis of detailed reports presented by one or more rapporteurs appointed by the Committee on Honouring of Obligations and Commitments by signatories of the ECLSG (also referred to as the Monitoring Committee)<sup>\*77</sup> and then acted upon. The rapporteurs are supported by the Independent Group of Experts on the ECLSG (with each member state of the CoE being represented<sup>\*78</sup>) and by officials of the Secretariat of the Congress. The task of the group of experts is related mainly to research work and gathering of relevant information.

In individual cases, the Committee of Ministers also deals with matters of applications by signatory states of the charter and adopts legally non-binding recommendations (serving an indirect guarantee function).

The monitoring system can be classified as an instrument of political control but one whose quality approximates it to the form of judicial supervision.<sup>\*79</sup>

The CLRAE has adopted two relevant recommendations concerning Estonia: Recommendation 81 (2000), on the situation of local democracy in Estonia<sup>\*80</sup>, and Recommendation 294 (2010), 'Local democracy in Estonia'<sup>\*81</sup>, in which, *inter alia*, attention is paid to the financial problems of local authorities. It seems quite symptomatic of the issues found that in the latter recommendation the congress had to remind Estonia that the urgent change of domestic legislation—a theme already mentioned in the former recommendation—remains to be resolved.<sup>\*82</sup>

## 6. Conclusions

It is a purpose of the financial guarantee of LG (§§ 154 and 157 (1) of the CRE; Article 9 of the ECLSG) first to enable effective performance of the right of self-management for LGUs where matters of local importance are involved and, second, to enable proper execution of national duties imposed by law (§154 (2) of the CRE). Whereas most elements of the financial guarantee—the right to sufficient funds for performance of LG functions, the right to the stability of the system for funding LG functions, the right to levy local taxes and to receive revenue from charges, and the right to assume debt obligations—are related to a sphere of

<sup>75</sup> RT II 1006, 11/12, 34 (in Estonian). English text available at <http://conventions.coe.int/Treaty/en/Treaties/Html/005.htm> (most recently accessed on 1.3.2012).

<sup>76</sup> In May 2009, a delegation of the Association of Estonian Cities and the Association of Municipalities of Estonia turned to the CLRAE in Strasbourg. A protest was entered against cuts made in February of the same year via the supplementary budget of 2009. A monitoring visit was requested to be paid to Estonia for assessment of whether activities of the central government were in conformity with the provisions of the ECLSG and for rendering of an opinion of the CoE in this respect.

<sup>77</sup> Rule 55 (1) of the Rules of Procedure of the Congress and Its Chambers. Available at <https://wcd.coe.int/ViewDoc.jsp?id=1923543&Site=Congress&BackColorInternet=DBDCF2&BackColorIntranet=FDC864&BackColorLogged=FDC864> (most recently accessed on 25.3.2012).

<sup>78</sup> Estonia is represented at present by Professor S. Mäeltsemees (of Tallinn Technical University) and the author. It should be emphasised that an expert acts fully independently within a group and does not represent the 'official point of view' of his or her country of origin.

<sup>79</sup> B. Schaffarzik. *Kommunale Selbstverwaltung im europäischen Mehrebenensystem. – Handbuch der kommunalen Wissenschaft und Praxis. Band 1. Grundlagen und Kommunalverfassung. Dritte, völlig neu bearbeitete Aufl. Berlin & Heidelberg: Springer-Verlag 2007, pp. 274–278.*

<sup>80</sup> Available at [https://wcd.coe.int/ViewDoc.jsp?Ref=REC%282000%29081&Language=lanEnglish&Ver=original&Site=DC&ShowBanner=no&Target=\\_self&BackColorInternet=F5CA75&BackColorIntranet=F5CA75&BackColorLogged=A9BACE](https://wcd.coe.int/ViewDoc.jsp?Ref=REC%282000%29081&Language=lanEnglish&Ver=original&Site=DC&ShowBanner=no&Target=_self&BackColorInternet=F5CA75&BackColorIntranet=F5CA75&BackColorLogged=A9BACE) (most recently accessed on 15.1.2012).

<sup>81</sup> Available at <https://wcd.coe.int/ViewDoc.jsp?id=1689329&Site=Congress> (most recently accessed on 1.3.2012).

<sup>82</sup> Subsection c of §6 of Recommendation 294 (2010).

local, communal life-organisation, the right to full funding from the state budget of national duties imposed by law goes beyond the right of self-management of local authorities. Accordingly, the role of the financial guarantee within the structure of a full Constitutional guarantee for LG is of a supportive, secondary nature.

The financial guarantee with its various levels does not function in the Estonian legal system as an unlimited right: the legislator and, to a certain extent, the executive power can restrict it on condition that they have a legitimate purpose in so doing and that the measures to be applied are proportionate to this purpose.

Legal protection of the financial guarantee of LG must be efficient. A guarantee of subjective legal status can be characterised as being efficient when there exists a possibility for an LGU to obtain protection from an independent court or tribunal for all levels of the guarantee (Article 11 of the ECLSG). When an LGU alleges that its right to have sufficient resources is violated, it must also show which of the functions it may fail to perform. Given the objective complexity for the LGU of substantiation of unconstitutionality of the existing system of funding of local authorities (related to failure in proper delimitation of public tasks), it seems quite probable that partial or full transfer to the state of the burden of proof to substantiate violation of a financial guarantee of LG will become the prevailing tendency in cases of such a nature.

Depending on the nature of the legal dispute, the LGU can bring a case against the state or one or more other LGUs:

- Directly before the Supreme Court on the basis of §7 of the CRCPA, or
- To an administrative court, where it can also request the court not to apply the unconstitutional act or other legislation of general application on which the administrative act is based (§152 (1) of CRE; §158 (4) of ACPA).

If the court of first instance or the court of appeal accepts this request, it will forward the corresponding judgement or ruling to the Supreme Court, by which means the Constitutional review court procedure will start (§9 (1) of CRCPA). When failure to pass legislation of general application has led to sufficient funds not being provided for performance of public tasks and damage has been caused to the LGU, or such a failure has caused damage to an LG in some other way, a local authority can submit a claim for compensation for damage arising from §14 (1) of the SLA and demand that the absence of such a regulation be declared to be in conflict with the Constitution (§9 (1) and §15 (1) 2<sup>1</sup>) of CRCPA).

As an alternative to the court procedure when violations of a financial guarantee of LG are caused by administrative (in)action of the state executive authority, the option of a challenge proceeding on the basis of provisions of Chapter 14 of the APA remains open to an LGU.

Within the framework of the CoE, a monitoring system—an instrument of political control to be exercised *ex officio* and on the basis of a municipal complaint—applied by the CLRAE (taking a thematic approach and an approach related to a particular country) in order to ensure compliance of state activities with the provisions of the ECLSG remains essential for the financial guarantee of LG and may now be even more vital.