INTERNATIONAL MULTI DISCIPLINARY JOURNAL FOR RESEARCH & DEVELOPMENT
eISSN 2394-6334 Impact factor: 8.854 Volume 13, issue 02 (2026)

STRUCTURAL MODEL OF LOCAL PUBLIC FINANCE IN TRANSITION ECONOMIES

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Abstract

The transformation of centrally planned economies into market-oriented systems has fundamentally reshaped public finance structures, particularly at the local government level. Transition economies face complex fiscal challenges, including revenue instability, expenditure decentralization, weak institutional capacity, and intergovernmental fiscal imbalances. This study develops a structural model of local public finance tailored to transition economies, emphasizing revenue assignments, expenditure responsibilities, intergovernmental transfers, borrowing mechanisms, and institutional governance. Using a comparative institutional approach and secondary data analysis from post-socialist countries in Eastern Europe and Central Asia, the study identifies key determinants of fiscal sustainability and local autonomy. The findings suggest that effective fiscal decentralization depends not only on revenue autonomy but also on transparent transfer formulas, accountable governance, and sound macroeconomic coordination. The proposed structural model integrates fiscal federalism theory with transition economy realities, offering a framework for policy reform in emerging and developing countries undergoing institutional transformation.

Keywords

local public finance, fiscal decentralization, transition economies, intergovernmental transfers, structural model, fiscal sustainability.

Introduction

The collapse of centrally planned economic systems in the late 20th century initiated a broad institutional transformation across Eastern Europe, Central Asia, and parts of Southeast Europe. Countries such as Poland, Hungary, Ukraine, Uzbekistan, and Kazakhstan embarked on economic reforms that included privatization, price liberalization, and fiscal decentralization. Among these reforms, restructuring local public finance systems became one of the most complex and politically sensitive components.

Under centrally planned regimes, local governments functioned primarily as administrative arms of the central state. Revenue generation and expenditure decisions were highly centralized, with limited local discretion. Transition to market economies required redefining the role of subnational governments, introducing fiscal autonomy, and establishing new intergovernmental fiscal relations.

However, fiscal decentralization in transition economies has produced mixed outcomes. While some countries achieved improved service delivery and local accountability, others experienced fiscal fragmentation, soft budget constraints, and macroeconomic instability. The absence of a coherent structural model for local public finance has often contributed to inconsistent reform trajectories.

This study aims to develop a comprehensive structural model of local public finance suited to transition economies. The research addresses the following questions:

1. What are the key structural components of local public finance in transition contexts?
2. How do institutional and economic factors influence fiscal performance at the local level?

3. What model can ensure fiscal sustainability, autonomy, and accountability?

Literature Review

The theoretical foundation of local public finance is rooted in fiscal federalism theory. First-generation fiscal federalism emphasizes efficiency in allocating public goods across levels of government, highlighting the importance of matching revenue sources with expenditure responsibilities. Second-generation fiscal federalism introduces political economy considerations, focusing on incentives, governance, and institutional constraints.

In transition economies, decentralization reforms were influenced by international institutions such as World Bank and International Monetary Fund, which promoted fiscal discipline and institutional restructuring. Research suggests that decentralization without adequate institutional capacity may lead to fiscal imbalances.

Scholars identify several recurring challenges in transition economies:

- Vertical fiscal imbalances (mismatch between local expenditure mandates and revenue sources).
- Horizontal disparities across regions.
- Weak tax administration systems.
- Political interference in transfer allocations.
- Limited borrowing frameworks and debt management mechanisms.

Empirical studies from Central and Eastern Europe demonstrate that countries adopting transparent transfer formulas and strengthening property tax systems achieved better fiscal outcomes. Conversely, countries with discretionary transfer systems experienced volatility and governance risks.

Despite extensive literature on fiscal decentralization, limited research integrates these elements into a unified structural model specific to transition economies. This paper addresses that gap.

Methodology

This research adopts a qualitative-analytical methodology combined with comparative institutional analysis. The study relies on:

- Secondary data from international financial institutions.
- Legal frameworks governing local public finance in selected transition countries.
- Comparative case studies of decentralization reforms.
- Analytical modeling of fiscal relationships.

The structural model is constructed based on five core components:

1. Revenue structure
2. Expenditure assignment
3. Intergovernmental transfers
4. Local borrowing and debt management
5. Institutional governance mechanisms

The model incorporates macroeconomic constraints and institutional capacity variables to ensure applicability to transition contexts.

Results

Revenue Structure in Transition Economies

Local government revenues typically consist of:

- Own-source taxes (property tax, local fees)
- Shared taxes (personal income tax, VAT shares)

- Non-tax revenues
- Intergovernmental transfers

In transition economies, property taxation remains underdeveloped due to incomplete cadastral systems and weak valuation mechanisms. Shared taxes often dominate revenue structures, limiting true fiscal autonomy.

A structurally sound revenue system requires:

- Clear tax assignment rules.
- Strengthened local tax administration.
- Diversification of revenue sources.
- Stable tax bases linked to local economic activity.

Expenditure Assignment

Expenditure responsibilities in transition economies often include:

- Primary education
- Basic healthcare
- Local infrastructure
- kommunal services
- Social assistance programs

A mismatch between revenue authority and expenditure mandates generates fiscal stress. The structural model proposes:

- Clear delineation of mandatory and discretionary expenditures.
- Costed mandates to prevent unfunded responsibilities.
- Performance-based budgeting mechanisms.

Intergovernmental Transfers

Transfers play a central role in equalizing fiscal capacity. Two major forms exist:

- General-purpose (equalization) transfers
- Specific-purpose (conditional) grants

The structural model emphasizes formula-based equalization transfers to reduce political manipulation. Key elements include:

- Objective indicators (population, fiscal capacity, expenditure needs).
- Transparent allocation rules.
- Predictability over medium-term planning horizons.

Local Borrowing and Debt Management

Transition economies often impose strict borrowing limits to prevent macroeconomic instability. However, excessive restrictions may hinder infrastructure investment.

The proposed structural framework suggests:

- Golden rule of borrowing (debt only for capital expenditures).
- Debt ceilings tied to revenue capacity.
- Transparent reporting and audit requirements.
- Central oversight without undermining autonomy.

Institutional Governance and Accountability

Fiscal decentralization requires strong institutions:

- Independent audit bodies.
- Transparent budgeting procedures.
- Citizen participation mechanisms.

- Anti-corruption frameworks.

Institutional quality directly affects fiscal performance. Countries with stronger governance structures demonstrate better fiscal discipline and service delivery outcomes.

Discussion

The structural model integrates economic and institutional dimensions of local public finance. Unlike models designed for advanced federal systems, transition economies require adaptive frameworks that consider:

- Legacy of centralized governance.
- Weak administrative capacity.
- Informal economic sectors.
- Political transition dynamics.

The model can be summarized as an interdependent system where:

Revenue autonomy + Transparent transfers + Clear expenditure mandates + Responsible borrowing + Strong governance = Sustainable local public finance.

Policy implications include:

1. Gradual decentralization aligned with institutional capacity.
2. Strengthening property tax systems.
3. Implementing formula-based equalization mechanisms.
4. Enhancing fiscal transparency and digital governance tools.
5. Coordinating local and national macroeconomic policies.

Conclusion

Transition economies face unique challenges in restructuring local public finance systems. Fiscal decentralization alone does not guarantee efficiency or accountability. Instead, sustainable outcomes require a coherent structural framework that balances autonomy with discipline.

This study developed a structural model composed of five interrelated components: revenue structure, expenditure assignment, intergovernmental transfers, borrowing mechanisms, and governance institutions. The findings demonstrate that institutional capacity and transparent fiscal rules are decisive factors for long-term sustainability.

Future research may focus on quantitative validation of the model using panel data from transition economies. Policymakers can utilize the proposed framework to design balanced decentralization reforms that promote economic development, fiscal stability, and democratic accountability.

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