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## THE ROLE OF LOCAL GOVERNMENT FINANCE EQUALIZATION ON RURAL DEVELOPMENT IN LATVIA

Inga Vilka

University of Latvia

inga.vilka@lu.lv

### Abstract

Currently one of the hottest local governments' issues on the agenda of the government of Latvia is the elaboration of new improved local government finance equalization system, which is an important integral element of the implementation of regional development policy. Local government finance equalization is affecting development capacity of any territory, including rural territories. The purpose of the article is to highlight and discuss in academic society the finance equalization issues that affect the rural municipalities and work out proposals for the new system. The study does not cover all local government finance equalization system's elements, but gives attention to three – importance of the equalization for rural local governments – municipalities (*novads*); revenue sources, that are necessary to include in the equalization system; criteria for calculation of local governments' expenditure needs.

**Key words:** local governments, finance equalization, rural municipalities, regional development, community capacity, criteria for expenditure needs.

### Introduction

Regional policy is a set of agreed and organised measures for ensuring development across the territory of a country. The objects of regional policy is authorities of different tiers – local governments and where it is regional and other sub-national level authorities (Vaidere et al., 2006), and local governments, their autonomy and capacity is one of most significant elements of regional development. In the past main activities of the regional development policy were directed towards reduction of unfavourable disparities of territories and their growth potential. In recent decades significant changes in the territorial perspective have been observed in the international context, focusing more on the competitiveness of territories rather than on ensuring the traditional support to industries or income redistribution. The policy is directed towards the development of competitiveness of each territory, not only towards the subsidization of the poorest regions, proven to be less efficient (Kalniņa-Lukaševica, 2013). Recently, a place-based approach has been put forward as a new solution to promote regional development and it is a topical EU discussion point (Baltiņa, 2014). In modern governance the principle *one fits all* has been substituted with tailor made approach: in the case of regional development policy, it is implementation of place based approach, what takes into account as possible more specific features – resources, capacities, potentials - of the particular territory in programmes, activities and projects, that impact the development of territories.

One of apparent tool of regional development policy, used in many European countries, is a local government finance equalization system. A substantial degree of financial equalisation is a prerequisite for the success of fiscal decentralisation and sound local self-government. At the same time, financial equalisation

is a prerequisite for the success of policies geared to economic stability and balanced, sustainable regional development (CE, 2005). Such system primarily is directed towards reduction of disparities of local governments' financial capacity to ensure provision of basic local governments functions and services in the whole territory of country. By purpose this tool could be evaluated as a tool of traditional, classic regional policy, but in tailoring of the equalization system there is a possibility to implement place-based approach by trying to take into account more specific features of the territories, as it influences the community capacity.

As there are significant differences in the financial capacity among different local governments in Latvia, since 1995 local government finance equalization system has been applied. Existing Law "On Local Government Finance Equalization" was passed in 1998. Local government finance equalization system ensures both equalization of revenue and equalization by different necessity (needs) for expenditures for municipalities. In general, the fact that there is such a system and some features of the system have to be evaluated positively, but at the same time there is a number of shortcomings in the system (RAPLM, 2007a). In 2009 the *Saeima* passed amendments in the Law, that could be considered as quick fixes for old equalization system adaptation for new local government system after the administrative territorial reform, but elaboration of more fundamental changes for improvement of the system (new system) was included in the agenda of the government and legislator.

In the current Declaration of the Government in the section Regional Development it is determined that „we will develop a new financial equalization system of local governments that will provide a balanced, regionally balanced access to resources for all local governments (Cabinet of Ministers, 2014). A similar

promise was in declaration of previous government, too.

The topic is extremely important for the development of all local governments of Latvia and is affected development capacity of any territory, including rural territories. The purpose of the article is to highlight and discuss in academic society the finance equalization issues that affect the rural municipalities and work out proposals for the new system. The study does not cover all local government finance equalization issues, but it gives attention to three – importance of the equalization for rural local governments – municipalities (*novads*); revenue sources included in the equalization system; it uses criteria for calculation of local governments' expenditure needs.

### Materials and Methods

In the study, the author uses literature review, legal acts analysis, as well as personal experience from participation in projects and working groups aimed at local governments finance equalization improvement. Besides qualitative approach, the author also uses quantitative method as statistical analysis. Over the history of management, many fashions and fads have appeared. Regular survey project has been implemented since 1993 and it shows that in 2009 benchmarking became the most popular tool (Daft, 2012). Also, in public sector the use of benchmarking is increasing and it has become the integral part of modern public governance. In this study for benchmarking of qualitative character the principles from recommendations of the Council of Europe as well as foreign experience are used for inspecting estimated revenues and expenditure needs criteria in equalization.

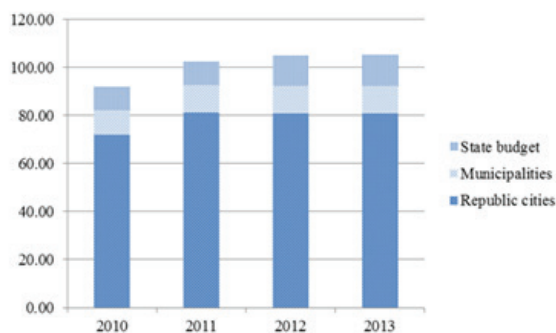


Figure 1. The revenue sources of the Local Government Finance Equalization Fund in Latvia in 2010-2013, million EUR.

Source: Treasury, local governments' annual basic budget reports, author's calculation.

### Results and Discussion

#### *The importance of the finance equalization for municipalities as rural local governments*

The share of the Local Government Finance Equalization Fund (LGFEF) in local government (basic) budget revenues reflects the significance of finance equalization. In previous five years the volume of LGFEF raised from 92.15 million EUR in 2010 to 109.6 million EUR in 2014 and the share of revenues of grants from the LGFEF in total annual local governments basic budget revenues during the period varied within limits between 4.7% and 5.2%. From all 119 local governments (9 republic cities and 89 municipalities) five republic cities and 11-13 municipalities from Riga planning region were the contributors in the LGFEF. For instance, in 2013 five republic cities (*Jelgava, Jūrmala, Rīga, Valmiera, Ventspils*) and 13 municipalities (*Ādažu, Babītes, Carnikavas, Garkalnes, Ikšķiles, Ķekavas, Mārupes, Olaines, Salaspils, Saulkrastu, Sējas, Stopiņu*) paid in the LGFEF. 92 local governments - three republic cities (one third of cities) and 89 municipalities (81% from all municipalities) received the grant from the LGFEF, but ten local governments - one city and nine municipalities - neither paid nor received the grant. Figure 1 reflects the structure of the LGFEF– share of contribution from republic cities, municipalities and state budget. In 2013, 76.9% of the LGFEF was formed from republic cities contributions, 10.8% from municipalities' contributions and 12.2% from the state budget grant.

At the same time budgets of municipalities receive more than 95% of the LGFEF, in 2013 – 97%, but the share that republic cities receive, does not exceed 5% of the LGFEF (see Figure 2), so the finance equalization is very significant for municipalities,

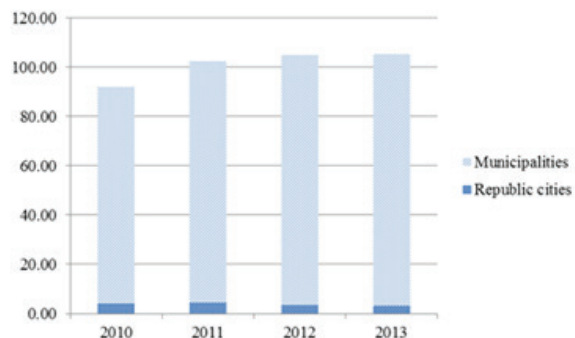


Figure 2. The grants from the Local Government Finance Equalization Fund in Latvia in 2010-2013, million EUR.

Source: Treasury, local governments' annual basic budget reports, author's calculation.

as they represent the rural territories of the country, the finance equalization is important for rural development.

The republic cities are totally urban administrative territories, but the municipalities formally either consist from one or several former rural administrative territories (*pagasts*) or from a combination of former urban administrative territory (town) and rural administrative territories. After the finish of administrative territorial reform in 2009 and disunion of one municipality in 2011 in Latvia, there are 50 municipalities which are formed only from rural territories and 60 municipalities with at least one town, five of those municipalities have several towns, for example *Talsu novads* has four towns in its territory.

According to analysis of local government basic budget data (2013) that contains a comparison of two main tax revenues (personal income tax and real estate tax) with the grant from the LGFEF, in the group of cities the volume of received grants is 0.4% from the volume of the two tax revenues, but the paid contribution in the LGFEF is 11% from the volume of tax revenues. In the group of municipalities, the volume of grants from the LGFEF is 20.3% compared with the tax revenues, but for particular municipalities, which are receivers of the grant, it varies from 2.2% to 113.1%. There were four municipalities in 2013 whose revenues from the LGFEF were higher than tax revenues, the grant from the LGFEF in 25 municipalities (including 4 above mentioned) is higher than half of the tax revenues. Tax revenues used to be one of main local governments

finance capacity indicator. The grant from LGFEF like tax revenues has unconditional character of revenues and its volume comparison proves that for significant part of municipalities it is a very important element of the finance capacity of local government that impacts the development capacity of local government and its community.

*Estimated revenues for local government finance equalization in Latvia*

The Council of Europe recommends that the estimate of the financial capacity of local authorities should preferably include all sources of revenues (CE, 2005). Here the earmarked grants, service charges, as well as capital revenues (as sale of property, for instance), that preferably have to be used for capital investments, are not included. Besides CE suggests where there is more than one tax, equalisation should not take place for each tax: a representative fiscal system should be devised that reflects the total local tax-raising potential (CE, 2005). Since local government finance equalization system has been introduced in Latvia it uses two main tax revenue sources – personal income tax revenues and real estate tax revenues as estimated revenues for equalization calculations.

Total tax revenue share in local government basic budgets in previous years formed 53.3 to 59.7% from basic budget revenues (see Table 1). Besides two above mentioned taxes, local government budgets have revenues from two more taxes – gambling tax and natural resource tax. The personal income tax revenues

Table 1

**Tax and fee revenues in local government budgets in Latvia**

Year	2010	2011	2012	2013	2014
Revenue position					
Total tax revenues, million EUR	1037.55	1087.08	1166.80	1247.78	1307.11
Tax revenue share in local government basic budget, %	53.3	54.0	57.5	58.1	59.7
Personal income tax revenues, million EUR	904.36	924.08	992.04	1067.04	1108.09
Share of personal income tax in total tax revenues in local budgets, %	86.8	84.5	84.5	84.9	84.2
Real estate tax revenues, million EUR	127.58	156.78	167.00	172.71	190.90
Share of real estate tax in total tax revenues in local budgets, %	12.2	14.3	14.2	13.7	14.5
Gambling tax revenues, million EUR	5.22	5.47	6.61	6.81	7.02
Share of gambling tax in total tax revenues in local budgets, %	0.5	0.5	0.6	0.5	0.5
Natural resource tax revenues, million EUR	4.79	6.71	8.71	9.65	10.00
Share of natural resource tax in total tax revenues in local budgets, %	0.5	0.6	0.7	0.8	0.8
Local fees, million EUR	5.32	6.11	8.49	7.73	na
Share of local fees in local government basic budget, %	0.4	0.4	0.6	0.5	na

Source: Treasury, for the years 2010-2013 annual local governments' budget reports, for 2014 month reports (January-December), author's calculations.

form the major part of total local governments' tax revenues - 84.2%, real estate tax - 14.5%, but natural resource tax - 0.8% and gambling tax - 0.5% (in 2014). As the uneven distribution of personal income tax leads to disparities of local governments finance capacity, from that following development capacity, no doubt that it has to be included in equalization. Also, in other European countries it is most used equalized revenue type. But during preparation of proposals for the development of new equalization system as improvement of existing one, a question about including the real estate tax was raised. For instance in Norway, local tax revenues are formed from income tax, property tax, wealth tax and tax on natural resources. Three taxes – income, wealth and natural resources taxes are included in equalization of revenues, but real estate tax as fully local voluntary tax is not included (Skarvang, 2015). In Latvia, real estate tax revenues formed 8.1% from basic budget revenues in 2013, 8.7% - in 2014. Data analysis of 2013 shows that 64% of this tax volume comes from the cities, but 36% - from municipalities. The average real estate tax per capita in the group of municipalities (68 EUR) is 1.9 times lower than in the group of cities (120 EUR). In the group of municipalities the lowest real estate tax revenues per capita in 2013 was 26 EUR (*Vilānu novads*), the highest 194 EUR (*Saulkrastu novads*). Exclusion of this tax from the local governments finance equalization would be unfavourable for the local governments of municipalities, especially for rural ones. In Latvia, the year 2013 was the first year when local governments had rights to set the real estate tax rate within limits stated in the Law. It is a new challenge for tax revenue estimation which is necessary for equalization calculations. To support the local governments to use taxation regarding local needs, it was decided to use the lowest rate for calculations. The local governments practice of the real estate tax rate setting after several years have to be evaluated and if necessary approach to evaluation method of this tax revenue would be reasonable to change. There are countries (for instance, Poland) where the highest possible rate is used for equalization calculations (Zeikate, Vilka, 2007).

To add the natural resource tax in equalization system is not possible as this tax is earmarked – it must be used for environmental protection purposes. The total revenues of gambling tax in 2014 formed 0.3% of basic budget revenues and 0.5% from all tax revenues. This tax mainly forms revenues in cities. The reason why the gambling tax is not included in the equalization system is its small volume, forecasting problems, and besides mentioned, the activities, what is subject of this particular tax, raise the additional problems what local governments have to solve (PKC and Astrop, 2007b). Previous five

years gambling tax revenues have increased. It could be reasonable to return to decision about including this tax in equalization system, when its share in budget revenues or at least in total tax revenue volume will exceed at least symbolical 1%. Inclusion of this tax in the system would be favourable for municipalities.

One more local government own revenue source that theoretically could be added in the system is local fees. The total revenues of revenues from local fees in 2013 formed 0.5% of basic budget revenues, compared with previous year the share decreased. Like with gambling tax the volume of local fees is too small to be included in the equalization system. Besides, it is concluded, that local governments insufficiently use fees as local fiscal incentives (RAPLM, 2010), it must be promoted more, but the inclusion of fees in the equalization system will not promote incentives.

#### *Criteria for expenditure needs*

The recommendations of the Council of Europe states that the equalisation of specific spending needs should be effected through grants based on appropriate and objective criteria. Spending needs should be estimated primarily on the basis of criteria which are objective and which local authorities do not directly control and they are unlikely to affect local authorities' freedom of choice, within the limits of the budgets available; do not penalise local authorities that endeavour to streamline the management of their services to make them more efficient, to increase the number of users and units produced in order to obtain economies of scale. And the Council of Europe recommends to take on account, as far as possible, of demographic, geographical, social and economic features leading to disparities in costs (Council of Europe, 2005).

It is reasonable to consider the range of criteria and their weights (significance) as the complex index for regional development. In practice countries establishing criteria on national level try to take into account either obligations facing the local government (its structural needs), its ability to meet those obligations in relation to its resources (its own and that of its constituent), or both. Study of PKC and Astrop (2007), Dexia (2008) reflects a wide variety of used indicators. Dexia had grouped them in four groups:

- Demographic criteria: the number of inhabitants, age structure, density, school-aged children, elderly, unemployed, immigrants, municipal counsellors, members of cultural or linguistic minorities, dwellings, etc.;
- Geographic criteria: surface area, topography, remoteness, climate (water shortage problems, for



example), forest and agricultural land coverage, water surfaces, etc.;

- Financial criteria: differences in fiscal wealth, financial needs, the level of government spending on a certain area (health, transportation, social programs), etc.;
- Socio-economic criteria: GDP (for regions), quality of infrastructure, the extent of networks (road, water supply and water treatment networks), level of social services, social housing stock, number of businesses, energy production, per capita added value, etc. (PKC and Astrop, 2007; Dexia, 2008). In the socio-economic category, one can sometimes find criteria relating more specifically to cities and aimed at compensating their higher spending responsibilities as core cities (centrality charges). In Denmark, for example, the fact of whether a municipality is classified as a central or peripheral city is considered when distributing grants. In Austria, a special demographic criteria exists known as a „scaled population multiplier” which gives priority to larger municipalities for which financial needs are presumed to be greater, although not on a proportional basis (Dexia, 2008).

Generally, a grant allocation combines a few of those criteria. It can be very elaborate. In the Netherlands, as many as 50 different criteria are considered for the allocation of the Municipal Fund and the Provincial Fund (Dexia, 2008). In Norway for counties as second tier governments 14 criteria are used (for instance, 6 age groups, area, sea route network, urban factor, and other), but for local governments of the first tier 28 indicators are used - mainly different age groups and other population groups (immigrants, mentally handicapped, unmarried over 67, education level – inhabitants with academic education etc.) and also such criteria as agriculture index, urbanity measure, travelling distance within the local zone, travelling distance to the closest district and other (Skarvang, 2015). For example, criteria of academic education level is connected with the provision of kindergarten services, as research proves the direct correlation between the demand for kindergarten services and the education level of parents – if there is higher education level, it demands for the more and higher service.

Assessing the disparities in determination of the financial necessity of each local government, the Latvian system uses only the division of local governments into two groups – republic cities and municipalities - and demographic criteria (the number of residents, the number of children up to age of 6 (included), the number of young people of the ages 7 to 18, the number of people above working age). This division in groups, where one group is considered as rural territories, for municipalities in general is more favourable than for cities, but at the same time the

richest local governments in Latvia (by tax revenue per capita) are among municipalities – so called *sleeping cars* in Riga hinterland. This grouping for equalization calculations makes cities feeling that the system is unfair and leads to the conflicts between the cities and municipalities. The use of few criteria leads more to the *one fits all* approach, while including of more different category criteria conforms to more place-based approach, to more tailor made approach. Also, the Council of Europe recommendations and foreign experience justified the necessity of more criteria that exists now in the Latvian system of equalization.

The study managed by the author done in 2007 (RAPLM, 2007b) and later for new local government finance equalization system besides four already used demographic criteria proposed four new criteria – area, distance to Riga (but for local governments that are closer than 30 km distance, this indicator is calculated in favour of Riga not a particular local government), the number of amalgamated units in municipality, and centre indicator of spillover effect for cities and town municipalities (with a different mark for Riga, national and regional significance centres) (RAPLM, 2007b). In current situation, responsible ministry and other stakeholders of the system are ready to extend the range of criteria only with one more – area. But implementing the place-based approach and use of more tailor made system would be the manifestation of modern thinking in the regional development policy. That is why the author suggests this discussion in academic society.

#### *Latvia's population data source problem*

One of main indicators characterizing any local government is the number of its population – permanent residents. This indicator is essential for monitoring, evaluation and development of regional development policy and essential for equalization system as an important part for provision of balanced regional development. The population data is necessary both for estimation and comparison of local government revenues and for estimation of expenditure needs. In the current calculations for local governments finance equalization the data of the Office of Citizenship and Migration Affairs (OCMA) are used. This is the situation since the year 2000, but prior to this, the data of Central Statistical Bureau (CSB) was used. Since the last Census of CSB in Latvia in 2011, there is a significant difference between the data about the number of population by the OCMA and data of CSB (see Table 2) and this difference in the country is increasing more rapidly in the group of cities. In 2014, the number of population of Latvia according to the data of CSB was 8.2% lower than according to the data of OCMA; in the group of cities this difference was larger (-8.9%) than in the group of municipalities

Table 2

**The difference between the data of Central Statistical Bureau and the Office of Citizenship and Migration Affairs on the number of population of Latvia**

Year	2011	2012	2013	2014
Number of population by data of OCMA	2,236.910	2,217.053	2,201.196	2,180.293
Number of population by data of CSB	2,074.605	2,044.813	2,023.825	2,001.468
Difference (CSB-OCMA against OCMA), %	-7.3	-7.8	-8.1	-8.2
Difference in group of republic cities, %	-6.9	-7.8	-8.4	-8.9
Difference in group of municipalities, %	-7.6	-7.7	-7.7	-7.5

Source: OCMA, CSB, author's calculation.

(-7.5%), but in 2011 situation was opposite – difference was larger in the group of municipalities.

The problem of data difference has already been indicated (VRAA, 2012; Vilka and Brēķis, 2013), but following activities are not sufficient enough. The problem would not be considered so important, if the difference would be symmetrical for all administrative territories, but it is not so. Looking at individual local governments, the difference between different sources vary from -0.2% to -13.4%, in five cities and 57 municipalities the difference is larger than average in the county. One can recognize that in group of municipalities in general smaller difference is in municipalities around the Riga. Those also are the richest municipalities with the highest local government budget tax revenues per capita. In 2014, using OCMA data the tax revenues in local budgets per capita varied from 241 EUR to 1290, using CSB data it indicates data from 264 EUR to 1303 EUR, bet minimal and maximal values or personal income tax revenues in local budget per capita was from 190 EUR to 1137 EUR (difference 6 times) according to OCMA and from 208 EUR to 1148 EUR (difference 5.5 times) using CSB data on population. Using data of CSB difference between the lowest and highest values is not as high as using data of OCMA. As the LGFEF grant/contribution values are directly connected with the number of population, for local governments where the difference between data sources is higher than average difference, the use of OCMA data is more beneficial. But what about the fairness of the system? And why is the regular Census necessary? Although for almost half of local governments more favourable could be the use of CSB data, most of local governments support the use of OCMA data, as this indicator is higher and used to be used for local government representation. Stay on this source avoids the explanation for society about the rapid decrease of indicator on population, which is expected in case of the change of data source.

As the CSB are the official source for data submitted to Eurostat, and they are used also for international comparison, it is suggested to use CSB data on population in local government finance equalization,

too. Based on Law on Regional Development in 2014 The Cabinet of Ministers adopted new regulations (No 367 from 01.14.2014.) on regional development monitoring and evaluation order and according them, the new calculations of territory development level index are introduced, where beside other amendments data of CSB on population are included again instead of previous calculations (since 2010) where data of OCMA were used. In 2015, based on the same Law the Cabinet of Ministers adopted new regulations (No 42 from 27.01.2015.) on criteria and order for state grant allocation to local governments for the EU funds co-financed projects implementation in the planning period of 2014-2020. Calculations of those regulations refer to the local government budget capacity indicator that is calculated as standardised values of local government estimated revenues before the equalization. This connection also justifies the necessity of using CSB data in local government finance equalization. If the data of CSB on population will not be used in equalization calculations, then the situation with local government data as base for different analysis including monitoring of development will become more confused.

### Conclusions

1. For municipalities as completely or partially rural local governments, grant from local government finance equalization system is very important budget revenue, in many cases by importance it is close to tax revenues.
2. Inclusion of two taxes' – personal income tax and real estate tax - revenues in calculations of estimated revenues is optimal. For rural local governments it is important to leave the real estate tax revenues in the system. In case of significant increase of gambling tax revenues, this tax also has to be included in the system. The tailor-made system development approach supports the evaluation of as possible more sources.
3. Modern approach to regional development, as well as the Council of Europe recommendations and foreign experience on benchmarking, supports inclusion of several new criteria for expenditure

needs' calculations. More specific criteria also lead to higher fairness of the system.

4. To avoid the further and larger confusion in monitoring and evaluation of regional development, it is suggested to use the CSB data on population in the local government finance equalization system's calculations.

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