Council of Europe
Conseil de l'Europe

Local finance in Europe

Local and regional authorities in Europe, No. 61

Local finance
in Europe

Local and regional authorities in Europe, No.61

Council of Europe Publishing

French edition:
Les finances locales en Europe
ISBN 92-871-3205-4

Publications appearing in the same series:

Major cities and their peripheries: co-operation and co-ordination management, No. 51
ISBN 92-871-2394-2

Local referendums, No. 52
ISBN 92-871-2396-9

Access to information about local authority decision-making, No. 53
ISBN 92-871-2490-6

Participation by citizens-consumers in the management of local public services, No. 54
ISBN 92-871-2492-2

Definition and limits of the principle of subsidiarity, No. 55
ISBN 92-871-2522-8

The size of municipalities, efficiency and citizen participation, No. 56
ISBN 92-871-2658-5

Economic intervention by local and regional authorities, No. 57
ISBN 92-871-2871-5

Local authorities' budgetary deficits and excessive indebtedness, No. 58
ISBN 92-871-3034-8

The status of major cities and their peripheries, No. 59
ISBN 92-871-3140-6

Environment and local and regional authorities, No. 60
ISBN 92-871-3164-3

Council of Europe Publishing
F-67075 Strasbourg Cedex

ISBN 92-871-3206-2

Printed at the Council of Europe

TABLE OF CONTENTS

INTRODUCTION

Local authorities are called upon today to play a decisive role in social cohesion, economic well-being and sustainable development in the countries of Europe. Their action is essential in guaranteeing democratic stability on our continent.

But their place in the state, and in the broader context of European construction, and the way they fulfil the role assigned them cannot be considered without reference to the financial means at their disposal.

If strengthening democracy means strengthening local self-government, this in turn means establishing systems of financing for local authorities which are at once efficient, fair and consistent with the state's economic imperatives. In other words, the principle of subsidiarity, decentralisation and local finances are all interdependent.

Local authority financing is currently at the heart of the political debate. All the Council of Europe's member states are faced with the challenge of reconciling the need to control and reduce public spending with greater financial autonomy in local government; they are accordingly seeking ways of achieving an equitable distribution of financial resources among the different levels of government in a context of budgetary cutbacks at every level of public administration.

There is no universal model of local government finance applicable to all the states of Europe; they each have their own specific needs and solutions. However, Article 9 of the European Charter of Local Self-Government lists certain general principles concerning the financial resources of local authorities. It reads as follows:

Article 9 – Financial resources of local authorities

1 Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.

2 Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.

3 Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.

4 The financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.

5 The protection of financially weaker local authorities calls for the institution of financial equalisation procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance 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.

6 Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.

7 As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.

8 For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law.

The Conference of European Ministers responsible for Local Government met in Lisbon on 10 and 11 October 1996 to discuss "Local Government finance in Europe" in the light of the principles set forth in the Charter.

Two reports, one prepared by the Steering Committee on Local and Regional Authorities (CDLR) and the other by the Congress of Local and Regional Authorities of Europe (CLRAE), provided the basis for the work of the Conference. These reports, and the resolution adopted by the Ministers at the Conference are the subject of this publication.

The CDLR report

The CDLR report presents various approaches to local financing, highlighting the advantages and disadvantages of each.

The purpose of any system of local government financing is to give local authorities the wherewithal to accomplish all the tasks incumbent on them. The first chapter of the report therefore stresses how important and useful it is for local authorities to participate in the provision of public services.

With the help of graphs and tables, the second chapter describes the structure of local finance in the member states of the Council of Europe, illustrating the great differences that exist from one country to another, but also certain similarities.

The following three chapters deal with the four main sources of local authority funding: borrowing, charging for services, local taxes and transfers, and with the uses to which funds from these different sources may be put. From a critical analysis of commonly occurring problems guidelines are derived that should be of assistance to policy makers in deciding on the system of financing best suited to their own countries.

The last chapter covers local authority cash flow management and suggests certain precautions that should be taken to improve efficiency.

The CLRAE report

The CLRAE report is based on a survey conducted among associations of local authorities in different member states. It therefore illustrates the current situation as seen through the eyes of the local authorities themselves.

The first questions addressed by the CLRAE report concern the powers and the size of local authorities. They reveal the interdependence of the functions incumbent on local authorities, their ability to assume them correctly, and their size.

The report goes on to examine the means by which local authorities are financed: local taxes, fees and charges, loans and transfers, including financial equalisation in favour of those local authorities with least resources. *Inter alia* it denounces the often low level of own resources and the situation of dependency which large downward transfers can generate.

One chapter is devoted to the specific problems of local authority financing in countries undergoing transition. The report concludes with an appraisal of the current situation in local self-government, listing the issues local authorities would like to see given priority.

The Resolution on Local Government Finance

The resolution which the Conference adopted lists certain general principles of local finance, and principles concerning administrative expenditure, capital investment and debt, financial equalisation and cash-flow management.

The resolution is not binding, but the very clear guidelines the Ministers have given themselves mark an important step in thinking on local authority finance and are a sign of the determination of national authorities to work with local authorities to find solutions which are both realistic and fair.

Report by the Steering Committee on Local and Regional Authorities (CDLR) on local finance in Europe

with the assistance
of Professor David King
and Mr Rémi Jequier

TABLE OF CONTENTS

INDEX OF TABLES AND CHARTS

I. LOCAL GOVERNMENT AND PUBLIC SERVICES

Article three of the European Charter of Local Self-Government proposes that local authorities should have the right to regulate and manage a substantial share of public affairs. In particular, they can be expected to share the economic activities of the public sector with the central government. These activities fall under three headings: stabilization, redistribution and resource allocation.

There are difficulties with local authorities participating in stabilization and redistribution and it is helpful to see why since some of the issues concerned are relevant to devising suitable systems of local government finance.

Problems with local government participation in stabilization

One reason why local authorities are not suitable for playing much part in the stabilization activities of the public sector (with the control of inflation, employment and growth), is that it would not be possible to give local authorities many instruments to use.

Thus, for example, local authorities would not have their own currencies, so they could not use monetary policy or exchange rate policy. In addition they would not be permitted to use tariffs or quotas. So, in practice, they could at most use fiscal policy, running deficits if they wanted to raise aggregate demand in their areas and surpluses if they wished to restrain aggregate demand in their areas.

As local authorities could, in principle, operate surpluses and deficits, it might seem that it would be reasonable to allow them to use fiscal policy to operate modest stabilization programmes. Such a strategy however encounters several problems.

First of all there are the general difficulties of an active anti-cyclical fiscal policy, which are probably even greater at the level of the local authorities than at the level of the central state, for example the problem of the timing of measures.

A second problem is that local authorities are typically so small that any macroeconomic effects they had would tend to spill over into other areas. If an individual authority wished to reduce unemployment in its area by running a deficit, it might decide to cut taxes in order to raise consumer spending and simultaneously use loans to keep its own public spending at its previous level.

But probably most of the extra consumer spending would be devoted to imports from outside the area, so that most of the extra employment would be created elsewhere.

Another problem stems from an argument presented below to the effect that local authorities should generally confine their use of loans to the finance of capital expenditure and that they should confine their use of taxes to the finance of current expenditure. If this argument is accepted, then they could run deficits only to the extent that they borrowed to finance capital spending, and they could not properly run surpluses.

So their use of fiscal policy would simply be confined to raising or lowering their levels of capital spending and borrowing according to the needs of the moment. But the necessity to alter their capital spending for macroeconomic purposes places a considerable constraint on their ability to use fiscal policy.

All in all local authorities are in an even worse position to run an active demand-side stabilisation policy than higher levels of government. But that does not mean that they are altogether unimportant. In a supply-side oriented policy frame, local authorities can play an important role in stabilising policy. This would for example involve stable and reliable investments in public infrastructure and – in general – the creation of a business-friendly atmosphere which attracts private investment and the creation of jobs.

The arguments that have been presented so far are well-known tenets from public finance theory. Since the treaty of Maastricht and the launching of the Economic and Monetary Union there is another important aspect that the member states of the European Union have to consider. At present, and even more so in the future, fiscal policy has to be judged in the light of the Maastricht criteria, which say that candidates for the monetary union must – among other things – not run an excessive deficit.

The treaty and the protocols annexed to it do not exactly describe what an excessive deficit situation is, but two criteria are named as reference values: a general government deficit of more than 3% of national gross domestic product (GDP) and a general government debt of more than 60% of GDP[1]. These criteria are not only to be fulfilled on entering the Monetary Union, but are also to be constantly respected by the members of the EMU.

Where local authorities enjoy some degree of freedom in their fiscal policy and where their deficits or surpluses form a larger part of the deficit of the General State, the necessity of close co-ordination among the different levels of the state will arise. This might, at least in some cases, even result in a new definition of the tasks and means of the various level of government.

1 Protocol No 5 to the European Union Treaty, on the procedure concerning excessive deficits, Article 1.

Problems with local government participation in redistribution

The difficulties with local authority participation in redistribution are quite different from the difficulties with their participation in stabilization. For local authorities certainly could be given weapons in the form of tax powers and transfer payment programmes. The problem is that the possibility of inter-area migration would make it very hard for individual areas to pursue their own independent policies. Thus, if a given area operates the least redistributive policies in relation to other areas, in due course, all other areas might have to operate similarly modest programmes of redistribution irrespective of the wishes of their inhabitants, the reason being that if those other areas introduced more redistributive policies than the given one, they would tend to drive rich people out and lure poor people in, and so find their positions untenable.

Perhaps the only qualification to make here is that small differences in distribution policies between areas will probably not cause problems.

Why governments provide services

Whilst there are problems with local authority participation in stabilization and redistribution, there are far fewer problems with local authority participation in the provision of government services. There is, of course, much to be said for leaving the provision of goods and services to the market sector. For firms have to provide the goods and services which consumers want in order to survive, and competition between firms should ensure that they produce goods and services efficiently.

However, there are several situations when governments do not leave resource allocation wholly to markets. These are situations when markets do not work very well, and they are called situations of "market failure". Market failure can arise in the case of the production of various items including the following:

- items where production is left to a monopolist, as may be the case, for example, with electricity, gas, water, sewerage; where there is a monopoly, to ensure that private firms do not exploit their position with high prices and poor services, there might be a statutory regulatory regime, or the public sector itself may take over production;

- items where pricing would be virtually impossible, such as defence and the police: here private firms would provide little or nothing, so the government sector may provide the services itself and force everyone to pay through taxes;

- items such as refuse collection which are intended to solve problems of externalities, for with market provision many people might throw their refuse in the streets or in the fields, rather than pay a private firm to remove it: here the government sector may respond by either providing the services itself or requiring the services to be provided by the private sector; in both cases it is usual for the services to be financed through taxes or other compulsory levies;

- items where people might consume less than the government would wish, perhaps especially education and health, for some people might be too poor to spend much on these items, and also some parents might ignore the benefits of education and health insurance for their children: here, again, the government may respond by providing the services itself and financing them with taxes that fall least heavily on poor people.

The case for allowing local authorities to participate in the provision of public services.

The arguments for allowing local authorities to participate in the provision of public services can be divided into two groups. Firstly, there are some advantages in having more than one tier of government. Secondly, there are some advantages for giving many services to the lower tiers.

The advantages of having more than one tier include the following:

- having more tiers means that electors have more votes and thus have more opportunities to signal their preferences;

- having more tiers means that each elected representative needs to supervise fewer services and fewer officials. Much of the recent public choice literature focuses on how far bureaucrats can further their own interests. A higher ratio of informed politicians may help to control them;

- having more tiers may help electors to evaluate the costs of each tier's services, but this will be possible only if the taxes of each tier are perceptible and relate closely to that tier's spending.

If voters can be thus made aware of the costs of the services provided by each tier, then they can weigh up those costs against the benefits. In turn, they may make better informed choices about whether the services are good value for money and whether they would like to see those services expanded or contracted.

The advantages of allowing lower tiers to provide some public services include the following:

- it enables the quality and quantity of service provision to vary between areas in accordance with local preferences. In contrast, central provision is likely to lead to uniformity rather than variety. This advantage of local authorities is recognised in article 4 of the European Charter of Local Self-Government which suggests that local authorities should, insofar as it is possible, be allowed discretion in adapting the exercise of their powers to local conditions;

- it allows people who do not like the service provision in their areas to migrate elsewhere;

- it is likely to facilitate more experimentation and innovation in service provision. In turn, this will facilitate comparisons between different modes of service provision.

It is not always appropriate to entrust local authorities with the provision of government services. There are two main situations where it may be inappropriate:

- local authorities may ignore the effects of their services on citizens in other areas. So it may be inappropriate to entrust them with services where these external effects are large. One particular worry here is that if the external benefits are large and are ignored, then local authorities may provide too little of the service concerned. This worry has usually pointed to the provision of main roads being best suited to very large local authorities or even to central governments;

  local authorities may be too small to exploit the economies of scale that arise with the production of some services. This possibility has usually pointed to defence being best handled by the central government or by an international body. But it should be noted that this problem is not always as serious as it might seem, for local authorities need not produce all the services that they provide because there are some services that can be purchased from private firms. For example, refuse collection and road maintenance can be contracted out; on the other hand, police services and planning cannot. Where services can be contracted out, it may be possible for small local authorities to commission large firms to produce the services. In this way, small areas may not be at much of a cost disadvantage.

Agency functions

The above discussion has implied that when local authorities provide services, they have substantial control over those services. But they may also undertake some activities on an agency basis for the central government. It is important to distinguish between genuine local services and agency functions because they require different financial arrangements from genuine local services.

II. OVERVIEW OF LOCAL FINANCE IN THE MEMBER STATES OF THE COUNCIL OF EUROPE

This chapter presents an overview of local finance in the member states of the Council of Europe with the aim of providing a numerical reference for the remarks that will be made in the following chapters.

For the purpose of facilitating the analysis, only percentages are presented.

The chapter first takes a look at municipal expenditure as an indicator of the relative importance of municipal economic intervention. The importance of this figure is checked against gross domestic product (GDP) and general government expenditure (GGE). Within municipal expenditure, special attention is put on municipal investment expenditure and its importance is assessed in relation to total municipal expenditure (M), general government investment expenditure (GGIE) and GDP.

Once the general framework of municipal expenditure is established, the chapter considers the various sources of municipal funding: exclusive local taxes, fees and charges, transfers and borrowing. Special attention is put on the category of transfers and for this reason, the various sub-categories of transfers: shared taxes, general grants and specific or earmarked grants are examined.

Municipal Expenditure

The amount of municipal expenditure varies significantly between the member states of the Council of Europe. For the purposes of the present report, two indicators are used to assess the relative importance of this item. Municipal expenditure (**M**) is expressed as a percentage of the gross domestic product (**M/GDP**) and of the general government expenditure (**M/GGE**).

Table 1 contains member states' percentages for these indicators. Leaving apart the countries, which for their specific features plot particularly low figures (below 1%), values for M/GDP range from 1.4% to 27.5%, while those for M/GGE from 4.1% to 60%. Differences are thus significant.

The first indicator (M/GDP) is shown in chart 1. Five member states are above the 15% mark, ten member states cast figures from 1% to 5% and the others can be found in the 5-15% range.

The second indicator (M/GGE) is shown in chart 2. Six member states can be found over the 30% mark. The vast majority of member states cast figures for M/GGE; in the 10-30% range and four in the 1-10% range.

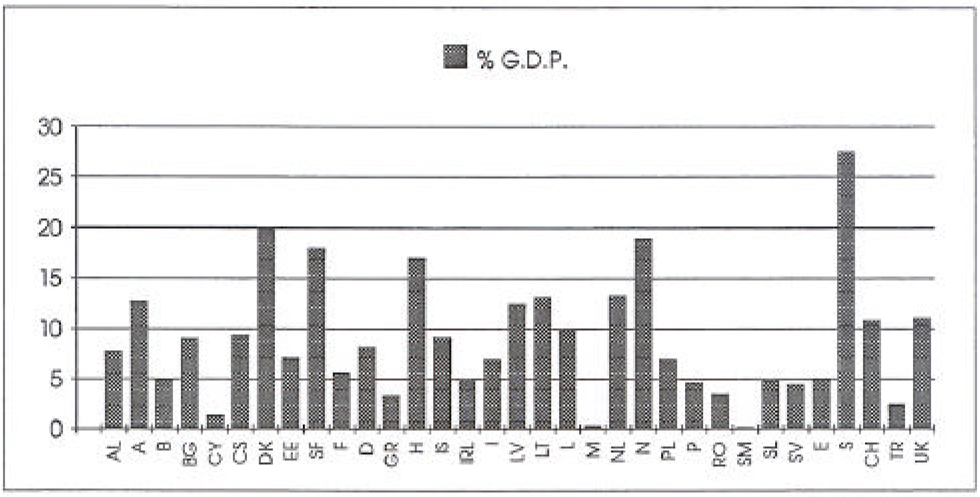
Table 1: Municipal expenditure in relation to Gross Domestic Product (G.D.P.) and General Government Expenditure (G.G.E.)

Country		% G.D.P.	% G.G.E.	
Albania	AL	7,7	25,4	1995 (1)
Austria	A	12,71	20,18	1993
Belgium	B	4,9	10,9	1993
Bulgaria	BG	9	20	1994
Cyprus	CY	1,4	4,1	1993
Czech Republic	CS	9,3	20,9	1994
Denmark (2)	DK	19,9	31,28	1994
Estonia	EE	7,1	17,6	1994
Finland	SF	18	29,5	1993
France	F	5,54	27,22	1992
Germany	D	8,12	28,69	1993
Greece	GR	3,33	5,6	1989
Hungary	H	17	53	1994
Iceland	IS	9,1	22,3	1994
Ireland	IRL	4,9	13,8	1994
Italy	I	7	13	1993
Latvia	LV	12,45	24	1994
Lithuania	LT	13,1	58,8	1993
Luxembourg	L	9,92	32,3	1993
Malta	M	0,337	0,629	1995
The Netherlands	NL	13,3	23,1	1994
Norway (3)	N	18,9	60	1994
Poland	PL	7	21,6	1994
Portugal	P	4,6	9,7	1993
Romania	RO	3,5	16,9	1993
San Marino	SM	0,11	0,19	1993
Slovakia	SL	4,79	11,78	1994
Slovenia	SV	4,4	10,1	1995
Spain	E	4,87	12,17	1994
Sweden	S	27,5	38	1994
Switzerland	CH	10,8	27,9	1993
Turkey	TR	2,41	12,3	1992
United Kingdom	UK	11	27	1994

Source: Council of Europe

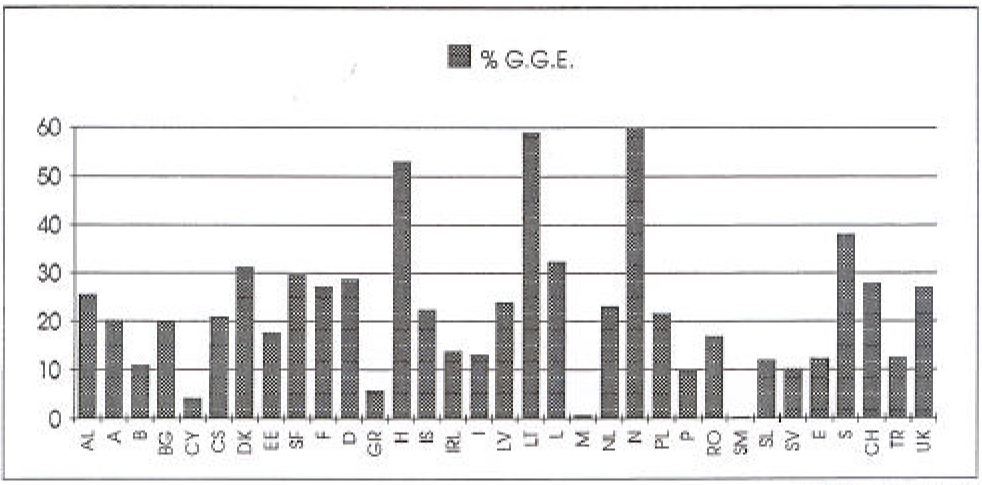
(1) Reference Year.
(2) The Danish Statistical Agency uses a definition of municipal sector which includes expenditures with 100% reimbursement (eg: pensions). According to this definition, total municipal expenditure amounts to 251.364.000.000 crowns 26.9 % GDP and 42.3% GGE.
(3) Given that Oslo is at the same time a municipality and a county-municipality and it amounts to the biggest share of municipal expenditure, the total figures include municipalities and county-councils.

Chart 1: Municipal expenditure in relation to Gross Domestic Product



Source: Council of Europe

Chart 2: Municipal expenditure in relation to General Government Expenditure



Source: Council of Europe

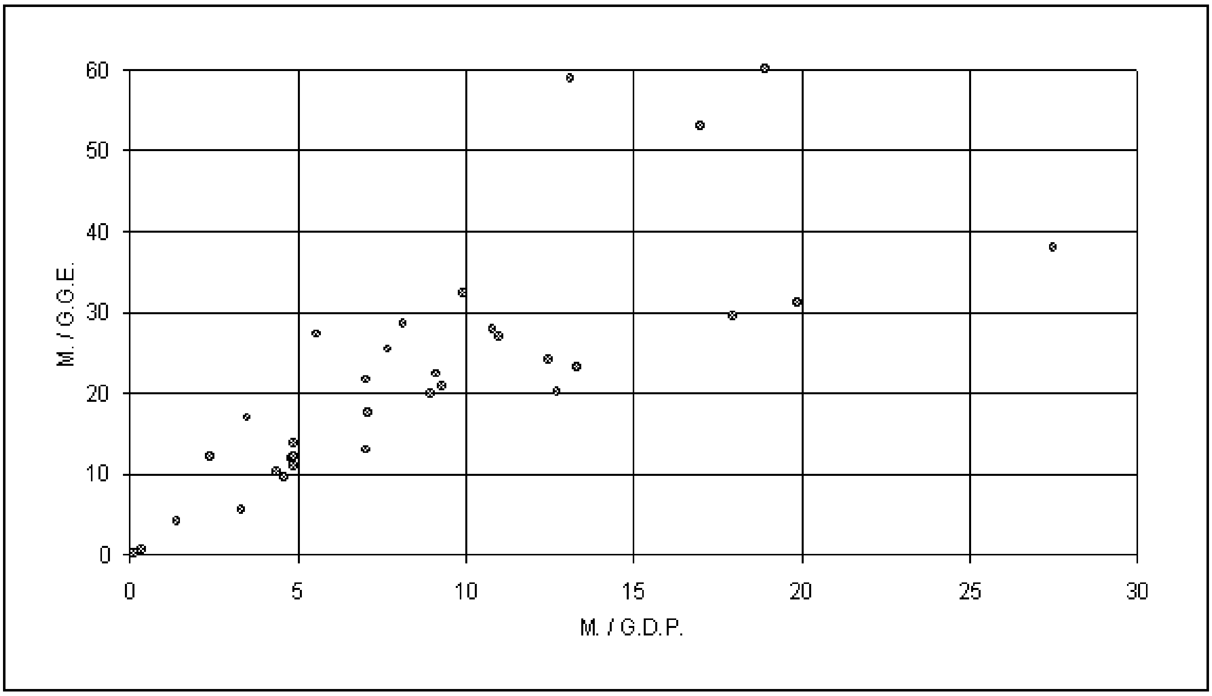
There does not appear to be any link between the levels of municipal expenditure in relation to gross domestic product and its level in relation to general government expenditure. In fact, in order to establish a possible relation between the two indicators, it would be necessary to refer to several variables, such as the importance of the local public sector or the number and strength of tiers of government. Thus, a correlation model cannot be established on the sole basis of the information provided.

Nevertheless, when determining states' position by simultaneously using both indicators, the resulting chart (chart 3, below) shows that states tend to concentrate in the quadrant which is defined by the intervals M/GGE: 0-30% and M/GDP: 0-15 %.

Thus, it can be said that in most member states of the Council of Europe, municipal expenditure accounts for less than 15% GDP and less than 30% of GGE.

Within this quadrant, two areas show up; the first one is defined by M/GGE: 0-20% and M/GDP: 0-5, which groups twelve states; the second one by M/GGE: 20 - 30% and M/GDP: 5 -15%, which groups fourteen states. Seven countries are located outside this quadrant.

Chart 3: Municipal Expenditure in the member states of the Council of Europe



Source: Council of Europe

Municipal Investment Expenditure

In the framework of municipal expenditure, it is particularly interesting to examine the relative importance of investment. For this purpose, municipal investment expenditure (**I**) is assessed in relation to total government investment expenditure (**GGIE**) and to gross domestic product (**GDP**). Table 2 shows the resulting values concerning the ratios municipal investment expenditure over total municipal expenditure (I/M), municipal investment expenditure over general government investment expenditure (I/GGIE) and municipal investment over gross domestic product (I/GDP).

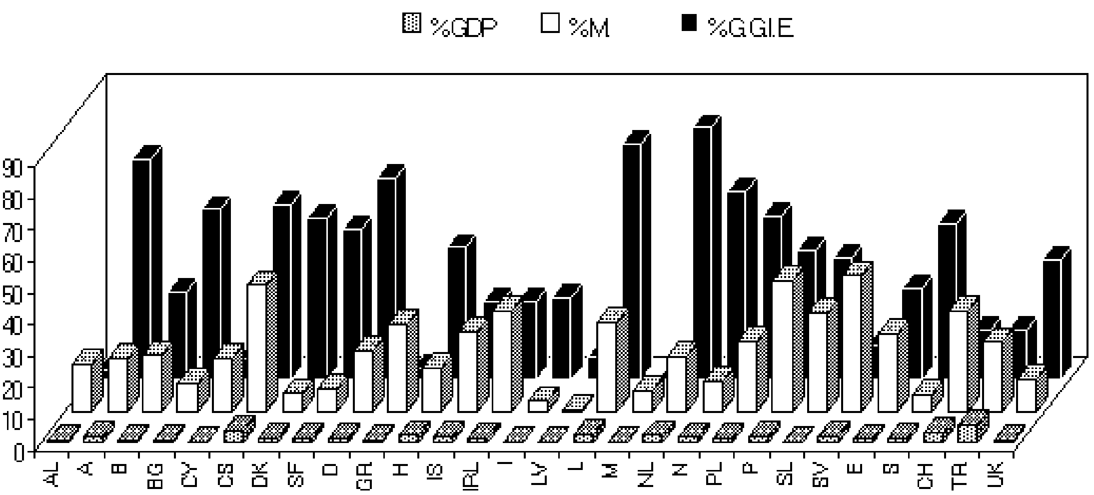
Concerning the first ratio (I/M), only one country is below 1%, while the figures for the remaining countries can be found from 3% upwards. Three member states can be found above 30%.

Concerning the second ratio (I/GGIE), values range from below 1% to over 80%. Eleven countries cast particularly high values (around or over the 50% mark).

Concerning the third ratio (I/GDP), values are below 4%. Eight countries cast values below 1%, and only two over 3%.

The corresponding values for I/M, I/GGIE and I/GDP are plotted together in Chart 4 below.

Chart 4: Municipal Investment Expenditure in the member states of the Council of Europe



Source: Council of Europe

Table 2: Municipal Investment Expenditure in relation to Total municipal expenditure (M.), to General Government Investment Expenditure (G.G.I.E.) and to Gross Domestic Product (G.D.P.)

Country		% M.	% G.G.I.E.	% G.D.P.
Albania	AL	14,44	3,05	1,11
Austria	A	16,77	70,30	2,13
Belgium	B	17,80	27,97 (1)	0,87
Bulgaria	BG	8,90	54,20	0,80
Cyprus	CY	17,10	6,70	0,24
Czech Republic	CS	40,00	55,90	3,72
Denmark	DK	5,70	51,40	1,26
Finland	SF	6,99	47,70	1,26
Germany	D	19,40	64,30	1,57
Greece	GR	27,92	3,88	0,93
Hungary	H	13,80	42,20	2,35
Iceland	IS	25,27	25,11	2,23
Ireland	IRL	32,00	25,00	1,57
Italy	I	3,31	26,18	0,23
Latvia	LV	0,64	7,76	0,08
Luxembourg	L	28,05	75,22	2,78
Malta	M	6,79	0,22	0,02
The Netherlands	NL	17,50	80,10	2,33
Norway	N	9,40	60,00	1,78
Poland	PL	22,50	52,00	1,58
Portugal	P	41,40	41,50	1,90
Slovakia (2)	SL	31,20	38,80	-
Slovenia	SV	43,00	11,20	1,89
Spain	E	24,43	29,41	1,19
Sweden	S	5,60	49,80	1,54
Switzerland	CH	31,70	15,83	3,42
Turkey	TR	22,00	16,00	5,53
United Kingdom	UK	10,00	38,00	1,10

Source: Council of Europe

(1) Flanders region only
(2) The reference year for these figures (1995) is different from that of figures in table 1 (1994); for this reason it is not possible to calculate the ratio municipal investment/Gross Domestic Product

Sources of Municipal Funding

Four main sources of municipal funding are examined: exclusive local taxes, fees and charges, financial transfers and borrowing.

Other sources of funding are grouped under the heading "other". They include fines and penalties, specific incomes from municipal organisations, interest of municipal deposits and most important, incomes resulting from the use of municipal goods and from sale of municipal property. The latter explain to a certain extent, considerable high figures for this category in certain countries.

Table 3 gives percentages for each of the categories mentioned above. When plotting these percentages in a composed bar graphic (see chart 5), it can be observed that the aggregates of municipal funding vary to a considerable extent.

Exclusive local taxes and financial transfers are particularly important in order to assess the financial structure of local government.

Exclusive local taxes

The weight of exclusive local taxes in municipal funding ranges from 0% to over 60%. In nine member states exclusive local taxes do account for more than 30% of municipal funding.

Exclusive local taxes are further examined in chapter IV.

Fees and charges

As a general rule, fees and charges do not account for more than one third of municipal funding. They weight more than 20% in five countries and 3% or less in seven.

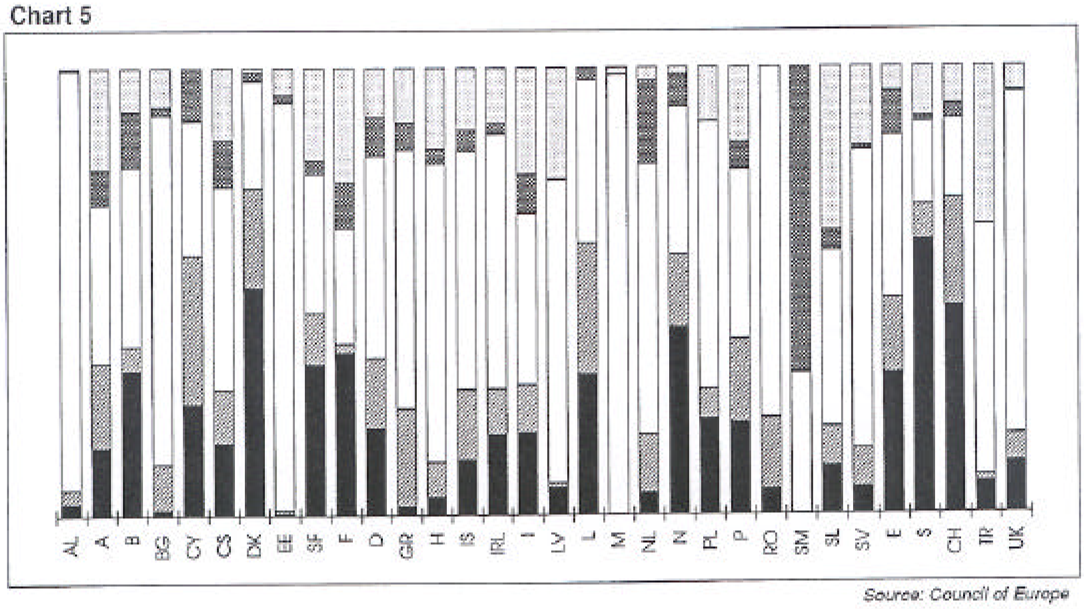
Fees and charges are further developed in chapter III.

Table 3: Sources of municipal funding

Country		Excl. local taxes	Fees & charges	Transfers	Borrowing	Other
Albania	AL	2,50%	3%	94%	0%	0,50%
Austria	A	15%	19%	35%	8%	23%
Belgium	B	32%	5%	40%	13%	10%
Bulgaria	BG	1%	10%	78%	2%	9%
Cyprus	CY	25%	33%	30%	12%	0%
Czech Republic	CS	16%	12%	45%	11%	16%
Denmark	DK	51%	22%	24%	2%	1%
Estonia	EE	0,10%	0,90%	91%	2%	6%
Finland	SF	34%	11%	31%	3%	21%
France	F	36%	2%	26%	10%	26%
Germany	D	19%	16%	45%	9%	11%
Greece	GR	2%	22%	58%	6%	12%
Hungary	H	4%	8%	66%	4%	18%
Iceland	IS	12%	16%	53%	5%	14%
Ireland	IRL	18%	10%	57%	2%	13%
Italy	I	18%	11%	38%	9%	24%
Latvia	LV	6%	1%	68%	0%	25%
Luxembourg	L	31%	29%	37%	3%	0%
Malta	M	0%	0%	98%	0%	2%
The Netherlands	NL	5%	13%	60%	19%	3%
Norway	N	42%	16%	33%	7%	2%
Poland	PL	21%	7%	60%	0%	12%
Portugal	P	20%	19%	38%	6%	17%
Romania	RO	5%	16%	79%	0%	0%
San Marino	SM	0%	0%	31%	69%	0%
Slovakia	SL	10%	9%	39%	5%	37%
Slovenia	SV	5%	9%	67%	1%	18%
Spain	E	31%	16%	37%	10%	6%
Sweden	S	61%	9%	19%	1%	11%
Switzerland	CH	46%	24%	18%	3%	9%
Turkey	TR	7%	1%	56%	0%	36%
United Kingdom	UK	11%	6%	77%	0%	6%

Source: Council of Europe

Chart 5



Source: Council of Europe

Financial transfers

In its various forms (earmarked grants, block grants, share taxes or others), financial transfers represent the main component of municipal funding. National figures for this item range from 18% to 98%, with most states situated in the 30-60% band. Over the 60% mark nine member states can be found, while below the 30% mark, values are cast by four countries.

Two main types of transfers can be distinguished: grants – which include two sub-types: earmarked grants and block grants – and shared taxes. Other types of transfers are grouped under the heading "other". Table 4 shows the corresponding values for each type of transfer as a percentage of total municipal revenues.

Figures in table 4 are plotted in chart 6, which highlights the relative importance of each type of transfer.

Tax-sharing is further examined in chapter IV and grants are examined in chapter V.

Borrowing

In most countries, local borrowing for financing municipal expenditure accounts for less than 10% of the total municipal funding. Two countries are on this mark and five countries are above it.

The CDLR study on "Borrowing by local and regional authorities"[1] presents the situation in various member states.

1 Study series "Local and Regional Authorities in Europe", N° 47. Council of Europe. Strasbourg - 1992.

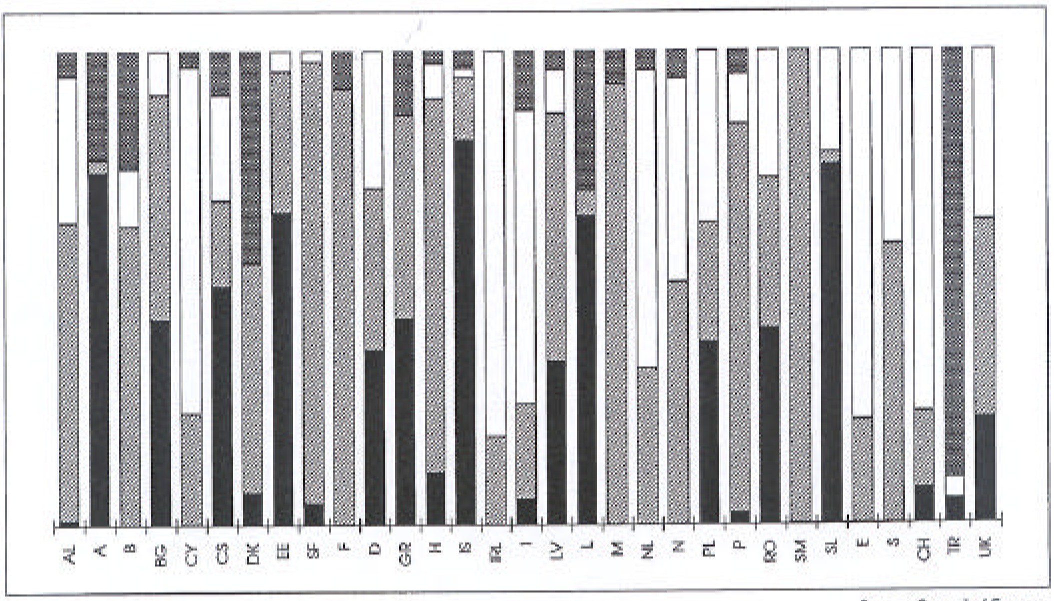
Table 4: Transfers breakdown

Figures in percentage of total municipal resources

Country / Pays		Shared taxes	General grants	Earmarked grants	Other
Albania	AL	1%	59%	29%	5%
Austria	A	26%	1%	0%	8%
Belgium	B	0%	25%	5%	10%
Bulgaria	BG	34%	37%	7%	0%
Cyprus	CY	0%	7%	22%	1%
Czech Republic	CS	23%	8%	10%	4%
Denmark	DK	2%	12%	0%	11%
Estonia	EE	60%	27%	4%	0%
Finland	SF	1%	29%	1%	0%
France	F	0%	24%	0%	2%
Germany	D	17%	15%	13%	0%
Greece	GR	25%	25%	0%	8%
Hungary	H	7%	52%	5%	2%
Iceland	IS	43%	7%	1%	2%
Ireland	IRL	0%	11%	46%	0%
Italy	I	2%	8%	24%	5%
Latvia	LV	23%	35%	6%	3%
Luxembourg	L	24%	2%	0%	11%
Malta	M	0%	91%	0%	7%
The Netherlands	NL	0%	20%	38%	3%
Norway	N	0%	17%	14%	2%
Poland	PL	23%	15%	22%	0%
Portugal	P	1%	31%	4%	2%
Romania	RO	33%	25%	21%	0%
San Marino	SM	0%	31%	0%	0%
Slovakia	SL	30%	1%	8%	0%
Spain	E	0%	8%	29%	0%
Sweden	S	0%	11%	8%	0%
Switzerland	CH	1%	3%	14%	0%
Turkey	TR	3%	0%	3%	51%
United Kingdom	UK	17%	32%	27%	0%

Source: Council of Europe

Chart 6



Source: Council of Europe

III. THE SOURCES OF LOCAL GOVERNMENT FINANCE AND THEIR USE

The four main sources of local government finance are loans, charges, taxes and grants. However, these should not be regarded as wholly substitutable. In fact, four guidelines can be asserted in the use of sources:

- charges should be used where possible for current spending and rarely for capital spending;
- where charges cannot be used for current spending, taxes should be used as far as possible in the case of genuine local services. Taxes should rarely be used for capital spending;
- where charges cannot be used for current spending on agency services, grants should be used as far as possible. Grants may also be appropriate for some capital spending;
- loans are very suitable for capital spending but should rarely be used for current spending.

The use of loans

The principles concerning the finance of capital and current spending stem from a value judgement that local authority citizens should pay for local authority spending which goes on things they enjoy, but not pay for local authority spending which goes on things they do not enjoy. For this reason, it is particularly important to consider the life span of the assets when deciding about their financing. Strictly speaking, this value judgement has four implications, as follows:

- loans are appropriate for local authority capital spending. This is because capital spending benefits people for years to come and the repayments and the interest on the loans will be paid from taxes raised in years to come. In line with this point, Article 9 of the European Charter of Local Self-Government argues that local authorities should have access to capital markets to borrow for investment purposes;
- loans are inappropriate for local authority current spending. This is because using loans for current spending would enable present citizens to shift the cost of the current spending which benefits them on to future citizens who will receive no benefit. If loans were used for current spending, there could be an excessive amount of spending as citizens would be tempted to vote for high levels of spending which they would not pay for;

- taxes and charges are generally inappropriate for local authorities' capital spending. If they are used for capital spending, then present citizens will have to meet the full cost of this spending even though much of its benefits will be felt only by future citizens. If taxes and charges are relied on for capital spending, there may be too little capital spending as citizens might be reluctant to pay the full cost of items from which they will receive little benefit;

- taxes or charges are acceptable for financing local authority current spending. For current spending benefits current citizens, and the burden of taxes and charges falls on today's citizens.

However, it may be added that there are two reasons why some capital spending may be financed by taxes or charges, or, effectively by a current account surplus.

- Future generations have no vote about how much capital spending the present generation will undertake and thus they have no vote about how much in the way of loans the present generation will incur that future generations will have to help repay. So the idea that future generations are entitled to enjoy some subsidy at the expense of the present generation is at least defensible; by implication, it is defensible to expect the contribution towards the cost of capital assets made by the present generation to be a little higher than their share of the expected benefits. It seems therefore reasonable to argue that there should be some tax or charge finance as well as loans for financing capital assets.

- Banks and other lenders may be unwilling to meet the entire cost of capital projects with loans. The tendency of most lenders is to expect borrowers to put up some of the finance themselves, not least as some way of reducing the risks to the lenders. Thus financial market behaviour may often require some contribution from local authority saving, that is from a current account surplus secured from charges or taxes, for the purchase of capital assets.

It may also be added that the use of loans for current spending need not always be eschewed. There are perhaps three occasions when they are an acceptable form of finance for current spending.

- It often happens that a local authority’s spending flows occur at a fairly constant rate throughout the year. In contrast, revenue flows may be less constant. An extreme case of irregular flows would occur if an authority relied on a property tax in which taxpayers paid by one annual instalment. In this case revenues might arise largely on a single day in the course of a year. It is quite reasonable for local authorities to use short-term borrowing to offset irregular flows of revenue. But in general they should be required over the course of a year either to balance their books on current account or run a small surplus to help meet the costs of capital spending.

- Occasionally a local authority will find the need to undertake current expenditure that was not foreseen. For example there might be damage caused by a storm or by a natural disaster. Or there might be a major incident requiring large unforeseen expenditure on the police. Unless local authorities have the power to raise tax rates at short notice, there is little alternative but for them to borrow to meet these unexpected needs.

- A local authority might rely on a local income tax and find that the economy moves into an unanticipated recession. Consequently, its tax revenues may turn out to be less than it might reasonably have expected, and they might be too little to meet its current expenditure commitments. A temporary loan here would seem in order.

Having established that loans are, in general, the most appropriate source of finance for capital spending, a few further points about their use may be mentioned.

Ideally, the period of the loan used to finance a given project should be the same as the expected life of the capital which it is used to finance, and repayments should be made throughout this time. In this way, all citizens benefiting from the project will contribute to its cost. Of course, it is often hard to predict the lifespan of assets. Column (3) of table 5 below shows that few countries covered by the Council of Europe's 1993 Report actually laid down rules relating the length of local authority loans to the life spans of the assets they are used to finance.

Table 5: Some aspects of local authority borrowing

Country	Access to capital markets *(1)*	Borrowing foreign currencies *(2)*	Rules over terms of loans *(3)*
Austria	With approval	With consent	Few rules
Belgium	With approval	With consent	Few rules
Denmark	Free	Unrestricted	30 years maximum
Finland	Free	Unrestricted	None
France	Almost free	Some rules	None
Germany	Free	With consent	Usually asset life
Greece	With approval	n.a.	n.a.
Ireland	With approval	Does not occur	Usually asset life
Italy	Free	n.a.	n.a.
Netherlands	Free	Not allowed	Few rules
Norway	With approval	Not allowed	Linked to asset life
Portugal	Free	n.a.	Linked to asset life
Spain	With approval	With consent	Few rules
Sweden	Free	Unrestricted	No rules
Switzerland	Free	Very rare	Few rules
United Kingdom	With approval	Very rare	Few rules

Source: Council of Europe (1993), Borrowing by Local and Regional Authorities; updated by the present report

n.a. not available

In order to secure equity between the generations which will benefit from the asset that a given loan finances, the share of the total interest plus repayments made each year on the loan should ideally equal the share of the total benefits enjoyed that year from the asset concerned; although, as noted above, maybe the present generation which votes for the asset should pay a slightly larger than proportional share of the cost, by means of some use of taxes or charges, thus effectively giving a small subsidy to future generations which have no vote.

Local authority borrowing may be controlled for macroeconomic reasons. For if local authorities borrow more and spend more, then their extra spending will add to aggregate demand while their extra loans will do little to reduce it. So there may be an appreciable rise in aggregate demand. Table 2 showed that investment expenditure by local authorities is, in most cases, above 1% of GDP and occasionally 2% or more. In a country where it would be, for instance, 3%, a rise by one third would, if financed by borrowing, add some 1% to aggregate demand.

Borrowing controls may also be imposed on individual authorities to ensure that they do not borrow more than they can reasonably afford to repay; such controls serve to protect their creditors.

Column (1) of table 5 shows that access to capital markets by local authorities is free in less than half the countries covered by the survey. Where there are rules over such access, column (2) shows that there are usually also rules covering borrowing in foreign currencies.

Controlling loans in aggregate is not always easy. A particular problem is that while caps may limit the total, the total may sometimes be much less than planned and it is hard for central governments to raise it. Moreover, there can be difficulties in apportioning the total permissible amount of borrowing between individual authorities.

The use of charges

Charging for local services has become very topical in recent years. This is partly because economists see genuine attractions in this form of finance and partly because politicians are always anxious to find substitutes for taxes. In discussing charges, it is helpful to distinguish between two types of charges, which will be termed real charges and quasi-charges.

"Real charges" occur when the amount of money that individual people pay are closely related to their usage of the charged service. Examples might include:

- charges for water that are based on meter readings;
- charges for refuse collection that are based on the volume or weight of refuse;
- charges for entering museums (especially if they relate to the time spent in the museum).

"Quasi-charges" occur when the amount of money which individual people pay are based on formulae rather than on their actual usage of the services concerned. Examples would include:

– charges for water that are based on property values;
– charges for refuse collection that are based on the size of homes or the number of residents;
– charges for heating that are based on the size of homes.

The attractions of real charges

To economists, it is real charges which have the most attraction. In fact, real charges can closely resemble market-pricing. Where they are feasible as, for instance, with water and museums, they may have efficiency advantages over tax finance and may also have equity advantages.

- The efficiency argument for charges is that a charged service, unlike one provided out of tax revenue, is no longer "free" at the margin; thus people will consume more of it only so long as the extra benefit to them is greater than or equal to the extra cost of supplying it. This is an advantage in most cases, including water, because it will discourage people from wasting water. It is less of an advantage in a few cases, such as museums and parks, unless they are filled to capacity; for when they are not full, the cost of admitting an extra visitor may be effectively zero, so that in fact the efficient price is also zero.

- The equity argument for charges is that heavy usage households will pay more than light usage households. For example, if water is paid for by a local income tax, then a household with a hose-pipe and a swimming pool will pay no more than an equal income household with neither, while if museums are paid for through taxes, there will be no tendency for regular visitors to pay any more for them than people who never visit them.

It should be added that an equity argument against charges is sometimes mentioned, namely that they can be a burden to poor people who make heavy use of charged services. This problem is often addressed by having some form of price discrimination with reduced charges for groups such as students, the unemployed and the elderly. But there might instead be a case for increasing transfer payments to these groups and instead confronting them, like everyone else, with charges that reflect the real cost of the services they are consuming.

The limitations of quasi-charges

Quasi-charges are much less satisfactory than real charges in terms of both efficiency and equity. To see why, consider charges for water that are based on property values.

The efficiency problem with these charges is that the consumption of more water is effectively "free". So people may consume some water which they value at less than the cost of supplying it. In other words, they may waste water.

The equity problem with these charges is that high users may pay no more than low users.

In fact, some taxes may do a better job at replicating real charges than quasi-charges do. For instance, a fuel tax might come quite close to replicating a real charge to car owners for the wear and tear made by their vehicles on roads.

Difficulties in using charges

The above analysis has indicated that charges are attractive in principle. But, in practice, charges are not feasible for many services provided by governments. This can be explained with reference to the reasons noted earlier that governments provide services at all. These reasons are recalled below, together with a comment on the feasibility of charging for the services thus provided.

- To provide services where there might be monopolies – such as gas, electricity and water. Charges can be used here and real charges are often used. Note that these services are often provided under conditions of falling marginal costs which means that setting prices equal to marginal costs would result in the enterprises concerned making losses. Consequently, two-part tariffs are sometimes used.

- To provide services where charging is not feasible, such as defence or the police. Clearly charges cannot be used here.

- To provide services that are intended to sort out externality problems, such as a refuse collection service that is intended to remove any incentive for people to throw their refuse in streets or fields. Real charges are sometimes used here, for example in parts of Switzerland. A simple method of operating them is to collect refuse only if it is placed in distinctive municipal bags that can be bought at a price that covers refuse collection and disposal costs. But the risk with real prices is that they will invalidate the aim of the service and encourage people to throw their refuse elsewhere. Quasi-charges might be more appropriate in this case.

- To stimulate the consumption of merit goods. Real charges would tend to offset the point of government intervention, at least if they attempted to cover the full costs of the service. But perhaps local authority services such as parks, museums, swimming pools, sports centres and old people's homes can be seen as merit goods where there is a desire for stimulating consumption by means of subsidized provision; in this case, real charges that covered part of the cost might seem the most appropriate form of finance, for they would secure some equity between heavy and light users, and would confront users with at least a non-zero price. But in the case of parks and museums, at least, there is also an argument for low, or possibly zero prices, on the grounds that the cost of admitting an extra person is zero.

So, in practice, complete reliance on real charges is usually limited to items under the first of these four headings.

This analysis may seem to imply that charges should be used at least where they are reasonably feasible. But even when they are feasible, they may not be the best method of finance. One reason for this is that charges may be costly to implement.

For example, water charges based on metering, though used in many countries, may not always be preferable to taxes as a source of finance for the supply of water. Operating such a system of charges requires each home to be metered and requires each meter to be read frequently. This entails substantial costs. The cost of installing and reading water meters may exceed the cost of supplying the extra water that would be demanded if water supply were not paid for according to usage.

Another problem with charges is that they can sometimes cause inefficiency. In a park or a museum with an entrance fee of 10 euros, people who are not prepared to pay more than, for instance, 5 euros would not go in. This seems a pity because admitting them costs nothing so it is unsatisfactory to keep them out. But although charges create this inefficiency, they do also create equity inasmuch as those people who use parks and museums the most will also pay the most. So a decision must be taken that weighs up the advantages of equity against the disadvantages of inefficiency.

Some possible uses of charges

Although the above sections have suggested that charges are often inappropriate in practice, there may be many occasions where countries do not currently use them, even though they would be appropriate. For example, charges might not always be used in the following circumstances where they would seem defensible:

– police attendance at football matches;
– fire prevention advice;
– hospital meals;

- adult education;
- extra-curricular education by schoolchildren;
- some library services;
- providing licences such as birth certificates;
- charging for crowded roads – it is likely that in future years there will be an especially keen interest in devising ways of charging here, for, on balance, it seems better to charge motorists who congest roads than subsidise public transport as an alternative.

Betterment levies

One final issue relating to charging may be mentioned here. Local authorities are often responsible for improving the infrastructure, for example by building roads in newly industrializing zones. Such improvements clearly benefit business in the zones concerned and there seems a case for charging them for these improvements by means of a one-off charge, such as a betterment levy. Such a levy would thus be a charge for capital expenditure. It might seem that such a levy would place the whole cost of the improvement on the initial businesses in the area, but they could hope to recoup much of the cost when the time comes to sell their properties because their property values will increase as a result of the improvements.

But perhaps some caution needs mentioning with these levies. One problem is that they may deter new development, or perhaps divert it to areas where the levies are lower. Another problem is that if the local authority concerned raises a business tax, such as a property tax or a profits tax, then it should gain from the businesses through higher future tax yields, assuming that the infrastructure improvements create more valuable properties or result in greater profits. In these circumstances, operating a betterment levy might almost seem like double-charging.

IV. LOCAL TAXES

It was argued in the previous chapter that local authority current spending should generally be financed by means of charges, taxes and grants. It was also seen that charges may not be feasible for many aspects of local spending. Thus taxes and grants are typically relied on to finance the bulk of local current spending. This chapter begins with some comments about the appropriate balance between taxes and grants and then it looks more closely at local taxes. The following chapter looks more closely at local authority grants.

The balance between taxes and grants

It is argued below that the appropriate balance between taxes and grants differs for genuine local authority functions and agency functions. Accordingly, these two types of function are considered separately,

Financing genuine local services

With genuine local authority services, that is services where local authorities are largely free to determine their own policies, there are four reasons for arguing that they should raise most of the finance for current spending in the form of taxes, and rely to only a modest extent on grants. The four reasons are as follows:

- local taxes are necessary to enable local authorities to vary the quantities and qualities of their services in accordance with local wishes;

- when local authorities rely on grants, local politicians may spend the money inefficiently and blame the resulting poor services on under-funding;

- local politicians, civil servants and voters may take more care with money that is raised locally than with money that has been given to them;

- when a government pays grants, it may well want to control how local authorities spend them; indeed, arguably it *should* do so as it is accountable to its national taxpayers for this money. But there seems little point in financing genuine local services in a way that will result in central control.

The need for local discretion over tax rates

Article 9 of the European Charter on Local Self-Government argues that local authorities should be allowed some power to determine the rates at which their taxes are levied. In fact, the power to alter the tax rate, at least within limits, is really required by each of the four reasons just noted.

- Local authorities will not be able to vary the quality and quantities of their services in accordance with local wishes unless they can vary their revenues by altering their tax rates.

- So long as local authorities have no ability to vary the amount of tax revenue that they raise, they will always be able to spend their money inefficiently and blame poor services on their lack of funds, no matter how large their funds actually are.

- If local authorities have no control over their tax rate or rates, they may still feel that their tax revenue is effectively given to them by the central government, so they may not be very careful over how it is spent.

- If the central government decrees the tax rate or rates which local authorities may set, it may feel it is effectively responsible for raising the money which they spend. In turn, it may feel it is giving its own money away; so it may feel entitled to control the way in which the money is spent.

Regarding the first of these four arguments for some local control over local tax rates, it is sometimes argued that local authorities need only be able to vary a small local tax in order to alter their service provision in accordance with local wishes. Thus some countries allow local authorities to vary the rate of only a single tax that raises 15% or less of their total current tax-plus-grant revenue.

But relying on local discretion for taxes which raise only a small fraction of revenue may not be wholly satisfactory. Suppose that a local authority does receive only 15% of its total tax and grant revenue from taxes, and suppose it wishes to raise its revenue by, for instance, 7.5%, a seemingly small amount, then it must double the revenues from its taxes. Thus it is likely to double its tax rates. Such a large rise in tax rates could cause three problems:

- it could give misleading signals to local voters, for there is unlikely to be anything else they consume where they would have to spend twice as much to get so little more;

- following on from the above, voters may be confused about why tax rates vary so much more between areas than service levels vary;

- it is possible that the tax increase needed will be opposed on the grounds that it takes the rates for the tax concerned far above "reasonable" levels.

It is sometimes argued that one danger of local discretion over tax rates is that there may be a tax competition between areas. In such a competition, local authorities might compete with one another to set low rates in an attempt to attract business to their areas. It is possible to interpret such a situation in two ways.

First, it may be argued that the result will be that local services will be provided at a lower level than that desired by local voters, so that there is inefficiency in resource allocation. This is not a very convincing interpretation because voters will presumably not acquiesce in a situation where services are poorer than they would wish.

Secondly, it may be argued that voters are willing to put up with poor services in the short run, hoping that low taxes will entice businesses and raise the demand for labour, and thus cause a rise in wages in the long run. This may seem to make tax competition satisfactory, in the sense that it reflects voters wishes; but there is a problem that voters in each area are likely to look only at the effects of low tax rates on themselves when, in fact, their use of low tax rates to entice businesses has external effects on people in the other areas where those businesses might otherwise have gone.

On the basis of this second interpretation, it is in fact arguable that there is a problem with any attempt by local authorities to attract businesses in that such attempts affect non-residents. One possible solution might be to remove business taxes from local authorities in order to prevent these being used at low rates as a lure. But even non-business taxes could be used as a lure because an area might hope that if it set, say, a low local income tax rate, then it would tempt businesses which thought they could then pay low wages. Moreover, there is a strong case – noted elsewhere in this report – for local authorities to tax businesses in accordance with the benefits which businesses receive from local services.

The correct approach in any country should be to verify, first of all, if there is any evidence that tax competition of the sort considered here does occur. The impact of local tax rates on business locations is likely to be very small, while the impact on local services is likely to be significant. So there is an a priori reason for doubting whether this sort of competition is a problem. If it is, then an investigation should be made to see if there is typically a wide discrepancy between the level of local taxes and the level of benefits which businesses receive from local services, for this situation is one where tax competition is most likely to occur; and here the solution is to try to reduce the discrepancy. If tax competition were to persist, even when the levels of local business taxes and the benefits to businesses from local services roughly balanced, then there could be a case for regulating the extent to which local tax rates could differ.

It may be noted, though, that local authorities could replace tax competition by setting uniform tax rates and, instead, competing to offer lures for businesses, maybe even in the form of subsidies, at the expense of other services. So there may ultimately be a need for widespread regulation over the extent to which local authorities can seek to attract businesses. But it must be stressed that such controls would be justified only if it could be shown that there is a problem in practice.

Financing agency services

In contrast to the situation with genuine local services, it is arguable that in the case of agency services most of the finance should come from grants. There are two main reasons for this:

- the central government is likely to take a more responsible view about how much local expenditure is required if it has to raise the money itself;

- local voters will be confused if they have to pay local taxes to local politicians who actually have negligible discretion over how that money may be spent.

Tax finance and macroeconomics

In chapter III it was noted that local authority borrowing levels may need to be controlled for macroeconomic reasons. It is worth considering whether the same applies to local authority tax rates. Certainly there are many countries where local authorities have little control over tax rates. For example, Portugal gives virtually no local discretion over local tax rates, while Norway applies caps which are effectively tax rate ceilings.

Looking at the aggregate demand, the case for regulating the level of local taxes is arguably weaker than the case for regulating the level of local borrowing. It is true that if local authorities spend more money, whether financed from loans or taxes, then they will add to aggregate demand.

Nevertheless, whereas using loans will not necessarily produce an offsetting fall in aggregate demand, using local taxes will, although the extent of this will depend on a number of complex interactions in the economy, including the effects of local tax increases on general government expenditure (e.g. social security payments or payments linked to inflation indices).
When people pay more in taxes, they have less money available for consumer spending (this however may be offset by increased general government spending financed by increased borrowing). Therefore, this problem is, to some extent, less serious with local taxes than with loans. There are, however, other macroeconomic matters which may lead to a control in the level of local taxes (e.g. the public sector's share of the economy and its implications for growth, employment).

A middle approach

It may be felt that the above analysis is a little too restricted in that it presents local authority services as either genuine local services or as agency services. It might be felt that it would be better to regard many local services as provided by local authorities on behalf of a partnership between themselves and the central government. On this basis, it might seem reasonable for local taxes and grants to account for roughly comparable half shares each of total local spending.

Certainly this viewpoint may apply in many countries. But it carries the danger that if responsibility is shared, there may be conflicts between the wishes of a local authority's electors and the central government's electors. So an approach which seems to promise co-operation can easily descend into conflict. Admittedly, with genuine local services the central government may intervene from time to time and lay down certain ground rules; while with agency services there may be a little room for local discretion at the margin. But in each case it is clear where the primary responsibility lies, and it is arguable that taxes should be the chief form of finance when the primary responsibility lies with local authorities, while grants should be the chief form of finance when it lies with the central government.

Tax-sharing

It was argued above that, for financing genuine local services, local authorities should be allowed access to substantial tax revenues with some control over the tax rates. However, some countries allow local authorities to secure large tax revenues while having no discretion over tax rates at all. They do this by using a system known as tax-sharing. Among the best known examples of tax-sharing are those in Austria and Germany, which cover the central government, the states as well as municipalities.

Tax-sharing means allowing local authorities the right to a share of the yields of certain national taxes. A country can have several shared taxes, with different percentages for each going to local authorities. The arrangements in Germany and Austria differ slightly and afford two useful case studies.

In Germany there are three main shared taxes. These and their current shares are:

Table 6: Main shared-taxes in Germany

	Centre	*Land*	Local authorities
Income tax	42.5%	42.5%	15%
Corporation tax	50%	50%	0%
Value added tax	50.5%	49.5%	0%

It should be noted that these three taxes account for about 75% of Germany's total tax revenue. In the case of income tax and corporation tax, the revenue accruing to a tier of subcentral government is apportioned between the authorities in that tier in proportion to the amount of tax raised in each authority. But the states' shares of value added tax is apportioned between the states in proportion to their populations.

In Austria, many taxes are shared, but the rules for determining the state and local authority shares are complex. So the actual division of revenues is less clear-cut. The main shared taxes and their approximate shares are:

Table 7: Main shared-taxes in Austria

	Centre	*Land*	Local authorities
Income tax	60%	22%	18%
Oil duty	88.5%	8.5%	3%
Value Added tax	69%	19%	12%

In each subcentral tier, income tax is shared with reference to state tax yields and populations while value added tax is shared with reference to populations. Oil duty is shared with reference to many factors including populations, road lengths, areas and oil tax yields.

The advantages and disadvantages of tax-sharing

The main advantage of a shared tax is that it is a relatively cheap way of securing tax revenues for lower tier authorities. Collecting a shared tax costs no more than collecting an equivalent central tax. The only additional cost that is incurred when a tax is shared is the cost of obtaining data for the allocation formula, such as ascertaining the tax yield or population of each area. However, tax sharing does have at least two disadvantages compared with genuine local taxes:

- local authorities cannot determine their own tax rates;

- the central government may see the shared tax revenues as part of its own revenues which it is giving away, and in this case it may want as many controls as it would want with grants.

It may be added that these disadvantages are perhaps less serious in Germany and Austria than they would be in many other countries. Regarding the first disadvantage, these countries do not see states and local authorities as existing chiefly to provide services that vary in accordance with local wishes. Rather they see them as existing to administer services which should be provided on a substantially uniform basis everywhere. Effectively, then, they see states and local authorities as acting on an agency basis.

Regarding the second disadvantage, the shares of the shared taxes that go to the lower tiers in Germany and Austria typically have some constitutional guarantee, so that the central governments there cannot easily see these shares as part of their own revenues that they are giving away. Tax-sharing would best suit other countries with similar views over the role of local authorities and similar constitutional guarantees over their tax shares.

Taxes in practice

Having explored the case for having some local taxes, it is time to consider the main candidates for local taxes. It should be stressed at the outset that there is no perfect local tax. Equally, however, there is no perfect central tax. So, just as central governments seek to rely on the least unsatisfactory central taxes, local authorities must rely on the least unsatisfactory local taxes.

The main local taxes

While there is no perfect local tax, there is a fair consensus in Europe about which local taxes are the most satisfactory. It is clear from table 8 that the two most common local taxes among Council of Europe members are property taxes (on domestic properties and on business properties), income taxes (on personal incomes and, to a less frequent extent, on business incomes) and taxes on trade, namely sales taxes. Few countries, either in Europe or elsewhere, have tried to have large revenue raising local taxes other than these. The main examples are not very promising. They include:

- the payroll tax used by the Australian states. A payroll tax is a tax paid by employers as a percentage of their payments to their employees; ultimately it is probably mostly "passed on" to employees in the form of lower wages. A payroll tax would have problems if it was levied by small local authorities as it would encourage workers to live in areas with high tax rates and good services but to work in areas with low tax rates;

- the natural resource revenues used by the Canadian provinces. The trouble with using these revenues at a local level is that they tend to favour some areas greatly at the expense of others. As a result, there is a risk that there will be large variations in service levels between areas unless large equalization grant schemes are introduced.

Table 8: Local exclusive taxes in member states of the Council of Europe

Countries	Real estate tax	Personal income tax	Tax on trade	Household tax	company tax
Albania	● ■		● ■		
Austria	● _		● _		● _
Belgium	○□	○□	○□	○□	○□
Bulgaria	● ■	● ■			
Cyprus	□	○	□		● □
Czech Rep.	●				●
Denmark	● _	● □			
Estonia		○ _	○ _		
Finland	● _	● □			● ■
France	● _			● _	● _
Germany	□		□		□
Greece		■			
Hungary	○ _		○ _	○ _	○ _
Iceland	● _				
Ireland	● □				
Italy	● □		● □		● □
Latvia	● _	● ■			
Luxembourg			● □		
Netherlands	○ □				
Norway	○ _(1) ● _(2)	● _			
Poland	● _				
Portugal				● _	
Romania		● _			
Slovakia	● ■				
Spain	● _		● _		● _
Sweden		● □			
Switzerland		○□ (3)			
Turkey	● ■				
United Kingdom	○ □				

Source: Council of Europe

● Mandatory tax
○ Non-mandatory tax
□ The municipality is free to determine the tax rate
_ The municipality is free to determine the precise rate within a given band established by the state
■ Tax rate is established by the state
(1) Property tax
(2) Wealth tax
(3) As a rule, municipalities are free to determine the tax rate, but there are exceptions

Three points may be noted about the use of the main local taxes:

- local income taxes are of exceptional importance in Scandinavian countries;
- local property taxes are of greatest importance in English speaking countries;
- local sales taxes are much less important. It is only in North America that subcentral sales taxes with varying rates occur; there, the fact that the states are big makes varying tax rates more feasible than they would be for most local authorities. It may be added that Australia's states effectively levy some sales taxes in the name of licences; for they sometimes charge licence duties on outlets such as filling stations and liquor stores and make the duties paid by individual outlets depend on their turnovers.

Criteria for local taxes

It is clear that three taxes stand out as popular local taxes. There are many criteria which can be applied to selecting good local taxes, and the following sections mention only some of the more important criteria.

A high yield and a fair distribution of the yield

Local authorities usually spend large sums of money, and it has been argued above that there is a case for allowing them to raise much of their revenue in the form of taxes. In turn, there is a case for them to raise some high yielding taxes. It is generally felt that high yielding taxes should relate to taxpayers' abilities to pay, and it is generally felt that incomes and spending levels are the best measures of ability to pay. So it is easy to see why personal income taxes and sales taxes appeal on this criterion.

In contrast, domestic property taxes probably relate poorly to ability-to-pay, and when these taxes have high yields, there is a case for circuit-breakers or rebates to help poor people facing large bills. The final incidence of taxes on corporate incomes and business property is a matter for much discussion, but it is likely that the final incidence does to some extent relate to the ability to pay of the people on whom it falls.

It may be added that no European country has secured a high local tax yield without having a local income tax. The value of a high yield becomes clear if the typical grant plus tax revenue for subcentral authorities is recalled. This is often around 10-15% of GDP or even more. Against this, it may be noted that property taxes have rarely raised even as much as 4% of GDP. So any country which has average levels of local spending and seeks to have local taxes that raise only half of this amount seems virtually obliged to levy a subcentral income tax.

Low administration and compliance costs

Ideally, local taxes should have low administration and compliance costs. Four points will be made here about the most popular local taxes:

- sales taxes are generally the best taxes on this criterion, though value added taxes have high compliance costs;

- property taxes often have higher costs than published figures suggest because these figures often ignore the costs of revaluations;

- income taxes may have higher costs than property taxes; but note that the more costly income tax may raise very much more money so that its costs may be lower as a percentage of the yield;

- it could be costly to operate a corporation tax if multi-area firms have to split their profits up between areas on the basis of some complex formula.

There are several ways in which administration costs may be held down. For instance:

- a given tax may be used for more than one level of local authorities. This is possible even if each tier sets its own rate. The attraction is that each taxpayer needs to be assessed only once and can be sent a single bill;

- a given tax may be used by both local authorities and the central government. Again, each taxpayer needs assessing only once and can be sent a single bill;

- collection can be done by groups of local authorities or by the central government. This is advantageous if there are economies of scale in collection;

- the same tax base may be used for more than one tax. For instance, one set of values may be used for both a local property tax and a central property transfer tax.

Low distortions

Ideally, local taxes should not distort people's behaviour, especially when tax rates in different areas are different. In particular, it is important to avoid giving people incentives to shift the tax base from one area to another.

Tax-base migration could be very serious with local taxes on businesses, such as business property taxes and corporation taxes, and it is often feared that business will migrate from areas with high tax rates. However, it should be noted that businesses do get some benefits from local services, such as roads, police and fire services, and these services may typically be better in areas with high tax rates. If so, the incentive to leave will be reduced. Probably the main conclusion here is that it might be unwise to make business taxes cover more than the benefit to local businesses of local services.

Tax-base migration can be specially serious with sales taxes. This is because people have an incentive to live in areas with high tax rates and good services, but then to go and do their shopping in areas with low tax rates. Probably the main conclusion here is that local sales taxes levied at varying rates should be confined to large authorities.

Tax-base migration should be much less serious with taxes on households such as domestic property taxes or local income taxes. For if tax rates relate closely to service levels, then people may willingly pay higher local taxes in order to get better local services.

Promoting efficient spending levels

Ideally, local taxes should help produce a situation where local authorities spend at the correct levels: that is, they should spend more so long as the benefits of extra spending exceed the cost. This section will consider two ways in which this criterion may not be met: "invisible" taxes and "tax-exporting".

Invisible taxes occur if local voters do not know how much they are paying in tax. The consequence is that they may not vote for the correct level of local spending. The following comments may be made about the main local taxes in this respect:

- domestic property taxes are very visible;

- personal income taxes are reasonably visible;

- sales taxes are not very visible: the amounts of tax may be printed on invoices and receipts, but people typically have very little idea how much they pay on these taxes in the course of a year.

- It is far from clear where the final incidence of taxes on business property or business profits lies, so it seems reasonable to argue that their burden is far from visible. But the incidence of local taxes on businesses must be divided somehow between their owners, their employees, their suppliers and their customers, all of whom benefit from the businesses and hence from the local authority services from which it in turn benefits. So the invisibility of the final incidence of these taxes is probably not much of a problem provided that the level of local taxes levied on businesses does not exceed the benefits that businesses derive from local authority services.

Tax-exporting occurs if the burden of a tax falls partly on non-residents. The result is that services are effectively subsidised by non-residents. This may lead to excessive spending. In comparing the main taxes, the following points may be made:

- there is little or no problem with exporting in the case of domestic property taxes and personal income taxes;

- there may be significant problems with exporting in the case of sales taxes, business property taxes and corporation taxes.

However, it is worth noting that some exporting is acceptable because some of the benefits of local services will also be exported. But it would be unwise to rely to a great extent on taxes where exporting is substantial. Perhaps the safest conclusions are, once again, that local business taxes are acceptable so long as they finance no more than the business share of the benefits of local services and that local sales taxes should be used with great caution.

A comment about buoyancy

Local authorities often object to property taxes on the grounds that the base tends to remain static, aside from new building. So the tax rate must be raised to keep up with any rises in price levels. The authorities claim that voters have illusions and mistake rises in tax rates for real increases and blame local authorities for extravagance. Much the same would occur with specific sales taxes fixed at so much per litre or packet, etc.

This problem could be solved with an income tax or a percentage sales tax, or even with annual property tax revaluations. But it is possible that people suffer more illusions with an income tax or a percentage sales tax whose real yield rises in times of growth without any rise in tax rates. For people may be unaware that their real tax payments are rising annually. If people have this sort of illusion, it might be expected that local expenditure growth would be most rapid in countries with the most buoyant local taxes.

Evidence from the United States suggests that state spending there does indeed rise most rapidly in states where there are buoyant income taxes. But it was found in the 1980s in Europe that there was no greater tendency for local spending to rise more rapidly in Denmark and Sweden, which had buoyant local income taxes, than it did in the United Kingdom which has generally had an inelastic property tax.

In short, it is hard to decide whether buoyancy is good, bad or a matter of indifference.

This analysis suggests that personal income taxes and domestic property taxes are the best local taxes. But a business property tax or corporation income tax may be satisfactory to finance the share of local services that benefit businesses. Given the choice, the property tax has the advantage that estimating the tax base in each area of a multi-area firm is relatively easy. In contrast, apportioning its profits between each area is a complex and controversial matter.

Given the popularity of local income and property taxes, it seems appropriate to make a few more points about each of them. But first it should be noted that there are good reasons for not relying on either as the sole local domestic tax.

- If a domestic property tax is the sole local domestic tax, and if the rate is held in moderation on the grounds that tax payments relate poorly to ability to pay, then the yield may be very small in relation to local spending.

- If a personal income tax is the sole local domestic tax, and if poor people are exempt, then there may be a significant number of households exempt from local taxes who thus have an incentive to vote for extravagant local services.

Property taxes

There are a number of key issues that need addressing with local property taxes:

- it must be decided precisely what the tax base is, who will do the assessments, and who will collect the tax. It may be best for the central government to supervise the general rules. But unless the central government is sharing in the tax, it may be best to leave collection to local authorities because they will have an incentive to collect as much revenue as possible;

- the tax base may be annual values or capital values. It is best to use as the base the alternative for which there is the most available data. Thus if most homes are rented, it would be best for the domestic property tax to use annual values as base, while if most homes are owner-occupied, it would be best for this tax to use capital values as the base. Most countries tend to use capital values;

- the tax base usually comprises the value of the land and buildings but not anything else;

- it must be decided how frequently valuations will occur. In general it is best to have frequent valuations in order to keep the tax up-to-date and to make the impact of revaluations on individual properties modest. With computer technology, annual revaluations are feasible;

- it must be decided which property is exempt. On the whole, the fewer the exemptions the better, for once some groups are exempt, other groups will be encouraged to argue the case for them also to be exempt. Embassies, cemeteries and religious buildings and public areas are the most common exemptions. Also quite often exempt is property used for agriculture or by charities, educational establishments, hospitals and governments;

- it must be decided who will pay the tax on rented property, the owner or the tenant. When the tax is paid by owners, they probably pass much of the burden on to tenants through increases in rents. Most countries tax the owner to make the tax invisible to the tenant, but in terms of visibility it is better to tax the occupant;

- to help poor people, there may be a system of rebates. It is harder to help poor tenants if the tax is paid by owners (who pass much of it on) than if it is paid directly by tenants;

- it must be decided how many instalments will be permitted for individual taxpayers. It will probably be found more popular to have frequent small instalments rather than infrequent large ones.

Income taxes

There are several key issues that need addressing with local income taxes.

- It must be decided whether the tax will be paid to the areas where people live or the areas where they work. Using the latter approach would really convert an income tax into a payroll tax and so, as noted earlier, would give people an incentive to live in high tax rate areas and work in low tax rate areas, so the residence approach is to be preferred. But the residence approach is not always adopted; and in Switzerland, for example, some cantons effectively allow their subordinate local authorities to tax people who live in their areas and people who work there.

- It must be decided who will do the assessments and the collection. As the central government will almost certainly be raising income tax revenues for itself also, there is much to be said for allowing it to do both. Such an arrangement is sometimes called using a "piggy-back" tax for local authorities.

- It must be decided whether investment income will be taxed as well as earned income. It may be administratively hard to include investment income; if so, investment income could be taxed at a uniform rate equal to the average local income tax rate and then its revenue distributed to each local authority on, perhaps, an equal per capita basis.

- It must be decided whether an individual local authority should set a single tax rate or whether it should set a set of tax rates that rise with income. The objection to a single rate, x percent of taxable income, is that the local component of an income tax will not be very progressive; it will secure progressiveness only because people below a certain income level may be exempt. On the other hand, allowing local authorities to set a variety of rates would be to allow them to play a significant part in redistribution which, for reasons outlined earlier, is an activity that should be primarily performed by the central government; also, it could result in high income citizens facing a very high marginal tax rate when central and local rates are added together. A compromise arrangement is to allow a local authority to tax a fixed proportion of the sum that each of its residents will pay in central income tax. Thus a local authority might set a rate of 15% and require each resident to pay a sum equal to 15% of his or her central income tax bill. In this way, higher rate taxpayers will pay higher fractions of their taxable income in local income tax than will lower tax rate payers.

- An individual local authority will typically set its tax rate at the start of a year and make a forecast of the revenue it will generate. In the event, the actual amount raised from its residents at that tax rate will often be significantly different from the forecast according to whether the economy in its area has performed better or worse than anticipated. Such authorities stand to face difficulties if the actual revenue raised is less than the forecast. Some countries, such as Norway, do nothing to help local authorities in this position, except to allow them to borrow temporarily to make up the shortfall. Some other countries offer more protection. For example in both Denmark and Sweden, the central governments collect all income taxes and actually pay each local authority the sum it expected to receive on the basis of its forecast instead of paying it the revenue actually collected from its residents. In Denmark, any difference between the amount that the government raises in an area and the amount which it pays that area is regarded as a loan from the central government to the local authority or vice versa; these loans are all repaid two years later with interest under an arrangement known as a "true-up". In Sweden, any difference between the aggregate amount that the government raises and the aggregate amount that it pays, particularly in terms of local income tax, is added to, or subtracted from the transfers that are made to local authorities two years later.

V. GRANTS

Grants fall into two main groups: specific or earmarked grants and general grants. Specific grants are grants which the recipient local authority must spend on some particular service. These grants can be either "wide" or "narrow" ; thus they could be paid for use on roads, which would be an example of a wide grant, or they could be paid for use on road signs, which would be an example of a narrow grant. In contrast, general grants are grants which may be spent by the recipient local authorities on any services they choose. Note that this discretion may often be circumscribed by rules which restrict the activities that local authorities may legally undertake.

Article 9 of the European Charter of Local Self-Government recommends that general grants should be used wherever possible. This recommendation implicitly accepts that there are occasions when specific grants are needed, and indeed there are some arguments for specific grants. This chapter begins by looking at the arguments for grants of both types. It then explores general grants schemes in some depth.

Arguments for specific grants

As specific grants restrict local authority freedom more than general grants, they should be paid only when there is a good case for using them in preference to general grants. There are perhaps three main occasions when they are justified:

- to finance services which local authorities provide as agents of the central government;
- to encourage local authorities to provide services that generate benefits for non-residents;
- to support local authorities if they provide services in accordance with some minimum standards laid down by the central government.

These three reasons are explored further below.

Agency services

It was argued in the previous chapter that most of the finance for any services which local authorities supply on an agency basis should be met by grants. It seems appropriate, in fact, for local authorities to receive separate lump-sum specific grants for each of these services, each grant covering most of the necessary expenditure. It might seem that the grants should cover the entire cost of these agency services, but if the grants covers only a percentage, even a large percentage such as 95%, then the authority has some incentive to keep its costs to a minimum.

Improvements generating externalities

Some local authority services have benefits which are essentially confined to the authorities' own citizens. For example, education essentially benefits the children of resident households. But some local authority services benefit non-residents. The most commonly cited example is a main road passing through an inland authority, for many vehicles belonging to non-residents may use it as they pass through the area. When the residents of the area vote, they will wish local spending on the road to increase so long as the extra benefits from the improved road to themselves exceed the extra cost to themselves. They will typically ignore the extra benefits from the improved road to non-residents. Consequently, there is a risk of underspending on the road in the sense that improvements whose benefits to non-residents and residents combined exceed their cost may not be made because their benefits to residents alone are less than the cost.

In these circumstances, the central government may react by introducing a system of matching specific grants for roads. Matching grants effectively reduce the cost to local citizens of any improvements, and thus they encourage extra spending on the road. However, it should not be supposed that introducing such a scheme of grants is a straightforward exercise. In order to provide the correct stimulus to each area, the central government should, ideally, estimate the degree of benefits to non-residents by each area's roads and introduce an appropriately large or small matching grant. But it is empirically hard to estimate the benefits to non-residents, and it may be politically hard to introduce different degrees of matching – or, in effect, different degrees of subsidy – in different areas.

Consequently, if the problem of external benefits is serious, it may be appropriate to adopt a different solution. This would be to remove the service concerned from the tier concerned and entrust it either to a higher tier of local authorities, or else entrust it to the central government.

Specific grants and minimum standards

Central governments often impose minimum standards on local authorities. When this happens, it is arguable that if the authorities provide the services at those minimum standards, then they are really acting only as agents of the central government, providing services in accordance with central wishes. Thus, as with other agency services, there is a case for most, if not all, the finance coming in the form of lump-sum specific grants. Unlike pure agency services, though, local authorities are free here to raise their service levels above the minimums imposed. It is the cost of any higher levels of service that should be borne chiefly from local taxes, like the cost of genuine local services.

A critique of minimum standards

Paying a grant to a local authority to enable it to meet an imposed minimum standard may make imposing standards seem quite harmless. But notice that the higher tier authority which pays the grants has to finance its grants with extra taxes. So the citizens of the lower tier authorities which receive the grants will also be paying extra taxes to the higher tier which pays the grants. So, in aggregate, the citizens of the local authorities will be no better off as a result of the grants scheme. Indeed, while the citizens of the typical authority will certainly have no extra income at their disposal, despite the grants, they will be subject to an extra constraint in how they may spend their income. In general, constraining people's spending patterns cannot increase their welfare. In these circumstances, it is worth asking what arguments can be adduced for imposing minimum standards.

Three arguments for minimum standards are commonly cited:

- to ensure that no-one has to suffer from services provided at levels below the minimum standards imposed. In particular, governments may be concerned about poor people who could not afford to move from areas that might offer low service levels. But it seems unfortunate that the efforts which are made to protect these poor people mean that all the other people in their areas must be forced to pay for higher levels of local services than they really want;

- to protect people who have to move occasionally by ensuring that they will be able to enjoy minimum local services wherever they go. Again, it seems unfortunate that this protection can be secured only by forcing the citizens of many authorities to pay for higher levels of local services than they want;

- to protect people in minorities, such as library users, from authorities which might ignore them. This is essentially a fair argument, but it may be wondered whether central governments are often much more concerned than local authorities about minorities.

Guidelines as an alternative to minimum standards

No doubt minimum standards can sometimes be justified by reference to one or other of the above arguments. But it is possible that some imposed minimum standards cannot be so easily justified. Indeed, it is possible that it might be appropriate to replace some imposed minimum standards with guidelines.

Consider, for example, services such as water supply and fire services which are often provided by local authorities. These authorities must decide how pure their water will be and how many fire engines they will have. So they need to consider how pure their water must be not to constitute a significant health hazard, and how many fire engines they must have to ensure that fires can be put out reasonably quickly.

These are technical issues, and many authorities may be too poor to employ the technical experts who could answer them. Higher tiers of government could hire experts and get them to issue guidelines. Then the lower tiers could decide how far they wished to meet these guidelines. But the lower tiers would become answerable to their own electors for any failure to meet the guidelines.

If this approach was adopted, with the guidelines being essentially optional rather than mandatory, then the case for using specific grants would largely disappear. The services would be essentially genuine local services that should be chiefly financed through taxes.

Arguments for general grants

Table 4 shows that in almost all Council of Europe member states, the level of general grants – or block grants – is considerably higher than the level of specific grants – or earmarked grants. There are essentially two reasons for having general grants. These are to sort out vertical imbalances and horizontal imbalances.

Vertical fiscal imbalances

Vertical imbalances arise when one tier of local authorities – or perhaps more than one tier – finds that if it levies its permitted tax or taxes at "reasonable" tax rates, then it has too little money to provide its services at "reasonable" levels. There are four alternative solutions to this situation:

- more local taxes could be introduced. In terms of promoting local autonomy, this is the preferred option;

- some services could be removed from the tier concerned. However, if this means centralizing or regionalising a service where local variations were previously possible, then there would clearly be a cost in terms of reduced diversity and so reduced ability to meet varying local preferences;

- a system of tax-sharing might be introduced to raise local tax receipts. But, as indicated in the previous chapter, tax-sharing might bring with it increased central control unless the tax shares accruing to lower tiers of government are constitutionally guaranteed;

- governments could distribute grants, typically general grants, to raise the revenues of the local authorities concerned. This might well result directly or indirectly in greater central control.

Almost all central governments rely to at least some extent on the fourth solution. When this solution is adopted, the grants concerned may be paid out on a formula that helps the central governments also solve the problem of horizontal imbalances.

Horizontal fiscal imbalances

A horizontal fiscal imbalance occurs when two local authorities seeking to have similar service levels find that they would need different tax rates. These imbalances can arise for three reasons:

- some areas may have higher needs than others; strictly, they may need more units of output per head, such as more school places per head, simply because they have relatively more schoolchildren;

- some areas have higher costs than others; thus the cost of a place in a school in one area may be relatively high if wage rates there are relatively high, so that more money has to be spent to secure teachers, or if the climate there is relatively cold, so that more money has to be spent on heating;

- some areas may have lower per capita tax bases than others, so that equal tax rates raise relatively low per capita amounts.

These horizontal imbalances can be reduced, or even removed, by means of an appropriate system of equalization grants. There are, in fact, two ways of operating equalization arrangements.

- A system can be set up which involves local authorities alone, and in which areas with relatively high resources or relatively low needs and costs pay money into an equalization fund which is then drawn on to make equalization grants to areas with relatively low resources or relatively high needs and costs. Such a scheme is unlikely to be set up voluntarily by local authorities because some of them will lose, probably indefinitely. But it could be set up by the central government.

- The central government could itself pay grants to all areas, paying less to areas with relatively high resources and relatively low needs and costs than it pays to areas with relatively low resources and relatively high needs and costs. Such grants would typically be general grants and would seek simultaneously to handle both horizontal and vertical fiscal imbalances.

In general, the first arrangement is likely to prove unpopular because it is made very explicit which areas lose out as they have to pay money into the equalization fund. Thus this arrangement tends to be confined to countries like Sweden and Denmark where there is little vertical imbalance. For when there is negligible vertical imbalance for a tier as a whole, some areas will doubtless be able to secure more revenue than they need for reasonable services if they set reasonable tax rates. Consequently there is a case for requiring them to make payments into an equalization fund as established with the first sort of scheme. An alternative would be to use a modified version of the second sort of scheme in which some areas would end up entitled to negative grants that they had to pay to the central government.

However, it might be felt more acceptable for areas with high resources and low needs or costs to pay money to other areas via an equalization fund, as on the first sort of scheme, than for them to pay money to the central government.

Reasons for tackling horizontal imbalances

There are both equity and efficiency arguments in favour of equalization. In equity terms, it seems unfair that people in some areas will have to pay higher tax rates and thus higher taxes than similar people in other areas who enjoy similar levels of local services. In efficiency terms, unequal tax rates for equal services could stimulate migration which would use up resources. The only qualification to this efficiency argument concerns differences in costs: there could be efficiency gains if people were encouraged by a lack of equalization arrangements to move from authorities where local services were relatively costly areas to areas where they were relatively cheap.

Thus the case for a measure of equalization seems strong, and article 9 of the European Charter of Local Self-Government calls for equalization arrangements to protect relatively weak local authorities. The most common type of arrangement is a system of equalization grants. Numerous issues arise with equalization grants, and the main ones will now be addressed.

Problems with equalization grants

It is easy enough to suggest that horizontal – and vertical – imbalances can be removed by suitable grants. It is less easy to implement such grants. A really effective grant scheme must start by specifying a "reasonable" tax rate, or set of tax rates, that local authorities could set, and then work out how much each area would raise with those rates. Then the scheme must work out how much each area would need to spend to provide all its services at "reasonable" levels. This is a much more difficult task, and the results will inevitably be contested by areas where the figures seem relatively low. Finally, the scheme would give to each area that set the reasonable tax rate or rates enough grant to top up its tax revenues so that it could provide its services at the reasonable levels.

Note, though, that there need be no compulsion on authorities to provide the services at the "reasonable" levels. The grants would merely enable them to do so if they so chose, but the authorities might prefer higher levels for some services and lower levels for others. In effect, the grants equalize the tax rates needed for reasonable service levels – or, in economic terms, they equalize the tax-prices for those services – but they do not compel the authorities to provide comparable services.

Note also that the grants need not compel local authorities to set the reasonable tax rate or rates. So there is no reason to suppose that uniform tax rates will result. This raises the interesting question of whether the grants should be lump-sum, and so not depend on recipients' tax rates, or whether they should rise (or even fall) if recipients set higher tax rates than the reasonable ones. This is a controversial question to which there is no wholly satisfactory answer.

The main objection to lump-sum grants is that two areas which set common tax rates that are different from the reasonable ones will not generally be able to have comparable service levels. Consequently, equity and efficiency problems may reappear. The following exemple may help to explain it:

Two given areas levy only an income tax which, at a "reasonable" rate, raises respectively 1,000 euros and 500 euros per head; the cost of providing services at reasonable levels is 1,200 euros per head in each area; thus, the first area would be paid a lump-sum grant of 200 euros per head, while the second one would be paid a lump-sum grant of 700 euros per head. If each area sets the reasonable tax rate, each will have a total revenue of 1,200 euros and each will be able to provide similar levels of services. But if each area sets double the reasonable tax rate so that tax revenues are 2,000 euros per head in the first area and 1,000 euros per head in the second one, with lump-sum grants, there will be no change in grant receipts. So total revenues will be 2,200 euros per head in the first area and 1,700 euros per head in the second one. Thus levels of services will be higher in the first area than in the second one so that there will be inequity between similar people in the two areas at these actual tax rates.

This problem can be removed by having grants that depend on tax rates. Suppose the grants were adjusted so that the two given areas would have equal per capita revenues from taxes plus grants of 1,200 euros at the reasonable tax rate and equal per capita revenues from taxes plus grants of, for instance, 2,000 euros at double that tax rate. Then, if each area set double the standard rate, the first area's grant would become zero while the second area's one would become 1,000 euros. Here, equity would still prevail.

Unfortunately, grants that depend on tax rates have two problems. First there are administrative difficulties, not least that the government might not know what its total outlay would be until after each area had set its tax rate. Secondly, some areas, like the second one in the exemple, might find that their grants rise when they spend more, so that increases in their service levels were effectively subsidized. Over-spending could result.

In contrast, lump-sum grants ensure that, in each area, the full cost of any changes in local spending levels falls wholly on local residents, and thus these grants should ensure that spending will rise only if local voters believe that the benefits from the rise are at least equal to the extra tax payments which they must make.

Inter-area redistribution with equalization grants

Equalization grants have to be financed by central taxes. Typically, some areas will pay less in taxes than they receive in grants while others will pay more. Thus the grants effectively create transfers of money between areas. These transfers may prove politically unpopular in the areas which "lose". It is worth making two observations about these transfers:

- the extent of any losing and gaining will typically be least if the local tax base is reasonably well distributed between areas;

- the transfers are, in fact, no more drastic than the transfers which implicitly occur as a result of central government provision of services. Typically, central governments seek to levy all their taxes at uniform rates in all areas and also to provide all their services at uniform levels in all areas. Thus in the provision of their own services, they are effectively subsidizing areas which have low tax bases and areas where services are costly to provide. Equalization does exactly the same - and no more - in respect of local services, enabling people in all areas to enjoy comparable service levels if they pay comparable tax rates.

Capitalization adjustments in house prices as an alternative to equalization

It is sometimes argued that there is no need to have equalization grants at all on the grounds that capitalization adjustments in house prices will preserve equity and thus prevent migration from actually taking place. If one area is fiscally disadvantaged in some way and people seek to leave, then house prices there will at once fall while house prices in relatively attractive areas will at once rise. These house price changes could act in a way that leaves the total cost of living in each area the same – once house costs and local service costs are both taken into account – and so restore equity and deter any actual migration. There are, however, two reasons for not placing too much reliance on this capitalization process and so for opting instead to have a system of equalization grants.

- It is really land prices that will alter. In the long run, at least in rural areas, land for homes may have its price set at the levels that are determined in the market for agricultural land. Thus the supply of land for homes may be perfectly elastic in rural areas at the level of agricultural land prices. If so, then land price differentials may not emerge as a result of local fiscal differences so that migration and inequity will still occur.

- Even if the supply of residential land were perfectly inelastic, as might occur in built-up areas, so that appropriate price differentials could occur, there would still be an equity case for equalization grants. For, without such grants, the owners of homes would face continual windfall gains and losses in the values of their homes whenever the taxable resources, or the needs, or the unit costs, in their areas altered, and these gains and losses would occur in a capricious way.

Equalization and development

Equalization is sometimes opposed on the grounds that it neutralizes any enthusiasm that local authorities might have for local development. Without equalization, an authority might support development on the grounds that it would raise its tax base, perhaps by resulting in new property and so raising the property tax base, or alternatively by raising incomes and so raising the income tax base. With full equalization, any increase in the local tax base would simply result in lower grants. But it is arguable that there is a case for wanting local authorities to be neutral about development, especially in an age when the environmental impact of development is of so much concern.

Some particular problems with subcentral property taxes

It was argued above that there is a case for equalizing differences in resources and needs, and perhaps also differences in costs. However, the case for equalizing differences in resources requires a little qualification in the case of a local property tax. As local property taxes occur in many countries, it seems worth raising this issue here.

To see the issue, it is necessary to begin by noting that the property tax base per head in a particular area could be relatively low for three reasons:

1. the area might have relatively little business property;

2. the average size of domestic properties in the area might be relatively small;

3. site values in the area could be relatively low, perhaps because the area is unpopular on account of a poor climate, so that demand for land is low, or perhaps because the area has land which is poor for agricultural purposes and is therefore cheap.

The result of the low tax base is that the area will have to set a relatively high rate of tax to provide services at levels comparable with service levels elsewhere. But does this mean that its citizens will actually pay more in taxes than people in equal size homes elsewhere who enjoy comparable local services? It certainly does mean this if the tax base differentials arise from factors 1 and 2, and so in these two cases there is a strong case for equalizing the differences concerned.

The situation is very different in the case of factor 3. It is true that this factor will cause tax rates to be relatively high in the area concerned, but these relatively high tax rates will be applied to relatively low property values. Consequently, people in the area may well find that they are paying no more in tax than people elsewhere who live in property of a similar size and type. In turn, there seem to be no problems of inequity or possible migration to address.

However, the situation is more complex than it initially seems. To see this, suppose that factor 3 was the only one that varied between areas. This can be most easily envisaged by supposing that the property tax applies to domestic properties alone, so that factor 1 is irrelevant, and by supposing that all localities have comparable mixes of large and small domestic properties, so that factor 2 is irrelevant. Then the only reason why tax rates would vary between areas with comparable service levels and comparable degrees of efficiency in service provision would be if some areas had higher site values than others.

The crucial point to appreciate is that site values, and hence property values, are likely to vary *within* areas as well as *between* areas. Within any area, there will be a uniform tax rate which means that people in low site value properties of a certain type will pay less tax than people in high site value properties of the same type. Thus there is, implicitly, full equalization within areas simply because there is a uniform tax rate and a uniform level of service provision.

If this intra-area system of implicit equalization is felt acceptable, then it would seem logical to extend the idea of equalization to the nation as a whole by having an explicit scheme of equalization grants to ensure that areas with, on average, low site properties, can still provide similar service levels as other areas with similar tax rates. If, however, the implicit intra-area equalization is felt inappropriate, then not only would the case for explicit equalization grants to disadvantaged authorities disappear, so also would the case for implicit equalization within areas. The appropriate policy would seem to be to replace a property tax on property values with a property tax that excluded site values.

General grants in practice

Although it is possible to have general grant schemes that involve paying grants which depend on recipients' tax rates or spending levels, most governments which operate general grant schemes opt for lump-sum grants, chiefly because they are simple to administer. Sweden and the United Kingdom are two examples of countries which have moved from grants that did depend on the tax or spending levels of the recipient authorities to lump-sum grants that do not.

The chief administrative advantages of lump-sum grants are that the grant to each area can be announced in advance and that the total amount of grant to be paid out can be easily calculated in advance.

With effort-related grants, the grant to each area depends on the tax rates it sets. The question arises of whether the government should set the formula for the grant scheme before or after local authorities set their tax rates. If the government acts first, then it will not know exactly how much grant in total it will have to pay out until the last local authority tax rate has been set. If the government acts last, then the local authorities will not know when they set their tax rates exactly how much grant they will receive.

Whilst most countries operate lump-sum grant schemes, few of these schemes are actually fully equalizing, even at a single tax rate. Rare examples of such schemes occur in three of the four nations that form the United Kingdom: England, Scotland and Wales. But, interestingly, the existence of separate schemes for these three nations means there is no equalization across the United Kingdom as a whole. In essence, Australia also pursues full equalization at a single set of tax rates, though the calculations are very complicated, partly because it is necessary to assess the implications of different states electing to select somewhat different taxes. There is slightly less full equalization in several other countries, including four federal countries – Austria, Canada, Germany and Switzerland – and also in some unitary countries including Denmark and Sweden.

In contrast, some countries have no systematic scheme of general grants with equalization components. The United States is an important example. And there are several countries which have general grant schemes that make very modest moves toward equalization. Portugal and Spain are interesting examples of such countries.

In Portugal, the central government determines each year a sum that will be used to finance a fund that is spent helping municipalities. But this fund has little equalizing impact. Its limitations in this respect are partly revealed by the fact that 40% of the fund is distributed totally with reference to population. However, the remaining 60% has some equalizing effect. 15% is distributed equally to all municipalities which helps smaller ones with the fixed cost elements of administration. Another 15% is distributed in proportion to area and 10% in proportion to road length, and these elements help areas with the high costs associated with sparse populations or large road networks. 5% is distributed with respect to the number of subordinate *freguesias* or parishes, 5% is distributed with respect to the degree of accessibility, and 5% is distributed with respect to the number of children, and these elements also help some of the more needy areas. The final 5% is designed to help municipalities which have low tax bases.

The Spanish government also determines an annual sum which is distributed on the basis of elected criteria. But this scheme is even less equalizing. 70% is essentially distributed with respect to population, though there is some bias towards smaller municipalities. And 5% is distributed with respect to school places. But the final 25% is distributed with respect to tax yields. This means that, if a number of areas with similar populations were compared, the largest sums would go to the areas with the highest tax rates and those with the highest tax bases; the fact that areas with high tax bases are favoured means this element runs counter to the principles of equalization.

VI. CASHFLOW MANAGEMENT

Cashflow management consists in adjusting liquidity inflows and outflows in time and space. Cashflow therefore comprises the liquid assets needed to make such adjustment possible at all times. The relevant operations cover all those transactions concerning municipal operating budgets, investments and balance sheets where cash movements are involved. Cashflow management is not, however, affected by certain accounting operations such as those concerning depreciations and provisions or, indeed, transfers and charges.

There should be no need to stress that managing municipal cashflow does not mean running the budget process or applying tax regulations or financial equalisation schemes. It simply means making sure that sufficient funds are available, at the right time and at the lowest possible cost, to make the necessary payments as they fall due.

The ability to do this depends mainly on the arrangements for transfers to municipalities from central or regional government and on the system employed ("single treasury" or otherwise).

Funds transferred from central government

The term transfer is used in its broadest sense, encompassing advances on taxes, block grants, annual operating subsidies and one-off investment grants. In some cases, the transfers concerned are calculated in relation to the financial capacity of the receiving authority.

In Germany, for example, in the *Land* of North Rhine-Westphalia (Düsseldorf), under the law on financial aid to municipalities for the year 1995, the general equalisation subsidies and the lump-sum investment promotion grants (accounting for over 90% of the transfers from the *Land* to the municipalities) were transferred as follows: one eighth on 23 January, one quarter on 21 March, 21 June and 20 September respectively, and the remaining eighth on 20 December 1995. How these two types of transfer are apportioned is determined according to some relatively complex criteria. In the first case, the sum available is apportioned according to various criteria that compare the (partly theoretical) needs of the municipality and its fiscal capacity. At present, 95% of the difference is made up by the *Land*. Investment aids, on the other hand, are allocated according to legal criteria that take particular tasks or responsibilities into account.

In Austria, the proportion of shared tax revenues payable to municipalities is transferred by the Federal Government. Certain current subsidies are paid once a year, while earmarked grants are transferred on an *ad hoc* basis. The sums paid by the Federal Government are calculated according to legislation that also stipulates the due dates.

In France, municipalities receive their block grants in twelve monthly instalments with an adjustment at the end of the year.

In Italy, the state generally transfers the funds intended for municipalities in two six-monthly instalments. Special funds are transferred by the government departments concerned as soon as they are credited to their own budgets. Each region sets its own rules for payments to municipalities to cover social services and culture. State transfers to municipalities include revenue from property taxes, the ordinary fund, the consolidated fund and the local taxation imbalances equalisation fund. The municipalities are powerless to change the times of the transfers, which are fixed.

In Portugal, monthly transfers to the municipalities are made through the financial equalisation fund, itself funded from the state budget according to foreseeable trends in revenue from VAT (at least 40% of the sums transferred must be used for investments). The criteria according to which the money is shared out, defined in the local finance act, take into account each municipality's population, road network, surface area and tax revenues. Municipalities able to prove that they are in financial difficulty may obtain advances on the scheduled monthly payments.

In the United Kingdom, the Government transfers the funds for local investments once a year in December. Only supplementary funds can be earmarked to specific projects, e.g. housing. Every year local authorities receive a guide concerning investments in each sector, e.g. education. Regarding funds for current expenditure, these are transferred in 25 parts (twice a month and three times in April) at dates fixed in agreement with local authorities.

It should be noted that the larger the proportion of these transfers in the municipal budget, the more regularly the state, *Land* or region has to transfer the funds. Whether the sums transferred are block grants, funds earmarked for specific purposes (operating deficit of a public service) or one-off investments has little incidence on cashflow management.

"Single treasury" or autonomous management

In the area of municipal cashflow management, two main systems exist: under the "single treasury" system, the state manages municipal finances, while under the autonomous management system, individual municipalities themselves are responsible for this. The first system applies in France, for instance, while the second applies in federal states such as Germany and Austria. Italy applies both systems, depending on the size of the municipalities (small municipalities of under 5,000 inhabitants or mountain communities of under 10,000 inhabitants have some degree of autonomy).

The "single treasury" system places all municipalities on an equal footing, as the relevant national treasury manages their finances according to standard procedures. The state collects all local taxes, but also pays advances on the due dates, regardless of the state of the payments made by the taxpayers. It also transfers the grants due to the individual municipalities and invests any surplus funds. In general, the relevant transactions are carried out without the debiting or crediting of interest, i.e. free of charge, on the principle that negative and positive balances generally offset each other in both size and duration over the year.

A further advantage of this system is security in the management of cash, as all transactions are performed by specialist staff from a central authority. The relevant municipal authorities take the decisions on the implementation of their budgets, while state employees carry out the necessary transactions. The principle of the separation of those who issue the orders and those who keep the accounts is thus respected, with the two groups performing their respective tasks.

Under the "single treasury" system, control procedures are simplified, as the municipalities only have "petty cash" holdings (purchase of supplies, collection of payments for services). Moreover, there is no danger of risky or speculative investments, as the state employs financial instruments that are known to be safe. The same applies to any loans which municipalities may need for investment projects: a state bank or the state itself lends the sums required for infrastructure projects at interest rates and on repayment terms which do not place excessive burdens on local finances.

To sum up, under this system, municipalities can, in theory, always turn to the state in the event of short-term financial difficulties, providing they comply with the relevant rules of procedure. They need have no worries about their medium and long-term cash positions.

Under the autonomous management system, each municipality is regarded as an independent entity, even by the state, when it comes to the management of its finances. The municipal authorities often appoint a municipal treasurer to perform the necessary tasks, in particular to draw up and implement annual liquidity plans. These contain comprehensive and progressive inventories of cash inflows and outflows, and provide the basic framework for treasurers' work. Each individual municipality therefore pays attention to its daily cash balance. If the latter is too often large and negative, this will be costly in terms of interest payments. If, on the other hand, the balance is positive, the municipality must be able to place the surplus in safe, short-term investments.

Financial autonomy of this kind means that individual municipalities must establish good banking relationships. In addition to long-term loans, which are often necessary for investment projects, municipalities and their banks must plan for liquidity problems such as end-of-month cash shortages. Possible options here are the opening of lines of credit[1] and the use of short-term advances.

Nevertheless, the objective is to attempt to apply the zero-cash method, i.e. to keep liquid assets at the lowest possible level in order to avoid having to resort to borrowing, which is often costly, or having idle excess cash that could be put to better use.

1 Banks undertake to provide, at two or three days' notice, a sum "x" for a period "y" at interest rate "z". The interest rates and any commissions are sometimes renegotiated in the light of money market trends.

Once the various measures have been put in place, the individual municipalities must make sure that proper checks of cash movements and stocks are carried out, ranging from unannounced spot checks to analysis of the risks of certain short-term investments. In addition to security arrangements when cash is physically transferred, daily financial operations require certain precautions such as the double signature of all documents and signed daily balance statements. It is also advisable for an elected municipal official, or even the mayor himself, to receive a daily statement showing the municipality's general cash position (total encashments and payments, list of the main movements, such as wages paid, or taxes received).

Specific rules of procedure determine the responsibilities of the various persons in charge of financial transactions within the framework of the relevant legislation.

The advantages and disadvantages of the two systems briefly described above are the subject of much debate, in particular in states which apply the "single treasury" system.

This approach is sometimes criticised by certain municipal officials, who would like more independence (freedom to invest surplus funds, relations with financial partners other than central government) or, at least, the introduction of a system for crediting and debiting interest on the municipal accounts opened with national treasury departments. As central government authorities have to concentrate on meeting their own commitments, they could perhaps delegate more powers to local authorities or municipalities in this area, resulting in a corresponding increase in the latter's responsibilities.

Moves in this direction can already be seen in the introduction of block grants to municipalities as a replacement for various individual subsidies which they used to have to apply for in accordance with their specific objectives. Municipalities often actually receive two block grants, one of which is specifically earmarked for infrastructure projects.

A trend of this kind towards increased responsibilities on the part of local authorities could also have an impact in cashflow management terms. Greater freedom of manoeuvre would require an appropriate overall framework involving laws and regulations, improved controls and the increased use of information technology.

Report by the Congress of Local and Regional Authorities in Europe (CLRAE) on local finance in Europe

with the assistance of Professor Günther Hedtkamp

TABLE OF CONTENTS

I. ATTRIBUTION OF RESPONSABILITIES TO LOCAL GOVERNMENT IN EUROPE

Local self-government – a local authority's political and economic independence from the central government and other higher tiers of the administrative structure of a state as far as local matters are concerned – is one of the basic pillars of democracy and therefore an important criterion for assessing the democratic development of a state. Accordingly, in its European Charter of Local Self-Government the Council of Europe calls for the implementation of the principles of local self-government, which it sees as an "important contribution to the construction of a Europe based on the principle of democracy and the decentralisation of power". Local authorities should be enabled by the constitution and ordinary laws "to regulate and to manage a substantial share of public affairs under their own responsibility and in the interests of the local population" (Article 3). Decisions that directly affect the local electorate can therefore be taken "close to the citizens" by people who are politically accountable, resulting in a democratic election, which is a mechanism for expressing approval or disapproval, functioning as a means of determining whether and to what extent decision-makers have considered citizens' wishes.

It is, of course, not possible to suggest, or indeed lay down, for all countries what functions are considered to fall within the responsibility of a local authority, because historical developments have an important role to play in this regard. Nevertheless, criteria not specific to a particular state can be developed that provide a basis for a politically desirable and administratively practicable solution to the problem of allocating responsibilities within a state. A basic principle at the level of constitutional and administrative law is that of subsidiarity, which, although initially subject to heated debate, is becoming more and more widely accepted. It is not only the relations of states to a supranational tier of government that are to be regulated according to this principle that people in the European Union are fond of emphasising. At the domestic level, too, only those functions should, according to basic democratic thinking, be transferred to a higher level that cannot be guaranteed to be carried out or cannot be properly carried out at the respective lower level However, it should, as a matter of fundamental principle, initially be assumed that the responsibility for carrying out a function lies with the lowest tier.

If an economic answer is to be given to this question, consideration should focus on the economic effects of public activities. A rational allocation of responsibilities will then consist in ensuring, if possible, that the area in which an activity is undertaken coincides with the political responsibility of a given tier, i.e. all activities whose effects are limited to local areas should be allocated to the local authorities and an activity influencing the national economy as a whole to the central government. For activities limited to particular regions, i.e. activities that affect areas beyond the boundaries of a local authority but not the entire national economy, intermediate levels can be introduced, whether they be administrative entities established under a national constitution or only associations established by special agreement, for example in the form of unions of local authority districts. In this way, it becomes possible for the costs of public activities to be attributed to a large extent to the decision-makers themselves – and ultimately to be included in the factors on which the electorate bases its choice – and therefore to render decisions more comprehensible. This is not only an economic but also very much a political advantage.

Such criteria can, of course, only determine basic features and cannot provide absolute rules that are valid in every country for a decision in an individual case.

Many European countries are still a long way from applying the principle of subsidiarity, however it is interpreted, and the principles of the Council of Europe's Charter of Local Self-Government. On the basis of gross domestic product, the expenditure of the local authorities ranges from 1.4% (Cyprus) to 27.5% (Sweden), with the local authority share above or slightly below 10% in only twelve countries. In twelve countries too, the share in overall public expenditure, which is a better guide to the degree of decentralisation in the public sector, is under 15%, and in five countries even under 10%, although it needs to be taken into account that delegated functions have been included in these calculations. This fact alone makes it clear that a purely quantitative approach is insufficient, even when the expenditure of constitutionally autonomous regional administrative entities in federal states that lie between the central government and the local authorities (cantons in Switzerland or *Länder* in Germany) is taken into account, because in these countries the principle of subsidiarity plays a decisive role in any case.

Allocation of functions in European countries

A consideration of the allocation of functions in European states reveals a clear emphasis on decentralised activities, with the question of local authority responsibility mainly influenced by whether the state concerned has a regional tier of government or not.

Among the typical functions carried out by, and generally the responsibility of, the local authorities are some aspects of public activity in the education sector, especially looking after children under school age, the care of old people, some health services, social welfare, housing, environmental policy and culture, but especially such typical local authority services as water supplies, waste disposal, the distribution of electricity, and transport. In many of these areas of activity local authority responsibilities are often supplemented by, or compete with, regional or central government functions. For example, nursery schools are, when they are not privately operated, usually run by local authorities, whilst in the school system local authority responsibility is mostly limited to particular areas of activity, whilst other areas are, owing to their regional or national importance, allocated to the higher tiers of administration. The same applies to health care and housing, local public transport, environmental policy and – more the exception than the rule – leisure and cultural facilities (e.g. museums, theatres, orchestras of national importance). In addition, many local authority activities must be carried out within an established legal framework, which often allows the local authorities little scope for discretion and leads to a blurring of the distinction between a purely local authority function and one that has merely been delegated. To be sure, even when the principle of subsidiarity is applied and externalities have been properly internalised account must be taken of the fact that a certain standardisation of policies is desirable in the national interest and that within a particular function category, for example education, it may be sensible to divide up the responsibility for areas of activity – here one only needs to think of primary schools, secondary schools and universities – among local authorities, regions and the central government.

However, in many countries there is a paternalistic attitude to local authorities that can be put down more to the desire to retain power and the arrogance of the higher tiers of administration than rational considerations. Many of the above functions are also defined from the outset as delegated activities by the legislature (as shared activities or activities for which the local authority is exclusively responsible). Here there is a danger, and one often complained about by the local authorities, that the local authorities will be assigned functions or that delegated functions will be extended without the necessary funds being made available.

Size of local authorities

The political and economic responsibility and ability of a local authority to fulfil its functions properly depends to a large extent on its size. The smaller it is the greater its ability will be to take decisions that are "close to the citizens". Conversely, its ability to meet citizens' wishes will decrease the larger it becomes. On the other hand, both according to the principle of subsidiarity and the economic criteria for the internalisation of externalities, the functions of higher tiers of administration will increase as the size of a local authority decreases. In the same way, the local authority's administrative competence (its ability to carry out its functions) will decrease the smaller the authority is. This leads to the question of whether there is not such a thing as an optimum size for a local authority. A clear answer cannot be given to this question either, since a great deal depends on history and traditions, as well as objective circumstances, such as the population density in a region, which may justify the small size of an authority compared with its population. On the other hand, the size of districts into which a large city is divided should not be smaller than that considered acceptable for the rest of the country. Assuming that these conditions are met, the following statement can be made about European countries.

In very many countries there are still, or once again (for example in the countries in transition), local authorities with fewer than 1,000 inhabitants. This also applies to some industrial countries, such as France and Germany. As far as size is concerned, everything indicates that it is correct to assume that such very small authorities can no longer carry out properly and independently very many of the functions that are basically typical of a local authority. In these cases it is necessary either to merge local authorities, if only for certain functions, or to create an additional higher tier. In many countries, this problem has been solved by means of boundary reforms, with very small authorities being combined to form larger entities. However, such an approach frequently meets with the resistance of the population and therefore raises the question of democratic legitimacy, even if a body higher in the administrative hierarchy should decide to carry out a territorial reorganisation.

A local authority with between 1,000 and 5,000 inhabitants must also be considered to face very big administrative and economic disadvantages, even though in many regions the low population density hardly leaves any alternative. When one considers that in most European countries the vast majority of local authorities are of this size (up to 5,000 inhabitants), it becomes clear that there is a problem here, and this is one of the reasons why local authorities are often *de facto* given so little scope with regard to financial autonomy.

These arguments should not be interpreted as a plea for large authorities. A boundary reform that leads, as in the UK, to an average local authority size of about 100,000 inhabitants would probably go beyond what would be considered a sensible objective of such a reform and conflict both with the principle of subsidiarity and the economic aim of internalising externalities. From the administrative point of view, too, excessively large local authorities lead to considerable inefficiency (administration too remote from the citizens) and encourage citizens' disillusionment with the state, which is on the increase in some places.

II. THE FINANCING OF LOCAL GOVERNMENT ACTIVITIES

Like every other tier in the administrative structure of a state, local authorities have taxes, fees, contributions and income from services supplied at their disposal. To supplement their finances they also have the possibility of raising loans from internal and external sources. In their capacity as lower government bodies local authorities are also given specific or non-specific grants by higher authorities.

Taxes

Whether an authority has genuine financial autonomy depends on the size of the income available for it to use as it wishes. The more a local authority must rely either directly or indirectly on the granting of funds when it wants to spend money or requires permission to do so, the less possible it is to speak of local self-government in a particular sector. On the other hand, the democratic legitimacy of decisions involving the expenditure of money depends on whether and to what extent local citizens are directly affected by the financing of whatever has been decided, with the result that the local council is called to political account in elections. They leads to the demand that the local authorities be given their own tax-raising powers and the right to fix the tax rate and, as the case may be, the basis of assessment. In order to preserve the comprehensibility of decisions of the local council and avoid the exploitation of individual groups of inhabitants as a result of those decisions, care should be taken to ensure that all citizens are subject to the payment of tax. Consideration should also be given to taxing people according to the principle that those who cause costs to be incurred (both individuals and companies) should pay, i.e. industry and commerce should be included in local authority taxation in addition to all groups of inhabitants.

Almost all countries have left it to local authorities to collect very small taxes, such as dog licence fees or entertainments tax. However, these taxes yield negligible amounts and it is debatable whether there is any justification for them in a rational tax system. Very few European countries have provision for genuine local taxes that yield an appreciable amount and for full autonomy to collect them. For example, the Nordic countries leave it to the local authorities to collect income tax, the rate of which is fixed at the local level. In most cases the basis of assessment can at least partially be fixed by the local authorities (tax exemptions). Switzerland and (with much less fiscal significance) Greece and Romania also permit local authorities to collect an income tax.

In other countries (approximately half of European states) the main taxes levied are the various forms of property tax on the French or British model, in most cases at rates that can be determined either freely or within specified limits by the local authorities. However, owing to difficulties assessing the value of assets and levying the sum payable these taxes only yield a relatively small amount.

In a number of countries, e.g. France (taxe d'habitation) and, for some time now, the UK (council tax), citizens, who are responsible for a considerable proportion of the expenses incurred by the local authority, have had to pay a separate tax that, owing to the limited possibilities of distinguishing between one payer and another, only yields a relatively small amount or else provokes a great deal of resistance.

In France, Austria, Germany and a number of countries in transition a tax on businesses (either on earnings or factors of production) continues to be levied (taxe professionnelle, trade tax, payroll tax), the rates also being determined by the local authorities.

Where genuine local taxes are levied in other countries these taxes are mostly dependent on the value of assets and are seldom payable by companies. Leaving aside the local authorities' share of revenue from a general consumption tax, for example value added tax, which is not an independent local tax, hardly any country in Europe has a sales tax of the type that is widespread in the American system.

In the Nordic states, purely local taxes yield (as a result of the income tax the local authorities are allowed to collect) between 30 and 60% of all local authority revenue. However, around 40% comes from local taxes in France and in Switzerland too. If shared taxes that the local authorities may either spend as they wish or according to specified criteria are added, the group of countries with substantial local taxes grows to include Austria and Germany. On the other hand, in almost half of European countries only 10% or less of expenditure is covered by taxes that the authorities levy themselves.

In most countries, with the exception of Germany and Austria, local taxes are collected by the general inland revenue service of the state concerned, with the local authorities' ability to influence this varying from one country to another. When there are a large number of small local authorities this is always necessary in the interests of efficient financial administration and of minimising collection costs. With regard to local self-government mere assistance on aspects of taxation is unimportant. What is more important is the fact that in those countries that have established a standard public revenue office for all authorities the handling of the budget from the technical point of view is carried out by civil servants either for all local authorities or only for the smaller ones. In many countries the budget is run by a special administrative unit headed by a treasurer responsible to the municipal council or by a special budget committee.

Where local authorities are allowed tax revenue in addition to these local taxes the income is derived from their share of community taxes or taxes imposed by higher authorities, usually the central government (shared taxes).[1] In this case too, sharing in this revenue may further the cause of local self-government and even be similar to levying a genuine local tax, especially when the local authorities are granted the right to impose a supplementary levy on such a central government tax and are free to fix the rate, perhaps within certain limits. However, this is only possible in exceptional cases. As a rule, the local authorities receive a percentage of these shared taxes that is fixed by the law or the constitution. Very often they do not receive an unlimited share of local tax revenue but are subject to limits established for the purpose of financial equalisation, with a percentage of the yield from such a tax allocated to a local authority according to a particular formula that takes account of such aspects as the relative financial position of the authority and any particular burdens it faces. Even though such provisions are a long way from realising the actual aim of allowing an authority to levy its own local tax this revenue does constitute an important pillar of local authority finance, and therefore something that must be considered a positive aspect. Such shared taxes only exist in a few countries (Austria, Belgium, Bulgaria, the Czech Republic, Hungary, Germany, Latvia and Poland), but they are as a rule extremely important. In most cases the local authorities are free to use them as they wish and they are allocated according to objective criteria - i.e. they are not discretionary.

As a rule the local authorities have no direct control over the way their system of finance is organised, especially over the levying of their own taxes. Political influence is exercised to a large extent through unions of small local authorities and conventions of larger municipal authorities, as well as the political parties. In some cases, for example Sweden, there is also institutional provision for direct participation.

1 Shared taxes are defined here as taxes the proceeds of which are used by several different tiers of government and not, as is normal in the UK, centrally collected local taxes that are subsequently distributed to the local authorities in accordance with fixed criteria.

Fees and contributions

As the local authorities generally handle essential public services – water supplies, sewerage, waste disposal and energy supplies (electricity and gas) – and also provide a number of other services in the area of child care and the care of old people, the fees the users of these services are charged may constitute a considerable source of income when the authority provides the service itself. The importance of fees and contributions for the local authority budget thus depends on whether and to what extent the authority is responsible for providing public services (the Nordic countries supply a very wide range, as do Austria, Luxembourg and a number of countries in transition) and on the form these services take, because in those cases in which services are provided by public undertakings that have been excluded from the local authority budget – i.e., only their net balance is incorporated in the budget - the fee budget is relatively small. As it is public undertakings that perform such functions in the developed industrial countries the proportion of fees in the local authority budgets of these countries is low, in contrast to countries with a relatively low gross national product.

The same applies to earnings from entrepreneurial activities, which, apart from the countries in transition, is in any case only of minor importance because in market economies the public authorities need to provide special justification for producing goods – i.e. the aim of generating income is not a sufficient reason. As a rule, when the local authorities, as service providers, supply work for payment it is not only costs that play a role in calculating the charge to be made but also political considerations. In cases in which higher authorities intervene by enacting framework legislation or by-laws in the interests of ensuring uniform living standards, as happens in many countries, the principle of local self-government is violated to the detriment of citizens' wishes and renders privatisation more difficult.

Possibilities available to local authorities of raising loans

As receipts of money (especially tax revenue) and expenditure do not take place at the same time, a short-term cash advance is often necessary as a bridging loan to prevent financial transactions coming to a halt. In a number of countries it is granted to the local authorities by a single state treasury, the central bank (in the UK) or specialised banks (in Germany, the municipal savings banks). All that is necessary is the imposition of a limit corresponding to the budget volume.

In all European countries the local authorities are also allowed to finance part of their work by raising loans, which may be granted by a higher authority or obtained from the capital markets either through a co-ordinating body or even directly by the local authorities themselves. In most countries up to 10% of expenditure is financed in this way. Only in few countries is the amount borrowed higher. Some countries even in principle allow money to be borrowed abroad, although in most cases authorisation must be obtained from a central government institution (a ministry or the central bank).

A medium- or long-term loan is basically justified for the financing of investments that will yield benefits in the future when these yields will offset the financial expenditure either entirely or to a considerable extent. However, this means of financing projects also suggests itself for reasons of inter-generation equity, since the generations that profit from the investment whilst it is being used can be required to pay a share of the financial burden commensurate with the benefit they derive. The financing of public expenditure on goods and services by raising a loan, or even the financing of a local authority's current account deficit, must be considered to be much more problematic.

The danger of local authorities becoming insolvent and higher authorities having to intervene, if not *de jure* then *de facto*, in the event of bankruptcy leads to the involvement of the higher tier of authority responsible for the local authorities. In most countries higher authorities keep an eye on the local authorities for this reason and make the raising of a loan dependent on their authorisation – either directly for each loan or indirectly in cases where each local authority budget is subject to formal approval (e.g. in France by the prefect). From time to time an independent body (regional accounts chamber in France) can sometimes be called in to examine a budget that is being objected to on account of the plan to raise a loan.

Such procedures only violate the principles of local self-government when the body that has to give its approval has to take a decision in accordance with objective and justified criteria laid down by law. This is tantamount to the supervision of the authority concerned to ensure it is acting legally. Examples of such objective criteria would be a net investment specified in the budgetary plan (perhaps as part of a cash budget) or other budget indicators, such as a certain percentage of the local value added, a certain percentage of the overall budget or certain categories of expenditure. The authority's indebtedness can also be taken into account. As these criteria are only applied when the purpose of a loan is to be examined (which can only be done with difficulty) or only formal indicators are employed without taking sufficient account of the possibilities available to the authority of financing its activities, the authority should be allowed to prove how it intends to guarantee the financing of its debt service from ordinary income (without a loan) for the entire period of debt repayment. In a number of countries this is also either explicitly or implicitly examined.

Countries differ in the way they supervise authorities to ensure they are acting in conformity with the law. In most cases this is done by a ministry responsible for such supervision, in many cases the ministry of the interior.

The raising of loans is closely related to the size of an authority, because it would be difficult to imagine small authorities, for example those with under 5,000 inhabitants, approaching the capital market themselves. They generally lack the administrative expertise, and the amount of the loan required is below the optimum level. In addition, they are often not credit-worthy (the mortgaging of municipal assets is usually not permitted), so that the creditor will at least demand a risk surcharge on the interest payable. For this reason, in countries with local authorities of many different sizes the raising of loans for small authorities, or even for all authorities, is carried out by special institutions that are either subordinate to central government bodies or the local authorities as a whole.

If such organisations only handle technical aspects and the formal allocation of money there is no reason to consider this to be a violation of the principles of local self-government. However, if such institutions are centrally controlled, especially for reasons of economic policy, such interventions must be viewed with a much more critical eye.

Grants and fiscal equalisation

In many countries transfer payments granted to local authorities by higher authorities account for a considerable proportion of local finances. In most countries these payments contribute more than 50% of the local authority budget, and in only a few countries (the Nordic countries, Switzerland and France) does an authority's own tax revenue exceed the amount of these transfers to a significant extent or correspond approximately to them. Thus, given the size of these payments the question arises as to whether local self-government is possible at all in such grant-dominated systems of financing expenditure. As these "vertical" revenue flows are in any case subject either *de jure* or *de facto* to the strong influence of the central authority granting the money, the level of the grant provides prima facie evidence of central government influence. However, to what extent local self-government is restricted as a result depends on the actual conditions under which the payments are made. Central bodies responsible for making grants have the strongest influence when such transfers are linked to a specified purpose and the grant is discretionary, and the greatest degree of freedom is provided by transfers that are determined according to objective criteria both with respect to the amount concerned (including the total to be allocated) and their distribution and when they are made available to be used as desired. Here the differences between one country and another are considerable, and without a precise knowledge of the arrangements in each case it is not possible to make an assessment of the degree of local self-government possible. In addition, "vertical" revenue flows are employed as a means of equalising local authority finances. The financial strength of local authorities can, for example, be adjusted by means of a capitation grant. The distribution of shared taxes according to this criterion has the same effect. The effect of the equalisation can be increased when establishing the size of the population by giving greater weight to certain persons according to the demands they make on the authority, for example persons belonging to certain age groups (children, old people).

Another system of financial equalisation consists in making payments "horizontally", i.e. by obliging the "rich" authorities to pay into an equalisation fund in favour of "poorer" authorities. Ideally, such systems should not only be geared to revenue but also, and especially, to different needs. However, it is difficult to solve this problem since the equalisation procedure is supposed to remain free from discretionary decisions and be subject to objective criteria, so that ultimately only the composition of the population is taken into account when making a transfer.

The principle of financial equalisation, the aim of which is to ensure uniform living standards in a state, often meets with resistance among those obliged to make the payments, so that in many countries it takes place "vertically", i.e. payments are made by the central government.

As is sufficiently well-known from experience gained in distributing income tax revenue, there are limits to any redistribution policy, and therefore financial equalisation too. However, how far these limits are drawn differs a great deal from country to country (e.g. for historical reasons or for reasons of mentality), so that the significance of "horizontal" and "`vertical' equalisation with a horizontal effect" also differs widely. An objective limit is reached when those having to make equalisation payments, but also the recipient local authorities, lose interest in exhausting other sources of income. In this case they fail to reach the objective of local self-government.

III. SPECIAL PROBLEMS OF LOCAL GOVERNMENT FINANCE IN THE COUNTRIES IN TRANSITION

The main aim of policy in the countries in transition is the decentralisation of a highly centralised totalitarian system and the restructuring of local authorities. This presents a challenge to both the political and the economic system, since it is necessary to produce goods and services that the consumer and voter wants. During the communist era local self-government was abolished in favour of the political monopoly of the Communist party, a single state authority, a uniform administration and the fiscal monopoly of the state. Consequently, the local authorities lost their legal status, their democratic legitimacy, their right to govern their affairs and their property rights. They became part of the central budget and degenerated into executors of the central government. Given these restrictions the authorities that remained had few possibilities of protecting local interests.

In all former communist countries the legal framework was quickly rebuilt in order to carry out institutional changes, and a guarantee of local autonomy was enshrined in constitutional law. Local authorities were given general responsibilities for all public functions not assigned to other public institutions, new property rights and the right of self-government through elected representatives.

It was obviously easy to put these principles down on paper, but it was more difficult to turn these general rules into detailed provisions. In practice, it will take years to achieve effective institutional and legal solutions. This is not only a question of organisation, experience, manpower and technical equipment but also a spiritual and political issue. In the old democracies too, it is an all-important task to take powers away from the central government, and this is all the more necessary in those countries in which power was until recently highly concentrated and new administrations have to be run by the staff that ran the old system since there are few qualified people who did not work in that system.

In the socialist countries the central planning system needed a certain degree of administrative centralisation for the purpose of providing the information that it wanted to disseminate and of implementing its policies. The countries in transition therefore inherited an administrative tier situated between central and local government. This tier had nothing to do with the decentralisation of power but was the link between the planning agency and economic units necessary to strengthen the power of the central government. These authorities were, as a result of their administrative functions, their organisation and the size of the region they governed, in general unable to fulfil the functions of an intermediate local authority in the new democratic system. Most countries abolished or restructured these authorities. The members of the restructured authorities are not elected but delegated by the local authorities. They have very reduced responsibilities, mostly to do with legal supervision and the co-ordination of public services. They also act as fora for exchanging information, oversee the functioning of the central government administration (both their old and their new role) and, above all, carry out delegated functions of the central government.

In most countries the constitution and legislation relating to local authorities permitted new municipalities to be established, which in some countries led to a very large number of small local authorities that were unable to provide the democratic institutions (e.g. a mayor and a local council) necessary to fulfil the proper functions of a local authority. From the beginning these countries have been confronted with the problem of carrying out reforms to reduce numbers and defining minimum standards.

It was extremely difficult to establish local authorities because this had to be combined with the reorganisation of property rights. The socialist enterprises were responsible for many areas, such as hospitals, cultural centres, concert halls, kindergartens, roads, etc., that would normally have been the responsibility of local authorities or other public sector bodies. Conflicts arising here cannot easily be resolved, because some property is claimed by the state, on the one hand, and enterprises or a privatisation agency, on the other. For example, medical care, cultural activities and sports are also carried out by private enterprise in market economies. However, the bulk of this property was given to the local authorities, in spite of the fact that it should be privatised or used by the state under its public housing policy. The municipalisation of this property constitutes a heavy burden on local authority budgets. Paradoxically, rents and user charges are controlled by the central government.

The local authorities inherited local industries from the beginning, not only those providing public services but also others engaged in the production of goods for private consumption. Lacking sufficient revenue, they will defend this source of income for as long as it is profitable, in spite of the fact that this is not in conformity with the principles of a market economy.

In general the revenue side of local budgets is insufficient. Where there is a very small local tax base it is difficult to obtain any revenue from local taxes. Most countries impose a property tax, but this is problematic since it is difficult to tax farmers and a large part of urban property consists of private housing or public property and is difficult to assess. An income tax that deserves the name is only at the initial stage of development in most countries owing to the fact that it is difficult to administer and obliges people to declare their earnings. Most revenue comes from minor taxes, such as vehicle licences in some countries, permits and user charges. The tax rates are in most cases fixed by the central government. Other income is derived from public property, grants allocated by the central government for general or specific purposes and loans. As far as grants are concerned, the amount received depends on the size of the general grant and the way in which it is distributed. The normal rule in many countries is to apply a small number of objective criteria laid down by law. The assessment of a grant allocated for a specific purpose depends on the size of the local budget and on whether its use is restricted to the financing of local investments. The local authorities need to be able to finance investments, at least a part of them, from their own normal revenues.

A consideration of the development of local finances in the countries in transition reveals that there have been positive developments over the last five years and that these countries are approaching western standards.

IV. EUROPEAN LOCAL AUTHORITIES'ASSESSMENT OF THE SITUATION WITH REGARD TO LOCAL SELF-GOVERNMENT

An initial survey of European local authorities has shown that not even half of them consider the funds available to them to be adequate. This is not surprising, since in most countries they are dependent on transfers and do not have sufficient possibilities of adapting their own income, especially tax revenue, to the financial burdens they face. In particular, some countries that basically consider the system of financing local government to be good in principle (e.g. Sweden) make the complaint made by almost everyone that higher authorities often assign new functions to the local authorities without making the necessary money available. As a rule, these functions consist of new or expanded social services (for example, in Germany the local authorities were obliged to make a nursery school place available to every child without being compensated for the investment and maintenance costs), or else functions are delegated that were previously the responsibility of the central government, such as the payment of unemployment benefit when the state shortens the period in which transfers from the unemployment insurance fund are made.

Most local authorities believe that the higher authorities are also either not willing or reluctant to revise the distribution of income between the tiers of government when considerable structural changes take place with regard to the functions carried out. These changes that have recently led to dramatic increases in local authority expenditure in certain areas, for example the social benefits that become necessary as a result of rising unemployment, caring for old people, an increase in the number of homeless and drug-dependent persons, the growth in crime or a rapid rise in the number of migrants from crisis areas and war zones.

If there is only a slow response to such developments it is not surprising that almost a third of countries surveyed complained about a lack of flexibility in the case of unforeseen circumstances. At first glance it might appear astonishing that it is precisely those countries that react more flexibly which have allowed their local authorities a relatively low degree of autonomy. However, when one takes a second look this very quickly becomes explicable, for when local government finances are viewed as a matter to be supervised by central government and local authority functions are to a large extent delegated the financial side is also considered more the responsibility of the central government, and therefore also seen in the context of the latter's budgetary requirements.

The possibilities available to local authorities of carrying out their activities in the way they wish, especially the possibility of establishing their own spending priorities, are relatively poorly developed both in countries with no tradition of local government (a number of countries in transition, but also Turkey) and in highly centralised countries (like the United Kingdom). In these countries the foundations of local self-government are only weak. However, also in countries with formal legal provision for a high degree of local autonomy and self-government the possibility of actually making use of these freedoms depends on whether the local authorities have any financial leeway that permits them to establish priorities that go beyond the minimum of obligatory functions and delegated activities laid down by law, or even to assume new functions. The budgetary position of local authorities appears in almost all cases to be characterised by the fact that most authorities either have no or insufficient financial means available.

Although regional differences in wealth, measured, for example, by per capita GDP, vary from one country to another, they lead in all large countries to differences in local taxable capacity and the tax burden and make financial equalisation necessary. The local authorities unanimously see it this way too. Those surveyed are even mildly in favour of, or indifferent towards, the system of financial equalisation when the influence of the local authorities on the arrangements for, and implementation of, the equalisation is either weak or non-existent. However, one should be very careful in concluding from this that there will be no problems in developing the system of financial equalisation further, because the local authorities will give different responses to the question of how they assess the situation when the financial equalisation system, which is still not well-developed in most countries, not only has provision for recipients but also for remitters of transfer payments. The responses will then certainly differ from one local authority to another, depending on whether it is one of those that benefit from the system or one of the losers. However, even then a great deal will depend on the extent of the redistribution. For example, criticism will increase the more the financial burden grows, which is something that can also be observed in connection with the policy of redistributing tax revenue.

A genuine system of "horizontal" financial equalisation between the local authorities in the form of the richer authorities making transfers either directly or indirectly (via a fund) to relatively poorer authorities is the exception, but many countries are endeavouring to introduce such a system. However, as the example of Germany shows, experience with these systems is more unfavourable than not, because it is politically difficult to get them accepted, they bring in relatively little capital and have the above-mentioned drawbacks. For this reason, the bulk of financial equalisation takes place via "vertical" revenue flows from the central government downwards, especially in the form of grants. As the redistribution of revenue as part of a financial equalisation system still plays a minor role in many countries and is yet to become more widespread, and as it is at the moment impossible to see what the scope of the equalisation will be and how it will be organised – although arrangements for it to be carried out, whatever form they will take, are expected in some places in the near future – most people are adopting a wait-and-see attitude in these countries.

The methods employed by the various countries that operate a financial equalisation system have up to now been very similar. For example, a local authority is only compensated for part of the amount that its income deviates from the average for all local authorities. When shared taxes and grants are distributed this is generally done on the basis of local tax revenue, but mostly according to egalitarian principles on the basis of the number of inhabitants, perhaps by weighting groups that cause particular costs to be incurred (children, old people). In those places in which attempts are being made to take into account other criteria with regard to financial needs, the financial equalisation procedure is adversely affected by permanent political disputes about the criteria that are being applied and about those that, in the view of other local authorities, should be applied instead, or at least in addition. The conclusion can be drawn from this that those involved in financial equalisation procedures should dispense with establishing and taking account of differences in financial burdens that result from the carrying out of public functions.

Only in relatively few countries are local authorities allowed to participate directly and in an institutionalised form in the taking of decisions of general principle or even in decisions on changes in the system of local government finance. They are, however, consulted in a relatively large number of countries. The exercise of these rights of co-determination is also governed more by tradition and the need for taking rational political decisions than the principles of local self-government. Unitary states especially depend on information from lower authorities, whilst decentralised countries that allow their local authorities to have sufficient funds and their own source of income – in particular local taxes – do not need a system of financial co-operation. However, as most countries are between these two extremes and the local authorities are controlled by the central government in many areas of activity – which entails considerable financial consequences – institutionalised co-operation would be desirable.

Happily, the number of grants tied to a particular purpose has declined in most countries in favour of non-specific grants. Although financial equalisation objectives are very often also pursued when a grant is made, even if it is not tied to a particular purpose, the local authorities in most countries evidently accept this on the whole.

In the countries in transition and Turkey, the influence of central government is greater and the criteria for discretionary grants are more numerous. There can be no doubt that the greater the number of criteria for allocating funds the more possibilities of exercising political influence there are, especially when the weighting is not free from subjective considerations.

The least criticism was voiced in the survey in the area of local authority borrowing. Here, most states are obviously very liberal and allow a very large amount of public debt, often even in foreign currency. In a number of countries there are, it is true, central government institutions through which loans are raised, but this procedure is not criticised since these central institutions evidently only handle the technical side of the transaction and only examine its legal aspects.

In order to ensure that the local authorities remain solvent, borrowing is mostly tied to certain criteria (e.g. investments), and proof must be furnished that the local authority can guarantee that it will service the loan it is raising. As in the case of other aspects on which an opinion was given, criticism was only expressed by the local authorities of countries where the situation as far as local self-government is concerned leaves much to be desired (e.g. Turkey).

Apart from the above-mentioned desiderata (better and more flexible system of local government finance, rights of co-determination, etc.) the local or even the state authorities in many countries are thinking about reforms of a more fundamental nature. These reforms concern:

– the size of local authorities, a reform that should be pursued with due caution;

– the creation of an additional tier between the central government and local authorities if one does not already exist (regions, provinces, department, counties, cantons, *Länder*), with the aim of bringing political and economic decisions "closer to the citizens" and rendering those decisions more comprehensible;

– the solving of the problem of centrally located municipalities with functions that transcend their own boundaries. In many countries this is one of the requirements of a reform because it is very difficult to solve the problem of getting surrounding areas to share the burdens that result from the function fulfilled by a central locality and establishing to what extent the benefits should be taken into account that result from the increase in the demands for private services of the people living in those areas, since these demands lead to an increase in the revenue of the locality;

– the centralisation that is again on the increase in individual countries in transition and is the subject of complaints by local authorities there. Traditions and ingrained attitudes on the part of public administrations play just as important a role here as mistakes made when changing the system and impatience with regard to all steps towards reform;

– the introduction of a standard public revenue office. The French system is especially interesting for countries with a large number of small and very small local authorities;

– the privatisation of local authority services in order to reduce expenditure and increase efficiency. Privatisation is often viewed as an important step towards solving the problems facing the local authority budget because this allows public undertakings that have until now often operated at a loss to be sold off or certain services to be provided by existing private companies, with the price of the service to the consumer remaining the same or even being reduced if success is achieved in getting others on the market to compete. A precondition for this is the existence of the relevant legal provisions (e.g. for flexibility with regard to company management or the variability of the product offered). A considerable amount of experience has been gained in such areas as refuse collection, water supplies, local public transport, road-cleaning, etc.;

– the reform of the local government tax system as a whole. In this connection the question arises as to what is the optimum form of local tax and the best system of local tax collection. It is important that the autonomy of the local authorities should be strengthened in the course of carrying out such reforms, which means the creation of local taxes that increase the financial scope of local authorities by giving them the possibility (if it does not already exist) of carrying out their functions without being controlled by third parties. In addition, the political responsibility and legitimacy of local government functions should be strengthened by the authority's right to fix the rates of such taxes itself. However, in the various countries concerned this is not always the direction in which policies are actually developing. For example, local taxes with a high yield are sometimes abolished in favour of shared taxes levied at a fixed rate, which has happened in Germany. As these taxes are often not distributed on the basis of the local yield and the local authorities are not given the right to charge a supplement such a "reform" goes in the wrong direction.

When reforms of public administration, the allocation of responsibilities and the financing of local government functions do not lead back to central government but to more local self-government this will not only increase efficiency and prosperity but also strengthen democracy. The countries of Europe have, after all, in principle declared their support for carrying out this task.

Resolution on local government finance adopted by the Conference of European Ministers responsible for Local Government

RESOLUTION ON LOCAL GOVERNMENT FINANCE

The Ministers attending the 11th session of the Conference of European Ministers responsible for Local Government, meeting in Lisbon on 10 and 11 October 1996;

Having examined the reports presented by the Portuguese Minister for Infrastructure, Planning and Regional Management and the Vice-President of the Congress of Local and Regional Authorities of Europe;

Recalling that Article 9 of the European Charter of Local Self-Government opened for signature on 15 October 1985 states the principles according to which "local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers", "local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law" and "part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate";

Recalling recommendations of the Committee of Ministers of the Council of Europe No. R (92) 5, on borrowing by local and regional authorities, and No. R (96) 3, on local authorities' budgetary deficits and excessive indebtedness;

Considering that the current economic and financial constraints at European level necessitate increased monitoring of the efficiency of financial management at all levels of government;

Considering that overall tax pressure in a number of member states has reached a level deemed by taxpayers to be excessive;

Aware that taxpayers increasingly wish to know how their taxes and charges are used, and that transparent public accounts must be ensured at all levels of state administration;

Aware that a legal and financial framework needs to be provided in order to regulate the measures that local authorities may take to attract economic activities to their own areas;

Aware that local public expenditure, particularly on social services, environmental protection and treatment of waste, are bound to increase unless citizens are made more aware of their responsibilities and participate to a greater extent in stabilising such expenditure;

Considering that all levels of state administration must contribute to reducing the deficit in public expenditure, as future generations should not have to bear expenditure which exclusively benefits present generations;

Recognising that support of local authorities whose sources of funding do not match their responsibilities is one of the principles of local democracy;

SUBSCRIBE TO THE FOLLOWING PRINCIPLES:

I. General principles

a) increased financial autonomy for local authorities must go hand in hand with increased financial responsibility and monitoring by elected representatives and with effective democratic control by local electors; moreover, local authorities must control local public spending so that excessive debt does not endanger their autonomy;

b) a good level of transparency of local public expenditure allows the administrative controls on local authorities' acts to be reduced and simplified and thus fosters the principle according to which administrative supervision of the activities of local authorities should aim at ensuring compliance with the law and constitutional principles as stated in Article 8, paragraph 2 of the European Charter of Local Self-Government;

c) it is desirable and even indispensable for a certain standardisation of the presentation of local authorities' budgets and accounts;

d) financial autonomy for local authorities implies that at least some fiscal potential must exist within their own area;

e) within the limits set up by the law, local authorities should have full freedom to set charges and fees for local public services, so that they can, on the one hand, ensure the quality of service expected by local users and, on the other hand, balance the operating budgets of those services and in order to achieve these aims, local authorities should also have the possibility of adjusting the level of local exclusive taxes;

f) however, steps should be taken to prevent gaps between rates or bases for exclusive local taxes from generating excessive differences between local authorities which could alter production costs and distort competition; high taxation which is not offset by increased efficiency in local public services penalises residents unduly, whereas excessively low taxation may result in unjustified requests for financial transfers, give tax payers incentives to move from one area to another and provoke the relocation of businesses, thereby creating imbalances which, in the final analysis, are harmful to local authorities as a whole;

II. Principles concerning current expenditure

a) as a general rule, local authorities should balance their annual operating budgets without resorting to loans; this may be achieved more easily by having a separate account management for the main local public services and also by giving them the objective to balance their annual operating budgets;

b) a substantial part of state assistance in funding local authorities' current expenditure should take the form of block grants, to be used freely by local authorities; earmarked state grants should be confined to significant capital expenditure and certain current expenditure;

III. Principles concerning capital expenditure and debt

a) States should establish a reference framework enabling local authorities to avoid crossing the critical debt threshold;

b) the period for repayment of loans contracted in order to fund capital investment should not exceed the period of use of the corresponding facilities, so that the cost of amenities decided on and used today is not transferred to future generations;

c) in funding capital investment, local authorities should refrain from resorting to speculative financial instruments, given the risks incurred;

d) local authorities should be encouraged by appropriate means to join together and to co-operate with the private and voluntary sectors, by partnerships or other appropriate means within the limits of the law, in setting up and running certain local public services which necessitate heavy investment, so as to achieve greater cost-effectiveness and more efficient and balanced financial management;

e) local authorities’ capital investment should foster sustainable development, in order to reduce progressively the weight of "remedial" public spending in favour of "preventive" expenditure; States should foster such choices by means of earmarked grants covering part of the costs incurred in such investment;

f) local authorities should establish capital investment plans which cover several years and are updated annually; they should also periodically publish their current position with regard to debt of all kinds;

IV. Principles concerning financial equalisation

a) the principle of support in regard to financially weaker local authorities implies a system of financial equalisation, the conditions, calculation and allocation methods of which should be clearly defined according to the law on a non-discretionary basis;

b) equalisation instruments should be devised in consultation with local authorities, in order to maintain a spirit of mutual support without however penalising the most efficient local authorities, or allowing subsidised authorities to have no incentive for greater efficiency;

V. Principle concerning cash-flow management

States which opt for centralisation of local authority cash-flow management must be scrupulous in making payments to local authorities when they fall due, so as not to jeopardise their solvency or create unwarranted cash-flow difficulties;

RECOMMEND THAT THE COMMITTEE OF MINISTERS OF THE COUNCIL OF EUROPE:

1. bring the present resolution to the attention of governments and invite them to apply the principles set forth in it and assist local authorities in their implementation;

2. instruct the CDLR to pursue the work in the field of local finance, bearing in mind the following elements:

   i) funding and management of local public social services by paying attention to a possible role of local authorities in the fields of unemployment and social exclusion and other local public services which are important for citizens' quality of life;

   ii) different methods of financial equalisation;

   iii) advantages and disadvantages of different schemes whereby municipalities join forces and co-operate with the private and voluntary sectors;

   iv) the effects resulting from the limits on national public debt set up at European level on the financial autonomy of local and regional authorities.

The delegation of Malta, referring to paragraph I.d) above, reminds the Conference that the Government of Malta, when ratifying the European Charter of Local Self-Government, did not undertake to consider itself bound by Article 9.3.