



Limitations of local taxation, financial equalisation and methods for calculating general grants

Local and regional authorities in Europe, No. 65

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Report by the Steering Committee on Local and Regional Democracy (CDLR)
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INTRODUCTION

This report is a continuation of the work done by the Steering Committee on Local and Regional Authorities (CDLR)¹ in preparation for the 11th Conference of Ministers responsible for Local Authorities (Lisbon, 10-11 October 1996), in which connection a study on *Local finance in Europe*² has already been published.

On the basis of the analysis contained in the above study and of the general framework of local government finance systems, the report first describes local government finances from the dual angles of own or transferred resources and of earmarked or non-earmarked resources in order to give an indication of the degree of financial autonomy and, in particular, of fiscal decentralisation in several member states of the Council of Europe.

The report then attempts to ascertain the factors – both technical and political – which may hinder fiscal decentralisation, the aim being to examine the link between the existence of limitations on local authorities' own fiscal resources and the establishment of systems based on financial transfers.

It then looks more closely at general and earmarked grants by central government to local authorities, as well as the functions which transfers of this kind perform.

Lastly, it highlights the crucial role of financial equalisation in local government finance systems, reviewing the operation of both horizontal and vertical equalisation mechanisms, as well as the difficulties surrounding the choice of redistribution criteria.

The report is accompanied by several appendices which present various national transfer systems and the methods used for calculating the grants paid to local authorities, which should help give a clearer picture of how such equalisation mechanisms work in practice.

In short, the purpose of the report is to highlight, on the one hand, the opportunities for increasing local authorities' discretion in terms of fixing the level and nature of local expenditure and, on the other hand, the various problems which need to be solved in this connection.

However, the report does not aim to offer solutions to all problems or solutions which are valid in all cases. In the field of local government finance, the solutions adopted in each individual country must be consistent with the particular situation of its local authorities. Several factors have a decisive impact on governments' choices in this respect.

First of all, the structure of the relevant state (federation or unitary state) and the way its territory is organised have an impact on the system of local government funding adopted.

1 This committee is now called Steering Committee on Local and Regional Democracy.

2 Published in the study series "Local and regional authorities in Europe", No. 61.

At the same time, the division of powers between the various tiers of government, the range of powers assigned to local authorities and the distinction between own and delegated powers also influence the funding methods used.

The size (population and geographical area) of local authorities and other factors (of a demographic, geographical or socio-economic nature) affect their ability to raise taxes and to perform certain tasks effectively and independently from the financial point of view.

Lastly, the number of local authorities and the greater or lesser differences between them (i.e. their relative homogeneity or, indeed, the existence of great disparities) also affect the methods of funding which states put in place, as well as the possibilities for adapting them over time.

It was not possible in this report to analyse all these factors or their various combined effects and relate them to the structure of local government finance in each member state. It is nevertheless necessary to bear them in mind when making comparisons or attempting to obtain a clearer picture of the great variety of approaches and solutions adopted.

I. LOCAL GOVERNMENT RESOURCES AND FINANCIAL AUTONOMY

There are different ways of breaking down local government revenues in order to establish the relative importance of each component. In its report on *Local finance in Europe*, the CDLR divided the sources of local authority funding into the following categories: exclusive local taxes, fees and charges, financial transfers, borrowing and other revenue.

Article 9 of the European Charter of Local Self-Government suggests, at least implicitly, that the structure of local authorities' resources should be broken down into two broader concepts, viz that of "own" resources and that of resources "of which they may dispose freely within the framework of their powers" (i.e. non-earmarked resources). "Transferred" resources or "financial transfers" differ from own resources, and "earmarked" resources differ from "non-earmarked" resources.

It should be noted here that the two categories do not overlap, as own resources may well be earmarked or non-earmarked and the same applies to transfers.

It is not always easy to assign specific funds to one category or the other, as the differences sometimes relate more to the terminology employed than to the substance of the matter. This may also apply to differences between sources of funding which fall within the same category.

Lastly, it should be noted that the two categories do not cover all sources of local government funding, in particular borrowing, which is outside this double classification and which is not considered in this report.

1. Own resources (earmarked or not)

a. *Concept of own resources*

This report draws the border-line between "own resources" and "transferred resources" according to whether local authorities have decision-making powers regarding the level of resources under consideration.

Local authorities' "own resources" are those whose level is controlled by the authority, within the limits of the law. They are always resources generated within the territory of the authority concerned and generated either through local taxes, charges for goods or services or income from property.

The concept of own resources thus suggests a dual link between the resources and the local authority concerned, at the same time implying the existence of a certain freedom of action.

Firstly, the resources can be linked to the territory of the authority because they are generated there, in other words, there is a geographical link between the resources and the authority.

Secondly, they are resources which the authority receives from citizens (as local taxpayers, users of public services or parties to private or public-law contracts), in other words, there is a direct link between the local authority which receives the funding and the citizens who make the payments.

This link involves a legal relationship, as the authority has a recognised right to raise the revenues in question. In most cases, however, the link also has major political significance.

This clearly applies in the case of own fiscal resources, i.e. the exclusive local taxes: these are the local taxes which each individual local authority is entitled to raise and collect and whose rates (and possibly base, and/or other elements) it can determine within the framework of the law; in this case the local taxpayers hold the local authority directly responsible for the level and use of the corresponding revenues.

However, own resources do not only include exclusive local taxes, but also comprise other sources of funding, which sometimes account for a major share of local government funds.

These include fees and charges, followed by income from land ownership, shares in businesses and financial assets, and income from the sale of fixed capital, stocks, land etc.

b. Local authorities' freedom of action with regard to their own resources

The concept of own resources does not mean that local authorities necessarily have absolute control over the funds concerned. In fact, this rarely applies. In most cases, for instance, exclusive local taxes are actually mandatory taxes,¹ the details of which are laid down by law, and local authorities' discretion is confined to the power to set the rate of taxation, often within certain statutory bands. On the other hand, with regard to local authorities' freedom to dispose of their resources, their own tax revenues are not subject to earmarking (apart from certain exceptional cases involving only negligible overall amounts).²

As far as charges for the use of local public services are concerned, local authorities usually have some degree of freedom in setting the levels of fees and charges. Nevertheless, upper limits are set at national level in most countries. In addition, even if there are no binding regulations on the level of charges, it is difficult (particularly for political reasons) for local authorities to charge users more than the actual cost of the service provided: in practice, the opposite is usually the case.

Formally speaking, these fees and charges need not necessarily be earmarked resources. Regardless of the way in which they are entered in local authority budgets, it seems only natural, however, that the income concerned should be used to fund the corresponding services, as the link between the service provided and the fee paid by the user forms the actual basis for the charging.

1 It should be noted that, even when local authorities have no statutory obligation to raise such taxes, they usually have to do so in practice in order to balance their budgets or even to avoid losing their entitlement to certain financial transfers.

2 The earmarking of local taxes involves local authorities being required to use the corresponding revenues for specific purposes. Examples are rare and include parking tax in Austria, which is used for funding investment in roads and public transport, tourism tax in Switzerland, which is used for funding activities and facilities associated with tourism.

As far as income from property or the sale of assets is concerned, the use of local authorities' movable or immovable property may also be subject to restrictions and national regulations. The situation regarding the revenue raised varies from case to case.

In conclusion, local authorities' freedom of action with regard to their own resources may be very great or very limited.

As a rule, however, local authorities do have a real degree of discretion, albeit within the law, with regard to their own resources and therefore also have some degree of control over these resources and their level.¹

2. Transferred resources (earmarked or not)

The situation is different with regard to transferred resources, in particular shared taxes, general grants and specific grants.

a. Shared taxes

Under tax-sharing systems, tax revenues are shared out between different tiers of government and/or between different authorities within a specific tier. The percentage share allocated to a particular tier and the procedures for allocating shares to the various authorities in a given tier are laid down in national legislation.

Local authorities therefore have no control over the sums allocated to them, as they cannot alter the rate of taxation, never mind any other aspects of the tax concerned. At the very most, the relevant local authorities, as a group, are able to negotiate with central government and use their political influence to ensure that the rules for tax-sharing are fair. The tax-sharing system does, however, give local authorities in some countries such as Austria and Germany access to significant levels of tax revenues.

The share allocated to each local authority may be based on the tax revenues generated within its territory (which poses the problem of calculating these revenues beforehand) or, at least partially, on parameters designed to ensure some redistribution of resources.

Tax-sharing systems place local authorities in a stronger position than is the case with other forms of financial transfers. When the local authorities enjoy some form of constitutional guarantee (as in Austria and Germany), central government itself is bound by the rules of tax-sharing.

From a political point of view, it is also more difficult for central government to reduce the tax share allocated to a lower tier of government than to reduce the overall level of general and earmarked grants to local authorities.

¹ When all the exclusive tax elements, including the rate, are determined by central government, without any scope for adjustment by local authorities, there is little or no distinction between such a tax and a shared tax calculated according to the tax base of the local authority in question. In this borderline case, the exclusive tax is in essence equivalent to a transferred resource.

Lastly, as with own taxes, the shared tax revenues are not earmarked and the local authorities concerned can use them as they see fit.

Local authorities are unable to modify the basic elements of a shared tax, in particular the tax-rate, and this constitutes a major difference from exclusive local taxes. Nonetheless, this difference tends to vanish when local authorities' margin of manoeuvre decreases as a result of, on one hand, the limits laid down by the legal framework and, on the other hand, the growth in local spending that obliges local authorities to apply the highest tax-rate and to use their whole fiscal potential.

Therefore, it is understandable that shared taxes are considered "own resources" in the states where local authorities funding is traditionally based, for a significant quota, on tax-sharing and where the local authorities' right to a given share is constitutionally guaranteed.

b. General grants

This also applies to general grants which local authorities are free to use as they would their tax revenue, subject solely to the limits inherent in the extent of such authorities' powers and in any distinction made between operating expenses and capital expenditure.

Grants may be calculated on a flat-rate basis, for example according to number of inhabitants or estimated tax capacity and/or expenditure requirements. They may also be linked to the beneficiary authority's own tax-raising effort in such a way that an increase in local taxes collected by an authority results in an increase in the grant paid to that authority. The opposite may also apply, with an increase in local tax pressure leading to a decrease in the grant allocated.

As far as the amounts paid to local authorities are concerned, general grants offer fewer guarantees than shared taxes insofar as the amounts can more easily be revised every year and are more likely to be affected by budgetary constraints. This applies both to general grants paid by the state (central or federal government) and to any such grants paid to local authorities by intermediary tiers of government.

Nevertheless, the border-line between the two becomes blurred when, on the one hand, sharing of tax revenue is based on criteria other than mere distribution according to tax base i.e. when redistribution (or even equalisation)¹ criteria enter into play and when, on the other hand, the grant allocated to each local authority is determined according to objective, legally defined criteria, and some degree of stability is given to the total annual amounts available and the future trend of such amounts.

This can be achieved through an indexing mechanism, whereby the overall amount to be shared out between local authorities is linked to an appropriate macroeconomic indicator.

¹ See, in this connection, the example of the *Land* of Bavaria in Appendix VII: local authorities' shares in certain taxes are distributed in the form of general grants (with an equalisation effect) and earmarked grants, meaning that the tax-sharing system is more like a method for determining the rules for calculating the overall amount which the *Land* has to share out.

c. Specific grants

In the case of specific grants, not only is the overall amount fixed every year according to available resources, but the use made of the funds is also determined by the granting authority and the payments are made according to criteria which give that authority great discretionary powers.

Grants of this kind are therefore transfers intended for a particular purpose. Local authorities in receipt of such grants may only use them to finance specific expenditures or categories of expenditure.

Moreover, the purposes for which these transfers can be used may be specified with varying degrees of precision, and municipalities may enjoy greater or lesser discretion as to the actual use made of the sums they are allocated.¹

A specific grant may be allocated as a flat-rate sum, in which case a local authority is free to use the grant to finance any project corresponding to the specified purpose. On the other hand, the state (or any other agency) may, on allocating a grant, require the beneficiary authority to contribute a predetermined share of the financing of the project(s) for which the grant is used.

In other words, the state may make allocation of a grant contingent on a concurrent financial effort by the beneficiary authority, and the amount of such a conditional grant dependent on the sum contributed by the authority.

Furthermore, the state may or may not set a ceiling on its contributions to projects. Where there is no ceiling, the state's contribution depends on the overall cost of the project and corresponds to a given percentage of it; where a ceiling is applied, the contribution is no longer connected with the cost, and the beneficiary authority must bear all expenditure beyond a given limit.

Therefore, depending on the circumstances, allocation of specific grants may involve serious constraints for local authorities or, conversely, leave them largely free to act as they see fit; as a consequence, the difference between specific and general grants can become so small that it all but disappears, no matter how a grant is classified. In fact, where the sole limit on use of the amount granted consists in differentiation between operating expenses and capital expenditure, it can also be considered that the dividing line between specific and general grants has already been crossed and that the grant is in fact a general one. This is the approach adopted in this report.

3. Relationship between fiscal decentralisation and local self-government

If the criteria underlying the two categories mentioned above (degree of freedom in determining the level and the use of revenues) are taken together, the main sources of local government funding can be classified according to the degree of autonomy enjoyed by local authorities in terms of decision-making.

¹ For example, a grant earmarked for road infrastructure allows greater freedom of decision than a grant which must mandatorily be used for road signs.

In simplified terms, exclusive local taxes are the most satisfactory solution from the point of view of local self-government, followed, at almost the same level, by shared taxes and charges for services and then by general grants, with earmarked grants being the source of funding which places the greatest restrictions on the receiving authorities' freedom of action.

It can therefore be said that there is some degree of correlation between the level of fiscal decentralisation and the strength of local self-government: a high proportion of local tax revenues in relation to total national tax revenues and to gross domestic product (GDP) is a sign of a high degree of local autonomy.

It should, however, be noted that, if the ratios in question are low, it does not necessarily follow that local self-government is also weak, as other factors also have to be taken into consideration.

Table 1 gives the relevant figures for certain Council of Europe member states in 1994,¹ and these are also illustrated in Chart 1.

It can be seen that there are great differences in the levels of fiscal decentralisation throughout Europe. While the Scandinavian countries show a high degree of decentralisation, local tax revenues represent under 10 per cent of total tax revenues in nine other countries.

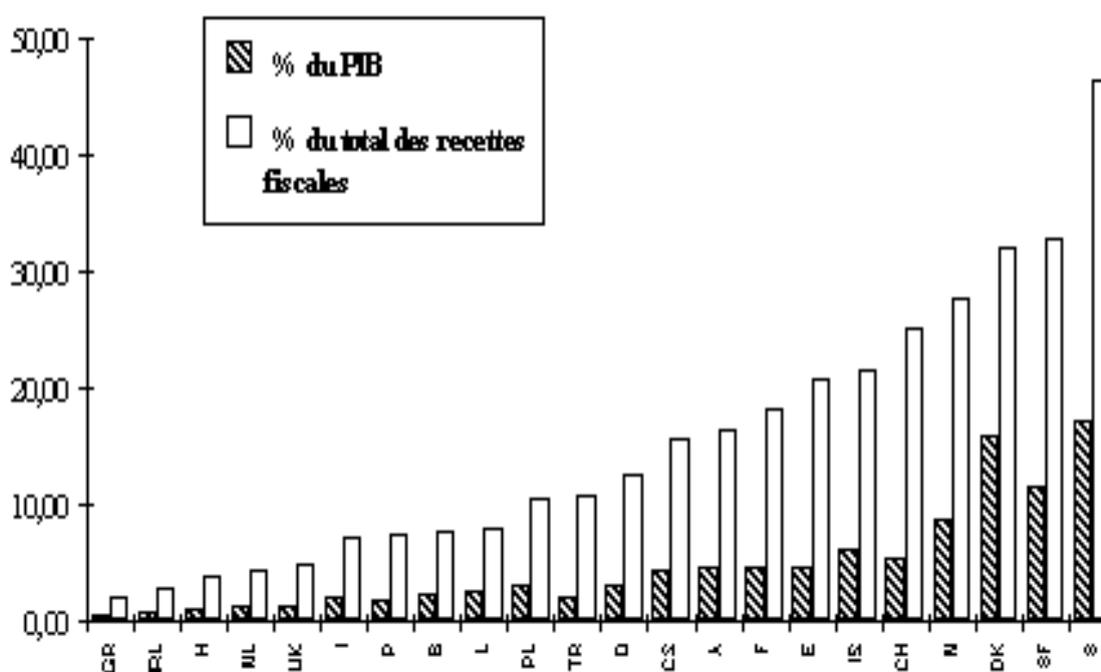
However, in countries with federal systems, the figures would have been much higher if the tax revenues of the individual federal states had been added to the local tax revenues category.

¹ The table is based on data published by the OECD in *Revenue statistics 1965-1995* (1996 edition). The tax revenues concerned are those of the state (central and federal government) and of local, regional and other intermediate authorities. Social security contributions have not been taken into account. The figures are for 1994 in all cases.

Table and Chart 1

Revenues from local taxes as a percentage of total tax revenues and of GDP (1994)

Country		Percentage of total tax revenues	Percentage of GDP
Austria	A	16.50	4.59
Belgium	B	7.75	2.41
Czech Republic	CS	15.72	4.44
Denmark	DK	32.00	15.97
Finland	SF	32.80	11.55
France	F	18.24	4.54
Germany	D	12.63	3.02
Greece	GR	2.05	0.57
Hungary	H	3.76	1.01
Iceland	IS	21.62	6.14
Ireland	IRL	2.76	0.88
Italy	I	7.05	2.02
Luxembourg	L	7.97	2.64
Netherlands	NL	4.41	1.15
Norway	N	27.65	8.65
Poland	PL	10.44	3.17
Portugal	P	7.33	1.78
Spain	E	20.79	4.57
Sweden	S	46.41	17.26
Switzerland	CH	25.14	5.41
Turkey	TR	10.82	2.02
United-Kingdom	UK	4.95	1.38



II. LIMITATIONS ON THE DEGREE OF OWN FISCAL RESOURCES FOR LOCAL GOVERNMENT

1. The level of local taxation and decentralisation

a. Article 9.3 of the European Charter of Local Self-Government

It is stated in the European Charter of Local Self-Government, Art. 9.3, that:

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

This paragraph of the charter refers to a particular aspect of decentralisation which also implies some freedom for each local authority to decide the level of its local taxes.

The arguments for this are mainly to further local accountability and to increase the degree of responsibility assumed by local authorities for the level of local services.

The idea that spending powers and responsibility for financing should be placed at the same level of government is referred to as the need for accountability. Accountability is only achieved if local authorities have to finance their expenditure by own taxation.

There is at present no way of monitoring progress in terms of compliance with Article 9.3 of the charter on this important issue.

This is because the term “local taxes” used in the international statistics includes revenue from the so-called tax-sharing arrangements, under which local authorities receive a guaranteed share in the tax revenue collected in the authority, together with the revenue from their own taxes.

Shared tax revenues reduce the vertical imbalance and give a certain degree of independence, but they do not, when used alone, give accountability, and they do not give the freedom for an authority to choose its own level of services by setting its own level of taxation.

Such freedom is only gained by local access to exclusive local taxes for which the tax rate can be determined by each local authority. However, it is possible to go beyond what is mentioned in the charter, and more local self-determination can be achieved if each local authority is also allowed to set its own deductions and tax base.

b. The advisability of using non-fiscal resources for funding certain local public services

In theory, it would be possible to have a system whereby local authority funding was based solely on exclusive local taxes, supplemented if necessary by borrowing, with the cost of the borrowing itself being covered by local tax revenues. Each local authority would then be free to adjust the level of local taxation in order to fund its expenditure.

However, no such system exists in any country. In 1994, there were only two countries where local authorities' own tax revenues accounted for over half of their income, i.e. Denmark (approximately 51 per cent) and Sweden (approximately 61 per cent).

At the same time, it is recognised that it is preferable to fund certain local public services through charges. In 1994, cumulative receipts from local taxes and charges for services amounted to around 73 per cent of local authority income in Denmark and around 69 per cent in Sweden. Switzerland is the only country with comparable figures (approximately 70 per cent in 1993).

It is also recognised that the methods used for funding a service must be consistent with need for transparency and the division of responsibilities. In the case of services for which central government delegates responsibility to local authorities, which thus act as agents of central government, it is therefore natural – and preferable – for the corresponding expenditure to be funded with transfers.

Similarly, when central government decides that a minimum level of a particular local public service must be provided for all citizens at a similar cost throughout an entire country and local authorities are therefore required to meet certain standards, transfers may be used to fund at least part of the standard services.

Nevertheless, the above considerations provide only a partial explanation for the high level of financial transfers. Indeed, in most European countries, local authorities' own resources do not even represent a third of their revenues, and one might ask why the fiscal autonomy of local government is restricted to such an extent.

There are two questions to be discussed in this connection:

- a technical question of whether local sources of taxation are buoyant enough to finance local government needs;
- a question of a more political nature is whether central governments feel that they can control local government expenditure policies without having recourse to transfers as instruments of control.

2. Technical limitations

The answer to the question of whether tax revenues are buoyant enough in the long term to keep up with trends in expenditure needs depends on the functions which are delegated to local authorities and on the taxes which they have at their disposal. This last point is discussed below.

a. Composition of local authorities' fiscal revenue in European countries

The composition of local taxes in different countries for 1994 is shown in Table 2. The table indicates the share of revenue generated by the different sources of local taxation as a percentage of total local fiscal income.¹ Nevertheless, it paints a very simplified picture. For example, it does not reveal more complex tax structures like that found in Belgium, with more than one hundred local taxes. Moreover, own local taxes and shared taxes are not separated in this table. The same figures are presented in Chart 2.

Table 2

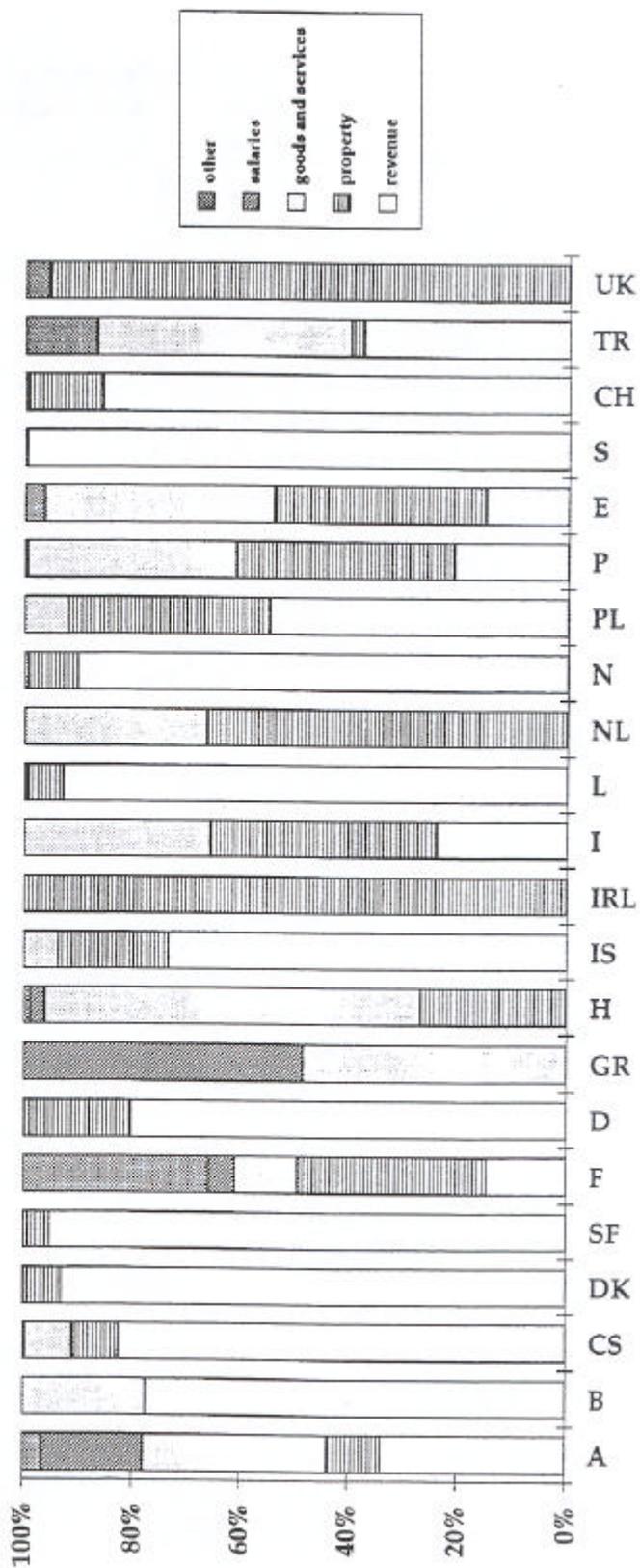
Composition of local fiscal revenue as a percentage (1994)

Country		Taxes on income/profits	Taxes on property	Taxes on goods and services	Taxes on payroll and work force	Other taxes
Austria	A	33.86	9.95	34.10	18.47	3.63
Belgium	B	77.58	-	22.42	-	-
Czech Republic	CS	82.64	8.26	8.57	-	0.53
Denmark	DK	92.79	7.07	0.11	-	0.03
Finland	SF	95.12	4.82	0.06	-	-
France	F	14.55	34.94	11.53	5.10	33.88
Germany	D	80.38	18.52	0.79	-	0.31
Greece	GR	-	-	48.29	51.71	-
Hungary	H	-	26.87	69.23	2.73	1.17
Iceland	IS	73.49	20.06	6.45	-	-
Ireland	IRL	-	100.00	-	-	-
Italy	I	23.93	42.12	33.96	-	-
Luxembourg	L	92.82	6.72	0.46	-	-
Netherlands	NL	-	66.86	33.00	-	0.14
Norway	N	90.10	9.32	0.58	-	-
Poland	PL	54.72	37.19	8.09	-	-
Portugal	P	20.85	40.51	38.15	-	0.50
Spain	E	15.01	39.10	42.24	-	3.65
Sweden	S	99.62	-	0.38	-	-
Switzerland	CH	85.84	13.73	0.43	-	-
Turkey	TR	37.52	2.46	46.95	-	13.07
United Kingdom	UK	-	95.60	-	-	4.40

¹ This table was prepared on the basis of figures published by the OECD in *Revenue Statistics 1965-1995* (1996 edition). Social security contributions are not considered. Composite local taxes, such as business taxes, which are very high in Germany and France, are broken down into their components. The group of taxes on payroll and work force covers taxes paid by employers, employees or the self-employed either as a proportion of payroll or as a fixed amount per person, which are not earmarked for social security expenditure.

Chart 2

Composition of local fiscal revenue in certain member states as a percentage (1994)



b. Advantages and disadvantages of the different types of local taxes

Among taxes on property, recurrent taxes on immovable property (real-estate taxes) are most frequently used. Real-estate tax plays a significant role as a local tax in English-speaking countries and the Netherlands, but its revenue potential – like that of other taxes on property – is limited by factors which cannot be examined in this study.

The fact is that taxes on property nowhere yield more than 4 per cent of GDP, and in Europe they exceed 3 per cent in only two countries – the United Kingdom and Luxembourg. This is far from enough to finance the expenditure of local authorities, in particular if they have to supply some of the free services of the modern welfare state, such as primary schools etc.

Real-estate tax is unresponsive to the effects of inflation and its base tends to remain static. Without regular (annual) adjustments of tax rates and/or of real-estate values, the tax revenue does not increase sufficiently over time to cover the price and wage increases of local government expenditure.

As to taxes on goods and services, revenue from such taxes can better reflect annual increases in wages and prices, but local differences of any significance would involve a risk of people shopping in low tax authorities while preferring to live in high tax authorities (with good services); thus there are limitations on their use as local taxes except in the form of tax sharing, where there are no local rate differences.

Sometimes local government is given a share of company tax revenue. Revenue from such taxes rarely shows the stability needed for the financing of local services. Another problem could be that, if, according to the law, the revenue is distributed to the authority of origin, conflicts on who has the right to the revenue arise. Companies frequently have activities in several local authorities, and there are often no economic criteria to determine where the income is created and, consequently, who ought to have the revenue. This kind of problem does not arise when the law provides for redistribution of the corresponding revenue on the basis of criteria different from the territorial origin of this revenue.

The tax which yields the most significant revenue over time is personal income tax. The use of personal income tax as an own local tax or a shared one is known in several countries.

Revenue derived from this tax represents a very high percentage of all local tax revenue in the six countries which are most decentralised in fiscal terms: 99.62 per cent in Sweden, 86.99 per cent in Finland, 92.77 per cent in Denmark, 81.80 per cent in Norway, 77.02 per cent in Switzerland, 73.49 per cent in Iceland.

It should be noted that in all these countries the tax is an own local tax¹ and that local authorities in Sweden, Finland, Denmark and (as a general rule) Switzerland are free to determine the rate of taxation.

1 Personal income tax is of course also levied by central government in all of the countries concerned.

Moreover, personal income tax is also an essential component of local taxes in other countries, in particular Belgium (61.54 per cent), the Czech Republic (82.36 per cent), Germany (80.38 per cent) and Luxembourg (92.82 per cent).

It therefore seems that there is no insuperable technical obstacle to fiscal decentralisation, in so far as local authorities have access to personal income tax. Reluctance to allow them access to such a powerful tax source and, at a more general level, to increase the proportion of own local taxes is more bound up with central government desire to retain a degree of control over local expenditure policies.

Nevertheless, it should not be overlooked that factors such as local authorities' size and number or significant differences in their individual tax capacities can have serious implications as regards the feasibility of launching or stepping up a fiscal decentralisation process.

3. Political limitations

It would seem that transfers from central to local government are instruments of control in all countries. Complete decentralisation would assume that central governments give up this instrument. The reality is that all countries have a vertical fiscal imbalance and all of them use some element of central transfers.

As already mentioned, where local authorities provide services on behalf of central government, the corresponding expenses should be financed through transfers.

Moreover, the desire to guarantee equivalent levels of service throughout national territory, at least for certain local public services, normally results in recourse to transfers as a means of financing such services.

However, these considerations apart, other arguments for setting certain limits on local taxation are advanced, primarily with the following objectives in mind:

- ensuring that local economic policies are consistent with the aims of national economic policy, in particular mastery of overall tax pressure and of public expenditure;
- avoiding situations which distort competition between economic agents;
- pursuing balanced, sustainable regional and local development;
- making adjustments at national level for disparities in the distribution of wealth and in funding requirements.

This raises the question how these objectives can be attained without interfering unduly in local self-government, that is to say without imposing unnecessary restrictions on local authorities' financial autonomy.

a. National economic policy and limitations of own taxation

There is no country where local authorities' own tax revenues are sufficient in themselves to cover all local expenditure. The main reason for this no doubt lies in central government reluctance to give local authorities full fiscal autonomy for fear that policies implemented at local level, which would escape all control, might hinder – or worse thwart – economic policies defined at state level.

What is more, central government needs to retain control over the resources required to fund the state's multifarious public expenses.

Certain macro-economic factors are also cited to justify controls over local-government tax policies.

In countries where local authorities have access to personal income tax, the size of the marginal tax rates is no longer controlled by central government. This is the case in Nordic countries.

There is much discussion on the effects of high marginal income tax rates, but in none of these countries has the local income tax alone reached marginal rates which are considered excessive, the average marginal rate of the local tax being about 18 per cent in Finland (with one single tier of local authorities) and approximately 30 per cent in the other Nordic countries.

However, problems arise because the central government also needs to tax personal income. For this reason one must speak of a certain limit on the local tax capacity.

The argument most often heard against exclusive local taxes is the risk of an upward drift in current public expenditure, with its well-known dangerous macro-economic effects.

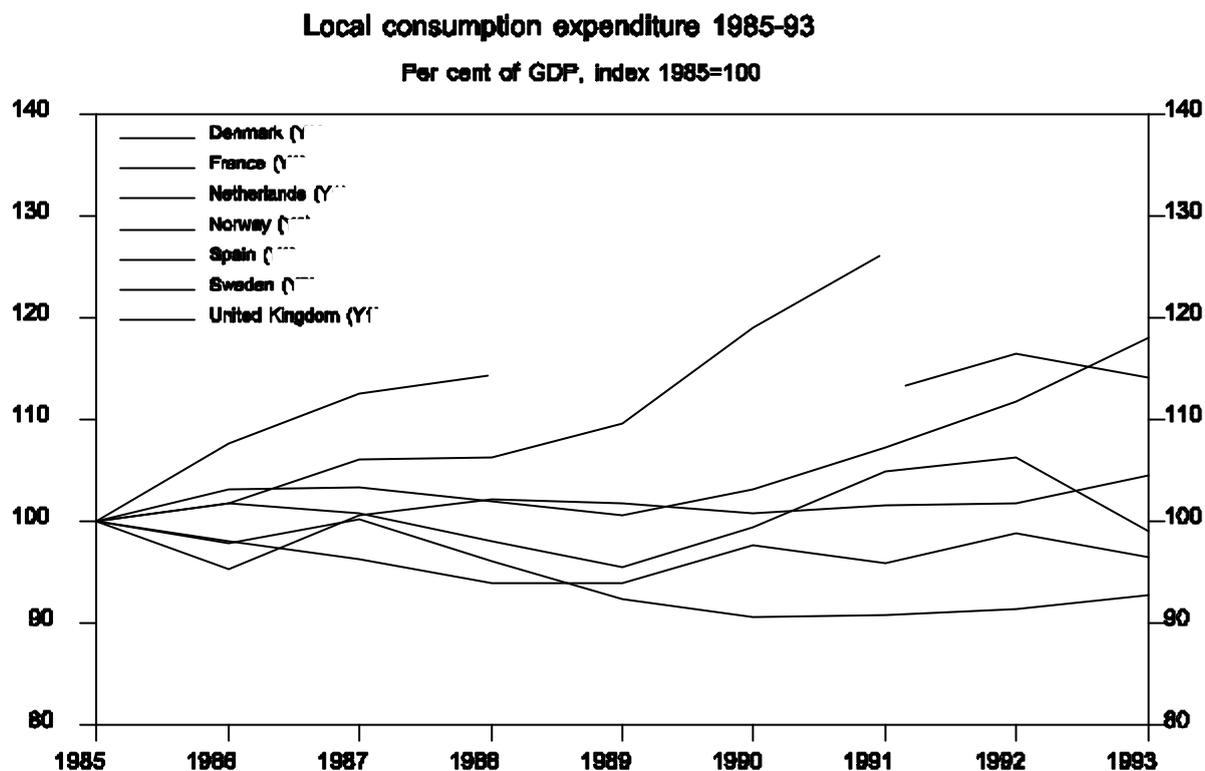
Nevertheless, Chart 3 shows that, since 1985, local consumption,¹ measured as a percentage of GDP, increased at the lowest rates in Sweden and Denmark with free local income taxation and in the Netherlands and the United Kingdom where local government has no access to income tax and the level of fiscal decentralisation is below 5 per cent.

In other words, there was no significant difference in growth rates of local consumption whether there was a powerful own local tax, or not.

This suggests that there is no need for a limit on the use of exclusive local taxes instead of transfer arrangements.

¹ According to the OECD, the (final) consumption of a public authority is the value of goods and services produced by that authority for its own use on current account. The variation of this value as a proportion of GDP gives a good idea of the variation of gross input and therefore the variation of current expenditure.

Chart 3



Care should be taken since this conclusion is a tentative one because the local consumption figures in Chart 3 do not take into account possible changes in local government responsibilities. A recorded low rate of growth in local consumption expenditure may be the result of central government having taken over some functions from local government during the period, rather than an expression of local expenditure restraints. Conversely, an increase in local consumption over a given period may be the outcome of transfers of functions to local government, with a matching decrease in central government expenditure.

Even if there is no proof that a high degree of fiscal autonomy has a negative impact on local consumption, it cannot be ruled out that in some circumstances central government may need to exercise control over local-government tax policy in order to contain public expenditure. Moreover, such policy must be assessed in the light of its potential implications in terms of total indebtedness, particularly given the constraints at European level.

Where the establishment of a degree of control over own taxation is justified for macro-economic reasons, it seems possible to achieve the desired result by placing upper limits on tax rates, and transfers would be needed only to the extent that such capping of rates results in vertical imbalances.

In this connection, since 1989 Denmark has had a budgetary co-operation scheme based on agreements between the government and associations of local authorities.

The aim of the agreements is to control local taxation and local expenditure by consensus. They are not binding on individual local authorities, since the associations cannot enter into commitments on behalf of their members. The agreements therefore only stipulate the overall balance to be achieved, leaving room for adjustments between local authorities depending on their individual circumstances.

The scheme has allowed the Danish Government to pursue the economic policy objectives it has set itself without any need to dictate conditions to local authorities, who are instead involved in the process and asked to approve those objectives. It should be pointed out that the other Nordic countries follow this method, even if it may prove difficult to apply the same approach in other countries.

b. The question of fiscal rivalry between local authorities

One of the consequences to be feared where local authorities are free to determine their own tax rates is that they will compete with each other to attract economic agents by reducing exclusive local tax rates.

Fiscal rivalry could, in some cases, foster efficiency and development. Nevertheless, unmastered, excessive fiscal rivalry between local authorities can lead to unwarranted differences in the expenses borne by firms depending on where they are located, generate distortions of competition and cause a concentration of the most profitable economic activities on the territory of the more favoured local authorities.

Where such a situation arises, or is likely to arise, certain limits on fiscal decentralisation may prove absolutely essential and may be the only means of protecting local authorities who have no effective defence against this form of competition.

However, here too, state interference must be carefully dosed. It is probable that not all exclusive local taxes involve the same risk of fiscal rivalry. Where the problem is really posed, it may suffice to introduce a floor tax rate in order to reduce, or even eliminate, the risk of such rivalry.

Solutions may be sought in the framework of intercommunal co-operation, as in the case of France, with local arrangements for redistribution of professional tax within urban communities and a tendency to apply average rates.

Where these various measures are not entirely satisfactory, the best way of dealing with the problem, while showing due regard for local self-government, would be to adopt a system of shared taxes (at either national or regional level), eliminating the risk of fiscal rivalry without cutting local authorities off from the tax (or taxes) in question.

c. *The need to set development guidelines*

Effective implementation of balanced and sustainable development policies requires that governments be able to influence decisions concerning certain capital expenditure projects (public and/or private) by promoting them, discouraging them or favouring certain locations.

Use of general and earmarked capital-expenditure grants, accompanied by a number of fiscal measures defined at national level, appears to be an efficient means of attaining such results.¹

It can therefore be said that the need to set development guidelines entails certain limits on fiscal decentralisation. However, the implications should not be exaggerated, as capital expenditure projects rarely represent more than one third of local authorities' expenses and are only partly state-financed.

d. *The need to offset imbalances in the distribution of wealth and in requirements*

It can be argued that a local-authority financing system based on the right for such authorities to levy taxes would result in unfairness on all levels, because of disparities in the distribution of wealth and in expenditure requirements. It would in fact compel local authorities to apply different tax rates in order to provide the same standard of services.

Such imbalances can hinder fiscal decentralisation, making it necessary to set up equalisation systems with the aim of eliminating them, or at least reducing them.² In so far as such equalisation takes place in the form of transfers, it accounts for some decrease in the percentage of total local income corresponding to own resources.

However, at the same time, equalisation is the answer to one major objection to fiscal decentralisation and indeed makes such decentralisation possible.

e. *Political limitations of fiscal decentralisation and the role of financial equalisation*

The last statement merits further consideration as to the role of equalisation. In fact, equalisation not only allows inequalities in fiscal capacity and in expenditure needs for the supply of services at an equal level to be smoothed out, but also it helps in responding to the other objections to fiscal decentralisation.

In this respect, the various political limitations to fiscal decentralisation can all be lessened by an efficient method of financial equalisation.

First of all, effective equalisation mechanisms which guarantee a minimum level of resources to all local authorities allow them to better control the level of their own resources, thus fostering as a result both the dialogue with the government and the setting up and pursuing of common targets for economic stability.

1 General and earmarked grants are discussed in detail in Chapter III.

2 The functioning of such systems is described in detail in Chapter IV.

It can also be noted that the setting-up of an efficient equalisation system significantly reduces the need for less-well-off authorities to apply high tax rates. It therefore acts as a brake on fiscal competition.

Finally, financial equalisation may contribute to the success of territorial planning policies and play an essential role as a factor of balanced regional development; in so far as equalisation mechanisms prevent an increase in existing economic imbalances and attempt to reduce them, they strengthen the effectiveness of the specific measures aiming at this result and may, at least in the medium term, allow their use to be limited.

In short financial equalisation is both a prerequisite for the implementation of fiscal decentralisation – or even decentralisation *per se* – and a consequence of such decentralisation.

4. Other impediments to fiscal decentralisation

It is inconceivable to study local taxation without taking account of the interaction between systems of financing set up at different territorial levels. The existence of one or more intermediate tiers of government between central government and local authorities, and the ensuing distribution of powers, affects both the nature and the degree of difficulty of the problems to be solved in launching and/or pursuing a process of fiscal decentralisation.

A country's tax system must be viewed as a whole, a single system that must be properly co-ordinated and balanced. In particular, central government must ensure that the tax burden is spread fairly among taxpayers according to their ability to pay. In this respect, the existence of different levels of taxation makes it more difficult to find appropriate solutions.

Moreover, a complicated territorial structure poses greater difficulties in arriving at a clear definition of the tasks incumbent on each level. Since the nature and extent of those tasks determine the financing solutions to be given preference, such difficulties inevitably result in impediments to fiscal decentralisation.

Lastly, within each territorial authority, the number of local authorities and the inequalities (of size, population, social conditions, etc.) between them can mean that certain solutions, which would have been feasible if the circumstances had been different, are not effective in practice.

Such problems lie outside the scope of this study. It can nevertheless be said that in states with a vast territory, where these problems are usually more acute, one avenue to be considered is the strengthening of regional authorities' role and the search for suitable solutions at regional level in view of the circumstances of the local authorities making up a region.

This is the approach followed by federal states, but it is possible to imagine a degree of fiscal federalism even within unitarian states.

III. STATE GRANTS TO LOCAL GOVERNMENT BUDGETS AND THEIR FUNCTION

Local budgets are fed with funds from a wide range of sources, including public or private and national or international bodies. This chapter deals only with public funds transferred to local authorities, particularly in the form of general and earmarked grants, without those authorities giving anything in return. Most of these funds come from the state (central or possibly federated government) budget. This is why the state's contribution to the funding of local expenditure is examined in greater detail. This examination is based in particular on the detailed information provided by the countries whose situation is presented in the appendices.¹

Shared taxes have been dealt with in the section on own tax revenue and are not covered here. Nevertheless, since they are a form of transfers and, furthermore, the sharing of certain tax revenues may in practice take the form of general or earmarked grants, the comments on the use of financial contributions and the methods of calculating them also apply to shared taxes, all other things being equal.

1. Presentation of public grants to local government budgets

Public grants to local budgets may be classified and examined according to different criteria. Those retained in the present report are: the sources of the grants; the degree of freedom of using the amounts received; the nature of allocation criteria.

a. Sources of the grants

With regard to the sources of the grants, a distinction should be made between:

- state grants, i.e. the amounts borne by the budget of the central government and, in federal states, the amounts borne by the budgets of the federated states;
- grants from regional authorities and, concerning grants to municipalities, grants from the other intermediate tiers of government (provinces, departments, counties, and so on);
- grants from authorities of the same tier, in particular amounts paid under horizontal equalisation arrangements, or by associations of municipalities to their members (e.g. amounts paid for a jointly funded local public service, which is managed by one municipality but from which other municipalities belonging to the association also benefit);

¹ These countries are Belgium, Czech Republic, Denmark, France, Germany (Bavaria), Italy, Netherlands, Poland, Spain, Sweden, United Kingdom (England).

- grants from authorities below municipal level, in particular amounts paid to municipalities which perform certain functions on their behalf;
- grants from international organisations (excluding loans) and in particular the amounts paid by the European Community.

Table 3 (at the end of this chapter) presents public grants to municipalities in some member states of the Council of Europe by sources, for the years 1994, 1995 and 1996.

b. Degree of freedom of using the amounts received

With regard to classification of grants to municipalities according to the degree of freedom in using the corresponding amounts, the distinction has already been mentioned between general grants and specific grants:

- general grants may be used freely, subject solely to the limits inherent in the extent of the authority's powers and in any distinction made between operating expenses and capital expenditure;
- specific grants may only be used for funding a specific expenditure (or expenditure of a given specific type);

Tables 4 and 5 (at the end of the chapter) present grants to municipalities in some member states of the Council of Europe, for the years 1994, 1995 and 1996 by use, following the categories below:

- mixed general grants, i.e. amounts which may be used freely for both operating expenses and capital expenditure;
- operating general grants, i.e. amounts which may be used freely, but to fund only operating expenses (i.e. current expenses);
- capital general grants, i.e. amounts which may be used freely, but only to fund capital expenditure;
- operating specific grants, i.e. amounts earmarked to current expenses related to a clearly-defined activity;
- capital specific grants, i.e. amounts earmarked to capital expenditure related to a clearly-defined project.

c. Nature of allocation criteria

With regard to the nature of the allocation criteria, it is possible to determine the amount to be paid to each authority on the basis of:

- objective criteria, i.e. criteria which leave the payer no discretion, the amount paid to each authority resulting from the application of parameters and calculation formulae established in conformity with the law;
- discretionary criteria, i.e. the payer is free to determine the amount to be paid on the basis of a subjective assessment of expediency.

2. The objectives of state transfer systems

State transfer systems aim at three main objectives.

The first is to guarantee local authorities the financial resources they need to fulfil their functions, or in other words to correct the vertical fiscal imbalances which arise where, at one or more levels of local government, the authorities find that levying of permitted taxes at “reasonable” rates does not provide them with sufficient money to supply the services incumbent on them to “reasonable” standards.

The second objective is to correct horizontal imbalances. A horizontal fiscal imbalance occurs where two local authorities which aim to offer the same standard of services find that they need to apply different tax rates in order to do so.

The third objective is to give a direction to local authority action, especially in order to ensure that local public services meet given standards, or to influence planning and development policies by promoting certain kinds of investment.

General and specific grants are not fully interchangeable; as a result their relative significance in relation to total amounts transferred depends, at least in part, on the priority given to each of the above objectives. For instance, general grants are more appropriate where the aim is to establish an equalisation system, and in such cases most states have opted for general grant solutions, which seek to tackle horizontal and vertical fiscal imbalances simultaneously.

Similarly, if the sole objective is to make up for the shortfall between local expenditure and own revenues, general grants should be used, since specific grants place greater restrictions on local authorities’ freedom of action, without there being any real ground for doing so. In this connection, it seems that general grants are normally used almost exclusively to supplement the financing available for municipalities’ operating expenses, rather than to fund investments.

Where it is a matter of financing services provided by local authorities on the state's behalf, of encouraging local authorities to supply services of benefit to non-residents or of coming to their assistance where services must meet certain minimum standards defined by central government, specific grants appear to be a more appropriate solution. The same applies where the objective is to promote certain investments in order to steer development in a given direction.

The member states of the Council of Europe tend to give general grants preference over specific grants. Tables 4 and 5 below show that in the majority of member states general grants outweigh specific grants. This is indicative of a move towards greater financial autonomy, but also of a tendency to use general grants for equalisation purposes.

It can be noted that in federal systems of government general grants are paid to local authorities by the federated states (not by central government). This is true of Belgium and Germany, *inter alia*. However, in non-federal states general grants are paid almost entirely by central government. It should nevertheless be pointed out that Spanish municipalities receive about a quarter of all general grants from the "autonomous communities" and other local authorities.

3. Calculating general grants

In Appendix XII to this report, the calculation methods used for the allocation of the main grants to local authorities (and in particular to municipalities) used in certain member states of the Council of Europe are presented. In this section only a few general remarks and examples will be considered.

a. Flat rate grants and others

With regard to the criteria used to calculate the amounts to be allocated to each beneficiary authority, a first distinction can be made between flat rate and other grants.

Although it is possible to implement a grant system in which sums are allocated according to rates of taxation or the beneficiaries' levels of expenditure, flat-rate general grants are simpler to manage.

Sweden and the United Kingdom are both examples of countries which have migrated from a system of grants indexed on tax levels or on beneficiary authority expenditure to a flat-rate system, disregarding such factors.

Flat-rate general grants have two main administrative advantages: the grant allocated to each authority can be announced beforehand, and it is easy to calculate in advance the total of all the grants to be paid.

Conversely, where general grants are linked to authorities' tax-raising efforts, the question might be raised whether the government should decide on the grants system before or after local authorities have set their tax rates.

If the government acts first, it will not know the exact total amount of the grants to be paid until the last local authority has determined its tax rate.

If, on the other hand, the government is last to act, the local authorities will not know exactly, when fixing their tax rates, what amount of grant they will receive.

b. Main allocation criteria

As a rule, the allocation of general grants should be made on the basis of objective criteria: the situation in member states under consideration fulfils this requirement, as the figures in Table 6 (at the end of this chapter) show. The rare exceptions to this rule should (and seem to) relate only to extraordinary grants (for instance those paid to municipalities affected by a natural disaster).

Among the most commonly used objective criteria, the following can be mentioned:

- population, i.e. the number of people living within the authorities in question, this number being sometimes weighted, namely for taking into account certain charges which increase more than proportionally according to the size of the authorities;
- population age-structure, i.e. the number of children, young people and/or elderly people;
- socio-population structure, i.e. the number of people of certain categories (for instance school children) or groups (foreigners, unemployed people, etc.) who require special care;
- some structural features of the authority, such as surface area (total or of built areas), the number of dwellings, the length of the road network, and so on.

c. General grants and equalisation

Systems that are mainly based on flat-rate general grants rarely result in full equalisation, even where a single tax rate exists. There are rare examples of systems having such an effect in three of the four countries making up the United Kingdom: England, Scotland and Wales.

For all that, equalisation is an essential component of a number of transfer systems. This is true of the system introduced in Denmark, where the general grant and the equalisation grants are paid to local authorities as a lump sum and must be regarded as forming a single system. The same can be said of Finland and Sweden's transfer system, which achieves almost total equalisation of tax bases.

In other countries, such as Portugal and Spain, the grants system involves only a small degree of equalisation.

In Portugal, the central government fixes an annual sum to be paid into a municipal aid fund. 40 per cent of fund resources are allocated according to the recipient authority's number of inhabitants. The criteria used to allocate the remaining 60 per cent do have some equalising effect:

- 15 per cent of resources are distributed equally among all the municipalities, a solution which helps the smallest of them with their fixed administrative costs;
- 15 per cent are allocated according to area and 10 per cent according to the length of the road network, a solution which helps municipalities where costs are high because of a low population density or an extensive road network;
- 5 per cent are distributed on the basis of the number of *freguesias* or parishes, 5 per cent according to ease of access and 5 per cent according to the number of children, factors which also favour certain municipalities having the greatest needs. The same applies to the remaining 5 per cent, which goes to municipalities with low tax bases.

In Spain the annual amount paid to municipalities as their "share in state revenues" (PRE), corresponding to three quarters of current transfers and over half of all transfers, is distributed according to the following criteria:

- 70 per cent on the basis of the number of inhabitants, weighted by a coefficient which ranges from one for municipalities with less than 5 000 inhabitants to 1.85 for those with over 500 000;
- 25 per cent according to the actual number of inhabitants, weighted to take account of each municipality's tax-raising effort (tax yields are therefore taken into consideration);
- 5 per cent according to the number of schools for which a municipality is responsible.

As a result, if municipalities with similar numbers of inhabitants are compared, the highest amounts will go to those with the highest tax rates and tax bases. The fact that the municipalities with the highest tax bases are favoured shows that the system has little or no equalisation aims.

The tendency to simplify grants systems runs counter to equalisation. For example, in France since the entry into force of the Act of 31 December 1993 reforming the global operating grant (*Dotation globale de fonctionnement* – DGF) the most important component of that grant has been a flat-rate sum which increases from year to year depending on two factors: the trend of total resources earmarked for the DGF and growth in municipalities' populations. The grant will therefore not keep pace with changes in expenditure requirements, which were better measured by some of the criteria used in the past.

4. General tables on grant systems

The following four tables have been prepared on the basis of information provided by various member states of the Council of Europe. Figures refer to 1994, 1995 and 1996. The reference years for the United Kingdom – where the financial year begins on 1 April – are: 1993/94, 1994/95 and 1995/96. With regard to this country, figures concern only England.

In the tables:

- the symbol * indicates that figures are unavailable;
- the symbol ** indicates that figures are provisional.

Ireland	100	100	100									
Italy	88.5	77.2	93.4	11.5	12.8	6.6						
Latvia	100	77.7	45.7				-	22.3	54.3			
Lithuania	100	100	100									
Luxembourg	*	100	*									
Malta	100	100	100									
Netherlands	98.3	99**	*							1.7	1**	*
Norway	93.4	93.3	93.4	2.4	2.4	2.4				4.2	4.3	4.2
Poland	100	100	100									
Portugal	82	84	*							18	16	*
Slovakia	100	100	99.8							-	-	0.2
Slovenia	100	100	100									
Spain	64	64.9	*	15.1	14.9	*	20.4	19	*	0.5	1.2	*
Sweden	100	100	100									
Switzerland	0.8	0.5	*	81.2	81.0	*	12.7	13.8	*	5.3	4.7	*
United Kingdom	75.7	78.1	76.9				24.3	21.9	23.1			

Table 4**Breakdown of general and specific grants paid to municipalities by purpose (amounts expressed as a percentage of the total grants)**

Countries	Mixed general grants			General grants for operating expenses			General grants for capital expenditure			Specific grants for operating expenses			Specific grants for capital expenditure		
	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996
Belgium: Brussels															
Flemish region	-	-	8.6	88.6	88.4	82.1	9.0	9.6	9.3	2.4	2	-			
Walloon region				89.1	82.6	83.3				5.6	7.5	7.2	5.3	9.9	9.5
Bulgaria				81.4	86.9	88.3							18.6	13.1	11.7
Croatia	1.9	12.5	16.8	52.6	15.5	10.4	1.9	13.6	21.2	39.2	46.1	39.4	4.4	12.3	12.2
Czech Republic				37.6	26.6	28.5	10.9	7.6	4.1	12.6	16.7	17.2	38.9	49.1	50.2
Denmark	49.5	50.2	45.3							50.5	49.8	54.7			
Finland				97.2	97.1	*							2.8	2.9	*
Germany				70.2	71.3	80.6							29.8	28.7	19.4
Iceland	18.3	21.8	*							39.9	41.2	*	41.8	37.0	*
Ireland				21	20	19				29	30	30	50	50	51
Italy				43.9	58.5	55.2	56.1	41.5	44.8						
Latvia	14.3	76	90							84.4	20.3	7.9	1.3	3.7	2.1

Lithuania	67.2	73.5	85.2							30.3	24.1	11.1	2.5	2.4	3.7
Luxembourg	*	-	*	*	67.3	*	*	-	*	*	8.7	*	*	24	*
Malta				92.9	83.3	74.6				7.1	5.3	5.7	-	11.5	19.7
Netherlands				40	24.9	*				50.6	26.3	*	9.4	48.8	*
Norway	58	57	56							42	43	44			
Poland	42	41.1	64.8							50.3	49.9	26.2	7.7	9	9
Portugal				44	45	*	30	32	*	(0.1)	(0.1)	*	26	23	*
Slovakia	8.1	8.3	7							37.7	43.7	31.1	54.2	47.4	61.9
Slovenia				87.6	84.7	78.5							12.4	15.3	21.5
Spain				70.7	71.7	*				7.8	7.4	*	21.5	20.9	*
Sweden	59.0	63.0	75.0							35.7	58.2	22.5	5.3	4.8	2.5
Switzerland	17.7	17.6	*							64.8	64.4	*	17.5	18.0	*
United Kingdom				47.4	49.2	49.1				47.5	46.1	46.5	5.2	4.6	4.5

Table 5

Breakdown of general and specific grants paid to municipalities by purpose (amounts expressed as a percentage of total municipal receipts)

Countries	Mixed general grants			General grants for operating expenses			General grants for capital expenditure			Specific grants for operating expenses			Specific grants for capital expenditure		
	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996
Belgium: Brussels															
Flemish region	-	-	1.7	17.7	17.3	16.4	1.8	1.9	1.8	0.5	0.4	-			
Walloon region				26.9	25.8	25.1				1.7	2.3	2.2	1.6	3.1	2.9
Bulgaria				37.2	37.6	30.3							8.5	5.7	4.0
Croatia	0.1	0.4	1.1	2	0.6	0.7	0.1	0.5	1.3	1.5	1.6	2.5	0.2	0.4	0.8
Czech Republic				8.9	5.1	5.0	2.6	1.5	0.7	3.0	3.2	3.0	9.2	9.5	8.8
Denmark	11.1	11.1	9.3							11.3	11.1	11.2			
Finland				26.3	25.7	*				0.05	0.01	*	0.8	0.8	*
Germany				18.1	18.9	20.3							7.7	7.6	6.4
Iceland	2.2	2.4	*							4.9	4.6	*	5.1	4.1	*
Ireland				11	10	10				5	16	15	26	25	27
Italy				24.3	30.1	32.9	31.1	21.3	26.6						
Latvia	6.3	19.9	4.8							35.8	5.3	4.2	0.5	1	1.2

Lithuania	18.5	19.6	19.2							8.4	6.4	2.5	0.7	0.7	0.8
Luxembourg				*	25.7	*				*	3.3	*	*	9.2	*
Malta				91.3	81.5	*				7	5.2	*	-	11.2	*
Netherlands				17	12.9	*				21.6	13.3	*	4	25.2	*
Norway	19	19	18							14	14	14			
Poland	15	15	25							18	18	10	3	3	4
Portugal				20	20	*	14	15	*	0.04	0.04	*	12	10	*
Slovakia				1.9	1.0	1.0				5.0	4.8	4.4	7.2	5.2	8.8
Slovenia				17.6	21.5	17.6							2.5	3.9	4.5
Spain				25.8	26.9					2.7	2.8	*	8	7.9	*
Sweden	12.0	12.0	14.0							7.0	6.0	4.0	1.0	0.9	0.4
Switzerland	3.1	3.0	*							13.5	10.9	*	3.5	3.0	*
United Kingdom				24.7	26.2	25.2				24.7	24.5	23.8	2.7	2.5	2.3

Table 6**Breakdown of general grant paid to municipalities by allocation criteria**

Countries	Mixed general grants						General grants for operating expenses						General grants for capital expenditure					
	Objective criteria			Discretionary criteria			Objective criteria			Discretionary criteria			Objective criteria			Discretionary criteria		
	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996
Belgium: Brussels							100	100	100									
Flemish region							100	100	100				100	100	100			
Walloon region							100	100	100									
Bulgaria							100	100	100									
Czech Republic							100	100	100							100	100	100
Denmark	99.8	99.8	99.7	0.2	0.2	0.3												
Germany							100	100	100									
Ireland							100	100	100									
Latvia	-	100	100	100	-	-												
Lithuania				100	100	100												
Luxembourg							*	100	*									

IV. FINANCIAL EQUALISATION

I. The reasons for financial equalisation

In nearly all countries local authorities supply some services for which fees and charges could be charged. Most of these services – refuse collection, maintenance of streets, building regulations etc. – could be paid for by the users and in theory they need not be provided at a loss.

However, the situation changes when free services provided by the welfare state are assigned to the local-government sector. As users are not supposed to pay for the full costs of these services they have to be tax financed, the purpose being wealth redistribution. Free schools redistribute it in favour of families with children, and free hospitals in favour of the elderly and the sick.

For individuals this creates differences between what they pay in taxes and the value of the services they receive – what has been called “fiscal *residua*”. Where many people with positive (or inversely negative) fiscal *residua* live together, a collective “fiscal *residuum*” (positive or negative) will result for the locality.

Local authorities have been given some means of financing this expenditure. When these services were provided by central government, differences in costs between local authorities were not apparent. Now they have become visible and created disputes between localities. This visibility of the cost of redistributive services supplied locally to national standards is the underlying basis for financial equalisation between local authorities.

At first sight, the obvious way to finance local services would be to ask local authorities to send in the bills and to refund their expenditure, in the form of specific grants. Nevertheless there is empirical evidence that such a system of local expenditure will grow beyond the willingness of the taxpayers to pay, if the local level can decide and the central government has to pay.

This is one argument for recommending that conditional grants should be changed into general grants, the amount of which would be determined on the basis of the “expenditure needs” (i.e. a certain amount of money per child of school age; the number of children of school age becomes in this case what is termed a measure of expenditure needs of the local authorities.)

This approach could be criticised because local authorities which are able, for example, to make schools cheaper than the average can use part of their grant money for quite different purposes.

Seen from an overall view however, nothing is wrong with this. It only means that general grants give the local authorities a strong incentive to become more efficient, because they are allowed to keep the savings they are able to make for themselves. The result is a more efficient public sector and everybody gets more for their money.

An efficient local public sector needs incentives for the local authorities to spend no more than is wanted by the local population. The situation described so far gives some incentives to local efficiency and to careful local setting of priorities. But it also results in local pressures for more spending and bigger grants, which central governments at times find difficult to resist.

This situation will be less likely to come up, the more local governments have the right to collect their own taxes.

However, the tax capacity is most likely not the same between authorities. Inequalities between citizens of different localities will arise when compared to the system of central provision, unless some local tax power is re-channelled from the rich low-need authorities to the poor authorities with high needs.

Thus, two equalisation objectives exist:

- to equalise differences in expenditure needs, and
- to equalise for differences in tax capacity.

Several arguments can be made in favour of such equalisation:

One is that a high degree of decentralisation may result in considerable personal inequality in terms of horizontal equity. Individuals would be able to secure personal gains by moving from one authority to another, even if the service level delivered is identical in the two authorities. Local “tax havens” would therefore arise for the well-to-do part of the population. Another consequence of unequalised decentralisation is that it may result in undersupply of the decentralised services in the poorest regions of the country. Moreover, the unequalised differences created by decentralisation will – without reason – expose the political leadership of the most unfortunate regions as poor administrators. They will, in the eyes of the electorate, seem unjustifiably incompetent, failing to deliver acceptable services and raising taxes that are too high.

Add to this that, in countries with insufficient infrastructure and where local governments are responsible for the development of the infrastructure, targeted capital grants to poor authorities may be necessary, although we may now move from the subject of local government finance to the quite distinct subject of regional development policy.

For all these reasons, nearly all countries with decentralised public sectors attempt one way or another to equalise differences in expenditure needs and in per capita tax bases.

In this respect, it is important to stress that the effects of policies designed to equalise tax bases can be counter-balanced by the effects of policies designed to foster tax effort; therefore there is a risk for these policies to neutralise each other where they are not conceived and implemented in a co-ordinated way.

2. Equalisation of differences in expenditure needs

It has already been pointed out why central government grants must not be given as conditional grants, but have to be distributed according to some objective measure of needs. Local expenditure needs can be defined as what is needed in order to supply local public services at the same level as they would be delivered by central government.

If grants do not reflect expenditure needs properly, the services will be of a poorer quality in some regions than in others. The problem is how to quantify a measure of expenditure needs, how to determine those factors which best describes the needs which the central government would have observed in securing an even level of service.

a. *Measuring expenditure needs*

A general objective when indicators of expenditure needs are selected is to avoid confusion between these needs and produced units of service or real expenses generated. This is what differentiates general grants from specific grants, the latter being based on criteria like units produced or money spent locally.

If indicators are selected which relate to the actual supply (for example, the number of teachers), the measure that should have been of expenditure needs, becomes a measure of what the local authority has chosen to supply. The more local supply is expanded, the more money is obtained from the central government. This is one of the features of specific grants, more so than general grants.

Another problem with such indicators is that they promote the use of institutions. As an example, though modern care goes in the better and cheaper direction to bring the service to people in their own homes, the grants linked to the supply of the service will tend to support the establishment of more public institutions. In other words, this method encourages those solutions which trigger a subsidy, even when other solutions to the problem are better and perhaps even cheaper.

The conclusion is that for measuring expenditure needs it is preferable to use criteria which are “neutral” in relation to local authorities’ choices, such as demographic criteria (age groups)

Not all expenditure needs are easily measured by demographic criteria. Such is the case, for example, when there are different needs per child in schools because of different social conditions in the homes of the children. Children from poor urban areas may need more teachers than children from wealthy suburban schools.

b. *Social indicators*

The measure of such “social needs” can only be done indirectly, by umbrella-criteria. These are criteria like “the number of children with a single parent”. Not because all single parents are in need of social assistance, but because a large proportion of them may be young, uneducated mothers, who are statistically more likely to suffer social problems.

To determine how reliable such criteria are, statistical estimations are used to find the relation between possible criteria and the expenditure patterns among authorities. First a list of statistics – which is available for each local authority – is prepared, and non-pertinent criteria are excluded. Next a test is made by regression analysis: data on promising criteria are run against data for expenditure on the different functions for all municipalities. The result suggests how well each criterion correlates with the expenditure data. A good correlation tells you that this criterion may work.

However, no country applies the computer results directly into the legislation. The problem is that the computer can tell that two variables are good, but at the same time that only one of them can be used, because they both measure the same thing. Somebody has to make the choice between the two variables and quite significant differences in the effects for particular local authorities may depend on this choice. Statistical techniques such as “factor analysis” do allow these kinds of difficulties to be tackled.

The introduction of social criteria gives the measure of expenditure needs a political element and sets some limits to the degree of objectivity of the needs measures.

One such limit on the design of an equalisation scheme can be that it is not always possible to find in the available statistical information on proper objective criteria. For example, the care of multi-handicapped individuals can be extremely expensive, but an objective measure for this – or for any other kinds of clients who are few in number but expensive to care for – may be difficult to design. In such cases central provision may be the most efficient solution.

c. Are a few criteria better than many?

The number of criteria needed depends on the amount and the complexity of the services for which the local authorities are responsible. If local governments have been given only few and uncomplicated functions, the measure of needs is simple.

The criteria for distributing the French “*dotation global de fonctionnement*” (DGF) before 1994 was simple. Table 7 below shows them schematically.

Table 7

Criteria for DGF grants in France before 1994

Criteria	Weight as a percentage
<i>Expenditure needs of this:</i>	62.5
Size of population	
Length of roads	40.0
Number of school children	4.5
Number of social housing units	4.5
	13.5
<i>Resources of this:</i>	37.5
Tax base	
Income per inhabitant	30.0
	7.5
Total	100.0

However, if many different – and complicated – services are the responsibility of the local governments, the measure can become quite complex and draw on many kinds of variables. In Denmark many criteria, as shown in tables 8 and 9 below, are needed. The number of criteria in Sweden, England or Norway is also large, resulting in quite complicated measures.

Table 8

Indicators of municipal expenditure needs in Denmark

Criteria	National equalisation	Equalisation in metropolitan areas	Type of expenses
Number of inhabitants	24.6	23.2	Employment, environment, libraries, public transport, roads, administration, etc.
Number of inhabitants of 0-6 years of age	9.8	10.9	Day institutions, health visitors
Number of inhabitants of 7-16 years of age	21.1	19.3	Schools, school dentists, youth centres
Calculated cash benefit expenditure	5.2	6.0	Social cash benefit
Number of inhabitants of 65-74 years of age	3.0	2.6	Home care for elderly people Old people's homes Pensioner residents
Number of inhabitants of 75-84 years of age	6.2	5.9	
Number of inhabitants of 85 years or over	6.2	5.3	
Calculated expenditure for rent support	1.8	-	Expenditure for rent support
Estimated employed related early retirement	2.2	1.9	Early retirement pension for inhabitants under 60 years of age
Number of children of single parents	6.5	8.1	Politically decided according to statistical analyses and alternative calculation of consequences
Residence criteria (outdated homes and modern rented homes)	5.0	-	
Number of rented homes	-	5.0	
Number of full time unemployed 20-59 years of age in excess of 5 per cent	5.0	6.3	
Number of inhabitants 25-49 years of age without vocational education	-	3.1	
Number of foreigners from third-party countries	2.0	2.5	
Inhabitants in areas with severe social problems	1.5	-	
Total weight	100.0	100.00	

Table 9**Indicators of municipal expenditure needs in counties in Denmark**

	Weight 1997	
Number of inhabitants	17.8	Environment, public transport, roads, administration
Number of inhabitants 0-20 years of age	5.3	Special schools
Number of inhabitants 16-19 years of age	5.5	High schools
Estimated age-related hospital expenditure	37.8	Hospitals
Estimated age-related medical expenditure	13.5	Medical expenditure
Number of children of single parents	10.0	Politically decided according to statistical analyses and alternative calculation of consequences
Number of single inhabitants 65 years of age or over	10.0	
Total weight	100.0	

It may well be that the number of criteria in some countries has become too large, that small and unimportant factors have been introduced under political pressure. This pressure is always to complicate formulae; moreover, formulae sometimes have to be revised *ab initio* if they are to be simplified and this makes the process more difficult. Nevertheless, it is an important objective to make the system simple, not at any price to make it as correct as possible.

There is a balance between the degree of simplicity of the systems and its ability to smooth out important differences on needs. If your criteria are not the best possible, the whole decentralisation will not work. Inefficiencies and personal inequalities will arise and result in political pressure for recentralisation. If the equalisation system cannot be designed to capture the important differences in expenditure needs, the system becomes politically unacceptable.

3. Equalisation of differences in the tax base

The existence of own local taxes creates a need for equalisation of differences in the tax base. In some cases this is not an overwhelming need. All depends on how important the relative role of own taxation is. The more local tax revenues are important, the more this need is likely to appear.

There seems to be a fairly uniform practice between countries as to what should be included in the equalisation on the taxation side. Distinction should be made between own taxes, shared taxes, fees and charges and entrepreneurial income, including interest income.

a. Own taxes

Equalisation may be needed when differences exist between national and local level of average tax base per inhabitant, as shown in the following example:

Local tax base per inhabitant (average)	40 000
Target tax base per inhabitant (average)	50 000
Difference in tax base per inhabitant	-10 000
Tax-value of difference when average ¹ tax rate is 15 per cent	- 1 500

The equalisation payment to this authority will be 1 500 per inhabitant if the system aims to a full equalisation. Such equalisation however is often criticised by those who have to pay. They will claim that their taxes are too high because of the equalisation. Sometimes the losers manage to confuse the issues in the political dialogue, so that a high degree of equalisation becomes synonymous with removal of the municipal freedom to set their own tax rates.

For these reasons the equalisation is rarely 100 per cent, although the United Kingdom tends towards this level. Equalisation rates are very high in Sweden (95 per cent), Finland (90 per cent) and Denmark (85 per cent).

Some complexity arises if there is more than one “own tax”. Unless the several tax rates are linked together by law at a common ratio, equalisation has in these cases to be done using the average tax rate. Assuming this is the case, each tax base can be weighted together, using the relative national revenue importance for each tax as weights.

b. Shared taxes

In some countries shared tax revenues are given back to the authority of derivation. This serves no functional role, but may be politically desired. However, the simplest way is to equalise all in one step, by distributing the shared tax revenue to the different authorities according to their expenditure needs.

c. Fees and charges

Fees and charges of local public services should not be equalised directly. Of course, local government inequality linked to the cost of these services should be taken into account in the framework of equalising expenditure needs.

¹ Normally, the average tax rate, but in some cases the actual tax rate, is used in the equalisation formula.

d. Entrepreneurial income and interest payments

Large differences among local authorities in entrepreneurial incomes are seen in several countries in Eastern Europe. Considering their scope and the difficulties to find other local revenues, such revenues ought somehow to be equalised.

For instance, in the United-Kingdom, the expenditure taken into account when assessing expenditure needs is the expenditure minus such revenue.

Another source of inequality among local authorities is that some have no debt and may even have some capital held in bonds, while others may be in serious debt. The first type has interest income, the other a burden. The question arises if such revenues should also be equalised. This is not done generally, the main reason being that it would be a wrong “signal” for central government to send to local governments, penalising those authorities who have saved and subsidising those authorities who have run into debt. However, the cost of servicing debt may be based on notional debt as in England.

4. Limitations on the degree of equalisation

A properly functioning system of local government equalisation is an absolute condition for decentralisation; without equalisation decentralisation would result in inequalities that would soon make central provision the most efficient solution for the public sector. If there were limits to the degree of equalisation, it would therefore also set limits for the attainable degree of decentralisation.

Some limitations on the degree of equalisation have already been suggested, which are mainly of a political nature. There are also certain problems of measurement.

One objection to a high degree of equalisation is in the problems of finding objective indicators for local authorities’ needs in relation to each kind of expenditure they have to bear because of their competencies. The challenge is enormous; the system would have to cover all authorities from the smallest village to the biggest city. Political decision will be needed to decide on the proper measure of needs, because the “right” measure is not there. To some, this is an argument why equalisation on the expenditure side must stop well before a full equalisation.

A related difficulty has been pointed out concerning those social cases where there are only few but very expensive clients. Such cases may be most efficiently handled by central government or financed by specific grants.

Another limitation is in the balance between measuring the needs as accurately as possible and the complexity of the equalisation. If many functions are decentralised, the equalisation systems are bound to be complex, and this opens up for criticism by those who loose from equalisation. They can then argue that the system is bureaucratic, not understandable, and in this way manage to make it politically unsupportable.

Assuming that tax capacity and expenditure needs are measured perfectly, it has been argued against too much equalisation that this may slow down the process towards an optimal location of the factors of production in a country. Labour is held back in locations where their marginal productivity is too low compared to the labour productivity in other locations, equalisation secures a certain minimum standard of local services, and this may reduce the incentives to move to more growth-oriented locations.

This argument raises the question of whether citizens, who live in regions with low financial capacity, should have the same access to schools, hospital, old age homes, etc. as those living in regions better supplied with raw materials, infrastructure and positive externalities. Would the argument have been raised had the services in question been centrally provided?

5. Equalisation techniques

A distinction is usually made between two equalisation techniques: horizontal equalisation and vertical equalisation, depending on whether transfers of resources take place between authorities of the same tier or not. These two basic models do not exclude each other and it is possible to apply both in conjunction.

a. *Horizontal equalisation*

This model – used in Germany among *Länder*, as well as within authorities of the same *Land*, in Denmark and in Sweden – consists of removing resources from the rich authorities and giving the proceeds to the less favoured ones, without the need for central funds.

Seen from the point of view of the central government, the present model has the advantage that it prevents local authorities from agreeing to demand more equalisation and it is without cost for the central government. It is not without political problems however and it must be considered carefully what is the political will for national equalisation before this model is applied.

In fact it creates conflicts among the regions; therefore the rich and most influential authorities will fight it. In Germany, the system has been under pressure because of the great financial needs of the new eastern *Länder*, and some limits to the system had to be introduced. In Sweden, in 1995, the Supreme Court declared the method unconstitutional, as it was regarded as a tax paid by one local authority to another. Sweden therefore had to change the wording of the legislation to make clear that the payments were all to and from central government.

Some explanations have already been offered as to why this may be so. Firstly, central governments want some control of the local government sector. This they obtain best through grants. Secondly, central governments dare not leave important taxation powers in the hands of local authorities for fear of excessive tax and expenditure increases. Otherwise, some other constraint on local authority budgets may be required.

In this model, grants must be given in a neutral way, so that they do not affect the equalisation schemes. It could be a fixed grant per inhabitant (Sweden), or a given per cent of the tax base (Denmark). Both can be designed to become neutral, gap-filling grants.

The methods of integration of grants and equalisation are described in Appendix XII.

b. Vertical equalisation

This model is based on central government grants to all (or only to the poorest) authorities, so as to bring their revenue up to a certain standard expressed as a percentage of the national average.

It is easier to find majority support for this model, and it is therefore used by most countries. There is a “fiscal illusion” here, it seems that everybody gets something and that nobody pays! The model is less likely to create conflicts between regions, it may be said to contribute to “nation building” where this is needed.

The model relies on central government resources and it may leave the most well-to-do authorities outside the equalisation scheme. A recent Swedish government report argued that the rich authorities for this reason could escape central control.¹ That was the main reason for Sweden to prefer the model of horizontal equalisation.

This method is particularly expensive for the central government if it decides to lift all authorities up to the maximum tax capacity, and to help all with needs higher than the minimum. It is for this very reason usually implemented in an imperfect version, leaving the most well-to-do authorities outside the scheme.

c. Mixed equalisation systems

Basic political problems which may arise in the two cases are not as different as is usually thought: on one hand, with regards to public finance as a whole, horizontal equalisation is as expensive as vertical equalisation; on the other hand, this latter form of equalisation may generate tensions too, not only between central government and local authorities, but also within the local authorities themselves, since they are not (and cannot be) supported all in the same way.

These political obstacles² probably explain why many countries are hesitating to go ahead with more decentralisation.

In so far as, in a given context, neither of the two models presented appears to constitute an entirely satisfactory solution to the problems arising, it must not be overlooked that they can be combined in a system that is financed partly by the local authorities themselves and partly by the state.

1 Of course, this conclusion is not valid in general, because it is based on the particular situation of Swedish municipalities, which benefit from high fiscal decentralisation.

2 Here the “political” and not the “economic” nature of these obstacles should be emphasised.

In Switzerland, the canton of Bern applies such a system. The Financial Equalisation Act, which came into force in 1992 and has taken full effect since 1995, provides for the setting up of an equalisation fund.

Half of the fund's resources come from compensatory payments by municipalities with a contribution capacity index of more than one hundred; they currently pay in a total of 30 million Swiss francs a year. An identical amount per year is contributed by the canton.

The fund's resources are used to make additional grants to financially weak municipalities. Only those with a contribution capacity index of less than seventy and an above-average tax charge per inhabitant are allocated additional grants.

CONCLUSIONS

1. Preliminary remarks

The response of each state to the financial needs of their local authorities should be consistent with the situation of these authorities. This situation varies from state to state according to the structure of the states, their territorial set-up and the allocation of powers to the different tiers of government. Differences between local authorities within a given state are just as significant and funding systems have to match them.

In other words, the structure of local finance cannot be the same for all member states of the Council of Europe. Nevertheless, it is possible to formulate some guidelines which states might follow.

These guidelines are based on the same basic principle: local self-government implies financial autonomy. Local authorities must have adequate financial resources, commensurate with the responsibilities provided for by the constitution and the law; local authorities' control over the level and use (which, of course, must be in accordance with the law) of the financial resources necessary to perform their tasks should only be limited if, and in so far as, it is required by the objectives of the national and, where applicable, regional economic policy.

In fact, decentralisation can only take place effectively where the structure of local finance enables local authorities to decide and implement, within their competencies, policies that are consistent with the expectations of their populations.

2. Structure of local finance

With regard to the structure of local finance, Article 9 of the European Charter of Local Self-Government indicates two major requirements that the systems for funding local authorities must fulfil.

- the existence of resources of which local authorities may dispose freely within the framework of their powers;
- the existence of resources of their own (in particular taxes, charges and fees) of which they can determine the level, within the law.

The first requirement is met, for example, when local authorities may dispose freely of all, or almost all, the revenues appropriated to them to cover operating expenses.

The weight of own resources in local finance and the degree of freedom for local authorities in determining the overall level of these resources are very different from state to state. This can be explained, partly at least, by the extent of own tasks in relation to delegated tasks. Therefore, it is difficult to indicate the share that these resources should reach. Certainly, when own resources are not less than grants (general and specific grants) it may be considered that financial autonomy has a solid base.

A significant share of own resources, but with very little room for manoeuvre, may be inadequate for ensuring a real freedom of choice to local authorities. Thus, it is important to assess the possibility for these authorities of adjusting – up and down – their budgets, from one year to the other, in order to match citizens' requests.

It may be considered that the room for manoeuvre is wide enough when own resources can follow the evolution of expenditure related to the execution of own tasks, expenditure whose level local authorities should be able to determine, within the law, according to the preferences expressed by citizens, subject to the objectives of national and, where applicable, regional economic policy.

Nevertheless, a more limited room for manoeuvre may be acceptable if the gap is filled by a system of unconditional transfers that on the whole allows for matching the evolution of costs related to the exercise of the local authorities' powers.

Questions which arise in this case have a political nature: on the one hand, local authorities' accountability vis-a-vis the electors is more clearly affirmed when it concerns the management of own resources; on the other hand, control on local authorities is, in general, wider when it concerns transfers. Nevertheless, these questions are in practice of little or no importance where tax-sharing is used.

3. Guidelines on local taxation

With regard to local authorities tax revenue, the basic questions are:

- what should the weight of local authorities' tax revenue be?, and
- what should the structure of the local tax system be?

a. Tax-revenue level

Fiscal decentralisation is a process that strengthens local self-government, as local taxation gives local authorities a strong base for long-term budget planning and for self-management, especially with regard to expenditure.

Moreover, fiscal decentralisation fosters the transparency of local policies and facilitates citizens' control over the appropriateness of tax-funded expenditure.

Tax-revenue level (which should not be mistaken for the level of own resources) may be assessed according to different parameters.

First of all, it is normal to take into consideration the importance of tax revenue in relation to local revenues on the whole. Nevertheless, it should not be overlooked that this relation is also determined by the choice of funding local public services more by means of charges and fees than by means of taxation. In addition, this relation is to be interpreted differently according to the percentage and the nature of the equalising transfers. As an indication, it may be said that, in general, tax revenue should not be less than public grants.

The tax revenue level may be also measured as a proportion of the total tax revenues for the country and as a proportion of GDP. The corresponding figures are very interesting, but cannot be used easily for direct comparisons, as differences are explained, partly at least, by the structure of states and their territorial set-up. Nevertheless, it may be maintained that a high percentage of local tax revenue in relation to the total tax revenues for the country and/or to GDP is an indication of strong local self-government, but attention should also be paid to the room for manoeuvre granted to local authorities concerning tax rates and the use of tax revenue.

It may be observed that in countries where fiscal decentralisation is highest, personal income tax is the predominant source of local tax revenue.

When the level of fiscal decentralisation is considered low on the basis of the previous criteria, central governments might examine, with the local authorities, measures which will make it possible to increase the proportion of local authorities' own and/or shared tax revenues.

When the local funding system is reviewed in order to increase the degree of fiscal decentralisation, the following elements are to be considered.

First of all, a country's tax system constitutes a single system that must be consistent and balanced. The existence of one or more intermediate tiers of government between central government and municipalities affects both the nature and the degree of difficulty of the problems to be solved. In particular, on the one hand, fiscal decentralisation should take place without increasing the overall fiscal pressure; on the other hand, central government must ensure that the tax burden is spread fairly among taxpayers.

Secondly, the relationship between the fiscal decentralisation and the size of local authorities should be considered. A wide-range local self-government requires local authorities of a certain size, or at least appropriate forms of co-operation, as numerous public services can not be shared without affecting management effectiveness and economy.

In addition, the smaller local authorities rarely have an adequate fiscal potential; this hinders fiscal decentralisation. Consequently, it may be necessary to implement fiscal decentralisation together with a reform of the territorial set-up.

b. The structure of local taxation

The main criteria which may be used in order to select "good local taxes" have been examined in detail in the CDLR report on *Local finance in Europe*,¹ to which readers can refer. Thus, suffice it to say that the structure of local taxation should meet the following conditions:

- an appropriate yield and low administration and compliance costs;
- a fair distribution of the tax burden according to the taxpayers' ability to pay and the benefit they have from tax-funded services supplied to them;

1 See footnote 1 to the present report.

- visibility of the tax burden for contributing individuals and enterprises (this being a precondition for an effective distribution of resources according to citizens' preferences);
- low distortions (i.e. the difference in tax rate between communities should be low or justified by a different level of services);
- a degree of buoyancy allowing for the adjustment of tax revenue according to the evolution of costs.

It is possible to satisfy these requirements both with a system based on own taxes and with a system based on a combination of own taxes and shared taxes, where the share allocated to local authorities is defined by law.

4. Guidelines on grants to local authorities

With regard to grants to local authorities, central government (and regional authorities) financial support to local budgets should take, in most cases, the form of general grants.

The total amount of general grants should be determined on the basis of criteria which take into account the economic growth and the increase in costs as a result of inflation, especially when the level of local authorities own resources and their room for manoeuvre on these resources do not allow for adjusting them to the growth of expenditure as a result of economic factors.

It would also be appropriate if central government guaranteed to local authorities a certain stability in the evolution of this total amount, possibly by law or within the framework of agreements aiming at ensuring economic stability with the co-operation of all tiers of governments.

The criteria for distributing general grants must, as a rule, be clearly defined according to the law on a non-discretionary basis. This should allow for local authorities to calculate in advance the amount of general grants they will receive and to adopt their budgets accordingly.

The use of specific grants should be limited, in general, to what is necessary for achieving the following objectives:

- (co-)financing capital expenditure, within the framework of policies for a balanced sustainable territorial development;
- ensuring that certain local public services are provided at a standard level on the whole national territory;
- compensating the spillover effects which may affect the supply of certain public services;
- funding certain public services which local authorities provide on the state's behalf.

5. Guidelines on financial equalisation

No local authorities' financing system can function without the setting-up of effective and fair equalisation means, which allow for the compensation, at least in part, of differences in fiscal capacity between local authorities, and of differences in costs required for the appropriate supply of services for which they are responsible.

Financial equalisation is a *sine qua non* condition of fiscal decentralisation and of a strong local self-government. At the same time, it may contribute effectively to the achievement of the objectives of economic stability and to the success of policies for a balanced sustainable territorial development.

Central governments, should periodically verify the functioning of their equalisation systems and examine, with local authorities, the improvements which could be made with a view to remedying the adverse effects of the unequal distribution of resources and expenditure requirements and granting local authorities genuine freedom of choice in the areas under their control.

Appropriate information should be given to local authorities on the functioning of the equalisation system, as local authorities cannot accept a system they do not know or understand.

With regard to equalisation of fiscal capacity, the tax base equalisation policies should be coordinated with policies designed to foster tax effort, in order to avoid these policies neutralising each other.

It is also appropriate to favour the incorporation into equalisation systems of voluntary redistribution mechanisms for certain local taxes, where the general scheme does not make such mechanisms unnecessary; these mechanisms may be introduced, in particular, in urban areas between the city centre and surrounding municipalities.

Regarding the equalisation of expenditure requirements, criteria should be favoured which:

- are not liable to affect the local authorities' freedom of choice, within the bounds of available resources;
- do not penalise local authorities which attempt to streamline the management of their services with a view to improving efficiency.

APPENDIX I

GRANTS SYSTEM FOR MUNICIPALITIES IN BELGIUM

I. BRUSSELS-CAPITAL REGION

1. General presentation

The (central) federal state no longer makes block grants to municipalities, with the exception of a special index-linked block grant to the city of Brussels as the capital of the kingdom. However, it gives grant aid for specific functions (municipal policing in particular).

The Brussels-capital region makes Brussels municipalities a general grant which forms part of their ordinary income and is therefore intended to cover operating expenses.

Besides this, in areas for which it is responsible, the region gives grant aid to municipalities to help them implement the policies pursued by the region and promote municipal action in a number of areas (urban development, urban renewal, housing, roads, etc.).

There are no general criteria for awarding grant aid to municipalities. The criteria vary according to the purpose of the aid. However, they must be objective. Criteria that are often applied are population, area, total length of roads, the presence within the municipality of (legally established) priority areas for urban development, etc.

2. The general grant to municipalities

The general grant to municipalities, introduced by the Order of 10 March 1994, which sets the rules for apportioning the general grant among the municipalities in the Brussels-capital region, replaces the Municipalities Fund. This is one of the largest items in the regional expenditure budget. In 1995, it amounted to 7 007 400 000 Belgian francs.

The order stipulated that the general grant would be linked to an index. The index is based on growth of the earmarked share of revenue from personal income tax (IPP), after deduction of certain annual payments established by the special law of 16 January 1989 on funding for the Communities and regions.

The earmarked share of IPP revenue and the amounts of the annual payments are specified each year in the general budget statement. The amounts of the annual payments are announced by the Federal Minister of Finances. In 1995 the index-linked increase in the grant was 2 per cent.

Before allocating the grant among the nineteen Brussels municipalities, two amounts are deducted from the relevant budget appropriation.

A sum of 150 million francs, which carries precisely the same index linking as the budget appropriation, is allocated to the city of Brussels.

After deduction of this allocation a further 5 per cent of the budget appropriation is deducted and allocated to the Joint Committee of the Communities, which in turn distributes it among the nineteen Public Social Assistance Offices in Brussels according to criteria which it itself sets.

The balance after the city of Brussels and the Joint Committee of the Communities deductions is divided into three parts:

- the basic grant = 20 per cent of the balance;
- the equalisation grant = 50 per cent of the balance;
- the compensation grant = 30 per cent of the balance.

In principle, the allocation of grants must be based on “objective” criteria. Hence the order specifies not only the criteria but also the reference years and the sources. The reference year is generally the one preceding allocation of the grant.

a. Equalisation criteria

The equalisation criteria for the general grant awarded to the nineteen Brussels municipalities are as detailed in the following table:

Item	Municipalities concerned	Equalisation criteria
Basic grant		Allocation according to
16%	All municipalities	number of inhabitants
4%	All municipalities	total developed surface area
Equalisation grant	Municipalities with:	Allocation according to:
24.5%	a per capita yield from supplementary IPP at a notional rate of 1% which is lower than the regional average	the ratio of the average regional yield to the average local yield multiplied by the number of inhabitants
10.5%	a cadastral income per dwelling which is lower than the regional average	the difference between the average regional income and the average local income multiplied by the number of dwellings
10.5%	a rate of supplementary IPP equal to or higher than 6.8%	the ratio of the local rate to 6.8% (with some adjustments)
4.5%	a surcharge on property tax equal to or higher than 2 411 centimes	the ratio of the surcharges to 2 411 centimes (with some adjustments)
Compensation grant		Allocation according to:
5%	All municipalities	ordinary education expenditure
5%	Municipalities which pay an average per capita grant to Public Social Assistance Offices higher than the regional average	the ratio of the two averages
5%	All municipalities	the number of foreign residents
5%	Municipalities which have entered into a security contract with the state and the region	the number of municipalities concerned (i.e. the grant is distributed among them equally)
5%	Municipalities in which 60% of the buildings were built before 1946	the ratio of the local percentage to the average regional percentage multiplied by a weighting coefficient based on the surface area of the municipality
5%	Municipalities with a higher population density than the regional average	the ratio of local density to regional density multiplied by the above weighting coefficient

b. *Guaranteed amounts*

As a result of the change in the equalisation criteria following the entry into force of the Order of 10 March 1994, some municipalities received much less as their share of the grant than they had been receiving from the Municipalities Fund. To cushion the blow and give them time to adapt, the order provided for a dual system of guaranteed amounts.

c. *Payment to the metropolitan authorities*

The order stipulates that 3 per cent of each municipality's share of the general grant must go to the metropolitan authority (the *agglomération*). This payment already existed under the Municipalities Fund system.

Although the institution has been done away with and the region has taken over its functions, the Regional Council and the Government have maintained this payment to underline the fact that the authority's responsibilities (particularly sanitation, fire-fighting and emergency medical assistance) are basically municipal and it is logical that the municipalities should continue to help finance the services concerned.

d. *How the Order of 10 March 1994 is implemented*

Article 17 of the order gives the regional government powers in this area, albeit highly limited ones: every two years it may change the percentages laid down in Articles 7 to 14, by a maximum of one fifth of the previous percentage. If it does so, it must inform the Regional Council within one month of its decision, failing which the decision is invalidated.

The government is not entitled to change the relative weighting of the basic grant, equalisation grant and compensation grant (set in Article 6). Nor can it change the criteria themselves.

The government must allocate the general grant before 1 November of the year of allocation to enable the balance to be settled before 31 December of the year in question. This entails a number of procedures (commitment of the balance, drawing up the settlement authorisation, approval from the Auditor General and, finally, payment).

To ensure that the municipalities have a regular income, the order provides for three advances to be paid during the second month of the first three quarters (February, May and August). These advances amount to 25 per cent of the share of the general grant obtained by each municipality the previous year.

II. WALLOON REGION

1. General presentation

The Walloon region apportions among its municipalities an entirely non-earmarked sum, the Municipalities Fund, whose size is adjusted in line with the municipalities' changing functions and duties, for which it provides the essential resources.

Municipalities which the high-speed train only crosses and which consequently only have the disadvantages of it are entitled to additional aid which is allocated according to the following criteria:

- the characteristics of the route;
- the type of area through which the route runs (residential, industrial, rural, etc.);
- the number of plots of developed land to be compulsorily purchased;
- the population of the municipalities concerned.

Grants are paid to finance:

- projects aimed at reducing social exclusion and improving general safety;
- improving municipalities' management capability;
- certain investments made in the public interest;
- sports facilities.

2. How the Municipalities Fund functions

This grant, which represented 99.11 per cent of all grants to municipalities in the Walloon region in 1994 (providing 25 per cent of their income) was introduced by the Decree of 20 July 1989. All the Walloon municipalities receive support from it.

The overall amount of the fund is fixed every year in the region's budgetary decree. There are no legal criteria for setting the amount.

The Minister for Internal Affairs and the Civil Service of the Walloon region is responsible for allocating the grant. The allocation criteria and arrangements are as follows:

- 5 per cent of the annual general grant goes to make up the special Social Welfare Fund which the French and German-speaking communities divide among the public social assistance offices in the Walloon region according to their own criteria;
- 32.5 per cent of the remainder of the fund is allocated to first-category municipalities (Charleroi and Liège);

- the other 67.5 per cent is allocated to second-category and third-category municipalities. The overall share is divided into a main grant (85 per cent) and a special grant (15 per cent).
- a. The main grant (85 per cent of the 67.5 per cent) is allocated as follows:
 - 14.85 per cent is allocated in proportion to the total population in each municipality, with every foreigner counting as 1.25 inhabitants;
 - 0.1 per cent is shared out equally between the municipalities with special language status (fifteen municipalities);
 - 0.05 per cent is divided in proportion to the population of the fifteen municipalities with special language status;
 - 26 per cent is divided between second category municipalities (twenty-two in total) in proportion to the population of each municipality multiplied by a tax coefficient;
 - 44 per cent is divided between third category municipalities in proportion to the total population in each municipality, multiplied by a tax coefficient and a population-density coefficient and divided by the per capita yield from the supplementary IPP reduced to a notional rate of one per cent.
- b. The special grant (15 per cent of the 67.5 per cent) is divided into three parts:
 - part A = 4.5 per cent allocated on the basis of the structural features, specific functions or financial circumstances of certain municipalities;
 - part B = 3.5 per cent, allocated according to vital or compulsory functions carried out by the municipalities;
 - part C = 7 per cent, divided among certain municipalities in difficult social and economic circumstances.

The provisions of the Decree on the Municipalities Fund and its implementing regulations are mandatory and therefore strictly applied.

The Walloon Government is only authorised to increase or decrease every two years the percentages allocated to each criterion or component of the special grant. Any such percentage may only be adjusted by one fifth and any adjustment requires a compensating opposite adjustment to a criterion in the same part of the special grant.

III. FLEMISH REGION

1. General presentation

The system of transfers in the Flemish region is based almost exclusively on grants. The region allocates two forms of grant to its municipalities, namely the Municipalities Fund, which is used for everyday expenditure and is mainly aimed at adjusting municipal income to the individual municipality's expenditure needs, and the Capital Investment Fund, which is a tool for infrastructure development. The Internal Affairs Department is responsible for apportioning them.

Up to and including 1995, there was also a special operational grant to partly offset the differences in per capita revenue-raising power. The special grant was introduced by a decree of 31 July 1990. The total amount to be distributed was fixed as a lump sum.

In 1994 these three grants accounted for some 23 per cent of municipal income. In the same year, earmarked grants, in support of local integration policies on behalf of the disadvantaged, constituted only 0.6 per cent of municipal revenue. There are no shared taxes in the Flemish region.

2. How the Municipalities Fund functions

As far as the method of calculating the share due to each municipality is concerned, the fund is divided initially into four parts:

- 42.9 per cent is allocated to municipalities with more than 150 000 inhabitants;
- 15.55 per cent is allocated to municipalities with 50 000 to 150 000 inhabitants;
- a further 0.2 per cent is allocated to municipalities with 100 000 to 150 000 inhabitants;
- 41.35 per cent is allocated to municipalities with less than 50 000 inhabitants.

Each allocation to municipalities with less than 150 000 inhabitants is divided up according to the following criteria:

- a. 40 per cent is based on the number of inhabitants;
- b. 10 per cent is based on the surface area of the municipality;
- c. 5 per cent is based on population density;
- d. 10 per cent is based on the number of working people in the municipality;
- e. 15 per cent is inversely related to per capita yield from the municipal supplementary IPP at a notional rate of one per cent;
- f. 15 per cent is inversely related to per capita yield from one hundred additional centimes on property tax;
- g. 5 per cent (only in the case of municipalities of 10 000 inhabitants or more) is based on the number of pupils and students in education in the municipality, with the exception of those attending primary and nursery schools.

The basic amounts under criteria a, b, c, d and g are increased by 30 per cent for coastal municipalities.

The proportion allocated to municipalities with over 150 000 inhabitants is apportioned at a flat rate between the two cities concerned, as follows:

- Antwerp: 64.51 per cent;
- Ghent: 35.40 per cent.

The region has no discretionary powers when applying the criteria; it is bound by the provisions of the decree.

3. *How the Capital Investment Fund functions*

The Capital Investment Fund was set up by a Decree of 20 March 1991. The total amount, to be distributed among all the municipalities, is fixed each year on the basis of the previous year's, adjusted in line with the cost-of-building index. In 1994 the fund represented 9 per cent of total grants (amounting to a little more than 2 per cent of municipal income). The apportionment criteria are given in the following table:

CRITERIA AND WEIGHTINGS	SETTING OF CRITERIA
Number of inhabitants – 45%	The average of the latest municipal population figure published in the Belgian official gazette and the maximum number of inhabitants in the ten-year period preceding the year to which the most recent figure published refers; this average is increased by 10% if the municipality's population density in that year is equal to or not less than 2.5 times the average for the Flemish region
Surface area – 15%	Measured in hectares
Length of roads – 15%	Length in kilometres of municipal main roads plus 0.8 times the length of other surfaced municipal roads and 0.6 times the length of provincial and regional roads
Number of dwellings – 15%	Number of dwellings in the municipality plus 0.2 times the number of dwellings built before 1945
Role as a centre – 5%	
Number of pupils – 5%	The number of children in basic education plus 1.6 times the number of pupils and students in secondary and higher education plus 0.25 times the number of pupils in education for social advancement and part-time arts education; the number of pupils for each education category is the average of the latest figure and the maximum number recorded in the five years preceding the year in which the grant is made

APPENDIX II

THE SYSTEM OF TRANSFERS TO MUNICIPALITIES IN THE CZECH REPUBLIC

I. GENERAL PRESENTATION

In the Czech Republic, financial transfers to municipalities include a tax-sharing system and a grant system.

1. Tax sharing

Since 1996, central government and municipalities share both the individual and the corporate income tax. At present, the criteria applied for the distribution of the amount of shared taxes between the municipalities are the following:

- i. personal income tax from dependent activity
 - 30 per cent of the whole district revenue of the tax is paid to municipalities; 20 per cent is allocated to each municipality in the district, the tax allocation percentages being made on the basis of the population criteria, and 10 per cent of the tax revenue is allocated to the municipalities where the taxpayer resides;
 - 30 per cent of the whole district revenue is divided between the respective district offices;
 - 40 per cent is given to the state budget.

The capital city of Prague, as well as the cities of Brno, Ostrava and Pilsen, dispose of 70 per cent of the tax revenue collected on their territories.

- ii. corporate income tax (except the tax paid by municipalities)
 - 20 per cent of the tax revenue collected in the Czech Republic is allocated to all municipalities; the tax allocation percentages are established on the basis of the population criteria;
 - 80 per cent of the tax revenue is given to the state budget.

2. State grants to local authorities

The share of the state grants in the total local government revenue decreased in connection with the new system of financing of local government, introduced in 1993. During the following three years, there was a certain tendency to reduce the amount of grants, as the local government share of the whole tax yield grew at a greater pace than the share of the central budget.

Grants from central government (and districts) are roughly 17-18 per cent of the total local government revenue. Approximately half of them are budgeted (regular) grants, which are either general or specific. The rest are specific subsidies paid out from central budget reserves; capital grants form the majority in this group.

II. ANALYSIS OF THE FUNCTIONING OF THE STATE GRANT SYSTEM

1. General overview

The grant system is relatively simple. It does not utilise criteria reflecting differences in municipalities concerning the size, number of citizens and their age structure, the length of roads and so on. Having too many municipalities and a lack of data on the past, it would have been impossible to create a sophisticated grant system. Instead, simple indicators were chosen, such as the number of children in a school, number of beds in a social care facility, and so on. The grant system aims to assist a municipality when running a special function.

In 1995, the following budgeted grants were paid to municipalities:

- grant for the execution of state administration;
- grant for education;
- social care homes grant;
- rest homes grant;
- health care grant (health centres which are not financed by health insurance);
- grant for municipalities located in areas where the environment has been damaged (Prague, North and West Bohemia, North Moravia);
- fire protection grant;
- housing grant;
- territorial equalising grant.

Budgeted grants are approved by the Parliament and determined in the Act on state Budget. The proposal for grants and their amounts is submitted by the Ministry of Finance in co-ordination with other competent ministries to the Government of the Czech Republic. In most cases the contribution to expenditures of municipalities concern local public services. The territorial equalising grant is the only one designed to balance the level of tax revenue of municipalities in districts with a low taxation capacity.

Moreover, a compensation subsidy is paid by the state in order to cover some social benefits paid by local government. Child benefit corresponds to almost half of these social benefits.

Besides budgeted grants and social benefits compensation, specific subsidies are distributed, which include various investment subsidies, especially those for environmental protection, housing, waste water treatment, local roads, local public transport, schools, cultural facilities, etc.

2. Information concerning the most important general grants

Some budgeted grants are given a specific purpose; i.e. the rest home grant, used to finance the construction of housing for elderly people. The following grants are, however, of a general nature.

- i. The grant for the execution of state administration is the state contribution to municipalities when they provide the administration functions delegated to them by the state administration. These activities are partly financed by administrative fees paid by citizens. The state grant is allocated on the basis of administrative needs criteria (i.e. the scope for administrative acts ensured by municipalities).
- ii. The grant for education is calculated as a certain amount (set each year) per pupil at primary and pre-school facilities. In the case of social and health care facilities, the grant is calculated as a certain amount per bed (set yearly). Each municipality is free to spend this money according to its own decisions, even if this amount is determined on the basis of specific needs related criteria.
- iii. The territorial equalising grant is designed to reduce differences in tax revenues and is therefore allocated on the basis of the difference between each local government's tax revenues and the national average of the tax revenue.

Grants are afforded only to municipalities which comply with allocation criteria. The number of municipalities which benefit from the grant is different depending on each grant. For example, in 1995 all municipalities (6 233) obtain certain grants for the execution of state administration; there are kindergartens or primary schools in 2 729 municipalities and each of them gets grants according to the number of pupils; rest homes were established in sixty-four municipalities, which obtain a respective amount of grants; only forty-one municipalities receive grants for social care homes.

The criteria are annually determined by the Ministry of Finance.

All the above-mentioned grants (and their allocation to particular districts) are determined by the Act on State Budget, approved by the Parliament. Each district office is responsible for the distribution of grants to municipalities within its territory, once the district assembly (authority consisted of representatives of each municipality within the district area) has finally approved it. The district assembly is entitled to choose different criteria, which are valid only within the framework of a given district.

APPENDIX III

STATE GRANTS AND EQUALISATION SYSTEM FOR MUNICIPALITIES AND COUNTY AUTHORITIES IN DENMARK

I. GENERAL PRESENTATION

The tax base of Danish municipalities varies greatly, and municipalities often have very different age profiles and social structure.

If an individual municipality were to fund all its expenses by itself, there would be very considerable differences among municipalities in service level and in tax burden.

The task of the equalisation system is to ensure that the same service level is achieved with a more uniform tax rate despite variations in the level of income and in the demographic profile of the municipality. It is said that the equalisation system is to ensure a more uniform relationship between taxes and services.

Differences in the tax/service relationship are due first of all to the fact that the price for maintaining the same level of service per inhabitant is not the same in all municipalities. There is a difference in the expenditure needs of municipalities. In practice, the expenditure need is measured by including a number of factors (expenditure need factors) that influence municipal spending: the number of pre-school children, of school children, of elderly citizens, etc. The difference between the municipality with the lowest expenditure need and the one with the highest need was DKK 8 000 per inhabitant in 1996.

Secondly, there is a great difference in the tax base of the various municipalities. The tax base of a municipality is an expression of the income level and the land value in the municipality. The difference between the highest and the lowest tax base per inhabitant was more than DKK 112 000 in 1996. Thus, the tax base per inhabitant in the wealthiest municipality was two and a half times higher than in the poorest.

Local authority equalisation and state general grants to municipalities and counties must be regarded as one single system and they are paid out to municipal and county authorities as a single amount. Grants and equalisation are often referred to collectively as block grants, and this income is not earmarked for any specific expenditure area.

The local government grants and equalisation system consists of four elements:¹

- equalisation of expenditure needs
- equalisation of tax base
- general state grants
- various special grants and equalisation schemes.

II. EQUALISATION OF EXPENDITURE NEEDS

There are three schemes for equalising differences in expenditure needs:

1. national equalisation comprising all municipalities in the country, including municipalities in the Copenhagen Metropolitan Area;
2. equalisation among municipalities in the Copenhagen Metropolitan Area, which is added to the national equalisation;

¹ It should also be mentioned that an important part of municipal finance is constituted by reimbursements, i.e. state financing of a given percentage – 50 per cent as a general rule – of some municipal expenditure (e.g. sound cash benefits).

3. equalisation among all the counties in the country.

In order to equalise differences in the expenditure needs of local authorities, there must be a way of measuring expenditure needs in individual municipalities.

Expenditure needs are calculated on the basis of a number of objective criteria, which are assumed to reflect the factors that determine the volume of municipal expenditure.

What is meant by “objective” criteria is that they reflect an established connection between various circumstances that cause expenses and the municipalities’ need to effect expenditure. Therefore, only “objective differences in expenditure needs” are equalised.

Differences due for example to higher service levels or lower efficiency are not equalised.

Moreover, only part of the objective differences is equalised. The rates of equalisation have been set at:

- 45 per cent in the national equalisation concerning municipalities;
- 40 per cent in the Copenhagen metropolitan area equalisation so that about 85 per cent of differences among municipalities in the Copenhagen metropolitan area is equalised;
- 80 per cent in county authority equalisation.

Following the calculation used as from 1996, equalisation of municipal expenditure needs take into account:

- expenditure needs resulting from age;
- expenditure needs caused by social factors.

Moreover, a special basic grant, which amounts in 1996 to DKK 7.5 million for all municipalities – big and small – aims at ensuring that the additional expense accruing to the smallest municipalities in particular is given special consideration.

The age-derived expenditure needs are calculated on the basis of 80 per cent of municipal and county expenditure, while the remaining 20 per cent is counted as relating to socially determined expenditure needs. In the metropolitan area equalisation, however, 25 per cent of expenditure is counted as socially determined, and in the national equalisation the expenditure covered by the basic grants is deducted in advance.

The age-derived expenditure needs are calculated as the number of inhabitants in a municipality in different age brackets multiplied by a “unit amount” for each age group. These unit amounts have been calculated on the basis of average municipal expenditure for each age level.

The socially determined expenditure needs are found on the basis of a calculated “social index” for each local authority. The social index is calculated from a number of “social criteria”. These criteria appear in Table 1.

The social criteria are not linked to individual expense areas in the same way as the age-derived criteria. On the contrary, the purpose is to take account of the more general aspects of the social burden municipalities have to carry.

It is the difference between the expenditure needs per inhabitant in a municipality and the national average expenditure needs per inhabitant which is the basis of equalisation. Municipalities whose expenditure needs are below the national average contribute to municipalities whose expenditure needs are above average.

The individual municipality's grant from or contribution to the scheme is calculated as the difference between the expenditure needs per inhabitant in the municipality and the national average multiplied by the equalisation rate and the number of inhabitants in the municipality. The total sum of expenditure needs equalisation among municipalities is zero, i.e. the sum of contributions made by some municipalities is equal to the grants received by the other municipalities.

Social criteria used in calculating the “social index”

	National equalisation municipalities	Special equalisation of the Copenhagen metropolitan area	Equalisation counties
Number of children of single parents	32.5%	32.5%	50%
“Residence criterion” (outdated homes and modern rented homes)	25%	-	-
Numbers of rented homes	-	20%	-
Numbers of inhabitants 20-59 years of age without employment in excess of 5% in the municipality	25%	25%	-
Numbers of foreigners from third-party countries	10%	10%	-
Number of inhabitants 25-49 years of age without vocational education	-	12.5%	-
Inhabitants in areas with severe social problems outside the Copenhagen metropolitan area	7.5%	-	-
Number of single inhabitants over 65 years of age	-	-	50%
Total	100%	100%	100%
Total weight of social criteria	20%	25%	20%

III. EQUALISATION OF TAX BASE DIFFERENCES

The benchmark for equalisation of differences in tax base is a tax base calculated as a (weighted) measure of the part of the authority’s tax base consisting of income tax and land tax.¹

Equalisation in the national equalisation scheme for municipalities is made on the basis of the average tax base per person in the whole country. Thus, the scheme pays its own way, since in principle contributions made by some municipalities are matched by grants received by other municipalities.

¹ For a municipality, the tax base is calculated as the income tax base plus 6.5 per cent of taxable land values. The tax base for a county is the global revenue from income tax and land tax divided by the tax rate.

The amount concerning a single municipality is calculated as the difference between the municipal tax base and the national average tax base per inhabitant. The difference is multiplied by the equalisation rate in the national equalisation, which is 45 per cent, and by a calculated common tax rate.

Furthermore, the municipalities in the Copenhagen metropolitan area participate in a separate metropolitan area equalisation scheme, where a further 40 per cent of the differences among metropolitan authority tax bases per inhabitant is equalised. The reason for having a higher level of equalisation among municipalities in the metropolitan area is the very considerable demographic and income variation existing in the Copenhagen metropolitan area.

In the Local Authority Equalisation and General Grants Act, provision is also made for a special grant to municipalities with a weak tax base. These municipalities, whose tax base per inhabitant is less than 90 per cent of the national tax base per inhabitant, are granted 40 per cent supplementary equalisation in addition to the national equalisation. This means that altogether 85 per cent of the difference between the municipal tax base and 90 per cent of the national tax base average per inhabitant is equalised. Total grants to municipalities with weak tax bases amount to DKK 873 million for 1996. This grant is financed collectively by all the municipalities via the block grant scheme.

The provision concerning municipal tax equalisation includes an over-equalisation provision – an equalisation ceiling – intended to ensure that a municipality will never have to give back more than 90 per cent of its tax revenue in the event of an increase in the income tax base.

In the county authority tax base equalisation, the agreed equalisation base is the average county tax base per inhabitant, and therefore this equalisation scheme is neutral in relation to state finances. Here, 80 per cent of the differences among county authorities is equalised.

IV. GENERAL STATE GRANTS

The annual state grant is mainly distributed according to the tax base in the local authorities, and therefore has no equalising effect, but is merely part of the financing of local authorities. The size of the total state grant is fixed by the Minister of Finance after approval by the Parliamentary Finance Committee.

A fairly small share of the state grants is given as special grants to municipalities with a weak tax base and is distributed under various schemes. The rest of the grant is distributed to the municipalities in proportion to the individual municipality's share of the total municipal tax base. In the counties, the entire state grant is distributed according to tax base.

V. SPECIAL GRANTS AND EQUALISATION SCHEMES

These special schemes include, among others:

- grants and equalisation concerning refugees and immigrants. The purpose of these schemes is to equalise additional expenses of municipalities related to integration, language instruction and social expenses etc. for foreigners;
- special grants to municipalities with special difficulties;
- grants to municipalities with major islands.

Survey of equalisation schemes

I. Municipalities	
A. Equalisation of tax base differences	
National equalisation for all local authorities	In the national equalisation, 45% of the difference between the municipal tax base and the national average tax base per inhabitant is equalised.
Grants to municipalities with a weak tax base	Municipalities with a weak tax base (less than 90% of the national average) are given extra grants amounting to 40% of the difference from national average.
Equalisation of the Copenhagen Metropolitan Area	A further 40% of the tax base difference of metropolitan municipalities is equalised among municipalities in the Copenhagen metropolitan area.
B. Equalisation of expenditure needs	
National equalisation for all local authorities	In the national equalisation, 45% of the difference between the calculated municipal expenditure needs and the national average expenditure needs per inhabitant is equalised.
Equalisation in the Copenhagen Metropolitan Area	A further 40% of the difference in the expenditure needs of metropolitan municipalities is equalised among municipalities in the Copenhagen metropolitan area.
II. County authorities	
A. Equalisation of tax base differences	80% of the differences in tax base per inhabitant is equalised among all the counties in the country.
B. Equalisation of differences in expenditure needs	80% of the differences in expenditure needs per inhabitant is equalised among all the counties in the country

APPENDIX IV

STATE GRANTS SYSTEM FOR MUNICIPALITIES IN FRANCE

I. GENERAL PRESENTATION

Most transfers to municipalities come from central government. There are four main categories of grants from state to the municipalities and some groupings of municipalities:

- operating subsidies;
- investment subsidies;
- funding of transferred powers;
- compensation for tax exemptions or relief.

With the exception of the rural development grant – allocated by the prefects – these subsidies are allocated by the minister responsible for local and regional authorities. The minister also determines the amounts to be allocated to the municipalities in accordance with the guidelines laid down in the relevant texts and has no discretion.

1. Operating subsidies

Operating subsidies include a fixed state contribution to local authorities operating costs. Moreover, the system is designed to balance out the disparities between municipalities by the introduction of a number of equalisation measures that take account of the population and tax revenue of the municipalities in question.

In 1996, operating subsidies accounted for 45 per cent of all state grants to municipalities and for 28 per cent of municipalities' total revenue.

2. Investment subsidies

With regard to investment subsidies, a large part of the state's action is in the form of reimbursement of the value added tax (VAT) paid on works carried out by the municipalities. In 1996, these subsidies accounted for 15 per cent of all state transfers to municipalities and for 8.5 per cent of their total revenue.

II FUNCTIONING OF THE SYSTEM OF STATE SUBSIDIES TO MUNICIPALITIES

1. Allocation of state subsidies to municipalities in 1996

	1996	1996/1995 evolution
Operating subsidies	113 640	+ 3.5%
Total operating grant (DGF)	103 576	+ 3.8%
Special primary teachers' grant	2 947	- 2.5%
Local elected representatives grant	259	+ 3.6%
Specific grants paid by various ministries	4 445	- 5.6%
state grant for National Business Tax Equalisation Fund (including rural development grant)	1 797	+ 29.5%
National Equalisation Fund	616	+ 8.3%
Investment subsidies	35 413	+ 1.6%
General capital grant	5 689	- 6.6%
VAT compensation fund	23 100	+ 1.3%
Levy on traffic fines	1 700	+ 30.8%
Specific grants paid by various ministries	3 593	+ 2.8%
Special Treasury accounts	1 331	+ 14.9%
Funding of transferred powers	25 094	+4.3%
General grant for decentralisation	14 158	+ 4.3%
Grant for professional training	4 950	+ 4.7%
Regional equipment grant for high schools	3 157	+ 3.7%
Departemental capital grant for secondary schools	1 562	+ 3.7%
General grant for Corsica decentralisation	1 267	+ 4.0%
Compensation for tax exemptions or relief	68 430	+ 6.4%
Grant for business tax compensation	17 473	- 8.7%
Grant for property tax relief compensation	850	- 34.5%
Compensation for local tax exemptions	12 946	+ 37.8%+
Compensation for others legislative exemptions	37 161	7.8%
Total amount excepted transferred taxes (with transferred taxes)	242 577 (281 066)	+ 4.1% (+3 0%)

(In millions of French francs)

2. General grants for current expenditure

a. Total Operating Grant (DGF)

The DGF (Article L.234-7 of the Local Authorities' Code of 31 December 1993) is the main state grant to municipalities and groupings of municipalities. It is set each year in the budget passed by Parliament. It is supervised and allocated by the Local Finances Committee.¹ For 1996, 1997 and 1998, the state and the municipalities have concluded a financial stability pact whereby the DGF will be increased in line with an index equivalent to the total of the rate of inflation and half the growth rate of the GDP (Gross Domestic Product).

Since 1994, the DGF has included:

- i. a fixed grant, paid to all municipalities, representing 90 per cent of the municipalities' DGF. The fixed grant is calculated exclusively in relation to demographic criteria, making it proportionate to the population of the municipalities in question. This grant is augmented each year by half of the rate of increase of all resources allocated to the DGF.
- ii. a development grant which breaks down into three sections:
 - A grant for groupings of municipalities to support the inter-municipality dimension. Only those groupings which have their own tax system qualify for this grant. The amount is calculated on the basis of the total population and the taxation capacity of the grouping in question. The grant is allocated by the Local Finances Committee to four main categories of recipients:
 - urban communities;
 - communities of towns and groupings of municipalities;
 - districts with their own tax system and communities of municipalities;
 - associations or communities of new urban areas.
 - The Urban Solidarity Grant (DSU), whose purpose is to contribute to the improvement of living conditions in urban municipalities with insufficient resources and a high level of costs.
 - The Rural Solidarity Grant (DSR) which enables rural communities to undertake development work in rural towns with a population of under 10 000 and in certain *arrondissement* chief towns with fewer than 20 000 inhabitants.

¹ In 1996, the Local Finances Committee comprised forty-two members from the parliamentary assemblies and elected representatives of the regions, *départements*, municipalities and groupings of municipalities, and representatives of central government.

b. *Special primary teachers' grant*

This grant, provided for in Article 4 of the Local Authorities' Code of 2 March 1982, is intended to compensate for the costs involved in providing housing for teachers in the municipalities concerned. It is divided into two:

- one part which compensates for the costs relating to housing actually occupied by teachers;
- a second part to compensate for the payment of housing allowances to teachers not residing in the municipality.

c. *Local elected representatives' grant*

This grant is paid to municipalities with fewer than 2 000 inhabitants. Its purpose is to alleviate the cost of statutory allowances which municipalities are required to pay to their elected representatives.

d. *Specific grants for current expenditure*

These are specific grants paid to the municipalities by various ministries.

e. *National Business Tax Equalisation Fund*

This fund, set up by a law of 4 February 1995, is financed by the state and by compulsory contributions from firms whose headquarters are located in municipalities where the business tax rate is below the national average.

This fund has two parts:

- i. The Rural Development Grant (Article 1648 B of the General Taxation Code). This is paid, subject to certain conditions, primarily to municipalities with fewer than 10 000 inhabitants, in the form of subsidies for development programmes, and is therefore considered more as an investment subsidy. It is also paid to groupings of municipalities with populations of under 35 000 or, subject to certain conditions, those with under 60 000.
- ii. Compensation for state-approved exemption from or relief on local taxes. These grants compensate municipalities for the loss of revenue resulting from the exemptions approved by the state for local taxpayers in the context of its taxation policy.

f. *National Equalisation Fund*

This fund was set up by the General Principles Act on Regional Planning. It is intended to help municipalities with modest taxation capacity which make an above-average tax effort in comparison with municipalities of the same size.

3. Investment subsidies

a. General Capital Grant (DGE)

Municipalities with a population of more than 2 000 and fewer than 20 000 are eligible for this grant, in the form of either a fixed sum, or a specific subsidy for each operation carried out. The type of investment which may qualify for the grant is laid down by a *département* committee co-chaired by the prefect and the chair of the *conseil général*. Municipalities with fewer than 2 000 inhabitants qualify only for specific subsidies. Since 1996, those with more than 20 000 inhabitants have no longer been eligible for the DGE.

b. VAT Compensation Fund

All municipalities benefit from this fund. Compensation is in the form of an allocation equal to the product of the amount of investment and a fixed compensation rate equivalent to the VAT rate. This therefore involves an assessment of actual municipal investment expenditure, in particular transactions relating to assets appearing in the municipalities' accounts.

c. Levy on traffic fines

The proceeds from police fines for traffic offences, deducted from state revenue, is allocated by the Local Finances Committee, provided for by Article L.234.20 of the Local Authorities' Code, in order to fund efforts to improve public transport and alleviate traffic problems.

4. Other subsidies

a. Funding of transferred powers

This funding includes the general grant for decentralisation set up in 1984 to compensate the transferred expenditures to local authorities that are not compensated by transferred taxation (i.e.: the rights of transfer, the *départemental* car tax and the regional car licence).

The others transferred powers refer to professional training and to local and regional capital expenditure for schools.

b. Compensation for tax exemptions or relief

Compensation for tax exemptions granted to specific taxpayers is calculated according to a legal rate fixed when the exemptions are approved. Compensation is not influenced by local authorities tax policies. On the contrary, tax relief is a state grant aimed at supporting local authorities taxation according to their needs. Thus, tax relief's cost is higher than compensation for tax exemptions. As a result, the state tends to use compensation for tax exemptions rather than tax relief.

APPENDIX V

THE SYSTEM OF TRANSFERS TO LOCAL AUTHORITIES IN GERMANY (BAVARIA)

I. PRELIMINARY REMARKS

In Germany, the responsibility for local affairs lies with the *Länder* (federated states). In addition to the constitutional guarantee of local government, Chapter X (Finance) of the Basic Law of Germany also includes some provisions concerning the funding of local authorities.

Throughout the federal territory, the municipalities receive a share of 15 per cent of the local revenue from income and wage tax. The funds are distributed on the basis of the relevant local revenue in the individual municipalities. However, the relevant basis for calculating the municipal share is not the entire tax revenue, but only those amounts due to a taxable income of up to DM 40 000 for unmarried persons and up to DM 80 000 for married couples.

Detailed questions of financial equalisation for local authorities and the calculation of grants to local authorities are the exclusive competence of the *Länder*, which have their own arrangements.

The information given below relates to the example of Bavaria. The procedures in the other *Länder* do not differ substantially from that in Bavaria.

II. GENERAL PRESENTATION

In Bavaria, financial transfers to local authorities aim at reducing both differences in their tax capacity and providing every municipality with the funds necessary for performing its tasks. Namely, financial transfers cover the burden of current expenditure, but they also finance capital investment projects such as the construction of schools, kindergartens, hospitals and roads.

Transfers are made from government funds. The system comprises tax sharing arrangements, the municipal share being mainly distributed in the form of general grants.

On the whole, general grants represented in 1995, 15.4 per cent of municipal revenue and specific grants 16.1 per cent.

III. TAX SHARING

1. General system of shared taxes

In the general system of shared taxes, the local authorities get a share of the *Land* revenue from income and wage tax, corporation tax, turnover tax, trade tax and income from the financial equalisation between the *Länder*. In 1995, the Bavarian municipalities' share of this revenue was 11.54 per cent.

Firstly, the funds for specific grants are derived from these financial resources (about 15 per cent).¹ The remaining amount (about 85 per cent) are distributed to the local authorities in the form of rate support grants (see IV. 1. below).

2. Shared motor vehicle tax

For the time being, the Bavarian municipalities get a share of 65 per cent of the revenue from motor vehicle taxes. Distribution to the municipalities is partly effected in the form of general grants, the amount of which is calculated on the basis of the relevant local tax revenue and the length of the road network, and partly in the form of specific grants for construction measures.

3. Shared real-estate purchase tax

The government makes available to the municipalities and *Landkreise* (counties) two thirds of the revenue from real-estate purchase tax. The tax revenue is distributed on the basis of the relevant local revenue. In this context, the municipalities not belonging to a *Kreis* and the major county towns receive the full amount of the share, while the municipalities belonging to a *Kreis* receive three sevenths and the *Landkreise* four sevenths.

IV. GENERAL GRANTS

1. Rate support grant

The rate support grant legal bases are: Article 106, paragraph 7 of the Basic Law; Article 83, paragraph 3 of the Bavarian Constitution; Articles 1 to 5 of the Act on Financial Equalisation between the Federation, municipalities and associations of municipalities.

This grant is designed to equalise partially differences in burdens of individual municipalities and tax capacities. In 1995, 89.5 per cent of the municipalities received this grant, which represented 53 per cent of the total amount of general grants.

Regarding the criteria of distribution, the legislator proceeds from the assumption that municipalities of about the same size and same structure have to spent about the same amount to cover their needs. Therefore, a fictive burden by expenditure based on the number of inhabitants (main factor of calculation) and some specific burdens (additional factors of calculation for tasks incumbent on towns not belonging to a *Kreis*, in the border area of the Czech Republic and the former border area of the GDR, above-average burden by social assistance) are compared with the municipality's tax capacity. If the tax capacity is lower than the actual expenditure, 55 per cent of the difference is compensated by rate support grants.

The authority responsible for the distribution of the sums available is the *Bayerisches Landesamt für Statistik und Datenverarbeitung* (Bavarian office for statistics and data processing). It has no margin of discretion in the application of the above-mentioned criteria.

¹ In addition to these funds, there are numerous other resources for specific grants from the *Land* budget.

2. Equalisation grant

The legal bases of this grant are Article 83 paragraph 3 of the Bavarian Constitution and Article 7 of the Act on Financial Equalisation between the *Land* Bavaria, municipalities and associations of municipalities.

It aims at making up the differences resulting from the expenditure incurred by municipalities in executing the tasks delegated from the *Land* to the local authority.

In 1995, this grant corresponded to 19.1 per cent of the total amount of general grants. All municipalities benefit from it.

The authority responsible for distribution is the *Bayerisches Landesamt für Statistik und Datenverarbeitung*.

Regarding the criteria of distribution, municipalities not belonging to a *Kreis* are allocated DM 59.00 per inhabitant, while *Landkreise* and municipalities belonging to a *Kreis* receive DM 29.50 per inhabitant (i.e. together the *Landkreise* and municipalities belonging to a *Kreis* receive DM 59.00 per inhabitant).

In addition, the *Landkreise* receive the full revenue from the fees and charges levied by the *Landratsamt* (county hall) in its capacity as *Land* authority; the municipalities and the *Landkreise* receive the local revenue in terms of cautionary fines and administrative fines levied by them whereas the *Landkreise* also receive the local revenue of cautionary and administrative fines levied by the *Landratsämter* in their capacity as Land authorities.

V. CRITERIA FOR SPECIFIC GRANTS

A measure is only eligible for a specific grant if there is an actual need for it to be taken.

The amount of the grant does not relate to the overall costs of the measure but to the so-called costs eligible for being subsidised.

Moreover, when determining the amount of the grant, account has to be taken of the financial situation of the recipient, the external effect of the measure in so far as it goes beyond the municipality's territory, the government's interest in such a measure and the amount of the funds available.

APPENDIX VI

STATE GRANTS AND EQUALISATION SYSTEM FOR MUNICIPALITIES IN ITALY

I. GENERAL PRESENTATION

The Italian system of central government allocations to local authorities, and particularly the system in favour of municipalities, is being thoroughly transformed starting from 1993 as a result of the introduction of the Municipal Tax on Real Property (the so-called ICI. – *Imposta comunale sugli immobili*).

This newly introduced tax has pushed towards a broader financial autonomy of local authorities by applying one of the principles that inspired the Local Governments Reform Act of 8 June 1990, No. 142, that is, the improvement of the self-government of local authorities.

On the basis of this Reform Act No. 142, the Legislative Decree of 30 December 1992, No. 504 was issued, in order to implement the new state allocation system to local governments. This system is to be considered within the above-mentioned general context trending towards a system by which state transfers no longer constitute the main financial resources of local authorities.

With the Legislative Decree No. 504 of 1992, the relationship between own resources and state transfers within local governments budgets is turning upside down: the former are becoming more significant than the latter because of the considerable receipts coming from the ICI.

The state allocations are to be finalised only to the financing of indispensable services, which represent the minimum organisation standard of local public services, presently constituted by those services uniformly spread all over the territory. This concept is being continuously developed and is subject to doctrinal debates in order to consider the fact that some local authorities are bound to provide for several services as a consequence of the so-called “attraction effect”. Nevertheless, the complete cost coverage cannot be assured for these services. The parameters used for the transfers assignments are: population, territorial surface, social-economical conditions, although the main criterion is constituted by the population. A debate is presently in progress among local authorities, especially those having less inhabitants, in order to stress the importance of the territorial surface factor.

The Legislative Decree No. 504 of 1992 splits the central government allocations into two main categories: the allocations finalised to the financing of the current expenditures and those finalised to the financing of the investments. The present document does not examine the state transfers for the investments, thus it can only be said that the old state allocation system for the investments was mainly constituted by a subsidy, covering the financial burden of loans (capital share and interest share), that was later transformed into capital account assignments, the amount of which was in fact quite reduced. Special contributions for the investments of some local authorities are still provided, only in case they result in a particularly degraded situation and should they have been dissolved as a consequence of Mafia infiltration in their councils.

After the reform enacted by the Legislative Decree No. 504 of 1992, we have to distinguish three different types of contributions in the present state allocation system finalised to the financing of functioning expenses: ordinary fund, consolidated fund, equalising fund for local taxation imbalances.

The first one is constituted by: the previous basic ordinary fund, reduced by the minimum mandatory rate basis of 4 per thousand of the above-mentioned ICI. tax receipts, plus the previous equalising fund. The second one consists of some specific personnel expenditure support allocations. The third one has introduced the new equalising system that will be illustrated later. The present ordinary fund has therefore absorbed the previous equalising fund.

It must be recalled that the need for an equalising system has been perceived since 1978, when the old system was abandoned which provided an annual loan for balancing the local authorities' budget deficiency. Starting from a system of state grants based on the current expenditure per inhabitant, that was allocated to local authorities having per capita current expenses below the national average level, and coming through a system based on prefixed coefficients relative to the population, a system was then adopted by which both the population and the services were taken into consideration by determining a parameter per each local government. It must be noticed that only the new resources had to be assigned by applying the new criteria, with exclusion of the historical amounts due.

II. THE ORDINARY FUND AND THE OBJECTIVE PARAMETERS FOR DEFINING THE STANDARDISED FINANCIAL NEEDS

The previous equalising fund, that is the one merging into the present ordinary fund, aimed to equalise the allocations to the individual authorities within the various demographic categories of local governments. As a reality, this system worked out well by eliminating the anomalous tops of the per capita transfers. In any case, some noticeable differences still persisted and within the demographic categories themselves.

The objective parameters system was based on the elements constituted by the indispensable services, by the expenses indicators, by the demographic categories, by the monetary parameters, by the degraded economic conditions coefficients and by the military installations.

This equalising method should have been applied to a share of the ordinary fund equal to 5 per cent the first year and growing at an annual percentage of 5 per cent, the final equalised assignments being 80 per cent of the total fund. This was a soft system since it was intended to withdraw financial resources over a long period, that is sixteen years, in order to reassign them among the various authorities and, of course, in order to assign minor transfers to over-endowed authorities. After a short initial phase of implementation of the above-mentioned allocation system, in 1995 a change was enacted together with the determination of the criteria for reducing the amounts of the state grants to local authorities, within the general financial balancing strategy of the public accounts. Rules were changed by introducing a stronger equalising method on the basis of which the financial requirements of local governments were compared to their resources.

These resources were calculated on the basis of the state allocations and of the revenues coming out from the newly attributed tax power (mainly constituted by the ICI, particularly for municipalities). Thus, it has been established that the resources coming from the above-mentioned 5 per cent share system had to be reassigned only to those authorities whose financial requirements were covered for an average amount less than the national average. In this way, state grants have been cut off to all the authorities but just some of them have received the reallocated sums. This restraint of the local finance system provoked the complaints of the over endowed governments, mainly corresponding to those having a large number of inhabitants, thus causing the system freezing point. For this reason, in 1996 state allocations were assigned on the 1995 basis in a percentage measure that was the same for everybody.

A new study for a total reform of the state grants assignments is presently in progress. This reform will be part of the general reform of the relationships among the central governments, the regions and the local authorities. It is based on the “subsidiarity principle” and will lead to the attribution of more power and functions to local authorities and, unavoidably, to a higher degree of financial self-government, thanks to a spreading out of the local taxation power, with corresponding restraints of the state allocations.

The old equalising method was particularly important up to the year 1993 when the state allocations represented almost the whole of the financial resources of the local governments expenditures. However, when a first type of local fiscal autonomy has been introduced, the alignment process of the per capita transfers for those local governments belonging to the same demographic area resulted in being absolutely inadequate and the need for an equalising method taking into consideration the different basis of local taxation was evident.

III. EQUALISATION OF LOCAL TAXATION

For this purpose, the equalising fund for the local taxation inequalities has been introduced, which is assigned to municipalities and to provinces and not to the mountain communities, since they have not yet been given an autonomous tax power. The total amount of the fund is fixed on the basis of the total amount of the ordinary base fund (the minimum mandatory receipts by 4 per thousand of the ICI, is also considered); this amount is increased annually according to the programmed inflation rate or to the expenditures increase rate of the state budget, both established on a triennial basis by the central government in the official state financial programmes. The contribution is assigned on a triennial basis amount and it was initially established that at the end of the three-year period the allocation had to be recalculated, in order to avoid the consolidation of the grants.

As far as the distribution criteria of the fund are concerned, it is to be noticed that the fund has been linked to the mandatory tax receipts, with the exclusion of any relation with the so-called “fiscal effort”, linked to the discretionary application of the taxes by the local governments. Therefore, the equalisation for the municipalities is applied to with reference to the receipts of the ICI at the minimum rate of 4 per thousand and to the electrical energy additional tax. The contributions are assigned to those governments having a tax base lower than the normal value resulting in the same demographic class of the government, by attribution proportionally calculated in respect to gaps and by attribution of higher increases to those governments having underprivileged conditions.

The amount of the fund to be distributed to the governments is shared into two parts, proportionally to the weight the two taxes have in relation to the revenues of the municipalities at national level. The first part is assigned on the basis of the gap between the real and the average value of the ICI, and the second one on the basis of the gap between the real and the average value of the electrical energy additional tax. Exceptional values are not considered in determining the average values, in order to avoid mistakes. The maximum gap is equal to one hundred and it corresponds to an increase of 5 per cent; this increase will be lowered step by step with the lowering of the difference from the average value.

This procedure is repeated up to the full capacity of the available fund for distribution to the local governments or, of course, up to the case by which all the governments should result in being perfectly aligned. If residual amounts are still available, these merge into the amounts reserved to the equalisation of the electrical energy additional tax, which follows the same procedure. The amount of the resultant attributions constitutes the total of the equalising fund for local taxation. In case part of the fund is still available because all the authorities have been aligned, the remaining sums will be distributed by using the objective parameters described above for the ordinary fund.

IV. CONCLUSION

To summarise, there have so far been two different types of equalisation: the first one, which has merged into the ordinary fund, and which aimed at rationalising the state transfers to local governments by eliminating the historical differences in the per capita assignments to similar authorities belonging to the same demographic areas, and the second one that, by considering the introduction of the autonomous local tax power, is providing a state support in favour of those authorities having minor tax base capability and that, therefore, are underprivileged in any case in the implementation of the autonomous tax power.

It has to be said, furthermore, that the equalising system is still going to be modified, since most probably we are moving towards a system that will be based on the “fiscal effort”, that is on the capability of local governments to actually manage the tax power, also beyond the effective tax base that may be locally available. At the present time, a study is in progress and the enabling legislative decrees are still to be issued.

APPENDIX VII

STATE GRANTS SYSTEM FOR MUNICIPALITIES IN THE NETHERLANDS

I. GENERAL PRESENTATION

The municipalities receive their revenues from three different sources: specific grants (51.4 per cent), the general grant from the Municipalities Fund (32.6 per cent) and own revenues (charges and taxes; 16 per cent). The municipalities are free (within the law) to spend their general grants as they see fit. In practice, however, they need their general grant for the defrayment of a number of regulated tasks which they execute in compliance with the general government.

The spending of specific grants is restricted to well-defined specific purposes. In the last decade, a considerable amount of decentralisation has taken place; the number of specific grants has been reduced significantly. In addition, a number of specific grants have been integrated into the general grant. In recent years – due to this integration and the constraints to spend the general grant freely – the differences between the specific grants and the general grant have become less well defined. This trend is expected to continue.

The main purpose of the general grant is to enable municipalities to achieve an equivalent capacity in producing and distributing services. For this purpose, after the revision (January 1997), the general grant levels differences in the capacity to generate taxes and reduces the cost-differences between municipalities.

The criteria for the allocation of specific grants differ from grant to grant (there are 141 grants). It is possible to distinguish at least three types of grants:

- a. grants with a lump-sum character (fixed price; fixed size);
- b. grants based on standard-cost compensation (fixed price; flexible size);
- c. grants based on declaration (flexible price; flexible size).

II. THE GENERAL GRANT PAID TO MUNICIPALITIES

Dutch municipalities receive only one general grant which is paid from the Municipalities Fund.

The new Allocation of Finance Act 1996 constitutes the legal base for the general grant. With it, a new model for the general grant of the Municipalities Fund has been introduced. Less will be allocated on the basis of physical characteristics of municipalities and more on social characteristics and regional functions. As a consequence, more money will flow to poor municipalities with a weak social structure and municipalities that form the centre of a region. Under the former allocation of finance act, the main principle of distribution was scale measured by the number of dwellings with a graded system of tariffs. Under the new system, these two principles will play a less significant role; the graded system of tariffs has completely disappeared.

The total amount to be distributed by the general grant is calculated by a new system that ties the growth of the general grant to the growth of the net-corrected expenditure of the central government. In principle, the general grant develops concurrently with the development of the expenditure of central government.¹ The system has a political component; twice a year, consultations taken place between central government and the VNG (which represents the municipalities) about this growth of the general grant and connected policy issues.

Responsibility for the distribution of the general grant is shared by two ministries: the Treasury and the Ministry of the Interior. All municipalities benefit from the general grant.

III. APPRAISAL

The most important problem encountered by the former general grant system was that the purpose of achieving an equivalent minimum capacity in producing and distributing services was not realised. Insufficient money flowed to municipalities with a weak social structure or to municipalities which form the centre of a region. Apart from this, the old system was fairly rigid. It did not develop according to the changing environment.

In 1997, with the introduction of a new allocation of finance act, a new distributive system has become operative. The introduction of this new system was accompanied by a major redistribution. The “winners” of this operation will be municipalities with a weak social structure, and municipalities that form the centre of a region. Other municipalities who will benefit are those with a low capacity of generate taxes. The objective is to make the new distributive-system more flexible and better equipped for a changing environment. The administrators of the municipal fund are determined to “service” the general grant on a more frequent basis by making small adjustments each year mainly to prevent the necessity of major redistribution in five or ten years’ time

1 The definition of the net-corrected expenditure by the central government is stated below:

Gross expenditure by the central government
minus
 – capital expenditures which are directly financed on the capital market;
 – contributions to social security funds and health insurance;
equals net-expenditure by the central government
minus
 – non-tax income;
 – environmental charges;
 – incidental receipts (privatisation);
 – international aid;
 – interest payments on government debt;
 – municipal and provincial funds;
equals net-corrected expenditure by the central government.

The general grant (according to the new system) is calculated by the following criteria (only the most important stated):

No.	Factor	Weight in guilders	Percentage share
1	Capacity to tax real estate (rates) (per 3 000.00 guilders value)	- 9.38	-18.8
2	Number of inhabitants	254.61	22.5
3	Number of young peoples	252.49	1.2
4	Number of elderly people	25.24	0.3
5	Number of people who receive an income which statistically is classified as being low	432.36	5.4
6	Number of people who receive social security payments	4 871.04	16.1
7	Number of people who receive income support	150.19	1.3
8	Number of minorities	809.50	2.5
9	Local customer potential ¹	117.76	9.9
10	Regional customer potential	55.83	5.1
11	Area of land and inland waterways	183.89	3.7
12	Area of submerged land	50.44	0.1
13	Number of dwellings	349.47	14.0
14	Address density * number of dwellings/ 1 000	157.05	10.9
15	Surface of the built-up area	1.99	9.8
16	Historic town-centres; first group (small)	18 750.52	
17	Historic town-centres; second group (large)	37 501.04	
18	Length of waterways with historic interest	99.41	0.3
19	Inhabited villages before 1830	67.12	0.5
20	Fixed amount for each municipality	259 951.44	1.0
21	Fixed amount for Amsterdam	415 730 092.55	1.4
22	Fixed amount for Rotterdam	217 577 025.38	1.3
23	Fixed amount for the Hague	137 274 730.28	0.9
24	Fixed amount for Utrecht	77 733 583.99	0.5
25	Fixed amount for each municipality in the Wadden area	300 000.00	0.0
26	Municipality in the Frisian Islands; under 2 500 inhabitants	360.00	0.0
27	Municipality in the Frisian Islands; between 2 500 and 7 000 inhabitants	270.00	0.0
28	Municipality in the Frisian Islands; more than 7 500 inhabitants	90.00	0.0
29	Unusable land; less than 3 000 inhabitants	22.09	0.9
30	Unusable land; between 3 000 and 400 000 inhabitants	6.82	
31	Unusable land; more than 400 000 inhabitants	51.55	
32	Villages inhabited before 1830 and historic centres	175.54	1.0
33	Others		8.2

There is no margin of discretion in the application of the above-mentioned criteria.

¹ Based on Christallers's central place theory (Christaller W, 1966, *Central places in southern Germany*, Englewood Cliffs, N.J. Prentice Hall).

APPENDIX VIII

THE SYSTEM OF STATE TRANSFERS TO MUNICIPALITIES IN POLAND

I. GENERAL PRESENTATION

The system of transfers which the Polish state makes to municipalities is mainly designed to:

- provide a supplement to the local authorities' own resources;
- offset the effects of the uneven distribution of funds between municipalities and reduce the effects of the costs borne by the least well-off municipalities;
- ensure that the municipalities have sufficient financial resources to meet the costs incurred through exercising their statutory responsibilities.

This system comprises the redistribution of certain tax revenues, the award of general grants and state aid towards funding certain tasks through the award of earmarked grants.

II. REDISTRIBUTION OF TAX REVENUES

The following portions of the state's tax revenues go to the municipalities:

- A. 5 per cent of the proceeds from income tax levied on corporate bodies and organisations without legal personality whose headquarters are located in the municipality.¹
- B. A portion of the proceeds from income tax levied on natural persons who reside in the municipality. This portion rose from 15 per cent in 1996 to 16 per cent in 1997 and to 17 per cent in 1998. The law of 5 December 1996 lays down the method for calculating the portion of each municipality. For the period from 1996-99, a gradual transition system has been introduced to calculate the amounts derived from income tax levied on natural persons residing in the municipality.²

1 The municipalities hosting subsidiaries of the corporate body or organisation without legal personality in question share in the redistribution of these tax revenues in cases where the subsidiaries produce a balance sheet and accounts and make a profit. If certain subsidiaries make a loss, the municipalities where they are located do not share in redistribution and the portion recovered by the municipalities hosting the other subsidiaries is reduced accordingly.

2 Under the new method, this portion is calculated using the index representing the relation between the amount of income tax on natural persons paid by the inhabitants of the municipality in question and the amount paid by the inhabitants of the entire country in year No. 2 (in 1996 for 1998), which is then multiplied by the estimated total of tax paid by the inhabitants of the entire country in the year n and by the index of 0.17. The previous method used as its second index the relation between the number of inhabitants in the municipality and the total population of the voivodship.

During the transition period, which ends on 31 December 1999, discrepancies (either positive or negative) between the amounts calculated under the new method and those calculated by each municipality under the old method are partially adjusted downwards.

III. GENERAL GRANTS TO MUNICIPALITIES

In accordance with the Act of 10 December 1993 on local authority funding (following the latest amendment in force since 1 January 1996), a general grant derived from the state budget is awarded to municipalities.

The total amount of the general grant must be not less than 7.5 per cent of the state's estimated resources and the sums paid by the municipalities by way of horizontal equalisation. The Ministry of Finance is the body responsible for distributing the available sums, which are divided into three parts:

- grant for educational responsibilities;
- compensatory grant;
- residual part of the general grant.

1. Grant for educational responsibilities

This grant (which is designed to enable municipalities to manage primary schools) must represent at least 6.6 per cent of the state's estimated resources. It is divided up as follows:

- 0.5 per cent of the total grant is used to form a reserve at the disposal of the Minister for Finance, who determines how it is to be used after consulting the Minister for National Education and the municipalities' national representatives;
- the rest of the grant is distributed among the municipalities on the basis of a calculation formula established by means of an order issued by the Minister for National Education, in co-operation with the municipalities' national representatives.¹

1 This formula is as follows: $[A1 \times W1 + A2 \times W2 + A3 \times W3) \times a/p \times (U_i/26 + U_j \times P_j/26) + 0.75 \times A1 \times L_d] \times 12 + (U_i + U_j \times P_j) \times K_o$

A1, A2, A3: teachers' average pay indices;

W1, W2, W3: average indices for vocational qualifications;

a: twenty-seven – weekly number of lessons;

p: eighteen – teachers' weekly working time;

twenty-six: average number of pupils in a class

twelve: number of months in the calendar year;

U_i, U_j: index of the number of pupils in urban and village schools increased by a multiplier in the case of special classes;

P_j: weighted index of the average number of pupils in village schools determined according to the number of pupils in the classes;

L_d: number of methods advisers in the municipality;

K_o: calculated remainder of operating expenditure per pupil.

2. Compensatory grant

The amount of the compensatory grant due to each municipality is calculated on the basis of a formula which takes account, among other things, of the population of the municipality concerned and its revenue-raising capacity.¹ Municipalities whose revenue-raising capacity exceeds a certain amount are not eligible for the compensatory grant.

3. Residual part of the general grant

The procedure for dividing up this residual part is as follows:

- one per cent of the total amount is retained for the general grant reserve (for the 1996-99 period, the general grant reserve has been increased to 5 per cent, as four fifths of this reserve are to be used to mitigate the effects of reforming the system for redistributing personal income tax to the municipalities); the general grant reserve is administered by the Minister for Finance (with the agreement of the municipalities' national representatives) who may, in particular, use 10 per cent of this reserve to provide emergency assistance to the municipalities.
- the remainder of the sum is distributed among all the municipalities taking into account their population according to the weightings indicated below.

Actual population of municipalities	Criteria for weighting the population
Fewer than 5 000 inhabitants	5 000 inhabitants
From 5 000 to 10 000 inhabitants	Equal to the actual population
From 10 000 to 50 000 inhabitants	10 000 + 110% of the number over and above 10 000 inhabitants
From 50 000 to 300 000 inhabitants	54 000 + 120% of the number over and above 50 000 inhabitants
Over 300 000 inhabitants	354 000 + 125% of the number over and above 300 000 inhabitants

¹ This formula is as follows: $0.9 \times (0.85 P - G) \times L \times d/D$

P: the index calculated by dividing the amount of the basic tax revenues in the first half of the year preceding the budgetary year, by the population of the country;

G: the index of basic tax revenue per inhabitant calculated by dividing the amount of the basic tax revenues of the municipality concerned in the first half of the year preceding the budgetary year, by the population of that municipality;

L: the weighted population of the municipality concerned (see the weighting criteria shown in the table);

d: the estimated resources of the state budget in the first half of the year preceding the budgetary year;

D: the actual resources of the state budget in the first half of the year preceding the budgetary year.

Municipalities where the index G is equal to or greater than 0.85 of index P are not entitled to the compensatory grant.

4. General grant to Polish municipalities in 1995: summary table

	Grant for educational responsibilities	Compensatory grant	Residual part
Criteria for determining the total amount to be distributed	Not less than 6.6% of the state budget resources, [in 1996 between 121% and 133% of the total budgetary funds paid in 1995]	Not less than 0.9% of the state budget resources and the sums paid by the municipalities by way of horizontal equalisation	
Proportion of the total amount of the general grant in 1995	50.9%	42.5%	6.7%
Percentage of beneficiary municipalities	100.0%	58.9%	100.0%

IV. OTHER GENERAL GRANTS

The latest amendment to the Act on local authority funding introduced a new general grant: enabling municipalities to claw back funds corresponding to the tax revenue lost as a result of agricultural or forestry tax relief or exemptions granted in accordance with current legislation.

V. SPECIFIC GRANTS

The municipalities may receive specific grants from the state budget designed to:

- finance tasks delegated to the municipalities by the government authorities;
- co-finance the municipalities' own tasks.

The grants for delegated tasks are calculated on the basis of the prescribed criteria for determining the expenses relating to the performance of these tasks. Their total amount is specified in the state budget. In the event that a municipality should perform only part of the delegated task, the relevant portion of the specific grant received by this municipality must be repaid to the state.

The award of specific grants designed to co-finance municipalities' own tasks is governed by strict, special rules. Grants for municipal tasks may be awarded in order, for example, to co-finance the investments made by municipalities.

The amount of the grant is in proportion to the sum contributed by the municipality and may not exceed 50 per cent or 75 per cent, as the case may be, of the estimated value of the investment concerned.

APPENDIX IX

GRANTS SYSTEM FOR MUNICIPALITIES IN SPAIN

I. GENERAL PRESENTATION

Grants account for over one third of Spanish municipalities' revenues (37.60 per cent in 1995). About 71.5 per cent of these are general grants intended to fund current spending, the most significant being the municipalities' share of state revenues. The remainder take the form of specific grants for capital expenditure or operating expenses.

It should be pointed out that central-government transfers account for only 62 per cent of the total, and that grants from the autonomous communities and "horizontal" transfers between municipalities represent considerable amounts.

The grants system for municipalities primarily aims to:

- a. Guarantee that municipalities' financial resources will suffice to cover the public tasks they assume and the needs they are expected to satisfy. The principle of financial sufficiency is enshrined in the Constitution (Article 142), as is that of financial autonomy.
- b. Redistribute financial resources so as to guarantee that all municipalities receive an equivalent amount of revenue for each unit of expenditure needs. The transfers system attempts to offset imbalances between municipalities' specific spending needs and their tax capacity.
- c. Make up for the effects of "spillovers" in the provision of certain public services, correcting the resulting distortions of the relationship between the cost of a service to the tax-paying public in a given area and the benefit they derive from it (an example is services provided by the capital, from which the population of the metropolitan area also benefits).

II. THE MUNICIPALITIES' SHARE OF STATE REVENUES (PRE)

1. Legal basis and objective of the PRE

The PRE alone accounts for over 99 per cent of state general grants to the municipalities and for about 60 per cent of total grants.

This general operating grant is governed by the Local Finance Act (Law No. 31 of 1988), as amended by Law No. 42 of 1994, and by the General state Budgets Act. It is a response to the constitutional requirement that – along with their own taxes – municipalities be guaranteed sufficient financial resources. The financial mechanism used allows automatic calculation of the total amount to be distributed. The municipalities' share in certain state tax revenues is therefore no longer the subject of political negotiations, but increases at the same time as such revenues.

2. How the P.R.E. is calculated

The Local Finance Act lays down the rules to be applied in calculating the PRE for the 1994-98 period, based on the following formula:

$$\text{PIEN} = \text{PPI} \times \text{ITAE} \times \text{IE}$$

Where:

- PIEN = the municipalities' share of state taxes for year N;
- PPI = the municipalities' percentage share (i.e. 3.6573992 per cent);
- ITAE = state revenue in 1989, excluding tax revenues transferable to the Autonomous Communities and revenues originating from the European Community, but including social security and unemployment insurance contributions;
- IE = a growth index obtained by dividing state revenue for year N by 1994 revenue. However, this index cannot be higher than the change in nominal GDP or lower than the consumer price index.

3. Distribution of the PRE

The rules governing distribution of the PRE, as defined each year in the General State Budgets Act, are currently as follows:

- i. The municipal authorities of Madrid and Barcelona are first allocated a sum corresponding to the result obtained when the growth index is applied to their shares for the preceding year.
- ii. The remainder of the PRE is distributed among all the municipalities, except Madrid and Barcelona, in accordance with the following criteria:
 - 70 per cent according to the number of inhabitants, weighted as shown in the following table:

Number of inhabitants in the municipality	Weighting coefficient
Over 500 000	1.85
100 001 to 500 000	1.50
20 001 to 100 000	1.30
5 001 to 20 000	1.15
Under 5 000	1.00

- 25 per cent according to the number of inhabitants, weighted to take account of each municipality's average tax effort for the year preceding the year in question;

- 5 per cent according to the number of general basic education establishments (primary and lower secondary schools), nursery schools and special schools being run in public centres whose buildings are owned by the municipality or for which the municipality bears the upkeep and maintenance costs. Schools which are in operation at the end of the year in question are taken into account.

4. Liquidation of the previous year's share of state revenues

The budget appropriation corresponding to the share of state revenues for the current year is fixed on a provisional basis according to the previous year's figure and growth in nominal GDP.

The share of state revenues for a given year can finally be liquidated only after the year-end, i.e. by the State Budgets Act for the following year.

The corresponding budget appropriation is distributed as follows:

- i. Madrid and Barcelona are respectively allocated the sums obtained by applying the final growth index to their shares for 1994;
- ii. municipalities within the Madrid metropolitan area and those that have joined the Barcelona metropolitan corporation are allocated compensatory amounts in view of the loss of influence resulting from their inclusion in the respective metropolitan bodies;
- iii. the remainder is distributed among all the municipalities, excluding Madrid and Barcelona.

5. Proposed changes in the PRE

The Spanish Federation of Municipalities and Provinces (FEMP) has proposed new rules to be applied to the PRE over the next five-year period.

The Federation is seeking in particular to:

- correlate changes in the share of state revenues with changes in state tax revenues (excluding revenues transferable to the autonomous communities) and growth in GDP;
- fix a provisional amount of funding for each five-year period, which will moreover be guaranteed under the system;
- carry out a final liquidation based on real data only once the five-year period is over, so that the objectives set for the model's development can be attained and a maximum growth limit is also established.

Central government has put forward a different proposal, following the same lines as the rules presently applicable.¹

III. SPECIFIC GRANTS

Grants earmarked to cover operating expenses play a minor role in the system. In 1995 they merely accounted for about 7.5 per cent of total transfers. Capital expenditure grants represent a more significant amount – about 21 per cent of total transfers in 1995, or some 7.9 per cent of municipal revenues. It should be pointed out that the autonomous communities pay about 48 per cent of specific capital grants, i.e. four times the specific capital grants from central government.

The main specific capital grants to the municipalities may be grouped as follows:

- specific grants paid by the “Municipal Co-operation Fund” set up by the autonomous communities to co-finance capital projects being pursued by municipalities within their territory. These grants can be used to reduce imbalances between regions;
- specific grants paid by the state for various schemes (education, civil defence, roads and road signs, special action areas, planned public works and services, fire-fighting, employment management, etc.). The distribution criteria are specified in the ministerial decrees governing each of these schemes.

Mention can also be made of the subsidies provided by the European Community.

¹ In terms of the sums involved, the two proposals scarcely differ as regards the amount which would be distributed in 1999 (the first year of the new five-year period). However, in view of the trend of the share of state revenues over a period of time, the difference can be seen to be of importance, and the differences arising each year would represent a total amount of almost 170 000 million pesetas.

APPENDIX X

STATE GRANTS AND EQUALISATION SYSTEM FOR MUNICIPALITIES AND COUNTY COUNCILS IN SWEDEN

I. GENERAL PRESENTATION

A new system of state grants and equalisation for municipalities and county councils came into force on 1 January 1996.

The municipalities and the county councils are today responsible for activities that have a very important bearing on the creation of equivalent living conditions for the entire population. There are great differences in the economic circumstances of individual municipalities and county councils as regards for example tax bases and structural conditions. The governing principle of an equalisation system is for the equalisation to ensure that all municipalities and county councils will be able to operate on equivalent economic terms. The system must also be designed so as to be stable and tenable in the long term, as regards both equalisation effects and funding.

The main components of the new system are:

- income equalisation;
- equalisation of structurally related cost differences;
- general capitation grants;
- certain transitional rules.

II. EQUALISATION OF TAXATION INCOME

The new equalisation system implies a far-reaching equalisation of both municipal and county council taxation revenue. After equalisation, all municipalities and county councils are to have incomes corresponding to the national average.

Municipalities and county councils with a taxable income per capita falling short of the national average will receive equalisation grants. Municipalities and county councils with a per capita taxable income exceeding the national average are to pay an equalisation charge to the state.

The grant/charge equals the difference between the municipal/county council and national average tax bases multiplied by a taxation rate set by the Government and thus beyond the control of the individual municipality or county council. The average taxation rates are then reduced by 5 per cent so as to give a 95 per cent compensation rate on which calculation of the equalisation grant/charge is to be based. A high compensation rate means far-reaching income equalisation. After equalisation, practically all municipalities and county councils will have a tax base varying between 98 and 101 per cent of the national average.

III. EQUALISATION OF STRUCTURAL COSTS

The new equalisation system implies an equalisation of structurally related cost differences between municipalities and county councils respectively.

A per capita structural cost will be calculated for each municipality and county council. The structural cost is computed as the sum total of theoretically calculated costs of various activities and costing items, the intention being to capture structural conditions in the municipality or county council concerned.

A municipality or county council whose per capita structural cost exceeds the national average is entitled to an equalisation grant. A municipality or county council whose structural cost per capita falls short of the national average will pay an equalisation charge to the state. The equalisation charge/grant corresponds to the difference between the structural cost incurred by the municipality or county council and the average national structural cost multiplied by the number of residents in the municipality or county council.

In the process of cost equalisation, theoretical cost differences between municipalities and county councils respectively will be calculated for one activity at a time. With this method, allowance can be made to the often completely different factors governing expenditure on the various activities. Cost equalisation includes both mandatory and certain optional activities, together with certain operationally non-specific items of expenditure. It is further based on uncontrollable factors that are taken to express differences of needs and structure in each of the activities concerned. In some cases the factors are “of an assessment character”, but have been selected because they are very important for pinning down certain types of structural difference. Activities and factors that form the basis of cost equalisation between municipalities and county councils respectively are listed at the end of this appendix.

Cost equalisation is based on latest known average expenditure on the activities included in the cost equalisation, i.e. expenditure for the year or two years before the funding year. Expenditure is then projected for two years on the basis of the forecast movement of net prices. The calculation of average expenditure is updated annually in the light of the latest available costing data.

Municipal and county council factors underlying the computation of supplements and deductions from cost equalisation should also be as fresh as possible. A balance should be aimed for, however, between freshness and stability. For example, the age structure should be updated annually, but otherwise updating intervals have to be decided *ad hoc*.

IV. A GENERAL STATE GRANT

In addition to the equalisation grant and the equalisation charge, a general state grant, payable on a capitation basis, has been introduced for municipalities and county councils. Amounts will be fixed annually, with reference to the number of population at 1 November in the year before the funding year.

The introduction of a general state grant will give the state an opportunity of controlling the financial scope of the local government sector. The total volume of state grants to the municipalities will be decided annually by the *Riksdag* (parliament), with reference to an assessment of the economic scope available for local government activities. The general grant can also be used for regulating financial relations between the state and the municipalities/county councils, for example when changes are made to the allocation of responsibilities.

V. INTRODUCTION OF THE NEW SYSTEM

For many municipalities and county councils, the outcome of the new system of grants and equalisation will be great changes to funding allocations compared with the present situation. For this reason, the new system is being successively introduced over a period of eight years. It is proposed that the maximum permissible annual reduction in funding should be SEK 250 per resident for municipalities (SEK 500 for certain of them) and SEK 150 per resident for county councils. It is proposed that the maximum total funding reduction for the whole of the introductory period should be SEK 2 000 per resident for municipalities (SEK 4 000 for certain of them) and SEK 1 200 per resident for county councils.

A parliamentary commission has been appointed for the purpose of continuously observing, evaluating and developing the new system.

State grants and equalisation for municipalities and county councils (as from 1 January 1996)

Activity (or equivalent)	Factors
<i>Municipalities</i>	
Child care	Age structure, parental employment participation rate, tax potential and population density.
Care of the elderly	Age structure, balance of the sexes, occupational background, cohabitation aspects and rural areas.
Individual and family care	Single women with children aged up to 15, migrants across parochial boundaries, Finnish and non-Nordic nationals, density of settlement.
Compulsory schooling	Age structure, rural areas, home language (mother tongue) and Swedish as second language.
Upper secondary school	Age structure, boarding supplements and study programme preferences.
Water and sewerage	Sparseness of settlement, geological conditions.
Streets and roads	Traffic and climate-related wear and tear.
Enterprise and employment promotion	Unemployment.
Construction costs	Index based on true costs.
Heating costs	Index based on true costs.
Frigid zone allowance	Estimated additional expenditure.
Additional expenditure due to population loss	Population loss during the past ten years.
Additional expenditure due to low population loss	Population within a radius of thirty and ninety kilometres.
Administration, travel and rescue services	Population, number of residents per km ² , degree of urbanisation.
<i>County councils</i>	
Health and medical care	Age structure, average life expectancy, persons living alone, rural areas and supplements for county councils with fewer than 200 000 residents.
Higher education	Students enrolled.
Frigid zone allowance	Estimated additional expenditure.
<i>Activities with shared mandate</i>	
Public transport	Density of settlement, workplace localisation, sparseness of population and archipelago communities.

APPENDIX XI

THE SYSTEM OF STATE TRANSFERS FOR LOCAL AUTHORITIES IN THE UNITED KINGDOM (ENGLAND)

I. GENERAL PRESENTATION

The information given below relates to England, but much of it is broadly representative of the situation in the United Kingdom as a whole.

Financial transfers from the state to local authorities in England comprise:

- a. the national total of revenue from tax on business premises (“non-domestic rates”); and
- b. state grants to local authorities.

The national total of non-domestic rates is distributed in proportion to resident population. This basis of allocation thus makes little contribution to equalisation, other than ensuring that the “larger” local authorities receive more than the “smaller” local authorities.

The present general grant system was introduced in 1990, though most of the general principles dates from the 1970s, and to some extent from before then.

The national total amount of grants is a ministerial judgement, taken as part of the annual decisions on the national budget. It concerns the general grant to local authorities (Revenue Support Grant – RSG) and the main specific grants. These are known collectively as “Aggregate Exchequer Finance” (AEF).

In preparing the budget, ministers have to form a view of the level of council tax likely to be charged by local authorities. However, this is not regarded as a planned or target level of taxation. In reaching a view about the possible level of council tax, ministers need to take a view of the likely levels of expenditure by local authorities, given the changing demands on them and the (usually) small change in the size of the tax base. The formulae for assessing the need for spending in each local authority area are reconsidered every year, in consultation with local government.

In setting the total of grants, central government balances the cost of providing services against the amount of public expenditure the country can afford, and the general level of local taxation which it considers acceptable. In doing so, central government takes account of the pressures on local government spending and services, and the potential for increased efficiency.

The government’s proposals for local government finance are the subject of consultation with local government, for about six weeks. The government then puts its final proposals to Parliament for approval.

In practice, representatives of local government give their views on many aspects of local government financial arrangements during the course of each year, which ministers can take into account in putting forward their proposals.

In 1996, grants represented 51.3 per cent of local government revenue (general grants = 25.2 per cent and specific grants = 26.1 per cent).

II. THE REVENUE SUPPORT GRANT

The main general grant for local authorities in England is the Revenue Support Grant (RSG). For the financial year beginning 1 April 1997, it represents 99.3 per cent of the general grants. RSG supplements the tax revenues of the local authorities. It is an unconditional grant which may be used for any purpose that is within the powers of the local authority (including interest and repayments of borrowing for capital expenditure).

The legal basis of the main general grant, the Revenue Support Grant, is section 78 of the Local Government Finance Act of 1988, as amended by the Local Government Finance Act of 1992.

In distributing this grant among local authorities, central government's objective is to enable a similar standard of service (as reflected in the Standard Spending Assessment – SSA) to be provided for a similar tax rate (the Council Tax for Standard Spending – CTSS) in every area.

The body responsible for the distribution of the sums available is the Department of the Environment, Transport and the Regions.

The Revenue Support Grant given to a local authority depends on:

- central government's assessment of the authority's need for spending (its Standard Spending Assessment – SSA);
- the size of its tax base for "council tax";¹ and
- the share assigned to the authority of the national total of non-domestic rates.

If all local authorities budgeted in accordance with their SSA, all council taxpayers whose property had the same value would pay the same amount in council tax. In this sense, the RSG provides 100 per cent equalisation. Local authorities which choose to spend at a higher or lower than the SSA are likely to charge a local tax rate which is higher or lower than the CTSS.

¹ The estimated tax base used in the calculation is similar to the actual tax base available to the local authority, as the council tax base grows relatively slowly.

In practice, local authorities can (within limits) budget for levels of expenditure different from their SSA. These variations in their budgets have no effect on the amounts of grant they receive. There is thus no equalisation of the tax charged for similar variations from SSA.

The most significant component of the RSG calculation¹ is the SSA.

The national total of SSAs represents the amount which the government considers that all local authorities need to spend to provide the services for which they are responsible. But local authorities can, and do, spend at levels different from their SSAs. Typically, the relevant total of local authority spending has been about 5 per cent greater than the total of SSAs.

The total of SSAs is subdivided between the main services provided by local authorities. These are education, personal social services, police, fire, and highway maintenance. There is a further block, "All other services", which includes many smaller local government services. There is also a block relating to the interest and repayment of loans for capital spending.

The Standard Spending Assessment for each authority is based on a formula which applies to all authorities that provide the same kinds of services. The SSAs are intended to take into account the differences between areas in what they would need to spend, if they all provided similar standards of services with similar efficiency. They thus take account of differences in the characteristics of areas and their people.

The relative weights given to indicators are generally determined by statistical analysis. In most cases, the statistical analysis is regression analysis of past expenditure by local authorities which is "explained" by indicators of the need for spending. The complete formula is published in *The Local Government Finance Report (England) 1997/98*.

The indicators considered for use in SSAs should, ideally, meet requirements of objectivity: they should not be capable of being influenced significantly by a local authority's own decisions. A number of other desirable criteria have been identified.

1 The basic formula for the RSG is:

$$\text{RSG} = \text{SSA} - \text{NNDR} - r \cdot \text{TB}$$

where

RSG is Revenue Support Grant

SSA is Standard Spending Assessment

NNDR is the authority's share of the national total of non-domestic rates

r is a national standard tax rate, specified by central government

TB is the council tax base of the authority.

In practice, there is more than one level of local government in each area. "NNDR" and "r" are subdivided between the levels of local government serving each area. The method of subdivision ensures similar treatment of authorities with the same responsibilities serving different areas.

The formulae are considered afresh every year in discussion with local government. The formulae are also determined afresh each year by Parliament. Once determined, there is no discretion in the application of the formulae. But there is a power to give general grants known as “special grants”,¹ in addition to the main general grant, though this is used sparingly.

III. SPECIFIC GRANTS

Besides the general grants, central government pays specific grants to local authorities for financing either current or capital expenditure.

The criteria for allocation of specific grants are very varied. Most are conditional on a specified type of expenditure being undertaken, often subject to prior agreement with central government. Increasingly, the allocation of specific grants follows competitive proposals from local authorities for the available national total of grants. The rates of grant vary widely, but grants seldom meet the whole of the relevant costs.

¹ The legal basis of the other general grants is section 88B of the Local Government Finance Act 1988, as substituted by the Local Government Finance Act 1992.

APPENDIX XII

A “NEUTRAL” SYSTEM OF GRANTS TO LOCAL GOVERNMENT

This appendix describes the notion of a “neutral” grant, that is a grant which can be increased or cut to adjust the vertical balance without disturbing the horizontal balance measured as relative tax rates of the local authorities. (The model is based on *Kommunal Udligning og tilskud til kommuner* Bilag 1 to *bet. nr. 963*. September 1983. Copenhagen).

Symbols

Symbols for authority i

S_i service level index, with national average = 1.00

t_i hypothetical tax rate before grants

t_i^* actual tax rate, “after grants”

The following symbols are measured per inhabitant in authority i.

Y_i tax base

P_i expenditure need

D_i total local government net expenditure

T_i grant, positive or negative.

A symbol with a line on top is average for the country.

Definitions

$t_i = D_i/Y_i$

$S_i = D_i/P_i$

The design of equalisation

Next the concept of ideal equalisation has to be defined. In the Scandinavian context the condition for full neutrality is that the ratio is the same for all authorities between the local tax rate and the local service level (t_i/S_i). (In countries which rely on property taxation, licenses etc., the measure could be the ratio between the tax revenue per inhabitant and the service level [$(t_i \times Y_i)/S_i$]. Whether this is the case is not clear from the available literature.

By assuming that t_i/S_i should be the same for all authorities, the equation for the correct equalising payment T_i for authority i is:

$$T_i = t_i^* (Y_k - Y_i) + S_i (P_i - P_k) \quad (1)$$

where the tax base and expenditure need for each authority are measured against some benchmark defined by k . T_i can be positive or negative, depending, among other things, on how k is defined.

The choice of k , Robin Hood or grants' model

Y_k and P_k can be set at any level. If the national averages are being used we get the ideal Robin Hood model, all positive and negative payments will add up to zero. If Y_k is defined to be equal to the highest in any authority, and P_k is the lowest observed expenditure need, all authorities will have positive grants coming, to be paid by the central government. This is the grant model.

The use of tax effort in the equalisation

For t^* and S the observed values for the particular authority may be used when calculating the (T_i)s, but in most countries the national averages are preferred. For t^* the national average tax rate is used.

Equation (1) can only express the correct, neutral payments if actually the "tax effort" and service level enter the calculation of the equalisation payment for each authority.

The use of national averages is, however, preferred in most countries because it is politically difficult to explain the reliance on "tax effort" in equalisation, and because the measure of service level depends on the measure of needs, which is debatable. A political argument against the inclusion of tax effort has been that it gives an incentive to increase taxes. (But this is of course true only for that half of the authorities who gain from equalisation, the other half who loose from equalisation have an incentive to lower taxes).

Two kinds of grants

"Control grants"

A vertical imbalance means that T_i is positive and:

$$S_i P_i - T_i = t_i^* Y_i \quad (2)$$

With full equalisation $t_i^* = S_i t^*$ and (2) may be written as:

$$T_i = S_i(P_i - \bar{P}) + t_i^*(\bar{Y} - Y_i) + S_i(\bar{P} - t^*\bar{Y}) \quad (3)$$

Comparing (2) with (1) it can be seen that the grant serves equalisation purposes with the first two elements on the right side, but the third element is a "neutral" grant with no equalisation effects. It serves only as an instrument of central government control and is called a "control grant".

Equalisation grants

If there is not any vertical imbalance, then

$$\begin{aligned} (\bar{t} \bar{Y} = \bar{P}), \text{ and} \\ (\bar{t}_i = \bar{t} \bar{S}_i), \text{ and} \\ (\bar{t} \bar{Y} - \bar{P} = 0), \end{aligned}$$

and (3) may be written as:

$$\bar{T}_i = \bar{S}_i (\bar{P}_i - \bar{t} \bar{Y}_i) \quad (4)$$

In this case the last element of (3) becomes zero. This means that the grant \bar{T}_i only serves equalising purposes, hence it is called an “equalisation grant”, as used in the Robin Hood model.

The design of neutral grants – two versions:

With a vertical fiscal imbalance a positive grant is needed. There are several ways to design such a “control grant” in a way so that it does not interfere with the equalisation. Full equalisation must assume a grant with following properties

$$\bar{T}_i / \bar{Y}_i - \bar{T} / \bar{Y} = \bar{P}_i / \bar{Y}_i - \bar{P} / \bar{Y}$$

1. Neutral grants according to tax base

One method is to rewrite this into

$$\bar{T}_i = (\bar{P}_i - \bar{t} \bar{Y}_i) + \bar{Y}_i \bar{T} / \bar{Y} \quad (5)$$

Compared to (4) it can be seen that apart from the equalising part, the grant for vertical balance is distributed according to the tax base. The horizontal equalisation is in this case done before the grants.

2. Neutral grants according to expenditure needs

The other method is to rewrite (5) as

$$\bar{T}_i = ((1 - \bar{T} / \bar{P})(\bar{P}_i - \bar{t} \bar{Y}_i)) + \bar{T} / \bar{P} \bar{P}_i \quad (6)$$

where the grant is distributed according to the needs of each individual authority. Horizontal equalisation in this case is done after grants.

The two models are identical in their effects, assuming that 100 per cent of the differences are equalised.

A very relevant difference is that when equalisation is made for less than 100 per cent of the differences between authorities model (5) automatically adjusts for changes in the grants, so that the degree of equalisation remains constant; this can be shown not to be the case for model (6). As partial equalisation must be assumed to be the most common case, this is an important conclusion.

The Danish choice of method:

The model of equation (5) was followed in Denmark. The reasons for the choice of this model were two:

- i. One was that grants related to expenditure needs (6) means that the degree of equalisation is not automatically maintained when the grants are changed, changes have to be legislated currently, and the government did not want this legislation brought up in parliament more often than necessary.
- ii. The other was that the legal formulation of model (6) turned out to be very complicated. Fears were that too many would claim that they could not understand the law, but the most frequent criticism of equalisation is always that the system is too complicated. It may be noted that the Danish model survived for ten years.

GLOSSARY

Financial assets

Actifs financiers

The gold, currency and other claims on other parties owned by an economic agent.

Grants or subsidies

Apports (ou Aides) financiers

Financial contributions to local budget (except shared taxes and borrowing).

Tax base

Assiette fiscale (ou base de l'impôt)

Base used for calculating the amount of the tax to be paid.

Financial autonomy

Autonomie financière

The idea of financial autonomy refers both to the availability of adequate financial resources and to the room for manoeuvre granted by states to local authorities when fixing their own tax rates and the use of their receipts.

Expenditure needs

Besoins de dépenses

Expenses borne by the local government to cover its operating and capital needs as well as to guarantee the supply of public services at an appropriate level.

Fiscal capacity or fiscal potential

Capacité fiscale ou potentiel fiscal

Global fiscal receipt that a local government is able to receive if it levies all its taxes at the highest rate fixed by law. Fiscal potential depends on tax base and on maximum rates applicable.

Fiscal rivalry

Concurrence fiscale

Adoption by local governments of attractive fiscal measures (e.g. low tax rates) to encourage the highest possible number of taxpayers to live in their area.

Fiscal decentralisation

Decentralisation fiscale

Attribution to local governments of own and/or shared fiscal receipts.

Objective criteria

Critères objectifs

Criteria for calculating grants that leave no room for manoeuvre to the authority in charge of the allocation of funds.

Discretionary criteria*Critères discrétionnaires*

Subjective elements of evaluation that allow, to a certain extent, the authority in charge of the allocation of funds to determine the amount of grants which are to be paid to each local government.

General grants*Dotations*

Grants to local governments without any special destination.

General grants for operating expenditure*Dotations de fonctionnement*

Grants to local governments allocated to fund operating expenditure.

General grants for capital expenditure*Dotations d'investissement*

Grants to local governments allocated to fund capital expenditure.

Mixed general grants*Dotations mixtes*

Grants to local governments allocated to fund either operating or capital expenditure.

Tax effort*Effort fiscal*

Local governments' level of use of their fiscal potential.

Exclusive local taxes*Impôts locaux exclusifs*

Taxes paid by the taxpayers to the local government to which they are attached. Local governments are empowered to fix the tax rate (and even other tax elements) within statutory limits.

Shared taxes*Impôts partagés*

Taxes which are redistributed between local governments of the same and/or of a different tier.

Earmarked local taxes*Impôts locaux affectés*

Taxes, the receipts of which are used for specific purposes.

Financial equalisation*Péréquation financière*

System which allows partial compensation for the imbalances existing between local government of the same tier. The imbalances in question come from the differences in fiscal potential and expenditure needs.

Charge***Prix d'utilisation***

Price paid by the user according to the units of service provided.

Products***Produits***

Total of receipts of all the services and the economic activity of a local government (public sales of storage, lands and so on).

Fee***Redevance***

Fixed periodic amount paid by customers in exchange for a service, fixed in that it takes no account of the units of service actually provided.

Tax revenues***Recettes fiscales***

Revenues of exclusive or shared taxes.

Own resources***Ressources propres***

Resources, the level of which is controlled by local government within statutory limits; their special feature is that they are attached to a given local government.

Transferred resources or financial transfers***Ressources transférées ou transferts financiers***

Resources paid to the budget of a local government by another budget, except borrowing.

Earmarked resources***Ressources affectées***

Resources which local governments only use to fund specific expenses.

Non-earmarked resources***Ressources non affectées***

Resources that local governments can freely use according to their competencies.

Subventions***Earmarked grants***

Grants allocated exclusively to run an identified task or to finance specific expenditure.

Specific grants for operating expenditure***Subventions de fonctionnement***

Grants allocated to a specific operating expenditure.

Specific grants for capital expenditure***Subventions d'investissement***

Grants allocated to a specific capital expenditure.

Tax rate

Taux de l'imposition

Percentage of tax base used to calculate the amount of the tax taxpayers will pay (tax base * tax rate = amount of the tax before rebates).

Total municipal receipts

Total des recettes des communes

Total amount of municipal financial resources whatever their type or origin, including loans.

Transfers

Transferts

General and specific grants, and shared taxes.

Horizontal transfers

Transferts horizontaux

Transfers between local governments of the same tier.

Vertical transfers

Transferts verticaux

Transfers between local governments of different tiers.

Exceptional transfers

Transferts exceptionnels (extraordinaires)

Amounts allocated in exceptional circumstances, for instance to municipalities which have suffered a natural disaster.