RECOVERY OF LOCAL AND REGIONAL AUTHORITIES IN FINANCIAL DIFFICULTIES

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1. INTRODUCTION

Local authorities in financial difficulties represent a problem for the central government: Should it provide economic assistance? In some cases, central assistance may be necessary, well founded and legitimate. Natural disasters or sudden closing-downs of large industries may place individual local authorities in dire economic circumstances largely beyond their own control. However, in other cases the necessity and legitimacy of central assistance is less obvious. For instance, economic difficulties due to local mismanagement should not automatically be alleviated by the central government. While the precise definition of what constitutes a legitimate case of central assistance to a local authority in financial difficulties probably varies across space and time, the problem of distinguishing legitimate cases from illegitimate ones is quite general. How can legitimate cases of central assistance to the recovery of local authorities in financial difficulties be distinguished from illegitimate cases? How can the central government help local authorities avoid financial difficulties? What can be done once local authorities find themselves in financial difficulties? These are the topics of this report.

The report argues that the recovery of local authorities in financial difficulties constitutes a strategic dilemma for local authorities as well as for the central government. At the *local* level, authorities face a collective action problem: It is individually rational for any given local authority to seek as much central assistance as possible while the collective interest of local authorities is to avoid too much central assistance because it may undermine local autonomy. At the *central* level, the problem is to distinguish legitimate from illegitimate cases and to make a credible policy of only assisting the former cases. The problem is that assisting illegitimate cases may be rational from a shortsighted perspective, but irrational from a longer-term perspective. Unless properly dealt with, these strategic problems may lead to irresponsible local economic behaviour and unnecessary central assistance. These strategic problems and their potential alleviation are discussed in greater detail in section 2.

Section 3 provides a number of illustrative case studies of central assistance to local authorities. The purpose is to illuminate why local authorities experience financial difficulties and how the problem is handled in practice. Section 4 makes a more systematic inspection of the member states of the Council of Europe in order to evaluate the extent to which they are equipped to handle the strategic problems. Section 3 and 4 are based on a questionnaire that has been sent out to all member states of the Council of Europe. Section 5 derives policy implications from the analysis.

2. THE STRATEGIC PROBLEMS OF PROVIDING CENTRAL ASSISTANCE TO LOCAL AUTHORITIES IN FINANCIAL DIFFICULTIES

This section argues that the provision of central assistance to local authorities in financial difficulties represents a strategic dilemma for local authorities as well as for the central government. The dilemma is first analysed from the perspective of local authorities, then from the perspective of the central government.

2.1 Central assistance seen from the perspective of local authorities

Efficient resource allocations by local authorities require that all benefits and costs of public actions are internalised by the public officials making the policy choices. The failure to account for all social benefits of a public action will typically mean that too little of the activity is provided. Conversely, the failure to account for all social costs will mean that too much of the chosen service or regulation is provided because the price of public action is artificially lowered in the eyes of the decision-makers. Unless the purpose is to stimulate public action, the opportunity to externalise costs should generally be avoided.[1]

From the point of view of individual local authorities, central financial assistance is almost always welcome. Externalising costs means that local citizens are given better services without higher taxes. For local politicians this is often an attractive option. Shifting the costs of local action onto the national tax base or onto the tax base of other local authorities is often an attractive option for individual local authorities.

But the costs have to be paid. Ironically, if all local authorities respond to the incentive of obtaining central assistance, they may well end up paying the costs themselves. Financing central assistance on a large scale without affecting local income sources is often difficult. This is most clearly seen in the case of central assistance financed by cuts in other central grants. For instance, the Danish central government's grant to local authorities with especially low tax bases is financed by reductions in the general block grant to local authorities.

But local income sources may be affected in less obvious ways. Even if central assistance is financed by national taxes, local income sources may be affected. If the central government and local authorities use the same tax base, increased central assistance may erode the tax base of local authorities and lead to increased vertical tax coordination problems. Even if the central government and local authorities have separate tax bases, increased central assistance may negatively affect the local tax base. This may be the case if central assistance leads to a generally higher tax level that reduces economic activity.

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[1] See: Wallace E. Oates. 1972. *Fiscal Federalism* (New York: Harcourt Brace Jovanovich, inc.); Richard A. Musgrave. 1959. *The Theory of Public Finance* (New York: McGraw-Hill Book Co.).

Furthermore, central assistance is seldom given without conditions. Protecting local autonomy constitutes an argument for independent revenue sources.

The problem is that, from the perspective of individual local authorities, the benefits of avoiding central assistance are *public* goods while the benefits of obtaining central assistance are *private* goods.[1] In other words, there is a conflict between the individual and collective interests of local authorities. To see this more clearly, consider the following figure 1.1.

Figure 1.1: The game for central assistance

		Local authority B:	
		Do not obtain central assistance	Obtain central assistance
Local authority A:	Do not obtain central assistance	Cell 1: Local authority A: 2 Local authority B: 2	Cell 2: Local authority A: 0 Local authority B: 3
	Obtain central assistance	Cell 3: Local authority A: 3 Local authority B: 0	Cell 4: Local authority A: 1 Local authority B: 1

Using the example of a country with two local authorities A and B, the figure shows the situation of the two local authorities considering whether to seek central assistance or not. They may each choose between the strategies of obtaining or not obtaining central assistance. This leads to four possible combinations of strategies. How do these outcomes look from the perspective of the two local authorities?

Let us consider that the degree of satisfaction of a local authority is:

- zero, if it does not obtain assistance and the other authority does; in actual fact, in this case finance from national taxes will affect the fiscal capacity of the authority which has not received assistance; in addition, the services/taxes ratio will degenerate in comparison to the similar ratio of the authority which has received financial assistance;

- 1, if both authorities receive financial assistance; in this case, both the fiscal freedom and autonomy of both authorities is reduced, whereas the services/taxes ratio of the two authorities remains comparable;

- 2, if no authority receives assistance; in actual fact, a reduced level of national taxation will allow greater room for manoeuvre for local taxation; in addition, the increased level of own resources and the fewer conditions imposed by central government will ensure that local authorities enjoy a greater degree of financial autonomy;

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[1] See: Robert P. Inman. 2000. “Local Fiscal Discipline in U.S. Federalism”, Wharton Research Paper (Philadelphia, PA: Wharton School).

- 3, if it obtains assistance and the other one does not; in this case, whereas the impact of a higher level of national taxation for financing assistance is distributed to both authorities, only authority A benefits financially; in spite of possible conditions attached to the assistance, the degree of satisfaction is higher.

If both local authorities co-operate and consider the degree of satisfaction of the system created by the two authorities together, they should try to be in cell 1, where the degree of accumulated satisfaction is at its greatest.

On the other hand, if the local authorities consider the dilemma from an individual point of view, and they therefore refuse to co-operate, they will probably find themselves in cell 4, where the degree of satisfaction both of each authority and of the system is inferior.

Take municipality A for example. Its authorities have no real choice:

- If authority B obtains financial assistance from central government, then authority A should seek to obtain as much, in order to reach level 1 satisfaction rather than 0;

- If authority B does not obtain assistance, then authority A should also seek to obtain assistance, in order to reach level 3 satisfaction rather than 2.

It follows therefore that in analysing the dilemma from an individual point of view, authority A should obtain financial assistance regardless of authority's B situation. With the same considerations for authority B, both authorities would probably obtain assistance and find themselves in a less beneficial situation than if they had co-operated and refused government assistance.

If both local authorities act rationally but with an individual view, they will end up in cell 4. In other words, they find themselves in a social trap. What is rational from an individual perspective leads to a collectively irrational outcome. Unless somehow checked, this logic leads to all local authorities fighting for central assistance even though they all realize that from a collective point of view they may all be worse off.

The empirical relevance of this line of reasoning can be illustrated by the events in Sweden following the economic crisis in the early 1990s. Swedish local authorities are generally financially healthy. But the economic crisis meant that several local authorities experienced economic difficulties. The first request for central government aid came in 1992 from a municipality with severe economic problems due to the near-bankruptcy of its housing company. After protracted negotiations the central government decided to allocate the local authority an extraordinary grant as part of an economic recovery plan. By 1998, 87 of a total of 288 local authorities had applied at least once for central help out of financial difficulties.[1]

[1] See: Jürgen von Hagen with M. Bordignon, M. Dahlberg, B. Grewal, P. Petterson & H. Seitz. 2000. "Subnational Government Bailouts in OECD Countries. Four Case Studies", Inter-American Development Bank, Research network Working Paper # R-399 (available at: www.iadb.org).

The Norwegian situation prior to the grant reform in 1986 constitutes another example. Before the reform the Norwegian central grant system was a rather fragmented and uncoordinated system of specific grants controlled by the individual ministries. The central government had discretionary powers especially in the area of tax equalizing grants. In this setting, local authorities had an incentive to present their economic situation as dire as possible as a way of qualifying for grants in the eyes of the central government. There is evidence to suggest that crisis-maximizing behaviour such as increasing local debt could be used as a successful strategy to obtain central grants.[1] The reform turned most of the central grants into general block grants and largely removed this incentive to local crisis-maximizing behaviour.

A related example can be found within German fiscal federalism. In 1988 the state governments of Saarland and Bremen turned to the German Constitutional Court for support of their demands for financial assistance from the federal government to help them cope with their high public debts. Both state governments claimed that their debts had been caused by negative economic developments that were outside of their own control. In the case of Saarland, this was the secular decline of coal mining and the steel industry, the two main industries of the state's economy. In the case of Bremen, it was the decline of the shipbuilding industry, the backbone of its economy. The two governments argued that the fiscal burdens associated with their high public debts made it impossible for them to fulfil their constitutional duties, and that, if left alone with their financial obligations, they would have to cut expenditures drastically, resulting in severe deteriorations of the supply of public services. This, they argued, would violate the constitutional mandate to provide equal living conditions across the states.

The Court ruled in 1992 and upheld the claims of both states. The Court argued that the German federal constitution aims at establishing homogeneity of fiscal conditions and equalization of living standards throughout Germany. In the Court's view, these objectives could only be achieved by mutual support between the federal government and the states and among the states. The Court thus stressed the constitutional principle of solidarity and concluded that a state experiencing extreme budgetary hardship is entitled to financial support from other members of the federation.

One interpretation of the Saarland and Bremen examples is that there is a certain tension between the German states' autonomy in spending and borrowing decisions and their limited freedom in determining their current revenue. Consequently, given the constitutional mandate to provide a uniform standard of government services in all states, the German federal government may end up having to pay for unsuccessful economic policies at the state level.[2]

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[1] See: Trond Fevolden & Rune Sørensen. 1983. "Spillet om skatteutjamningen", *Tidsskrift for samfunnsforskning* 24: 59-76; Rune J. Sørensen. 1987. "Spillet mellom stat og kommune", *Norsk statsvitenskapelig tidsskrift* 1/1987: 65-81.

[2] See: Jürgen von Hagen with M. Bordignon, M. Dahlberg, B. Grewal, P. Petterson & H. Seitz. 2000. "Subnational Government Bailouts in OECD Countries. Four Case Studies", Inter-American Development Bank, Research network Working Paper # R-399 (available at: www.iadb.org).

As these examples suggest, the logic sketched in figure 1 can be influenced by institutional mechanisms. In both the Norwegian and the German examples the institutional setting provides subnational authorities with an incentive to engage in crisis-maximizing behaviour in order to attract central financial assistance. In both examples the logic in figure 1 is underpinned by a local financial system with limited independent revenue sources and central government access to means of financial assistance. In all examples information asymmetries make it difficult for the central government to distinguish legitimate from illegitimate requests for financial assistance.

The local government finance system may thus exacerbate or alleviate the logic in figure 1 and thereby impede or facilitate the central government's decision whether to allocate assistance to local authorities in financial difficulties.

If local revenue sources are fixed or determined by the central government or if central grants are important elements in local finance, local authorities may argue that local deficits are a central government responsibility. In some cases this will be a valid argument, e.g. because new central demands cannot be met within existing budgets. In other cases the argument will be flawed because the local deficit could have been avoided by responsible local policy choices. Because of information asymmetries, it will be difficult for the central government to distinguish valid from flawed arguments.

There is thus a case for establishing a local government finance system with a large element of independent revenue sources that the central government may point to as alternatives to increased central assistance. Further, there is a case for establishing rules for local government borrowing which makes it difficult to use loans as a strategy for pressuring the central government for financial assistance.

In other words, unless local authorities are forced to finance local expenditures from local revenue sources, they may pass on costs to other local authorities, higher levels of government or future generations. Such a situation provides incentives to overspend, undertax and overborrow in the hope that local expenditures will ultimately be subsidized by taxpayers in other jurisdictions. Such behaviour not only encourages the creation of local financial difficulties, it also makes the provision of central assistance difficult because legitimate requests for assistance are hard to distinguish from illegitimate ones.

The analysis so far supports the European charter of local self-government (article 9), which states, among others, that:

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

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

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

The implications for the central government are analysed in more detail in the following subsection.

2.2 Central assistance seen from the perspective of the central government

Assisting local authorities in financial difficulties is often considered a legitimate act from the central government. What exactly constitutes legitimate reasons for financial assistance is, of course, a political question to be decided by each individual nation. But the problem of distinguishing legitimate from illegitimate cases is common to all nations. Illegitimate requests for central assistance are likely to occur in most systems, because the very availability of central funds provides an incentive for all local authorities to seek assistance irrespective of their real economic situation.

The central government's problem is twofold. The first is to solve the information asymmetry problem. How can the central government know when a request for assistance comes from a local authority with no real need for assistance? The problem is that often the local authority is the only one to have full knowledge of its real economic situation and that it has no incentives to reveal the true state of affairs if this disqualifies it from receiving assistance.

The second problem is that even if no information asymmetries were involved, a declared policy of only assisting legitimate cases may not be credible. Economic and political considerations may make it attractive for the central government to assist local authorities even though no real need exists. If a policy of only assisting legitimate cases is not credible, local authorities have an incentive to pressure the central government for assistance in the hope that the central government ultimately gives in even though no real need exists. In other words, the second problem is how to make credible a policy of only assisting legitimate cases and thus deter illegitimate requests for assistance.

The information asymmetry problem constitutes an argument for the establishment of some kind of central monitoring system of local government economic performance. This can be done in various ways. If guaranteeing the impartiality of the system is important, monitoring should be entrusted to an independent agency positioned outside the reach of political intervention. Independent bodies do not completely eliminate problems, but they may offer better solutions to both the information asymmetry and credibility issues. Monitoring should then be done according to general and official indicators of economic performance. Monitoring done by the central government itself is less robust to charges of partiality, but administrative considerations may make this option preferable.

The credibility problem is more difficult to handle. To see the nature of this problem consider the following three examples. First, should governments negotiate with terrorists over the release of hostages? Many governments around the world have a stated policy of not negotiating with terrorists. This is intended to deter terrorists: If there is nothing to be gained from kidnapping, rational terrorists will not take hostages. However, terrorists are often rational enough to know that once hostages are taken, the announced policy may have little force, and that the temptation to make some concession to obtain the hostages' release may become overwhelming. The only way to deter truly rational terrorists is somehow to take away the discretion of policy makers and commit them to a rule of never negotiating. If policy makers were truly unable to make concessions, the incentive for terrorists to take hostages would be substantially reduced.

The second example concerns monetary policy. How can a low inflation policy be made credible? Economic actors know that the central government may face irresistible temptations to print money in order to finance the government budget or allow inflation to increase in order to fight unemployment. If the government cannot convince economic actors that it does not intend to use these opportunities, these actors will raise their inflation expectations accordingly. The result will be that inflation is higher than desired. This credibility problem may be solved by delegating monetary policy to an independent central bank committed to the goal of low inflation.[1]

A third and particularly illustrative example of the credibility problem is provided by the British government's access to capital markets before and after the Glorious Revolution in 1688. Before the revolution the Crown found it difficult to persuade economic actors to lend it money. The reason was that none could prevent the King from reneging on his loan obligations, and he had a record for doing so. Consequently, economic actors were hesitant to lend money to the Crown and, when they did so, they demanded higher interest rates. After the revolution, the Crown found it difficult to unilaterally break its contractual obligations because now Parliament had to be involved in these decisions. Consequently, the policy of not reneging on loans gained credibility. Just a few years after the revolution, the government was able to obtain loans on a much greater scale and at much lower interest rates than before.[2]

The somewhat surprising implication of these examples is that policy makers can sometimes better achieve their own goals by having their discretion taken away from them. In the case of hostages, there will be fewer hostages taken and killed, if governments have no discretion to negotiate with terrorists. In the case of monetary policy, inflation will be lower if the government delegates monetary authority to an independent central bank. In the case of access to capital markets, the government can obtain more and cheaper loans if its sovereignty is constrained.

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[1] See: V. Grilli, D. Masciandaro & G. Tabellini. 1991. "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries", *Economic Policy* 13: 343-392.

[2] See: Douglass C. North & Barry R. Weingast. 1989. "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England", *Journal of Economic History* 49: 803-833.

What does this imply for the recovery of local authorities in financial difficulties? The first and most basic implication is that a policy of only assisting legitimate cases is not necessarily credible. If the government has full discretion to assist any case of local financial difficulty, a policy of distinguishing between legitimate and illegitimate cases is not necessarily credible. The reason is that all actors know that temptations to accommodate illegitimate requests for assistance may become overwhelming.

The reason is that denying assistance – even in illegitimate cases - entails costs for the central government. *Economic* costs may occur if a refusal to assist local financial difficulties is interpreted by the credit markets as a signal that the central government is likely to disavow its own financial obligations. This interpretation may be justified, e.g., if there are constitutional or statutory rules linking local borrowing to a central government responsibility to pay or when there are significant and well-understood political linkages between local and central governments. In this case the rational reaction by credit markets is to demand higher interest rates when lending money to the central government. Economic costs may also arise if local debt assumes a large position in the portfolios of important national investors, and if local defaults lead these investors to fail causing in turn a national economic crisis.

Political costs may occur if local taxpayers are important constituencies for the national government. If national taxpayers are less valuable political constituents than local taxpayers, a policy of only assisting legitimate cases may have severe credibility problems. This may especially be the case when the local authority with financial difficulties is large and has important symbolic value (e.g. the national capital). There is evidence to suggest that party political objectives sometimes enter into the central government's grant distribution formula.[1]

If the costs of saying no to assisting local authorities in financial difficulties are high, how credible is it that the central government will live up to such a policy – even if the request for assistance is illegitimate?

The second implication of the above analysis is that this depends on the discretionary powers of the central government. If these are considerable, severe credibility problems may arise. The credibility problem constitutes an argument for constraining the discretionary powers of the central government when dealing with local authorities in financial difficulties:

- There need to be a clear and widely accepted definition of what constitutes a financial difficulty for a local authority.
- The definition of legitimate reasons for central assistance in cases of financial difficulties among local authorities should be explicitly decided, preferably by law.

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[1] See: Hugh Ward & Peter John. 1999. "Targeting Benefits for Electoral Gain: Constituency Marginality and the Distribution of Grants to English Local Authorities", *Political Studies* 47: 32-52; Matz Dahlberg & Eva Johansson. 1999. "On the Vote Purchasing Behavior of Incumbent Governments", Working Paper 1999:24, Uppsala, Sweden: Department of Economics, Uppsala University (available at: http://www.nek.uu.se/publications/publ.html).

- Other means should be required to be put in place before central financial assistance is granted.

- The programmes involving granting financial assistance on a large scale to local authorities in financial difficulty should involve the parliament.

- Central assistance should be matched by significant and comparable local own financial effort

- In general the central government should not guarantee for local loans. Exception could be made for loans for development spending and on the assumption that adequate guarantee against local revenue is secured.

- The results of illegitimate financial difficulties among local authorities should be made clear, for instance in a municipal bankruptcy code.

It may prove useful to make a distinction between difficult situations which could have been predicted (structural income deficit, circumstantial economic crisis affecting the authority…) and situations made difficult by exceptional circumstances (natural disasters, exceptional risks…). The nature of the action carried out by central government could therefore depend on the reason for the difficulty, resulting in a better targeted intervention and the avoidance of any undesirable incentive.

3. CASE STUDIES OF CENTRAL ASSISTANCE TO LOCAL AUTHORITIES IN FINANCIAL DIFFICULTIES

This section provides a number of case studies of financial difficulties in local authorities in the member countries of the Council of Europe where central assistance has been granted or at least considered. The purpose is to illuminate the following questions:

- Why do local authorities experience economic difficulties?
- How does the central government handle the information asymmetry problem?
- What is the range of options open to the central government if it decides to intervene in the local situation?
- What is the level of government discretion vis-à-vis the parliament?

By use of case studies this section provides a qualitative illumination of these questions. The individual case studies do not answer all these questions, but when pieced together they may illustrate all the questions.

The strength of the case study approach is that it gives detailed insight into the nature of the problem and provides the reader with a substantial understanding of the problem under investigation. The main weakness is that the representativeness of the cases may be questioned. In order to mitigate this problem the following section provides a more systematic quantitative analysis.

The case studies are abbreviated versions of studies made by the individual member countries. They have been asked to provide cases, which illustrate typical ways of dealing with local authorities in financial difficulties in their countries.

3.1 Illustrative cases of central assistance to local authorities in financial difficulties

Central assistance to polish local authorities hit by a natural disaster

In 19997-98 heavy floods caused severe damage to local authority property in Poland. Damage was estimated at some 2,600 million zloty (PLZ). Wroclaw and Opole were the hardest hit towns. The central government stepped in with grants to relieve the costs of reconstruction work. All in all grants were allocated to 823 local authorities, including 653 urban and rural communes, 21 towns with district (*powiat*) status and 149 districts (*powiats*). The initiative came from the government. It submitted a series of bills to parliament covering types and extent of aid and standard criteria for providing it.

Local authorities qualified for aid when the cost of the damage to their property exceeded 5% of their own resources. They submitted applications and grants were awarded when the provincial governor (*Voïvode*) had verified the background information. To qualify, local authorities were not initially required to contribute to the cost of the repair work. From mid-1998, however, they were required to indicate, in their applications, exactly how the funds would be spent. They were also required to cover 20% of the costs from their own resources.

In examining grant applications, the central government applied the following criteria:

- The work's social importance, and its effect in helping the local authority and local residents to return to a normal state of affairs.
- The effective use of resources, i.e. the extent to which grants were allocated to new, not ongoing, tasks.
- Adjustments to compensate for the differing capacities of local authorities to cover the cost of the damage sustained.
- The individual approach of the projects proposed.

The principles adopted made no provision for direct negotiations with local authorities on the allocation of grants. In addition to grants, local authorities were given supplementary loans (interest: 2% per annum) for the construction of municipal housing for people who had lost their homes in the floods. The central government also built 1,600 houses for flood victims which were given free of charge to local authorities.

<u>Central assistance to a Swedish local authority with economic difficulties in the municipal housing company</u>

The Swedish municipality of Steningsund applied in 1995 for SEK 250 million in financial support from the central government. The municipality argued that the financial problems were due to a large depreciation of the real estate owned by the municipal housing company, which forced the municipality to take over responsibility for debts of SEK 250 million. Initially, the central government replied that the financial problems had to be dealt with by the municipality itself. After repeated applications, a meeting was held between the municipality and the Interior Ministry.

The Interior Ministry analysed the financial situation of the municipality based on data provided both from the municipality and from other available sources. The financial situation had developed in a positive direction on the years 1993-95. The local income tax rate was raised by 0.23 percentage points in 1995, but the outcome of the budget was negative due to take-over of the housing company's debt. The financial situation worsened in 1996, mainly due to increased interest payments.

The Interior Ministry was abolished in 1998. Issues concerning municipal finance ore now dealt with by the Ministry of Finance.

In the Ministry's opinion, the municipality would have to make substantial expenditure cuts to achieve a balanced budget. Financial support was therefore considered appropriate in order to avoid severe reductions of the service level. The central government decided to allocate the municipality a grant within a limit of SEK 40 million during the years 1997-2000. The grant was given on the condition that Stenungsund made a plan on how to reach a balanced budget.

The plan included the following parts:

- An analysis of the financial management within the municipality
- An analysis of costs and efficiency of the services provided by the municipality
- An analysis of the possibilities of increasing fees as a means to increase revenue
- Measures to achieve a balanced budget in the long run

The plan should be presented to the Ministry before the first payment of the grant. Once a year the municipality should report to the Ministry on the measures implemented according to the plan to improve the financial situation. In case of non-fulfilment of the plan, the grant should be repaid.

Central assistance to a Bulgarian local authority in industrial decline

According to all indicators, the municipality of Pernik in Bulgaria was in industrial decline in the late 1990s. Industries relied on outmoded technology, unemployment was steadily increasing and financial prospects were generally bleak. The municipality's own income plus its grants from central government could not even cover its spending needs on priority items such as wages, insurance and social assistance.

After a series of consultations with the municipality, the central government decided to provide assistance in the form of grants earmarked for specific purposes. The legal background was provisioned in the State Budget Act, the Municipal Budgets Act and the Annual State Budget Act, which authorize the central government to intervene in local budgetary affairs.

The municipality's debt equalled 6% of the budget. The central government restricted its assistance to 70% of this debt because it found evidence of a certain lack of financial discipline. Capital investment expenditure had been allowed to exceed set limits and, on inspection, the municipality's budget figures were not up to date. The local authority received a loan of BGL 250 000, an earmarked grant of BGL 1 134 000 for the payment of wages, insurance contributions, and grants and to cover the cost of medicines, electricity and food for hospitals, schools etc.

The central government's decision was based on information from the monthly and quarterly budgetary reports, which all local authorities in Bulgaria are required to send to the Ministry of Finance. In addition, the central government had independent information from its own checking procedures and from reports by the Court of Auditors and the national financial control service. The government's decision did not involve the parliament.

The central government's financial assistance was conditioned on a stabilisation programme made by the municipality and approved by the Finance Ministry. Included in this programme were short-term measures aimed at closing or restructuring certain activities; cutting staff numbers; converting some branches of its activity into commercial companies under the relevant trading legislation; updating the inventory of rented municipal property and reviewing the rents; freezing capital investment in certain non-priority building work for the municipality and restricting repair work to a basic minimum; assessing fuel needs and allocating fuel quotas for public buildings.

In the medium term it was planned to accelerate existing privatisation programmes, liquidate or restructure certain non-profitable municipal companies (in some cases changing their ownership structure), and to step up the supervision and auditing of the functioning and operational transparency of local businesses.

Central assistance to a local authority in Norway with economic problems due to guarantees for loans taken by private companies

The small municipality of Lebesby in Finnmark County in Norway had provided guarantee for the financial liabilities of private enterprises in the late 1980's. According to the Local Governmental Act this was allowed (until 1993 when the act was revised). One of the municipality's guarantees concerned an enterprise involved in fish farming. Shortly after its establishment, the fish farm went bankrupt. The municipality then had to take over a debt of NOK 50 mill. To make matters worse, some other guarantees provided by the municipality also resulted in increased debt for the municipality.

The municipality applied for central governmental assistance. The municipal council made it clear that they found it impossible to cover extra short-term debt of NOK 60 mill. (or more than 100 pct. of annual revenues) and at the same time fulfil their legal obligations on public services.

The central government decided to allocate an extraordinary discretionary grant to the municipality of NOK 10 mill. in 1992 and NOK 5-8 mill. the following years. In reaching this decision, the government had to rely on information provided by the local authority itself (although some additional information was given by the regional governor). This was not seen as any particular problem because the reason for the financial difficulty was considered obvious.

The extraordinary grant could be fitted into the discretionary grant scheme as adopted by the parliament. When the government later informed the parliament on what measures that had been chosen, this information was considered sufficient.

In addition to the grant, the following measures were implemented in relation to the municipality:

- The municipality was allowed to restructure its short-term debt into long-term debt.
- The municipality was required to present a revolving financial plan on how to correct the situation. The plan had to be approved by the regional governor after consultations with the Ministry.

- The municipality was required to cut its expenditure level by NOK 3-5 mill. as a contribution to the solution of the problem.
- The regional governor's staff was increased in order to extend supervision of the municipality.

Central assistance to a Belgian local authority in deficit

Today Belgium is a federal state composed of communities and regions. There are three regions: the Walloon, Flemish and Brussels-Capital regions. Administrative control (tutelage) and general financing of the authorities are the responsibility of the Regions. The balanced budget principle within authorities is a legal requirement. In the three regions, certain authorities experience recurring difficulties in balancing their tax receipts and expenditure.

The Brussels-Capital region has created a fund (the Brussels Regional Fund for the Re-financing of Local Authority Treasuries), financed by an annual amount from the regional budget, which in particular helps the Brussels authorities concerned. The granting of assistance is decided by the regional government and takes the form of loans.

For example, the municipality of Etterbeek has obtained two loans in this way. In return, the municipality has concluded an agreement with the Region. This negotiated agreement between the municipality and regional authorities includes a financial plan aimed at reaching financial stability for the authority. For the duration of the agreement, an inspector appointed by the regional authority has access to all the authority's files and documents and can thus check whether all clauses are being respected. A committee composed of representatives from the local and regional authorities also periodically evaluates the implementation of the financial plan. If the control system is certainly not without constraints, it is largely accepted insofar as there is regular consultation between the parties concerned.

Considerations of central assistance to a local authority in Germany

On several occasions, a local authority in the rural district of Passau in Bavaria in Germany had requested assistance to address its poor economic situation. Requests had been submitted to the state committee responsible for distributing grants according to the Bavarian Financial Equalization Act. According to this act, state assistance can be granted to local authorities to alleviate unpredictable economic difficulties. The state committee includes representatives of the Ministries of Finance and the Interior, and the Local Authorities' National Associations.

The committee had not been able to grant economic assistance since the local authority's financial difficulties were not caused by an unpredictable reduction in revenue beyond its own control. In the eyes of the committee, the local council had to bear the responsibility for the financial situation. In 1998 the supervising authorities refused to approve the local authority's loan-taking. It was then no longer possible to ensure the local authority's ability to meet its financial obligations. The local authority was now at risk of becoming insolvent, partly because of its financial obligations towards a private company.

The local authority then appealed to the Minister-President and the Ministry of the Interior of Bavaria. The state government found that a long-term recovery plan was needed for local authority. Lower government levels should make this plan, but the state government made a number of guidelines. All revenue sources should be comprehensively exhausted, in particular:

- The levy rates for impersonal tax should not fall below Land averages.
- Facilities operating on a cost-covering basis should not make losses.
- All concession fees should be levied.
- Administrative costs, user fees and charges, rent, leases and similar private law fees and public law charges should be levied to the degree appropriate to the situation.

All expenditure should be carefully assessed, in particular:

- No voluntary outlays should be granted.
- Obligatory outlays should be reduced to the level of what is indispensable.
- Construction and technical maintenance should be restricted to meeting minimum needs.
- Personnel deployment should be evaluated in accordance with standard parameters for what is absolutely necessary; additional posts should generally be ruled out.
- Current investments should be completed as per contract; all new investments should be postponed.

The state ministries have indicated that, once this plan is ready, they are willing to examine the possibility of extraordinary financial assistance in the form of a repayable bridging loan.

Considerations of central assistance to a local authority in the former Yugoslav Republic of Macedonia

The municipality of Tetovo in the former Yugoslav Republic of Macedonia[1] was divided into seven municipalities as part of the territorial reform in the mid-1990s. Law regulated this reform, but no provisions were made for the division of liabilities between old and new municipalities. The seven new municipalities inherited a considerable debt from the old municipality of Tetovo incurred in connection with a local road-building project.

One of the seven new municipalities could not meet the financial obligations of its share of the debt. The creditor threatened to take matters to court. However, having met with all parties involved in the case, the Ministry of Local Self-Government is willing to intervene in the case and has made a proposal to the government that a grant be allocated to the municipality to alleviate its financial burden. A favourable government decision is expected.

[1] The financial situation of local authorities in the former Yugoslav Republic of Macedonia is very weak (local authorities only account for some 1% of public expenditure), according to Recommendation 82 (2000) of the Congress of Local and Regional Authorities in Europe.

Central Assistance to a Danish local authority with a fiscal imbalance

A local authority in Denmark had for a number of years experienced a considerable growth in its expenditures on cash benefits and day care facilities for children. Furthermore, the number of inhabitants in the working age had decreased, i.e. the tax base of the municipality was shrinking. To solve this financial difficulty, the municipality applied to the Ministry of the Interior in 1999 to be granted an exemption from the regulations of municipal bank overdrafts.

Furthermore, the municipality calculated that if it had to solve the financial difficulties without any help from the central government, it would have to cut down expenditures by DKK 16 million, corresponding to 4 per cent of the municipality's current and capital expenditures in 1999.

The Ministry of the Interior held two meetings with executives from the municipality. At these meetings the municipality put forward a proposal for a solution to the financial difficulties, which was discussed with the Ministry of the Interior. Following these meetings the municipality was granted an exemption from the regulations on banks overdrafts from 1999 to 2002 on the following conditions:

- Expenditure is cut down by DKK 5.9 million in 1999. The cutbacks are increased by DKK 1 million in each of the years 2000-2005.
- The municipality observes a quarterly plan for the improvement of its liquid assets. If this plan is not observed, the municipality takes appropriate action.
- The municipality informs the Ministry of the Interior about the development of its liquid assets on a quarterly basis.
- Current expenditure and the number of employees are not increased.
- The municipal tax rate is not increased.

In order to alleviate the financial situation of the municipality the Ministry of the Interior granted a permission to raise a loan of DKK 11 million for current expenditure in order to observe the regulations on bank overdrafts. The municipality was also granted permission to raise a loan of DKK 5 million for capital expenditures. Furthermore, the municipality received a grant of DKK 1 million in 1999 and DKK 4 million in 2000 from the Ministry of the Interior's fund for municipalities in financial difficulties.

Solving liquidity problems in a local authority on Malta without central aid

In 1997, as part of their annual report to the parliament's Auditor General, the local government auditors on Malta reported that the current liabilities exceeded the current assets in one local authority. This deficiency was significant because it represented 77% of the local authority's grant (total allocation) for the subsequent financial period. The situation was such that the local authority would not be in a position to meet its obligations if all the creditors demanded payment within the following financial year.

In the opinion of the local authority, the economic difficulty was partly caused by projects for which the central government was responsible (e.g., re-construction of roads, construction of several lifts to improve public access within the civic centre) and an unexpected decision by the new central administration to reduce the annual grant allocation.

When the central government's Local Councils Department became aware of the situation, consultations were held to establish the real causes of the crisis and to determine the best course of action to remedy matters. A series of meetings were held and an action plan was devised for implementation and close monitoring. At the meetings, the local authority was requested to provide comprehensive documentary material. In addition, the central government also appointed a private management consultant to investigate the financial situation within the local authority. The central government reached the following conclusion:

- The local authority deserved to be chastised for acting in breach of its financial provisions.
- Financial mismanagement (excessive indebtedness) was rather the result of over-zealousness than irresponsibility.
- An element of *bona fide* could not be ruled out.

In the wake of the meetings with the central government, the local authority presented and won approval for a cash-flow projection that premised the gradual settlement of all dues to creditors within a time-scale of 3 years without seriously hampering the local authority from discharging its basic communal functions. This move effectively redressed the imbalance.

The solution to the local authority's problems was thus found in a revision of local priorities. No special assistance was granted from the central government. But an increase in the annual grants to all local authorities awarded during the subsequent financial periods also helped the defaulting local authority in improving its financial performance.

Central assistance to a UK local authority with expensive local amenities

In 1998-99, the London borough of Haringey developed serious short-term financial difficulties. This was brought about by a variety of circumstances one of which arose from the treatment of a large financial deficit on a particular property, Alexandra Park and Palace, a local amenity held in trust for public use. Over a number of years, the borough had run up a deficit of around £55 million on the Park and Palace due to the inability of the charitable trust responsible for the property, which was also employee of the Council, to pay for its upkeep.

The central government's Department of the Environment, Transport and the Regions (DETR) had for some time been in contact with the borough over this deficit, because it was large in relation to the borough's overall budget and did not appear to conform with capital finance controls. DETR was also in discussion with the Treasury Solicitor's Department, the Charity Commissioners, the Treasury, and the Department for Culture, Media and Sport (who listed the Palace as a building of national historic importance) about this problem.

The borough had originally reached agreement with its then Auditor that the £55 million would be repaid gradually over 20 years. This was a pragmatic move, recognising that the borough did not have £55 million to repay the amount in one hit. However, in 1998, the borough's new Auditor insisted on the repayment period being reduced to 10 years to protect local taxpayers. This would force the borough to find a total of £7.7 million a year from already very stretched finances. This, combined with other burdens, contributed to create a short-term financial crisis in the local authority.

In view of this, and convinced that the borough's circumstances could not reasonably have been foreseen, DETR Ministers concluded that Haringey should receive some form of assistance to protect the delivery of local statutory services.

A supplementary credit approval (SCA) of £2 million was agreed, together with a capitalisation direction from the Secretary of State, which allowed the borough to use the extra resources wherever they would be most effective. These measures meant the borough could spread some of its costs in 1999/2000 over more than one year and so bring its budget back to a manageable level.

Central assistance to the national capital in Norway

By the end of 1983 the city of Oslo, Norway's capital, had an accumulated deficit of NOK 770 mill. (equivalent to 10% of annual revenues). The deficit was not caused by any particular or extraordinary situation, but was a consequence of expenditures exceeding annual revenues for a number of years. Because of the deficit, the city ran short of liquid resources and could be forced to stop obligatory payments.

Oslo applied for assistance from the central government. The government analysed the situation and presented a white paper to inform the parliament of the city's financial situation. The analysis showed that the difficult financial situation of Oslo was a result of a set of causes such as the fact that the grant scheme did not identify certain spending needs. At the same time, it was obvious that there had been imperfections in the financial management of the city. The government proposed (and the parliament agreed) to increase governmental transfers to Oslo by NOK 100 mill., but on the condition that:

- Oslo presented a plan on how to correct the situation.
- Oslo reduced its own expenditures in order to be able to adopt a balanced budget.
- The central government's supervision of the city of Oslo was extended. The Ministry of Local Government should lay down annual loan brackets both for capital expenditures and liquidity purposes.

After a temporary recovery in the financial situation in 1985-87, the situation deteriorated again at the end of the decade. By 1989 the deficit had increased to approx. NOK 3 bill. (equivalent to 12,5% of annual revenues). In addition, the city had experienced a loss of NOK 2 bill. due to changes in the exchange rate on its debt in foreign currency. Together with the other larger cities, Oslo again applied for governmental assistance in 1989.

The central government once again presented a white paper to the Parliament and proposed that action was taken to help the larger cities resolving their financial difficulties. In particular, the government proposed a revision of the calculation matrix of the general grant scheme. Parliament agreed. The revised calculation matrix increased governmental transfers by NOK 200 mill.

Again conditions were attached. The previous conditions were applied again, but in addition some extra measures were introduced:

- The maximum period of covering deficits was increased from four to eight years.
- The Governor of Oslo’s supervisory staff was increased in order to extend central governmental supervision of the city.

When dealing with the city’s financial problems, the central government used different types of information. First, Statistics Norway published economic statistics that enabled the government to compare the situation in Oslo with other large cities. Second, the government had to rely on information from the city of Oslo where adequate information was not available by statistics. Third, the Ministry of Local Government also decided to let independent consultants investigate the financial situation and the financial management of Oslo.

By the end of 1995 the city’s deficit had been fully covered.

<u>Central assistance to a Hungarian local authority in an area in economic crisis</u>

The city of Hatvan in northeastern Hungary (30.000 inhabitants) had a chronic deficit in the late 1990s. This was caused, inter alia, by an unfavourable change in the industrial structure. In 1999 the city applied for central government assistance of HUF 101 million.

The central government basically had to rely on information sent in by the city. The city’s application was screened by the central government’s regional office. Here, the city’s information on tax revenue from the local industry was considered undervalued. Consequently, the regional office reduced the necessary assistance to a maximum of HUF 76 million.

At the central level, the Ministries of Finance and the Interior treated the city’s application. They found that the city’s budget revealed that too much was spent on social and non-obligatory purposes. Consequently, they also reduced they necessary amount of assistance.

In the end, the city received a grant of HUF 57 million. The central government found that, despite the undervalued tax revenue and unnecessary expenditures, the city itself had taken significant steps to correct the situation. The decision to allocate a grant to the city was taken by the central government after presentation to the parliament, procedure that is laid down in the annual law on the state budget.

Solving economic problems in Swiss local authorities

In the canton of Fribourg in Switzerland, local authorities may not run deficits larger than 5%. When local deficits exceed this limit, the cantonal authorities intervene. In assessing these situations, the cantonal authorities rely on the municipalities' figures, but also carry out their own checks. Initially, the supervisory authority will try to solve the local financial difficulties through voluntary measures. If this fails, the cantonal government has the prerogative of increasing the local tax rate in order to balance the municipal budget.

There have only been a few examples of operational budgets repeatedly exceeding the permitted limit. In these cases, the supervisory authority's attempts to rectify the situation through voluntary measures (such as reducing expenditure and increasing revenue) have sometimes been unsuccessful. In these cases, the municipal representative bodies refused to increase taxes voluntarily. Consequently, the situation had to be rectified through coercive measures.

Refusing to grant central assistance to a UK local authority

In the early 1990s the local authority of Welwyn Hatfield District Council in the UK granted planning permission to a private company, Slough Estates, to build a shopping centre. At the time, the local authority made a commitment not to allow any similar development in the area. However, it subsequently granted planning permission for another shopping centre. Slough Estates claimed that, as a result, they incurred considerable loss and challenged Welwyn Hatfield in court.

The court found that the local authority had deliberately misled the company, and awarded Slough Estates some £49 million damages. With interest and legal costs the bill amounted to £54 million. This was equivalent to five times the net general fund budget of the local authority.

Advised not to appeal against the judgement, Welwyn Hatfield entered into negotiations with the company. The local authority made a down payment of £10 million to Slough Estates from their own resources. They then applied to central government for Supplementary Credit Approvals (SCAs) to allow them to access up to £15 million of capital receipts previously set aside. Under the capital finance rules the local authority could not release this money without credit approvals.

The policy of the Department of the Environment, Transport and the Regions (DETR) is that SCAs, outside identified departmental programmes, can be given only in exceptional circumstances. Local authorities are funded by central government to carry out their functions and it is expected that they will use their available funds prudently to achieve this.

Ministers of the DETR met with the local Member of Parliament and members of Welwyn Hatfield Council to hear their case. There were also meetings of officials of the Department and the Council to discuss the implications of the case for the delivery of local services.

The ministers concluded that there was scope for Welwyn Hatfield Council to find additional money without central government financial assistance and refused the local authority's request for SCAs. It was noted that the Council had £400 million of capital assets. It was suggested to them that they might, for instance, sell their housing stock. The expertise of the Department's officials was offered to assist the local authority in exploring these avenues.

In reaching their decision, Ministers took into account that the local authority's predicament was the result of a dubious planning decision and that to offer assistance could send the wrong messages to local government.

As negotiations became protracted, Slough Estates threatened further court action. Faced with this ultimatum, Welwyn Hatfield reached a compromise with Slough Estates agreeing to pay them a further £19.7 million. The settlement avoided the need for local tax rises, or the sale of assets, while at the same time protected services. The money was identified by outside consultants from within the local authority's finances, consisting of capital receipts, business rate reserve funds, special funds, and the general fund balance. Effectively, the payment meant the local authority reorganising certain of their priorities and reducing their reserves.

The government's approach – taking a firm stance in the first instance, combined with the offer of non-financial support and expertise – thus resulted in a negotiated settlement between the parties, which allowed Welwyn Hatfield to repay nearer £30 million than the £49 million total damages.

<u>Central assistance to a German town</u>

In the late 1980s, the small county town of Burscheid (population 19,000) in North Rhine-Westphalia asked the Land's Ministry of the Interior for budgetary relief. In connection with a major development project, the town had incurred losses, which it was not able to cover on its own.

The Ministry of the Interior made available some DM 23 million which were to be paid out in five instalments (decree dated 15 November 1989); this support was dependent on the following conditions:

- the town had to adopt a budgetary consolidation plan outlining the measures it intended to take in order to achieve a balanced budget within the next four years;
- throughout that period, the town was not allowed to make any expenditures beyond its legal obligations;
- the town was not allowed to incur new debts;
- the town council had to expressly admit that the budgetary crisis of the town had arisen from its own faults and;
- fifty per cent of the funds had to be paid back once the budget was balanced.

The town accepted these conditions. As it turned out, only just under DM 16 million were paid out to the town of Burscheid in three instalments until 1994. By that time, the town had managed to balance its budget. The town is still paying back the funds in instalments of DM 500,000.

The funds for such budgetary relief come from the financial equalisation scheme for local authorities. This means that the support was granted at the expense of the other towns and local authorities because the funds provided to Burscheid were no longer available for re-distribution in the framework of the financial equalisation system.

While this measure was successful, it did not serve as an example for similar cases nor will it do so in the future because

- The financial situation of many local authorities has deteriorated since the early 1990s to an extent that cases which are comparable to the situation in Burscheid at the time, do no longer constitute unique exceptions;
- There are not sufficient funds to effectively intervene in particular to deal with the budgetary crises of major cities;
- Budgetary relief that is granted to help local authorities to overcome a budgetary crisis which is always at least partly due to the individual financial decisions of the local authority concerned, is generally perceived to be a reward for lacking budgetary discipline and therefore not acceptable to the other towns and local authorities.

<u>Exceptional operational grants to French local authorities</u>

Each year the French government may make exceptional grants to local authorities which, as a result of extraordinary circumstances, are experiencing particularly severe financial difficulties.

Under the provisions of the Local and Regional Authorities General Code (CGCT) and the General Tax Code (CGI) - which were the outcome of **legislative activity** - exceptional operational grants may be made to local authorities "in which extraordinary circumstances give rise to particular difficulties" or which “experience severe financial difficulties owing to a fall over one or more years in their business tax base or their resources from mining charges”.

These operational grants are not allocated for any specific purpose.

The conditions governing the award of such grants are very strict.

No local authority may receive such a grant unless its budget has been declared not to balance.

Secondly, under no circumstances may a grant be used to finance a capital fund deficit, which must be balanced by means of a reduction in capital development programmes, by capital fund income or, where possible, by increased self-financing.

Finally, exceptional grants may only be made following preliminary investigation by the regional audit office (CRC) of the situation in the local authority concerned and where the CRC's recommended recovery measures do not successfully absorb the operational deficit.

These central government grants must not be viewed as a standard source of financing and are designed not to offset an imbalance in its entirety but to facilitate implementation of a recovery plan.

This is therefore an exceptional form of assistance that relies to a considerable extent on implementation by the local authority of recovery measures, which it is designed to support.

In 2000, for example, only five local authorities received such grants, totalling 380,520 euros.

The decision to provide assistance is made by order of the Ministry of Economy and Finance and the Ministry of the Interior pursuant to the legislation described above.

Measures may be taken when the country is faced with a natural disaster with repercussions for local authority finances.

Specific examples of arrangements made in France for exceptional grants following natural disasters: the November 1999 floods and the storms of December 1999

Repairing the damage

Head 67-54 of the Ministry of the Interior budget is generally earmarked for the provision of assistance to local authorities where uninsurable capital has been damaged by natural phenomena such as storms, flooding and landslides. Street networks are the main beneficiaries of such grants, which as a rule are allocated at a contributory rate of 20%.

Head 67-54 is also remarkable in that it is usually allocated not as part of the initial budget act but only at year's end under budgetary amendments, following the inspection of documentation put together by local authorities and forwarded by the prefecture of each *département*.

In 2000, however, a substantial amount of credit was allocated to this head in the course of the year (259 million euros' worth of programs being authorized) as a consequence of support measures agreed in favor of local authorities following the December 1999 storms - "Lothar" and "Martin" - and the flooding which affected four south-western *départements* in November of the same year.

Local authorities in forest areas

As well as causing widespread material damage, the December 1999 storms resulted in budgetary difficulties for local authorities that had traditionally derived substantial income from forestry, since many forest areas were destroyed.

A variety of measures were therefore introduced to provide assistance for these authorities.

Most importantly, under the budget amendments act of 13 July 2000 a figure of 30.5 million euros was earmarked for assistance in 2000 and 2001 to local authorities experiencing budgetary difficulties as a result of reduced income from forestry.

The following authorities were eligible:

- Those in which income from forestry amounted on average to at least 10% of total operational income during the period from 1996 to 1998;

And

- Those that were unable to balance their budgets in 2000, as a result of reduced income from forestry. Imbalance might mean one of two situations: either the original 2000 budget actually had been declared not to balance (this was in practice rare), or the original budget for 2000 had balanced only because the anticipated income from forestry was optimistic as compared with the real level of such income in 2000.

The prefect calculates Grant levels locally, with help from a *département* commission. Assistance may not exceed the budget imbalance resulting from the fall in income from forestry, which is measured against the average for the 1996-1998 period.

Financial support which the Luxembourg government allocates from the national budget to local authorities affected by industrial decline (the steel crisis of the 1980s) or by natural disaster (such as storms and flooding)

In theory there is no legal obligation on the government to intervene when a local authority finds itself in deficit. A number of rules and checks already exist to prevent local authorities from themselves running up a budget deficit.

For example, local authorities in the Grand Duchy are duty bound to present a balanced budget to the supervising authority. If that authority, the Ministry of the Interior, finds that the budget is not in accordance with laws and regulations, especially if it does not match income forecasts made in the national budget (business tax plus the local authority share in the proceeds from state taxes), it may adjust the budget or, as happens in practice, return it to the local authority for the local council to make the changes necessary to balance the budget. The local authority enjoys complete freedom in choosing how to do this, and it consequently bears responsibility for its acts: the local council may opt either to increase operational income by raising the cost of both compulsory and optional services or to reduce overall operational expenditure. In such situations the council usually also cuts its investment programme by cancelling or postponing projects, starting with those which are not statutory or compulsory. As a general rule, therefore, local authority budgets are always balanced. However, despite observance of this rule of good conduct, there are occasions when the budgetary account goes into the red because of unpredictable events such as a sharp drop in tax revenue or a natural disaster.

When this happens the local authority is entitled to draw on resources it has previously "set aside" for its own use in an "economic equalisation fund" which is jointly paid into by local and national government, contribution levels being set by the State as part of its annual budget. If these reserves have been exhausted, if the drop in tax revenue turns out to be structural, or even if a one-off deficit threatens to disrupt the operation of local services, the Ministry of the Interior intervenes, with government consent, by making a compensatory allocation in return for local authority implementation of a suitably vigorous recovery programme. Such a situation arose in the early 1980s, when the State took action to help a number of local authorities beset by the crisis in the steel industry, which at the time was the principal tax-earner for local government in the south of the country.

Similar grants have been awarded more recently to local authorities affected by storms or flooding. In the interests of national solidarity, and with government agreement, the Ministry of the Interior has made compensatory payments to subsidise local authorities repairing damage to council-owned property. In such cases, Interior Ministry intervention is financially neutral, assessed on the basis of the damage sustained and irrespective of the financial situation in the local authority concerned. In practice, grants of this sort are allocated as follows:

Following a natural disaster and once government agreement has been obtained, the Ministry of the Interior asks local authorities to make a full declaration of damage sustained with an estimate of the cost of repair. Where property is uninsured, the Ministry of the Interior reimburses 80% of costs on production of a statement of bills settled within a fixed period, which may not be exceeded.

The Ministry of the Family, Social Solidarity and Youth pays compensation for damage sustained in natural disasters by private property-owners.

Example of an additional municipalities fund grant in a Dutch municipality

Reiderland is a municipality with a population of approximately 7,000 in the province of Groningen. The municipality came into being in 1990 through a merger of three municipalities. Its isolated location next to the German border was one cause that the municipality had an extremely high unemployment rate: in the mid 1990s, unemployment in Reiderland was at 25% while the average national figure was 7.5%. There are several municipalities in the immediate vicinity of Reiderland that have to contend with a weak social structure. This is due to the area of East Groningen in which Reiderland is situated, having to cope with a decline in industrial work opportunities.

Central government became involved in Reiderland's issues because the municipality did not have balanced budgets and submitted a request to central government from 1991 for an additional grant. A municipality can request an additional grant if it does not succeed structurally in budgeting for its essential expenditure. Its own income, such as municipal property tax, sewerage and cleaning charges, must then be included up to a reasonable level. This involves municipal property taxes being 40% higher than the national average and sewerage and cleaning charges being 100% cost-effective. A condition of the additional grant being awarded is that the shortfalls in principle owe their cause to factors over which the municipality is unable to exercise any, or almost no, influence of its own. The managers of the municipalities fund (Minister for the Interior and the State Secretary of Finance) can award the additional grant for one or more years above the normal general grant from the municipalities fund. The income of municipalities is comprised of approximately 35% from the general municipalities fund grant; 55% from specific grants and 10% from their own income. The additional grant is at the expense of the general grant from the municipalities' fund that is provided to the municipalities.

Information on the financial position of the municipality originates from the municipal budget, as well as from the municipal accounts. The municipal accounts are accompanied by a short-form auditor's report on the degree of legitimacy of expenses and the reliability and completeness of information in the municipal accounts. In addition to this, the province verifies (in terms of its supervisory relationship with the municipality) whether the income and expenditure estimates of the municipality have been based on actual basic principles and lead to an actual budget. If the information is insufficient, the municipality should provide additional information. Moreover, the managers of the municipalities fund can have reports compiled by independent external experts in this area, for example on the costs necessary for the maintenance of roads or computerisation.

The managers of the municipalities fund reacted positively to the municipality's request for an additional grant. This also occurred for several municipalities in the immediate vicinity of Reiderland.

In the period 1991 to 2000 inclusive, Reiderland received a total of almost NLG 26 million or an average of NLG 2.6 million per annum. This is a relatively large sum because the general grant from the municipalities fund for the municipality amounts to approximately NLG 11 million per annum. The total sum in the budget amounts to over NLG 31.5 million. The principal intention of the money is for overdue road maintenance, shortfalls in the sheltered employment scheme, deficiencies on land owned by the municipality and for the appointment of additional staff to get social security payments in order.

Moreover, the Ministry of Social Affairs and Employment has provided an additional redevelopment grant of NLG 22 million for shortfalls in the provision of social work from a total of NLG 45 million (joint regulation of three municipalities), which has considerably lowered the municipal share in the shortfall.

The award of the additional grant is based on a statutory regulation, namely Article 12 of the Grants to Municipal Authorities Act to which parliament has assented, of course. The actual award is made without consulting parliament. However, parliament is able to call the managers of the municipalities fund to account subsequently. An independent advisory board of experts (the Council for Grants to Municipal Authorities) and the province involved advise the fund managers on the proposed additional grant.

Consultations are made with both the municipality as well as the provincial supervisor on an analysis of the causes of the financial problem and on possible solutions. The prognosis for this will be stated in an official report compiled under the responsibility of an inspector from the Financial Inspectorate of Local and Provincial Authorities. Regarding this, agreement is always reached on the facts with the municipality and the province; the prognosis can be left open as regards the solution, particularly concerning the level of the additional grant. Very often, however, both the province and the municipality agree with the proposed grant. The managers of the municipalities fund decide on awarding the additional grant on the basis of the report, the reaction from the municipality and advice from the Council for Grants to Municipal Authorities and from the province.

The municipality had to economise on, for example, municipal facilities, particularly in the areas of culture (community centres) and recreation (sport) and on the maintenance of green areas. Moreover, the municipality had to draw up an improvements plan for the Ministry of Social Affairs and Employment for carrying out social security payments. The municipality also had to increase its own income, particularly municipal property taxes. The municipality attempted to attract investors with a view to increasing work opportunities in the municipality: a health resort in combination with a bungalow park. Unfortunately, this project partially failed, leaving the municipality with unsaleable land. Plans have been developed recently by the province to realise a completely new, attractive residential district next to water in collaboration with the surrounding municipalities and private investors by means of a Public Private Partnership (PPS) construction (The Blue City). Polders will be returned to water to achieve this. The construction of this more expensive housing is an attempt to alter the imbalance in the composition of the population and to challenge the population drain threatening the municipality.

The desired effect will have been achieved once the municipality can show balanced budgets (over several years) following the end of the period in which it receives additional grants. This is presently the case for Reiderland. Construction of The Blue City, the new residential district with expensive housing built next to water, is as much an opportunity as a risk.

3.2 Lessons from the case studies

A number of lessons can be drawn from the case studies. Evaluated according to the theoretical framework presented in section 2, the following conclusions can be made:

- Central assistance to local authorities in financial difficulties is a phenomenon known in most countries. In all the countries involved in the analysis, the central government has experience with intervention in financial difficulties at the local government level. However, central assistance is not granted in all cases.

- Local authorities may experience financial difficulties for a number of reasons. The case studies suggest that economic problems may arise as the result of factors beyond the control of local authorities. Examples are natural disasters, general industrial decline, and unclear division of municipal debt in connection with territorial reforms. However, the case studies also suggest that economic problems may be the result of decisions taken by local authorities themselves. Examples include involvement in local private businesses, dubious policy decisions, and failure to reduce expenditure when revenue declines. The case studies suggest that both types of factors are often at work in situations where financial difficulties are experienced.

- When dealing with cases of financial difficulties in local authorities, the central government has an information asymmetry problem. In all the analysed cases, the central government had to rely on information provided by the local authority in question. This was often supplemented by other sources such as analyses by independent consultants, but it is very difficult for the central government to have the same insight into the local situation as the local authority itself.

- When trying to solve financial difficulties in local authorities, a number of options are available to the central government.

    - Contributions from the local authority itself to the solution of economic problems seem to be a minimum requirement.
    - An economic recovery plan is very often required as a condition for central assistance
    - Economic assistance need not involve the central budget. Assistance may take the form of grants, but loans and changes in equalization schemes are also used.

- Local autonomy is reduced when the central government decides to assist local authorities in financial difficulties. Central assistance is seldom given without conditions. In addition, central supervision is often increased.

- There is considerable variation in the amount of discretion granted to the central government when dealing with instances of financial difficulties in local authorities. Central governments in some nations seem to enjoy considerable discretion, while others need to involve their parliaments to a greater degree. But even within individual countries, central government discretion seems to vary from case to case depending on factors such as the size of the problem, what kind of problem is involved, and which type of legislation the problem can be handled according to.

As noted, these conclusions are based on case studies whose representativeness may be questioned. The following section makes a more systematic analysis of the situation in the member countries of the Council of Europe.

4. ARE THE MEMBER COUNTRIES OF THE COUNCIL OF EUROPE INSTITUTIONNALY PREPARED FOR HANDLING THE PROBLEM OF LOCAL AUTHORITIES IN FINANCIAL DIFFICULTIES ?

In this section a more systematic investigation is made of how the member countries of the Council of Europe are equipped to handle the problem of local authorities in financial difficulties. The point of departure is that the institutional setting may stack the deck differently for the different actors involved in the problem.

The following questions are analysed in greater detail, cf. the theoretical framework outlined in section 2:

- Does the system of local finance give local authorities any incentives to avoid financial difficulties?
- How does the central government handle its information asymmetry problem?
- Can the central government make credible a policy of only assisting legitimate cases of financial difficulties at the local level?

The section is based on data from a questionnaire sent out to all member countries of the Council of Europe. 28 countries corresponding to a response rate of 68 per cent have answered the questionnaire.[1]

4.1 The system of local finance

As noted in section 2 the local government finance system may influence the extent to which local authorities experience financial difficulties and the extent to which they apply for central assistance.

If local revenue sources are fixed or determined by the central government or if central grants are important elements in local finance, local authorities may argue that local deficits are a central government responsibility. In some cases this will be a valid argument, e.g. because new central demands cannot be met within existing budgets. In other cases the argument will be flawed because the local deficit could have been avoided by responsible local policy choices. Because of information asymmetries, it will be difficult for the central government to distinguish valid from flawed arguments.

There is thus a case for establishing a local government finance system with a large element of independent revenue sources that the central government may point to as alternatives to increased central assistance. Further, there is a case for establishing rules for local government borrowing which makes it difficult to use loans as a strategy for pressuring the central government for financial assistance.

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[1] The 28 countries are: Belgium, Bulgaria, Croatia, Cyprus, The Czech Republic, Denmark, Estonia, Finland, Germany, Georgia, Greece, Hungary, Ireland, Latvia, Lithuania, Malta, Netherlands, Norway, Poland, Portugal, Russia, Slovakia, Slovenia, Sweden, Switzerland, former Yugoslav Republic of Macedonia, Turkey and United Kingdom. For Belgium, the representatives of the three regions of Flanders, Wallonia and Brussels have sent replies to the questionnaire. For this reason the number of total answers is 30. Not all countries have answered all questions, which is why the number of answers in the tables in this section do not always add up to 30.

Table 4.1 shows the extent to which local authorities in the member countries of the Council of Europe can loan-finance expenditures. The table shows that loan-financing is an option open to all local authorities in the member countries. But the rules vary from country to country.[1]

Table 4.1. Borrowing rules

Number of countries	Yes	To some extent	No	Total
Can local authorities loan-finance capital expenditure?	25	3	-	28
Can local authorities loan-finance current expenditure?	13	6	9	28
Can local authorities raise loans in foreign currency?	14	8	5	27
Is central government approval required for raising loans?	12	5	9	26
Is borrowing by local authorities regulated by parliamentary acts?	14	4	9	27
Is borrowing by local authorities regulated by administrative decrees from the central government?	8	5	13	26
Does the central government guarantee the repayment of loans made by local authorities?	4	6	17	27

From the perspective of incentives to avoid financial difficulties, the following points can be noted:

- Local authorities do not seem to be subjected to a strict balanced budget requirement in any of the member countries. Local authorities in all member countries seem to have some access to loans. It may here be noted that a balanced budget requirement has been shown to be quite conducive to the avoidance of financial difficulties.[2]

- In several countries there is no regulation of borrowing by local authorities, neither in the form of parliamentary acts nor administrative decrees from the central government.

- In many countries, local authorities can loan-finance current expenditure. Such a rule may provide local authorities with an incentive to shift costs onto future generations.

- In some countries the central government guarantees the repayment of loans made by local authorities. Such a rule may provide local authorities with an incentive to default on loans and thus shift the costs of repayment onto the central government.

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[1] For a full treatment of the borrowing rules in the member states of the Council of Europe, see: *Borrowing by local and regional authorities*, Report prepared by the Steering Committee on Local and Regional Authorities (CDLR), Local and regional authorities in Europe, no. 47 (Council of Europe, Strasbourg: Council of Europe Press, 1992); *Local authorities' budgetary deficits and excessive indebtedness*, Report by the Steering Committee on Local and Regional Authorities (CDLR), Local and regional authorities in Europe, No. 5 (Council of Europe, Strasbourg: Council of Europe Press, 1996).

[2] See: Robert P. Inman. 1997. "Do Balanced Budget Rules Work? U.S. Experience and Possible Lessons for the EMU", pp. 307-332 in Horst Siebert (ed.), *Quo Vadis Europe?* (Tübingen: J.C.B. Mohr); Roderick Kiewiet & Kristin Szakaly. 1996. "Constitutional Limitations on Borrowing: An Analysis of State Bonded Indebtedness", *Journal of Law, Economics and Organization* 12: 62-97.

As far as other local income sources (*taxes* and *charges*) are concerned, the theoretical framework in section 2 establishes a case for a local government finance system with a large element of independent revenue sources.

The argument was that independent local revenue sources provide local authorities with alternatives to central assistance in case of financial difficulties. The central government may require these income sources to be exhausted before any central assistance is allocated. If local revenue sources are fixed or determined by the central government, local authorities may plausibly argue that local deficits are a central government responsibility.

In short, the analysis supports article 9 of the European Charter of Local Self-Government that argues that local authorities should be allowed some power to determine the rates at which their taxes are levied.

The question of local freedom to set tax rates in the member countries of the Council of Europe has been analysed in detail elsewhere.[1] There seems to be a great deal of variation in the extent to which the central government allows local authorities independence in the tax area. In some countries, no tax rates can be determined locally. In other countries, local authorities are free to determine the tax rate or allowed to set tax rates within a band established by the central government.

The arguments for using *central grants* to finance local authorities are well known. In brief, earmarked grants can be used to finance services, which local authorities provide as agents for the central government, or to encourage local authorities to provide services that generate benefits for non-residents. General grants can be used to raise the revenue of local authorities (i.e. to solve vertical fiscal imbalances) or to equalize differences in expenditure needs and tax bases (i.e. to solve horizontal fiscal imbalances). [2]

Achieving an appropriate balance between taxes and grants is difficult. But seen from the perspective of incentives to avoid financial difficulties, it is important that there is a genuine element of local financing. If central grants are important elements in local finance, local authorities may plausibly argue that local deficits are a central government responsibility.

[1] *Local finance in Europe*, Local and regional authorities in Europe, no. 61 (Council of Europe, Strasbourg: Council of Europe Press, 1997); *Limitations of local taxation, financial equalisation and methods for calculating general grants*, Report by the Steering Committee on Local and Regional Authorities (CDLR) prepared with the collaboration of Mr Jørgen Lotz, Local and regional authorities in Europe, No. 65 (Council of Europe, Strasbourg: Council of Europe Press, 1998).

[2] See e.g. the references in the preceding footnote.

4.2 Solving the central government's information asymmetry problem

As argued in section 2, the central government has an information asymmetry problem when dealing with cases of local authorities in financial difficulties. How can the central government know if a request for assistance comes from a local authority with no real need for assistance? The problem is that only the local authority has full knowledge of its real economic situation and that it has no incentives to reveal the true state of affairs if this disqualifies it from receiving assistance.

The information asymmetry problem constitutes an argument for the establishment of some kind of central monitoring system of local government economic performance.

Table 4.2 shows the extent to which the central authorities in the member countries of the Council of Europe monitor the financial situation of their local authorities. The table shows that most, but not all, member countries have some kind of monitoring arrangement.

Table 4.2. Monitoring by central authorities

Number of countries *with* some kind of monitoring system to follow the financial situation of local authorities	20
Number of countries *without* a monitoring system to follow the financial situation of local authorities	7
Sum	27

Table 4.3 shows that monitoring may be done according to standardized indicators. But apart from the ratio of debt to own resources there seems to be no widely used indicator.

Table 4.3. Criteria used by monitoring body to assess the financial situation of local authorities

Number of countries using the following monitoring criteria:	
• Ratio of debt burden to working capital	5
• Ratio of debt to own resources	11
• Total amount of security which local authorities are able to provide	2
• Maximum security which a local authority can offer to a single borrower and/or for a single operation	2
• Other criteria	14

Table 4.4 shows the institutional affiliation of the monitoring body. The table shows that monitoring is typically done by the central government. The task is very often entrusted to the Ministry of Finance or the Interior Ministry.

Table 4.4. Institutional affiliation of the monitoring body

Number of countries with the following institutional affiliation of its monitoring body:	
• Government body	15
• Parliamentary body	1
• Independent body	2
• Semi-independent government body	1
• Semi-independent parliamentary body	0
Total	19

Monitoring is conceptionally different from supervision and auditing. Monitoring is done for informational purposes while supervision and auditing is done for legal purposes. In principle, supervision and auditing need not entail any involvement by the central government. Equally, the findings made by supervising and auditing bodies need not be reported to the central government. [1]

In practice, the distinction may be blurred if supervision and auditing are done by central government bodies or bodies that regularly inform the central government of its findings. As an example of auditing authorities performing this function the Maltese National Audit Office is instructive. The head of this office (the Auditor General) is an officer of the Maltese House of Representatives. He appoints local government auditors who are responsible for reporting on the financial situation of every local authority. All cases of local authorities in deficit are referred to the Public Accounts Committee appointed by the House of Representatives. This system ensures that central authorities know in advance when the financial situation of a particular local authority is heading towards a critical stage. Further, the local authority will be warned to take timely corrective measures to preclude the crisis. In the event of persistent default, a recommendation will be made to the President of the Republic to dissolve the defaulting local authority.

Another example is the UK Audit Commission that was established in 1983 to appoint and regulate the external auditors of local authorities. These auditors have a duty to consider whether the local authority has put in place adequate arrangements to ensure that its financial standing is soundly based. They also have a duty to consider whether a local authority has adequate systems of internal financial control that are effective in practice. The UK central government expects auditors, where they become aware of any transgression, to take appropriate action, for instance by reporting the problem, and in the final instance to apply to the Courts to declare an item of account unlawful. In the opinion of the UK government, this system has proved effective in bringing to light financial transgressions by local authorities.

[1] On supervision and auditing, see: *Supervision and auditing of local authorities' action*, Report by the Steering Committee on Local and Regional Authorities (CDLR) prepared with the collaboration of Prof. Juan Santamaria Pastor and Prof. Jean-Claude Nemery, Local and regional authorities in Europe, No. 66 (Council of Europe, Strasbourg: Council of Europe Press, 1999).

4.3 Solving the problem of making credible a policy of only assisting legitimate cases of financial difficulties at the local level

As argued in section 2, a central government policy of only assisting legitimate cases is not necessarily credible. If the government has full discretion to assist any case of local financial difficulty, a policy of only assisting legitimate cases may be difficult to implement. The reason is that all actors know that, even if information asymmetry problems did not exist, temptations to accommodate illegitimate requests for assistance may become overwhelming because of the economic and political costs of denying assistance. Consequently, full governmental discretion may encourage illegitimate requests for assistance.

The credibility problem constitutes an argument for constraining the discretionary powers of the central government when dealing with local authorities in financial difficulties.

Table 4.5 and 4.6 show whether the member countries of the Council of Europe have a formal grant scheme targeted for local authorities in financial difficulties and how detailed the associated regulation is. Table 4.5 shows that about half of the member countries have a special grant scheme for this purpose. Table 4.6 shows that, among the countries with such a grant scheme, the central government is seldom allowed full discretion to allocate the grant. The grant schemes typically specify the conditions to be met by local authorities in order to be eligible for grants. Further, the amount that can be given in grants may also be specified. However, parliamentary approval in individual cases seems typically not to be necessary.

Table 4.5. Special grant scheme for local authorities in financial difficulties

Number of countries *with* a grant scheme targeted for local authorities in financial difficulties	14
Number of countries *without* a grant scheme targeted for local authorities in financial difficulties	13
Sum	27

Table 4.6. Rules of special grant schemes for local authorities in financial difficulties

Number of countries	Yes	To some extent	No	Total
Do the rules of the grant scheme formally specify the conditions to be met by local authorities in order to be eligible for grants?	10	2	2	14
Do the rules of the grant scheme formally specify the amounts that can be given in grants?	4	3	4	11
Is parliamentary approval necessary for the central government's allocation of grants to individual local authorities?	1	2	9	12

Note: The table only includes the 14 countries that have a special grant scheme targeted for local authorities in financial difficulties, cf. table 4.5.

However, Table 4.7 shows that a special grant scheme is typically no precondition for allocating assistance to local authorities in financial difficulties. Assistance may be financed from other grant schemes or from general funds. Parliamentary approval for this line of action seems seldom to be required. This finding indicates that considerable governmental discretion is involved in the decision whether or not to allocate assistance to local authorities in financial difficulties.

Table 4.7. Financing central assistance to local authorities in financial difficulties from other sources

Number of countries where it is *possible* for the central government to allocate a grant to a local authority in financial difficulty from other grant schemes or from general funds	17
Number of countries where it is *not possible* for the central government to allocate a grant to a local authority in financial difficulty from other grant schemes or from general funds	9
If possible, is parliamentary approval necessary? - yes - no	 2 15

As argued in section 2, other solutions than financial assistance should be examined before grants are considered. If it is widely known that grants are a means of last resort and only allocated on harsh conditions, it may be easier to deter illegitimate financial requests. Table 4.8 illustrates the extent to which alternative solutions are used in the member countries of the Council of Europe.

The table shows that non-economic solutions are very common, either as alternatives to grants or as supplements. The central government often, but not always, meets with the local authority to discuss the local financial situation. It seems to be a widespread practice to have a plan made on how to correct the situation, either by the local authority in question or in collaboration. Further, own contributions by the local authority to solve the economic problem are also often demanded. Interestingly, it seems to be the case that central governments prefer local expenditure cuts to local tax raises as own contributions. Extreme non-economic measures such as the central government taking over the responsibility for local economic planning, burdensome local tasks or local debt are relatively rarely used.

The large amount of negative answers to the last question in the table concerning "other" measures indicates that the options listed in the table constitute a fairly exhaustive list of non-economic measures used instead of or in combination with economic assistance.

Table 4.8. Non-financial solutions to local financial difficulties

Number of countries	Yes	No	Total
The central government…			
…holds meeting(s) with the local authority to discuss the situation	23	5	28
…demands that the local authority presents a plan on how to correct the situation	22	6	28
…draws up a plan in co-operation with the local authority on how to correct the situation	17	11	28
…takes over the economic planning of the local authority	3	25	28
…grants exceptions from normal regulations of local authority borrowing	9	19	28
…demands that the local authority increases taxes or other revenue sources	9	19	28
…demands that the local authority cuts down expenditure	18	10	28
…reduces the local authority's expenditure pressure by taking over burdensome local tasks	3	25	28
…takes over (part of) the debt of the local authority	7	21	28
…implements other than the above measures	9	19	28

In addition to constraining central governmental discretion and examining non-economic solutions, section 2 also argued that the consequences of illegitimate financial difficulties among local authorities should be made clear, for instance in a municipal bankruptcy code.

If it is uncertain what really happens in case of severe, but illegitimate, economic difficulties, a central government policy of only assisting in legitimate cases may be difficult to implement. Local authorities may persuasively argue that, unless clearly specified in advance, bankruptcy is an unacceptable end result of a local crisis. But, if bankruptcy were a credible end result, it would constitute a powerful deterrent against financial negligence.

However, Table 4.9 shows that local bankruptcy is generally not allowed in the member countries of the Council of Europe. In only five countries is it legally possible for a local authority to go bankrupt. The questionnaire further shows that only in two of these five countries does the legal framework specify a local bankruptcy procedure. The questionnaire further shows that there were no known cases of local authorities going bankrupt in 1999 in any of the member countries of the Council of Europe.

Table 4.9. Bankruptcy rules for local authorities

Number of countries where it is legally *possible* for local authorities to go bankrupt	5
Number of countries where it is legally *impossible* for local authorities to go bankrupt	22
Total	27

In several member states the bankruptcy problem seems to be considered a question of mainly academic interest. The reason given is that, even if bankruptcy were possible, increased local taxation can always be applied.

However, it should be kept in mind that local taxation is actually constrained, to a greater or lesser extent, by the central government in most member countries of the Council of Europe. Further, as the case studies in section 3 reveal, local authorities may experience financial difficulties that cannot be solved by local means, even if local taxation were unlimited. If bankruptcy is not possible in these cases, it may be difficult for the central government to avoid becoming involved. When all relevant actors know this, the incentive at the local level to avoid financial difficulties is reduced.

The questionnaire shows that there may be functional equivalents to bankruptcy procedures, although these are rare. For instance, in Switzerland bankruptcy proceedings cannot be brought against local authorities, but the cantons do not generally assume liability for their municipalities' obligations. Consequently, it is possible that a municipality finds itself incapable of honouring its commitments. The Swiss federal law has special rules covering this eventuality. It stipulates, inter alia, what kinds of municipal property may be involved in a financial settlement and what procedure to follow. Creditors may request the appointment of an administrator, i.e. a body in charge of the financial management of the municipality and entrusted with the necessary powers. To date, this act has only been implemented in the case of one municipality

In the UK, legislative powers provide that if a local authority does not pay its debts for two months after a formal demand, a receiver may be appointed. Powers conferred on a receiver do not include selling property, but relate to income, that is the receiver may be permitted by the Court to take over part of the revenues. However, these powers have not been used in modern times. The central government would be likely to step in before such a point was reached to prevent bankruptcy in view of the affect on local people.

4.4. Conclusion

The analysis in this section leads to the following conclusions:

- The system of local finance in member countries of the Council of Europe does not always provide local authorities with incentives for prudent economic policy choices.

  Local authorities are generally not subjected to a strict balanced budget requirement. Loan-financing of capital projects may be sensible, but local authorities are often also given access to loan-financing in the area of current expenditures. Furthermore, in several member countries the central government guarantees for local loans.

  Current revenue sources are often determined with considerable local independence although in some cases they are constrained by central limitations.

- The central government's information asymmetry problem is not always tackled.

Many, but far from all, countries have established some kind of monitoring system to follow the economic situation of local authorities. Monitoring is overwhelmingly done by the central government rather by an independent body.

- The central government's credibility problem is not always tackled.

  Central governments seem to enjoy considerable discretion when deciding whether or not to allocate economic assistance to local authorities in financial difficulties. As argued in section 2, this need not be in the central governments' own self-interest. However, most central governments use other instruments than economic assistance to deal with cases of local authorities in financial difficulties. The most general finding is that the central government enters into a dialogue with the given local authority, requires the local authority to present a plan on how to correct the situation and demands that the local authority also somehow contributes to solving the financial difficulties.

  In most countries, local authorities cannot go bankrupt. Furthermore, this is not generally an option that member countries find realistic or promising when dealing with local authorities in financial difficulties.

5. BEST PRACTICES GUIDELINES

This report has argued that local authorities in financial difficulties represent a problem for the central government: Should it provide economic assistance? In some cases, central assistance may be necessary. In other cases central assistance would be misplaced.

The report has made no attempt to define what constitutes a legitimate case of central assistance to a local authority in financial difficult. This is a political matter to be decided by each national government. But the problem of distinguishing legitimate cases from illegitimate ones is general. So are the problems of how financial difficulties can be avoided and what can be done once they have arisen. If these problems are not handled properly, irresponsible local economic behaviour and unnecessary and excessive amounts of central assistance may be the result.

At the *local* level, authorities face a collective action problem: It is individually rational for any given local authority to seek as much central assistance as possible while the collective interest of local authorities is to avoid too much central assistance because it may undermine local autonomy. This detrimental assistance-seeking logic can be mitigated by institutional mechanisms. In particular the analysis suggests the following guidelines[1]:

[1] Of course, the situation of the authorities involved greatly varies between countries but also within a country between the different authorities, so the intervention should be adapted to each particular case.

When formulating borrowing rules for local authorities, the central government should consider potential incentives to overborrow.

If, for instance, local authorities can loan-finance current expenditures, an incentive to shift costs onto future generations may be established. Such incentives should only be accepted if salient policy objectives make them impossible to avoid.

When formulating borrowing rules for local authorities, the central government should consider the linkages between the central government and local authorities.

If, for instance, the central government guarantees for local loans, a local incentive to default on loans and thus shift the costs of repayment onto the central government is established. Again, such incentives should only be accepted, if salient policy objectives make them impossible to avoid.

When designing local finance systems, independent revenue sources should be made available to local authorities.

This is one of the obligations deriving directly from Article 9 of the European Charter of Local Self-Government. If local revenue sources are fixed by the central government, local authorities may plausibly argue that local deficits are a central government responsibility. An incentive to pressure the central government for increased funds is thus built into the system. In addition, the appropriate action in the case of a local authority showing a structural income deficit does not consist of financial assistance, but rather in intervening to eliminate the causes of this structural deficit.

When designing local finance systems, a proper balance between grants and taxes should be established.

This is also one of the obligations deriving directly from Article 9 of the European Charter of Local Self-Government. If central grants are important elements in local finance, local authorities may plausibly argue that local deficits are a central government responsibility. Again, An incentive to pressure the central government for increased funds is thus built into the system.

At the *central* level, the problem is, first, to distinguish legitimate from illegitimate cases. Information asymmetries may make this a very difficult task. Second, the problem is to make credible a policy of only assisting legitimate cases. The costs of denying central assistance may give a policy of "no to all illegitimate requests" severe credibility problems and encourage all local authorities to seek central assistance, irrespective of real needs. These problems can be mitigated by institutional mechanisms. In particular the analysis suggests the following guidelines:

The central government should consider establishing a monitoring scheme to follow the financial situation in local authorities.

Monitoring is costly, but alleviates the information asymmetry problems involved in handling cases of local authorities in financial difficulties. Whether monitoring should be done by the central government or by an independent body should be decided according to the relative importance of impartiality and administrative expediency.

The discretion of the central government to decide whether to allocate economic assistance should be carefully considered.

Central government discretion is a mixed blessing. It may work contrary to the government's interests. Full discretion may result in credibility problems and thus encourage all local authorities to seek central assistance. The precise division of responsibilities between the central government and the parliament should be decided with this fact in mind.

Non-economic solutions should be used as alternatives or supplements to financial assistance.

In order not to encourage assistance-seeking behaviour, the central government should consider making use of non-economic solutions. Examples include dialogue with the given local authority, the demand to present an economic recovery plan, and the demand to make own contributions to the solution of financial difficulties.

Legal procedures for handling a local financial crisis without central government assistance should be established.

Local authorities may experience financial difficulties that cannot be solved by local means, even if local taxation were unlimited. If the legal framework does not specify how this situation is handled, the local authority may plausibly argue that the central government has implicitly accepted to help out. In that case, it may be difficult for the central government to avoid becoming involved even though the crisis is due to local economic mismanagement. The incentive at the local level to avoid financial difficulties is thus reduced. Legal procedures may take the form of a local bankruptcy code.

Financial assistance should be adjusted according to how rich an authority is

It would be necessary to set, as a condition for assistance, an important financial **effort** and not **contribution** from the authority in financial difficulty. In fact, a wealthy authority with unused fiscal resources could easily fulfil the obligation to contribute the same amount as the central government to a recovery plan. A poor authority would find it difficult to fulfil such a condition. Hence, to grant assistance proportionally to the contribution of the authority could encourage rich authorities to not use their resources and to wait for the state to intervene, and could exclude those poorer authorities which need assistance the most.

All undesirable incentives must be avoided

Financial assistance may create dependency (the authority starts to see itself as dependent on state financial assistance and this may prevent it from finding its own resources or improving its budget management). It may also create effects of imprudence (authorities depend too much on the state safety net and become imprudent in their risk evaluation and budget management), effects of competition (authorities start fighting among themselves over State financial aid)… Any possible undesirable incentives must be examined and the necessary steps taken to avoid them both when general rules concerning assistance are set up and for each individual case.

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