
Illustration:
*The Effects of Good Government*
by A. Lorenzetti - Sala dei Nove
Siena, Italy (1339)

# LOCAL FINANCE BENCHMARKING: INTRODUCTION AND METHODOLOGY

**TOOLKIT**

The toolkit supports evidence-based decision-making by local and central authorities helping them make the best use of available resources.

Council of Europe

Centre of Expertise for Good Governance

June 2020

CENTRE OF EXPERTISE FOR GOOD GOVERNANCE

COUNCIL OF EUROPE
CONSEIL DE L'EUROPE

# LFB

# LOCAL FINANCE BENCHMARKING:

# INTRODUCTION AND METHODOLOGY

CENTRE OF EXPERTISE
FOR GOOD GOVERNANCE
in cooperation with
Ken DAVEY
Gábor PÉTERI
Zsuzsa KASSO

*The opinions expressed in this work are the responsibility of the authors and do not necessarily reflect the official policy of the Council of Europe.*



Council of Europe

Centre of Expertise for Good Governance

https://www.coe.int/en/web/good-governance/centre-of-expertise

## Introduction to Local Finance

An effective system of local government is important for both political and economic reasons. It shares power and promotes the accountability of local public services. It also helps to fit those services to local needs and preferences. The financial framework within which local government operates is crucial to meeting both these objectives. Sound financial management is also one of the 12 Principles of Good Democratic Governance.

The Local Finance Benchmarking Tool (LFB) offers a practical implementation of two recommendations of the Council of Europe – CM/Rec(2004)1- Recommendation of the Committee of Ministers to member states on financial and budgetary management at local and regional levels and CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities. LFB was first co-developed in 2007 by the Council of Europe's Centre of Expertise for Local Government Reform (now Centre of Expertise for Good Governance) and the Local Government and Public Service Reform Initiative of the Open Society Institute. The benchmarks were revised in 2013 and 2017, based on the implementation results in several CoE member states. So far, the LFBs have been implemented in about a dozen of CoE member states, including Bulgaria, Ukraine, Moldova, Georgia, Armenia, Basque region of Spain, and Greece[1]. In 2021, the implementation is planned in Lithuania and Slovakia

The aim of this introduction is to sketch the general philosophy of fiscal decentralisation behind the European Charter of Local Self-Government and the detailed recommendations which accompany it. The next section is focused on methodology and guidance for using the Local Finance Benchmarks.

Local government finance is a matter of common principle rather than practice since the basic structure of local government and the assignment of both expenditure responsibilities and revenue sources differ widely between European countries, as do the economic circumstances within which it operates. Both principles and practices should be designed to afford local representative bodies much freedom of action, but also incentives to use it accountably.

How much power and responsibility regional and local governments actually exercise depend substantially on

(1) what range of public services they finance;
(2) whether their revenues are commensurate with these responsibilities;
(3) how much real choice they have in allocating their budget to individual services;
(4) whether they can determine the rates of their taxes and charges (both allowing them to vary their level of spending and making them answerable to the payers).

The term "local government" here is used to describe both upper (regional, county, district) and lower (city, municipal, settlement) tiers of self-government.

### *Spending Responsibilities*

There is wide diversity between individual states in the scale of the tasks devolved to local government. In most countries local government is responsible for what are often called "communal services": local roads and lighting, water supply and sanitation, waste management, parks and sports facilities, cemeteries, social housing. What varies greatly is the extent of local responsibility for the social sector,

[1] Some recent country reports ae available on the websites of the Centre of Expertise: https://www.coe.int/en/web/good-governance/lfb-eap; https://www.coe.int/en/web/good-governance/greece-policy-advice

chiefly comprising education, health and social assistance. In some cases, the whole service is funded by the State Budget, in some costs are split between levels of government, in some local budgets meet all costs except central supervision.

This varying degree of local budget responsibility for the social sector makes a major difference to the nature and scale of decentralisation. Without such responsibility local government expenditure is unlikely to exceed 5-6% of GDP. Responsibilities for education, health care or social assistance are likely to double or treble this proportion. This in turn has a major impact on financial self-sufficiency. Major social sector responsibilities are usually combined with a substantial dependence on State grants or tax shares, both because of the limited capacity of revenues which can be assigned to local levy and because of the degree of geographical equality expected in access to these services and, in consequence, the need to equalise financial resources.

***Local Taxation***

The Charter lays considerable emphasis on the power of local governments to levy their own taxes. By local taxation the Charter means taxes which

(1) accrue to the budgets of the local government in whose area they are collected, and

(2) are subject to some degree of variation by the recipient local government; i.e. the local government has some discretion in deciding how much each person pays, by setting the rate, determining the basis of assessment, granting exemptions etc.

Local taxation is important for two main reasons. Firstly, power to vary tax rates allows local governments to fit their levels of expenditure to local needs and preferences. Secondly, fixing the amount of tax which citizens have to pay makes local leaders more answerable for the way they spend their income.

To meet these objectives, local taxes need certain characteristics. Firstly, the geographical origin needs to be clear so that the revenues truly come out of local pockets and the burden cannot be passed on to people or organisations in other jurisdictions. Secondly, it should be possible for rates to vary between jurisdictions without significant administrative cost or distortion to trade. Thirdly, tax bases should be reasonably buoyant so that natural expansion arises from the same pressures such as inflation, population and economic growth which demand increases in local expenditure.

Taxes on *property* are the most common local taxes, though not necessarily the most important. They have two major advantages for local government. Firstly, their base is obviously localised; there is no room for argument where the revenue should accrue; there are clear connections between the value of real estate and the municipal expenditure on local infrastructure. Secondly, real estate is the one tax base which cannot be hidden by a "black economy".

There are also significant weaknesses which, in practice, keep the yields of property taxes far below those of major taxes on income and consumption. The tax has to be collected directly from the taxpayer, making it more politically sensitive than other levies paid indirectly or deducted from salaries. The lack of direct correlation between the assessment of property tax and the income from which it has to be paid adds to this sensitivity. Assessing market or rental values of the tax is complex and slow; as a result cruder and less discriminating bases of assessment are often used limiting incidence and potential yields; in either case it is hard to keep valuations up to date so that the tax base responds very slowly to changes in prices or economic growth which increase demands on municipal expenditure.

As a result, property taxes rarely raise more than 1-2% of GDP, enough to fund much municipal infrastructure, but not major social sector responsibilities. It is critical to their contribution that local governments have power to raise rates regularly to keep pace with prices and are encouraged to do so.

*Personal income taxation* meets the requirements for a local tax. In some western European states (notably Switzerland and the Scandinavian countries) local governments add their own rates as surcharges on the national rates of personal income tax; the national rates are kept low enough to allow room for the local levies. It is no coincidence that these are the countries where local government has the highest measure of fiscal independence. This is because personal income tax has far greater potential capacity than any other tax capable of levy at local level. It also has clear linkages to expenditure on personal services such as health and education.

Taxation of *corporate profits, business turnover* etc has provided substantial revenue to several European systems of local government but is generally in decline as a local government revenue throughout Europe. There are severe technical difficulties in assigning such receipts to the local government from which the business incomes truly derive. Corporate profits are highly volatile, and the base lacks the stability to support services with such a large component of regular committed expenses as those of local government. National governments are anxious to restrict taxes on this base to attract inward investment.

Taxation of *sales of goods and services* has also provided substantial revenues to some local governments, notably in some Balkan countries. However, it is being widely eliminated from local government revenue, largely because of its competition with value added tax, which is obligatory in the European Union and under adoption in states aspiring to EU membership.

### ***User Charging***

At municipal level user charging is often as significant as local taxation in its yields and impact on household incomes. It is less discussed, partly because it tends to be undertaken by subsidiary enterprises rather than the parent municipality. However, deregulation of prices and withdrawal of state subsidies are generally increasing both the burden of charges such as housing rents, water and heating charges and public transport fares, and the responsibility of municipal governments for determining tariffs.

National policy generally discourages the general subsidies which often restrained utility charges in the past and favours full cost pricing accompanied by the introduction of subsidies to low income households, probably more equitable and efficient but more administratively demanding.

### ***Intergovernmental Transfers***

Intergovernmental transfers take a number of forms:

> Shares of national taxes distributed *either*
> (1) by formula (e.g. per capita), *or*
> (2) by origin (i.e. to the local government where they are collected).
>
> Grants which are *either*
> (1) specific, i.e. targeted to support specific expenditures (e.g. social benefits, education), *or*
> (2) general, i.e. untargeted and used at the discretion of local government (often known as block grants).

Targeted grants are usually intended to stimulate a specific type of expenditure which is favoured or mandated by national government.

Tax sharing and block grants usually have two main purposes, vertical and horizontal equalisation. *Vertical* equalisation means closing the gap between the cost of the services devolved on local governments and the yield of their direct revenue sources. *Horizontal* equalisation adjusts differences between individual local governments in their per capita revenues or spending needs. In some cases, such as Sweden and Poland, equalisation is partially financed through horizontal redistribution, i.e. by transferring revenue between local governments with above and below average incomes.

Transfers have a critical role in most countries in ensuring that local government resources are commensurate with responsibilities, and that people in poorer areas do not experience unacceptably low standards of service. But dependence upon transfers poses obvious threats to local autonomy as well as risks of political partiality in their distribution. The Charter and the two recommendations define a number of principles and practices to reduce these risks.

Firstly, transfers should so far as possible comprise block grants or tax shares whose use is not prescribed by Government. Earmarked grants may be justified for certain types of capital, but their availability and the criteria should not restrict local choice over expenditure priorities.

Secondly, the volume and distribution of transfers should be governed by permanent legislation and not subject to arbitrary changes in annual national budgets. So far as possible the volume should be indexed to factors such as national revenue growth or GDP so that local government's share of resources remains stable and buoyant.

Thirdly, the distribution of transfers should be determined by objective formulae which preclude bargaining and negotiation with individual recipients, although local authority associations should be consulted on their design. Eligibility for equalisation funds should not be influenced by local decisions, being based on measurements of revenue potential and spending needs which ignore actual budgets and performance. Calculations of revenue capacity, for example, should assume that all local governments levy the same rate of tax, and should not change because a particular authority chooses to increase or reduce it. Spending need should be determined by objective factors such as the number of school age children in the case of education.

Capital investment grants are more difficult to subject to transparent formulae because of their one-off nature, but their availability and the criteria for their award should be publicised so that all eligible recipients can apply.

### ***Capital Finance***

Local governments are often able to devote operating surplus to capital expenditure and any revenue from sale of assets should be spent on investment, not on current costs. Even so, the cost of large capital projects such as road construction, water treatment plants or new school building often exceed the capacity of annual budgets and can only be financed by long term credit.

National laws and policy should permit local governments to borrow money for investment (though not for operating budget deficits), although it may be necessary to impose limits to prevent excessive debt. A ceiling on the proportion of annual revenue devoted to debt service is the usual control.

National governments or local authority associations are also advised to establish suitable sources of loan finance for local governments. These may consist of banks specialising in municipal credit, or national funds acting as an intermediary between the capital markets and individual municipal borrowers. Such specialised and pooled institutions generally lower transaction costs and spread risks. Another vital piece of the institutional framework for capital finance is legislation governing cases of municipal insolvency.

Much physical and social infrastructure is now funded by private enterprises carrying out property development which creates the demand for extra roads, sewage capacity, school places etc; this is usually demanded as a price for planning permission.

### *Financial Management*

The recommendations on local government financial resources are all designed to maximise local choice – discretion over both raising revenue and spending it. The key instrument is the annual budget, but local governments are encouraged to frame this within the context of longer-term forecasts, so that both capital investment and the improvement of service operations can be effectively planned and programmed. Forecasting future ability to operate a new capital asset and to service associated debt is a vital part of an investment decision.

The Charter emphasises the role of the whole elected council in approving budgets and in monitoring their implementation, a role which should not be delegated. This does not preclude delegating some detailed discretion over the use of funds to subsidiary institutions like schools, so long as the representative bodies retain overall control of the purposes for which money is used. Budget proposals should also be sufficiently public for wider consultation with interest groups, neighbourhood organisations, service users and other non-governmental bodies, but public participation should not usurp the ultimate responsibility of elected members for the hard budgetary choices.

Monitoring budget execution requires reliable information. Professionally competent and up to date accounts are essential to this; so is internal audit reporting directly to the Council or its chief executive. Valuable also are national statistics showing relative standards of services and their costs against which performance can be judged.

### *External Control*

Any form of external control is often seen by local government as a threat to its autonomy; in practice it can, properly designed and exercised, improve its accountability and safeguard public confidence.

External audit is crucial to the maintenance of integrity and efficiency. Systems vary; in many countries responsibility lies with the national audit organisation responsible to Parliament for auditing all public bodies. In other cases, there are other state bodies particularly responsible for local government or a special audit service established by the local authority associations. In some states there is no state imposed system, but a legal obligation on each local government to appoint independent auditors from the commercial system. What matters are the independence and professionalism of the auditors, their affordability by all sizes of local government, submission of their reports to the elected council, and disclosure to the general public.

Audit has traditionally focussed on the legality and honesty of local government financial transactions. However, there has been an increasing tendency for external audit to devote attention to issues of efficiency and to compare local government practices in terms of productivity and "value for money". Similar principles apply to the inspections of local government services such as schools, which can have very positive impacts providing they focus on helping to improve performance rather than casting blame.

Another area for national organisation is the training and qualification of local governments' financial staff. This may be the concern of national government, of local authority associations or of the finance profession itself. However organised, it is important that financial managers are appropriately trained, appointed on merit and protected from political interference when seeking to maintain standards of legality, integrity and efficiency.

Central governments often subject local government financial decisions to the approval of ministries or regional administrators. These provisions may arise from macroeconomic policy, as in the case of borrowing or tax levels. Alternatively, such controls may arise from a paternalistic desire to protect local citizens from abuse of power. The danger is that such controls may be exercised irrationally, incompetently or for political advantage and, therefore, counterproductive. Where such controls are justified, they are better exercised through the imposition of normative rules and standards than by case-by-case decisions.

In 2019, a new CoE recommendation outlining principles of administrative, financial, and democratic supervision was adopted: CM/Rec(2019)3 - Recommendation of the Committee of Ministers to member states on the supervision of local authorities activities .

## Local Finance Benchmarking: Methodology

The LFB is one of the practical toolkits of the Centre of Expertise; other relevant benchmarks include the PEB – Public Ethics Benchmarking toolkit, and ELoGE – a benchmarking tool to assess compliance of municipalities with the 12 Principles of Good Democratic Governance.

Benchmarking can be primarily used for analytical, diagnostic purposes. However, quantifiable results through scoring will also help identify areas for intervention and prioritise development of specific policies. Therefore, the score cards help identify the basic local finance framework at local level as proposed by the Council of Europe legal instruments and thus are intended to help both governments and municipalities to identify their strengths and weaknesses and to improve their regulations and practice.

The European LFB Score Cards are structured lists of statements about local finance. There are two Score Cards - one addressed to local authorities and another one to central authorities; each scorecard has 2 parts, based, respectively, on Rec(2004)1 on financial and budgetary management at local and regional levels, and on Rec(2005)1 on the financial resources of local and regional authorities.

The score cards presented here are general European models; implementation in each particular country should only be performed after adjusting them to national context. Once elaborated, the National Benchmark will include average scores of participating municipalities. It will become the yardstick against which each municipality can be measured, either through self-assessment sessions, through assessment by independent experts or through peer reviews.

In the case of financial resources 76 items are focused on central governments, while only 31 items are for local governments; in the case of financial management the ratio is more balanced, 43 items for both levels.

Consequently, the recommendations on fiscal decentralisation might be better used for assessing the *overall system of local and intergovernmental finances*, rather than appraisal of specific local governments' performance.

Evaluation of the national system of financial resources and financial management requires more complex analytical tools. Assessment of national policies and the regulatory framework in both areas are embedded in the domestic legal, political and institutional system. There is no one "best" or ideal solution, which could be used as a benchmark.
In order to assess the various components of fiscal decentralisation, as parts of a broader framework, the scorecard method should be supplemented by specific financial statistics and fiscal indicators.

Data analysis and scoring jointly provide the basis for evaluation of policies and legislation, influenced by the central authorities.

This is the reason why four core benchmarking tools have been prepared, addressing both recommendations and targeting the two levels of government:

**Fiscal decentralisation: focus and methods of assessment**

| ***Set of recommendations*** | ***Levels of government*** | |
|---|---|---|
| | *Central authorities* | *Local authorities* |
| *Financial resources* | Statistical data analysis<br>Institutional review<br>Scorecards | Statistical data analysis<br>Scorecard based benchmarks |
| *Financial management* | Institutional review<br>Scorecards | Scorecard based benchmarks |

***Comprehensiveness and structure of recommendations***

Recommendations formulated by the CoE provide very comprehensive and at the same time rather detailed sets of assessment criteria for evaluating fiscal decentralisation. However, during the preparation of proposed benchmarks three issues had to be solved:

*(i) overlapping recommendations:* each set of recommendations is started by general principles and followed by specific recommendations. Consequently, some of the proposed benchmarks for assessing the general principles should be repeated during evaluation of specific aspects of fiscal decentralisation (e.g. recommendations on own source revenues, local taxes).

*(ii) unbalanced structure of recommendations:* very often less important issues were raised to the level of a recommendation, which has resulted in uneven weight of recommendations (e.g. Financial Resources Recommendation 2, *vs.*, Recommendation 21). So sometimes recommendations had to be restructured by grouping together various factors into one chapter. This mostly happened in the case of financial management issues.

*(iii) missing elements of fiscal decentralisation:* in the set of recommendations on financial resources, the municipal property and local assets were not mentioned. However, this is a critical condition of fiscal decentralisation, especially in countries entering the process of decentralisation after long decades of centralised, state ownership. There are some factors which are not mentioned (e.g. buoyancy of local taxes) or some which are debatable (e.g. no paper profit is calculated in user charges) or not clear (e.g. Local financial resources Recommendation 13.)

The two sets of benchmarks include an attempt to respond to these problems.

***Benchmarks***

The benchmarks are grouped according to logical sub-groups of recommendations.

The first left column of the tables gives a logical structure of the recommendations.
Various groupings were used: sometimes one general recommendation is divided into several sub-recommendations, while in other cases two or three original recommendations are brought together into one statement. In both cases the serial number of recommendation is marked.

The scores are linked to individual recommendations or to the sub-group of recommendations in two ways.

(i) The recommendations are *grouped by areas* and each recommendation is scored separately:

| **SECTION and AREA (with reference to the number of Recommendation)** | **ACTIVITY, INDICATOR** | **VERIFICATION STATEMENT/ DOCUMENTS** | **SCORE/ WEIGHT** |
|---|---|---|---|
| ***I. Section*** | | | |
| **Area of recommendations** | | | |
| a) recommendation (R.x) | | | Score 0-10 |
| | | | |
| c) recommendation (R.y) | | | Score 0-10 |

(ii) A recommendation is *divided* into several *components.* Weights are given to each component:

| **SECTION and AREA (with reference to the number of Recommendation)** | **ACTIVITY, INDICATOR** | **VERIFICATION STATEMENT/ DOCUMENTS** | **SCORE/ WEIGHT** |
|---|---|---|---|
| ***I. Section*** | | | |
| **Major recommendation (R.x)** | | | **Score 0-10** |
| a) component of the recommendation | | | Weight a) (%) |
| | | | |
| c) component of the recommendation | | | Weight c) (%) = total 100% |

The benchmark is specified through activities or indicators, linked to the recommendation analysed. It identifies various measurable elements of the recommendation. The actual benchmarks are specified by the two middle columns.

The benchmarks are formulated in different ways:

(i) specifying the *assessment criteria* of the recommendation:

| | | |
|---|---|---|
| a) objectivity of spending needs is guaranteed through criteria not controlled by local governments (R48, R49) | • grants allocated through statistical (objective, uncontrollable) indicators in percentage of total grants<br>• information system supporting grant allocation is based on statistical data collected regularly | National budget: intergovernmental transfers and tax sharing<br>Statistical systems on local government services<br>Local financial statistics |

(ii) providing indicators for *assessing the accomplishment* of the selected recommendation:

| | | |
|---|---|---|
| a) sufficient own resources to fund significant proportion of local responsibilities, set by law | • number of local taxes<br>• ratio of local taxes to current and total revenues | Municipal fiscal statistics<br>Tax legislation |

The third column indicates the potential *sources of information*, where the relevant information should be found. Standardised tables on fiscal data exist as well[2].

### Scoring

Each benchmark will be assessed on a ten-unit-scale, which allows refined scoring along the continuum from zero to ten.

Four types of professional assessment are converted to scores, as follows:

(i) Component does not exist or is inconsistent with the recommendation: => 0
(ii) Factor exists, but does not properly match with the recommendation: => 3
(iii) Specific item follows the recommendation, but incomplete: => 6
(iv) Benchmark is perfectly in line the recommendation: => 10

This scoring will be combined with weighting for the components for some recommendations. The weighted averages are calculated for those recommendations, which are assessed through groups of benchmarks.

### Statistical data on government finances

There are several international statistics, which might be the bases of data collection on government finances (IMF's Government Finance Statistics*,* OECD Revenue Statistics/ Fiscal decentralisation database*,* Eurostat Government Finance Statistics*).* For the development of the benchmarks the European System of Accounts (ESA 1995) was used. The datasets on national and local government expenditure, revenues and intergovernmental fiscal relations should be based on the European standards.

The existing statistics address three basic issues of intergovernmental fiscal relations. The first one is the *composition of own revenues*, which include shared taxes and local taxes in the Council of Europe recommendations on financial resources. As revenue sharing is an important source of municipal funding in the targeted CoE member countries, careful analysis is needed for specifying the real taxing autonomy. For assessing local government fiscal autonomy, here the taxonomy developed by the Network on Fiscal Relations Across Levels of Government (OECD) was used. For specifying the status of fiscal decentralisation, each and every local tax revenue is classified by unified criteria.
The other critical issue is the specification of *intergovernmental transfers*, grants, subsidies, donations, etc. There are three dimensions for characterising a transfer:

(i) What *type* of grant: general or earmarked?
(ii) *Method* of central budget allocation: formula-based or not?
(iii) Scope of *local autonomy* in using the grant: conditional or discretionary?

---

[2] E.g. OECD Fiscal decentralisation database - http://www.oecd.org/tax/federalism/fiscal-decentralisation-database.htm

All international datasets, including for general fiscal indicators of decentralisation, and for analysing the various types of grants and transfers, should be adjusted to domestic fiscal information systems, available in the countries of implementation.

**Implementation**

The benchmarks of fiscal decentralisation proposed here are exclusively based on the Council of Europe recommendations. This standardised methodology for assessing the scope and focus of fiscal decentralisation should be tested and later further adjusted to local circumstances. The actual use of the benchmarks should be preceded by:

a) *expert comments* from national experts in the countries of implementation. The reviewers should focus primarily on the adaptability and feasibility of the proposed benchmarks. The two types of benchmarking techniques (central and local) will be reviewed from a methodological point of view, as well.
*b) testing* in a country which is interested in the results of an assessment or which is relatively well researched, so the results can be verified through other sources.

Following the technical comments and the testing stage, there are several options for the actual implementation of benchmarking:

- in one country, gradually building up pan-European averages as points of reference for central authorities;
- regional comparisons for country groups, like the Nordic or Caucasus countries;
- local authority benchmarks in one country, at least in three or four municipalities.

The actual use of the benchmarks should be based on the cooperation of (i) experts responsible for international comparison and (ii) local expert teams. The standardised benchmarks should be adapted to the local conditions. Beyond translation to local language, the terms and dimensions of comparison, benchmarking should be adjusted to the domestic conditions, as well.

In each country team at least three types of expertise are needed for responding to the questions raised through benchmarking: (i) local government finances and intergovernmental fiscal relations; (ii) public budgeting, reporting, auditing and (iii) government accounting.

In both areas of fiscal decentralisation benchmark-based evaluation of central authorities might be implemented in different ways:

(i) national governments sign up for benchmarking and implement it (in-house or by contracting it out);
(ii) assessment by local government associations or local think tanks;
(iii) external evaluation by international experts in cooperation with local partners.

At the local authorities' level, benchmark-based evaluation can be done through self-assessment (in-house or contracting it out to consultants), followed by a peer review.

The tested and fully elaborated benchmarks of fiscal decentralisation might be used by several potential partners, who could also provide funding:

(i) Council of Europe, EU, and/or national governments could jointly finance the assessment;
(ii) in cooperation with CoE central levels can be evaluated;
(iii) benchmarking is built into the next stage of the Fiscal Decentralisation Initiative.

EN

Website

Centre of Expertise for Good Governance
https://www.coe.int/en/web/good-governance/centre-of-expertise

COUNCIL OF EUROPE

CONSEIL DE L'EUROPE