

**FISCAL DECENTRALISATION IN EU APPLICANT STATES AND SELECTED  
EU MEMBER STATES**

**Executive Summaries on EU Applicant States and EU Selected Member States**

**PREPARED FOR THE WORKSHOP ON "DECENTRALISATION: TRENDS, PERSPECTIVE  
AND ISSUES AT THE THRESHOLD OF EU ENLARGEMENT"**

**To be held in Denmark on October 10-11 2002**

**Paris  
September 2002**

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**1. EU APPLICANT COUNTRIES – EXECUTIVE SUMMARIES**

## 1.1 BULGARIA

### *1.1.1 Main features of local finance and intergovernmental fiscal relations*

Bulgaria is a parliamentary republic and an integral (unitary) state with local self-government where no autonomous territorial formations are allowed to exist. The Bulgarian system of local self-government comprises only one sub-level – municipal councils (governments). The organisation and manner of operation of local self-government authorities and local administration are regulated by the Local Self-Government and Local Administration Act adopted in 1991.

Local governments autonomy is guaranteed by the Constitution of the Republic of Bulgaria, the Local Self-Government and Local Administration Act, the Municipal Property Act, the Republic of Bulgaria Administrative and Territorial Division Act, the Municipal Budgets Act and the Local Taxes and Fees Act.

The territory of the Republic of Bulgaria is divided into municipalities and regions (districts). The administrative territorial organisation of the Republic of Bulgaria as of the end of year 2000 comprises 262 municipalities and 28 districts. As of the end of year 2000, in half of the municipalities the population was between 10,000 and 50,000 people and 41.5% of the total population of the country was living in 13 municipalities.

The municipality is the basic administrative territorial unit at the level of which self-government is being practiced. The municipality is a legal entity. The self-government body within the municipality is the municipal council elected directly by the population of the respective municipality for a period of four years. The mayor is the body of executive power within a municipality.

All municipalities regardless their size enjoy the same rights and responsibilities. The responsibilities of each municipality are divided between it's own (education, welfare services, street cleaning, etc.) and delegated ones. Component administrative territorial units within the municipality are the parishes (settlements).

According to the Constitution, local authorities are free to associate in the solution of common matters. All municipalities are being represented by the National Association of the Municipalities in the Republic of Bulgaria and there exist also other associations established on a regional or other principle. Municipal budgets were actually separated from the central budget in 1993 with the introduction of the Methodology of Determining the Budgetary Relations between the Central Budget and Municipal Budgets. According to the Organic Budget Act, resources should be provided in the central budget for financial support of the municipalities. The resources are allocated in the form of general-purpose grants on the basis of objective criteria and in concrete cases specific grants or subventions can be used. The state can support municipalities also by conceding (remitting) state revenues.

From budgetary point of view municipalities are first level spending units. Municipal budgets are not subject to approval by the National Assembly. According the Republic of Bulgaria's Annual Budget Act only the relations between municipalities and the central budget are approved, i.e. the concrete amounts of the grant – general purpose and specific one are defined and the size of the contribution due by municipalities to the central budget respectively. In compliance with the Municipal Budgets Act, the Republic of Bulgaria's Annual Budget Act for the respective year and the Local Self-Government and

Local Administration Act municipal councils consider and approve the proposed by the mayor of the municipality budget for the respective year.

The ratio of the central budget grant to the overall budget of a given municipality is an indicator for that municipality's financial dependence on the state. In Bulgaria dispersion between the municipalities under this indicator is very high. In 2000, the netted budgetary relation between the municipalities and the central budget was BGL 746 million, comprising BGL 762 million grants and BGL 16 million contributions to the central budget.

Municipal budgets fund general secondary schools, partly hospital care through municipal hospital companies, fully the social support system, public works, expenditures related to the coming generation – crèches and kindergartens, libraries, museums and other expenditures.

A region is an administrative territorial unit entrusted with the conduct of regional policy, the implementation of state government on a local level, and the ensuring of harmony of national and local interests.

Each region is governed by a regional governor directly appointed by the Prime Minister and aided by a regional administration. The regional governor ensures the implementation of the state's policy, the safeguarding of the national interests on the territory of the region, of law and public order, and exercises administrative control. There are 28 regional administrations established on the basis of the 28 regions in which the territory of the Republic of Bulgaria is divided.

The regional administration is a body of the central government and exercises its competencies dependent of the central government. It has only co-ordinating and supervising functions with respect to municipalities. Regional administrations are second level spending units financed by the Council of Ministers budget.

### ***1.1.2 Major empirical findings***

Since 1997 Bulgaria is under currency board arrangement. Sustainable fiscal policy and reform are critical if macroeconomic stability has to be maintained under a currency board. The currency board arrangement has been supported by a restrictive fiscal policy and abrupt speeding up of the structural reforms. In accordance with the Constitution, municipalities' permanent sources of revenues are established by law. The most important source of local budgets is tax revenue.

The state has conceded to the municipalities 50% of the personal income tax, collected on the territory of the relevant municipality, and 10% of the profit tax, which in the Corporate Income Tax Act has the name "tax for municipalities". Nevertheless, the greater part of the municipalities is not in position to self fund the public services they have to provide to the population and need state grants. Only a few local governments are self-sufficient – in 1998 their number was 18, in 1999 – 8 and in 2000 - 13.

The Constitution of the Republic of Bulgaria explicitly provides that taxes shall be set only by law, i.e. they are a prerogative of the National Assembly. This means that "local parliaments" are deprived of the right to impose on their citizens additional tax burdens in cases of need for funds or when the economic situation changes.

Municipal administration assists tax administration authorities in setting the tax base (gives information regarding concrete local fees sizes, permissions for use of municipal property for trade and advertising, the number of lease contracts negotiated and the amounts there under, changes in the ownership of housing,

etc.) required for setting taxes and fees rates and for the control on the collection of revenues in the municipalities' budgets.

Under performance/over performance of tax revenues during the year is on the account of the central budget, while under performance/over performance of non-tax revenues is on the account of municipal budgets. The projected impressments of tax revenues over performance for the central budget contained also the over performance of local taxes, like property tax and the other taxes. To avoid this iniquity in 2002 it is projected to impress only the over performance of personal income tax and tax for municipalities' revenues.

Non-tax revenues form about 20% of the overall municipalities' own revenues. Fees bring over 50% of non-tax revenues. According to the Local Taxes and Fees Act, a municipal council has the right to set the size of the fees within the limits provided by law. Municipal administrations collect fees with the exception of the household waste fee, while local taxes and household waste fee are collected by the tax administration authorities, which are under the subordination of the Ministry of Finance. The possibility for granting municipalities the right to set the size of local fees themselves is under consideration at the moment.

Expenditures made from municipal budgets, considered as a share of GDP, remain comparatively stable and at the same level during the three years under consideration – 8% of GDP. However, analysing them by types, i.e. according to the functions they are directed to, we see changes in their percentage of the overall municipal expenditures. This is explained mainly with the ongoing structural changes and changes in the financing of the respective branches. Health care expenditures decreased in 2000 because since mid-1999 the funding of out patient care moved from municipal budgets to the Ministry of Health. In 2000 the process of the transformation of hospitals into companies financed both by the municipalities and the Ministry of Health began. Despite the separation of out patient care in 1999, municipalities still had relatively high health expenditures that year, because of the additional resources the central budget disbursed to them to cover the unpaid liabilities of the respective health establishments. The decrease in health expenditures is compensated by an increase mainly in education and social security and welfare spending. Reviewed data for year 2000 show the percentages of municipal expenditures out of national level by types: general public services 8%, education 31%, health 21%, social security and welfare 16%, housing and community amenities 15% and others 9%.

The Bulgarian education system comprises non-mandatory pre-school education, eight-course elementary education, four-year secondary one and different types of university education programmes. There are two categories of elementary and secondary schools depending on the form of their management and financing. The first category of schools are directly under the Ministry of Education and Science or other line ministries and can be called "schools of national interest" – specialised vocational schools, schools for disabled children, transport, trade and other schools. The second category of schools are managed and financed by municipalities within their budgets. However, municipalities' powers in respect of municipal schools resources management are very much limited by the national standards for the number of students in a given class and the number of school hours. The same is valid also with regard to the power of municipalities to optimise the personnel engaged in municipal education – headmasters are being appointed by the Regional Education Inspectorates (under the subordination of the Ministry of Education and Science), the number of employees and their average wages are also set by the Ministry of Education and Science. Prognostic data for number of personnel employed and average wages, number of students and number of classes participate in the formula for determining the grant for each municipality.

A novelty in the system of education funding is the model of delegated budgets developed under a PHARE pilot project which started in 1998. With this approach headmasters receive the whole amount of their budgets and manage them themselves. They have the right to allocate resources for budget items at their

own discretion and to keep the savings together with any other additional revenues they might receive. It is expected that the model of delegated budgets will lead to tangible improvement in the effectiveness of the resources used.

Social assistance in the Republic of Bulgaria includes granting of social benefits and aids in kind:

- benefits to guarantee a minimum income;
- allowances under the Births Encouragement Act;
- benefits in cash and in kind for disabled people;
- energy assistance for heating in winter to families of low means;
- services provided by the social cares authorities.

Social assistance funding is shared between the central government and the municipalities. Every year when the budget of the state is being prepared the Ministry of Labour and Social Policy calculates the amount of resources required for social assistance. In the grants transferred to the municipalities by the Ministry of Finance there is a specific social benefits grant, which until the end of 2001 represented 50% of the overall amount of social benefits municipal social assistance authorities had to pay to the population. For 2002 this amount is already 75% in the form of specific grant and 25% provided from municipalities own resources. Energy assistance is an exception of the described above manner of funding social benefits expenditures. It is funded in full by the state budget through specific transfers to the municipalities during the heating season.

In 1999 the Republic of Bulgaria began radical reforms in the health care sector. From 1990 till 1999 the universal health care system suffered from a lack of investment and the consequent decline in the quality of services provided at an increasing cost to patients as side payments became the norm. The quality of health care varied with patient's employer, location and ability to provide side payments. The main objective of reforms is to improve the population's health condition indicators and to create incentives for more effective spending of the resources. These reforms hold the promise of considerably reducing the role of Government in this sector. A National Health Insurance Fund was established to act as intermediary in the provision and purchase of health services on the basis of contracts negotiated with general practitioners, group practices or hospitals, registered as companies. It performs the administrative functions in accumulating funds from the health insurance contributions collected from the population and their allocation for financing of health services. The reform seeks to gradually develop an efficient mix of private and public health care while eliminating the system's bias against basic and preventive care, albeit at a higher explicit cost to individuals. Health insurance of the unemployed is financed by municipal budgets. The principal challenges are to avoid an escalation of costs, to finance hospitals and specialised care without increasing contribution rates, and promote supplementary private health insurance. With the old health care system subsidising of expenditures was done either directly through the Ministry of Health Care or by the municipalities through including certain health indicators when grants for municipalities were determined. The establishment of the National Health Insurance Fund resulted in abrupt decrease of municipalities' share in health care spending.

One third of the hospitals in Bulgaria are the property of municipalities in the form of municipal companies established in pursuance of the Health Establishments Act. By the end of year 2000 they were financed as hospital establishments directly from municipal budgets. From 2001 their gradual transformation into joint stock companies, wherein municipalities have shares, has begun. Hospitals are managed by Boards of Directors who sign management contracts with the Ministry of Health Care, the municipalities respectively. A process of accreditation is ongoing, performed by the Ministry of Health Care, to ascertain the abilities of hospitals to meet the standard quality requirements in order to receive the relevant funding.

### **1.1.3 Major problems in fiscal design**

When we consider fiscal design problems, we should mention in the first place the servicing of the country's external debt, which represents a considerable part of GDP. Our country is under a currency board arrangement since 1997, which has led to limiting the resources for the respective systems, municipal and social spending inclusive. The ongoing reforms in all key branches of social and economic life that have not finished yet place municipalities in a very dynamically changing environment and make financial and material indicators difficult to compare over the years. The still ongoing state and municipal enterprises privatization strongly influences economic relations within the municipalities by affecting and sometimes radically changing the structure of the revenue side of municipal budgets. In respect to local governments' autonomy in looking for revenue sources to finance public services provided to the population we should note the restricting regime provided in the Constitution of the Republic of Bulgaria regarding the establishment of taxes and their size by the municipalities. It is only in the powers of the National Assembly to establish taxes and their size. In this way municipal councils are deprived of a mechanism of flexibility in ensuring funds for their operations.

A discussion is ongoing at the moment regarding the clear definition of the competencies of municipalities in respect of the functions assigned to them by the state and their financial provision. Together with the National Association of the Municipalities in the Republic of Bulgaria a valuation and differentiation is being made of municipal responsibilities and those delegated by the state by comparing them with the respective parts of own revenues, which are also being divided on the basis whether the revenue source is defined as a municipal or a state one.

The local governments have to improve the financial discipline of the municipalities' enterprises and their performance through special treatment for loss-makers.

### **1.1.4 Status of policy reform considerations**

The main aspects of the ongoing reform in local self-government are outlined in the Government Program for 2001-2005 and include:

- Strengthening of municipalities' fiscal decentralisation;
- Optimisation of state and municipal responsibilities for public services provided;
- Improvement of the mechanisms for allocation of budgetary relations between municipalities and the central budget.

The above stated tasks comprise the resolving of the following issues:

- Division of state and municipal responsibilities as a first step towards a justified financial assessment of the rights and responsibilities delegated to municipalities;
- Delegating to municipalities the right to set local fees rates themselves;
- Improvement and optimisation of the Methodology of Determining the Budgetary Relations between the Central Budget and Municipal Budgets, making it more transparent and clear;
- Development of a system of measures for decreasing municipalities' arrears;
- Separation of capital from current expenditures;

- Improvement of the mechanism of social security and welfare funding;
- Carrying out of a discussion with regard to the Capital Municipality budget status, taking into account its specific functions as the country's capital.

The budgetary reform implemented in Bulgaria is directed towards overall reorganization of the budget process, attainment of comprehensiveness and consolidation of information, increase of fiscal transparency and strengthening of fiscal discipline.

Local Governments have the real power and responsibility for the preparation and implementation of their budgets adhering to the main budgetary principles, the uniform budget classification and requirement for being co-ordinated with the state budget. The wide range of improvements in the budget process in Bulgaria is designed to be consistent with best practices in EU and other OECD countries.

Decentralisation policy is remaining a priority item in the Government's reform agenda. Main tasks facing local budgetary management in Bulgaria are to ensure efficiency of public services provision, improve capability of municipal financial officers for management of scarce resources and develop better a allocation system, promoting in such way the principles of budgetary autonomy.

## 1.2 CZECH REPUBLIC

### *1.2.1 Main features of local finance and the inter-governmental relation*

The Czech Republic has a unitary status. Up until 2001 there were only two tiers of government - central government and local government at municipal level. Local government covers more than 6 000 municipalities. The autonomy of local government is granted by the Constitution and the Act on Municipalities.

The local government budget is separated from the Central government budget. The only link is given by the grant system. All municipalities regardless their size enjoy the same rights and obligations. Each municipality represents a legal entity. Its responsibilities are divided between own and delegated ones. The own responsibilities include among other tasks in education, welfare services, housing, health care, culture, public safety, street cleaning, water, electricity and gas supplies, sewerage system. Among delegated responsibilities can be found: birth, death and marriage registers and building permissions. Different tasks in environmental protection, sanitation, statistics and so on belong also to this group.

The basic reform of local government system took place in 1993 together with the overall tax reform. Since that the local finance system underwent several minor changes. The radical change took place only in 2001 together with regional government installation.

The most important source of local budgets is tax revenue. There are no local taxes, only local fees at present. Municipalities participate on personal income tax and corporate income tax. They also receive the total yield of real property tax collected within their territory. As concerns the tax on buildings, the base is given in the form of physical parameters, the usage plays also a certain role.

The income tax sharing was up to 2000 including as follows. Municipalities were granted 20 % of the total yield of corporate income tax. The municipal share was distributed on the base of population of each municipality. The personal income tax has three parts in the Czech Republic. First, it is the wage tax, which was distributed among municipalities according the district collection. Municipality, in which employers' office was registered, received 10 % of the collected amount, 20 % was distributed according the number of citizens in each municipality within a given district, and the rest was assigned to the central government. The unincorporated income tax yield was allocated to the municipality, in which the particular entrepreneur had his permanent home address.

This above described system led to growing disparities among municipalities of different size and location. It was seen injustice as any municipality could influence this revenue only very little. It also led to a special competition among municipalities concerning the location of employers' registered office and permanent home addresses of entrepreneurs. It was a competition, which had nothing to do with building up a bigger tax base. Moreover, some additional cost was involved, which then lowered the tax revenue for municipal sector.

The change applicable since 2001, however, did not solve the problem of a rather small municipal discretion over their revenue. A certain room for own decision of local government is provided only by local fees. In this case local government also administers this revenue source. The law sets the list of local fees and their upper limits. Some of local fees are planned to be transmitted into local taxes. The fee on

operated gambling machines, on recreational units and the fee on use of public space are examples of local fees.

The system of central government grant consists of mainly operating subsidies, which are decided each year when preparing the central budget. They do not take into account the revenue level of any municipality as they are calculated as a certain amount per pupil in pre-school facilities and primary schools, per bed in social care facilities, as a contribution to the tasks of state administration provided by local government and so on. Capital grants are as well decided when preparing the central budget on ad hoc base. Once started projects have the priority.

All grants transferred to local government are specific grants in the sense that their provision does not allow local government to allocate them according their discretion. The precise use of grants is defined by the central government. In case that a municipality does not succeed to spend the grant amount in the given year and for the given purpose, it must return this amount back. All municipalities, which received a grant, must make an annual statement for these grants.

### **1.2.2 Major empirical findings**

The local government sector is separated from the central budget. The only link is the grant system. There is only one level of local government – municipalities. All municipalities, regardless of their size, have the same rights and obligations. In 1999, there were 6,239 municipalities in the Czech Republic. The number of them grew at the beginning of nineties, immediately after the law enabled even a tiny part of a municipality to separate. 90 per cent of municipalities have less than 2 000 citizens. More than half of the inhabitants live in big cities of over 10 000 citizens. The size structure of municipalities is therefore fragmented: small and very small municipalities prevail. However, the role and tasks of municipalities are defined by the law, regardless of their size.

Total sub-national revenues account for 20.8% of total government revenues and for 8.6% of GDP. As a share of total sub-national revenues tax revenues represent 47.7%, non-tax revenues 36.3% and grants 16.0%.

The composition by type of tax of sub-national tax revenues shows that taxes on incomes and profits are the most important item (89.4%), followed by taxes on property (5.6%) and taxes on goods and services (4.9%).

A substantial exemption in public revenue development represents a 1999/1998 increase in "other non-tax revenues" of 127 per cent, which is caused by the 185 per cent jump at the local government level. This development reflects extraordinary capital revenue. Municipalities sold their securities, mainly shares of companies supplying gas and electricity, and others.

The distribution of non-tax revenue depends on the municipality population because the state originally distributed the shares of supply companies to municipalities according to the size of their population. So, the minimum municipal revenue was CZK 1,400, while the bigger towns received millions of CZK; the maximum reported revenue was CZK 528.2 million.

The "current" grants cover both capital and current (operating) grants. Capital grants represent about 40 per cent of the total amount; development is slightly declining – 43.6 per cent in 1997, 40.4 per cent in 1998 and 39.4 per cent in 1999. With regard to the development of non-conditional grants and conditional grants at actual costs, the decrease in 1998 was caused by a reduction in capital grants. Local government receives grants from both the state budget and state funds; e.g. in 1999, State Environmental Fund granted municipalities a total amount of CZK 1,283 million.

In the Czech Republic, the most important municipal policy sectors are (1) housing and community amenities, (2) transportation and communications, and (3) general public services.

### ***1.2.3 Main problems in the fiscal design***

Some problem of the tax sharing system valid up to 2000 were already removed by the change in 2001. At present there is a necessity to change the tax sharing system in the way, which would enable to introduce a link between the municipality effort and its tax revenue.

Generally, all taxes in the Czech Republic are decided by the central government fixed in legislation, central government also collects and administers all taxes. Local government in the Czech Republic has only very limited tax authority. At present, the local government control over tax rates, tax bases and collection is not significant – less than 3 % of total municipal tax revenue could be called as actually own taxes of local government. Municipalities have a certain room when deciding rates of real property tax and local fees rates (with restricted discretion over fee base).

Local taxes installation is almost an evergreen in the policy debate on local finances in the Czech Republic. The apparent fear that local government would radically increase the tax burden is still too strong to introduce local taxation or anyhow increase the influence of a municipality over its revenue. Nowadays local government has only very limited power to decide its revenue. That makes them too dependent on sharing taxes and grants and receipts from sale of their property.

Relatively low yield of the property tax and its decreasing share on the total local government revenue are other issues to be solved soon. The new property tax should be based on market prices and give municipalities more discretion over this revenue. Also numeral exceptions, which exist at present, should be reduced.

The whole system of regional government finances is under consideration only. At present regional elected representatives often complain that they have almost no way how to get funds to manage their office and tasks properly. To prepare a new schedule might be very difficult due to the fact, that particular regions will be given different facilities and therefore have different needs of funding. This complicates the introduction of the unified system of their financing.

What to do with district office is another task to be solved. At present they provide a wide range of state administration tasks as well as many services, which do also municipalities. In many cases these functions were left to them because of the very small size of prevailing municipalities. The present consideration includes that district offices should be abolished by year 2002. Yet, there is no mechanism, how to transfer some of their functions to the regional level of government.

### ***1.2.4 The status of policy reform consideration***

The overall public sector reform is just proceeding. It has several tasks. First of all it is the establishment of regional self-government. First regional election took place in November 2000 and this way the local councils for 13 regions were elected. Prague, which is a municipality as well as region, will hold first election together with municipal election in 2002. Financial terms and responsibilities will be provisional for first two years of their existence. In this period they will be under close control of the central government and will be financed mainly through central government specific grants. Their present responsibilities, as given in a special law, include among others regional development, environmental protection, some roads, regional transport, secondary education, social care facilities, museums, and big libraries. Particular facilities needed for carrying out these tasks will be transferred during this year.

In the year 2001 a new system of tax sharing was established. The sense of this change was to bring more justice into the system. The underlying condition was not to change the relation of the proportion of central budget and local budgets tax revenue. Into the sharing system now belong not only income taxes, both personal as well as corporate ones, but also value added tax. Within the personal tax not only wage tax is shared, but also the unincorporated income tax. All shared taxes are allocated among municipalities on the base of the total yield collected and according the number of citizens of each municipality. There are some coefficients involved that make the sharing more favourable for bigger municipalities (new sharing rules could affect the amalgamation process, but in January 2001 the number of municipalities increased by seven). The further improvement of this sharing principle is still under consideration. It should connect in a better way the effort of a municipality with its tax revenue.

The public sector reform follows following tasks:

- improvement of the overall efficiency of public sector;
- stress on transparency of funds spent and on the stability of the finance system;
- increase of the control mechanism;
- introduction of medium term financial planning, and
- local taxes installation.

As the main tool of the improvement of the overall efficiency of public sector is considered further transfer of functions from the central government to lower tiers of the government. Standards of the accessibility and quality of public services are being worked out and are supposed to improve the public services provision. Similar role is seen in building up an unified information system for the whole public sector and in using modern management methods, tools, and forms.

The transparency should be improved by the existence of clear rules and responsibilities split within the general government, by clear definition of the government sector towards private one, by availability of reliable and understandable set of information, and by including all necessary items into the relevant budget. The unified government account will be established, which enable the integration of all public information systems and the link among expenditure and cash management. This single government account should also bring some savings as far as the borrowing cost is concerned.

The establishment of the State Treasury is under preparation. It will monitor and check public funds operations also (at lower levels of government and in case of extra-budgetary funds will check the flows from the central budget), provide public debt management, management of EU funds, and prepare medium term financial outlook

The new budgetary law adopted in 2000 introduced besides ex post control also ex ante control and the division of management and control functions.

Medium term planning should include not only expected revenue and expenditure items in needed composition for a given period of time, but also the assessment of impacts of today's decisions for future revenue and expenditure.

Local tax installation should increase the local government discretion over its revenue. It is also supposed to introduced more accountability into the local government spending.

### ***1.3.1 Main features of local finance and intergovernmental relations***

The basic provisions concerning local government level in Estonia are laid down by the Constitution of 1992. The Constitution recognises the principle of local government and states that all local issues shall be resolved and managed by local authorities, which shall operate independently pursuant to law.

Estonia is currently divided into 247 local government units. Estonia has had a one-tier local government system since 1994. Among the 247 local governments, there are 42 towns and 205 rural municipalities. Towns and rural municipalities are equal in their legal status.

As there is no regional government level in Estonia, the co-operation of municipalities within a county is of great importance to municipalities both in their relations with central authorities and in co-ordinating their own activities. Local authorities have a constitutional right to form associations or establish joint institutions. Associations of local authorities within counties carry out tasks set by the central government as well as by local authorities.

The basic functions of local government include the organisation of social services, welfare services for the elderly, housing and utilities, the water supply and sewerage, the provision of public services, physical planning, public transport, and the maintenance of local roads and streets. Local authorities maintain pre-school childcare institutions, primary and secondary schools, libraries, community centres, museums, sports facilities, shelters, care homes, health care institutions and other agencies and institutions founded and/or owned by the local government.

Most local government responsibilities are full and exclusive, but there are some tasks shared between the municipalities and the central government. In addition to local functions, municipalities carry out a few central government administrative tasks which can be passed on to local authorities by a contract between an authorised central government body and a specific local government unit.

### ***1.3.2 Major empirical findings***

In Estonia, general government revenues consist mainly of taxes – the share of taxes is approximately 90%. The Estonian tax system has been relatively stable since 1994. The share of local government revenues in general government revenues has been above 20% during recent years. Personal income tax – 56% of which is local government revenue – amounts to about 60% of local government total revenues.

Amongst taxes, land tax also forms quite a significant share. With regard to local government non-tax revenues, property income and sales have traditionally been important. In Estonia, local governments rely somewhat on grants from central governments but not very much – the share of these has been 22-23% of local government total revenues, over the last few years.

Personal income tax constitutes, on average, ninety-one percent of the total tax revenue paid to municipal budgets. There are considerable differences in the income per capita between municipalities. The receipts from personal income tax per capita differed by about 11 times between the richest and poorest municipalities, in 2000. The trend is for income to grow faster in those municipalities which are located closer to Tallinn.

Revenue from local taxes only represents a small share of the local budget. The total proportion of municipal taxes does not exceed one percent of local government revenues. Several taxes have not been imposed by any of the local authorities during the last few years and thus remain only theoretical.

There is no special regulation for local government non-tax revenues. The most considerable part of non-tax revenues comes from the so-called own revenues, which are used by the institutions collecting these. Although most of the own revenues have been included in the budget there are still some local governments which do not show all of their revenues in the budget. By law, all revenues should be included in the budget.

The financial resources allocated from the central government budget for the support of local budgets are called the Support Fund. The amount of the support fund in a draft central government budget, and its distribution, are determined during the negotiations between the representatives of the associations of local authorities and the Government of the Republic. There have been lots of ideas lately on changing the principles for the distribution of the support fund. There have been discussions to increase the importance of local taxes and on taking more precisely into account the expenditure needs of local governments distributing the support fund.

In addition to the Support Fund, there are allocations intended for specific purposes. The number of specific grants is changing from year to year. Local authorities also fulfil several tasks which are, in principle, the ones of central government but can be executed more effectively by municipalities. The funds for financing these tasks are transferred to local budgets through the budgets of ministries.

### ***1.3.3 Major problems in the fiscal design***

Local government expenditure has made up about 20% of general government consolidated expenditure in recent years. Most of local government expenditures have been made in education – about 40% of total expenditures. Since the beginning of 2001, the importance of local governments has been growing, in this regard, as the Estonian government has decided to move all costs of primary and secondary schools over to the responsibility of local governments. This sees the share of local educational expenditures grow to more than 50% of total local expenditures.

Altogether, there are hundreds of local functions, most of which have to be carried out by all local governments. Certainly there are differences in the costs of covering these functions, based on more or less objective reasons. But because, on one hand, no comprehensive analysis has been done, and, on the other, not a single local government admits that financing is high enough, it is hard to speak about efficiency and effectiveness in municipalities.

In general, the differences in costs are not very big. One exception is certainly in general public services. Expenditures on these services represent around half of total current expenditures in the smallest local governments, whilst the average is only about 13%. Of course, the size of government is crucial in other spending areas, as well, but this is not so clear as in general public services. In education, for example, even people in the smallest local governments are used to having their “own” schools.

There have been thoughts on mapping the functions of local governments for some years, already. At least this would help to find out what the exact tasks of local governments are, and what the costs of fulfilling these tasks have been. In practice, nothing has been done so far.

The general government deficit and the official debt burden have been relatively small in Estonia. Similarly to general government, the local government budget has been close to balanced – even though always in slight deficit over recent years. Accordingly, gross debt has been at the very low level of about

2.5% of GDP, and net debt at around 1.5-2% of GDP. Central government has, in few cases, helped local governments in debt by providing them with additional loans, and only one municipal government has been bailed out so far. In this regard, no uniform regulation has been worked out yet.

#### ***1.3.4 Status of policy reform consideration***

During recent years, no finance reforms have been carried out in Estonia. Discussions are held on the necessity of financial, territorial and organisational reforms in the field of local government. As a part of natural development, sixteen local government units have amalgamated into eight units and one local government unit has been divided into two, recently. Since 1996, no changes in the local government budget formation have been carried out.

There is some evidence that smaller local government units have smaller administrative capacity in the level of public service provision and infrastructure conditions. A lot of research has been carried out on the local government socio-economic situation. They state under-performance of some local government tasks in some smaller municipalities, mainly due to scarce financial resources. Some local government units have been faced with problems in fulfilling their financial duties e.g. in relation to the burden of loans on the budget, or buying public services from other municipalities.

In order to improve local administrative capacity, an administrative reform is being prepared in Estonia. There is political consensus on the fact that reforms to improve the efficiency and administrative capacity of local government units are necessary. There is an unavoidable need to reduce the number of local governments. It is obvious that almost all functions are relatively more expensive in smaller local governments. However, this does not necessarily mean that bigger ones are more effective.

At the same time, central government is planning a reform whereby additional tasks will be delegated to the local level of government to order the division of tasks between central and local government. The additional tasks will have to be financed from the central government budget. Central government will affect local expenditure by determining the mechanism for financing the additional tasks. Also, the central government is planning a reform of the mechanism of local government budget equalisation.

The reforms are still under discussion and no final political decisions have been taken yet.

## 1.4 HUNGARY

### *1.4.1 Main features of local finance and intergovernmental relations*

In line with the principles of deployment of powers laid out in the Constitution the act on local governments specifies the detailed rules on the types of local governments, their mandatory responsibilities and the economic foundations of their operation.

The Hungarian system acknowledges only local governments as the base of the one-tier subnational local government system. In terms of type a local government may be a municipal government (that of a village, town, county right town, the capital city and its districts) or a county government. These, however, do not constitute a hierarchy, for the distribution and controlling functions of the former county councils have been terminated.

It should also be noted that the system established in 1990 is excessively fragmented. A total of 1,600 councils were replaced by 3,115 local governments - one for each settlement.

Over recent years the number of local governments continued to increase through separation of some formerly integrated municipalities and this process has not yet come to an end. On 1 August 2000 a total of 3,177 municipalities were operating. In the case of more than half of the total of almost 3,200 municipal governments the population is below 1,000, while in almost 300 municipalities the population is below 200.

Along with the fragmented structure of the local government system, local governments perform and exercise a very wide scope of responsibilities and powers. Local governments perform functions in almost all areas of the state responsibilities.

Despite all local governments have almost identical rights and responsibilities, in a large number of municipalities the number of inhabitants and financial resources are not sufficient for the efficient and economical performance of the services required by the population.

### *1.4.2 Major empirical findings*

The year 1990 was something of a milestone in the regulation of the funding sources of local governments since an entirely new regulatory system was introduced.

Former funding regulation system was a centrally controlled, so-called expenditure oriented financial regulation system which was based on the establishment of the expenditures on an individual bargaining basis. State subsidies were determined as the difference between the amount of spending and the local revenues.

In 1990 it was replaced by a so called resource oriented regulation system where the potential spending of a local government for the provision of public services is determined on the basis of the disposable resources (funds) realised by local governments. Instead of the earlier practice, the basic principle of the new resource regulation is that the central budget contributes to the performance of the mandatory duties specified in the act on local governments and the sectoral laws for which local governments also have to involve their own revenues.

This system is aimed to incent local governments and their institutions to perform economical financial management - whilst complying with the standards specified in the sectoral laws.

In order to ensure a balanced economic growth reduction of income concentration is one of the key points of the Government's fiscal policy. The proportion of the operating revenues of the general government system had dropped from the 44.2 percent of GDP in 1996 to 41.6 percent by 1999. In line with the reduction of the share of the general government system as a whole local governmental revenues had decreased from 11.8 percent of GDP in 1996 to 11.1 percent by 1999.

**Tax revenues** represent 82-85 percent of the operating revenues of general government. These revenues has dropped over four year period from 36.8 percent to 35.5 percent of GDP.

Some 8-10 percent of tax revenues of the general government are booked among the current revenues of local governments representing 33 percent of their total revenues.

Despite the reduction of the centralisation of incomes in the general government system the share of local governmental tax revenues has increased from 3 percent to 3.7 percent of GDP during the same period.

Tax revenues of local governments fall into two large categories: shared taxes and duties, and local taxes.

**Shared taxes and duties.** 40 percent of the centrally imposed and collected personal income tax is transferred to local governments, 15 percent is redistributed to the place of income generation, while 25 percent is allocated normatively taken into consideration the local tax potential. Duties are collected by local governments, a percentage of which is transferred to the central budget

**Local taxes.** In order to enable local governments to perform public services in line with the local characteristics and requirements and to provide them with means for financial management a system of local taxes was developed in 1990. The state has partially transferred its traditional right of taxation - reserved for Parliament - to local governments within the limits specified by law.

Under authorisation by and in accordance with the provisions of the act on local taxes the council of elected representatives of a municipal government may issue decrees imposing local taxes.

However local governments are not under obligation to introduce and collect local taxes. The act on local taxes establishes the possibility of taxation.

The number of local governments collecting local taxes and their revenues have been steadily increasing. In 1999 a total of 2,970 local governments - 93 percent of all local governments - applied local taxes. Local taxes accounted for some 18 percent of all current revenues in 1999 - to be compared with the mere 3.5 percent in 1990. The most frequently applied locally imposed tax type is the local business tax accounting for some 84 percent of all local governmental tax revenues.

Most of the **non-tax revenues** of general government are collected in the central budget. The share of local governments of such revenues accounts for an estimated 30 percent, representing 18 percent of their total revenues.

The rules on the establishment of these non-tax revenues are specified by decrees issued by the Government and line ministries concerned. Charges and fees applied by a local government are established and announced by local governmental decrees. In some cases decrees also determine the mandatory allowances to be applied by local governments.

**Grants.** For the performance of their mandatory responsibilities local governments are entitled to grants from the central budget. The titles and the amount of grants are approved by the Parliament annually.

Normative contributions represent the massive part (80 %) of these grants. Their allocation is based on indicators of concrete tasks. There are some 100 titles of allocations presently. This, however, is not a form of task-financing, because the spending of such subsidies is not subject to restrictions. A local government decides at its own discretion, how much it spends on what tasks.

A slight part (12%) of state contributions serve for specific purposes allocated under normative rules.

Such subsidies are related to special operational purposes or to development projects of local governments.

Another smaller part (8%) of grants is spent also on specific purposes but allocated on individual basis. Mention should be made of an extra support for the performance of mandatory tasks of local governments. This kind of support represents some 1 percent of all grants and is provided for “local governments in disadvantaged position for reasons beyond their control” having no sufficient revenues. The budget act specifies the normative conditions under which a local government can have access to such subsidy. Its utilisation is linked, of course, to the operating expenditures, but it is not fixed to any specific target.

**Expenditure.** Under the act on local governments a local government is entitled to determine the ways and modes for the performance of their duties - depending on the requirements of the local population and its financial resources. A local government decides whether to make arrangements for the provision of a certain public service itself (through its own institution, a contractual arrangement or purchasing the service) or to co-operate with other local governments.

Under the provisions of the act on local governments the tasks of providing for certain public services may be imposed on local governments only by law.

The local governmental act also provides that where a mandatory duty is imposed on a local government the Parliament has to provide the necessary funding for the performance and exercising of such tasks and power, deciding on the amount and mode of the budgetary contribution.

The largest proportion of the current expenditure of local governments is made up by spending on the performance of education, health and social/welfare responsibilities.

In 1999 education, health and the social/welfare area accounted for 33 percent, 19 percent and 16 percent, respectively, of the total current spending of local governments. The expenditure of local governments on education, health and social/welfare functions accounted for 66- percent, 44 percent and 11 percent, respectively, of the total general government spending on the relevant areas.

### ***1.4.3 Major problems in the fiscal design***

The most substantial problem of the Hungarian local governmental system is that an excessive degree of decentralisation has evolved in the system of scopes of duties and responsibilities.

The smallest municipalities have almost identical duties and responsibilities as does the capital city. The organisation of the performance of tasks for conurbation areas is not provided for in the system. This has not been yielding efficient solutions because there is little propensity to establish economic associations while there are no means for mandatory association in today’s Hungarian legislation. International and domestic experience also shows that larger associations are not usually established on a voluntary basis.

No clear-cut arrangement has been introduced that would assign institutions performing regional tasks, county governments performing territorial functions along with the necessary financial and other operational requisites for such task performance. A persisting problem is that municipalities may unilaterally transfer their institutions performing territorial duties to county governments which are obliged to take over and operate such institutions - and municipal governments may just as unilaterally take back such institutions. Another unsolved problem is that the ownership of assets should be transferred always along with the transfer of the relevant tasks (those who were given ownership rights in 1990 are now obliged to transfer only the right of utilisation, to the new organisation in charge of maintaining an institution).

The establishment of a regional level of governance covering several counties has gained importance from the aspect of EU accession as well. This constitutes some of the tasks to be carried out in the near future as part of the reform of the public administration system.

A more concentrated scheme of the allocation of tasks may make it possible to replace the current normative subsidy system adjusted to the fragmented regime of task performance with a regulation comprised of a substantially smaller number of elements, based primarily on global subsidies.

#### ***1.4.4 Status of policy reform considerations***

In the spring of year 2000 the Government decided on the directions for the continued development of the institutional and financial system of general government. According to the Government decision, in order to ensure efficient and transparent utilisation of public moneys, the definition of the range and sub-systems of general government need to be reviewed, along with the general and specific regulation of the tasks of the various sub-systems. To this end, the scopes of responsibilities and powers of the state have to be reduced through the regulation of technical/professional and organisation efficiency requirements on the one hand, while on the other hand there is a need for a perceptible reduction of the number of institutions and for the simplification of their internal organisation structures.

The parties in Parliament agree that the current system of the deployment of responsibilities and powers in the local governmental system is not the most appropriate or most efficient solution, but in respect of the mode of its rearrangement one should expect heated debates. Even local governments themselves have different views on the issue.

From a professional angle the following distribution of duties seems most reasonable:

A conurbation local governmental scope of duties - existing only in respect of a few types of responsibilities in the Hungarian local governmental system - should be established. This means that keeping the number of local governments unchanged, the scopes of responsibilities of towns local governments performing the roles of district centres would be broadened, while those governments of smaller municipalities would be reduced.

The tasks that demand increased expertise and resources, including the maintenance and development of kindergartens, nursery schools, schools, the organisation of social/welfare benefits, the maintenance and improvement of roads between municipalities should be involved.

Furthermore, the mandatory - regional - roles of county governments should be clearly specified, terminating the permeability between them and municipal governments. This should result in transferring the property to the local government that maintains the given institution.

At a regional level it seems justified in a longer run to create elected local governmental bodies. The tasks of maintaining, developing of institutions serving several counties - hospitals, secondary schools etc. - and infrastructure development tasks (e.g. main roads, motorways) should be delegated to this level of local governance.

The review of the deployment of responsibilities and powers of local governments is underway. The effort is co-ordinated by the Minister of the Interior and is carried out with the involvement of the line ministries and the associations of local governments. It should be noted, however, that the amendment of the act on local government needs a two thirds majority of votes in Parliament which necessitates a broad political consensus.

In co-ordination with the review of the local governmental tasks and the rational deployment of responsibilities and powers the regulation of the resources of local governments also need to be improved, in the course of local revenues should be increased and at the same time increasing of income differences should be restricted.

## 1.5 LATVIA

### 1.5.1 Main features of local finance and intergovernmental relations

In Latvia there are three types of self-government:

- local governments of urban areas – big cities (republican cities);
- rural (*pagasts*) authorities and towns, and
- regional governments.

There are 578 municipalities in Latvia, including 7 urban municipalities representing big cities (republican cities), 26 regions (*rajons*), 73 towns and 472 rural municipalities (*pagasts*).

The resident population are 2 439 445, of which 1 683 556 urban population and 755 889 rural population. There are 1 224 463 population in republican cities, of which 796 732 lives in Riga the Capital of Latvia.

The big cities have the functions of both: the rural authorities, towns and the regions (at the same time). The rural authorities and towns (or the big cities) are not subordinated to the regions. The regions have separate functions and structures.

The general work principles of these municipal councils, their economy, competence, the rights and obligations of the council its institutions and chairmen, the relations of municipal councils with the Cabinet of Ministers and the Ministries, and the relations with other municipal councils are regulated by the Law “On Local Governments”.

The permanent functions of municipalities are specified in law “On Local Governments”. They shall be executed in accordance with the procedure established by respective laws and regulations of the Cabinet of Ministers.

The current Law “On local government”, article 15, stipulates 17 permanent tasks for rural authorities and towns and 4 permanent tasks for the regions (*Rayons*). The permanent tasks of the 7 “republican cities” are both those of the rural authorities and towns and those of the region – in total 21 permanent tasks.

Apart from the permanent tasks, the rural authorities and towns are also responsible for a number of temporary tasks (laid down by laws and regulations) and voluntary tasks. Among the most comprehensive temporary tasks are implementation of the land reform, restoration of property rights, and other questions related to privatisation of public properties. Voluntary tasks concern for instance local orchestras or tourism development initiatives.

The problem in Latvia, as in many other countries, is that the necessary standard of tasks is not detailed in law, and the minimum national standard service level is very seldom stipulated. To a wide extent, the division of these tasks (e.g. leisure activities for children) depends on the abilities of the regional and local governments in the region and personal initiatives from politicians and administrative employees. Therefore, the current division of these “self government tasks” differs considerably from region to region.

Recent new legislation (Law on Administrative Territorial Reform) and reforms of existing legislation (Law On Local Governments) have been aimed at rationalising the number of local governments and improving the distribution of financing at the local and regional level to allow for better provision of services. There is wide consensus on the importance of building institutional capacity at the local level to improve functioning and service provision by the Local Governments and their municipal enterprises, however limited progress has been made in implementing the local government reform agenda.

### ***1.5.2 -1.5.3 Major empirical findings. Main problems in the fiscal design***

The revenue of Local Governments is generated from the following sources:

- percentages of state taxes:
- 71.6% of the personal income tax;
- 100% of the real estate tax;
- percentages of state duties;
- duties imposed by local governments;
- grants and earmarked grants allocated from the state budget;
- grants from the local government financial equalisation fund;
- service fees.

Local governments are financed by shared taxes (income tax), inter-governmental transfers (state grants and earmarked grants) and state taxes (real estate tax) and own revenue (duties and fees). Shared taxes and transfers constitute by far the largest share of local government revenue (more than 70 percent in 1998-1999). Own local revenue is composed of fees and duties that the local governments can administer.

In accordance with binding regulations issued by the respective republican city or rural authority, town' s municipal council, local governments may impose duties on the following:

- official documents issued by the urban or rural municipal council;
- organisation of entertainment in public places;
- accommodation of holiday-makers or tourists;
- commercial activities in public places;
- the keeping of animals, wild or domestic;
- driving through special protection zones;
- placing advertisements, posters or announcements in public places, containing visual commercial information;
- keeping boats, motor-boats or yachts;
- use of municipal symbols for commercial purposes.

Local governments have the right to collect state duties for issuing special permits (licences) to engage in specific types of businesses. These duties are paid to local government budgets.

Local governments receive grants and earmarked grants from the state budget for the fulfilment of specific tasks assigned to them under the Law “On Local Governments” and under other specific laws. The government of Latvia is working on the medium –term budget preparation program, but today there are no binding documents that would stipulate multi–annually the amount of specific and general grants for the Local governments. They are set annually at the national budget law.

Local governments still have limited autonomy to raise their own taxes. There are only state taxes in Latvia. Local Governments have a right to collect taxes and this is a real estate tax for all municipalities and in addition three municipalities: Riga, Ventspils, Liepaja collect also personal income tax. Municipalities don't have a right to set the tax rate, to give tax exceptions etc. All taxes are set by the Central Government.

The most significant shortcoming in this important area of intergovernmental fiscal relations has been and continues to be the lack of tax autonomy. This minimum level of autonomy would create better accountability of local officials to constituents, increases the efficiency of public expenditure decisions, and is the best way to address the vertical imbalance between responsibilities and funding sources. Granting some degree of revenue autonomy to local governments has proven to be difficult, but needs to be addressed in the next round of intergovernmental finance reform.

Probable together with the implementation of administrative reform we will observe the possibility to give more rights for municipalities to set the real estate tax rate within some limits.

The choice of both the personal income tax and real estate tax as the major sources of revenues for local governments, is appropriate because their tax bases tend to be relatively stable during business cycles of the economy. They are not easily exportable, and there tends to be a linkage between the payment of these taxes and the benefits received by taxpayers from local public services.

Local governments have taken around 24 percent of general government revenues for the last three years.

The Equalisation Mechanism. The current formula-driven Equalisation Fund performs well in many respects. It has provided a good measure of objectivity in the determination of the equalisation grants, it has provided the intergovernmental finance system with a high degree of equalisation, and it has also contributed to increasing the revenue certainty and budgetary stability for local governments.

The Equalisation Fund implements both revenue capacity equalisation and expenditure needs equalisation. This is quite proper for Latvia because there are not only significant disparities in revenue availability across local governments, but also different demands on local budgets arising from the demographic profiles and other cost factors.

The Rules on Local Governments' borrowing. The government of Latvia observes strict financial and fiscal policy and the annual debt level for the municipalities is limited and is stated in the annual law on national budget. The ceiling for 1999 was 30 mill. Ls (the same as for 1998). The amount for the year 2000 being 17 mill. Ls where 10 mill. Ls of the total amount was for borrowing (and from that 0.5 mill. Ls was for the stabilisation of local governments finances) 7.0 mill. Ls are for guarantees. Along with the financial resources that are denominated in the national currency, and State Treasury can lend to the municipalities on favourable terms, with comparatively easy and fast procedures and without foreign exchange rate risk, the government has arranged credit facilities with the European Investment Bank and with the Nordic Investment Bank for the local government's long term borrowing purposes. The Local Governments borrowing procedures are strictly observed by the Local Governments Borrowings and Guarantees Board. Without permission from this Board Local Government has no right to borrow. If Local government wants to borrow from other Sources than the State Treasury, special permission from the Minister of Finance is requested.

Central Mandates on Economic Management. Municipal councils draft, adopt and implement their budget plans independently. State institutions are not allowed to interfere with the drafting and implementation of local budgets unless prescribed by law.

The Minister of Finance has prescribed a standard classification for the recording of local government budget revenue, expenditure and debt, and has established rules for budget accounts. Local government budget plans must always be balanced.

In accordance with State Treasury instructions, all the financial activities of the municipal councils are registered in the official local government financial accounts. The local government budget for the current budget year includes all the revenue collected or received by the local government (and its institutions) which is then used by the local government to achieve its goals.

Municipalities budget preparation and reporting system is getting better with every year.

Local governments' annual reports have to be audited by the state-sworn auditors from FY 2000 before submitting to the State Treasury.

The State Audit Office may check the budget accounts for the current budget year submitted by republican cities, regional, or rural authorities and towns' municipalities councils, concerning the implementation of their basic and the special budgets.

### ***1.6.1 Main features of local finance and intergovernmental relations***

The essential element of the system of municipal financial resources is municipal budgets. Every municipality has an independent budget. Municipal budgets are approved deficit-free. From 1998, a significant step was made towards the development of a modern, reliable and sustainable system of municipal budget revenues. The system sets the overall volume of municipal expenditures, as well as the principles and procedure for the allocation, calculation and transfer of revenue sources assigned to this volume. The Seimas approved in 1999 the Law on the Methodology of Determination of Municipal Budgetary Revenues based on budgetary co-operation. One of the principles of the law is that the main financial indicators should be established through negotiations between central government (represented by the Ministry of Finance) and the municipalities (represented by the Municipal Association). Another important principle is that the evaluation of a municipality's fiscal requirement is based on calculated expenditure requirements, which are determined on a three-year basis.

The state budget and the municipal budgets make up the national budget of the Republic of Lithuania. The essential criterion reflecting effective macroeconomic control is that the municipal budgets must be balanced prior to approval. The law on the methodology of determination of municipal budgetary revenues defines the ratio of the size of municipal budgets to the size of the national budget. In this case, municipal expenditures are linked with the general state of the state economy and of the national budget revenues. Municipal borrowing is controlled by Central Government and the Ministry of Finance.

The use of municipal budget resources is inspected by the controllers of municipalities. In certain cases, the execution of municipal budgets is inspected by the state controller.

### ***1.6.2 Major empirical findings***

By analysing the changes in the revenue and non-tax income of local governments, we can conclude that income tax of natural persons becoming an income source solely for local governments is a positive tendency in forming a base for local government budgets. Compared to 1997, income tax revenues of natural persons in local government budgets increased by 45%. Lithuania's economy experienced difficulties due to Russia's financial crisis of 1998. That is why, in 1999, as compared to 1998, the revenues from the income tax of natural persons in local government budgets increased only by 6.4%. Assigning said taxes to the budgets of local governments, knowing that budget revenues will not change, should give more confidence to local government administrations. These conclusions are backed up by the example of the decrease in revenues at other administrative levels, in 1999, partially due to Russia's financial crisis of 1998. Tax-revenues of municipalities increased constantly (4.93% in 1997, 6.18% in 1998 and 6.63% in 1999 of GDP). Analysing tax classification, the major part (about 90% in 1999) of the municipal tax revenues consists of taxes on income, profits and capital gains. The rest (about 10% in 1999) consists of taxes on property: as a share of tax revenue, this is decreasing but as an absolute amount, it is increasing. Local governments only have the right to impose a small part of their own taxes. These taxes are assigned to the non-tax revenues. Local governments have the right to set the tax base and tax rate for local levies and for municipal budgetary revenue obtained for the services rendered. The two types of revenue comprise up to 10% of all non-tax revenue of local governments.

Grants in total have decreased during the period 1997 – 1999, from LTL 852.6 million to LTL 128.4 million, i.e. by more than 6 times. This was caused due to a considerable decrease in both general and special grants. The amount of the general grants is based on the expenditure volume of municipal budgets and the volume of tax and non-tax revenues assigned to cover such expenditure volume, according to tax laws. During the last two years (1998 and 1999), these revenues have increased more than municipal expenditures, therefore the amount of general purpose grants has decreased accordingly. Basically, it was due to the fact that, from 1998, personal income tax became the basic revenue source for municipal budgets, and revenues from that tax have increased. The decrease in specific grants, to cover standard costs, is noticeable due to the recent Government policy to decrease the amount of such grants. Grants, allocated to cover actual costs, are oriented to state social policy implementation, therefore the amount of grants has remained quite stable.

An analysis of the expenditures reveals that the largest portion of municipal expenditures is allocated to social services which include education, health-care, social security and welfare, sports and culture. Municipal expenditures on social services constitute about three quarters of total expenditures (72.6% in 1997, 74.1% in 1998, and 77.8% in 1999). Education absorbs the major part of the expenditures, i.e. 49.4% of the total expenditures in 1997, 52.8% in 1998 and 56.3% in 1999. Social security and welfare consumes about 15% of total expenditures. Expenditures on health-care within municipal budgets are quite moderate, because, since the health-care sector reform, in 1997, these services have been financed from the budget of the Compulsory Health Insurance Fund. The number of health-care institutions funded from municipal budgets was reduced and, as of 1 July, 1997, was very small. In 1998 and 1999, municipal budgets financed primary health-care services only. Another significant part of municipal appropriations (about 10 per cent) is used for housing and community amenities, which are - exceptionally - municipal functions. Services attributed to fuel and energy, as well as transport functions, constitute between 3 and 3.5% of municipal budgets each. Appropriations in these expenditure line items are used to compensate expenses incurred due to application of passenger transport benefits as well as to compensate heating costs for low-income households. The function of public order and public security, for which municipalities spend up to 1% of their budgets, is delegated to municipalities who organise the activities of their fire-prevention agencies.

Having analysed the changes in municipal budgetary expenditures in the past few years, we can conclude that the budgetary resources allocated for social services remain stable and are even increasing, notwithstanding the changes in the municipal revenue sources. This increase could be explained by the fact that municipalities are responsible for more and more functions in the sphere of social services and this is also related to the Government's social policy.

An analysis of municipal expenditures shows that they represent the major part of the three basic political sectors, like any other current expenditure of state or municipal budgets for a certain sector. This is, first of all, true of municipal expenditures for such services as pre-school training, general education, sanitation and environment protection, street lighting, other functions in the sphere of housing amenities and public utilities. Funding for pre-school institutions and general schools accounts for 83% of the total state expenditures for this sector, while expenditures on sanitation and environment protection, street lighting and other services in the sphere of housing amenities and public utilities account for 100% of the total state expenditures for this sector. This is also related to the fact that these functions are mainly within the competence of municipalities – the division of expenditures between the central government and municipalities is mainly determined under generally accepted principles (municipalities are only responsible for pre-school and general education, and public utilities, for their residents, whilst the central government is responsible for services that are used by all citizens of the country, such as national defence or public order and security).

### **1.6.3 Main issues in the fiscal design**

The main quality of the new Law on Local Self-government is the more precise and clear description of its functions, together with a link to legal and procedural aspects. The new law clearly regulates the powers and rights of municipal institutions. In the old version of the Law, only two types of function were described: autonomous and those delegated by the State. Functions delegated by the State included: civil registration, keeping the register of municipal, state and private enterprises as well as public organisations; carrying out secondary health activities; they may also have managed state parks (national and regional), organised the municipal police, civil security and fire safety, and implemented other functions delegated by law. Autonomous functions were described separately for each part of the internal management system: the Council, the Mayor and the Board. Moreover, autonomous functions included many procedural functions, which were actual rules of internal management and responsibility, and these were not clearly defined, either. This caused co-operation between levels of governments to be ineffective, and created contradictions and difficulties in appraising functions financially (in the budget preparation process).

At present, discussions are taking place in Lithuania on state (transferred to local self-government) functions and the funding necessary to implement them. The problem is that there is no existing, unified methodology for the calculation of the cost of the functions, especially when the Government delegates certain functions related to state or public management, the cost of which differs in each municipality. In addition, there are certain inadequacies between implementing functions and municipal budgets. Therefore, some conventional decisions are to be made in relation to the above-mentioned shortcomings, in the near future.

The new Law on Budget Structure regulates the implementation of objectives and tasks, and gives a legal basis for budget reform. The Law contains certain basic principles:

- Appropriations are defined as resources of the state and municipal budgets, approved by the Law on the Approval of the State Budget and decisions of municipal councils concerning the approval of municipal budgets; and assigned for the implementation of activities and programmes of the state and municipal institutions.
- The introduction of the concept of “special programmes”, i.e. whose expenditures are covered not only by the funds of the national budget but also by other funds.
- The definition that taxes, obligatory payments, and levies collected in the Republic of Lithuania may only be allocated through the National Budget of Lithuania, the State Social Insurance Fund, the Obligatory Health Insurance Fund, and the Privatization Fund.
- The determination of the main duties, rights and responsibilities of the appropriation managers.
- The definition of requirements for the publicity of budget information.
- The definition of requirements for the adoption of other laws that affect budget revenues and expenditures.
- The draft state budget shall be prepared for a period of one budget year and estimated for a period of three budget years.
- It is also planned to submit to Seimas performance measures of the appropriation managers’ programme results.
- The definition that state budget revenue received in excess, and appropriations that are no longer valid, shall be used for: the repayment of public debt, the financing of carried over appropriations; covering shortfalls in municipal tax revenue, with the exception of cases where the Seimas pass amendments to the current year budget.

The annual state budget has to be prepared according to the long-term strategic plan of Central Government and strategic activity plans of ministries and Government agencies. The need to have a

strategic plan was formed in order to implement effective reforms in the areas of public administration and the legal system. The Strategic Planning Manual was prepared in order to help ministries, government agencies and other public management institutions to prepare strategic plans, programmes and draft budgets. The manual covers the principles of strategic planning and budget formation. The manual helps to implement the integrated planning and budget system as approved by the Government. Planning and budget reforms can only be implemented successfully when both reforms are carried out together. Strategic priorities are not implemented successfully when they are presented without a reliable financial plan and firm financial obligations.

Central Government has recommended that municipalities apply strategic planning principles. Specific training in municipalities has begun. Recently, certain municipalities have introduced these principles.

#### ***1.6.4 Status of policy reform considerations***

One of the key factors bringing about new aspects of the self-government reform is the Program for 2000 to 2004 of the new Government that was formed after the election to the Parliament in 2000.

With the view to limit the power of the central government over municipalities and relying on potential capacities of municipalities to act more efficiently, economically and more understandably to the public, the Government of the Republic of Lithuania has set in its program for 2000 - 2004 the following measures to be taken:

- to detail all functions of the central government and municipalities, to eliminate overlapping of the functions, to specify in as much detail as possible the powers and to limit authority;
- to develop an efficient legislative mechanism to ensure that each institution of the respective municipality is observing the laws on its own will;
- to give municipalities the power to deal with land-related and land management issues;
- to transfer all institutions dependent on regional administrations as well as other bodies to the supervision of those town and regional municipalities, in the territory of which the above-referred institutions and other bodies are located;
- to gradually phase-out centralised re-allocation of budgetary resources. To give possibilities for the municipalities to form their budgets from local taxes and levies. To set that both natural and legal persons shall pay two types of taxes – a fixed amount to the state and to the municipality.
- to set statutory limits, within which a municipality may itself set the size of taxes due to it;
- when changing administrative borders of municipalities, to take account of the opinion of the public and to set the procedure for remuneration of losses;
- to give the property, which is not necessary for the needs of the central government and which is not to be returned to its former owners, to municipalities;
- not to delegate any functions to municipalities, unless they are appropriately financed;
- to promote social housing development in municipalities, to grant state support to socially vulnerable people and young families;
- to finance schools by the principle “money follows a student”, to guarantee equal opportunities to non-governmental and governmental educational institutions;
- to implement the principle “money follows a child” in supplementary education field as well.

In the 1st quarter of 2001, it is planned to draft the methodology for calculation of the need for the resources from the state budget of the Republic of Lithuania to perform the functions delegated to municipalities so that budget proposals to finance central government functions and those delegated to

municipalities collected to draft a law of the respective year on approval of financial indicators of the state and municipal budget are well-grounded.

In the 2nd quarter of 2001, the Law of the Republic of Lithuania on the Methodology for Estimating Municipal Budgetary Revenues shall be amended to adapt it to the provisions of other legislation already applicable (Local Self-Government Law, Law on Budgeting) and to be still adopted (relevant taxation legislation).

Quite a significant portion of the expenditures that are currently financed by municipalities will be financed centrally, i.e. by state budget grants.

To finance other functions performed by municipalities, the same revenue equalisation mechanisms as provided for in the currently applicable law will be applied, since the differences between tax revenues of individual municipalities per capita are very large. Therefore, it is forecast that both the equalisation of differences in tax revenues and equalisation of differences in expenditure structures among individual municipalities will be further applied. Levels of tax revenue equalisation and demographic indicators to be used to determine the levels of equalisation of differences in the structure of expenditures are planned to be established in a single Methodology Law.

It is anticipated that after the fiscal reform of municipalities planned by the Government is implemented, the principle of revenue equalisation will be more applicable to perform independent functions of municipalities, while expenditure setting principles will be applied with respect to functions delegated by the central government, the latter being financed by special grants from the state budget. We can forecast that as a result the ratio of grants within municipal budgets will increase in the coming years.

**1.7.1-1.7.2 Main features of local finance and intergovernmental relations. Major empirical findings**

The last stage of local government reform in Poland has begun in 1999, when were established two new tiers of local government - poviats and voivodships. These new tiers were fitted with new financial sources - especially special grants and general subsidy - and also took over new tasks from state government. Much more independent than poviats and voivodships are gminas - the lowest level of sub-national government, which have existed since 1990. The gminas have functioned in stable financial environment - significant part of its revenues consists of tax revenues.

Units of sub-national government receive revenues from three basic sources:

1. From taxes:
  - Local taxes,
  - Share of state taxes;
2. From non-tax revenues, and
3. From grants:
  - General subsidy,
  - Special purpose grants.

After the reform of sub-national government, the most important source of revenues has become grants. In 1999 it was over 51 per cent of total local revenues. In comparison in 1998 the share of grants in local revenues was 35.8 per cent and in 1997 it was 34.3 per cent. Such significant growth was influenced from the fact, that new tiers of sub-national government (poviats and voivodships) received grants (general subsidy and specific grants) as main sources of revenues. It should be pointed out that existing system subsidising units of local governments are a denial of the self-government idea and do not permit making a decision in an independent and flexible way. The local governments are dependent on government decisions on granting subsidies and their amounts. It is very important in the case of grants for investment, where unforeseen delay in submitting the required money has a negative impact on the effective use of financial resources, completing on time, etc. With respect to these problems, grants should gradually be replaced by increasing own revenues. A parallel decision is required to reduce the quantity of commissioned tasks by state administration and, at the same time, increase own tasks together with accurate financial resources to realise them properly.

On the other hand, the share of tax revenues in total revenues fell from 37.6 per cent in 1997 to 24.5 per cent in 1999. The budgets of gminas remain the only budgets that are funded from local taxes and charges that constitute, in their entirety, the own revenue of gminas. The revenues of poviats and self-governing voivodships do not come from any independent tax sources other than a share in state taxes – personal income tax and corporate income tax. During the years 1997 – 1999 the growth of tax revenues of sub-national government was insignificant and in 1999 with comparison to 1997 it grew only by 8 per cent. At this time units of local authorities did not received any additional source of tax revenues. That 8 per cent growth was mainly a result from an increase in revenues from real estate tax, which grew during this period by 1503 mln of zlotys – it was equal to 34.0 per cent.

Revenues from taxes on income, profits and capital gains did not change significantly during years 1997 – 1999. The growth of revenues from this source was equal to 5.4 per cent. Unfortunately local authorities have little influence on the development of their revenues from central tax sharing (the role of sharing in direct taxes is primarily fiscal – the provision of funds to the eligible unit of self-government).

The statutory tax authority of sub-national government is quite limited and brought down to non-uniform functional powers. In most cases, it allows lowering upper rates of local taxes, to the extent laid down in statutes. The upper tax rates are determined and updated on an annual basis by the Finance Minister within the framework of the general tax policy of the state.

Another instrument of tax authority used by the units of local self-government is the granting of relief, deferment and remission of taxes that make up the gmina's revenues and are directly paid to the gmina's account. The same power can be exercised in the form of a waiver of the collection of such taxes (relevant decisions may solely refer to individual applications filed by taxpayers).

The responsibilities of the units of local self-government may be divided into duties being their direct responsibility, and responsibilities delegated by the central government administration.

Duties are being delegated to units of local government by the central government administration under a number of statutes regulating various areas of public activity. They may also be implemented on the basis of agreements made between unit of local government and a body of the central government administration. Such duties are financed from funds transferred to local government especially for that purpose by the relevant body of central government administration.

Funds allocated to the performance of own duties of sub-national governments come from own revenues, i.e. from taxes, charges, receipts from assets and the general subsidy. On the other hand, delegated duties are financed from specific grants transferred by the government administration.

Public expenditure specified in the self-government's budget resolution applying to particular year cannot be exceeded as it is capped.

During the years 1997 – 1999, almost all areas of expenditure grew. The relation of total local expenditures to GDP was higher over 2 percentage points in 1999 than in 1997. The most important tasks realised by sub-national government embrace: education, social security and welfare, and housing and community affairs. The expenditure on these three sectors covered almost 67.6 per cent of total local expenditures in 1999.

There exist, in Polish law, different restrictions in the area of borrowing, bond issue and provision of guarantees. These restrictions are imposed on all local authorities. The total amount repayable during a relevant budget year cannot exceed 15% of the revenue projection for a given budget year of that local authority. Also, the total amount of debts at the end of the budget year cannot be more than 60% of the aggregate revenue of that unit during a relevant budget year.

The units of local government may also incur loans and issue securities in order to cover the in-year shortage in the budget of the units of local government. Such debts are repayable or redeemable within the same year as the year of incurring or issuing them. This is due to the irregular inflow of revenue from taxes and other revenue to the budget accounts of the units of local self-government, and the necessity of incurring current expenditure on a regular uninterrupted basis.

In addition to that the units of local self-government may also borrow at certain banks and financial institutions on preferential terms.

It should be noted that units of local government are independent entities, acting under their own responsibility. Local authorities must cover any budget deficit themselves. On the other hand, in case of temporary financial difficulties, loans for financing deficit may be extended from the state budget in the course of rehabilitation proceedings. The conditions of granting such loans (interest rates, repayment dates) are laid down in the loan agreement.

The central authorities influence neither level of local revenue nor expenditure. Even the amount of revenue transferred from the state budget, i.e. subsidies and specific grants, depends on objective criteria laid down in the Acts and, hence, the central authorities are unable to interfere in the amount of this revenue. Neither are these authorities able to exert influence on the amounts spent from local budgets and the sole supervisory criteria is the correctness of implementation of duties assigned to individual levels of local government.

The regional clearing chamber fulfils the external control of sub-national governments. Regional clearing chamber also fulfils information and training functions, providing the council with professional opinions on the draft budget, information submitted by the gmina council (powiat, voivodship) and concerning the implementation and execution of the budget, and also findings of comprehensive inspections of the financial management of a local government.

#### ***1.7.3-1.7.4 Major problems in the fiscal design. Status on policy reform considerations***

The fact of decentralisation, and the new tasks and functions given to all levels of local government, have not entailed an increase in the amount of their own financial resources. A considerable part of the tasks, especially those carried out by poviats and voivodships is still financed by means of transfers from the state budget.

This way of financing is considered to be the factor restraining local government reform and reducing their independence by limiting the ways in which tasks are realised and financed. The method of financing described above violates the so-called basic acts such as the Act of gmina government, the Act of powiat government, and the Act of voivodship government. Apart from this, supplying local governments with targeted grants via the national budget does not motivate local governments to obtain their own financial resources or to efficiently manage the money they get. It is also a characteristic of specific grants, which constitute a type of revenue that is earmarked for special purposes and must be returned to the state if not used.

Thus, government proposes changes in the types of local government tasks, and the ways of financing them. Government aims at replacing targeted grants transferred to local governments with own source revenues, and transforming commissioned tasks to own tasks. Increasing the financial independence of local communities will require changes in special acts.

### ***1.8.1 Main features of the local finance and intergovernmental fiscal relations***

In accordance with the principles and competencies' delimitation of central and local public administration, as provided by the Constitution of Romania, the Law on local public administration regulates the general regime of local autonomy, the organisation, operation and competencies of local public administration authorities.

From administrative point of view, the territory is constituted from communes, towns and counties, where local autonomy is exercised and where local public administration authorities are organised and function. One or more villages may form a commune, and some towns can be declared municipalities, according to the law.

The Municipality of Bucharest is divided into six administrative-territorial subdivisions, called sectors.

Communes, towns and counties are legal entities of public law; they have their own patrimony and complete legal capacity. Law establishes the territorial delimitation of communes, towns and counties. Any change of their territorial limits is made only by law and after the preliminary consultation of the citizens of the administrative-territorial units involved, by legally organised referendum.

In the 2948 administrative-territorial units existing in Romania, 84 are municipalities (2.8% of total), 179 towns (6.1%) and 2685 communes (91.1%). All these units – municipalities, towns and communes – have identical competencies and attributions.

The local and county councils, as deliberative authorities, and the mayors and the presidents of county councils, as executive authorities, represent the authorities through which local autonomy is realised in communes, towns and counties.

At the level of the municipality of Bucharest, the General Council of the Municipality of Bucharest and the local councils of the sectors are the deliberative authorities, and the general mayor of Bucharest and the mayors of sectors, as the executive authorities.

Each commune, town, county, respectively the municipality of Bucharest and sector of Bucharest draws up the local budget that includes local public revenues and expenditure provided by law.

Local authorities have the following competencies and responsibilities regarding local public finance:

- Elaborate and approve local budgets at due terms;
- Establish, find, control, pursue and collect local taxes and fees, and other revenues of local administrative-territorial units, through their own speciality offices, within the conditions of the law;
- Pursue local budgets' execution and rectification, during the budgetary year, observing the condition of budgetary balance;
- Efficiently administer the public or private property assets of administrative-territorial units;

- Contract short, medium and long term loans and ensure the repayment of the related obligations, on due dates;
- Administer financial resources during budgetary execution, in conditions of efficiency;
- Set the options and priorities for approving and effecting local public expenses;
- Elaborate, approve, modify and supervise the operation of development programs of administrative-territorial units, as the base for annual local budgets management;
- Organise and survey the financial administration control of their own financial administration, as well as of the public institutions and services subordinated to local and county councils, and to the General Council of the Municipality of Bucharest.

All local public administrations have identical competencies and responsibilities, but an important number of localities don't have sufficient financial sources and that implies the annual allocation of resources for balancing purposes, based on earmarked amounts from some revenues of the state budget, provided by the law of state budget.

### **1.8.2 Major empirical findings**

Until the end of 1989, all financial, fiscal and budgetary matters were approached unitarily, centralised, local authorities having little competence related only to deciding the size of certain expenses and revenues, within the limits transmitted from the central level.

Starting with 1990, fiscal and budgetary policy entered a profound reform process, still developing, engaging organisational and competence changes, establishing mechanisms for taxation and budgetary revenues collection.

The effective implementation of this reform was materialised in new laws regarding public finance and local autonomy, such as: the Law on public finance, the Law on local public finance, the Law on local public administration, the Law on local taxes and fees, etc.

The local financial resources are taxes, non-tax revenues, capital revenues, quotas and amounts earmarked from some revenues of the state budget, transfers with special destination from the state budget, revenues with special destination and loans for financing investments.

Local governments are entitled to establish and levy local taxes and fees. The Law on local taxes and fees establishes these taxes and fees and their limits, the obligation of physical and legal entities of paying them, the payment dates, the possibility for the local and county councils to establish local taxes and fees within the limits and the conditions of the law and the possibility of increasing or decreasing local taxes and fees up to 50%.

Law on local public finance allows earmarking quotas from some revenues of the state budget. Thus, at the administrative-territorial units level were established quotas allocated from the income tax collected by state budget:

- 36.5% to local budgets of communes, towns and municipalities, where the employers perform their activity, 10% to county budget and 16% at the disposal of the county council for balancing the budgets of the communes, towns, municipalities and, exceptionally, of the county.

- For the municipality of Bucharest, the quota is 62.5% and it is distributed as follows: 18% to local budgets of the sectors of Bucharest, 36.5% to Bucharest's budget and 8% at the disposal of the General Council of the Municipality of Bucharest, only for balancing the local budgets of its sectors (these is 2002 earmarking quotas).

The State Budget Law may establish amounts earmarked from revenues of the state budget and draws the criteria for allocating them to administrative-territorial units, in order to ensure the balance of the budgets of certain less developed administrative-territorial units which cannot cover themselves the expenditure with revenues and quotas earmarked from income tax.

The weight of the local budgets revenues out of the gross domestic product represented 3.9% in 1998, 4.3% in 1999, and 4.4% in 2000, this increase being generated by the enforcement of the Law of Local Public Finance and by the decentralisation of some public services, starting with year 1999, for which there were secured the necessary financial resources as quotas and amounts earmarked from the state budget.

The percentage of fiscal revenues of local budgets into the gross domestic product was 2% in 1998, 3.0% in 1999, and 3.1% in 2000. The percentage of the tax revenues in the total local budgets revenues was 51.7% in 1998, 70.2% in 1999, and 69.7% in 2000.

Discretion of local authorities when assessing local taxes and fees is limited. Most of the tax revenues are derived from quotas and amounts earmarked from income tax revenues. These quotas and amounts represented 66.9% in 1998 and 75.0% in 2000.

Beside the quotas and amounts earmarked from some revenues of the state budget (income tax and value added tax), the local budgets receive subsidies from the state budget destined to:

- investments partly financed by external loans, in which the Government is involved;
- supporting child protection and handicapped people schemes;
- financing the elaboration and/or update of the general urban planning and local urban planning regulations;
- financing house building;
- financing the program of road paving and water supply of villages;
- financing the activities targeted to the reduction of seismic risk of the existing dwellings.

Furthermore, the law allows local authorities to contract loans for local interest investments and for refinancing local public debt. The law also establishes an indebtedness degree of the local authorities, which means that the annual service of the local public debt cannot override 20% of the total current revenues, including quotas earmarked from income tax.

Accordingly the weight of the local budgets revenues out of gross domestic product, the weight of current expenditure of local budgets out of gross domestic product increased from 2.9% in 1998 to 3.5% in 2000.

It can be noticed an increase of the local budgets' current expenditure starting with year 1999, by 67.3% compared to 1998, and by 54.4% in 2000 compared to 1999.

The process of decentralisation of public services was emphasised starting with 2001, when the pre-university public education, the expenditure of crèches and of local centers for agricultural consultation started to be fully financed from the local budgets.

Simultaneously, there were provided the financial resources necessary to finance these expenses, meaning the amounts earmarked from the value added tax, which constitutes state budget revenue.

In 2002, certain cultural institutions, the remuneration of non-clerical employees in cult units, the social support and the allowances for house heating during the cold season, regulated by the Law on minimum guaranteed income, started to be financed by local authorities. The finance sources are provided by the state budget through amounts earmarked from income tax and value added tax.

### ***1.8.3 Major problems in fiscal design***

The local autonomy concept, provided by the Constitution of Romania and the Law on Local Public Administration, would be applied only if it is accompanied by an effective financial autonomy. This autonomy is realised by decentralisation of the administration of some taxes and fees that are sources of the state budget, and by adequate management of the revenues considered by law as sources of the local budgets.

In order to get political and economic practical results of the local autonomy, based on the principle of subsidiary, the local authorities should be as independent as possible against the subsidies granted by central authorities in order to fulfill their tasks.

Ideally, given the case of a high degree of financial autonomy of the local collectivities, their own revenues should cover most of the local budget's needs.

Local taxes and fees represent the most secure source for medium and long-term budgetary forecasts. The local authority must have the capacity to establish, within the conditions provided by the law, and maintain a certain fiscality that is not burdensome for citizens, but which still allows local authority to finance the most part of the expenditure from collected revenues.

There are several strengths and a few remaining problems with the new revenue sharing system. The first main strength is that the system reduces the earmarked amounts, which gives greater discretion to local governments in spending decisions. The transfer system has been improved in terms of both predictability and transparency. Local governments know roughly how many revenues they will receive and they are not depending on any other level of government to distribute these revenues.

With these new powers, local governments are expected to be more responsible for budget execution and investment planning.

Clear and correct information about the level of the local public administration's own revenues and necessary expenses are needed for the adequate motivation of the decisions taken at central level regarding the amounts allocated from some state budget revenues (income tax and value added tax).

By decentralisation, every citizen should be granted equal access to basic standard public services. However, compared to big and very big localities, the small ones are confronted with hardships determined by the low financial capacity, so the Government and the county administration must intervene in order to ensure the absolute necessary resources.

Because the small localities have the same functions as the big ones, over the time, there have risen some problems related to both vertical (the equalisation of functions and revenues) and horizontal (among various collectivities) equalisation, and this has determined yearly adjustments of the rates and criteria of allocation, depending on the localities' size and type, in accordance with their actual needs.

For this purpose, having these pre-requisites as a starting point, the proposed criteria in 2002 for the allocation of the amounts earmarked from income tax, destined to balance local budgets, and of the 16% quota of the income tax at the disposal of the county council, is the fiscal capacity of the administrative-territorial units. It channels more efficiently the balance amounts to those categories of local public administrations that have insufficient revenues for providing public services, even after they receive the earmarked quotas.

#### ***1.8.4 Status of policy reform considerations***

Romania is presently engaged in a comprehensive process of implementing thorough reforms of local public administration.

An essential component of this reform process is the decentralisation of certain important activities in the field of local public finance, which will lead to a more efficient assignment of financial resources, harmonisation of public interest with the private one and stimulation of the development of lasting local economy.

The increasing autonomy of local collectivities essentially contributed to democracy development though the absence of a real financial autonomy would make the notion of local autonomy meaningless.

Financial autonomy of local collectivities requires creation of efficient systems of local public finance, equitable and correlated to the necessities and the economic policy at national level. Thus, the application of subsidiary principle, the decentralisation, and the increase of the financial capacity of local collectivities represent three interdependent action directions.

An efficient system of local public finance must ensure:

- development of the local public administration authorities, according to the local autonomy principle and to market economy mechanisms;
- determination of total financial resources of local public administration authorities in relation with their management obligations;
- decision autonomy of local authorities, including those related to expenditure, with the purpose of increasing the efficiency of public expenditure and the responsibility towards the electors of these authorities;
- stimulation of local authorities for making efforts in order to involve their own resources;
- simple administration and low operation costs;
- a transparent system of budget transfers based on objective, stable and mandatory criteria;
- compensation of the results of some revenue differences among various local administrations, providing to every citizen a minimum level of access to vital services;
- mechanisms for supporting the development of public infrastructure and its adequate financing;
- reliability with the conditions of macroeconomic stabilisation.

The target of the reform of local public administration is to make it capable of fulfilling its functions in order to contribute to economic and social development of the administrative-territorial unit.

The elaboration process of the local budgets must result in the consolidation of local administration independence, by lowering the weight of the funds allocated from the state budget and increasing the weight of the revenues derived from local taxes and fees.

The central administration has to make sure that local administration uses efficiently and reasonably the resources allocated by the state. The internal audit also plays an important role at the level of local administration.

The legitimacy of state's actions are not confined only to management or efficiency matters but must take into consideration the interactions between central and local levels and the elaboration of strategies concerning modernisation and development of public services.

For this purpose, the following actions are considered:

- The decentralisation of public services and the increase of the responsibility of local authorities regarding the quality of services rendered to population.
- The extension of centralised systems over the services with major impact on health and living level of population (water supply, sewerage, and sanitation) and the increase of population access to these services.
- Restructuring the social protection mechanisms for disfavoured segments of population, through:
  - extension of social protection for really disfavoured segments of population;
  - enforcement of the new Law regarding minimum guaranteed income.
- The promotion of lasting development measures by initiating concrete measures regarding the alignment of the Romanian practice and standards of local public services to the requirements of the European Union.
- Promoting market economy principles and reducing the monopoly degree by initiating measures for competing the providers of services, the finance capital and management.

## 1.9 SLOVAK REPUBLIC

### *1.9.1 Main features of local finances and intergovernmental fiscal relations*

The present system of local governments in the Slovak Republic was established in 1990, when new legislation and elections created a first-level system of elected communal bodies with legal personality and defined rights. The Slovak Republic has 2,879 municipalities and 5.4 million inhabitants. The second level of local government was established only in 2001.

Local self-government is anchored in constitutional law of the Slovak Republic (in the 1992 Constitution). The amendment of the Constitution, accepted in 2001, established that local government comprises municipalities and superior territorial units. They are independent local and administrative units, associating members of the population permanently residing on their territories.

By Constitution, the municipalities and superior territorial units are legal entities independently managing their own property and financial sources. Municipalities and superior territorial units (administrative regions) finance their needs using mainly their own revenues, as well as subsidies received from the state.

The principal law defining the position and operation of municipalities - the Municipal Structure Act - specifies the competencies of municipalities and their bodies (town clerks and municipal councils) and their decision-making powers in executing self-governing functions.

The basis of financial management of a municipality is outlined in the municipal (communal) budget, constructed for the period of one calendar year. The principles of municipal budgetary economy are laid down in the Budgetary Rules Act, where the revenues and expenditures of communal budgets are defined. The revenues structure of communal budgets is predominantly comprised of tax revenues. Communal tax revenues include parts of three "shared" taxes, managed by the state: the personal income tax from dependent activities and emoluments, the corporate income tax and the road tax. The shares of municipalities in these state-managed taxes are defined annually in the State Budget Act. Other communal tax revenues are taxes and charges that are collected by municipalities: the real estate tax (land tax, tax levied on constructions and housing tax) and taxes levied on specific services (local charges) whose rates and the corresponding sums are determined by the municipalities themselves, exercising their statutory powers. Both categories of tax revenues are incorporated in the communal budgetary revenues system, and municipalities are empowered to decide on the use of the relevant funds.

According to law, special purpose subsidies may be allocated to municipalities from the state budget and from state funds. Municipalities obtain such funds either by direct financial transfers from the Ministry of Finance of the Slovak Republic or from the applicable state funds. Further budgetary revenues of municipalities represent non-tax earnings and loans.

### *1.9.2 Principal empirical findings*

The public administration model in Slovakia consists of two components since 1990: state administration and self-governments, functioning separately and relatively independently in terms of organisation, competencies and finances (dual public administration model). In 1996 there were 8 regional offices and 79 district offices within the system of local state administration. By scope of jurisdictions, the regional

and district offices provide for multi-sectoral execution of state administration; they were organised with uniform horizontal powers. However, self-governments failed to achieve equal position in the dual model because there were no regional governments before 2001 and no decentralisation of competencies from state administration to the municipalities and regional self-governments has materialised.

The crucial powers of public administration are executed by the central government (see Table 4.1 in the Country Report). Such powers include, in particular, general public services, defence, public order and security, education, health care, social security and assistance, agriculture, forestry, mining, transport, telecommunications, and other fields of the economy.

Municipalities execute their powers within their own self-governing accountability to a certain minor extent. As of 1990, local governments have delegated powers in the field of general public services, social security and assistance, housing construction and facilities of municipalities, recreation, cultural and church issues, transport and telecommunications. The central government participates in the exercise of these powers, i.e. they are shared powers.

There are 2,879 municipalities in the territory of Slovakia, more than 68 % of which have populations below one thousand, i.e. the territory is split into a large number of small municipalities. On the other hand, there is a high population concentration in the major cities; almost one half of all S.R. population dwells in cities with populations exceeding 10 000. The category of municipalities with populations above 100 000 includes the cities of Bratislava and Košice (see Table 2.2 in the Country Report). In principle, all municipalities, regardless of size, have identical rights and liabilities.

Communal budgets are separated from the state budget, thereby manifesting the independence of economic management of self-governments. The relations between the state budget and municipal budgets are expressed in a system of specific-purpose subsidies which are part of the State Budget Act of the relevant year. Pursuant to the Act on Municipal Structure, the annual financial statements of municipalities are subject to external audit.

Tax revenues of local governments include taxes on income, profits and capital gains, property tax, tax on goods and services and other taxes (Table 3.2 in the Country Report). Tax revenues, non-tax revenues and subsidies represented, in the 1998 - 2000 average, 60.6 %, 19.7 % and 19.7 %, respectively, in the structure of local government revenues.

Communal tax revenues are predominantly, in terms of financial volume, represented by shares in taxes managed by the state (shared taxes). The share of municipalities in these taxes is specified annually by central government within the State Budget Act for the relevant year, either as an absolute sum (personal income tax from dependent activities and emoluments) or a percentage of collected taxes (corporate income tax, road tax). The method of distributing the tax yield among the individual municipalities, based on the per capita principle is also specified in the Act. State tax administration offices execute monthly transfers of funds, in volumes determined by the above criteria, to the municipalities. Thus, in respect of the tax revenues, municipalities have no powers to influence the volumes allocated to them. They are free to decide on the use of these revenues for their budgeted expenditures, except for the road tax; the Act stipulates full use of this tax for construction, repair and maintenance of local roads, and for coverage of any related expenses. Although shared taxes are characterised in the Act on Budgetary Rules as own (communal) budgeted revenues, from economic aspects they may be considered general-purpose transfers.

Further tax revenues in the municipal budgets are the real estate tax and local charges. These revenues averaged 35.8 % in the total tax income of communal budgets in the 1998 to 2000 period. Municipalities have only little powers in determining the rates of real estate tax and of local charges.

Subsidies provided to local self-governments are classified as unconditional specific-purpose subsidies. They include, in particular, current subsidies and capital subsidies provided from the state budget, from state funds and from the National Property Fund of the Slovak Republic (Table 3.4 in the Country Report). The volumes of these subsidies are decided in the course of constructing the state budget; their use is specified by the central government in the State Budget Act. A system of global general-purpose subsidies is not applied in Slovakia. Municipalities may use funds from their subsidies until the end of the budget year, and account for them annually by methods specified by the Ministry of Finance. Subsidies granted but not drawn, or used in contradiction with the specified purpose must be returned to the state budget or state fund.

Municipalities in Slovakia may finance their needs also from credits and loans extended by domestic and foreign banks; there are no special measures in force regulating the rate of indebtedness of municipalities (Table 4.2 in the Country Report). Issuance of communal bonds must be approved by the Ministry of Finance, or (from 2001) by the Office for the Financial Market of the Slovak Republic.

### **1.9.3    *The main issues in fiscal structure***

The powers to approve legislation relating to the individual taxes are exclusively vested with the central government. The preparation of new legislation is co-ordinated by the Ministry of Finance, then subjected to governmental debate and finally approved by the National Council of the Slovak Republic.

The jurisdiction of municipalities in specifying the tax rates and charges is restricted to the real estate tax and local charges in the sense of the relevant laws. However, their decision-making powers are limited since the Real Estate Tax law stipulates that, although the basic tax rate may be reduced or increased by the municipality depending on local conditions, this must adhere to the maximum limits defined by the law. This solution is similar to that applied in the Local Charges law, where the maximum rates are set by statute; these may be increased in specific cases by the municipality but not above a specified highest percentage. The laws on the real estate tax and on local charges also stipulate that management of these taxes is within the responsibilities of municipalities. All yields from the real estate tax and local charges are communal budget revenues, managed by the municipality. However, as derived from the above, this communal autonomy is not absolute in respect of the collection of such taxes and charges. The Ministry of Finance retained powers in formulating and implementing the tax policy. All other taxes collected in the territory of Slovakia are managed by the central government, through a special network of state tax offices falling within the competence and management of the Ministry of Finance.

Thus, obviously, the autonomy of local self-governments in the Slovak Republic remains limited in increasing their communal tax revenues.

The government plans a staged approach in the decentralisation of finances within the reform of public administration. In the first stage (lasting a minimum of two fiscal years) conditional decentralisation subsidies will be provided to municipalities and regional self-governments for the purpose of financing their transferred competencies. In the second stage after evaluation of the transferred competencies financing system, the competencies of municipalities and regional self-governments in the field of taxes will be strengthened resulting in their growing own tax revenues.

However, the process of fiscal decentralisation and strengthening of the financial autonomy of local self-governments is strongly influenced by the existing significant diversification of the territory into a large number of small communities, and substantial differences in the economic performance of the regions in the Slovak Republic.

#### **1.9.4 Reform steps made since 2001**

Eight self-governed regions were established as of January 1, 2002 in the Slovak Republic, with their territories and seats being identical with those of the regional state administration offices. Self-governed regions are legal entities, managing independently their own property and funds under conditions defined by law and providing for the rights and interests of their citizens. The chairperson of the regional self-government, and the regional council of representatives elected in direct elections are the official bodies of regional self-governments.

In 2001 there were new budgetary rules introduced in the field of public finances. The reform of public finances, targeted toward optimising and increasing the efficiency of management of public finances in terms of time and material, consists of the following parts: reform of the state budget, introduction of medium-term financial planning in public finances, fiscal decentralisation following the decentralisation and modernisation of public administration, and constitution of the Treasury.

Budgetary rules were complemented by redefining the status of the superior territorial unit (regional self-government) budgets; the revenues and expenditures in their budgets were specified, along with the rules of management of these budgets. The amended Budgetary Rules Act, defining the basis of revenues of the superior territorial units (regional self-governments) stipulated that their revenues will include the yield from a personal income tax surcharge, established by the regional self-governments under a special law. It is assumed that the administration (collection) of this tax would remain in the competence of the central government but that the regional self-government would be entitled to decide on the amount of a surcharge - within limits established by statute - to the nationally applicable tax rate. The system of surcharges is expected to be introduced in 2004 within the second stage of the fiscal decentralisation.

Repayable sources of financing (sources received from credits, loans, returnable financial facilities and resources from bond issues) were redefined, along with the conditions and procedures applying to municipalities and regional self-governments in accepting and using such sources to finance their requirements, regulation of indebtedness and debt service, as well as the authority of the Ministry of Finance in this field.

Local self-government budgets were internally itemised as current budget and capital budget. The obligation was established that current budgets must be constructed as balanced (or surplus) budgets. The capital budget may only be constructed with a deficit if the deficit could be covered by funds accumulated from previous years or by repayable financing sources, repayable from the current budget in the following years.

External control has been strengthened. Municipalities and self-government regions are now duty bound to subject their economic managements in the preceding year to external audits; such auditing includes compliance with the budget in accordance with the Budgetary Rules Act, management of other financial funds, position and development of the debt, and observance of the rules of using repayable financial sources. The auditors, identifying violation of obligations established by the Act, are under obligation to report such findings to the Ministry of Finance which is empowered to verify the submitted facts by procedure established in the law on financial control and internal auditing.

When a municipality is unable to settle its liabilities, the amended Act enables introducing two special economic management regimes: the recovery regime and receivership. The recovery regime precedes the introduction of receivership. In the recovery regime the measures to deal with the insolvency are adopted by the communal bodies themselves; if there was no correction achieved in a period specified by the law, the Ministry of Finance on behalf of the state may decide on introducing receivership.

The Ministry of Finance commenced preparation of a new legal adjustment in the field of local taxes. The proposed new law on local taxes will transform key parts of local charges into local taxes. The present proposal anticipates higher decision-making powers of municipalities; in particular, they will be empowered to increase the upper limit rates of these taxes specified by law. This new legislation, expected to assume effect in 2003, is going to cede the administration of taxes to the municipalities.

In a further reform step, the Ministry of Finance is preparing a separate law on budgetary rules, applying to territorial self-governments (municipalities and regional self-governments) and a separate law on adjustment of revenues in the communal budgets and superior territorial unit budgets with shares of state-managed taxes, including adjustment of their structures and methods of distribution. This new legislation should assume effect on January 1, 2004.

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***1.10.1 Main Features of Local Finance and Intergovernmental Fiscal Relations***

The constitution, the establishment of municipalities and municipal boundaries act, the local government act, the public finances act, the accountancy act, and the secondary legislation to these acts regulate the field of local government. These acts of law and regulations set out the number and areas of the municipalities, their functions, the manner in which municipalities are financed, the composition of budgets and method for amending budgets, the implementation of municipal budgets, the management of municipal property, public sector borrowing, budget supervision, and the manner in which records are kept of public finance revenues and expenditure at the local level.

The local government act allows for the creation of two tiers of local government in Slovenia: municipalities and regions.

Pursuant to the local government act of 1993 municipalities were created in Slovenia as self-governing local communities. Pursuant to the establishment of municipalities and municipal boundaries act, on 1 January 1995 the 62 old municipalities were replaced with 147 new municipalities, of which 11 had city status. On 1 January 1999 a further 45 new municipalities came into being, so there are currently 192 municipalities in Slovenia, of which 11 are cities. In 2001 the procedure for founding new municipalities was restarted. The application procedure yielded 50 proposals for new municipalities, but at the moment it appears that only one new municipality will be created based on this procedure. Municipalities may also have sub-sections (local, village or district communities), whose founding and functions are defined in the charter. Of the 192 municipalities there are currently 95 that fail to fulfil the basic legal criterion on the number of inhabitants required for founding a municipality, namely 5,000. Many municipalities were created on the basis of a provision in the local government act that states that in exceptional cases a municipality may have fewer than 5,000 inhabitants for reasons of geography, border location, ethnicity, history or economics. A particular problem in the creation of new municipalities is the municipal sub-sections that have the status of a legal person, as often these are the very entities that the requests for new municipalities concern. The municipalities in Slovenia vary greatly in terms of population: six have fewer than 1,000 inhabitants, 18 between 1,000 and 2,000 and 71 between 2,000 and 5,000, while two municipalities have more than 100,000 inhabitants.

Despite the constitution and acts of law allowing for the founding of regions, no regions have yet been created. The biggest problem with founding regions is that the constitution states that the regions be founded on the basis of independent decisions by municipalities. For this reason in practice they have never come to rise, as given their differing interests the municipalities have failed to agree on founding regions. Amendments to the constitution allowing regions to be founded on the basis of an act of law are under preparation. Activity is also underway inside the Slovenian government to draft the systemic legislation allowing for the creation of regions. Concepts for a regions act were thus prepared in 2001. Individual ministries are keeping records of specific tasks that should be transferred to the regions from the national level, and a financial evaluation of the tasks to be transferred to the regions is also underway. With regard to the number of regions and their size there are several variants, but none has yet been finalised. Neither is the timetable for the entry into force of the regions act yet known. The regions would be wider self-governing local communities with their own bodies and like municipalities would in this manner be independent of the state. Of course the key solutions depend on the amendments to the constitution to be adopted by the National Assembly.

Before the reform of the state administration in 1995 the municipalities also carried out administrative tasks that were the responsibility of the state. In the reform all administrative tasks defined by acts of law as the responsibility of municipal bodies and carried out by municipal bodies until 31 December 1994 were taken over by the state under the takeover of state functions act. The municipalities created on 1 January 1995 pursuant to the establishment of municipalities and municipal boundaries act thus only perform those functions defined in the local government act.

Municipality functions are defined in the local government act. The municipalities are responsible for regulating matters of local importance in almost all areas of public concern.

### ***1.10.2 Major Empirical Findings***

Before the reform of local government there were 62 municipalities in Slovenia (of which five were in the capital Ljubljana). Of these, 23 (40 per cent) received the financial adjustment from the national budget, which even then gave indication of the differing financial strengths of the municipalities and the substantive dispersal of individual resources in specific areas of the country. In the further splitting and creation of municipalities it was and will remain impossible to pursue tax formulation and collection in an extent that would gain autonomy for municipalities to such a measure whereby the majority would be self-financing.

Since entering into force in 1995 the financing of municipalities act has undergone several changes. The last substantive amendment was adopted in 1998, but because of constitutional court decisions the basic concept of the act has been demolished. On the basis of the current system of financing, all municipalities whose own income fails to reach the level of appropriate expenditure through which the municipality can ensure that the tasks defined by the constitution and acts of law are performed are entitled to financial adjustment funds from the national budget. Every municipality that fulfils these legal provisions receives funding from the national budget. Thus in 2000 such funding was received by 163 of the 192 municipalities (85 per cent), of which just one had city status. Changes in the system for financing municipalities should move in the direction of increasing municipalities' own income and consequently reducing the number of municipalities that receive financial adjustments from the national budget.

#### ***Revenues***

Between 1998 and 2000 the revenues of the state institutional sector (general government) ranged from 42.79 to 43.58 per cent of GDP. Local government revenues during this period increased from 5.14 to 5.33 per cent of GDP.

**Tax revenues** in general government accounted for 93 to 94 per cent of total revenues. These revenues rose from 39.93 per cent of GDP in 1998 to 41.10 per cent of GDP in 1999, before falling to 39.67 per cent of GDP in 2000.

Local government tax revenues as a proportion of general government tax revenues rose from 7.44 per cent of the total in 1998 to 7.59 per cent in 1999 and 7.87 per cent in 2000. Local government tax revenues accounted for between 58 and 60 per cent of local government's total revenues.

Municipalities' tax revenues are divided into those pertaining to the state and the municipalities, and those pertaining to the municipalities alone. The tax basis, tax rates and taxpayers are defined by acts of law. Local authorities have relatively little jurisdiction over the introduction of individual taxes.

**Non-tax revenues** in general government accounted for between 6 and 7 per cent of total revenues. The proportion of general government non-tax revenues accounted for by local government non-tax revenues

ranged from 31 to 37 per cent. Non-tax revenues accounted for between 18 and 21 per cent of total local government revenues.

The majority of non-tax revenues pertained solely to municipalities, but some were split between the state and the municipalities on the basis of law (revenues from concession fees for gambling, administrative fees, compensation for environmental degradation and usurpation).

The non-tax revenues pertaining entirely to municipalities are set by the municipalities on the basis of acts of law.

**Transfers** to local government go to municipalities from the national budget in the form of general grants and special grants.

Municipalities get general grants from the national budget for funding the municipality's appropriate expenditure. Appropriate expenditure is the level of funding with which the municipality can ensure that its constitutional and legal functions are carried out. The National Assembly sets the level of appropriate expenditure per inhabitant when the budget is approved for an individual budget year. The appropriate expenditure per inhabitant is set as an average sum per inhabitant in the country. Any municipality that fails to cover its appropriate expenditure as calculated according to the criteria in the financing of municipalities act through the revenues for covering appropriate expenditure defined in the financing of municipalities act is entitled to funding from the national budget in the form of the financial adjustment. The financial adjustment is not a purpose-specific revenue for municipalities.

Municipalities can obtain special grants from the national budget for investment expenditure and for current expenditure.

From 1998 to 2000 transfers to local government accounted for between 22 and 23 per cent of all local government revenues. Transfers to local government, both current transfers and investment transfers, rose in this period. The principal reasons were the increase in the number of municipalities in 1999 (from 147 to 192) and the annulment by the constitutional court of certain provisions of the financing of municipalities act relating to the setting of the financial adjustment for municipalities. The consequences of these decisions were seen in the significantly greater demand for current transfers to municipalities from the national budget.

In the 1998 to 2000 period general grants accounted for between 65 and 78 per cent of all transfers to municipalities, and special grants between 22 and 35 per cent. Given the rise in the number of municipalities entitled to such funding the proportion of special grants also rose sharply from 1998 to 2000.

Special grants for investments are allocated to municipalities pursuant to the financing of municipalities act. Special grants are also allocated to municipalities on the basis of tenders by the responsible ministries.

### ***Expenditure***

Municipalities can carry out original functions and transferred functions. Local matters that the municipalities regulate independently and that only affect the inhabitants of the municipality are defined as original functions. The transferred functions are those transferred by law from the state to the municipalities. The original functions are financed by the local community revenues set by the financing of municipalities act and the financial adjustment from the national budget, while state funding for the transferred functions is provided from the national budget. No functions were transferred from the state to the municipalities during the 1998 to 2000 period.

Pursuant to the local government act the municipalities are responsible for carrying out tasks in almost all areas of public concern. The specific responsibilities are defined in individual acts of law governing particular areas. In carrying out the tasks for which it is responsible pursuant to area acts of law a municipality is independent. The tasks to be carried out by a municipality in a particular budget year are defined in the municipal budget, which is formulated for the period of a single year. In drawing up and implementing the budget the municipality must observe primary and secondary legislation relating to the execution of the functions for which municipalities are responsible (e.g. the norms and standards for carrying out activities, wage bases) and the provisions of its own acts issued on the basis of the charter. The individual municipality acts on the disposal of budget funds (rulings, orders, resolutions, contracts) must be in accordance with acts of law and other regulations.

The most important fields in the area of expenditure by municipalities are education (pre-school and primary education), housing and community amenities, communal activities, environmental protection, housing activities, planning, and transportation and communications (road activities). These fields accounted for 59.1 per cent of all expenditure by municipalities in 2000.

Between 1998 and 2000 there was nominal growth in expenditure by municipalities. The higher rate in growth in 1999 in comparison with 1998 was affected by the rise in the number of municipalities in 1999.

### ***1.10.3 Major Problems in Fiscal Design***

The major problem in the area of local public finances is the large number of municipalities, which have the same functions and sources of income irrespective of their size, which entails differing financial capacities for the individual municipality. Given that the fiscal strength of the municipalities varies so much, within the existing system of municipality financing certain municipalities are dependent to a great extent on financial adjustment funding from the national budget. Having a greater proportion of tax revenues going to local government should therefore reinforce the fiscal strength of municipalities.

Municipalities' tax revenues are divided into those pertaining to the state and the municipalities, and those pertaining to the municipalities alone. The tax basis, tax rates and taxpayers are defined by acts of law.

Of total national tax revenues 7.6 per cent pertains to municipalities. The most important source of tax revenues for municipalities is the share in income tax, which accounts for over 70 per cent. In addition another important revenue is real estate tax, which is wholly original municipal revenue and contributes about 16 per cent of tax revenues. The majority of the remaining tax revenues are also an original source for municipal budgets.

It is true that municipalities do not have much influence on setting the level of tax revenues, with the exception of real estate tax. The level of these revenues is almost entirely formulated by the municipalities themselves. However it is assessed that the (excessive) number of the municipalities in a country of Slovenia's relatively small size is leading to breaches in the basic taxation principle of equality before the law and consequent unfair levying of certain tax liabilities. The solution is therefore not seen in greater responsibility for municipalities in setting the level of liabilities and defining those liable to pay tax, but in a uniform system for some taxes, particularly real estate tax.

Indisputably it is necessary to find an approach to generate greater original revenues for municipalities, perhaps including non-tax revenues, naturally in accordance with their responsibilities and obligations towards citizens and the state.

Given that procedures to create regions were started in 2001, it will also be necessary to build a system for financing the regions in line with their defined responsibilities, and to co-ordinate it with the system for financing the municipalities on one hand and the system for financing the state on the other.

#### ***1.10.4 Status of Policy Reform Considerations***

The main areas where reform is underway are the creation of new municipalities, the system for financing the municipalities, the creation of regions and payment transactions.

Acts of law allow the procedure for founding municipalities and for defining or changing their boundaries to be carried out once in the period between regular elections to municipal councils. This creates pressure every four years for new municipalities to be founded, even if the criteria set out by law are by-passed. A particular problem is the municipality sub-sections that have legal person status, as often these are the very entities that the requests for new municipalities concern.

Another reason for new municipalities being created is the existing system for financing the municipalities, which since it was established in 1995 has undergone several changes because of constitutional court decisions, which have destroyed the original concept of the law. On the basis of the current system of financing, all municipalities whose own income fails to reach the level of appropriate expenditure through which the municipality can ensure that the tasks defined by the constitution and acts of law are performed are entitled to financial adjustment funds from the national budget. Every municipality that fulfils these legal provisions receives funding from the national budget, irrespective of the level of funding for appropriate expenditure it acquires through its own revenues. In theory this means that a municipality that did not have any of its own revenues would receive all its funding from the national budget. In practice such cases do not occur, but certain small and fiscally weak municipalities generate a very small proportion of revenues from their own sources, and consequently depend to a great extent on the financial adjustment funds from the national budget (up to 87 per cent).

Given these additional problems a new system of real estate tax is also under preparation; it will unify the system of levying and introduce the tax as a compulsory form of taxation in all municipalities. Through a single valuation criterion (market value) and uniform criteria for defining the subject of taxation and those liable to pay tax, the taxation will cover all real estate of the same type and all taxpayers irrespective of their legal status. This will allow municipalities to use the tax as an instrument of fiscal and planning policy, via the possibility of the municipality influencing the value of real estate in its environment and via the possibility of independent setting of the tax rate within the legally defined framework.

The second tier of local government envisaged both in the constitution and in the local government act has not yet taken shape. The biggest problem with founding regions is that the constitution states that the regions be founded on the basis of independent decisions by municipalities. For this reason in practice they have never come to rise, as given their differing interests the municipalities have failed to agree on founding regions. Amendments to the constitution allowing regions to be founded on the basis of an act of law are under preparation. The expert bases for drafting a regions act are also already under preparation, and will define the functions to be performed by regions either as original or transferred functions, whereby financial evaluations must also be prepared so that the finance ministry will be able to draft a financing of regions act.

Reform of payment transactions is also currently underway in Slovenia. The system of recording taxation for the whole public sector is to be changed. For public sector persons this means that the function of managing money will be concentrated at the level of the state or municipalities within the framework of a single treasury account for the state or municipality. However there are also problems arising in this area, namely of how to have this function performed entirely by the state or the municipality, each for its direct and indirect budget users, as the users feel that with the introduction of a single treasury account they will lose control over their revenues and expenditure.

**2. SELECTED EU MEMBER STATES – EXECUTIVE SUMMARIES**

## 2.1 BELGIUM

### 2.1.1 *Main feature of inter-governmental relations*

Belgium is a federal country with a complex structure of co-operative federalism. Belgian system of inter-governmental relation was deeply changed by a series of reforms begun in 1970. The last step took place in 1993. It represents the fourth stage in the federalization process undertaken over the last 30 years. But the state reform is still ongoing. After a new round of negotiations between the federal State and the decentralized authorities a new agreement has been reached in July 2001.

Belgian system consists of one federal or central government and a composite level of sub-federal government.

An upper level comprises three “communities” (Flemish, French and German-speaking) plus three regions (Flanders, Wallonia and Brussels Capital Region). The Regions are strictly geographically defined while the Communities are, in principle, defined by culture and language. In 1980, Flanders decided to amalgamate region and community. In practice, the Flemish Community controls Flanders and has jurisdiction in the Brussels Capital Region. The German-speaking Community has jurisdiction in nine communes in the Walloon Region. The French-speaking Community has jurisdiction in the Brussels Capital Region (through the French Community Commission of Brussels) and in the Walloon Region, except in the German-speaking communes. The presence of a single Flemish government and two French-speaking governments make Belgian federalism asymmetrical. Each Community and Region has its own legislative body (Council), but the Council of the Flemish Community is at the same time the legislative body of the Flemish Region.

Both Communities and Regions have legislative powers. They issue decrees that have the force of law without hierarchy between the Communities or Regions and the federal government.

Despite federalization, the traditional system of sub-national government, consisting of provincial and local authorities, has remained largely intact. The most important difference from the earlier situation is that responsibility over provincial and local government has been transferred from the old central government to the new federal authorities.

An intermediate level of government includes ten provinces. Finally a local tier comprises 589 municipalities.

As written in the Constitution “Belgium is a federal State made up of Communities and Regions”. So there is no hierarchy between the State and the regional and community governments.

The federal parliament comprises the chamber of representatives and the senate. The senate has 71 members, 21 of which are appointed by Flemish, French and German-speaking Community councils. Senate approval is required, especially in respect of constitutional amendments and special legislation of concern to the Communities.

Despite statements to the contrary, the Belgian federal reform must not be seen as a devolution of government power. In fact, the power of central government has been strengthened.

Belgian Constitution does not explicitly state the fields of competence of the federal parliament. As a consequence, within a specific policy area more authorities can have simultaneously responsibility. So it is difficult to summarize the allocation of competence between the various categories of regional and local authorities.

Without being prejudicial to the competence of the Communities and Regions, the federal government retains exclusive legislative powers in the following areas: defense, legal system, social security, monetary policy.

The following federal responsibilities are shared with federate authorities: finance, public health, international relations, taxation, economic policy, energy, external trade, agriculture, employment, transport, language use, aid to developing countries.

Articles 127 to 130 of the Belgian Constitution stipulate that the Communities have legislative powers in the following fields of jurisdiction: culture; education, except for determining the beginning and end of compulsory schooling, minimum conditions governing the granting of diplomas, and the pension plan; services offered to individuals (called in French “matières personnalisables”); the use of languages in respect of administrative matters, teaching and contacts between employers and their staff; intra-Community and international cooperation, including the conclusion of treaties in realms that fall exclusively under their jurisdiction.

Services offered to individuals include, in particular, health policy and policy governing the disabled, but not social security, which falls under federal jurisdiction, although this point is regularly called into question by some.

The Constitution does not specifically define the Regions’ fields of jurisdiction, which are instead specified through special legislation that requires a two-thirds majority in both chambers of parliament. According to the list established by the Conseil Supérieur des Finances, the Regions assume the following main fields of jurisdiction: economic policy, including assistance in respect of investment and employment; employment; transportation; public works; the financing of subordinate powers; scientific policy pertaining to their fields of jurisdiction; energy; wastewater treatment and the protection and distribution of water; policy governing waste and environmental protection; monuments and sites.

More recently the following fields of jurisdiction have been added: foreign trade; agriculture; international relations from the standpoint of the Regions’ fields of jurisdiction.

Moreover Regions supervise the work of provinces and municipalities.

The so-called Lambermont or Saint-Polycarpe agreements, reflected in legislative terms in the special law of July 13, 2001 transferring various fields of jurisdiction to the Regions and the Communities and the special law of July 13, 2001 respecting the refinancing of the Communities and the extension of the fiscal jurisdiction of the Regions, extended regional jurisdiction, especially in the realms of agriculture, foreign trade and authority over local powers, broadened the means of the Communities and the Regions, especially with regard to the latter, through the attribution of broader fiscal autonomy.

Provinces support education and cultural activities and are also responsible for supervising the municipal authorities. Moreover, they have responsibility on urban planning, maintenance of infrastructure, implementing all federal, community and regional legislation and regulations.

Finally, municipalities’ tasks concern local civic administration and public order, road maintenance and urban development, education, health and social services.

In Belgium local authorities may enter into cooperation agreements, setting up “inter-municipal associations” to tackle jointly issues of common interest. The most important structure is the *Joint municipal authority* that is set up and managed on the basis of voluntary rules adopted by the participants. The major policy areas are energy supplies and waste disposal. The regional government supervises these joint authorities.

The funding of the Communities and Regions is at present based on three principles: financial responsibility (each Region and Community has its own financial resources); solidarity assistance which is reimbursable; the continuation of the Economic Union (fiscal policies vary but are coordinated).

The federal government sets and collects most taxes. Communities, regions and local authorities have limited taxing power. Regions and communities rely extensively on tax revenues (mainly from VAT and personal income tax) shared with the central government. Local authorities have wide freedom to borrow in order to finance capital investment and to cover short-term discrepancies between income and current spending.

### **2.1.2 Major empirical findings**

After the constitutional reform of 1993 the system of financing regions and communities is based on the two principles of financial accountability and solidarity. It is a statutory requirement that resources be transferred to those authorities on a sufficient scale to enable them to perform their functions effectively. Then each region determines the criteria by which further allocations will be made to provincial and local authorities.

Communities and regions are required to contribute to discharging the federal public debt.

Belgian regions have at their disposal own-source tax and non-tax revenues. Non-tax own-source revenues include hunting and fishing fees and forestry operation fees.

At present, Regions’ own-source revenues stem from three items: indexed share of the national yield from personal income tax, which has the status of a joint tax; formerly federal taxes, now called “regional taxes”; and new taxes adopted by the regions.

Regional fiscal revenues are massively dominated by the personal income tax proceeds. The regions have also the possibility of establishing additional taxes or granting rebates on the portion of personal income tax attributed to them as a joint tax.

After the 2000 Lambermont agreement the power of regions to establish additional taxes or rebates has been broadened. The new law established that the regions exercise their jurisdiction in respect to general tax reductions or increases, additional taxes or tax reductions without reducing the progressive graduation of personal income tax and at the exclusion of any unfair tax competition.

The tax powers of Regions are circumscribed by a number of principles. The Regions cannot alter the tax base, nor the tax calculation established by the federal government. Surtaxes or rebates set by Regions may not diminish the progressivity of personal income tax. Surtaxes or rebates may not exceed 3.25% of federal tax until 2003 or 6.75% as from 2004. Harmful tax competition should be avoided.

With regards to “regional taxes”, on a first group (the tax on gambling and betting, the tax on coin-operated amusement devices and the tax on the opening of drinking establishments) regions enjoy complete autonomy and so may freely determine the tax base, exemptions and tax rates.

A second group includes the real estate tax and transfer duty upon death and inheritance tax. In this instance regional fiscal autonomy is not complete. Regions enjoy autonomy only with respect to tax rates.

Sometimes tax autonomy is much less complete. As for registration fees on the transfer for payment of real property central government sets the tax base and rates and regions may only establish additional taxes or grant refunds.

There is absence of autonomy with regard to the tax on vehicle use, for fear of encouraging fictitious registrations in the Region with the lowest taxation.

Since 1993 environmental taxation has been reserved for the regions. This includes eco-taxes and water and waste taxes.

With regards to “new” regional taxes, according to the constitutional principle “*non bis in idem*” regions may levy taxes on any matter provided that there is no federal tax on this matter or that the federal government has not shown the need to levy such a tax.

The overall amount of the transfer to Regions based on the personal income tax revenue was originally set equal to the transferred expenditure. Then it was indexed to inflation and, starting from 1994, gradually linked to the real-terms increase in GDP. The allocation of funds among Regions, initially set equal to the historical spending, then has been linked to the income tax revenues collected in each Region.

Communities could levy taxes under the same conditions as the regions, but in reality they have never exercised this power.

French-speaking and Flemish Communities draw most of their revenue on transfer from the federal government related to three taxes, i.e. personal income tax, radio-television fee and above all the value-added tax. In particular, the allocation of VAT was originally based on a historical amount (referred to the education expenditure). Recently it has been adapted to objective criteria, i.e. the number of young people attending elementary and secondary schools. In the future there will be a reduction in the distribution of resources on needs and an increase on fiscal capacity.

Besides shared taxation other smaller sources of finance include specific grants from central government, non-tax revenues and loans.

The German-speaking community is finance on a different basis, relying largely on structural grants not connected to any tax base. But they receive also some revenue from VAT and from radio-television fee.

The most important source of financing for municipalities is grants from regional government. In particular each of the three regions manages a Municipality Fund and determines criteria for allocations from it to the municipalities. Moreover, apart from fees and charges for services some specific grants are made to municipalities and to the city of Brussels by the federal government.

The local authorities (provinces and municipalities) have tax autonomy, but under the control of the Regions. Municipalities raise around two-fifths of their total revenue from taxation, the large majority of which results from supplements to federal taxes.

Local authorities have wide freedom to borrow in order to finance capital investment and to cover short-term discrepancies between income and current spending.

The only mechanism designed to reduce differences in financial capacity between the federated entities is a fairly modest program called the *Intervention de solidarite' nationale*. Under the program, those Regions

in which the average per capita yield of personal income tax falls below the national average are entitled to an unconditional transfer from the federal government.

The fiscal autonomy of the Regions expanded between 1990 and 1997. The share of revenue over which they enjoy full autonomy increased from only 1.7% of their tax revenue in 1990 to 7.1% in 1997. At the end of the period, tax-sharing revenue from personal income tax was rising much more sharply than the Regions' own taxation, indirectly reducing the relative importance of Regional fiscal autonomy.

After the Lambermont agreement the power of regions to establish additional taxes or rebates has been broadened. As a consequence, the Regions now enjoy almost complete autonomy over 40% of their revenue (regional taxes) and they have rate autonomy over the remaining 60% (personal income tax).

Despite federalization in Belgium, the federal government engages in most of the country's public spending. However, the presence of the other federated entities is significant in the realms of health, social assistance and unemployment insurance.

Apart from general services, social security (around 45% of total spending) and health (around 17%) are the most important federal government's expenditure area.

Education is the Communities' biggest expenditure item, followed closely by social protection. Economic affairs are a key spending item in the Regions' budgets, while public security and education for local governments.

In particular, as a share of total spending for provinces the most important expenditure areas are education (34.6%), culture (13.2%), followed by health care (6.2%), industry (6.1%), environment (5%) and social services (4.1%). For municipalities they are education (17.1%), public safety (13.6%), social services (12.5%) and culture (11.5%).

Taking into consideration all sub-national government (i.e. Communities, Regions, Provinces and Municipalities), as a share of total sub-national expenditure the most important sectors are education (37.8%), social security (16.5%), general public services (15.4%) and economic affairs (14.9%).

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1998 - Belgium is under the unweighted average of OECD Federal countries (16.6% against 18.6%).

Total sub-national revenues represent about the 33% of total national government revenue. Sub-national revenues are mainly composed of tax revenues (78.5%) and grants (23.4%), while non-tax revenues represent a not significant item (4%).

Sub-national tax revenue as percentage of total national tax revenue is equal to 25.8% for regional government and to 5% for local government. As a percentage of GDP, tax revenue is 10.8 and 2.3 respectively for regional and local government.

As shown in Table 2, for regional government more than 55% of total tax revenues is based on income and profits. The share is higher for local government (84.2%).

Another important tax source is general taxes for regional government (36.2% of total tax revenue) and taxes on use of goods for local government (13.5%).

Table 1 Total revenue by level of government, in billions of National Currency

	Federal Government			Social Security Funds			Regional Government			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	876.87	920.51	918.18	19.52	22.99	23.47	479.77	518.48	560.21	170.51	169.78	160.32	1546.67	1631.76	1662.18
2000 Social security contributions	50.27	50.59	51.11	1223.42	1263.94	1312.48	0	0	0	3.25	0.64	0.64	1276.94	1315.17	1364.23
3000 Taxes on payroll and workforce	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
4000 Taxes on property	65.32	77.67	78.93	0	0	0	50.16	57.00	63.13	0	0	0	115.48	134.67	142.06
5000 Taxes on goods and services	427.77	459.10	494.75	159.92	161.54	171.18	380.85	384.85	391.59	27.39	28.10	29.50	995.93	1033.59	1087.02
6000 Other taxes	0	0	0	0	0	0	0	0	0	0	24.75	25.68	0	24.75	25.68
<b>Total Tax Revenue</b>	1420.23	1507.87	1542.97	1402.86	1448.47	1507.13	910.78	960.33	1014.93	201.15	223.27	216.14	3935.02	4139.94	4281.17
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	28	22	n.a.									n.a.			n.a.
Fees, sales, fines	29	33	n.a.												n.a.
Contr. to govt. employee pension funds															
Other Non-tax revenue	1	10	n.a.									n.a.			n.a.
<b>Total Non-Tax Revenue</b>	58	65	-				46	47					104	112	-
<b>Grants</b>	20	7	n.a.							268	277		288	284	n.a.
<b>Total Revenue</b>	1498.23	1579.87	-	1402.86	1448.47	1507.13	910.78	960.33	1014.93	515.15	547.27	-	4327.02	4535.94	-
<b>Tax revenue as % of GDP</b>	16.3	16.6	16.4	16.1	15.9	16.0	10.4	10.6	10.8	2.3	2.4	2.3	45.1	45.6	45.4
<b>Sub-national tax revenue as % of total tax revenue</b>							23.1	23.2	25.8	5.1	5.4	5.0			

Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001

Table 2. Tax revenue from the main sub-national taxes as percentage of total tax revenue of sub-national Government

		1975	1985	1999
<b>1000</b>	<b>Income and Profits</b>	\	\	55.2
	State	76	84.7	84.2
	Local			
<b>3000</b>	<b>Payroll</b>	\	\	\
	State	\	\	\
	Local	\	\	\
<b>4000</b>	<b>Property</b>	\	\	6.2
	State	\	\	\
	Local	\	\	\
<b>5110</b>	<b>General taxes</b>	\	\	36.2
	State	\	\	2
	Local	\	\	
<b>5120</b>	<b>Specific goods &amp; services</b>	\	\	2.1
	State	\	\	\
	Local	\	\	\
<b>5200</b>	<b>Taxes on use of goods</b>	\	\	0.3
	State	21.5	11.8	13.5
	Local			
<b>6000</b>	<b>Other taxes</b>	\	\	0
	State	2.5	3.5	0.3
	Local			

Source: OECD, *Revenue Statistics, 1965-2000*, Paris, 2001

Table 3 Subnational expenditure by function, as a percentage of subnational government expenditure (1999)		
	Provinces	Municipalities
1	21.1	17
2		
3	34.6	13.6
4	6.2	17.1
5	4.1	12.5
6		
7	13.2	11.5
8		
9		2.2
10		
11		
12	6.1	11.9
13	14.7	14.20
14	100	100
15		
Total government expenditure. Consolidated % of GDP	47.58	
Total subnational government expenditure. % of GDP	n.a.	

Source: own calculation from DEXIA (2000).

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## 2.2 DENMARK

### 2.2.1 *Main feature of local finance and the inter-governmental relation*

Denmark is a unitary State whose Constitution establishes the principle that “the right of local authorities to govern independently under the supervision of the State must be laid down by law”.

This self-government principle means that local authorities are free to adopt their own local polities within a broad framework of national laws. As a consequence individual authorities have significant powers to decide their own polities and to adapt their public offer to the wishes of local population.

There are now two types of local government bodies in Denmark, with the municipality as the local unit and the county council as the intermediate unit. The general rule is that the counties are not superior to the municipalities. Structural reform that took place in 1970 laid the basis of the present Danish local government system. Before the reform Denmark was divided into 1391 municipalities and 25 counties. After the reform the number was reduced to the present 275 municipalities and 14 counties. Each municipality belongs to a county, except for the two authorities making up the capital city – Copenhagen and Frederiksberg – each of which has the dual functions of county and municipality.

In general, the Danish system of local government is very comprehensive, both as to the share of the overall public tasks carried out by municipalities, and the right of municipalities and counties to impose taxes and to determine their own levels of taxation and service. A very large share of Danish municipal expenditure is financed by municipal income. This limits the formal possibilities of central government to influence the overall level of taxation and of public expenditure.

The 1970 reform was based on the principles of devolution and subsidiarity. As a result, the distribution of responsibility between the State, the counties and the municipalities implies that most competences that directly concern local citizens have been progressively transferred to municipalities and counties. Today the responsibility for providing most public services lies with local authorities.

The 14 counties and 275 municipalities provide around 80 % of public services and are relatively free to choose how to do so. In addition, municipalities administer all social benefit schemes.

County tasks include public transport across municipal boundaries, hospitals, primary health care, secondary education and regional physical planning. They also decide some environmental issues.

Municipalities are responsible for a large number of public service tasks in the social, education, technical, environmental and cultural sectors. These include day care for children and services for the elderly such as special housing and old people's homes, meals-on-wheels, nurses and helpers in private homes. The municipalities administer various social benefits. They are also responsible for primary schools (7-16 years), cultural activities such as libraries and subsidies to sport clubs, as well as local roads, environmental protection, town planning, water supply, sewage, local industry and employment policy. They also administer the system of local income taxes.

Where functions are nation-wide in scope, and where the nature of the duty so requires, these stay with the State. These include foreign affairs, defence, police and overall communication.

Danish local authorities are primarily financed through local taxes and general block grants. Since the 1970 reform, tax revenue as a share of total local revenue has increased, reflecting both higher tax rates and stronger economic activity. On the other hand, revenues from central government transfers declined in the 1990s. Moreover, the reform process consolidated many of the specific grants into a general block grant. The basis of its allocation was changed from the reimbursement principle to criteria representing local needs and resources. However, significant earmarked grants from central government remain for some areas of current expenditure.

### **2.2.2 Major empirical findings**

Income tax is at the center of the Danish system of local finance. Income tax covers more than 90% of the total tax revenue of local government.

There are no formal limits to the local income tax rate. Both counties and municipalities can freely set their own tax rate on income. Income tax base is laid down by law. Regional and local authorities decide the income tax rate each year as part of the adoption of their budget. The tax rate on income is however an important issue in the agreements between central and regional/local governments. Generally, all parties involved agree that the income taxes of regional/local governments on average may not exceed a certain level.

Local authorities have the job of assessing residents' taxable income. On average, the tax rate levied by municipalities is 20%, ranging from a minimum of 13% to more than 22%. The average rate levied by county councils is just under 10%.

A much less important tax instrument is that levied on the value of land and premises. Upper and lower limits fixed by central government constraint the tax rates that municipalities may set, while land tax for counties is set by statute at one per cent.

A significant share of local total revenue comes from user charges and fees. There are three different types of those user payments. For public utilities such as gas, electricity, water, public transport and waste disposal, expenditure is in most cases met fully by users through specific charges. A second category is composed of direct charges to users of welfare services. In most cases, local authorities are debarred by law from recovering through charges more than 30% of operating costs. However, some services, such as for elderly people at home, must be provided free of charges. Finally, cultural and recreational services provided by local authorities may be subject to charges in some instances.

Two basic principles guide the inter-government financial relations in Denmark. The first, called *Expanded Total Balance Principle*, requires the State to compensate local authorities whenever national new legislation increases local spending. Conversely, resources must be refunded where new national legislation has the opposite effect. The second principle, called *Budget Guarantee Scheme*, compensates local authorities for additional expenditure that is thought to be driven by factors outside their control. Compensation is made through specific central grants.

Final decisions about the size and allocation of grants are reached by central government jointly with representatives of local authorities through a formal process of annual negotiations.

The total size of transfers made available by central government as block grant to local authorities depends on several factors, such as previous year's transfers; changes in local spending caused by national legislation; price and wage changes in the local government sector.

Having determined the total size of transfers, the State calculates an initial allocation to local authorities according to their own tax bases. Then, an equalization mechanism comes into play to adjust the initial allocation, seeking to offset in part the differences among Danish local authorities firstly in resources and secondly in expenditure needs.

Resource equalization is achieved through a self-financing mechanism. As in Sweden, local authorities with a per capita taxable base level below the average for Denmark receive a grant, while those with higher-than-average taxable base must pay a contribution. The total grant amount is as large as the sum of contributions.

In addition to the distribution according to tax bases, central transfers are adjusted according to expenditure needs. At this aim, the base is calculated from a composite index taking into account: the minimum spending level required to run a sufficiently professional administration in a small local government; demography and social indicators such as the number of the authority's inhabitants in specific age categories or the number of children of single parents. The elements entering the composite index are supposed to be exogenous to individual local authorities to ensure that they have limited ability to manipulate the base.

Redistribution is based on differences between revenue and expenditure bases and national averages. For counties, 80% of the deviation from national averages for both tax and expenditure bases are redistributed. For municipalities, only 45% is redistributed, but those municipalities with tax bases less than 90% of the national average are compensated through a specific grant by an additional 40% of the gap.

Specific central grants are paid mainly to finance local authorities spending in the areas of health care, social services and social security cash benefits. The rate of reimbursement varies depending on the service area involved. For instance, the rate is 100% for health care but 50% in the case of assistance to non-insured unemployed people.

For counties, capital spending accounts for only a small share of their total expenditure. Counties are in general excluded from borrowing. On the contrary, municipalities have access to borrowing without permission of central government, but only if they plan to use capital funds for investment in specified sector, for instance electricity, energy saving, construction of elderly people's residence. Otherwise, loans have to be approved by the Ministry of the Interior.

As shown in Table 3, the local expenditure as a share of total government expenditure has gradually increased in last years, from 45.66% to 46.39%. It has remained stable in term of GDP.

Social security and welfare is the most important public function carried on by local government in Denmark.

Taking into consideration all sub-national government, as a share of total sub-national expenditure the most important sectors are social security and welfare (56.69%), health (16.46%), education (13.39%) and other economic affairs (4.95%).

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1998 – Denmark is over the unweighted average of OECD Unitary countries (30.9% against 9.5%).

Total sub-national revenues represent about the 44% of total national government revenue. Sub-national revenues are mainly composed of tax revenues (51.4%) and grants (40.4%), while non-tax revenues represent a less important item (8.2%).

Taking into account regional and local government, sub-national tax revenue as percentage of total national tax revenue is equal to 31.8% and as a percentage of GDP is 15.8.

As shown in Table 2, for regional and local government more than 92% of total tax revenues is based on income and profits, especially personal income (90.6% of the total tax revenue).

Another important tax source is that on property, which represents the 6.6% of total local tax revenues.

Table 1. Total Revenue by level of government, in millions of National Currency.

	Central Government			Social Security Funds			Regional Government			Local Government			General Government (total revenues)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	172071	168984	183451	0	0	0	162662	172360	180961	334733	341344	364412			
2000 Social security contributions	3	3	3	17428	18042	25794	0	0	0	17431	18045	25797			
3000 Taxes on payroll and workforce	3240	4705	3878	0	0	0	0	0	0	3240	4705	3878			
4000 Taxes on property	7321	9303	9080	0	0	0	11269	11590	12797	18590	20893	21877			
5000 Taxes on goods and services	179565	191337	200444	0	0	0	121	126	137	179686	191463	200581			
6000 Other taxes	41	41	41	0	0	0	0	0	0	41	41	41			
<b>Total Tax Revenue</b>	362241	374373	396897	17428	18042	25794	174052	184076	193895	553721	576491	616586			
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	36961	38328	34604				4286	4426	4226	41247	42754	38830			
Fees, sales, fines	13969	15020	15576				20658	20996	22550	34627	36016	38126			
Contr. to govt. employee pension funds															
Other Non-tax revenue	4516	4719	5409				3886	4076	4255	8402	8795	9664			
<b>Total Non-Tax Revenue</b>	55446	58067	55589				28830	29498	31031	84276	87565	86620			
<b>Grants</b>	4583	4826	4665				140844	145728	152176	145427	150554	156841			
<b>Total Revenue</b>	422270	437266	457151	17428	18042	25794	343726	359302	377102	783424	814640	860047			
<b>Tax revenue as % of GDP</b>							15.6	15.8	15.8	49.8	49.5	50.4			
<b>Sub-national tax revenue as % of total tax revenue</b>									31.8						

Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001

Table 2 Tax revenue from the main local taxes as percentage of total tax revenue of Local Government

	1975	1985	1999
<b>1000</b> <b>Income and Profits</b>	86.4	93.5	92.8
<b>1100</b> <b>Individuals</b>	84.8	91	90.6
<b>1200</b> <b>Corporate</b>	1.6	2.6	2.1
<b>4000</b> <b>Property</b>	13.2	6.4	6.6
<b>5110</b> <b>General taxes</b>	\	\	\
<b>5120</b> <b>Specific goods &amp; services</b>	0.2	0.1	0.1
<b>5200</b> <b>Taxes on use of goods</b>	0.1	\	\
<b>6000</b> <b>Other taxes</b>	0	0	0.6

Source: OECD, *Revenue Statistics, 1965-2000*, Paris, 2001

**Table 3 Sub-national expenditure by function, as a percentage of sub-national government expenditure**

	1998	1999	2000	2001
1 General public services	4.03	4.21	4.12	3.98
2 Defence				
3 Public order & safety	0.35	0.37	0.36	0.34
4 Education	12.04	12.93	12.81	13.39
5 Health	15.92	16.78	16.23	16.46
6 Social Security & Welfare	58.12	59.18	57.14	56.69
7 Housing & community amenities	0.77	0.83	0.88	0.76
8 Recreational, cultural & religious affairs	2.87	2.97	2.87	2.80
9 Fuel & energy				
10 Agriculture, forestry, fishing & hunting				
11 Mining, manufacturing & construction, except fuel & energy				
12 Transportation & communication				
13 Other economic affairs	5.11	5.18	4.94	4.95
14 Other functions				
Total current subnational government expenditure. % of GDP	31.36	31.21	31.1	
Total current subnational government expenditure. % of total current government expenditure	45.66	46.14	46.39	

Source: Danish Government

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### 2.3.1 *Main feature of local finance and the inter-governmental relation*

Over the past 20 years France has moved from one of the most centralized systems in Europe to one of the most decentralized. Actually, the financial autonomy of French local authorities is extensive, effective, strongly supported by decentralization, and guaranteed by the political weight wielded by local elected representatives in the parliamentary deputation. This autonomy is considerable both from the standpoint of the mobilization of resources (taxes, transfers and borrowings) and the use to which resources are put.

The French Constitution defines two tiers of “collectivités territoriales” below the central State and gives a pledge that local authorities shall “administer themselves freely through elected councils, under the conditions laid down by the law”. In recent years, regional authorities, which had been merely consultative bodies, has been transformed into a third level of elective government.

Local government has broadly three-level structure, or even four-level if account is taken of the inter-communal level. Metropolitan France (with a population of 60 million) has 36.621 communes, 96 departments and 22 regions.

The 36 communes with 100.000 or more inhabitants account for 15% of the population; the 841 communes with 10 000 or more inhabitants account for 49.5% of the population. Symmetrically, the 35 710 communes with fewer than 10 000 inhabitants, of which – 28 183 have fewer than 1.000 inhabitants, account for 16% of the population. The average size of French communes is thus small, the lowest in the EU member countries, i.e. 1578 inhabitants.

The French regions are very disparate in terms of population, i.e. 10.6 million in the Île-de-France region, but 0.7 million in the Limousin region or 0.25 million in Corsica.

Communal fragmentation makes necessary the voluntary grouping of basic authorities with a view to jointly managing amenities or elaborating economic development and urban planning projects on a more relevant scale than the communal level. Voluntary groups of communes take mainly an associative form.

In an associative group, the communes (municipal councils) transfer to the group decision-making and executive power in respect of the jurisdictions transferred in exchange for a financial contribution and levy additional taxes to this end. The total number of groups has risen from 10.636 in 1972 to approximately 20.000 today. Since 1992, an alternative formula, the federative one, has become more popular for voluntary grouping. Under the federative formula local authorities apply a substitutive tax at a single rate to finance inter-communal public expenditure.

A number of compulsory competences are attributed to local authorities by law. Authorities are free to assume other ones.

The regions have been assigned jurisdiction over land use planning and development, regional planning, assistance to businesses, ongoing vocational training and apprenticeship, river ports and navigable waterways, fishing fleets and aquaculture, construction and the maintenance of high schools.

The departments are responsible for social action and health, maritime ports and aquaculture, non-urban school transportation, the maintenance and construction of colleges, and assistance in respect of rural amenities.

The communes are responsible for urban planning (documents, planning and authorization to use land), general jurisdiction over local urban services, the construction and maintenance of nursery and primary schools, libraries, occupational health and general health services, sports facilities, urban public transport, and jurisdictions exercised on behalf of the State, e.g. civil status and voters' lists.

All communal jurisdictions may be transferred to inter-communal groups (except for police powers). The groups manage a wide range of services that has continued to grow over the years.

Local authorities in France enjoy significant financial flexibility. The only constraints concern control over legality, control over budgetary balance and compliance with certain prudential rules. Although financial flexibility is high, local spending accounts for a low share of GDP.

The French system is characterized by the prominence of local tax resources, their great variety and the significant complexity of grants' system from central government.

Local and regional authorities' capital expenditure is funded for around one-third from central government grants and for the remainder from own sources. Borrowing is subject to no control by central government.

After a period of fiscal decentralization a trend in the opposite direction has occurred in France in more recent years. In last decade the budgetary performance of local authorities has grown worse. Local authorities' own tax resources have been squeezed by the abolition or reduction in local taxes, which have been replaced with grants from the central government.

Local budgets are still balanced and do not lead to macroeconomic risks. However this result has been achieved at the cost of slower growth in capital expenditure.

Local taxation has been changed by a lot of recent central government decisions including the removal of the wages component of business tax, the withdrawal of the share of residence tax earmarked for the regions, the withdrawal of the regions' and departments' share of property tax on undeveloped land, the abolition of motor vehicle tax.

Compensation grants from central government do not reflect local tax circumstances. Local authorities can no longer exercise tax policy options at the same degree as they have lost a large part of their tax instruments. This loss of financial autonomy is a source of serious concern to local authorities.

### **2.3.2 Major empirical findings**

In France local governments finance their expenditure through own taxes, grants from central government, other revenue sources including fees and user charges and loans.

There are over 40 local taxes. Four major direct taxes together yield four-fifth of total tax revenues. Moreover, these taxes overlap, i.e. the communes, departments and regions independently vote on the tax rates that apply to the same taxation base, without the deductibility of taxes collected at a lower level. This is true of the property tax on undeveloped property, the property tax on developed property and the housing tax, which are based on cadastral values that are supposed to represent the revenue from the property in question. The housing tax, of which the regional share has been eliminated, is subject to keen criticism because of its regressivity in relation to income.

The fourth and final local direct tax, the business tax (“Taxe professionnelle”) constitutes (or rather, constituted) a high-yield tax. Until recently, this tax alone accounted for nearly half of the tax revenues of local authorities. It was very unevenly distributed and was the principal cause of the very great disparity in tax wealth between local authorities. Its base is made up of rental values of enterprises’ buildings and equipment, plus a set percentage of their salary bill (though this element has been gradually removed since 1999). Central government offers a range of relief and exemptions and imposes tight constraints on the rate at which an authority can levy the business tax.

Local authorities do not control tax bases, which are established for remuneration by the State’s taxation services on behalf of local authorities. Taxing powers are subject to central constraints even though they are more extensive than in many EU countries.

A lot of less important taxes are levied on specific local authorities’ services. These taxes are in effect a substitute for user charges which in France account less than in other EU countries.

About one-third of total local revenues comes from central grants. Most of these resources are block grant, so recipient authorities can choose how to spend them. Both the total annual amount of central grants and the criteria of allocation are determined for the most part automatically by formula.

The main categories of central grants are block grants toward current spending (the most important grant, named *Dotation Globale de Fonctionnement* - DGF), compensation for exemptions and relief on local direct taxation, grant to reimburse value-added tax paid by local authorities and capital grants. Additional grants are paid to specific local authority by government’s discretionary judgement.

For the DGF formulae are used to determine both its growth and its allocation. Its annual growth rate is set at the rate of inflation plus half of the GDP growth rate. Resources are distributed to local authorities partly according to objective factors related to need and partly according to each authority’s fiscal capacity. Compensation for exemptions and relief are also automatic contributions by which central government compensates local authorities for reductions in tax revenues that arise from its own legislation.

Capital spending is financed through a combination of central grants, borrowing and own resources. Any substantial investment is usually preceded by negotiation with partners of other levels of government – including State - to secure joint capital funding.

Borrowing, contributing around half of all capital spending, is the most important source of finance. French local authorities have exceptionally wide freedom to borrow in order to finance capital investment. The only constraints refer to prudential rules that link debt with current revenues.

As shown in Table 3, the local expenditure as a share of total government expenditure and of GDP has remained stable in last available years (1994-1997), respectively 17.46% and 9.85%.

Housing and community amenities are the most important public function carried on by local government in France, followed by education and social security.

Taking into consideration all sub-national government in 1993, as a share of total sub-national expenditure the most important sectors are housing (24.11%), education (19.65%), social security and welfare (17.67%).

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1998 – France is in line with the unweighted average of OECD Unitary countries (9.9%).

Total sub-national revenues represent about the 18.7% of total national government revenue (1997).

Sub-national revenues are mainly composed of tax revenues (47%) and grants (34%), but also non-tax revenues represent a significant item (19%).

Taking into account regional and local government, sub-national tax revenue as percentage of total national tax revenue is equal to 10.2% and as a percentage of GDP is 4.6. These percentages have decreased in recent years.

As shown in Table 2, for regional and local government more than 51% of total tax revenues is based on taxes on property.

Another important tax sources are those on specific goods and services and on use of goods, which account respectively for 6.5% and 4.1% of total local tax revenues.

Table 1 Total revenue by level of government, in Billions of National Currency.

	Central Government			Social Security Funds			Regional Government			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	512.50	551.00	603.09	159.69	347.86	367.85				0	0	0	672.19	898.86	970.94
2000 Social security contributions	33.65	35.10	35.60	1477.33	1360.68	1424.69				0	0	0	1510.98	1395.78	1460.29
3000 Taxes on payroll and workforce	64.36	66.76	68.21	4.71	5.47	4.70				15.74	16.56	17.94	84.81	88.79	90.85
4000 Taxes on property	83.90	79.84	87.01	0	0	0				190.19	203.46	209.70	274.09	283.3	296.71
5000 Taxes on goods and services	890.21	911.22	960.96	28.31	30.55	31.47				43.58	41.29	42.82	962.1	983.06	1035.25
6000 Other taxes	13.86	12.93	10.36	0.98	0	0				135.91	140.48	136.24	150.75	153.41	146.6
<b>Total Tax Revenue</b>	1598.48	1656.85	1765.23	1671.02	1744.56	1828.71				385.42	401.79	406.7	3654.92	3803.2	4000.64
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	46	n.a.	n.a.							13	n.a.	n.a.	59	n.a.	n.a.
Fees, sales, fines	131	n.a.	n.a.							118	n.a.	n.a.	249	n.a.	n.a.
Contr. to govt. employee pension funds	0	n.a.	n.a.							0	n.a.	n.a.		n.a.	n.a.
Other Non-tax revenue	32	n.a.	n.a.							17	n.a.	n.a.	49	n.a.	n.a.
<b>Total Non-Tax Revenue</b>	209									148			357		
<b>Grants</b>															
	52	n.a.	n.a.							280			332		
<b>Total Revenue</b>	1859.48			1671.02	1744.56	1828.71				813.42			4343.92		
<b>Tax revenue as % of GDP</b>	19.5	18.3	19.9	20.4	20.4	20.6				4.7	4.7	4.6	44.5	44.5	45.2
<b>Sub-national tax revenue as % of total tax revenue</b>										10.5	11.0	10.2			

Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001

Table Tax revenue from the main local taxes as percentage of total tax revenue of Local Government

	1975	1985	1999
<b>1000</b> Income and Profits	\	\	\
<b>1100</b> Individuals	\	\	\
<b>1200</b> Corporate	\	\	\
<b>4000</b> Property	46	47.2	51.6
<b>5110</b> General taxes	\	\	\
<b>5120</b> Specific goods & services	4.8	5.1	6.5
<b>5200</b> Taxes on use of goods	3.2	8	4.1
<b>6000</b> Other taxes	46	39.7	37.9

Source: OECD, *Revenue Statistics, 1965-2000*, Paris, 2001

**Table 3. Subnational expenditure by function, as a percentage of subnational government expenditure**

	1990	1991	1992	1993
1 General public services	11.35	11.57	10.71	10.61
2 Defence				
3 Public order & safety	2.16	2.2	2.18	2.29
4 Education	19.14	19.66	20.18	19.65
5 Health	2.23	2.32	2.29	2.29
6 Social Security & Welfare	17.56	16.51	17.28	17.67
7 Housing & community amenities	21.39	22.08	22.22	24.11
8 Recreational, cultural & religious affairs	7.88	7.71	8.05	7.68
9 Fuel & energy	4.7	4.5	4.38	4.22
10 Agriculture, forestry, fishing & hunting				
11 Mining, manufacturing & construction, except fuel & energy				
12 Transportation & communication	5.63	4.55	4.24	3.64
13 Other economic affairs				
14 Other functions	7.96	8.90	8.47	7.85
15 Total	100	100	100	100
Total current subnational government expenditure. % of GDP	9.03	9.40	9.75	10.01
Total current subnational government expenditure. % of total current government expenditure	17.5	17.76	17.78	17.51

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### **2.4.1 Main feature of local finance and the inter-governmental relation**

After a long period of stability Italy is currently undergoing a radical period of constitutional and administrative reform. Over the 1990s a number of reform in the system of inter-government relations have been approved. The last reform of constitutional nature took place in the end of 2001 and its implementation is actually ongoing.

Italy is a unitary State with four levels of government: central, regional, provincial and municipal. Sub-national government comprises 20 regions, 100 provinces and about 8,100 municipalities. All are directly elected, multifunctional government bodies. Five regions are called “special statute” regions, as they have wider legislative and administrative powers. One of the special statute regions, Trentino-Alto Adige, has delegated almost all its legislative and administrative powers to the two component provinces (Trento and Bolzano), which can be considered to be regions in their own right. The remaining 15 regions are “ordinary statute” regions. While provinces and municipalities have a long tradition in Italy, ordinary regions are a relatively new entity. Even if they were created under the 1948 Constitution, the formal establishment took place only in 1970.

According to the 2001 constitutional reform, State, Regions, Provinces and Municipalities are “equi-ordinated”. All administrative tasks are attributed to municipalities and can be attributed to upper levels of government (i.e. provinces, regions and State) only according to the principle of subsidiarity.

The new Italian Constitution changes the model of fiscal inter-governmental relations in a variety of aspects. More legislative powers are assigned to regional authorities. A number of responsibilities that previously were in the State exclusive or concurrent (with Regions) competence has been transformed into the exclusive regional competence. For instance central government has among others the following exclusive responsibilities: defence, foreign policy, currency and financial markets, the determination of the essential levels of performances concerning civil and social rights to be warranted on the entire national territory. The Constitution assigns to the concurrent legislative competence (State and Regions) matters as foreign trade, health care, education, co-ordination of public finances and tax system. Finally, all the matters not included in the list of the State exclusive responsibilities or in the list of the concurrent responsibilities are assigned to the regime of exclusive regional competence.

In finance, more emphasis is given to regional taxes and to regional sharing of national taxes. The latter will be assigned to regions according to the regional distribution of tax bases and not, as in the past, according to need evaluation. This will generate greater interregional differences in service levels than in the past.

Moreover, the new Constitution entitles individual regional authorities to submit proposals to Parliament in order to obtain more sphere of autonomy, but the Parliament is under no obligation to approve them.

The new Constitution extends to local governments (Provinces, Municipalities and, in the future, metropolitan areas) the same criterion of equalization based on fiscal capacity. Moreover, the Constitution assigns to local authorities the power to execute the whole of legislation, both central and regional.

A new Constitutional law is going to be submitted to the Parliament for approval during this year. The draft proposal contains the provision for attributing exclusive legislative power to regions in matter such as health, education and local police.

In Italy the traditional fiscal inter-governmental relations had the following main characteristics: i) a marked revenue centralization; ii) a correspondingly high share of grants in revenues of sub-national governments and iii) a marked predominance of conditional grants.

Over the 1990s this system has been reformed. First, to foster tax responsibility, new taxes have been transferred in 1992 to local authorities and in 1998 to regional authorities. Second, with effect from 2001, the system of central conditional grants to regional authorities has been replaced by a new system of tax revenue sharing. Third, following the 1997 reform sometimes referred to as “administrative federalism”, a large decentralization of functions occurred, with around 40% of the administrative functions transferred from the central Ministries to the Regions, Provinces and Municipalities. Finally, as mentioned, during 2001 the most important constitutional reform over the last fifty years has been approved.

The most important responsibility for the ordinary regions is health care. This accounts for well over half of their total expenditure. Other areas for which they can legislate include social welfare, the implementation of European Union agricultural structure policy, economic development, manpower training, housing, tourism and cultural activities, regional public transport and environmental protection. They also cover the operating deficits of regional and local transport systems and finance their capital expenditure. The regional role goes beyond financing lower levels of government and also includes planning, regulation and auditing. The regions also co-ordinate the capital programmes of the municipalities and provinces located in their territory.

Special statute regions have an even broader range of functions. Their financing system is also distinctive. Differently from other regions, they have access to a share of central government’s income tax and VAT revenue. Moreover, they benefit from fiscal redistribution since, with 16% of national population, they receive 29% of all regional resources.

The provinces have a limited number of functions -- in particular the maintenance of designated provincial roads, school building and maintenance, social care in selected fields and pollution control.

The municipalities are the public body closest to the citizens and form the core of local government in Italy. They carry out “own functions” and those delegated by the State or regional authorities.

Own functions include three categories of responsibilities: social, economic and territorial. Firstly, education, covering nursery schooling, school buildings for other age-group, social functions such as police, care for elderly, general health care and public housing. Secondly, municipalities are responsible for economic development services such as tourism and trade fairs. Finally, they provide a number of territorial services such as road construction and maintenance, urban transport, refuse collection and disposal, provision of gas and electricity.

The municipalities perform a wide range of functions, either directly or using contracted suppliers (for example, citizen records, street lighting, garbage collection and disposal, urban transport, local police, nursery schooling, public welfare and public housing). Some of these services -- especially urban transport and garbage collection and disposal -- may be delivered by communally owned companies. This may mean that they compete with the private sector (for example, in the sale of fresh milk and milk derivatives) or with public companies operating at the national level (in the case, for example, of gas and electricity distribution).

The municipalities, like the regions, have important regulatory functions including land use zoning, environmental control and the issue of trading permits.

Though the atomization of Italy's municipalities gives rise to a lot of economic inefficiencies, there have been not many successful moves to merge or associate them.

State and Regional authorities may, in certain cases, create or give incentives for the creation of associations of municipalities for the management of activities and services concerning adjacent areas.

Consortia of municipalities may be formed between municipalities and provinces for the joint management of one or more services. Each consortia has its own legal personality and autonomy and its status is approved by the councils of directors of the associated authorities.

Unions of municipalities may also be established between two or more municipalities with less than 5 000 inhabitants in the same province, in anticipation of their eventual merger, for the joint execution of a number of various functions or services. They are run on a system similar to that of the municipality. If no merger occurs within ten years, it is dissolved.

The regions delegate most responsibility for programme implementation to the municipalities, provinces, highland communities, local health authorities, etc. along with the necessary funds.

The period since 1970 has seen the transfer of numerous functions from the State to the regions: for example in the fields of agriculture, manpower training, health care, transport, environmental protection and economic development. This has been accompanied by a transfer of resources, personnel and facilities. Law 142, passed in 1990, set the stage for a reorganisation of the provinces and municipalities. This should lead to a major reallocation of functions between the different government levels. Law 142 also provides for the creation of nine metropolitan cities and also that the region should establish the functions of the provinces and municipalities, other than those guaranteed by national legislation. However, many of the directives provided by this law have not been implemented, and it is probable that it will be amended.

#### **2.4.2 Major empirical findings**

During the 1990s the structure of regional and local financing has markedly changed. On total revenue the share deriving from central grants has decreased, while that from taxation has increased.

As from the '90s, in Italy there has been a stronger push for increasing the tax-raising power of local authorities.

An important degree of tax-raising power has been introduced for each level of local government by means of a specific significant tax (Regional Tax on Productive Activities – IRAP for Regions, Municipal Tax on Immovable Property – ICI for Municipalities, Provincial Registration Tax – IPT for Provinces), supplemented by additional taxes associated to national taxes, with a tax rate that could be established at their discretion (Additional Tax on Personal Income for Regions and Municipalities); their own minor taxes are maintained and the relevant regulatory power (for Provinces and Municipalities) has been increased.

More specifically, the tax system of local governments includes the following taxes.

The Regional Tax on Productive Activities (IRAP) was introduced in 1998. It replaced a number of central and local levies, including the health service contributions. IRAP is levied on the net value of the production derived in each Italian region by enterprises and professionals. The taxable base is the difference between the value of the production in the tax year and the costs of production, excluding

personnel costs and interest. Regions have the power to increase or decrease the ordinary tax rate (4,25) by up to one per cent.

Since 1998 Regions have been access to a tax revenue-sharing on the personal income tax. At present the share is equal to 0,9% of the tax base. Each region may increase such rate up to 1,4%.

Other regional taxes include that on motor vehicles, the tax on solid waste depositing in rubbish dump and the tax on methane consumption.

Regions have also access to a share of the national petrol tax revenue and have the power to levy surcharges on it.

The last major change in regional financing took place in 2001. The most important central grants, such as those directed to finance regional health spending, has been cancelled and replaced by a new system of tax revenue-sharing, based on VAT. Ordinary regions have access to a share of national VAT revenue equal to 38,55%. This fund is distributed among regions through an equalisation mechanism that takes fiscal capacity and expenditure needs into consideration. In particular, the mechanism is based on the following factors: population; fiscal capacity; expenditure needs (especially those referred to health care); size of regions. The equalisation operates so to compensate those regions having less tax revenues and size and more expenditure needs. The equalisation is not complete, as only the 90% of the inter-regional differences are compensated.

For local authorities after a long period of central grants distributed on the basis of historic spending, the 1993 reform introduced two main funds (ordinary fund and equalisation fund) to support local current spending and an other one to support capital investment. The ordinary fund is distributed taking into consideration both standardised needs and fiscal capacity. In particular, individual authority receives a grant equal to the difference between its expenditure needs and its tax receipts mainly from the local property tax. The fiscal equalisation fund is allocated to help offset differences in resources between local authorities.

The main municipal tax is the tax on immovable property (*imposta comunale sugli immobili* - ICI). It is levied on the possession of immovable property (buildings, lands) located in Italy. The taxable base is the value of the property. It is paid to the municipality where the property is located. The tax rate is set by each Municipality and may range from a minimum of 0,4 per cent to a maximum of 0,7 per cent. Tax relief is given for the owner's principal property.

Municipalities have access to a tax revenue-sharing on the personal income tax. At present the share is equal to 3,5% of the tax base. Each municipality may levy a surcharge on the personal income tax up to 0,5%.

In last year revenues from user charges and sale of goods and services have showed steady growth, confirming the trend in the Italian public sector towards more private and market-based provision. Moreover, a number of minor local taxes (such as taxes on advertising, on solid waste disposal and on occupancy of public spaces and areas) are going to be transformed into user charges.

Finally, the most important tax instruments for provinces are the motor vehicle registration tax and the additional tax on the excise duty on energy. A Provincial additional tax on personal income has been introduced, but it is not yet operative.

Regional and local authorities can borrow and issue bonds. Borrowing is regulated by the so-called golden rule, which has an indirect ceiling fixed by law. Debt service cannot exceed 25% of total own revenues and can finance only capital investment.

For the regional sector health is the major area of service delivery, taking by far the largest share with almost three-quarters of current spending. However, capital investment account for over one-fifth of total outlay and here agriculture accounts for 15 per cent of spending.

For Provinces, education together with transport and communications are the main areas of spending, on both current and capital accounts. Education is about 33% of total current expenditure, while transport and communications account for 19% and economic affairs for 11%.

Finally, for municipalities the major items of expenditure on both current and capital accounts are welfare, education and transport. These three main services respectively take 34, 13 and 10 of total current spending.

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1999 – Italy is over the unweighted average of OECD Unitary countries (12%).

Total sub-national revenues represent about the 22% of total national government revenue (1999). Sub-national revenues are composed of grants (52.6%), tax revenues (33.8%) and non tax revenues (13.5%). In 1997-1999 the tax revenues' share has significantly increased, from 22.9% to 33.8%.

Taking into account regional and local government, in 1999 sub-national tax revenue as percentage of total national tax revenue is equal to 9.4% and as a percentage of GDP is 4%.

As shown in Table 2, for regional and local government the most important tax sources are from “other taxes” (51.6%). Other tax instruments are taxes on property (21.7%), on specific goods and services (10.3%), on use of goods (8.7%) and on income and profits (7.7%).

Table 1 Total revenue by level of government, in millions of National Currency.

	Central Government			Social Security Funds			Regional Government			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	301230	274600	308536	0	0	0	9280	13410	6764				310510	288010	315300
2000 Social security contributions	0	0	0	293799	259473	264884	0	0	0				293799	259473	264884
3000 Taxes on payroll and workforce	1134	1180	360	0	0	0	0	0	0				1134	1180	360
4000 Taxes on property	26947	24315	23342	0	0	0	17606	17934	18956				44553	42249	42298
5000 Taxes on goods and services	200700	212464	232846	0	0	0	24307	25449	22777				225007	237913	255623
6000 Other taxes	0	0	8604	0	0	0	5784	46813	38984				5784	46813	47588
<b>Total Tax Revenue</b>	530011	512559	573688	293799	259473	264884	56977	103606	87481				880787	875638	926053
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	21785	23144	31997				4776	4718	6126				26561	27862	38123
Fees, sales, fines	16765	15556	12576				13333	15213	17774				30098	30769	30350
Contr. to govt. employee pension funds													0	0	0
Other Non-tax revenue	13358	15130	15243				10270	10123	10985				23628	25253	26228
<b>Total Non-Tax Revenue</b>	51908	53830	59816				28379	30054	34885				80287	83884	94701
<b>Grants</b>	17153	15863	13600				162846	131488	136005				179999	147351	149605
<b>Total Revenue</b>	599072	582252	647104	293799	259473	264884	248202	265148	258371				1141073	1106873	1170359
<b>Tax revenue as % of GDP</b>	26.7	24.7	26.7	14.8	12.5	12.3	2.9	5.0	4.0				44.3	42.2	43.2
<b>Sub-national tax revenue as % of total tax revenue</b>							6.5	11.8	9.4						

Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001

Table 2 Tax revenue from the main local taxes as percentage of total tax revenue of Local Government

	1975	1985	1999
<b>1000</b> Income and Profits	80	66.7	7.7
<b>1100</b> Individuals	48	16	\
<b>1200</b> Corporate	32	10.7	\
<b>4000</b> Property	17.5	\	21.7
<b>5110</b> General taxes	\	\	\
<b>5120</b> Specific goods & services	\	10.2	10.3
<b>5200</b> Taxes on use of goods	2.5	0.3	8.7
<b>6000</b> Other taxes	0	22.7	51.6

Source: OECD, *Revenue Statistics, 1965-2000*, Paris, 2001

Table 3 Subnational expenditure by function, as a percentage of subnational government expenditure (2000)			
	Ordinary Regions	Provinces	Municipalities
1 General public services	6.09	33.6	30.56
2 Defence			
3 Public order & safety			3.97
4 Education	1.19	22.2	9.02
5 Health	68.35		
6 Social Security & Welfare		2.4	10.11
7 Housing & community amenities	1.27		
8 Recreational, cultural & religious affairs	1.38	5.4	5.52
9 Fuel & energy			
10 Agriculture, forestry, fishing & hunting	1.68		
11 Mining, manufacturing & construction, except fuel & energy	1.114		
12 Transportation & communication	5.69	5.5	13.45
13 Other economic affairs	1.77	6.0	4.74
14 Other functions*	11.45	24.9	22.63
15 Total	100	100	100
Total current government expenditure. Consolidated % of GDP		46.50	
Total current subnational government expenditure. % of GDP		13.81	

Source: own calculations from Ministero dell'Economia e delle Finanze (2002) and Istat (2002).

Notes: \* For all levels of Government it comprises environmental and territorial protection

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## 2.5 THE NETHERLANDS

### *2.5.1 Main feature of local finance and the inter-governmental relation*

The Netherlands is known as a “decentralized unitary state” with three levels of government: central government, intermediate government (provinces) and local government (municipalities). Intermediate and local authorities are entities directly elected by the citizens. There is a hierarchical relationship between the three tiers of government. In financial terms, municipalities are the most important level of local government.

Central government is pursuing an active policy of amalgamation of local authorities. The number of municipalities has gradually been reduced. At present there are twelve provinces and 548 municipalities. About eighty polder boards are responsible for maintenance of the dykes, for managing surface water levels in the Low lands and for the treatment of waste water. The boundaries of the geographical area that is the responsibility of a particular polder board do not match those of provinces and the local government.

According to the Dutch Constitution, national law establishes sub-national government’s powers and responsibilities. These constitutional provisions are stipulated in the Municipal Act and in the Provincial Act.

Central government plays a major part in policy implementation at the local level. A wide range of field agencies has been created in order to implement national policies. In last years there has been a tendency to convert some agencies into independent public boards.

Central government is generally responsible for tasks concerning Dutch society as a whole. This implies a responsibility for the system of justice, defence, foreign affairs, tax collection, and infrastructure (in a wide sense). Central government also provides general guidelines for future development. The main function of the province is to translate central government plans to their territory. Municipal government is seen as the main provider of public services to the citizens.

Provincial governments overall play an intermediate role between central government and the municipalities. These intermediary tasks primarily relate to co-ordinate activities in areas such as traffic and public transport, welfare services, culture, spatial planning, public housing and environmental affairs. There is a limited number of executive tasks in areas such as (provincial) public works (including water management) and the environment.

In general, provinces perform activities that require administrative capacity not available in the average municipality. Moreover, provinces play an important role in coordinating and supervising municipalities and in allocating financial resources among municipalities. Furthermore, provinces control the municipal budgets, as the budgets of provinces are controlled by the central government.

Municipal governments are active in a vast range of policy areas including welfare, public order, education, housing, public health care and social security. Direct public service delivery is concentrated in these local governments. However, this does not imply that all powers in these fields are in the hands of local governments.

Municipal tasks are carried on under a system of joint activities, whereby the central government lays down the legal framework for the municipalities activities through detailed regulations. Municipalities hold

a certain degree of autonomy in some areas, such as construction and maintenance of roads, cultural and leisure activities.

The principle of co-administration or co-governance is specified in the Provincial and Municipal Government Acts. This concept refers to the duty of sub-national governments to implement general regulations issued at a higher level of government.

Although in some policy-areas (for instance education and social security) strict guidelines are attached to the local implementation of co-administration tasks, the overall picture is somewhat more balanced. The implementation or execution of many (though not all) co-administration tasks is not a neutral nor technical operation. There is often ample discretionary power for local governments to adjust the execution of these tasks to their local needs. Co-administration also implies that municipalities and provinces have a responsibility for making regulations on certain topics without having detailed guidelines by central government on how to do so.

Central and sub-national governments are very much interdependent. Especially in recent years, less emphasis has been put on hierarchical relations and more attention paid to closer co-operation between the different levels of government on the basis of partnerships.

### **2.5.2 Major empirical findings**

Since 1980s the share of total revenue deriving from local taxation and general central grants has been increasing, while that deriving from specific central grants has been decreasing.

Local authorities' tax powers are stipulated in the Municipality Act and in the Provincial Act. In general, municipalities are not allowed to levy taxes that are not covered by the Act, but they are free to set tax rates and also to determine whether the tax has to be levied.

Local governments can impose a limited number of taxes, of which the local property tax is by far the most important in revenue terms. Other municipal taxes are benefit tax, residential commuter tax, tourist tax, parking taxes and dog-license fees.

The property tax consists of two separately assessed taxes: one imposed on owners and one on renters. Owner-occupiers are subject to both taxes. The tax base of the local property taxes is in both cases the estimated market value of the property. The "Immovable Property Valuation Act" regulates the uniform taxation and valuation of immovable property in the Netherlands. Local governments assess the value of each object and councils are free to set the rate of the tax.

In addition to the property tax, there is another one levied on immovable property, called benefit tax. This is levied on the benefits accruing to property owners in the form of capital gains due to certain activities carried on by municipalities.

The property taxes are category (b) taxes in terms of the OECD's tax autonomy classification, because the tax base is defined in central government legislation. This is also the case for most other taxes levied by local government.

A few taxes with limited revenue are category (a) but have not been identified as such.

Property values estimated by local government for its property tax are also used as the tax base for one levy of the polder boards. In addition, polder boards impose a head tax (fixed amount per address) and a land tax. Polder boards are free to set tax rates only, so that the levies are of type (b).

Provinces impose one tax, a surcharge on the motor vehicle tax levied by central government. Provinces are free to set the rate of the surcharge, subject to a ceiling imposed by the central government.

Municipalities apply a lot of user charges on services they provide. Revenue from these charges may not exceed the operating costs. The most important user charges are refuse collection rates, pollution charges and sewage disposal rates.

As mentioned, the most important source of local financing consists of transfers from central government. Both municipalities and provinces receive general and specific grants from central government. General grants are distributed respectively from the Municipal and the Provincial Fund. Since the 1997 reform the distribution of both the Municipal and the Provincial Fund is cost-oriented and takes the tax capacity of local authority into consideration.

Besides the general grant, municipalities and provinces receive specific central grants to carry out specific duties. For municipalities specific grants cover areas as public education, social benefits, labour and public transport. For provinces the three most important specific grants are those for housing of elderly people, youth help and cleaning of the soil.

As shown in Table 3, the local expenditure as a share of total government expenditure and of GDP has gradually decreased in last years (1994-1997), respectively from 24.21% to 21.71% and from 16.75% to 13.31%.

Social security and welfare, housing and education are the most important public function carried on by local government in the Netherlands.

Taking into consideration all sub-national government, as a share of total sub-national expenditure the most important sectors are social security and welfare (22.61%), housing and community amenities (19.98%) and education (17.93%).

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1997 – the Netherlands is over the unweighted average of OECD Unitary countries (13% against 9.5%).

Total sub-national revenues represent about the 23.2% of total national government revenue. Sub-national revenues are mainly composed of grants (76%) and non-tax revenues (14.4%). Tax revenues account only for 9.6% of total sub-national revenues.

Taking into account regional and local government, sub-national tax revenue as percentage of total national tax revenue is equal to 3% and as a percentage of GDP is 1.3.

As shown in Table 2, for regional and local government more than 62% of total tax revenues comes from taxes on property.

Another important tax source is that on the use of goods, which represents the 36% of total local tax revenues.

Table 1 Total revenue by level of government, in millions of National Currency.

	Central Government			Social Security Funds			Regional Government			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	80460	82020	86710	0	0	0	0	0	0	0	0	0	80470	82020	86710
2000 Social security contributions	0	0	0	126560	126070	137140				0	0	0	126560	126070	137140
3000 Taxes on payroll and workforce	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
4000 Taxes on property	8530	9530	11120	0	0	0	5700	6070	6450	5700	6070	6450	14230	15600	17570
5000 Taxes on goods and services	78700	84340	92080	0	0	0	3490	3670	3870	3490	3670	3870	82100	88010	95950
6000 Other taxes	1270	1360	1490	0	0	0	0	0	0	0	0	0	1270	1360	1490
<b>Total Tax Revenue</b>	168960	177250	191400	126560	126070	137140	9190	9740	10320	9190	9740	10320	304710	313060	338860
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	21320	n.a.	n.a.				13870	n.a.	n.a.	13870	n.a.	n.a.	35190	n.a.	n.a.
Fees, sales, fines	12740	n.a.	n.a.				7720	n.a.	n.a.	7720	n.a.	n.a.	16300	n.a.	n.a.
Contr. to govt. employee pension funds	8580	n.a.	n.a.												
Other Non-tax revenue		n.a.	n.a.												
<b>Total Non-Tax Revenue</b>	21320						13870			13870			35190		
<b>Grants</b>															
	170	n.a.	n.a.				72940	n.a.	n.a.	72940	n.a.	n.a.	73110	n.a.	n.a.
<b>Total Revenue</b>	190450	-	-	126560	126070	137140	96000	-	-	96000	-	-	413010	-	-
<b>Tax revenue as % of GDP</b>	23.0	22.8	23.5	17.2	16.2	16.8	1.2	1.2	1.3	1.2	1.2	1.3	41.5	40.3	41.6
<b>Sub-national tax revenue as % of total tax revenue</b>							3.0	3.1	3.0	3.0	3.1	3.0			

Table 2 Tax revenue from the main local taxes as percentage of total tax revenue of Local Government

	1975	1985	1999
<b>1000</b> Income and Profits	15.4	\	\
<b>1100</b> Individuals	15.4	\	\
<b>1200</b> Corporate	\	\	\
<b>4000</b> Property	54.2	75.1	62.5
<b>5110</b> General taxes	\	\	\
<b>5120</b> Specific goods & services	2.7	1.1	1.5
<b>5200</b> Taxes on use of goods	27.7	23.8	36
<b>6000</b> Other taxes	0	0	0

**Table 3 Subnational expenditure by function, as a percentage of subnational government expenditure**

	1994	1995	1996	1997
1 General public services	11.09	9.42	9.41	9.41
2 Defence				
3 Public order & safety	3.7	3.37	3.36	3.36
4 Education	8.19	17.94	17.94	17.93
5 Health	2.85	2.56	2.57	2.56
6 Social Security & Welfare	24.6	22.61	22.61	22.61
7 Housing & community amenities	23.02	19.98	19.98	19.98
8 Recreational, cultural & religious affairs	6.22	5.83	5.83	5.83
9 Fuel & energy	0.57	0.47	0.47	0.47
10 Agriculture, forestry, fishing & hunting	0.03	0.03	0.03	0.03
11 Mining, manufacturing & construction, except fuel & energy	0.55	0.46	0.46	0.46
12 Transportation & communication	7.72	6.72	6.73	6.73
13 Other economic affairs				
14 Other functions	11.46	10.62	10.62	10.62
15 Total	100	100	100	100.00
Total current subnational government expenditure. % of GDP	16.75	15.56	16.13	13.31
Total current subnational government expenditure. % of total current government expenditure	24.21	23.57	24.97	21.71

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**2.6.1 Main feature of local finance and the inter-governmental relation**

Over the past twenty-five years Spain has undertaken an important decentralization process. In 1978 when the current Spanish Constitution was approved Spain was essentially a very centralized country. The new Constitution dramatically modified that situation by the introduction of new regional structures, the Autonomous Communities (ACs), based on common historical, cultural or economic characteristics.

Under its Constitution, Spain is not a federation in the strict sense, but rather defines itself as a “state of autonomies”.

The national parliament comprises the chamber of representatives and the senate. The senate has 259 members, 51 of which are appointed by the legislative assemblies of the ACs. The Senate holds an absolute veto over constitutional amendments, but has only a suspensive veto over bills.

Spain is now, therefore, a unitary State with three levels of devolved government: 17 regions (Autonomous Communities), 50 provinces and 8.078 municipalities.

There are two categories of Autonomous Communities depending on the level of responsibility. The seven ACs with high level of responsibility have had recognition of the right to assume a larger powers range since the beginning of the autonomous process or later within a slower, constitutionally designed process. The remaining ten ACs have assumed only the “common” competencies, which are extensive but crucially omit health and education. But the Spanish Constitution is open, so steps are now under way to convert the ten ACs in “high” ACs.

Common competencies are for instance agriculture, ports and airports, roads, environment, culture, tourism.

ACs also differ depending on the number of provinces in their area. One-province Communities have assumed the responsibilities and financial resources previously held by the provincial deputations, which have since disappeared as territorial entities. On the contrary multi-provinces Communities have a constitutional obligation to maintain the provincial deputations and their responsibilities and financial system.

Autonomous Communities share with central government the important role of supervising and financing local government.

At local level there are two institutions, provinces and municipalities. Other types of local entities (metropolitan areas, consortium, etc.) can be created to manage local public services in efficient ways. There are currently 8.078 municipalities, the 60% of which have a population under 1.000 inhabitants.

Local authorities’ responsibilities are regulated by law, not by the Constitution. Law establishes a minimum level of competences which municipalities are obliged to provide depending on their size. For instance all municipalities have to provide public lighting, refuse collection and public road maintenance. Large municipalities have also to provide collective urban passenger transport and environmental protection.

In most cases responsibilities are shared by the central government and the regional governments. It's the case of major road and transportation, housing, social services and development policy.

Up to last years regional authorities in Spain were financed mainly by central government grants. Some of these grants were presented as "revenue sharing" as they were linked to the yield from specified national taxes. With effect from 1994 reforms have begun to devolve to ACs tax powers. For municipalities with effect from 1988 reforms gave them access to a variety of local taxes and user charges.

On the expenditure side capital investment absorbs a larger proportion of total spending than in many other EU countries. Regional and local authorities have been given access to borrowing to finance capital expenditure. Levels of new borrowing have however declined in recent years.

### **2.6.2 Major empirical findings**

The Spanish system of common regime for financing regional authorities is composed by three blocks of resources, known as the *sufficient block*, the *solidarity block* and the *autonomy block*.

The first block guarantees the covering of the effective cost of the services transferred to ACs. Revenues originate from two sources: ceded taxes and a share in central government tax revenues. Ceded taxes are tax on net wealth, inheritance and gift taxes, property transfer tax, stump duties and gambling tax. Shares on central tax revenues are the real base of the system. This tax-sharing system returns to the regional authorities a share of national receipts from specified major taxes.

Distribution of the revenue-sharing grant to ACs is based on a formula allowing for the following factors: functions performed by the Community; its potential revenue from taxes, fees and charges; expenditure needs, calculated with reference to population, personal income, fiscal effort and the number of provinces within the Community.

Each AC shares directly in the yield of the personal income tax in the amounts declared by the residents of each AC. The revenue share will be gradually increased from 15% to 30%.

After the 1997 reform ACs have also independent access to taxation on personal income, which means that they can determine tax rates for the regional devolved part and decide on deductions and exemptions.

Moreover, for ACs taking on the health service role as part of high level of competence an addition central grant is distributed according to population.

The *solidarity block* compensates the disparities in the endowment of stocks of public capital between ACs. The block is composed mainly of central government grants, which are available only to regions with income level below 75% of the EU average.

Finally, the *autonomy block* guarantees additional resources to those ACs that want to increase the level of services they provide. The block is composed of financial instruments like own taxes, surcharges and borrowing. However own taxes are limited by a number of binding conditions (avoidance of double taxation, avoidance of tax exporting, maintenance of the unity of the interior market). So the main taxes created by ACs consisted of taxes on gambling and a number of environmental taxes.

Surcharges may be made on central income tax and ceded taxes with two limitations: the nature of the taxes surcharged must not be modified (for instance the progressive character of the personal income tax) and the central government tax revenue must not be reduced. In practice, no community has ever established a surcharge. All ACs have chosen to finance their additional expenditure by borrowing.

For historic reasons, a different system applies to Basque Country and to Navarra. The system, known as *foral regime*, is based on an agreement whereby the AC receives all revenue from central taxes and then returns a proportion of them to the central government.

For provinces, tax powers are negligible, extending no further than a surcharge on the municipal business tax. Five taxes are available to municipalities, three that are mandatory and two that they can levy at their discretion. The most important taxes are property tax and business tax. Municipalities' discretion in setting tax rates is limited by upper and lower bounds.

The financing system of municipalities is similar to that of ACs. Own taxes and a share in central government taxes are the two basic sources of finance. As for ACs tax-sharing grants to municipalities are general and unconditional.

But while for ACs each community has its own percentage, for municipalities total resources are calculated as a percentage of central government's aggregate yield from specified central taxes, for instance personal income tax. The percentage is fixed periodically by agreement at national level. Distribution among municipalities is then determined by a need formula whose main factors are population, tax effort and number of school places.

Two other sources of financing are available to municipalities: user charges and public prices. User charges are levied on services or administrative functions supplied universally to all citizens. They cannot be set at a level higher than actual service cost. Public prices replace user charges for services with a more market-oriented approach.

Finally, municipalities may borrow only to finance investment and only for a maximum term of twenty years. Formal authorization is required by the Finance Ministry or in some cases by the Community, but not when annual debt service and repayments are less than 25% of current revenues. Central government can set additional limits and constraints for reasons of macroeconomic policy.

The central government is responsible for most public spending in Spain, but ACs are assuming an increasing role in the public sector. Their share of public spending has risen from 19.2% to 23.9% in last years.

As shown in Table 3, the local expenditure as a share of total government expenditure and of GDP has gradually increased in last years (1995-1997), respectively from 30.20% to 32.40% and from 15.91% to 16.56%.

Health and education are the most important public function carried on by local government in Spain.

Taking into consideration all sub-national government, as a share of total sub-national expenditure the most important sectors are health (20.54%), education (18.27%) and housing and community amenities (10.69%).

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1997 – Spain is over the unweighted average of OECD Unitary countries (15.7% against 9.5%).

Total sub-national revenues represent the 18.2% of total national government revenue. Sub-national revenues are mainly composed of grants (54%) and tax revenues (37.1%), but also non-tax revenues represent a significant item (around 9%).

Taking into account regional and local government, sub-national tax revenue as percentage of total national tax revenue is equal to 17% and as a percentage of GDP is 5.9.

As shown in Table 2, regional and local governments have access to a lot of tax instruments. The most important are taxes on property (35.5% of total local tax revenues), taxes on income and profits (26.4%), especially from individuals' income (23.1%).

Other important tax sources are general taxes (11.5%), taxes specific goods and services (10.6%) and taxes on use of goods (13%).

Table 1 Total revenue by level of government, in millions of National Currency.

	Central Government			Social Security Funds			Regional Government			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	7040	7070	7770	0	0	0				1173	1336	1469	8213	8406	9239
2000 Social security contributions	107	101	110	9567	10391	11330				0	0	0	9674	10492	11440
3000 Taxes on payroll and workforce	0	0	0	0	0	0				0	0	0	0	0	0
4000 Taxes on property	45	50	57	0	0	0				1561	1782	1977	1606	1832	2034
5000 Taxes on goods and services	6256	6976	7894	0	0	0				1590	1831	1953	7846	8807	9847
6000 Other taxes	-55	2	-13	0	0	0				174	157	167	119	159	154
<b>Total Tax Revenue</b>	13393	14199	15818	9567	10391	11330				4498	5106	5566	27458	29696	32714
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	764	n.a.	n.a.				31	n.a.	n.a.		n.a.	n.a.	834		
Fees, sales, fines	179	n.a.	n.a.				220	n.a.	n.a.	383	n.a.	n.a.	782		
Contr. to govt. employee pension funds		n.a.	n.a.					n.a.	n.a.		n.a.	n.a.	0		
Other Non-tax revenue	559	n.a.	n.a.				62	n.a.	n.a.	252	n.a.	n.a.	873		
<b>Total Non-Tax Revenue</b>	1502						313			674			2489		
<b>Grants</b>	400	n.a.	n.a.				5332	n.a.	n.a.	1655	n.a.	n.a.	7387		
<b>Total Revenue</b>	15295			9567	10391	11330	5645			6828			37334		
<b>Tax revenue as % of GDP</b>	16.3	16.2	16.9	11.7	11.9	12.1				5.7	5.8	5.9	33.6	34.1	35.1
<b>Sub-national tax revenue as % of total tax revenue</b>										16.4	17.2	17.0			

Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001

Table 2 Tax revenue from the main local taxes as percentage of total tax revenue of Local Government

	1975	1985	1999
<b>1000</b> <b>Income and Profits</b>	57.3	26.9	26.4
<b>1100</b> <b>Individuals</b>	43	14.4	23.1
<b>1200</b> <b>Corporate</b>	\	2.5	3.2
<b>4000</b> <b>Property</b>	8.5	16.8	35.5
<b>5110</b> <b>General taxes</b>	31	31.7	11.5
<b>5120</b> <b>Specific goods &amp; services</b>	3.2	15.7	10.6
<b>5200</b> <b>Taxes on use of goods</b>	\	5.5	13
<b>6000</b> <b>Other taxes</b>	0	3.5	3

Source: OECD, *Revenue Statistics, 1965-2000*, Paris, 2001

**Table 3 Subnational expenditure by function, as a percentage of subnational government expenditure**

	1995	1996	1997
1 General public services	6.69	6.77	6.88
2 Defence			
3 Public order & safety	3.96	4.08	4.24
4 Education	16.88	18.3	18.27
5 Health	21.53	21.5	20.54
6 Social Security & Welfare	5.01	5.13	5.14
7 Housing & community amenities	11.18	10.19	10.69
8 Recreational, cultural & religious affairs	5.56	5.32	5.55
9 Fuel & energy	0.12	0.05	0.07
10 Agriculture, forestry, fishing & hunting	2.89	3.44	3.49
11 Mining, manufacturing & construction, except fuel & energy	1.1	0.97	0.99
12 Transportation & communication	7.54	6.72	7.16
13 Other economic affairs	2.81	2.66	2.73
14 Other functions	14.73	14.88	14.24
15 Total	100	100.01	100
Total current subnational government expenditure. % of GDP	15.91	16.21	16.56
Total current subnational government expenditure. % of total current government expenditure	30.20	30.98	32.40

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### **2.7.1 Main feature of local finance and the inter-governmental relation**

Sweden is a unitary State whose Constitution establishes the principle of local self-government and the right of local authorities to levy taxes and determine tax rates.

There are now two types of local government bodies in Sweden, with the municipality, *kommun*, as the local unit and the county council, *landsting* (in some cases called a “region”) as the intermediate unit.

The number of municipalities (which cover the entire territory of Sweden) is 289. There are 21 county councils (including the municipality of Gotland). The current Local Government Act, which went into effect in 1992, defines the roles of municipalities and county councils.

There are currently four pilot programs aimed at a new regional division of responsibility in Sweden. Under these programs, regions consisting of more than one county have taken over certain tasks from the State, including the responsibility for regional business development.

County councils do not have hierarchical authority over municipalities. The essential difference between local and county government lies in the nature of tasks allocated to them.

Each county has a county administrative board representing the national government at regional level and a county council.

The number of municipalities has markedly decreased in last four years. This process had a favorable impact on municipal finances and administration.

Every municipality and county has a decision-making body called municipal council and county council. Members of these bodies are directly elected by the people at general elections every four years.

There is a growing need for municipalities and county councils to work together. The mechanism of co-operation is usually specified in a contract. More extensive co-operation may be regulated through a local government federation. In such a federation, one or more municipalities may work together with one or more county councils. The number of these federations is growing and totaled 60 last year.

The tasks of the local government sector fall into two categories: those fulfilled under the general powers granted to municipalities and county councils under the Local Government Act, and those based on special legislation. The division of labour between the municipal and county council sectors has so far been based essentially on the principle that tasks requiring a larger population base should be handled by the county councils. Health care is a typical example.

The Local Government Act stipulates that municipalities and county councils themselves shall take charge of those matters of general interest that are related to their respective territories and that are not the preserve of some other body.

Under this general power, municipalities and county councils engage in such fields as the provision of housing, street and road networks, communications and transportation, water and wastewater, generation and distribution of energy, cultural affairs and leisure activities. In recent years, municipalities have also

assumed responsibility for a growing number of refugees from abroad, in exchange for special compensation from the State.

The specially regulated tasks of municipalities, which they are usually required to provide, include schools, social services, elder care, care of people with physical or intellectual disabilities, physical planning and building, certain environmental tasks and rescue services. Examples of such tasks handled by county councils are health care and public dental services. Local or regional public transit systems are a joint responsibility of municipalities and county councils and are often operated through jointly owned companies.

The relationship between the State and the local governments is characterized by continuous cooperation in a variety of areas and in different forms. There are constant changes in the division of labour between these levels of government.

It is up to the Swedish Cabinet and Parliament to decide on the overall framework of public sector activities. There is a general consensus that within these limits, the municipalities and county councils ought to enjoy a large measure of freedom to shape and carry out public programs on the basis of varying local conditions.

The State provides guidance and supervision to local governments through its power to pass laws and issue ordinances and regulations, and through the monitoring of local governments by State agencies. Special legislation related to education, social services, planning and building matters etc. are also a form of supervision, since it establishes detailed regulations on how municipalities and county councils should manage various programs.

### **2.7.2 Major empirical findings**

Local and intermediate authorities have access to the following main financing sources: local taxes, central government grants, fees and user charges, borrowing and receipts from sale of capital assets.

The finances of sub-national government differ from most other EU member countries for two reasons. First, exceptionally large fiscal powers have been given to local and regional authorities. Second, fiscal power rests entirely on a single tax base – personal income.

Before 1991 the local tax base included corporate profits, household income derived from capital and certain types of real estate. Today the local tax base consists entirely of earned income and pension income.

The State has a great interest in controlling the overall tax burden in Sweden. This may conflict with the taxation and self-determination rights of local governments.

During the years from 1991 to 1994, the Swedish Parliament froze local income taxes at existing levels. In 1995 and 1996 these rules were relaxed and as a result, many municipalities boosted their tax levels. During the years from 1997 to 1999, any municipality or county council that increased its income tax relative to the 1996 level lost half the extra revenue that this tax hike might have yielded, due to reductions in their State grants. Since the beginning of 2000, there have been no restrictions on tax levels.

As of 2000, the highest combined municipal and county council tax is 33.17 percent of tax-able income and the lowest is 27.13 percent. The average rate is 30.53 percent.

Since 1996 in Sweden there is a new equalization system for municipalities and county councils. The purpose is to enable all local governments to offer their inhabitants the same standard at the same price.

The equalization scheme is designed to be self-financing so that it can operate without contribution from the State.

Municipalities and county councils with a per capita taxable income level below the average for Sweden receive a grant, while municipalities and county councils with higher-than-average taxable income must pay a fee. The total grant amount is as large as the sum of the fees. The fee and grant, respectively, total 95 percent of the difference between local per capita taxable income and the national average.

Municipal and county councils also receive a block grant from the State. This consists of two portions: a population-related and an age-related portion. The former is payable as an equal sum of money per inhabitant, while the latter is payable per inhabitant belonging to various specified age categories. The size of the grants is different for municipalities and for county councils.

A relatively large proportion of local government revenues consists of fees for services provided. In 1999, these amounted to more than 8.4 percent of total municipal revenues.

Capital spending as a percentage of total municipal and county councils expenditures has declined continuously since the early 1970s. Both municipalities and county councils may finance their capital spending without permission from central government. Recent proposals from the central government could lead to the reintroduction of stronger controls on local capital spending.

In 1999, public sector expenditure in Sweden was equal to 59 per cent of GDP. Central government was responsible for just over three-fifths of this spending, most of it in form of transfer payments. In the same year the expenditures of Swedish municipalities and county councils totaled 22.7 per cent of GDP. The local government sector grew rapidly during the 1960s and 1970s. This growth slowed by half in the 1980s, compared to the 1970s.

As shown in Table 3, education is the largest branch of municipal operations, accounting for 31 percent of total gross expenses. The next largest item is care of the elderly and programs for people with functional impairments (28 percent), followed by pre-school activities (12 percent). Effective from 1992, the municipalities assumed responsibility for care of the elderly. They also took over care of the intellectually disabled (1991–1996) and responsibility for paying the costs of long-term psychiatric patients (1995).

Health care totally dominates the role of the county councils, accounting for more than 80 percent of their total operating expenditures.

Capital spending as a percentage of total municipal and county council expenditures has declined continuously since the early 1970s. In 1999, such investments accounted for 5.6 percent of all municipal and county council expenditures.

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1999 – Sweden is over the unweighted average of OECD Unitary countries (21.1% against 9.5%).

Total sub-national revenues represent the 30.6% of total national government revenue. Sub-national revenues are mainly composed of tax revenues (75%) and grants (19.5%), while non-tax revenues represent a less significant item (5.5%).

Taking into account regional and local government, sub-national tax revenue as percentage of total national tax revenue is equal to 30.6% and as a percentage of GDP is 15.8.

As shown in Table 2, regional and local governments have access to a single tax source, the personal income tax.

Table 1 Total revenue by level of government, in millions of National Currency.

	Central Government			Social Security Funds			Regional Government			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	98482	101247	118418	0	0					285498	298884	315268	383980	400131	433686
2000 Social security contributions	68004	173879	171799	205459	108550	91910				0	0	0	273463	282429	263709
3000 Taxes on payroll and workforce	30302	46972	78644	0	0	0				0	0	0	30302	46972	78644
4000 Taxes on property	36982	36798	38567	0	0	0				0	0	0	36982	36798	38567
5000 Taxes on goods and services	193515	202678	214435	0	0	0				735	0	0	194250	202678	214435
6000 Other taxes	974	1296	979	0	0	0				0	0	0	974	1296	979
<b>Total Tax Revenue</b>	<b>428259</b>	<b>562870</b>	<b>622842</b>	<b>205459</b>	<b>108550</b>	<b>91910</b>				<b>286233</b>	<b>298884</b>	<b>315268</b>	<b>919951</b>	<b>970304</b>	<b>1030020</b>
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	73600	67541	73204							11589	13753	11626	85189	81294	84830
Fees, sales, fines	8870	8863	10705							0	0	0	8870	8863	10705
Contr. to govt. employee pension funds	4230	4231	4028							4155	4841	9073	8385	9072	13101
Other Non-tax revenue	1640	1643	1333							2431	1664	2475	4071	3307	3808
<b>Total Non-Tax Revenue</b>	<b>88340</b>	<b>82278</b>	<b>89270</b>							<b>18175</b>	<b>20258</b>	<b>23174</b>	<b>106515</b>	<b>102536</b>	<b>112444</b>
<b>Grants</b>															
	9820	9828	9296							56857	81806	82050	66677	91634	91346
<b>Total Revenue</b>	<b>526419</b>	<b>654976</b>	<b>721408</b>	<b>205459</b>	<b>108550</b>	<b>91910</b>				<b>361265</b>	<b>400948</b>	<b>420492</b>	<b>1093143</b>	<b>1164474</b>	<b>1233810</b>
<b>Tax revenue as % of GDP</b>	23.6	29.8	31.2	11.3	5.7	4.6				15.8	15.8	15.8	50.7	51.3	51.6
<b>Sub-national tax revenue as % of total tax revenue</b>										31.1	30.8	30.6			

Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001

**Table 2 Tax revenue from the main local taxes as percentage of total tax revenue of Local Government**

	1975	1985	1999
<b>1000</b> Income and Profits	99.6	99.7	100
<b>1100</b> Individuals	91.5	98.3	100
<b>1200</b> Corporate	8.2	1.4	/
<b>4000</b> Property	/	/	/
<b>5110</b> General taxes	/	/	/
<b>5120</b> Specific goods & services	0.3	0.2	/
<b>5200</b> Taxes on use of goods	0.1	0.1	/
<b>6000</b> Other taxes	0	0	0

*Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001*

Table 3 Sub-national expenditure by function, as a percentage of sub-national government expenditure (1999)		
	Councils	Municipalities
1 General public services	2.00	
2 Defence		
3 Public order & safety		
4 Education	4.00	31.00
5 Health	87.00	
6 Social Security & Welfare		51.00
7 Housing & community amenities		
8 Recreational, cultural & religious affairs		
9 Fuel & energy		
10 Agriculture, forestry, fishing & hunting		
11 Mining, manufacturing & construction, except fuel & energy		
12 Transportation & communication		
13 Other economic affairs		
14 Other functions	7.00	18.00
15 Total	100	100
Total government expenditure. Consolidated % of GDP		58.90
Total sub-national government expenditure. % of GDP		22.70

Source: Ministry of Finance (2002).

Notes:

- 1) "Other functions" includes public transport financing (councils) and recreation, culture, street maintenance, fire protection, etc. (municipalities).
- 2) "Social security & Welfare" includes care of elderly and disabled persons (30%), child care (13%) and individual and family care (8%).

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## 2.8 UNITED KINGDOM

### 2.8.1 *Main feature of local finance and the inter-governmental relation*

After a long period of stability the UK is currently undergoing the most radical period of constitutional reform for over a century. Over the 1980s reforms were intended to increase local accountability and financial responsibility, while in the 1990s they moved on the opposite direction. Local governments' fiscal powers have been progressively restricted by the central government. Actually tax revenues in the UK are among the most centralized in any OECD country.

UK is a unitary State made up of the four constituent nations of England, Scotland, Wales and Northern Ireland. The structure of local government is very different among the four nations. In England the structure is complex. Generally while in urban areas there is one level of local government, in rural areas there are two levels (counties and districts). In the year 2000 a new Greater London Authority was created with elements of both a county and a regional authority. In Wales there is one level of 22 unitary authorities. Scotland has one level of 32 unitary authorities. Finally Northern Ireland is divided into 26 districts.

Until 1999 in Scotland, Wales and Northern Ireland administrative departments of national government exercised most central responsibilities (such as health, agriculture and relations with local authorities). Recently in Scotland and Wales these powers have been transferred to the new Scottish Parliament and Welsh National Assembly. For Northern Ireland a new constitutional settlement based on power sharing between the main communities has taken place. Finally, in England new signs of regional government have begun to emerge. During the 1990s a lot of central government departments were consolidated into ten Government Offices for the regions and recently eight Regional Development Agencies were established. The long time Government's aim is to establish in England elected regional governments.

In the UK local government has no general power. They may exercise only the powers expressly transferred to them by law. In England, Wales and Scotland education is the most important responsibility of local government. Police and personal social services are other important ones. Local finance is mostly derived as fiscal autonomy is very limited.

The present system of local finance and the inter-governmental relation in the UK does not lead to any significant problems from a macroeconomic management perspective. The very high share of local expenditure financed by central government grant combined with the tight capping on the remainder and borrowing limits enables tight overall control of local current spending.

On the contrary some problems arise in the present system. First, the high share of local expenditure financed by central government grants has injected a very high gearing level for marginal spending. If a local authority spend at 10% above the standard spending assessment, this will lead to an addition of about 50% on the council tax above the government standard. This gearing ratio puts a considerable burden on the needs assessment for determining standard spending. The smallest error can have a sizable impact on low-resource areas. Second, the reforms introduced in recent years far from enhancing local democratic accountability have made local governments less accountable for the local taxes they set. Third, the current council tax, like its predecessor, is still regressive in income terms.

More generally there is a broader issue of the loss of local democracy, the counterpart to the centralization of powers and control. Local authorities having no power to provide public services in ways that vary in accordance with local wishes are seen as agencies of the central government. Yet major elements of local services, including education and social housing, are under the command of private associations, financed by the central government and managed by joint boards, which are not accountable to the local electorates.

On the financial side, there are two main reasons why local authorities have been weakened. First, tax autonomy has been strongly limited. This creates the problem known as gearing. A typical authority which doubled its tax rate would find its total revenue rising by a mere 20%. The increase is much lower (about 7%) when the authority is poor. Second, local authority spending decisions have been constrained by the use of capping.

The direction of reforms over the last years in the UK has been unequivocally toward centralization and control on local government action. But it is difficult to believe that the present intergovernment fiscal relations in the UK are stable.

Last years have seen major reforms to the unwritten UK Constitution introducing new democratic arrangements to the governance of Scotland and Wales and possibly also for Northern Ireland. The introduction of a Scottish Parliament and Welsh Assembly seems to be the first steps along the path to regional government within the UK. In the longer run, the government made clear that elected regional authorities would be allowed to develop if approved by referendums of local people. Moreover, a number of councils have been promised greater autonomy in the future.

It seems unlikely that the next few years will see any significant reforms in local taxation. Nevertheless the introduction of local congestion taxes and taxes on workplace parking is under discussion. Moreover in Scotland local tax system has been devolved to the regional government. So it's possible that the local tax system in Scotland could eventually diverge from that in England.

Finally, from a political point of view the government is encouraging local councils to pilot new methods of voting in the next few years in an effort to boost turnouts. Moreover, beginning with the new Greater London Authority the government's intention is to introduce for the first time directly elected mayors, with executive powers.

In the Government's view, in order to modernize local government finance the aims should be to fund all authorities adequately; promote continuous improvement in service quality and efficiency; provide a reasonable degree of financial predictability and stability; balance funding for local government's delivery of national priorities and targets with real freedom and responsibility for local authorities; be fair to those who use and pay for local authority services; clarify accountability for financial decisions; be intelligible and transparent to all stakeholders; make partnership between local authorities working easier and to encourage consultation, particularly with local taxpayers.

### **2.8.2 *Major empirical findings***

In the UK the major sources of income for local councils are grants from national government, Non-Domestic Rates and the Council tax.

The share of local expenditure financed by tax revenues has changed dramatically in recent years. Until the 1980s the sole local government tax was a property tax called rates, which was levied on both domestic properties and non-domestic properties at tax rates set by local authorities. The tax base was the rental value of the property. During the 1980s tax revenues (rates) accounted for 50% local current expenditure and grants for the other half.

In 1990 in England, Wales and Scotland control over the local tax on non-residential property (non-domestic rates) was transferred to the central government, which simultaneously replaced the residential property tax (domestic rates) with the community charge system or poll tax. Officially domestic rates were abolished for different reasons. The burden was very high in areas with high property values. Domestic rates were seen as inequitable. There was very little relation between the public services received by taxpayers and tax paid by them.

The new poll tax was a flat rate tax on adults, with local authorities setting the tax per head in their areas. It was very unpopular as poor people paid as much for local services as very rich people. Public pressure forced the poll tax to be replaced in 1992, except in Northern Ireland where domestic rates still survive.

In England, Scotland and Wales the poll tax was replaced in 1992 by a tax known as the council tax, which is in effect a combined property tax and personal tax on the occupiers of domestic property. The effective tax rate depends on the statutory tax rate set by the local council, the value of the property in which the taxpayer lives and the characteristics of the people who live in the property. Much of the administration of the council tax lies in the hands of the local government, but the determination of the tax base lies with the central government through the government Valuation Office.

Since 1993 the share of local expenditure paid for through the Council Tax has gradually begun to increase again from less than 20% to around 25% in recent years.

In 1990 non-domestic rates were transferred to the central government, transforming a local tax into an assigned revenue. Only local authorities in Northern Ireland retain control over the setting of non-domestic rates, but there are a large number of mandatory exemptions, particularly on industrial property.

Central government sets the tax rate (known as the Uniform Business Rate). Companies pay a tax bill based on the national uniform rate multiplied by the rateable value of the properties they occupy. The rateable value is an official estimate of the market rent for the property. Business properties are revalued every five years.

Revenue from national non-domestic rates is pooled nationally and then distributed to local authorities on an equal amount per capita basis. Assigned revenues are taken into account when determining Revenue Support Grant so that more tax revenues do not necessarily lead to higher total revenues for local authorities.

Although revenues from Uniform Business Rate are considered as tax revenues, it is more appropriate to see them as a type of general grant from the central government.

Since 1990 the local government's freedom to set tax rates has been effectively limited by a system of capping, although, strictly, capping applies to expenditure rather than taxes. Before each financial year the central government can force an authority to reduce its budget, and so effectively force it to cut its planned tax rate.

Local authorities charge for over 600 activities, bringing in over 10% of total revenues. Charges typically cover a relatively small percentage of operating costs. Approximately 70% of local income from user charges arises from charges for housing services. Charging for many local services is banned or heavily restricted by law. Moreover all the revenue raised has to be used to finance expenditure on the relevant activity.

The most important source of finance for local authorities is an unhypothecated block grant from central government, known as Revenue Support Grant, which intends to compensate local authorities for differences in their needs and resources. The grant system differs between the four nations, but the central

principle of “point equalization” is the same. Grants ensure that all local governments which plan to spend at a level determined by central government (known as Standard Spending Assessment – SSA) would be able to set the same standard tax rate. SSAs differ from council to council and are calculated separately for seven main groups of services (education, personal social services, police, fire, transport, capital finance and other services). Although councils are notified of their SSA for each of seven services, the grant is a block grant which local authorities have the freedom to allocate to services according to their needs. Tax revenues which are taken in to account in determining grants are revenues from national non domestic rate and revenues from local Council tax at the standard tax rate.

Councils also receive specific grants which are paid in order to cover costs of services which councils administer on behalf of central government or new services that central government intends to promote.

Capital spending, which accounts for about 20% of local total spending, is financed through a combination of grants, borrowing, the receipts from selling off existing assets and from general revenues. Housing is the most important element of local capital budgets. Local governments are prevented by law from borrowing for current expenditure purposes. They are permitted to borrow for capital spending. There are tight controls over the spending from capital receipts: only 25% of capital receipts from housing and 50% of other capital receipts may be used for capital expenditure, with the residual to be set aside for debt repayment.

Since 1979 there has been a considerable reduction in local authorities’ powers and functions. The main changes have taken place in housing, education and transport. The most important expenditure competence of local authorities are education, personal social services, police, housing, environmental services, highway maintenance and fire services. In the case of education, local authorities provide schools but not post-school education. Personal social services include services for children in need, elderly people, and other who are handicapped. Highway maintenance covers only secondary roads as primary roads are under the responsibility of the central government. Housing is a scheme of transfer payments in favor of poor people to help them to pay their rent and also the council tax. Environmental services comprise the collection and disposal of rubbish.

As shown in Table 3, the local expenditure as a share of total government expenditure has remained stable (around 22.1%). It has gradually decreased in term of GDP (from 11.9% to 10.45%).

Social security, welfare and education are the most important public function carried on by local government in the United Kingdom.

Taking into consideration all sub-national government, as a share of total sub-national expenditure the most important sectors are social security and welfare (32.54%), education (28.69%) and public order and safety (12.28%).

With regard to the size of sub-national governments – indicated by share of sub-national revenue out of GDP in 1998 – the United Kingdom is in line with the unweighted average of OECD Unitary countries (9.9%).

Total sub-national revenues represent about the 21.4% of total national government revenue. Sub-national revenues are mainly composed of grants (72.6%), while the other two components have about the same importance (13.3% non-tax revenues and 14% tax revenues).

Taking into account regional and local government, sub-national tax revenue as percentage of total national tax revenue is equal to 4.1% and as a percentage of GDP is 1.5.

As shown in Table 2, for regional and local government about all (99.7%) of tax revenues comes from taxes on property.

Table 1 Total revenue by level of government, in millions of National Currency.

	Central Government			Social Security Funds			Regional Government			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Tax Revenue</b>															
1000 Taxes on income, profits & capital gains	104950	121245	126916	0	0	0				0	0	0	104950	121245	126916
2000 Social security contributions	0	0	0	48968	55319	55188				0	0	0	48968	55319	55188
3000 Taxes on payroll and workforce	0	0	0	-1321	0	0				0	0	0	-1321	0	0
4000 Taxes on property	19790	22686	22150	0	0	0	10909	12050	13043	10909	12050	13043	30699	34736	35193
5000 Taxes on goods and services	93255	98587	100643	0	0	0	0	0	0	0	0	0	93255	98587	100643
6000 Other taxes	0	0	0	0	0	0	94	63	43	94	63	43	94	63	43
<b>Total Tax Revenue</b>	217995	242518	249709	47647	55319	55188	11003	12113	13086	11003	12113	13086	276645	309950	317983
<b>Non-tax revenue</b>															
Oper. surpl. of dept. enterpr. & prop. income	10348	10218	9555							5546	6148		15894	16366	9555
Fees, sales, fines	3140	2869	2010							4692	4715		7832	7584	2010
Contr. to govt. employee pension funds	4172	4251	4323							518	589		4690	4840	4323
Other Non-tax revenue															
<b>Total Non-Tax Revenue</b>	17660	17338	15888				10756	11452		10756	11452		28416	28790	15888
<b>Grants</b>	1739	1384	3176							62295	62622		64034	64006	3176
<b>Total Revenue</b>	237394	261240	268773	47647	55319	55188	84054	86187	13086	84054	86187	13086	369095	402746	337047
<b>Tax revenue as % of GDP</b>	27.1	28.6	28.0	5.9	6.5	6.2	1.4	1.4	1.5	1.4	1.4	1.5	34.4	36.6	35.7
<b>Sub-national tax revenue as % of total tax revenue</b>							4.0	3.9	4.1	4.0	3.9	4.1			

Source: OECD, Revenue Statistics, 1965-2000, Paris, 2001

Table 2 Tax revenue from the main local taxes as percentage of total tax revenue of Local Government

	1975	1985	1999
<b>1000</b> Income and Profits	/	/	/
<b>1100</b> Individuals	/	/	/
<b>1200</b> Corporate	/	/	/
<b>4000</b> Property	100	100	99.7
<b>5110</b> General taxes	/	/	/
<b>5120</b> Specific goods & services	/	/	/
<b>5200</b> Taxes on use of goods	/	/	/
<b>6000</b> Other taxes	/	/	0.3

Source: OECD, *Revenue Statistics, 1965-2000*, Paris, 2001

**Table 3 Sub-national expenditure by function, as a percentage of subnational government expenditure**

	1995	1996	1997	1998
1 General public services	3.87	4.18	3.79	3.95
2 Defence	0.03	0.04	0.03	0.02
3 Public order & safety	11.83	11.46	11.87	12.28
4 Education	27.69	28.4	28.19	28.69
5 Health				
6 Social Security & Welfare	31.65	32.5	33.62	32.54
7 Housing & community amenities	6.88	5.5	5.54	5.42
8 Recreational, cultural & religious affairs	3.57	3.59	3.06	3.05
9 Fuel & energy				
10 Agriculture, forestry, fishing & hunting	0.16	0.13	0.13	0.14
11 Mining, manufacturing & construction, except fuel & energy	0.02	0.03	0.01	0.02
12 Transportation & communication	5.45	5.17	4.89	4.86
13 Other economic affairs	0.88	0.68	0.83	1.01
14 Other functions	7.97	8.35	8.04	8.01
15 Total	100	100	100	100
Total current subnational government expenditure. % of GDP	11.9	11.27	10.68	10.45
Total current subnational government expenditure. % of total current government expenditure	22.35	21.70	21.91	22.10

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