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International Lessons on Balance of Funding Issues: initial paper

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Executive Summary

Introduction

1.0 This paper summarises the interim findings of a review of secondary data on approaches to the balance of funding in a range of western democracies. Its primary purpose is to identify specific countries that may offer lessons for the current review of the balance of funding in England or which the ODPM may wish us to study in more detail as part of its wider study of international approaches to local and regional governance.

Key issues

2.0 Our analysis of the literature to date suggests that in order to analyse approaches to the balance of funding it is important to clarify a number of key issues.

Own resources and transfers

3.0 First, there is an important distinction to be made between two principal sources of local revenue: (i) 'own resources' generated by local authorities themselves and (ii) 'transfers' paid to sub-national government by central government. There are a variety of 'own resources' including: local taxes (property, income, business, sales, consumption, environmental, property conveyance), fees, loans, and rent from property. 'Transfers' usually take the form of grants but some forms of shared taxation may also be transfers. The key issue in terms of the balance of funding is the extent to which local authorities participate in the determination of such taxes and can influence both their base and rate. In the vast majority of cases, local authorities have little control over these. There are, though, regimes with relatively high levels of 'own' resources and low levels of transfers (e.g. Germany, Switzerland, the Nordic countries and France) as well as others with low local resources and high degree of transfers (e.g. Austria, the Netherlands and the UK).

Political decentralisation vs. fiscal decentralisation

4.0 Second, it is important to consider levels of (i) political decentralisation and (ii) fiscal decentralisation since it is the combination of the two that determines the level of discretion that local authorities actually have over fund raising and expenditure. Our review suggests that whilst there are a number of countries in which there has been quite extensive political/administrative decentralisation in the last ten to fifteen years this has not always been accompanied by fiscal decentralisation.

Ring fencing

5.0 Third, it is important to take account of the extent to which resources may be (i) 'earmarked' for specific purposes or (ii) 'non-earmarked' or general. Both 'own resources' and 'transfers' may be ring fenced. A key determinant of the level of local fiscal autonomy is therefore which tier of government determines the uses to which funding can be put. Thus 'own resources' that are ring fenced for specific purposes by a central government may allow less local control than transfers that are not ring fenced.

Central-local relations

6.0 Underlying these distinctions are two contrasting models of central-local relationships: (i) a principal/agent model and (ii) a 'choice' model. The 'principal agent' approach envisages local government primarily as an agent of delivery of priorities and objectives that are determined by 'higher' tiers of government – the region, Land, province or national government – and relies on bureaucratic/legal controls. A 'choice' model emphasises the needs and preferences of local people – service users, citizens, local business etc. –and depends on mechanisms by which local stakeholders express their priorities – for example through voting or public engagement and stakeholder engagement/consultation. In many countries the principal-agent model came to underpin central-local relations in the post-war welfare state era when local authorities were used to implement welfare policies (such as the provision of public sector housing, state education and health services). In recent years there has been growing recognition of the limitations of this model and some interest in new forms of central-local relations.

International trends

7.0 Our research has drawn on data from the Council of Europe, OECD, and IMF sources as well as the academic literature. It suggests that whilst there are a wide variety of arrangements with regard to the balance of funding in different countries, there are also a number of *general trends* which merit further analysis.

Transfers vs. own resources

Block and ring fenced grants

8.0 Overall, there appears to be a general tendency towards increasing use of 'transfers' and decreasing reliance on 'own resources'. Accompanying this trend, and apparently contradicting it, is a general move in favour of 'block' rather than 'ring fenced grants'.

Local fiscal autonomy

9.0 The result has been that, in general terms, the level of local fiscal control has increased in recent years and the 'choice model' seems to have become more important though most states continue to embody elements of the 'principal agent' approach. The explanation of the apparent contradiction noted in 8.0 may be that the choice model is served by the element of fiscal control over transferred resources rather than by own resources

Levels of local authority expenditure

10.0 At the same time, from the point of view of strengthening local democracy, there are concerns about the decline in the level of 'own resources' and in most EU countries there have been attempts to keep down the overall level of local authority spending in order to meet the convergence criteria laid down in the Maastricht Treaty.

Local property taxes

11.0 The property tax, the quintessential local tax, has apparently been a small and decreasing part of local revenue in several countries (including Denmark, Luxembourg, Austria and the UK). Although there are some states where it has increased (Spain, Italy and Portugal). (The *imposta comunali sugli immobili*, a recently introduced and apparently successful local property tax, may be worth examining in greater detail at a later stage in this research).

Business taxes

12.0 Most states have diversified systems of taxation with taxes on business activity being popular. They are popular with central governments because of their high yield and buoyancy. However, this form of taxation has come under increasing pressure as localities have competed to attract and retain businesses.

Local spending as % of GDP

13.0 Analysis of the elements of the balance of funding in the UK compared to other countries is complicated. Political and legal contexts vary between states, the available data are often several years out of date and local government finance systems in other countries are do not of course stand still. However, according to an analysis by the OECD, local government expenditure as a percentage of GDP appears to be comparatively low in the UK (see graph in Annex 2, Technical Annexes). Analysis by the Council of Europe of the proportion of expenditures in terms of "the origin of resources in local budgets" in 1994/1995 suggests that the UK corresponded quite closely to the average for the member states of the Council of Europe in terms of own resources, transfers, fees and charges, raised capital and "other" sources. The figures for the UK and Council of Europe member states (average in brackets) were as follows: 'local taxes' = 25% (25.73%); 'fees and charges' = 11% (12.24%); 'transfers' = 53% (49.03%); 'capital raising' = 8% (5.55%); 'other' = 4%

(6.88%). Local expenditure as a percentage of GDP in the UK is 11% (8.91%) and as a percentage of General Government Expenditure it is 27% (22.12%). The average for Council of Europe member states excluding the transition countries in east and central Europe for local taxes is 33% (UK, 25.73%) and for transfers 40% (UK, 53%).

Proportion of local taxes

14.0 The proportion of local taxes appears to be higher than in the UK in a number of countries including Norway, Denmark, Sweden and Switzerland (where it is above 45%) and Belgium, France, Luxembourg, Finland, Germany and Italy (where it is between 30 and 45%). Countries such as Spain, Portugal and Greece have comparable rates to the UK. Austria and the Netherlands have lower proportions than the UK. These data suggests therefore that the UK is towards the lower/middle end of the spectrum.

Further analysis of specific lessons from other countries

15.0 The broad trends outlined above are useful contextual material. But what is really needed is more in-depth analysis of the operation of specific funding mechanisms in specific countries to determine whether they offer useful lessons for the UK. Depending on the issues that are of most interest, we believe the following countries (which share a number of similarities with the UK in terms of their levels of socio-economic development and strength of their democratic systems) might provide lessons for local government reform in England:

- *Local income tax*: Sweden, Denmark and Belgium - the European Charter recommends that states do not adopt a single form of local taxation, which is precisely what most of the Nordic countries have done. Nevertheless, the long experience of these countries of this type of local revenue deserves further analysis. Furthermore, in recent years, the Scandinavian countries have been carrying out important reforms of the Welfare State in which local authorities have played a key role. The system has therefore been far from static. It would be useful to examine some of these reforms and their consequences for local authorities, particularly with regard to issues such as equalisation, gearing, and citizen participation. Belgium is included in this group precisely because it combines a number of types of local taxation, although its rather complicated political and institutional structures are somewhat removed from those of the UK, even after devolution.

- *New forms of property tax*: the general tendency has been to reduce reliance on property tax even though it is regarded as the quintessential local tax. Nevertheless, it is unlikely that it will be completely abolished in the UK (or in any of the Anglo-Saxon countries where it has a strong tradition at the local level). It might be useful therefore to look at a number of instances where it has recently been introduced and where it seems to be successful, for example Italy and Spain. The interest in studying these two states is also that they are regionalised unitary states with asymmetrical forms of devolution quite similar to the UK's.

- *Fiscal equalisation* (high levels of transfers) and *strong citizen interest/participation*. This is a key aspect of the balance of funding issue. It is sometimes argued that a high level of fiscal equalisation involving usually earmarked transfers from central government will lead to both irresponsible spending patterns by local authorities and a weakening of citizen participation at the local level given the subsequent reduction in local fiscal autonomy. Three countries stand out which *seem* to have both strong equalisation schemes and strong citizen participation at the local level. The Netherlands has a central transfer percentage even higher than the UK, is strongly committed to equalisation but also seems to have strong citizen interest and participation (albeit declining somewhat in recent years). Germany has a more balanced system of funding but does have a strong system of horizontal fiscal equalisation combined with strong citizen interest. Canada is another federal state with an Anglo-Saxon political tradition, thus its local governments rely on the property tax and also a commitment to financial sharing.

- *Combinations of local revenue.* It may be interesting to look at a number of cases where there is a combination of local revenues. Examples include France, Belgium and Spain.

1.0 Introduction

The purpose of this paper is been to report on the first stages of an analysis of the academic and policy literature relating to international approaches to local government finance. This has drawn primarily on the academic literature on local government finance in other countries and secondary data from the IMF, OECD, World Bank and Council of Europe. Its aim is to:

- Identify broad trends and issues in terms of approaches to the balance of funding in other western democracies; and
- Suggest some approaches and countries that may repay more in-depth analysis in order to examine potentially useful lessons for the English context.

Following completion of this current phase of the work we hope to focus on how specific arrangements operate in detail in other countries and the likely impacts, potential advantages, risks, constraints and trade-offs associated with their introduction in the English context. The aim is to provide information that helps to inform the work of the Review Group, and wider policy debate, in a pragmatic way by analysing specific international experience and its applicability to the English context.

International surveys of the balance of funding carried out by organisations such as the IMF, the OECD, World Bank and the Council of Europe reveal a great variety of systems in place. Even within a group of relatively homogeneous countries such as the Scandinavian states, where cross-country policy learning and institutional imitation is frequent, there are important differences in balance of funding arrangements between states. The so-called 'Anglo-Saxon' countries (the UK, Ireland, the US, Canada, Australia and New Zealand) while sharing some common features (an attachment to the local property tax, for example) also differ considerably, not least in that some are federal states (US, Canada and Australia), others are quite centralised unitary states (New Zealand and Ireland) and the UK is a regionalised unitary state. Not surprisingly therefore, the balance of funding arrangements differ in each case.

On the other hand, all states in the western developed world and, indeed, further afield, are subject to similar pressures. In particular what has become known as globalisation has imposed a new fiscal orthodoxy associated with 'neo-liberalism'. This has involved increasing reliance on market forces in the delivery of public services, attempts to reduce public expenditure and an emphasis on efficiency and fiscal rectitude. Within the European Union, and in states which plan to accede to it, these global tendencies have found expression in the creation of the Single Market, Economic and Monetary Union and the creation of the Euro. During the 1980s, the new orthodoxy led to a profound reconceptualisation of the Welfare State model, which found expression in attempts to cut public spending as well as to reduce levels of taxation. These tendencies have affected sub-national governments at all levels as they had previously been essential instruments in redistribution and welfare policies in most western states. They also affected balance of funding arrangements which had to adjust both to rising expectations of citizens for better services and less willingness to accept the levels of taxation necessary to fund these services. It is striking that these same underlying pressures apply to all western European states, including the Nordic countries, the Netherlands and, more recently, Germany, as well as countries such as the US, Canada, Australia and New Zealand.

The international scene, therefore, reveals a picture of great diversity at the institutional and policy levels but also one of considerable convergence in terms of the challenges that are confronting contemporary states. Furthermore, there has been a certain degree of convergence at the level of the policy and institutional responses to these challenges thanks to common membership of bodies such as the European Union, the Council of Europe and the OECD, a shared awareness of the problems and a process of mutual learning. Indeed, organisations such as the IMF and World Bank have consciously promoted particular policy approaches among their members as a condition for the granting of loans. This does not mean that contrasting institutional arrangements, such as those found in federal and different kinds of unitary state, are unimportant. These do affect policy responses to the challenges facing states and impact on the detailed operation of balance of funding arrangements. The same is true of what has been called 'state traditions' of political and administrative culture and intergovernmental relations (Dyson, 1980; Loughlin and Peters, 1997). But it does mean that, from the point of view of the UK, interesting lessons may be learned from different kinds of state which are confronting broadly similar problems. Furthermore, the UK itself is evolving because of devolution into a somewhat hybrid entity that is neither a traditional unitary state nor a federal state and which might therefore learn useful lessons from approaches in a range of other countries.

One of the great difficulties of comparison is that the same terms, or closely related terms, can mean quite different things in different countries and languages. Moreover, the same term might be used to describe a phenomenon whose significance is different in different settings. For example, a "region" in Finland or Ireland, where it means a grouping of counties, is very different from a "region" in Italy or France, where it refers to a political entity with a democratically elected regional government. In section 2 of this report we therefore seek to clarify some of the basic terminology that is relevant to comparing the balance of funding across a number of states in order to avoid misunderstandings. Section 3 outlines what we see as general trends in balance of funding arrangements in a majority of states and notes some of the most important exceptions to these broad trends. In Section 4 we suggest a number of emerging issues and lessons that might be drawn from our international survey with regard to these issues. Section 5 indicates a number of case studies in relation to specific issues that are of special interest in current debate on local government finance in the UK: local income tax, the property tax, fiscal equalisation and gearing and the relationship between these and citizen interest and participation in local government.

It is important to emphasise that we have relied mainly on secondary sources in the academic literature (see bibliography) as well as surveys carried out by international organisations such as the IMF, the OECD and the Council of Europe. The academic literature has been useful in clarifying some of the main issues and problems in local government finance in other states as well as in proposing some solutions to these problems. However, from the point of view of the current review, it is limited by its somewhat abstract nature and by the difficulty in transposing potential solutions into real-life political and administrative settings in the UK. The data available from the international organisations also have their strengths and their limitations. Among their strengths are the broad overview they provide and the possibility of identifying some of the general trends referred to above. They also provide data over relatively long periods of time, which allow us to analyse the dynamic tendencies of local government funding. Among their limitations is the fact that the data are often presented in a non-analytical way and are little more than snapshots of the situation. The data also mostly refer to the mid-1990s although the Council of Europe has tried to update its data through its networks of experts. Furthermore, some of the aggregate data distinguish between “national” and “sub-national” funding but without further disaggregating the latter into different levels – regional, provincial/county, municipal. Finally, there is a need not simply to update this data but to harmonise it as there are serious inconsistencies across the different surveys, even within the same organisation such as the Council of Europe. However, in spite of these limitations this analysis of current trends does provide a basis for the identification of issues and ‘case study’ countries that might repay more in-depth examination in later stages of the study.

2.0 Clarification of Terminology

It is important to distinguish between two major sources of revenue for local authorities: (i) "own resources" and (ii) "transfers" or "grants" from central government. The "balance of funding" issue depends crucially on the relative proportions of each of these two sources.

2.1 "Own resources"

"Own resources" refers to funding that local authorities raise themselves and over which they have some discretion in terms of *how* they are raised and the purposes *for which* they are raised within the bounds of the law or the constitution. That local authorities should be able to raise their own resources is an important principle of local democracy as defined by the *European Charter of Local Self-government*, whose Article 9 states that the financial resources of local authorities should be commensurate with their responsibilities and that they should be raised and controlled by the local authorities themselves, albeit within the context of national policies. The Charter has been signed and ratified by the UK Government.

The following are the main forms of "own resources":

2.1.1 Local taxes

There is no unconditional right to local taxes, which are always formulated in the context of national policy, although, as stated above, local authorities have an absolute right to their own resources, of which local taxes are an important part. A tax may be allocated to the local authority or created by it. However, for it to be truly *local*, the authority must be able to define its basis and to vary its rate.
A further distinction may be made between *exclusive* and *shared* or *non-exclusive* taxes. Exclusive taxes are closest to the ideal of a truly local tax. However, they are relatively rare and usually not those which are most buoyant or produce the greatest

yield. The taxes which do have these characteristics (for example taxes on business) are usually those which central governments keep for themselves.

Most countries have systems of shared taxation which are common to both central and local authorities or, in federal states, shared in different combinations across the federal, regional and local levels of government. Taxes that are shared across levels of government may be primarily under the control of the central government or they may be primarily under the control of the local level (as is the case in the Nordic countries) (see table at Annex 8, Technical Annexes)). In Germany, the distribution of taxes is regulated by the Constitution and is primarily under the control of the Länder. Where shared taxes are under the control of national or regional government, the impact on local autonomy is more akin to transfers to local authorities. Only where they are primarily under the control of local governments can they be regarded as genuinely local taxes (Council of Europe, 2000, p. 37).

We thus have three basic categories of local taxation:

(i) Exclusive local taxes.

(ii) Common taxes that are non-exclusive but local.

(iii) Common taxes that are non-exclusive but more akin to transfers.

2.1.2 Fees and Charges

There are some local authority services for which users pay a price which covers part or all of the cost of the service provided. A distinction may be made between "real charges" and "quasi-charges" (Council of Europe, CDLR p. 31). With real charges, what individuals pay is closely related to their usage of the charged service (e.g. water charges based on meter readings; charges for refuse collection based on volume or weight of refuse). Quasi-charges are when the amount of money individuals pay is based on formulae rather than their actual usage of the services (e.g. charges for water based on property values; charges for refuse collection based on the size of homes or the number of residents).

2.1.3 Revenue from local authority property

Authorities may generate revenue from their own property holdings. Approaches to efficient asset management are, for example, attracting increasing attention in UK local government.

2.1.4 Loans

Loans may be obtained from the financial markets or they may come in the form of transfers from central government. They arise when it is necessary for a local authority to balance its budget which is usually in advance and which may therefore be vulnerable to shortfalls in expenditure due to unforeseen natural or economic circumstances. There are a variety of rules governing the possibility of local authorities obtaining loans in the different member states. In no state is there an unrestricted right to borrow and the conditions are usually laid down either by the constitution, statute or the central government. In some cases, as in some of the Nordic countries, central government will guarantee to underwrite a local authority's budget if this proves inadequate but this transfer is regarded as a loan which must be repaid with interest by the local authority over a specified period of time (usually two years).

2.2 Transfers

The term transfers covers all movements of budgetary resources from the central state to local authorities. These are intended to meet the aim of the European Charter's Article 9, para. 2 mentioned above, which stipulates that local authorities' resources must be commensurate with their responsibilities and recognises that own resources alone and, in particular, local taxes are insufficient to do this.

2.2.1 **Grants**

Grants constitute the main form of budgetary transfers in most countries (see table at Annex 5, Technical Annexes). In general they have been used by central (and/or regional) governments as a way of ensuring that local authorities carry out certain tasks according to the specifications laid down by central authorities (for example ensuring that local authorities provide specific services and/or meet nationally set minimum service standards) (see table at Annex 6, Technical Annexes). They have also been used as a means of financial equalisation (by transferring funds from relatively prosperous localities to areas with higher needs and/or smaller fiscal bases).

2.2.2 **Block grants** vs. **Specific grants**

The significance of this distinction between block and specific grants is that block grants give a local authority a high discretion in the use of the money transferred, while, specific grants are ear-marked for specific purposes which are usually determined by a higher tier of government. In the latter case, the local authority is in effect in a principal/agent relationship with the central government that is allocating funding and, thus, usually has a lower level of autonomy. Article 9 of the European Charter recommends that block or general grants be used as a way of ensuring local autonomy.

2.2.3 **Shared taxes**

As noted above, shared taxes can sometimes be regarded as transfers rather than genuine local taxes since local governments may not have discretion over how the funding is used. The best known examples are Germany and Austria both of which have several shared taxes. Some shared taxes give the local authority a degree of discretion over their base and rate but in the vast majority of cases this is determined by a formula detailed in the constitution or by a higher authority. Thus, these shared taxes should be regarded as transfers from above which, in practice, limit local autonomy (Council of Europe, CDLR, pp. 40-41).

3.0 General International Trends

In this section we summarise the evidence of general trends in the balance of funding that may be relevant to the English context.

3.1 Decentralisation

A key question for this review of trends outside of the UK is whether there is a general tendency towards decentralisation or, on the contrary, towards, centralisation in the balance of funding. In order to address this issue properly we first need to distinguish between at least three aspects of decentralisation:

(i) ***Political decentralisation*** namely the transfer of formal political power from "higher" (often national) levels of government to "lower" level governments (usually local and/or regional). There has been a general trend across western Europe towards political decentralisation since the 1970s and such decentralisation has been recognised as a general principle of good governance by bodies such as the Council of Europe, the European Union, the IMF, and, more recently, the United Nations. The UK, resisted this general trend throughout the 1980s and early 1990s but has begun to embrace it since the election of the Labour Government in 1997 with its commitment to the new Scottish Parliament, the Welsh, Northern Ireland and London assemblies and elected regional government in English regions that vote for it. Centralisation or decentralisation might also occur at the regional level in the sense that a regional government may accumulate political power and functions at the expense of lower levels such as provinces and municipalities. This is the case, for example, in Belgium where the regions have taken over some of the functions of the lower levels. A similar process has occurred in Catalonia.

(ii) ***Fiscal decentralisation*** concerns the transfer of financial resources to lower levels of government according to the principles enunciated above. This can, in theory at least, be achieved without the establishing of new structures associated with political decentralisation. Equally it may be that, in many cases, political decentralisation, involving the devolution of responsibilities to new assemblies or indeed to local authorities, may occur without the appropriate transfer of financial resources. The general trends in fiscal decentralisation across Europe and other western democracies are less clear-cut than are recent developments with regard to formal political decentralisation.

(iii) ***Political decentralisation without fiscal decentralisation***, otherwise known as Vertical Fiscal Imbalance, is in reality a form of continuing centralised control. As Caulfield (2000, p.1) notes "In OECD countries there has been a growing mismatch between the functional competencies and fiscal responsibility of local government".

3.2 Decentralised control over funding

There are two opposing arguments found in the academic literature with regard to the decentralisation of control over local funding. The first was made in the 1950s in a situation of (national) welfare economics. It contends that "only central governments could achieve local economic efficiency through policies of fiscal equalisation and redistribution" (Caulfield, 2000 quoting Tiebout, 1956 and Musgrave, 1973). The counter-argument stresses that local fiscal autonomy is necessary as a way of increasing the accountability and responsiveness of sub-national governments. These two approaches reflect a difference between “choice” or “agency” models of local-central government relations. In the choice model, local authorities are seen as being best placed to make decisions that reflect the needs and preferences of their local communities. In the agency model, local authorities are seen first and foremost as agents carrying out policies on behalf of the principal, which is central government.

The ***principal/agent model*** was dominant during the period of the hegemony of the Welfare State (1945-1975). During this period, as the tasks of government in general expanded, sub-national authorities were increasingly used as agents for the implementation of central government’s redistributive, equalisation and welfare policies. As the tasks of local governments expanded, intergovernmental transfers were increasingly used as a means of funding their functions. There were a variety of mechanisms used for providing this funding ranging from direct grants to tax sharing between central and sub-national governments. In general, grants were *earmarked* for *specific purposes.* This tended to diminish the degree of *local autonomy.*

The ***choice model*** may be seen as closer to the neo-liberal approach which predominated in the 1980s and 1990s. This approach is, in effect, a response to the crisis of the welfare state model of governance and the financial austerity which was promoted at national levels as part of what has become the new orthodoxy (sometimes known as the “New Public Management”). In the European Union, this was reinforced by the drive towards the creation of a common currency and the criteria of financial rectitude laid out in the Maastricht Treaty. Often, it was local authorities which had to bear the brunt of these developments and, in any case, there was a general tendency to reduce direct grants as welfare policies were cut back. In some countries this was accompanied by increasing local autonomy over funding, but where funding was less available local authorities were often left to take the responsibility for citizens’ discontent. To some extent, then, the decentralisation movement of the 1980s and 1990s was the “decentralisation of penury”, often under the guise of enhancing local democracy. In other countries (including the UK), however, the imperative of controlling public spending led central governments to tighten their grip on spending at local level. There are, nevertheless, models that can be seen as reflecting an approach that is rooted in the concept of local democracy and is not necessarily "neo-liberal" since, during this period, there has been a general trend in many countries (though not the UK) away from specific-purpose grants and towards block grants (see tables at Annex 6 and 7, Technical Annexes). Most countries currently combine the "agency" and "choice" models, though most tend to emphasise one or the other as a dominant tendency (Caulfied, 2000).

3.3 Budgets in relation to Gross Domestic Product & General Government Expenditure

Although there are severe methodological problems in comparing general trends across countries, we can identify some indicators with regard to the degree of fiscal centralisation/decentralisation. In doing so it is important to bear in mind that simply stating aggregate figures may not necessarily give a true reading of the degree of centralisation or decentralisation. This will also be a function of other factors such as the constitutional rules governing intergovernmental relations, which differ in federal states and unitary states, the degree of local autonomy and discretion in the determination of local budgets, institutional factors such as the nature and size of the local authorities and in political factors such as whether there are coalition or single party local governments. Nevertheless, the aggregate trends are useful starting points and provide an overall context for more detailed analyses of particular cases.

3.3.1 The scale of the local budget in the context of Gross Domestic Product (GDP) & General Government Expenditure (GGE)

As a general rule, and bearing in mind the caveat highlighted above, the higher the local budget in relation to both GDP and GGE, the greater the degree of fiscal decentralisation. Putting the UK in the context of the Council of Europe states, we can see that it is above average - 11% of GDP as compared to an average of 8.91% and 27% against an average of 22.12% of GGE (see table at Annex 1, Technical Annexes).

In this regard, the UK finds itself in a middle group of countries (France, Switzerland, Germany and Finland) whose percentages of GGE range between 27-30%. As might be expected, Norway (18.9% of GDP and 60% of GGE) and Sweden (27.5% of GDP and 38% of GGE) stand out as leaders in this respect and to these should be added the other two Scandinavian countries Denmark (19.9% of GDP and 31.28% of GGE) and Finland (18% of GDP and 29.5% of GGE). The lower levels of GGE percentage in these two countries is accounted for by the fact that social security payments are not included in these figures but there are similar levels of GDP percentage.

IMF data provides some evidence of trends between 1985 and 1994. and suggests three main trends:

(i) stability at a high level in local authorities' share of overall public authority budgets: Denmark, Belgium, Netherlands, Germany.

(ii) increasing local budgets: several countries who have been "catching up" with regard to decentralisation: Spain, Italy, Portugal, France.

(iii) decreasing local budgets: mostly involving countries of East and Central Europe (but these need to be treated with caution as the date 1994 was too soon after the transition for post-transition reforms to be taken into account) but also some old-established western democracies: including UK, Sweden, Switzerland.

3.3.2 The reduction of local authorities' own resources, increasing shared taxes and transfers

According to the Council of Europe data, (Council of Europe, 2000, p. 7, p. 40). in all its member states, transfers now account, on average, for 49.03% of all local government funding, while local taxes are only 25.73%, with the remainder accounted for by "fees and charges" at 12.24%, "capital raising at 5.55% and "other" at 6.88% (although the high level of transfers is partly accounted for by the presence of the countries of east and central Europe). The UK is situated quite close to these averages with transfers at 53%, local taxes at 25%, fees and charges at 11%, capital raising at 8% and "other" at 4%.

However, a distinction needs to be made between the older democracies of western Europe and the transition countries of east and central Europe (Council of Europe, 2000, p. 41) and it is more useful to compare the UK figures with the averages of the first group. Among the older democracies, the average for local taxes is 33% and for transfers 40%, while among the latter the figures are 18% and 66%. The older democracies can be further divided into four distinct categories:

(i) countries where local taxes are more than 45% (Norway, Denmark, Sweden, and Switzerland at 46%);

(ii) countries where they are between 30% and 42% (Belgium, France, Luxembourg, Finland, Germany and Italy);

(iii) countries where they are between 20% and 30% (Spain, Portugal, Greece and the UK);

(iv) countries where they are less than 20% (Austria, Netherlands).

Two important observations can be made about these figures.
First, there is no correlation between the balance of funding and the state form – federal or unitary and, among the latter, centralised, decentralised or regionalised unitary. Federal states (Belgium, Germany and Switzerland) are found in categories (i), (ii) and (iv); centralised unitary states (Greece, Portugal) in (iii) and (iv); decentralised unitary states (the Scandinavian countries and the Netherlands) in (i), (ii) and (iv); and regionalised unitary states (France, Spain, Italy and the UK) in (ii), (iii) and (iv).
Second, in the majority of the older democracies local taxation is above 20%. The surprising exception is the Netherlands, where it stands at just 15%. The UK is situated within the majority grouping but it is also in a category which includes Portugal and Greece, two highly centralised unitary states. It could be argued that, given its size and moves towards decentralisation, one might expect the UK to more ‘naturally’ fit into group (ii) alongside France and Italy.
(See table at Annex 4, Technical Annexes)

3.3.3 Local autonomy

Given the foregoing analysis does it make it sense to categorise states along a spectrum of federal to centralised unitary? The answer to this question is found in the degree of discretion of the local authorities. Most transfers take the form of grants which local authorities may freely dispose of (Council of Europe, 2000, p. 15). (See tables at Annex 5, 6 and 7, Technical Annexes). Furthermore, it is important to take account of the share of funding between the national and local levels and intermediate levels such as the Länder and the Regions and provinces.

3.3.4 The primary local tax: property tax

Historically, the primary form of local taxation has been the property tax, which is a tax on assets and not on income or consumption. In the 25 countries analysed by the Council of Europe (2000), this form of taxation was found in 23, the exceptions being Malta and Sweden. However, the *basis* of the tax varies considerably across Europe. It can be simply a tax on land, i.e. unbuilt property (YRM, Greece, Lithuania, Russia); or only on buildings (Belgium, Hungary, Ireland, Iceland, the Netherlands, Norway). The two taxes can both be applied but *remain distinct* (Austria, Denmark, France, Germany, Latvia, Portugal). It can be applied to *both* buildings and land (Luxembourg, Slovenia, Spain, Turkey, United Kingdom). Tax payers are usually landowners but in some cases (Netherlands, UK) they may be tenants.

There are also many different ways of calculating the tax: some countries use the “rateable value” or “rateable income” of the asset. Others (Iceland, UK, Sweden) use its “market value” or its “estimated value” (Lithuania). The valuation is usually carried out by specialised commissions in collaboration with the tax department of the local authority (Ireland) or of the central state (Belgium, France). Germany combines these methods.

There is also a wide variation in the property tax as a proportion of local tax revenue ranging from 100% in Anglo-Saxon countries (UK, Ireland but also the US, Canada and Australia) to very small proportions (17% in Belgium, 14% in Spain and Italy, 12% in Latvia, 11% in Iceland, 10% in France, 8.8% in Portugal and 7.6% in the Netherlands).

According to OECD figures, the proportion of property tax has been in decline in several countries: Denmark, Luxembourg, Austria and the UK, although in a few others it has been increasing: Spain, Italy and Portugal. However, these trends should be placed in the broader context where local taxes are already a very small proportion of total local revenue in most countries and, according to the same OECD figures, have been steadily decreasing since 1975 (from 12.5% to 11.8% of GDP).

Recent analyses have suggested that the scope for genuine local taxes, i.e. taxes for which local councils can at least determine the rate (such as property taxes), is narrowing (Council of Europe, 2000, p. 15 and p. 43) (See table at Annex 8, Technical Annexes).

Among the reasons for the decline of this form of local taxation are:

- the difficulty of evaluating its bases and of determining the true market value of property;
- its lack of buoyancy and its inflexibility;
- its unpredictability given the large fluctuations in property values;
- its “blindness” – i.e. it gives little consideration to the social situation of tax-payers (Caulfield, 2000, p. 7);
- it is subject to central government controls through rate capping; and
- the difficulties arising with the introduction of value added tax.

The previous UK government ran into political difficulties when it substituted the Community Charge (“poll tax”) and had to revert to a form of property tax (the council tax). On the other hand, Italy provides an example of the successful introduction of a council tax on property (ICI). It is also true that other taxes may be associated with the property tax, as in France, where the tax on the removal of household rubbish is levied on the same basis of assessment (Council of Europe, 2000, p. 46).

3.3.5 Supplementary taxes: income tax, the business tax, and others

These are the two principal local taxes which supplement the property tax. They represent the largest portion of taxes controlled by local authorities in Europe and, in some states, the majority of their resources. In Sweden, income tax accounts for 58% of all local revenue and, in France, trade tax accounts for around 50% of the local authorities own tax revenue (Council of Europe, 2000, p. 47).

(i) Local Income Tax

- Income tax levied and collected by local authorities is found mainly in the Nordic countries (Denmark, Finland, Iceland, Sweden) but also in Belgium and Switzerland.
  International experience suggests that a local income tax offers two main advantages:
  - its simplicity both in the basis of assessment and its rate of assessment. However, there is a difference in the way the tax is calculated. The local rate is applied on a proportional basis, that of the state on a graduated basis reflecting two different philosophies: redistribution on the part of the state and the common good on the part of local authorities;
  - it is more equitable than the alternatives and can be adjusted for inflation both continually and uniformly. It can therefore help to reduce disparities in taxation over the national territory.

  There are also disadvantages:
  - its base is limited by options decided at a higher level;
  - it is not very transparent – local tax policy and national tax policy are difficult to separate;
  - the "joint" nature of the tax means that the central government must become involved in setting the base and the rate of the tax, thus lessening the autonomy of the local authority (see table at Annex 9, Technical Annexes).

  The European Charter of Local Self-government recommends that there be a diversified system of local resources. Reliance on a single source of income, whether income tax or property tax goes against this principle.

(ii) Business Tax

- Local taxes on business activity are numerous and varied. The main form is a company tax and this is found in Belgium, France, Germany, Italy, Luxembourg, Portugal and Spain (see table at Annex 9, Technical Annexes).

One problem with this form of taxation is that there is no homogeneous basis for its assessment. The primary item may be: profits (Germany, Italy, Luxembourg, Portugal); capital assets (France); the number of persons employed (Belgium, Spain), motor power (Belgium). This may stand alone or jointly with other items: capital assets (Germany); wages and salaries (France); surface area (Spain and Italy), electrical power (Spain), or activity sector (Spain and Italy). The independent professions may or may not be included (doctors, lawyers, notaries public, etc.).
Another problem is that the central state is also in competition with local authorities for these taxes because of their high yield and buoyancy.

- Some other taxes can be found in other states:
  - "pocket-money" tax: on dog licences, entertainment, etc.
  - consumption/sales tax (now overtaken by VAT).
  - environmental taxes (a growing area).
  - vehicle taxes: has become more widespread as several states have decentralised and the vehicle tax has been used as a way of financing this decentralisation: Italy, France, Portugal, Spain.
  - property conveyance tax: found in Southern Europe: Spain, Portugal, France as well as Slovenia and YRM.

4.0 Emerging issues and lessons

4.1 Introduction

The purpose of this paper is to report on our analysis of the academic and policy literature relating to international approaches to local government finance. This suggests that:

- There is a wide diversity of approaches to the balance of funding issue in other western democracies.
- Some other countries appear to offer examples and experiences that may be relevant to current policy developments in England and in particular to work of the Review Group examining the Balance of Funding.

However, as noted above, whilst analysis of academic literature and secondary sources is useful in providing an overview of broad trends in relation to the balance of funding in different countries, a proper assessment of the usefulness or otherwise to English policy makers of approaches in other countries requires a more detailed, firsthand examination of how particular systems operate in specific countries.
In this section we outline some of the issues that we believe may be particularly relevant and we would welcome further discussion with the Review Group and others about which, if any, of these we might usefully examine in more detail in order to assist the on-going policy debate on the balance of funding issue

4.2 Issues for further analysis

It would be premature at this stage to finalise the issues for more detailed examination. However, on the basis of our analysis of the literature to date, we believe that there are a number of issues relating to international experiences and approaches that are likely to be informative.

4.2.1 Recent trends in the balance of funding

Our analysis to date suggests a number of interim findings:

- It seems clear that the balance of funding has been changing in recent years in many other western democracies.
- The overall trend appears to be towards increased reliance on transfers from central to sub-national governments (see table at Annex 4, Technical Annexes). Prima facie this represents increased central control over the total amount of expenditure by sub-national governments, a development which is consistent with the imperative of controlling total public spending.
- Paradoxically though there also appears to have been a general shift away from the hypothecation of funding that is transferred to sub-national governments, a development that is likely to increase local discretion over how the available funding is spent.
- The forms in which funding is distributed by central to sub-national governments vary considerably between different countries (see tables at Annex 4 and 5, Technical Annexes).
- The constitutional and political settings in which changes in the balance of funding have taken place also vary considerably, as do the functions, structures and powers of sub-national governments in different countries.
- These findings suggest that there is no one ideal approach to the balance of funding issue that can be transplanted wholesale to England. There are, though, a number of experiences that appear to be worth examining in more detail to shed light on the potential (positive and negative) impacts of changes in the balance of funding in England and the level of risk associated with change.

Key questions that might be addressed in more detail through examination of the detailed operation of the balance of funding in other countries include:

- What have been the drivers of recent changes in the balance of funding in other countries and how do these compare with policy imperatives in England?

- What have been the (positive and negative) impacts of changes in the balance of funding in other countries?
- How might ring fencing be reduced in England without jeopardising central government priorities?
- What wider policies (for example changes to the powers and duties of local government) would need to accompany changes in the balance of funding in order to achieve desired outcomes?
- What, if any, have been the risks of changes in the balance of funding in other countries?
- What evidence is there about how these risks might be best alleviated in the English context?

4.2.2 Processes of reform

Our analysis to date suggests that there have been some significant shifts in the balance of funding and that changes in the balance of funding have been implemented in a variety of different ways in other countries.

This in turn suggests that we might usefully examine the following questions:

- What mechanisms/reforms have been used in other countries to change the balance of funding?
- Which approaches to implementing reform appear to have been most successful?
- To what extent might these be usefully replicated in England?
- How might changes in the balance of funding reinforce the wider objectives of government policy including the local government modernisation agenda? We might, for example, examine what evidence there is that changes in the balance of funding could increase local democratic participation and whether a different balance of funding would enhance (or constrain) new powers that authorities have been granted including new flexibilities and freedoms and the power to promote well-being.

4.2.3 Handling pressures on resources

Our analysis of the literature suggests that most national and local governments are under pressure to control public spending. We might therefore usefully explore how other countries are dealing with pressures on local resource bases including approaches to:

- Maintaining appropriate control over public spending;
- Dealing with the high gearing effects associated with small local tax bases;
- Coping with rising public expectations; and
- Funding public sector pay increases.

Criteria used to determine the appropriate balance of funding

Stoker and Meehan (2003) suggest five ‘design principles for a system of local government finance’ that the balance of funding review might take account of - accountability, equity, fairness, buoyancy and a ‘holistic approach’ that encourages ‘joined-up’ working between agencies.

Our analysis suggests that:

- The criteria used by other countries to determine the appropriate balance of central and local funding vary considerably as do underlying assumptions about the role of local governments.

We might therefore usefully explore in more detail:

- The criteria used to determine the balance of funding and assumptions about the respective roles of central and sub-national government in other countries.
- The extent to which and ways in which the design criteria suggested by Stoker and Meehan are reflected in the local government finance systems of countries.
- The extent to which criteria used elsewhere might be useful in informing current policy discussions in England and, in particular, the work of the Review Group.

4.2.4 New policy instruments

Our work to date suggests that:

- There are very different combinations of finance arrangements in different countries (see tables at Annex 4 and 5, Technical Annexes).

It might therefore be useful to examine in more detail:

- How have finance reforms been combined with other policies (e.g. political reforms, structural changes, local government re-organisation etc.)?
- What combinations of finance and other reforms appear to have been most effective?

In particular we believe that it could be useful to the Review Group if we gather and synthesise more detailed evidence about the workings of a range of finance instruments including:

Local taxes:

- What are the main kinds of local taxes in use in other western democracies?
- How do different kinds of local taxes operate in practice?
- What have been the impacts of the introduction of new local taxes in other countries (including political impacts, fiscal impacts, equity issues etc.)
- What combinations of local taxes appear to work best in other countries?
- What does international experience suggest might be the advantages, disadvantages and risks associated with the introduction of local taxes in England?
- What does international experience suggest about the relative merits and the risks associated with the introduction of:
    - local income taxes
    - local sales taxes
    - local tourism taxes?

- What practical problems and constraints have been encountered elsewhere with each of these kinds of local taxes and how, if at all, might they be alleviated in England?

Business rates:

- What are the main kinds of business rates used in other western democracies?
- How do these operate in practice?
- What does international experience suggest might be the advantages, disadvantages and risks associated with the different approaches to business rates in England?
- In particular what, if anything, does experience in other countries suggest about the likely benefits, disbenefits and risks associated with restoration of local control of business rates?

Charges and fees:

- What are the main kinds of fees and charges that exist in other western democracies?
- How do these operate in practice?
- What does international experience suggest might be the advantages, disadvantages and risks associated with the different approaches to business rates in England?
- What might be the implications for charging on issues of equity and fair access to services?

5.0 Case Studies to examine key emerging issues

Clearly, which country (or countries) are selected for more detailed analysis needs to be determined by the particular issue(s) that are of most interest to the Review Group and other policy makers. In this section we identify some of the countries that we believe may be most relevant to some of the main issues that have emerged from our analysis to date.

5.1 Local Income Tax

Countries that may offer useful lessons in relation to local income taxes include Denmark Finland, Norway, Sweden and Belgium.

In the Scandinavian countries, a local supplementary income tax is by far the main source of local revenue although each Scandinavian country has a different arrangement. In all the Scandinavian countries, with their strong welfare states, equalisation has been an important consideration and this has had to be reconciled with a strong tradition of local democracy and participation even though this has been in decline in recent years (Lidstrom in Loughlin, 2001). However, this has come under criticism and there have been several reforms in recent years. It would be useful to examine in greater detail the reasons behind and the scope of these reforms with a view to seeing the advantages and disadvantages of this form of tax.

The Belgian case might be interesting to follow up given that income tax is combined with other forms of local taxation, including the property tax, thus avoiding the reliance on one predominant single tax criticised by the Council of Europe. In effect, although Belgian municipalities are dependent on the region for the transfer of a portion of taxes raised and collected by the region, they may also impose a supplementary property tax (which may be 10-40 times as high as the base rate) and also a supplementary income tax (usually set at 6-8% of personal income). However, the central government may impose restrictions on both the base and the rate of the supplementary property tax (PricewaterhouseCoopers, 2000 p. 27).

5.2 New forms of property tax

Italy and Spain appear to be an potentially interesting case studies in relation to propery taxes.

As mentioned above, both countries have introduced forms of property tax in recent years and, according to Council of Europe (2000) evaluations, in the Italian case, at least, these seem to have been quite successful. In Italy, fiscal decentralisation has been part of the ongoing constitutional reforms of the Italian state which, at least in part, attempted to reduce the excessive levels of central control over the regions and municipalities. (see Francesco Merloni, "Du centralisme de l'Etat à la République des autonomies territoriales", in Alain Delcamp and John Loughlin (eds) (2003). Own resources in the form of taxes in the ordinary regions went from 2% of local revenue in 1991 to 46.9% in 1999. For the municipalities, the figures were 14.4% in 1991 to 28.3% in 1995. With fees and charges added, self-financing of the communes in 1999 was 44.5%. The major new tax was the tax on property - the *imposta comunali sugli immobili*.

5.3 Fiscal equalisation and strong citizen interest/participation

The Netherlands, Canada, Germany appear to be interesting in relation to the issues of fiscal equalisation and citizen participation.

The Netherlands is an interesting case study given that its level of transfers is even greater than the UK's but there is also a high level of participation and interest in local politics in that country, although again this is declining but to nowhere near the UK level (Hendriks, in Loughlin, 2001). It is also of note because of the 'Tilburg Model', named after the town which developed more neo-liberal type policies in the 1980s and has become a reference point to local authorities in both the Netherlands and Germany (for the Netherlands, see Frank Hendriks and Pieter Tops, 1999, and, for a riposte to this analysis, Hellmut Wollmann, 2000). In Germany, there are a variety of arrangements in different Länder and it is interesting to note the arrangements for reconciling this diversity with the overall commitment to *Finanzausgleichung*, which has been largely a horizontal equalisation process involving the Länder, who also have responsibility for vertical equalisation within their territories as they have primary responsibility for local fiscality. In Germany, too, there is currently an enquiry going on with regard to the German federal system and whether this ought to be reformed. Canada has also tried to combine strong fiscal equalisation with citizen participation while Germany is interesting because of its institutional mechanisms of *Finanzausgleichung*.

5.4 Combinations of local revenue

France, Belgium and Spain all offer interesting examples of combinations of local revenue.

Belgium and the southern European countries are interesting precisely because of the attempt to combine several forms of taxation (see table at Annex 10, Technical Annexes). There is an abundant literature on the French case and this would be interesting to follow up given that country's decentralisation programme has now been in place since the early 1980s (Loughlin and Mazey, 1995). In France, there have been four different kinds of property tax (in existence since the Revolution and therefore known as the 'quatre vieilles', even if they have been updated in recent years): on built premises in both rural and urban areas (*impôt foncier bâti*), on residents (*taxe d'habitation*), and on business premises *taxe* professionelle). Belgium is a fully fledged federal state but may have important lessons with regard to regional/provincial/municipal relations. In effect, there has been a fiscal centralisation at the *regional* level at the expense of the provinces and municipalities. The interest of the Spanish case lies in the fact that it is a unitary state with strong regional institutions. There have been tensions between the national and regional levels about tax distribution but the share of local taxes, including property tax, has been increasing over the years and the central and regional government have attempted to develop a long-term planning approach (PricewaterhouseCooper, 2002, p. 142). This could be of interest to the UK government whose own devolution programme is quite similar to that of Spain..

5.5 Next steps

We anticipate that we can add most value by focusing in detail on a number of specific issues, probably examining their operation in detail in a small number of case study countries. This will enable us to examine in detail how alternative approaches operate in practice and the likely impacts and potential risks of replicating such arrangements (or variants of them) in England.

However, given the resources likely to be available to undertake case studies, we probably will not have the capacity to address all of these issues or to deal with them all in the same level of detail. We would therefore welcome further discussion with the ODPM and/or members of the Review Group in order to determine:

- For which, if any, of these issues further information and analysis would be most useful?
- What, if any, other issues they consider important?
- Which approaches elsewhere are likely to be of particular relevance to the work of the Review Group and other on-going policy developments and discussions?
- Which countries are most likely to provide useful insights?

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7.0 Annex – Briefing Note on Sweden

Major changes in the system of financing Swedish local government, during the period of 1990-2003: a briefing note prepared by Professor John Loughlin and Dr Anders Lidstrom for the meeting of the research subgroup on 18 November 2003.

7.1 The background: local government finance in Sweden is heavily bound up with the Swedish welfare state system. This system, sometimes referred to as the "Swedish Model", was fully established by the 1960s. Local government played an important role in the system and, although there were high levels of own resources at the local level, local autonomy was highly circumscribed by central controls based on principles of uniformity, equity and equalization. Strong interest groups, e.g. the trade unions, linked to the Social Democratic Party were important in the maintenance of the system. The system ran into serious financial and economic difficulties from the mid-1980s and this led to a number of reforms and experiments. One was the "free commune" experiment which lifted some of the centralised regulations in specificied policy areas, especially education, leaving some local authorities free to pursue their own policy approaches in these areas. Another was the reform of the taxation system (the reduction of the rate of marginal personal and capital-income tax) and the deregulation of the financial markets following world-wide trends. These reforms were applied *before* Sweden entered into a severe economic crisis in the late 1980s, which severely tested the "Swedish Model". Centre-right governments at this period introduced important modifications into the system (including cuts in welfare services). Some of these were reversed by subsequent Social Democrat governments but many were left in place. Local government reform has been part of this ongoing set of reforms.

7.2 The grants system: Before 1990, central government financial support to local government was transferred through a mixture of ear-marked and general grants. In 1990, ear-marked grants in some areas (such as education) were merged into a sector grant, allowing a more discretionary use of the resources. Three years later, 1993, all sector grants were amalgamated into one, general grant for the municipality. This general tendency towards decentralization has now turned into a re-centralization phase. In 2000, a new special grant to education was introduced - the Wärnerssonpengarna (Ingegärd Wänersson was at the time the Swedish minister of primary and secondary education and the label refers to the money (pengar) she provided as a grant) which provides additional support to municipalities which have not reduced the teaching staff in the schools.

The background is that the Government, already in 1997, attempted to transfer more resources to schools by increasing the general grant. It turned out that only a marginal share of these resources went to the schools, but they were instead used for solving other problems that faced the municipalities. It became obvious that the very strong emphasis on general grants was difficult to combine with the fact that central government was still politically accountable for the status of Swedish schools. In a way, it was recognized that the decentralization reforms “went too far”, in particular as the value of equality in education is still upheld as a major political goal. The Association of Local Authorities have protested, but in vain. There have been similar developments in Norway.

7.3 The level of funding: In the early 1990’s, central government finances were heavily in deficit because of a combination of high levels of unemployment, low growth rates and an unwillingness by the socialist government of that time to reduce spending on public welfare. The huge deficit was mainly handled through considerable reductions in public funding of welfare. Grants to local authorities were reduced and local government forced to cut back on its services. Better times emerged in the latter part of the period, and some of the previous reduced services were possible to restore. However, further increases of central government grants, which were promised, have not occurred due to new problems in the Swedish economy (low growth rates) after 2000.

7.4 The system of local government equalization: One of the most heavily discussed topics has been how a system of equalization between local authorities should be constructed. A system based on grants from central government to the most exposed municipalities (mainly with regard to unfavourable population structure) has been replaced by a system in which rich municipalities transfer resources to less well-off municipalities. In the formula, both need and resources are equalized. The underlying idea is that there should be a match between equal conditions and equal level of services. If municipalities wants a higher level of service, that should be reflected through higher taxes. The formula has been modified several times during the period. In particular the county council of Stockholm and municipalities in greater Stockholm (especially wealthy suburban municipalities) complain loudly!

7.5 The local government income tax: Tax levels have been reduced marginally. The average municipal and county council proportion of the total income tax was 31,16 % in 1990 and 30.52 % in 2002 . In order to prevent municipalities to compensate for reduced grants, a temporary lid on municipal tax increases was introduced in1991 and kept until 1993. *There has been no debate about the income tax in itself*, i.e. no suggestions that it should be abolished, replaced by other systems of finance, etc.

In practice, the percentages are based on "taxable income", which is what is left after deductions. There are general deductions which everybody can make (but some of them are related to income), but you can also claim to have your taxable income reduced if you have specific costs for earning your money (most common is probably that you have to commute to work). Please also note that the municipalities and the county councils make their tax decisions independently of each other (even if informal consultation usually occurs).

7.6 The "Principle of financing". In 1993, the Parliament introduced a new principle in central-local government relations: It was decided that if central government transferred new functions to local government, it would also ensure that local government would receive the necessary resources, without having to increase the local tax. On a few occasions, this principle has not been complied with, according the Swedish Association of Local Authorities.

7.7 Municipal budgets in balance: From 2000 a new rule has been introduced, forcing municipalities to keep their budget in balance.

7.8 The current review: The main issue about local government finance is the overarching question about how local government will be able to provide good welfare services with an ageing population and with increasing demands within certain areas (health care, mainly). During this year, a parliamentary committee is looking into the division of functions between different levels in society, and the question of how to create a stable base for financing welfare services is included in that. A first report will be presented on December 15.

7.9 Cost and income equalization between municipalities is also likely to be a hot issue, perhaps also the balance between general and ear-marked grants. However, I don't know of any discussion about the income tax. There has been the occasional voice during the last few years about the advantages of a local property tax, but this has always resulted in nothing.

8.0 Technical Annexes

Data for the paper have been drawn from the following sources:

(a) Limitations of local taxation, financial equalisation and methods for calculating general grants (Local and Regional authorities in Europe, No 65 – Council of Europe) ("**Limitations of Local Taxation**");

(b) The financial resources of local authorities in relation to their responsibilities: a litmus test for subsidiarity (4th General Report on Political Monitoring of the Implementation of the European Charter of Local Self-Government, Rapporteur Mr Jean-Claude Frécon, Strasbourg, 20 April 2000) ("**Council of Europe (2000)**")

(c) Local Government Finance in OECD Countries (Janice Caulfield, paper presented to 'Local Government at the Millennium' International Seminar February 19th, 2000, University of New South Wales) **("Local Government Finance 2000**")

(d) Taxing Powers of State and Local Government – OECD Tax Policy Studies – No 1 **("OECD Tax Policy Studies – No 1")**

(e) Fiscal Design across Levels of Government: European Perspectives – OECD Presentation by Jeffrey Owens on "Local Government in England: Balance of Funding Review", London June 2003 ("**OECD Presentation 2003**")

Annex 1

Local budgets in relation to Gross Domestic Product (GDP) and to General Government Expenditure (GGE)

Country	Initials	% GDP	% GGE	Reference year	%GDP	%GGE	Reference year
Albania	AL	7.7	25.4	1995			
Austria	A	12.71	20.18	1993	12	15.2	1994
Belgium	B	4.9	10.9	1993	7.4	11.2	1995
Bulgaria	BG	9	20	1994			
Cyprus	CY	1.4	4.1	1993			
Croatia	CR						
Czech Republic	CS	9.3	20.9	1994			
Denmark[1]	DK	19.9	31.28	1994			
Estonia	EE	7.1	17.6	1994			
Finland	SF	18	29.5	1993	23		
France	F	5.54	27.22	1992	9.2	19	1995
Germany	D	8.12	28.69	1993	10	16.7	1995
Greece	GR	3.33	5.6	1989	2.1	5.6	1995
Hungary	H	17	53	1994		14.1	1997
Iceland	IS	9.1	22.3	1994		22	1996
Ireland	IRL	4.9	13.8	1994	5.4		1994
Italy	I	7	13	1993	13.7		1995
Latvia	LV	12.45	24	1994		19	1997
Lithuania	LT	13.1	58.8	1993	10	35.2	1996
Luxembourg	L	9.92	32.3	1993	11.7		1994
Malta	M	0.337	0.629	1995		2	1996/7
Moldova	MOL						
Netherlands	NL	13.3	23.1	1994	19.1	36.2	1994
Norway[2]	N	18.9	60	1994	11	40	

Poland	PLK	7	21.6	1994			
Portugal	P	4.6	9.7	1993	3.7	12	1994
Romania	RO	3.5	16.9	1993			
Russian Fed	SU						
Saint-Marino	SM	0.11	0.19	1993			
Slovakia	SL	4.79	11.78	1994			
Slovenia	SV	4.4	10.1	1995		10	1995
Spain	E	4.87	12.17	1994	7.2		1995
Sweden	S	27.5	38	1994	28.7		1994
Switzerland	CH	10.8	27.9	1993			
Ex rep of Macedonia	FYR					*1.46*	*1995*
Turkey	TR	2.41	12.3	1992	3.3		1996
Ukraine	UKR						
United Kingdom	UK	11	27	1994	10	25	1994/5
Average		8.91	**22.12**				

Source: Table 1, para 4.1, section IV, Council of Europe 2000

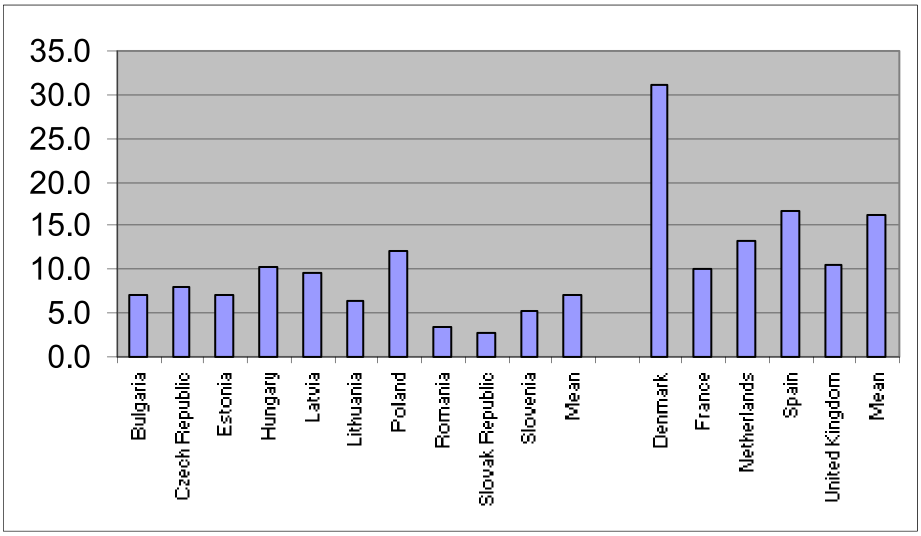
Notes:

1: If social security expenditure were included, which is reimbursed 100%, Danish municipality expenditure would represent, according to KJ, 26.9% of GDP and 42.3% of GGE.

2: KJ decided to include counties in their statistics, claiming that Oslo which is both a commune and a county, represented alone nearly half the municipality expenditure.

Annex 2

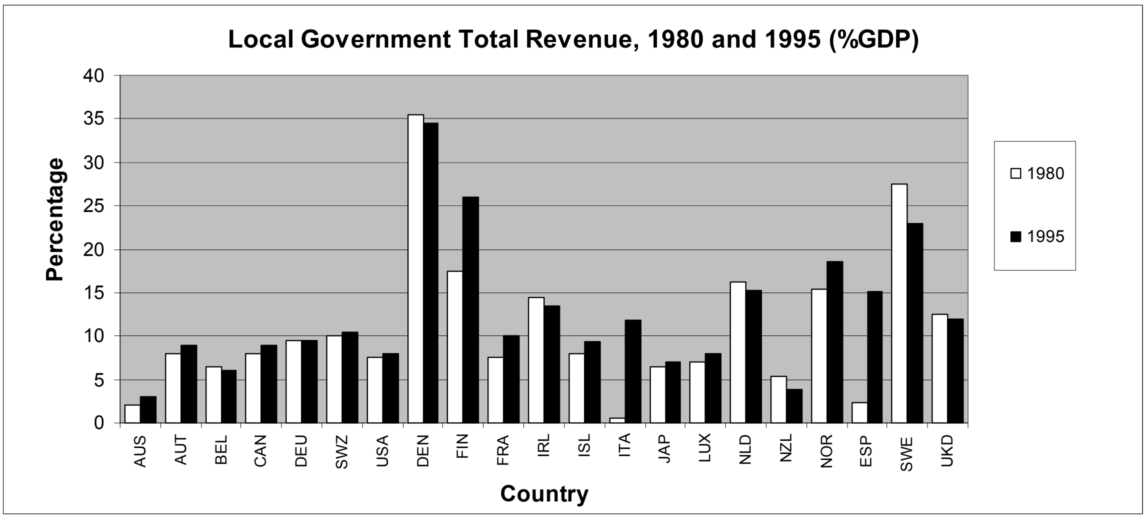
Decentralisation profiles – Sub-national expenditure levels (% GDP)



Source: Slide no 2, OECD (2003)

Annex 3

Local Government Total Revenue, 1980 and 1995 (% GDP)



Source: Local Government Finance (2000), p. 6

Note: For key to country name abbreviations see Annex 12.

Annex 4

The origin of the resources in local budgets

Country	Initials	Local taxes	Fees and charges	Transfers	Capital raising	Other
Albania	AL	2.50	3.00	94.00	0.00	0.50
Austria	A	*16.30*	*21.00*	*43.70*	*10.00*	*9.00*
Belgium	B	*40.75*	*6.00*	*44.26*	*0.00*	*8.99*
Bulgaria	BG	1.00	10.00	78.00	2.00	9.00
Cyprus	CY	25.00	33.00	30.00	12.00	0.00
Croatia	CR					
Czech Republic	CS	16.00	12.00	45.00	11.00	16.00
Denmark	DK	*52.20*	*22.30*	*24.50*	*0.00*	*1.00*
Estonia	EE	0.10	0.90	91.00	2.00	6.00
Finland	SF	*39.50*	*24.00*	*28.40*	*5.60*	*2.50*
France	F	*42.00*	*8.00*	*29.00*	*9.00*	*12.00*
Germany	D	*35.00*	*4.00*	*32.00*	*7.00*	*0.00*
Greece	GR	*27.00*	*8.00*	*63.00*	*2.00*	*0.00*
Hungary	H	*13.00*	*8.17*	*63.61*	*6.71*	*8.51*
Iceland	IS	*16.00*	*21.00*	*57.00*	*0.00*	*7.00*
Ireland	IRL	*64.20*	*18.00*	*5.40*	*4.60*	*7.80*
Italy	I	*31.00*	*11.00*	*42.00*	*7.00*	*10.00*
Latvia	LV	*65.00*	*1.00*	*29.00*	*0.00*	*5.00*
Lithuania	LT	*6.40*	*0.00*	*87.30*	*0.00*	*6.30*
Luxembourg	L	*32.88*	*24.88*	*33.16*	*8.00*	*0.00*
Malta	M	*0.50*	*0.00*	*97.80*	*0.00*	*1.70*
Moldova	MOL					
Netherlands	NL	*15.00*	*2.00*	*83.00*	*0.00*	*0.00*

Norway	N	*47.50*	*12.80*	*36.20*	*0.00*	*3.50*
Poland	PLK	21.00	7.00	60.00	0.00	12.00
Portugal	P	*23.00*	*10.80*	*49.30*	*7.50*	*9.40*
Romania	RO	5.00	16.00	79.00	0.00	0.00
Russian Fed	SU	*22.00*	*2.50*	*72.50*	*0.00*	*3.00*
Saint-Marino	SM	0.00	0.00	31.00	69.00	0.00
Slovakia	SL	10.00	9.00	39.00	5.00	37.00
Slovenia	SV	*6.80*	*13.90*	*79.30*	*0.00*	*0.00*
Spain	E	*29.80*	*18.50*	*27.10*	*14.90*	*9.70*
Sweden	S	*56.00*	*15.00*	*20.00*	*0.00*	*9.00*
Switzerland	CH	46.00	24.00	18.00	3.00	9.00
Ex rep of Macedonia	FYR	*62.30*	*28.80*	*1.50*	*0.00*	*7.40*
Turkey	TR	*4.76*	*20.90*	*48.86*	*0.00*	*25.48*
Ukraine	UKR					
United Kingdom	UK	*25.00*	*11.00*	*53.00*	*8.00*	*4.00*
Average		**25.73**	**12.24**	**49.03**	**5.55**	**6.88**
Average for data gathered by CDLR		**18.33**	**11.72**	**50.88**	**6.94**	**12.14**

Source: para 5.2, Section V, Council of Europe (2000)

Annex 5

Breakdown of Transfers – Figures as a percentage of general municipal revenue

Country	Initials	Shared taxes	General Grants	Specific Grants	Other
Albania	AL	1	59	29	5
Austria	A	26	1	0	8
Belgium	B	0	25	5	10
Bulgaria	BG	34	37	7	0
Cyprus	CY	0	7	22	1
Croatia	CR				
Czech Republic	CS	23	8	10	4
Denmark	DK	2	12	0	11
Estonia	EE	60	27	4	0
Finland	SF	1	28	1	0
France	F	0	24	0	2
Germany	D	17	15	13	0
Greece	GR	25	25	0	8
Hungary	H	7	52	5	2
Iceland	IS	43	7	1	2
Ireland	IRL	0	11	46	0
Italy	I	2	8	24	5
Latvia	LV	23	35	6	3
Lithuania	LT				
Luxembourg	L	24	2	0	11
Malta	M	0	91	0	7
Moldova	MOL				
Netherlands	NL	0	54	4	3
Norway	N	0	17	14	2

Poland	PL	23	22	15	0
Portugal	P	1	31	4	2
Romania	RO	33	25	21	0
Russian Fed	SU				
Saint-Marino	SM	0	31	0	0
Slovakia	SL	30	1	8	0
Slovenia	SV				
Spain	E	0	8	29	0
Sweden	S	0	11	8	0
Switzerland	CH	1	3	14	0
Ex rep of Macedonia	FYR				
Turkey	TR	3	0	3	51
Ukraine	UKR				
United Kingdom	UK	17	32	27	0
Average		**12.77**	**22.87**	**10.32**	**4.42**

Source: Table 4, para 7.1.1, section VII, Council of Europe (2000)

Annex 6

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

Countries	Mixed general grants			General grants for operating expenses			General grants for capital expenditure			Specific grants for operating expenses			Specific grants for capital expenditure		
	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996
Belgium: Brussels															
Flemish region	-	-	1.7	17.7	17.3	16.4	1.8	1.9	1.8	0.5	0.4	-			
Walloon region				26.9	25.8	25.1				1.7	2.3	2.2	1.6	3.1	2.9
Bulgaria				37.2	37.6	30.3							8.5	5.7	4.0
Croatia	0.1	0.4	1.1	2	0.6	0.7	0.1	0.5	1.3	1.5	1.6	2.5	0.2	0.4	0.8
Czech Republic				8.9	5.1	5.0	2.6	1.5	0.7	3.0	3.2	3.0	9.2	9.5	8.8
Denmark	11.1	11.1	9.3							11.3	11.1	11.2			
Finland				26.3	25.7	*				0.05	0.01	*	0.8	0.8	*
Germany				18.1	18.9	20.3							7.7	7.6	6.4
Iceland	2.2	2.4	*							4.9	4.6	*	5.1	4.1	*
Ireland				11	10	10				5	16	15	26	25	27
Italy				24.3	30.1	32.9	31.1	21.3	26.6						
Latvia	6.3	19.9	4.8							35.8	5.3	4.2	0.5	1	1.2
Lithuania	18.5	19.6	19.2							8.4	6.4	2.5	0.7	0.7	0.8
Luxembourg				*	25.7	*				*	3.3	*	*	9.2	*
Malta				91.3	81.5	*				7	5.2	*	-	11.2	*
Netherlands				17	12.9	*				21.6	13.3	*	4	25.2	*
Norway	19	19	18							14	14	14			
Poland	15	15	25							18	18	10	3	3	4
Portugal				20	20	*	14	15	*	0.04	0.04	*	12	10	*
Slovakia				1.9	1.0	1.0				5.0	4.8	4.4	7.2	5.2	8.8
Slovenia				17.6	21.5	17.6							2.5	3.9	4.5
Spain				25.8	26.9					2.7	2.8	*	8	7.9	*
Sweden	12.0	12.0	14.0							7.0	6.0	4.0	1.0	0.9	0.4
Switzerland	3.1	3.0	*							13.5	10.9	*	3.5	3.0	*
United Kingdom				24.7	26.2	25.2				24.7	24.5	23.8	2.7	2.5	2.3

Source: Table 5, pages 38 and 39 Limitations of Local Taxation

Annex 7

Breakdown of general grant paid to municipalities by allocation criteria

Countries	Mixed general grants						General grants for operating expenses						General grants for capital expenditure					
	Objective criteria			Discretionary criteria			Objective criteria			Discretionary criteria			Objective criteria			Discretionary criteria		
	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996
Belgium: Brussels							100	100	100									
Flemish region							100	100	100				100	100	100			
Walloon region							100	100	100									
Bulgaria							100	100	100									
Czech Republic							100	100	100							100	100	100
Denmark	99.8	99.8	99.7	0.2	0.2	0.3												
Germany							100	100	100									
Ireland							100	100	100									
Latvia	-	100	100	100	-	-												
Lithuania				100	100	100												
Luxembourg							*	100	*									
Malta	100	100	100															
Netherlands							100	100	*									
Norway	93	94	95	7	6	5												
Poland	100	100	100															
Portugal							100	100	*				100	100	*			
Slovakia							100	100	100									
Slovenia							100	100	100									
Spain							100	100	*									
Sweden	100	100	100															
Switzerland	100	100					100	100					100	100				
United Kingdom							100	100	100									

Source: Table 6, pages 40 and 41 Limitations of Local Taxation

Annex 8

Taxes of sub-central government by type of tax autonomy 1995 (*, #)

Sub-central government taxes as percent of total tax revenues		**Sub-central government tax revenues by type of tax autonomy (@)**							
		a	**b**	**c**	**d.1**	**d.2**	**d.3**	**d.4**	**e**
Austria	**19**								
- Local Government	8	9	11			81			
- Länder	10	2				98			
Belgium	**28**								
- Local Government	6	13	84				2	1	
- communities	13		3			97			
- regional government	10	8	92						
Czech Republic	**13**								
- municipalities	13	2	5	3			90		
Denmark	**31**								
- municipalities	22		96				4		0
- countries	9		93						7
Finland	**22**								
- local government	22		89				11		
- region Åland	0	100							
Germany	**29**								
- local government	7	1	52			47			
- Länder	22					100			
Hungary	**6**								
- local government	6		30					70	
Iceland	**20**								
- local government	20	8	92						
Japan	**24**								
- municipalities	16	0	94						6
- prefectures	8	0	83						17
Mexico	**20**								
- local government	4						74	26	
- states	16	14				86			
Netherlands	**3**								
- Municipalities	1		100						
- polder boards	1		100						
- provinces	0		100						

New Zealand	**5**								
- local government	5	98							2
Norway	**20**								
- Municipalities	13		5				1	94	
- countries	6							100	
Poland	**7**								
- local government	7		45	1			54		
Portugal	**6**								
- local government	3	49	14						37
- regions	2								100
Spain	**13**								
- local government	9	33	51			16			
- regions	5	15	7			78			
Sweden	**32**								
- municipalities	22	4	96						
- parishes	0	2	98						
- country councils	11		100						
Switzerland	**38**								
- communtieis	16		97				3		
- cantons	22	89				6	5		
United Kingdom	**4**								
- local government	4		100						

Source: Table 1, pages 14 and 15 of OECD Tax Policy Studies – No 1

* Revenue figures for sub-central government may slightly differ from those published in the 1998 editions of Revenue Statistics, due to revisions. Figures may not add due to rounding
# Government levels ranked by increasing geographical scale.
@ a = SCG sets tax rate and tax base.
b = SCG sets tax rate only.
c = SCG sets tax base only.
d.1 = SCG determines revenue-split.
d.2 = revenue-split can only be changed with consent of SCG.
d.3 = revenue-split fixed in legislation, may unilaterally be changed by central government.
d.4 = revenue-split determined by central government as part of the annual budget process.
e = central government sets rate and base of SCG tax.

Annex 9

The different categories of local taxes*

	Property tax		Income tax	Household tax	Business and Trade Taxes			Other
	B	NB			Consom-mation	Entre-prises	Muta-tions	
Austria	I E	I E			I E			
Belgium	F T		F T			F T		F T
Denmark	I E	F E	I E					
Finland	I E		I T					
France	I E	I E		I E		I E		F T
Former Y. Rep. of Macedonia		I A					I A	
Germany	F T	F T				F T		
Greece		I A			I A			F T
Hungary	I E							F T
Ireland	I E							
Iceland	I E		I T					F E
Italy	I E					I E		F T
Latvia	I A	I E						
Lithuania		I E						F E
Luxembourg	I E					I E		
Malta						I A		
Netherlands	F E			F E				F E
Norway	F E							I E
Portugal	I A	I E	F E		I A		I A	F A
Russia		F E				F E		F E
Slovenia	F E						I E	I E
Spain	I E				I E	I E	F E	F E
Sweden			I E					F T
Turkey	I A				I A			I A
United Kingdom	F E							

Source: Table, para 6.1.1, Section VI, Council of Europe (2000)

*Key: Tax: mandatory: I
Tax: non-mandatory: F
Rate: complete discretion: T
Rate: limited discretion (imposed bracket or ceiling): E
Rate: prescribed by State: A

Annex 10

Composition of local fiscal revenue as a percentage (1994)

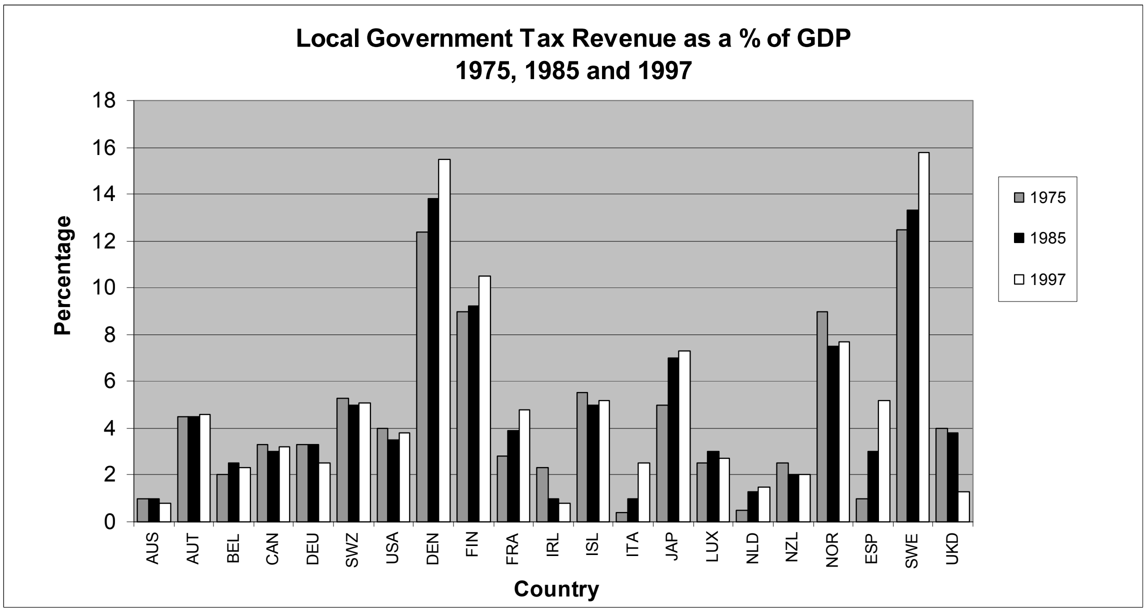
Country		Taxes on income/ profits	Taxes on property	Taxes on goods and services	Taxes on payroll and work force	Other taxes
Austria	A	33.86	9.95	34.10	18.47	3.63
Belgium	B	77.58	-	22.42	-	-
Czech Republic	CS	82.64	8.26	8.57	-	0.53
Denmark	DK	92.79	7.07	0.11	-	0.03
Finland	SF	95.12	4.82	0.06	-	-
France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

Source: Table 2 page 17 Limitations of Local Taxation

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

Annex 11

Local Government Tax Revenue as a % of GDP 1975, 1985 and 1997



Source: page 9, Local Government Finance (2000)

Note: For key to country name abbreviations see Annex 12

Annex 12

Key to Country name abbreviations

AUS: Australia	DEN: Denmark	JAP: Japan
AUT: Austria	FIN: Finland	LUX: Luxembourg
BEL : Belgium	FRA: France	NLD: The Netherlands
CAN: Canada	IRL: Ireland	NZL: New Zealand
DEU: Germany	ISL: Iceland	NOR: Norway
SWZ: Switzerland	ITA: Italy	ESP: Spain
SWE: Sweden	UKD: United Kingdom	

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