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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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STATE BUDGET SUPPORT TO LOCAL GOVERNMENTS

A Report for the SIGMA Programme

Edited by

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FOREWORD

This publication is intended as a reference tool for officials of Finance Ministries and other policy centres in SIGMA countries who are engaged in the continuing reform of systems of local government.

SIGMA is a joint initiative of the OECD/CCET and the EC/PHARE and is mainly funded by the PHARE. The SIGMA Programme offers comparative information and analytical methodologies to the central government institutions of eleven Central and East European countries in their efforts to reform and modernise the public administration.

Modifications to the local government systems continue in all SIGMA countries and, in several cases, further major reforms are under discussion. SIGMA has neither the expertise nor the resources to co-operate in the broad subject area of local government policy. However, the Programme tries to respond to specific problems encountered by its central government counterparts as local government reform impacts upon their work. This volume is part of that effort to respond.

At its meeting in October 1993, the SIGMA Liaison Group (board of management) approved the project to commission papers on transfer payments to local government in Western Europe with a focus on the aspects of the systems most likely to be relevant at this stage of the reforms in Central and Eastern Europe. France, Portugal, Sweden and the United Kingdom were selected to be representative of the range of situations found in Western Europe and considered as relevant experiences for the SIGMA countries. Published sources provided basic information on the current situation in SIGMA countries. Experts nominated from each of the SIGMA countries prepared reports to update and supplement the information base. The experts from SIGMA countries met with the authors of the four commissioned papers in Paris in June to help define the main issues, to discuss recent developments, and to advise on the final drafting of the papers in this volume.

Note that this project was undertaken during the first phase of the SIGMA Programme when there were six eligible countries. When SIGMA phase II was approved in June 1994, Albania, Estonia, Latvia, Lithuania and Slovenia became eligible. However, those involved in this project believed that the timely publication of the work was in the interests of all eleven countries and that it should not be delayed to repeat the entire process in the additional five states. Consequently "SIGMA countries", as used in this text, refers to those countries participating in SIGMA's initial phase; Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovak Republic.

SIGMA wishes to thank the distinguished authors of these papers who are identified in the chapters which follow. Our special gratitude is owing to the nominated experts from SIGMA countries, not only for the knowledge and expertise they brought to the project, but also for the fact that, in their various roles, they are all fully engaged personally in the formidable reform tasks in their respective countries. They are:

Mrs. Valentina GROZDANOVA
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Professor Gerard Marcou of the University of Lille II, Director of the Centre de Recherches Administratives Politiques et Sociales (affiliated to the CNRS) planned and co-ordinated the overall project. He also wrote the synthesis paper which appears as Chapter I. Finally, the onerous complexity of getting the material into print could not have been overcome without the contributions of Lynn Maxwell as language editor, and Joan Levins, Tim Brown, and Francoise Locci of the OECD.

Neither SIGMA nor the authors intend anything in this book to be taken as a "model". Rather it is hoped that the problems encountered and the lessons learned in the operation of transfer payment systems in Western Europe will help SIGMA governments design more effectively the features which should be built into the new schemes which they will build, and rebuild, to fit the unique needs of each of their countries.

Lawrence J O'Toole
Counsellor for Expenditure Management
SIGMA Programme

STATE BUDGET SUPPORT TO LOCAL GOVERNMENT IN EASTERN AND WESTERN EUROPE

A Report for the SIGMA Programme

by

Prof. Gerard Marcou

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STATE BUDGET SUPPORT TO LOCAL GOVERNMENTS IN EASTERN AND WESTERN EUROPE

Introduction

Transfer payments from the State budget to local governments are a key issue, both for local governments and for the public finance of the nation. There are several kinds of transfer payments: for general or specific purposes, grants, subsidies (for a single and specified object) or tax shares. These are the main forms of State budget support of local government. Some others exist or can be devised, such as cash and advance facilities, or guaranties of local governments' commitments, for example. In this paper, only grants, subsidies and tax shares will be considered. Additionally, the access to credit will be identified as a key issue for local government reform and local government management in SIGMA countries.

There is practically no country where State grants to local budgets do not exist, although the amount and purpose of these grants varies dramatically from one country to another. Tax sharing exists only in a number of countries. This is generally considered a local finance issue with respect to local autonomy and allocation efficiency. But, this is also, or should be, a subject of central government policy. It is quite obvious that State transfer payments cannot be analysed without referring to the whole of local government finance. But, they also influence the level of overall public expenditure and reflect the central government's policy on local government, which is a much broader context. This book is focused on the central government viewpoint, and is intended to help ministries of finance in SIGMA countries in reviewing their budgetary support policy, in light of macroeconomic constraints and central government policy goals, regarding decentralisation and the pattern of local government.

The approach of this book is to examine some experiences of Western European states in the field of transfer payments from the State budget to local government. This can be of interest for SIGMA countries looking for their own ways, in the same field as well as in others. This synthesis will present these experiences by taking into account both a diagnosis of current problems experienced in SIGMA countries regarding transfer payments and the specificity of the selected Western European experiences. The transferability of a foreign experience depends very much on the analysis of the problems to be solved, on the resources available and on the context in which the said experience has developed and in which it should be implemented. The diagnosis will help select and assess the cases, from the various national experiences reported in the following papers, which seem to be appropriate references for SIGMA countries. The presentation of these cases will take care to make clear what kinds of conditions were crucial and what kinds of problems arose which brought about reforms, or, at least, attempted reforms in the West European context.

Whatever the country considered, transfer payments from the State budget to local governments cannot be presented outside of the context of the local government system as a whole, especially, but not exclusively, the local finance system. Clearly, the amount and regulation of grants and tax shares depends on the distribution of responsibilities among government levels, and on other government income sources established by the law (e.g. primarily local taxes). But, from a public finance viewpoint, central government transfers can be analysed according to three purposes: i) task performance, ii) equalisation and iii) macroeconomic goals.

The wider the scope of local responsibilities, the higher the share of total public income that needs to be assigned to local budgets. In that case, there will be a public policy choice between an increase in grants or the assignment of high yield taxes to local budgets.

As far as grants are concerned, they can be allocated following very different principles. There can be specific grants for delegated functions, performed on behalf of central government, and for which the costs incurred by local governments have to be offset. Or, grants can be directed to compensate for spillover effects where strong external factors would cause underprovision of services if these services had to be financed only from the resources of the responsible locality (ex. grants for roads or to cities performing central place functions[1]). For local tasks assigned by the law, grants may be an instrument to enforce minimum standards in the delivery of certain services. Lastly, grants can be specifically assigned to investments. In all these cases, grants are specific in their purpose, even if, in some cases, they are not targeted and may be spent freely.

But, grants can be devised on a quite different basis, i.e. not to meet a specific purpose, but to supplement tax revenues in order to adjust budget resources to meet the needs to be satisfied by local governments. That function can be achieved either through the assessment of needs and costs, which is specific to the British response, or through equalisation of tax bases by a general grant, which is supposed to preserve the policy discretion of local governments. However, tax base equalisation is usually combined with some form of need equalisation, in order to redress inequalities in costs and needs. The Swedish model relies heavily on tax base equalisation but includes also a horizontal equalisation of cost disparities between municipalities. In other countries, however, the grant system is rather based on need assessment (France, Portugal).

In the latter conception, the purpose of transfer payments from the central government is not specifically to secure the performance of certain tasks, but to ensure that all local governments have budget resources in accordance with the scope of their competence. It is basically an equalisation purpose since the responsibilities assigned to local governments have to be performed independently of unequal distribution of wealth, resulting from unequal tax bases. In theory, the equalisation of tax bases through a general grant or through tax sharing indicia tend to equalise spending powers, while general grants based on the assessment of needs and costs tend to equalise levels of spending per inhabitant. In fact, much depends on the real tax powers given by the law to local councils. Since no system is perfect, some countries tend to combine both (France, for example, where equalisation partly based on the assessment of needs is coupled with a larger tax power to local councils), but the result is not always better. No grant system is a pure application of a theoretical or desired model. The weight of the past is very important in all cases since changes have to be incremental to avoid upsetting many local budgets which anticipate the present system to last and because better off localities are not inclined to give up their privileged position, that can be reduced only over time.

Theoretically, there is an option between financing local government expenditure by transfer payments from the central government or by local taxation or, as an alternative, by user fees. But, whereas local taxation is local government's own source of revenue, grants are, potentially, a means of controlling local government expenditure in volume and/or in application. Therefore, not only economic, but also constitutional and legal arguments have to be considered.

Also discussed is whether revenues from tax-sharing are equivalent to tax revenues or similar to grants. Tax sharing is often classified with local tax revenues because of its fiscal origin. In most cases,

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[1] Central place functions are those which benefit all surrounding municipalities.

however, there is no difference, from an economic viewpoint, between a general grant and a tax-share assigned by the law. The key point is that local governments, which benefit from a tax-share, have no tax power. Individual local government decisions have no influence on local tax revenues when the sharing key is applied to national revenues yielded by the tax. From a legal viewpoint, it cannot be argued that tax-sharing is a more appropriate way of establishing a guarantee to local government, of the amount and the evolution of the local government's share. Such arrangements can also exist in the case of grants established directly in the State budget. Nevertheless, except in the case of constitutional guarantees, the last parliamentary act will always prevail. As regards allocations, the same methods can be applied to a grant or a tax share.

Nevertheless, there are two arguments in favour of a distinction between tax shares and general grants: 1) tax shares can be calculated on the basis of the tax revenue yielded locally, and some examples can be quoted and 2) as far as grants are concerned, they can be based on a sharing key or on an indexation of the grant amount as a whole and on differentiated allocation rules according to different purposes, which allow more flexibility for macroeconomic purposes and for bargaining with local authorities.

Obviously, macroeconomic reasons may determine the evolution and the allocation of grants. This is true, in fact, for local finance as a whole. But, central government control on grants is more direct since they are direct payments from the State budget to local governments. The limitation of grants can be used to moderate the level of local government spending, especially if local governments have little discretion, in law or for political reasons, to increase taxation.

Another macroeconomic reason for grants is that they are less disturbing to the market than unequal tax rates imposed by individual local governments. But, it can also be argued that local taxes play a very minor role, if taken individually, in a person's decision to locate. Lastly, since the stabilisation and distribution functions of central public finance are no longer as relevant as in the past, local governments are no longer confined in their provision of public goods. They contribute to the stabilisation function through policies aimed at developing local employment and carry out programmes with redistributional effects. Grants can also be used by the central government as an instrument to enforce national policy priorities by orienting local government expenditure accordingly.

It is clear, however, that macroeconomic purposes for transfer payments may conflict with the principle of local autonomy. This is why the constitutional value of local autonomy, which is generally recognised in democratic countries, requires that it be supported by a sufficient tax power and a sufficient tax revenue level of its own. Whereas too much dependence by local budgets on transfers would infringe local autonomy, this goal cannot be achieved only though tax sharing, since individual local governments have no influence on the amount of their own tax share. Local tax revenues are expected to make local governments more accountable to citizens, and more concerned with an effective management of resources employed in performing their tasks. They give more options between a higher level of services and a lower level of taxation. To a large extent, grants and tax shares, as local government resources, tend to favour the value of equality of citizens in the delivery of services or the spending capacity of the local authority. Whereas, local tax revenues tend to favour a greater diversity, but give rise to inequalities. This is even more so if user fees are taken into account, since they can be increased for certain services managed according to the ability-to-pay principle.

These basic issues regarding State transfer payments to local government are as relevant to an analysis of local finance in SIGMA countries as to the presentation of West European experiences. Six SIGMA countries are considered here: Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia. The selected West European countries are: France, Portugal, Sweden and the United Kingdom. This sample was composed according to several criteria: a selection of only unitary states, since all SIGMA states are unitary republics; of larger and smaller countries; countries with big municipalities or with numerous, small municipalities (France). Portugal was chosen because it is a society where agriculture is still important in employment and because of its past experience of transition from an authoritarian to a democratic regime (but afterwards it does not seem to make a difference). Sweden was considered essential because it is a country with a large public sector and huge welfare programmes carried out by local government. The case of France was relevant because of the recent devolution of new responsibilities from the State to local governments and because of its territorial pattern with State field services for the execution of central government policies.

The first section will be devoted to the diagnosis of transfer payments in local finance of SIGMA countries. The second section will review the experiences reported in the following chapters, as assessed from the analysis previously presented.

Transfer payments in local finance of SIGMA countries: a diagnosis

A broad overview of existing SIGMA countries' local government is necessary to explain the basic features of local finance and the place of transfers. It is necessary to appraise local finance by taking into account the size of municipalities, especially in countries where there are a large number of very small municipalities, but this would have exceeded the limits of this paper.

The following observations will bring forward several policy issues for central governments regarding State budget support to local government, and, above all, its interrelation with other resources in local finance and the future of the local government system as a whole. One major feature all these countries share is uncertainty on the future. Local self-government has been established everywhere, but many aspects of the local government system are still not decided. This might be the only common feature. For the rest there is considerable diversity. Nevertheless, it is possible to present two main local finance system profiles which are now in formation.

The local government structure

The basic data is summarised in the following table. All types of administrative divisions are classified according to different models characterised by size and legal status (local self-government units are shown in bold print; units which are administrative divisions of central government are shown in regular print). The following local government types are distinguished, from the largest to the smallest: region, province (*département*) or county, district (similar to the German *Kreis*) and municipalities (*communes*). The region may be either a large territorial self-government unit, as in France (although laws to establish such intermediate self-government levels in SIGMA countries are still in the drafting stage) or it may be a large administrative division of the central government. A local government unit is a legal entity, whereas in a pure administrative constituency there is only an authority appointed by the central government. But, in some SIGMA countries, municipalities are represented along with central government appointees at the intermediate level.

***Table* I**
Local government pattern and structure in SIGMA countries

	BL	CZ	H	PL	R	Sl
	110 000 km^2 9 M. hab.	78 864 km^2 10.4 M. hab.	93 000 km^2 10.4 M. hab.	312 680 km^2 38 M. hab.	238 000 km^2 22.8 M. hab.	49 035 km^2 5.3 M. hab.
Regions	9 oblasti including **Sofia**	-	8 regions **Budapest**	-	-	-
Provinces /Départements or Counties	-	-	**19 comitats 20 cities with comitat right**	49 voivodships including **Warsaw** Council representing municip.	**40 judets Bucarest Ilfov Agric. District**	
Districts / Kreise	(28 okolia Council representing municip.: were not established)	72 okresy Council representing municip. **Prague, Brno, Ostrava, Plzen** 381 cities with delegated state functions for surrounding municp.	-	-	-	38 okresy **Bratislava Kosice** 121 subdistricts (obvod)
Municipalities / communes	**255 obshtina + 24 municip of Sofia**	**6 196 municip. among which 468 towns** 4 946<1 000 133 >10 000 7 >100 000	**3 136 municip; among which 216 towns and 23 Budapest districts** 1 661<1 000 153 >10 000 9 >100 000	**2 468 municip. among which 301 cities 535 miasta-gmina 1 632 gmina (rural comm)** 1 122<7 000 138 >40 000 25 >200 000	**2 951 municip. among which 56 cities**	**2 851 municip among which 134 towns** 1946<1 000 61 >10 000 2 >100 000

(Sources: United Nations, council of Europe and reports prepared for SIGMA)

This table reflects the situation at the end of the year 1993. It makes clear several typical features.

Municipal level established

First, the municipal level is the only level where local self-government has been established in four countries, whereas Hungary and Romania have established a second tier. It was thought that democracy should be rooted in localities. The municipality is considered the basis of local self-government and it had to be established first. At the same time, intermediate levels of local government were looked upon with distrust, as the stronghold of the former regime. Either they were removed, because of their role under communist rule (regions in the Czech and Slovak republics), or they were scaled down to pure central government offices to avoid competition between two levels of local self-government that would have hampered the consolidation of municipal self-government (Poland). Only in Romania did the *judet* retain wide powers, probably because the reform process is less advanced in this country, despite the fact that *judet* are now organised as local self-government units (Local Government Act n. 69/1991). In Hungary, the *comitat* were maintained as a result of a compromise with those who wanted to suppress them. They basically have a subsidiary role (Marcou / Verebélyi, 1993: 65, Mildner / Wollmann, 1993).

This structure matches the general popular feeling rejecting the forced amalgamation of communes implemented under communist rule in most of these countries (Marcou / Verebélyi, 1993: 47; Vidláková, 1993; Bercík / Vavrík, 1993; Verebélyi / Balazs /Bertök, 1993: III). The result is that, except in Bulgaria, the number of communes is high. In the Czech and Slovak Republics and in Hungary, the number of small communes is extremely high and increased further, in past years, by the splitting up of many amalgamated communes. In Poland, the number of communes increased over about two years from 2 375 (1991) to 2 468 in early 1994. In the Czech Republic, the number of communes increased sharply from the late eighties (4 092) to the end of 1993 (6196), whereas, during the same time, the number of cities decreased (from 686 to 468). In Slovakia, the same phenomenon occurred, with the number of communes increasing from 2 725 in the eighties to 2 853 in July 1993. In Hungary, most common councils, which administered several localities, disappeared in three years. There are now 3 154 municipalities (Sept. 1993), most of them with their own council, instead of only 1 610 in early 1990. Only Bulgaria escaped such a fragmentation and kept its large municipalities. However, in Poland, most large municipalities amalgamating rural communes with a small town survived. It remains that, except in Bulgaria, there are a high number of small communes in these countries: in Hungary, 1 661 communes have less than 1 000 inhabitants, in Slovakia, 1 952 and in the Czech Republic, more than half of all municipalities have less than 500 inhabitants. In Bulgaria, on the contrary, despite the existence of 4 419 villages, the *obshtina* (municipality) is the only local government level.

Despite this excessive fragmentation of the communal pattern, the level of co-operation between municipalities is still low. In Hungary, not only common councils disappeared, but the possibility to have a common office for several communes (joint Notariat) is not widely used. One third of communes with less than 1 000 inhabitants preferred to set up their own office. Until now, additional subsidies for projects carried out jointly (for example, 10 per cent for sewers) did not greatly change this situation. There existed 363 associations of all kinds in early 1992 (Verebélyi / Balazs / Bertök, 1993: III,13). In Slovakia, co-operation is meant to overcome fragmentation. The law provides for co-operation through joint offices, common to several councils, joint authorities or common undertakings. But, most communes remain reluctant. In all countries, co-operation is very much limited to single projects. The people’s support of self-government in the local community is a democratic claim that the law cannot ignore. This is consistent with provisions on the direct election of mayors (although not in the Czech Republic, nor in bigger Hungarian and Polish cities) and institutions of direct democracy. Co-operation and deconcentration are probably the only ways to cope with this reality.

Uncertainty at intermediate level

A second common feature is the uncertainty in intermediate levels. The establishment of an intermediate level of local self-government is now on the agenda in all countries which, at present, do not have it. Further steps in decentralisation depend on such a reform for tasks of too wide a scope to be transferred to municipalities. Only in Hungary and in Romania is there, at present, an intermediate level of local self-government, the province, with legal capacity and decentralised responsibilities. There is a provincial executive, elected by a provincial council, elected itself indirectly, e.g. by all local councillors of the province (Hungary: Act n°65/1990; Romania: Act 69/1991). In Hungary, *comitats* (counties) form a very old and traditional territorial pattern in the country. As the seat of aristocratic self-government since the XIIIth century, they were integrated in the State structure of the Habsburg Empire, retaining self-government responsibilities until the end of the last century (Wollmann, 1994: 133). In Romania, the present division, *judet*, was introduced under communist rule and deviates considerably from the traditional *judet* pattern of the past. Nevertheless, the *judet* has been a traditional level of government in Romania, with remote historical origins and was maintained under various governments during the XIXth century (Iordan, 1993). Other countries are inclined to introduce local self-government at a regional level, the concept of which has still to be defined.

In Poland, the voïevodship is the district of a State authority, the voïevod, appointed by the Government at the provincial level, along with a consultative council representing municipalities. The voïevodship has a deconcentrated budget (Act of 22 March 1990) (Marcou / Verebélyi, 1993: 66). A similar arrangement is provided in the 17 September 1991 law on local government in Bulgaria for the district level, a traditional government level, until 1944, which existed as a grouping of municipalities. But, districts were not established until now and it is believed that districts would conflict with the new regions (Todorov / Tsankov / Baltadjieva, 1993: 11).

In other countries, the intermediate level of government is normally the district, which is a small unit that can be defined as a grouping of municipalities and a level of the deconcentrated State administration. In Slovakia, districts are the smallest level of government, as in the Czech Republic. In the Czech Republic, municipal representation is established at the district authority level, with decision-making power on the district budget and on subsidies to municipalities. Therefore, the district can be called a "semi-government" (V. Kamenickova). There is no such assembly in the Slovak Republic. Czech and Slovak districts are territorial divisions for deconcentrated State authorities, with a budget delegated to them for their own purposes; in the Czech Republic, this budget includes subsidies and tax shares assigned to them. Bigger municipalities (381 in the Czech Republic, 121 in the Slovak Republic) carry out additional delegated State functions for their surrounding area, especially for decision-making according to the Administrative Procedure Code. But, both in the Czech and in the Slovak Republic, districts are subject to reform. They could be abolished if regions where to be created. Their functions could be amalgamated into regional State administrative offices or decentralised to new self-governed regions.

In Poland, the districts (*powiat*) existed in the past, but were removed in 1975. Whether to restore districts and big cities, vested with district status, as an intermediate level of self-government, upon which State functions presently exerted by the voïevod would be transferred, was contemplated (Jalowiecki, 1993). In fact, this reform was finally abandoned by the new government elected in October 1993. The municipalities, which did not want to see their autonomy infringed by a new self-government level too close to them, and the Peasants' Party, now the Government, opposed the reform.

The region, as an additional or alternative government level, is nowadays hotly discussed in all SIGMA countries, with reference to what is considered (wrongly) to be the new Western model. As in the West, the concept is very unclear.

In Hungary and Bulgaria, administrative regions have already been established, for the State functions, with a senior public officer appointed by the Government; the Commissioner of the Republic in Hungary, the Governor in Bulgaria. In these two countries, the region is not deemed to be a self-governing institution.

On the contrary, the region is discussed in Poland (Jalowiecki, 1993), the Czech Republic (Vidláková, 1993; Hendrych / Pomohac / Vidláková / Zarecky, 1993)) and Slovakia (Bercík/Vavrík, 1993) as an issue for the next steps in decentralisation. But, there is no consensus on what should be the real purpose of such a reform, except that it will not pave the way for federalisation of the State. This precludes reform schemes based on a small number of big regions. But, the number and size of regions are closely related to the kind of functions to be delegated to them and the various proposals are not based on any concept of administrative reorganisation.

In Poland, three possibilities have been elaborated upon by a commission set up by the former Government (Jalowiecki, 1993), these being: a) 9-12 regions based on the biggest cities; b) return to the traditional mapping of 17 voïevodships, removed in 1975; or c) about 25 voïevodships based on regional urban centres. The commission preferred the first option, but, at present, regionalisation does not seem to be on the Government's agenda.

The Constitution of the Czech Republic, adopted in 1993, provides that the Republic is divided into regions, districts and communes. The reform prepared in 1993 by the Government is based on the concept of regional decentralisation within a unitary State. Regions will perform only those functions assigned to them by the law, as opposed to the general competence recognised to municipalities. The Czech Government has approved two bills which have not yet been submitted to Parliament: one on establishing regions, and the second on their responsibilities. Their number might be comprised of between 13 and 17, i.e. almost the same number as in 1950 (14, but the number of regions had been reduced to 8 in 1962 and they were suppressed in 1990), since it is still considered adequate in relation to the concentration of settlements and economic activities. In the Slovak Republic too, a second level of local government is provided for in the new Constitution. The Slovak Government adopted, in October 1993, a reform scheme providing for the integration of 38 district offices into 7 regions, establishing self-governed regions with an elected council. This reform scheme was not passed by Parliament.

This regional decentralisation would make possible the devolution (transfer) of State responsibilities to the regional councils. In both countries, the management of secondary schools, hospitals and cultural facilities would be transferred to the regions. But, the future of these reform schemes is uncertain. Prepared in a hurry after the partition of the former federation, they are subject to criticism and politically controversial. In the Czech Republic the number of regions is still subject to discussion, and the bills have still to be submitted to the parliament. In the Slovak Republic, the Government change in March 1994 modified the reform's prospects. Decentralisation is still on the agenda, but should be carried out over the long term and regionalisation could be prepared only for the next local elections (1998). The local elections in November 1994 were too soon to ensure all the conditions for the successful implementation of the reform. Furthermore, the number of regions and their functions are still being discussed. Some propose 4 regions, others 13 or 14, instead of 7 in the previous Government's scheme.

Central government / local government relationships evolving

Lastly, the model of the relationship between local government and the State is not settled yet. Due to the thrust for democracy, great autonomy was granted to municipalities by new laws on local government and the State retained, in general, very few control powers. But, the scope of responsibilities voted in municipalities varies considerably from one country to another. It is broader in Hungary and Bulgaria considering that the major part of education and health service costs, including teachers' salaries, are funded by municipalities in both countries and these two functions are the biggest burdens in public budgets. In Poland, primary and secondary education costs are transferred step by step to municipalities which apply for such transfer. At present, 25 per cent of municipalities have taken over this responsibility and it is expected that this number should be 75 per cent in January 1996. In the Czech Republic, municipalities are responsible only for school infrastructure and (non-teaching related) running costs, but such a reform is a matter of discussion. To the contrary, Hungary has just decided to remove the responsibility for teaching costs from municipalities (it represents 60 per cent of local budget expenditure) and transfer it to the State. The teacher will be subject to a new public service law. In Slovakia, the decentralisation of education and health services depends on the future of regionalisation.

The example of education competency shows that the key issue is whether, and to what extent, the State is expected to carry out national policies or to achieve national goals in sectors subject to decentralisation. The distinction of optional and mandatory tasks (Hungary) or local and delegated responsibilities (Poland, the Czech Republic) reflect different ways for the law to allow the Government to keep control of certain tasks performed by local government.

Another way is deconcentration, which means that the State will carry out locally, with its own subordinated field services, a number of tasks which cannot be run centrally. This last option is typical of the Czech and Slovak republics, where a lot of services are provided directly by district offices, in the former with the participation of local government represented in an advisory council. In Slovakia, the undesirable multiplication of vertical structures of ministries with their own field agencies has overlapped the district offices, making the co-ordination between the various government branches and with municipalities more difficult. In fact, deconcentration exists in each SIGMA country since the tasks are performed by the former State apparatus if their transfer to local government has not been implemented.

The combination of decentralisation and deconcentration varies greatly. The Czech and Slovak republics tend to implement a clear-cut division of responsibilities between the State and local government, especially in the Czech Republic, whereas Hungary and Poland tend to rely more upon local government for the implementation of national policy goals. The model of relationship which will prevail will depend very much on the kind of second local government level established, if any.

The examples quoted above indicate that the weight of the past will be strong. As far as the second level of government is concerned, it is remarkable how the reforms or reform proposals tend to restore or maintain the former territorial pattern. Also, in the relationship between the State and local government, former administrative traditions tend to be rediscovered. Indeed , these never disappeared during the communist rule, even if some new institutions were imported from the West in past years (for example, provisions for supervision and auditing in Hungary and Poland). If this is true, it is possible to anticipate that the part of deconcentration in the new local government system should remain important in all SIGMA countries, although more so in the Czech and Slovak republics than in Hungary or Poland. But, in Hungary, the high number of municipalities with very broad responsibilities could bring about the evolution to a partial recentralisation with a deconcentration of tasks performed by the State.

The diversity of local government in SIGMA countries is reflected in the diversity of local finance. The share of grants and the functions assigned to grants are very different.

A comparative outline of local finance

Comparisons in public finance are always very difficult and subject to misunderstandings when data is not established, from the outset, on the basis of the same definitions. The level of expenditure is even more difficult to compare, since it depends not only on the distribution of responsibilities, but also on the level of service provided by the government. Despite these difficulties, the comparison will clearly show very different local finance systems. This means that transfer payments have to be assessed within their respective local finance system.

Main macro-economic values in local finance

The following tables summarise the main indicators. Table II is aimed at a comparison of main macroeconomic values concerning local government between SIGMA countries. Table III compares the breakdown of local government revenues between these countries. In Table II, transfers to local government and the social security fund, as the case may be, are withdrawn from the amount of central government expenditure. They are given in total with a minus sign in the column “Central government budget”. Included in compulsory payments to local government are only local taxes. Tax-shares and grants allocated to local government are included in compulsory payments to the central government. Users charges and fees are not compulsory payments, since they are paid directly for a service. Much of the data provided by preliminary reports is used only indirectly, after calculations to comply as far as possible to homogeneous definitions.

***Table* II**

Central and local government budgets in SIGMA countries (1993)

Countries	Macroeconomic values (in national currency and in % of GDP	Central govern. budget	Social security fund	Local govern. budgets
POLAND municipalities	Compulsory payments: - mln Zl - %GDP	 384 935 204 24.81%	 186 527 000 12.02%	 32 438 345 2.09%
	Public expenditure: - mln. Zl - %GDP	 389 524 000 25.1%	 259 634 400 16.73%	 95 849 073 6.17%
	Transfers from central budget: - mln Zl - %GDP among which: * Grants - mln Zl - %GDP * Tax shares - mln Zl - %GDP	 - 124 995 670 - 8.1%	 73 420 000 4.73% 73 420 000 4.73%	 51 575 675 3.32% 27 140 471 1.75% 24 435 204 1.57%
BULGARIA Municipalities	Total revenue (own revenue for loc. gov.) - mln Leva - %GDP	 69 679.5 24.4%	 32 146.2 11.2%	 5 098.9 1.4%
	Compulsory payments: - mln Leva - %GDP			 2 083.8 0.73%
	Public expenditure: - mln Leva - %GDP	 68 560.6 24.0%	 38 979.7 13.6%	 33 695.1 11.8%
	Transfers from central budget: - mln Leva - %GDP among which: * Grants - mln Leva - %GDP * Tax shares - mln Leva - %GDP	 -47 435 - 11.9% - 34 138.0 - 7.3% - 13 297.6 - 4.6%	 5 541.8 1.9% 5 541.8 1.9% 0 0	 28 516.2 9.9% 15 298.6 5.3% 13 217.6 4.6%

(Table II continued)

CZECH REP. data on local government <u>include district</u> budgets	Compulsory payments: - Mds Kc - %GDP	(incl. Soc. sec. contributions) 386.2 41.8%	(health insur. contrib. only) 36.9 4.0%	 7.8 0.8%
	Public expenditure: - Mds Kc - %GDP	 313.9 38.6%	 47.9 5.2%	 90.2 9.8%
	Transfers from central budget (reconstructed): - Mds Kc - %GDP among which: * Grants - Mds Kc - %GDP * Tax shares - Mds Kc - %GDP	 - 72.2 - 7.8% - 43.0 - 4.6% - 28.2 - 3.0%	 16.0 1.7% 16.0 1.7% 0 0	 58.4 6.3% 30.2 3.3% 28.2 3.0%
SLOVAKIA Local government: <u>municipalities only</u>	Compulsory payments (partly reconstructed): - Mds Ks - %GDP	(incl. Soc. sec. contributions**?**) 135.6 40.2%	-	1.6 0.5%
	Public expenditure (partly reconstructed): - Mds Ks - %GDP	 173.1 51.5%	-	 19.3 5.73%
	Transfers from central budget to local government (partly reconstructed): - Mds Kc - %GDP among which: * Grants - Mds Ks - %GDP * Tax shares - Mds Kc - %GDP	 -7.9 -2.34% - 2.2 - 0.6% - 5.6 - 1.6%		 7.9 2.34% 2.2 0.6% 5.6 1.6%

(Table II continued)

HUNGARY Municipalities and counties (*comitats*)	Compulsory payments (partly recons-tructed): - Mds HUF - %GDP	946 28.4%	564.5 17.0%	27.1 0.8%
	Public expenditure: - Mds HUF - %GDP	922.5 27.8%	554.4 16.6%	622.4 18.7%
	Transfers from central budget (partly reconstructed) <u>to local government:</u> - Mds HUF - %GDP among which: * Grants - Mds HUF - %GDP * Tax shares - Mds HUF - %GDP	- 318.3 - 9.6% - 266.9 - 8.0% - 51.4 - 1.5%	- 91.6 - 2.8% - 91.6 - 2.8% 0 0	409.9 12.3% 358.5 10.8% 51.4 1.5%
Romania Municipalities and *judets*	Total revenues: - Mds Lei - %GDP	3 792.4 18.1%	1 315.1 6.3%	712.5 3.4%
	Compulsory payments: - Mds Lei - %GDP			92.7 0.4%
	Public expenditure: - Mds Lei - %GDP	3 568.8 17.0%	1 174.7 5.6%	696.0 3.3%
	Transfers from central budget (partly reconstructed) <u>to local government:</u> - Mds Lei - %GDP among which: * Grants - Mds Lei - %GDP * Tax shares - Mds Lei - %GDP	- 560 - 2.7% - 328.2 - 1.6% - 231.8 - 1.1%		560 2.7% 328.2 1.6% 231.8 1.1%

(Source: Ministries of finance of Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia)

This table is based on the concepts of compulsory payments and public expenditure. Compulsory payments are taxes or obligatory payments imposed on individuals and corporations, independent of any consideration. In addition to taxes, there are social security payments. These have to be considered because the separation of the State budget and the social security budget is not the same in every country (see the case of the Czech Republic where most social security allowances are funded directly through the budget and in Hungary where the social security funds allocate grants to local governments). In the table, the compulsory payments levied are assigned to the authority which exerts the tax power. Logically, this would have led to the amalgamation of the central government budget and the social security fund, since social security rates are fixed by the central government and not by the fund management. But, the specificity of the State budget and the fact that most transfers to local government come from the State budget justify the presentation in separate columns.

Moreover, this presentation permits the comparison of authorities' tax powers. It makes clear that local government tax powers are very narrow. The only compulsory payments levied by local governments, local taxes, have an extremely low yield, except in Poland where they are in excess of 2 per cent of the GDP. Indeed, most of local government's tax revenues are tax shares, which means, in fact, that local councils have no influence at all on tax yield, just as for grants. It is so in the Czech Republic where the revenue from personal income tax is levied in each district according to rates fixed nationally for the whole territory and shared equally between the district office, which is a State deconcentrated administration, and the municipalities of the district. This scheme generates inequalities related to the district border.

Public expenditure here is public budget expenditure. Social security costs are presented as public expenditure only to give an overall idea of publicly controlled spending, since the division between budgetary funding and social security contributions in financing social security benefits varies from one country to another, but is not always, or totally public expenditure. Table II makes clear that the level of local government expenditure is usually low or extremely low, except in Hungary where it is in excess of 18.7 per cent of the GDP, a very high proportion, even compared with Western countries. In Hungary and in the Czech Republic (9.8 per cent of GDP), the figure includes counties' and districts' expenditures, respectively. But, in Hungary, municipal expenses are expected to be as high as 565 billion HUF in 1993 or 17 per cent of GDP. And, in the Czech Republic, districts' share of the total local public expenditure decreased from 35 per cent in 1992 to 16 per cent in 1993. This reflects the fact that in some countries the decentralisation is beginning and the scope of responsibilities can be further widened, especially as far as budgetary responsibilities are concerned.

It appears also from the table that, among transfers from the central government budget, the amount of grants is usually higher than tax shares where the level of local government expenditure is higher. In Hungary, grants represent 10.8 per cent of GDP and tax shares 1.5 per cent of GDP, about the same proportion as in Poland where local government spending equals 6.17 per cent of GDP. The same tendency is reflected in the data on Bulgaria where local government spending makes up 11.8 per cent of the GDP: 5.3 per cent of the GDP goes to central grants and 4.6 per cent of the GDP goes to tax shares; it is confirmed by forecasts for 1994 (local government spending: 8.6%; central grants: 4.3%; tax shares: 2.9%). A contrario, in the data on Slovakia, 5.73 per cent of the GDP is local government spending, 0.6 per cent of the GDP consists of grants and 1.6 per cent of the GDP is tax shares. The Czech Republic has a relatively high level of local government spending too; despite the sharing of the whole income to yield between districts and muncipalities, grants reach 3.3 per cent GDP, whereas tax shares reach only 3.0 per cent GDP. Romania is the only exception: grants exceed tax shares, despite the very low level of local government spending because of the very low level of their local revenues.

To a certain extent, the level of local public expenditure reflects the scope of responsibilities performed by local governments, although not totally, since this reflects the bulk of services delivered by local governments directly whereas certain services can be delivered by the private sector under regulation by the local authorities. But, privatisation has not gone so far as to undermine the value of this indicator. Therefore, SIGMA countries will be classified in the next table according to decreasing levels of local government spending as a percentage of the GDP.

Local government revenues

***Table* III**
Local government revenues in SIGMA countries:
structure and amount in national currencies (1993)

Local govern revenues	HUNGARY		CZECH REP.		BULGARIA		POLAND		SLOVAKIA		ROMANIA	
	Billion HUF	%	Billion Kc	%	Million Leva	%	Billion Zl	%	Million Ks	%	Billion Lei	%
Own tax revenues	27.1	4.4	7.8	7.7	2 083.8	6.2	23 245	24.1	1 610	7.68	92.7	13.0
Fees and charges	91.9	14.8	3.0	3.0	2 373	7.0	5 088	6.1	2 076	9.92	17.2	2.4
Grants and subsidies	358.5	57.6	30.2	29.8	15 299	45.4	27 140	28.1	2 227	10.6	328.2	46.1
Tax shares	51.4	8.3	28.2	27.8	13 040	38.7	24 435	25.3	5 647	26.9	231.8	32.5
Capital incomes: - sale of properties - loans	48.9 *25.3*	7.8 *4.1*	9.1 *7.0* *2.1*	9.0 *6.9* *2.0*	na	na	10 525	10.9	2 053 *798*	9.79 *3.8*	42.6	6.0
Others: - rev. budg. organisations or non incorp - extrabudg. funds - fines, forfeits - others	44.6 yes *37.3* 	7.1 *6* 	19.2 *10.2* *8.1* *4.7*	22.7 *10.0* *8.0* *4.6*	900.3 *240.8* na *437.6* *212.8*	2.7 *0.7*	5 306 na	5.5	7 362 na	35.1	0	0
TOTAL	622.4	100	101.3	100	33 695	100	96 539	100	20 966	100	712.5	100

(Source: Ministries of finance of the respective countries)

Notes: 1) Own tax revenues are taxes levied by local governments; a tax power can exist only on these tax revenues, either if the local council is empowered to fix the rates, or to decide upon exemptions of certain categories of potential tax payers, or to influence directly tax bases through local policies.
2) The category "Other revenues" is presented differently in the available data. In some countries, it includes capital incomes (Czech Republic), whereas, in most countries, capital incomes are presented separately (Hungary, Slovakia, Poland. Sometimes, "Other revenues", which are non tax revenues, represent a significant part of the total revenue, as in Slovakia, and a breakdown of this category would be desirable.Subcategory figures are displayed in those cases where they were provided by the finance ministries of the country.
3) In some cases selling properties, as a result of privatisations or not, is known to have brought important resources to certain cities. A better knowledge of the impact of such policies on local budgets would be useful.

Several observations of interest can be made from this table.

1) It confirms Table II, concerning the importance of "own tax revenues" in local budgets. Local taxes provide only a very small portion of the total local government revenue, except in Poland where local taxes are 24.1 per cent of the total revenue. Poland is, so far, the only SIGMA country where municipalities have tax power. The percentage of local tax revenues is remarkably low in countries which have the highest level of local public expenditure, Hungary and Bulgaria. It is relatively high in Romania too, but in the context of extremely small local budgets (see Table II).

2) Grants and subsidies always represent between a quarter and more than a half of the total local government revenue, except in Slovakia where they are only in excess of 10 per cent. In this country, it is, in fact, a deliberate Government policy to achieve a clear-cut differentiation between State and local government responsibilities and between State and local government budgets. In 1991, grants provided 49.3 per cent of the total revenue. In 1994, they should provide only 8.1 per cent. Furthermore, grants tend to be higher in countries with a higher level of local government expenditure, if we set aside the case of Romania which is biased by a very low level of local public expenditure.

3) Except in Hungary, tax shares provide between one quarter and one third of the total local government revenue.

4) If grants and tax shares are cumulated, since they are both transfer payments from the State budget, different profiles appear. Transfer payments provide more than half of the total local government revenue, except in Slovakia (37.5 per cent). But, there are still other inequalities between the other countries. Economically less developed countries (Bulgaria, Romania) appear to be much more dependent on transfer payments from the State budget than other countries. But, among these two countries, as among more advanced countries, where local government performs more tasks and shows a higher level of public expenditure, they depend more on transfer payments.

5) It would be interesting to cumulate local governments' own revenues of all kinds. Unfortunately, only two categories of such revenues are clearly identified: local tax revenues and fees and charges paid by users. But, in countries where the category "Other revenues" is significant, it is believed that some other local resources are included, like benefits from activities carried out by the municipality or transfers from reserves that cannot be isolated. It is so in the Czech Republic, where "revenues from budgetary organisations" come partly from users charges (swimming pools, music schools ...) and partly from taxes (municipal motor vehicle permits). The same definitions can be accepted, in general terms, for the other countries which provide this data. Capital incomes can also be considered as local revenues, since the decision to borrow or to sell properties belongs to the local council. But, in fact, they are not revenue in the proper sense, because the resource which is so obtained cannot be repeated. Nevertheless, it appears that fees and charges are highest in Hungary (14.8 per cent of the total revenue).

If local tax revenues, fees and charges are cumulated, it appears that these local revenues are, in total, the highest in Poland (more than 30 per cent), followed by the Czech Republic (20.7 per cent), Hungary (19.2 per cent) and Slovakia (17.6 per cent). This leads to the conclusion that these four countries have the widest resource autonomy among the six. The level of expenditure is most significant in Hungary.

If these own resources are added to the amount of "capital incomes" and "other revenues", it appears that Romania and Bulgaria have the smallest percentage of resources independent of the centre in total local government revenue, since these two countries have very low capital incomes or other revenues. On the other hand, in Slovakia, 62.6 per cent of the total local government revenue can be said to be more or less independent of central government influence due to the very high level of "other revenues". Benefits from privatisation and the selling of properties (see hereafter) are the main sources of these "other revenues". Poland seems also to have a high proportion of resources that are independent of central government (46.6 per cent), according to the same calculation.

Transfer payments

If we look now in further depth at transfer payments from the State budget to local governments, it appears that, despite some common elements, they fit into very different patterns. Therefore, they show different features, depending on the local government functions they support and on the maturity of the transition process.

In all six countries, transfer payments are both grants and tax shares. In Bulgaria, interest free credits may be granted from the State budget to municipalities in order to overcome temporary shortages of funds. These credits have to be reimbursed by the end of the budgetary year. Short term loans can be granted to municipalities in Romania for the same purpose. Transfer payments differ very much in their proportion between grants and tax shares, as already observed, and in their allocation. Discretion in spending also differs very much from one country to another, as far as grants are concerned. In all six countries, the personal income tax is subject to sharing. In Bulgaria and Slovakia, tax sharing is applied to several taxes levied nation-wide, but income tax revenues are, by far, the most important. In Romania, it is subject to changes every year. Lastly, there are, in all six countries, some extrabudgetary funds which provide earmarked investment subsidies representing a small amount of grants in the total local government revenue.

If we now consider transfer payments within the local finance system of each country, two basic tendencies can be distinguished. Some countries turn to a system where the main resource should be a normative grant based on a need assessment (Hungary, Bulgaria) and tax shares should be supplementary to local revenues. Whereas, other countries turn to a system of spending capacity equalisation, where grants supplement these resources to support specific functions or projects (Poland, Czech and Slovak Republics). The case of Romania is particular. There, decentralisation is still beginning and there is no apparent conception of a local finance system.

In *Hungary*, the concept and structure of transfer payments is determined by the very wide scope of local government responsibilities. These include a major part of public education (primary and secondary schools, kindergartens, skilled workers training schools and other institutions, including teachers' salaries until the implementation of the reform transferring them to the State budget), social assistance and public health institutions. In other countries, and in the West, these are the responsibility of the State administration or are funded by the social security system. Indeed, Hungary is the only country where local governments receive grants from the social security fund (equal to 2.8 per cent of the GDP in 1993). For such basic services, an 'as equal as possible' level of service must be provided to all citizens and the finance system has to be devised in order to achieve that requirement. Local government's main resource is, therefore, the normative State contribution (77.8 per cent of the total of grants allocated to local government) and an ensemble of normative grants, among which the most important are based on cost analysis. In the total 207.5 billion HUF and 25 normative grants in 1993, 11 normative grants in the sector of education amounted to 47 per cent, 6 normative grants in the sector of social assistance amounted to 22 per cent and the 5 normatives for general grants amounted to 27 per cent. These 5 general normative grants are not based on cost analysis. They are lump sum grants based on other indicators (for example, a per capita basis for settlements in backwards regions). It raises the question of whether it would be better to sort out these normatives and establish another grant for equalisation purposes. At present, the unequal tax potential is not taken into account in any normative; however, there is an equalisation scheme within the personal income tax sharing. The number of normative grants increased in a few years from 15 to 27 (in the 1994 budget) in order to match needs more exactly. Whatever the title under which the money is provided, spending is untied for the beneficiary local government. But, the efficiency of the system depends on the quality of the information system and of the indicators upon which the calculus of the normative grants is based. A standardised nation-wide documentation system is to be built to improve the reliability of indicators.

These normative grants are devised to cover operational costs. The social security grant covers the payment of social benefits and amounted to 15 per cent of the total revenue of local government in 1993.

But, this is not sufficient since healthcare and social assistance represent, respectively, 16 per cent and 6 per cent of the total expenditure. This means that the tax share on personal income tax (30 per cent of the tax yield from 1993, instead of 50 per cent previously), which provides 8.3 per cent of total revenue, is almost completely consumed by expenses in the social sector.

If we consider that fees and charges are normally deemed to cover running costs, it means that the amount of local resources that can be invested for development purposes is relatively low. So far, local taxes are not levied everywhere, but may be introduced by the local council. Only 40 per cent of local authorities have introduced effectively some local taxes. We can consider that the revenues they provide are deemed to be development (capital expenditure), rather than current expenditure. This proportion suggests that the revenues from local taxes should increase in the future. In fact, the revenue from the turnover business tax, which is the main local tax, increased from 12.1 to 21.7 billion HUF between 1992 and 1993. As a result, nevertheless, local investments depend very much on State subsidies. Targeted grants, for tasks exceeding the capacity of individual local authorities and earmarked (equalising) grants have been introduced for that purpose. Altogether, they amount to 10.7 per cent of the total local government revenue in 1993 (15.7 per cent in 1992). Additionally, subsidies are granted by the development fund, an extrabudgetary fund set up for regional development purposes, and by which local governments may apply for financial support for their projects (1993: 6 per cent of the total local government revenue). Lastly, in 1993, borrowings brought local governments 4 per cent of their total resources. In 1993, capital expenditure amounted to almost 18 per cent of the total local government expenditure. This means that, in 1993, there was practically no contribution from local resources to investment funding.

The pattern of transfer payments to local government in *Bulgaria* presents many similarities with that of Hungary. It is based on a rather similar scope of responsibilities, but the transition process is much less advanced. Local budgets have been taken from the State budget only since 1992. The year 1994 is, at most, the third budgetary year for Bulgarian municipalities. As a less developed economy, the overall level of public expenditure for the State, the social security fund and local government is much lower than in Hungary. Nevertheless, Bulgarian municipalities perform roughly the same functions in the fields of education, healthcare and social assistance (as a whole, 60 per cent of their expenditure) as Hungarian local governments. In both countries, almost all public services are provided by local government. But, as emphasised earlier, Bulgarian municipalities depend much more on State transfers, grants and tax shares, and, in particular, investment decisions remain centralised.

In *Bulgaria*, local tax revenues, fees and charges are supposed to cover all expenses (current or capital) corresponding to the interests of the municipality's inhabitants, whereas grants are deemed to cover all costs incurred for tasks performed on behalf of the State. The latter are the most consuming and have been covered since 1992 by a general grant split into three parts: a continuity component, based on the previous year's subsidy, a normative grant based on 17 objective criteria, an adjustment grant and a target subsidy for investments. The continuity component is related to the former allocation system for the execution of centrally planned expenses, which was based on expenditure norms per unit. The new normative grant is based on a need assessment. Its amount is calculated as a result of a regression analysis, rather than cost. Among the criteria, there is the size of the population, the income per capita, the number of towns and villages in the municipality, as well as the number of patients in regional hospitals, or, to quote some newly introduced criteria, the number of non-working, single mothers, the number of pupils in secondary schools or the number of funeral ceremonies. As is common with such assessments, the weighting of the different criteria is the most controversial issue. The weighting of the continuity component and the normative grant in the general grant as a whole is crucial. The adjustment grant is based on the increase of the preceding year and a function of the gap between per capita own revenues of the municipality on one hand, and both the upper and the lower level of per capita own revenues of all municipalities on the other hand. Additionally, earmarked subsidies are granted to specific projects submitted by the municipalities or to promote programmes on a nation-wide basis. Anyway, the general grant is too low to cover all the costs of the function it is supposed to fund and municipalities are forced to use their own resources to maintain the corresponding services. Tax sharing is used for this purpose.

The rationale of tax sharing, which makes up a high proportion (38.7 per cent) of the total local government revenue, is not very clear. The main portion comes from income tax (8.6 billion leva of a total of 13 billion; but in 1994 almost 13 billion leva of a total of 14.5 billion). Additionally, municipalities received the turnover tax paid by local businesses. But, since 1994, this tax has been replaced by the VAT, which is received by the State in its totality. Due to its high level, this resource is inevitably involved in the funding of the mandatory functions of municipalities, which are its main burden. But, if it is allocated according to criteria which are different from those of the normative grant, it will conflict with the need assessment upon which the grant allocation is based.

As regards investment expenditure, this amounts to a relatively low proportion in local budgets: 9.8 per cent in 1993, and it is decreasing (1992: 13.2 per cent; forecast 1994: 8.2 per cent). But, decisions on investments do not belong to the local authority. This power belongs further to ministries, to which municipalities submit their projects. The Public Investment Programme 1993-1995 was settled by the Government, after consultations with sectoral ministries and municipalities

As well, in Hungary, as in Bulgaria, there is certainly a relationship between the new normative system for the calculation of grants, based on need assessment, given to local governments responsible for providing most services to the population and the former resource allocation system for the execution of expenditures corresponding to centrally planned tasks. This system relied necessarily on a cost analysis of each task to be performed. But, at that time, local spending was under central control, whereas, now, the need assessment is only a way to allocate resources, at least as far as current expenditure is concerned.

In the *Czech Republic, Poland* and *Slovakia*, on the contrary, much less weight is given to grants, as compared to tax shares, in transfer payments from the State budget to local government. Grants tend to be targeted or earmarked. Whereas, the bulk of functions to be performed are financed otherwise, by local revenues and tax shares. As opposed to the three other countries, grants amount to between 26 and 30 per cent of the total local government revenue in Poland and the Czech Republic. They are just over 10 per cent in Slovakia, where they decreased sharply as a result of Government policy, and they will fall again to 8.1 per cent in 1994. Furthermore, a smaller portion of grants consist of capital grants: 11 per cent (of the total local government revenue) in the Czech Republic, 5.4 per cent in Slovakia (but only 1.9 per cent in 1994) and, in Poland, only 0.4 per cent (3.5 per cent of the general grant). Lastly, in all three countries, the general grants tend to diminish compared to specific grants. In Slovakia, all grants are specific. In the Czech Republic, general subsidies are going to diminish further in 1994, due to a sharp fall in the equalising grant (from 9.9 down to 2.9 billion Kc) and, in the future, the number of grants is expected to be higher, under pressure by local government, but probably without increasing their total amount. This means that targeted grants will prevail even more. In Poland, the ratio between general grants and specific grants changed from 6809 / 5948 in 1991 to 11046 / 16094 in 1993 (in billion Zl). Another common feature is that the allocation of subsidies tends to be deconcentrated: at the district level in the Czech Republic and at the voïevodship level in Poland. In the Czech Republic, however, the district council decides now only on the equalisation grant to municipalities (see below).

Since grants are not primarily used to finance capital expenses, they are, in fact, used by the central government to cover the costs of some functions assigned by the law to municipalities, to support specific local government functions or to compensate local disparities in tax potential, as will be seen hereafter. In Poland, most specific grants (72 per cent of their total amount) rely on parliamentary acts which assign new mandatory tasks to municipalities. But, the major portion of general grants is, in fact, nowadays targeted:

it is the grant support for municipalities which take over the responsibility for the economic management of schools. Their number is growing, so that the school grant, which is part of the general grant, amounted to 58.9 per cent of the general grant in 1993, instead of 15.7 per cent in 1991. It is true that, in law, spending is free, but once the task has been taken over there is no way to use the money for another purpose. In the Czech Republic, the block grant is, in fact, a grant based on an assessment of needs for selected functions, delegated State duties (for example: planning permissions, birth or death certificates...) or functions that the State wants to support specifically (schools, homes for elderly people...) in each district, municipalities being classified according to size and altitude (Prud'homme / Gilbert, 1993: annex E). The system has been simplified recently, and the discretion of district councils regarding the share of the block grant allocated to municipalities has been removed. Now, 90 per cent of the central grants to municipalities are allocated directly to them by central government. The equalisation grant is the only one which is still decided by the district council. Spending is free of limitations, except for the payment of social benefits. In Slovakia, grants are allocated only to support certain activities in municipalities under 5 000 inhabitants and the operation of public transports in the three big cities.

It must not be overlooked that, in these three countries, extrabudgetary funds exist that allocate grants or loans to projects submitted by municipalities. Eight such funds exist in Slovakia, the most important being the State Environment Fund. Projects are selected after a tendering procedure. These funds receive budget subsidies, but also other resources such as penalties or donations, for example. Nevertheless, the resources of these funds become scarce. For example, the Czech Environment Fund will not support any projects in 1994. The same tendency can be observed in Hungary, where resources from extraordinary funds will be reduced to 2 per cent of the total local government revenue, instead of 6 per cent in 1993 (4 per cent in 1992).

The opinion prevails in all three countries that local government functions must be financed basically by local taxes, other local resources, such as fees and charges, and by tax shares, which provide a major source of revenue. Tax shares always provide more than one quarter of the total local government revenue. But tax-sharing suffers from instability. In Poland, municipalities receive 15 per cent of the personal income tax and 5 per cent of the income tax on legal persons levied in the voïevodship. In the Czech Republic, personal income tax is shared at the district level between municipalities and the district on a 50/50 basis. In Slovakia, the tax-sharing has been changed every year since 1991. Until 1993, municipalities received a share of the income tax allocated on a national basis, but according to changing indicators of entitlement. Since 1994, three taxes are shared: municipalities receive 29.92 per cent of the income tax on wages on a per capita basis, 5.67 per cent of the income tax on legal persons on a per capita basis, weighed by a multiplier increasing with the size of the municipality with a special weighing for Bratislava and 30 per cent of the road tax (paid for motor vehicles used for business purposes) collected in a certain tax area on a per capita basis. This mix provides less revenue in 1994 than the share of the personal income tax in 1993. But, the purpose of this change might be to correct equalisation in favour of cities and other places where economic development needs more resources.

Equalisation seems to be a greater concern in these three countries than in Hungary. With more local tax revenues, local budgets will normally reflect more economic inequalities between localities. In Slovakia, local taxes (mainly the newly introduced real property tax) are expected to provide a much higher part of the local government revenue (between 22 and 30 per cent depending on the estimates - see Bercik / Capkova report: 1994). In Poland, the real property tax should provide, in 1993, between 14.8 and 20.6 per cent of the local government revenue, depending on the estimates (Gilowska, report, 1994: 14, and 1994a: 81). In the Czech Republic, local taxes are not expected to increase. But, tax sharing of the income tax at the district level entails inequalities which cannot be justified, since local government has absolutely no power over this tax. The general grants include an equalisation component which is deemed to set off tax potential inequalities, but it is declining. In Poland, the distribution of the local governments' share of the personal income tax and of the income tax on legal persons, within the voïevodship, has a strong equalisation effect in favour of rural municipalities, although limited to 72 per cent of the average tax potential. But, it is politically contentious since peasants are not subject to the personal income tax, and are, instead, subject to an agricultural tax. The agriculture tax is a local tax amounting to 4 per cent of the total local government revenue. But, the equalisation component of the general grant is steadily decreasing, from 45.3 per cent of the total general grant in 1991 down to 19.3 per cent in 1993. In the Czech Republic, the equalising grant, a levelling subsidy for municipalities with very low per capita tax bases, decreased from 9.9 billion Kc in 1993 to 2.9 billion Kc in 1994. In Slovakia, the equalisation effect that can be expected from the recent tax-sharing reform is very haphazard.

Lastly, *Romania* differs from the five other countries in many respects. This is not only because of the low level of local expenditure. In fact, the local expenditure is distributed very unequally; 50.4 per cent is spent by the *municipe*, i.e. bigger cities, and 25.7 per cent by the *judet*. This last data reflects the fact that the intermediate level of government has remained much stronger in Romania than in other SIGMA countries. Due to the very low level of local resources, grants and tax shares represent the overwhelming part of local government revenue, making up 78.6 per cent. This is less, however, than in Bulgaria. Local governments are entitled to a portion of the tax on salaries. But, this tax-sharing is not based on repartition criteria. It is a payment from the State budget, withdrawn from the tax on salaries, to cover the difference between expenses on the one hand, and the sum of local resources and grants, on the other hand. Grants are allocated for the payment of social benefits, for central heating, for public transport and for capital expenses. Indeed, nearly all local investments are funded by grants, subject to a local contribution in certain cases. These grants are distributed by the *judet*. Basically, all local investments are still centrally planned. This system is, in principle, very inflationary since each local government is entitled to a payment from the tax on salaries equal to the difference between its expenses and its other resources. Only control of local government activities can prevent such inflation and, in fact, preventative budgetary control is still practised.

Conclusions

From this survey it is possible to distinguish two emerging models of local finance and to identify five policy issues.

Two models developing

It can be expected that the **two models** of local finance systems that have been identified in the previous survey will further develop. It is too soon to know in which direction local finance in Romania will evolve. We will come back to its case at the end. To sum up, at the risk of excessive simplification:

1) Some countries (**Hungary and probably Bulgaria**) have a local government system with a wide range of functions, supported by a local finance system in which the main resource is a general grant based on spending need assessment, calculated on a uniform basis, e.g. not taking into account revenue disparities or with marginal equalisation of revenue disparities (through income tax sharing in Hungary, through an adjustment grant in Bulgaria - see above). However, local government's capital spending is very dependent on State support, which is provided by targeted or earmarked subsidies.

2) In some other countries (**Poland, Czech Republic, Slovakia**), major services will continue to be provided by the State directly and, in some cases, in co-operation with local government. Deconcentration will, therefore, accompany further decentralisation. Major resources are local tax revenues and tax sharing. Central grants amount to a smaller part of the local government revenue. Capital spending is basically funded from own resources (including tax shares). The need for equalisation is normally much greater.

Five policy issues

From these different starting points, current policy issues concerning transfer payments are not exactly the same and responses will differ. As a whole, however, five policy issues can be identified: the next steps for reform of the local government structure, future steps in functional reform, the issue of equalisation, the problem of capital incomes and, lastly, the issue of financing investments.

Three of the six countries are expected to reform their **levels of local government**: Poland, the Czech Republic and Slovakia. All three belong to the second "model" that we have distinguished. The contemplated reform involves establishing regions as local self-governments. This will imply assigning resources to such regions, depending on their tasks. In all three countries, education and healthcare would be transferred to the new level of government. For the financing of these tasks, three solutions are possible: taxes assigned to the regions, a tax share or grants based on the expected level of expenditure. The last solution is the worst, since it would make the region a mere agent of the central government. But, the second one is not much different. The share assigned to the regions will be decided by the parliament on the basis of expenditure forecasts and the regions will have no influence on their main incomes. The assignment of one or several regional taxes will give the region a limited tax power. But, equalisation will probably be necessary. Nevertheless, the more probable solution in the Czech and Slovak republics would be to shift the income tax sharing to the regional level and to grant a share to the regions.

A specific structural problem in Hungary is caused by the contrast between the very wide scope of municipal responsibilities and the small size of most of these municipalities. In fact, countries with a very large range of decentralised responsibilities, carried out by local governments, are generally countries with large, less numerous municipalities. To overcome the gap, the Hungarian Government has to follow a narrow path: forced amalgamation being impossible, it intends to achieve, by law, compulsory co-operation between municipalities, where it does not exist on a voluntary basis, as proposed in a Spring 1994 bill. Another way is to recentralise certain competencies, like, as recently decided, the return of teachers' salaries' funding from local to central government.

The next steps in **functional reform** will delegate new responsibilities from the State administration to local government. There is no reason to expect the delegation of new tasks in Hungary and Bulgaria, where local government is already responsible for the provision of most services to the population. However, in Bulgaria, local investments remain centralised and depend significantly on subsidies from central government. A next step in decentralisation could be to progressively decentralise investment decisions. With regard to such a reform, it would probably make sense to clarify the purpose of the various transfer payments to municipalities. The need assessment for grants could be extended to a minimum level of capital expenditure for reconstruction and development works in order that the total revenue makes possible the financing of such investments autonomously. More capital expenditure would be possible, either by an increase of local revenues (for example, higher tax rates) or by specific subsidies for projects that the State wants to support for its own policy goals. In Poland, the Czech Republic and Slovakia, the devolution of new tasks upon local governments is related to regionalisation, but some tasks can be transferred to municipalities even if regionalisation does not take place. This process is already underway in Poland with municipalities taking over the economic management of schools and in Slovakia, where the economic management of primary schools and kindergartens will be transferred to municipalities after the local elections between November 1994 and January 1996.

But, such a reform can only be successful if the financial conditions are right. In Poland, as seen previously, a school grant was introduced in the general grant for municipalities, taking over the economic management of schools. In Slovakia, a hasty devolution of libraries and nurseries upon municipalities in

1991 turned into a disaster. Many of them had to be closed for lack of funds to operate. Basic preconditions for the devolution of services are a fair evaluation of the operational costs, investments necessary for upkeeping and to ensure stable additional resources to cover these costs. Otherwise, decentralisation means a lower level of services. Where there are a high number of small municipalities, the devolution of new responsibilities could be bound to setting up a joint authority in order to be sure that management will be performed at a level corresponding to the scale of the task and that all beneficiary localities will contribute to the costs. Otherwise, decentralisation could decrease the quality and number of services provided.

With respect to this issue, the French experience is worthy of study (see below "compensation for transfer of new tasks"). For Co-operation between different government levels, Portugal and France offer specific experiences in contracting procedures.

Equalisation is an issue more for countries in the second group. In the case of Hungary and Bulgaria, the system of grants based on need assessment does not require any further equalisation, as long as local tax revenues are not significant, since its purpose is to assure a sufficient amount of resources are available, on average, to cover needs everywhere according to fixed standards. According to this logic, inequalities have to be redressed by improving the system of indicators upon which need assessment and costs are based or the weighing of the various indicators. However, in Hungary, the increase of local tax revenues could make it necessary to introduce an equalisation system. The main local tax is the business turnover tax. Its yield has doubled within two years but is concentrated in a small number of cities. A limited equalisation mechanism is included in the personal income tax sharing in Hungary and as an adjustment grant within the general grant in Bulgaria.

In Poland, the Czech Republic and Slovakia, on the contrary, grants tend to be more targeted, either to offset new tasks imposed on local government by the law or for central government purposes. However, more discretion is left to local governments for the responsibilities they want to carry out or develop and the scope of these responsibilities will depend not only on needs but also on means. Therefore, an equalisation system can be necessary if the amount of local resources results in big inequalities of spending capability, due to very unequal tax bases. This equalisation can be achieved through appropriate allocation criteria, either in tax-sharing or in a general grant.

The selected Western European countries offer various experiences in the practice of equalisation. Regarding the assessment of the needs, the UK offers the most sophisticated experience; regarding the equalisation of tax disparities, the Swedish experience has been successful despite current problems in the implementation of the 1993 reform.

Another issue is **capital resources**. They are not always clearly identified in the budgets and they are not always subject to clear, long term policy choices. Capital income includes borrowings (see hereafter), the resources from selling properties or property rights, be it land properties resulting from the transfer of former State properties to local governments, property rights in these properties or resources from the privatisation of local public enterprises. Capital grants are also capital income, but have been already considered. In fact, the main policy issue for central governments is to establish an appropriate legal framework for the use of the assets of which the local council disposes.

In Hungary, municipalities are now involved in the evaluation of former State properties being transferred to their ownership. They have to define which are primary assets, that are not negotiable, and which are only subject to restricted negotiability (Verebélyi / Balázs / Bertök, 1993: III, 20). This will make possible a better protection of the public interest and better economic management of assets for development purposes. The tendency to sell properties in order to receive resources for current needs might be dangerous in the long term, if the municipality is subsequently obliged to purchase land for public services or development purposes and has to pay a higher price. For example, in 1994, 50 per cent of incomes in the 1994 budget of the city of Bratislava are expected to come from the selling of properties.

The last issue is **financing local investments**. As we have seen, local investments are more dependent on State budget support in the countries of the first group (Hungary and Bulgaria), than in countries of the second group (Czech Republic, Poland, Slovakia). In Hungary and Bulgaria, it seems that the State budgetary policy and the constraints of striving for budgetary balance affect more directly the resources available for local capital spending than in other countries. This is so since they are financed basically by central government subsidies. Table IV, hereafter, suggests this conclusion by the ratio of local capital expenditure to total local expenditure, whereas the absolute level of capital expenditure is heavily correlated with economic development. Nevertheless, and despite these differences, <u>in all six countries, including Romania, financing local investments is hampered by the lack of capital finance.</u>

***Table* IV**

Local government capital expenditure compared with total local government expenditure and the GDP in 1993 for five countries (data not available for Romania) (%)

Ratios	CZECH REP.	SLOVAKIA	POLAND	HUNGARY	BULGARIA
K expenditure / T. expenditure	35	34.1	25	17.9	8.2
K expenditure / GDP	3.4	1.7	1.5	3.3	0.6

By law, municipalities are free to borrow or to issue bonds under the same conditions and control as any person acting in the capital market. But, in fact, the situation is far from being satisfactory. The very low level of borrowings in local government resources (see above Table III) is not due to management but to the difficult access to credit. Only some big cities have succeeded in issuing bonds (for example, Prague). Five Czech cities borrowed on foreign capital markets but these are exceptional situations. The common lot for all municipalities is not only that they cannot borrow on foreign markets, but that there is almost no capital to be lent to them on the domestic market. In none of these countries, except Slovakia now, is there a bank specialised in lending money to local government. Commercial banks are often reluctant to lend money to municipalities or they require collateral that municipalities cannot afford. Therefore, municipalities have no access to the long term credit dramatically needed for infrastructure investments.

In Slovakia, the Municipal Bank was set up in November 1992 by the bigger cities, which are the shareholders. It increased its equity in 1993. The new bank provides short and medium term (up to four years) credit below market rates. One hundred and sixty-three municipalities got credit from the Bank in 1993.

Furthermore, municipalities lack the expertise to set up long term investment programmes combining several funding sources (Gilowska, 1994a: 61). In Poland, the Municipal Development Agency, which is being prepared with the support of an EC assistance programme (OMEGA), should be a non-financial institution providing technical assistance to municipalities setting up investment programmes or combining grant facilities of various origins with commercial investment funds made available through the Municipal Credit Programme. It should be a broker and promoter for the benefit of municipalities. It will have access to the relevant extrabudgetary funds already existing for the purpose of financing investment projects. The Municipal Development Agency will be directly answerable to the Government.

These examples are proof of local governments' need for loan capital in SIGMA countries. Discussion of the development of transfer payments, as a central policy issue, should not be separated from the issue of assuring local governments' access to long term loan capital.

Transfer payments to local government in four West European countries: a brief summary of selected experiences

The four countries selected for their experiences in the field of transfer payments to local government reflect the extreme diversity existing among Western European countries. Others would have been of paramount interest too, such as the Netherlands which has a strong local public sector financed almost entirely by grants or Switzerland with its high number of small communes and local finance system based on local taxes, supplemented by tax shares where grants are marginal. But, a choice was necessary. We hope that our choices will be judged as relevant.

In this section, we will first summarise the main features of each of the four countries presented. Then, four topics will be discussed from a comparative perspective with regard to the problems of the SIGMA countries that have just been reviewed. These four topics are: the assessment of needs, the equalisation of tax potential disparities, compensation for the transfer of new tasks to local governments and co-operation between government levels, especially between State and local governments. These topics will be presented briefly as this paper will focus on basic issues and lessons from the experience. The following chapters will provide details.

Basic features of local government in France, Portugal, the United Kingdom and Sweden

The four countries were chosen not only for their size but also due to the territorial pattern and the structure of their local government. The following table sums up the main data. The levels with self-government institutions are printed in dark letters.

***Table* V**
Pattern and structure of local government.

	FRANCE	PORTUGAL	UNITED KINGDOM	SWEDEN
	549 000 km2 58.1 M inhab. among which 5 000 km2, 1.5 M in oversea dpts	92 400 km2 9.8 M inhab.	244 800 km2 57.6 M inhab.	450 000 km2 8.7 M inhab.
Regions	**26 regions, among which - 21 regions - Corsica - 4 oversea regions**	**2 autonomous regions (Azores, Madeira)**	Scotland Wales Northern Ireland	-
Provinces / Départements or Counties	**100 départements among which 4 oversea depts (DOM)**	-	England and Wales: - Greater London - 6 metropolitan counties **- 47 shire counties** Scotland: **- 9 regions** **-3 islands** (single tier)	**24 counties with 23 councils Göteborg, Malmö and the island Gotland** do not belong to a county and carry out county responsibilities
Arrondissements / Districts / Kreise	329 arrondissements	-	England and Wales **- 333 districts** Pop.:22 100 - 384 400 **- 36 metropolitan districts** Pop.: 156 300 - 998 200 **- 33 London boroughs** Pop.: 132 200 - 319 200 Scotland: **- 53 districts** Pop.: 10 000 - 715 600 Northern Ireland **- 26 districts**	-
Joint authorities	19 008	Free associations of municipalities*	Joint authorities of metropolitan counties and of Greater London	30 municipal associations*
Municipalities / Communes	**36 771 communes** among which 212 in oversea dpts 25 249 <700 841 >10 000 31 >100 000	**305 municipalities** comprising 4 220 parishes Municipalities: 94 <10 000 18 >100 000	10 200 parishes + a number of inner city districts	**286 municipalities** 64 <10 000 11 >100 000

Municipal level

Of the four countries, France has three particular characteristics: a high number of communes, three levels of local government and a regional level. Among the more than 36 000 French municipalities, only

841 have more than 10 000 inhabitants. Whereas, in Sweden, only 64 have less than 10 000 inhabitants. In England, the smallest shire district has more than 22 000 inhabitants, and, in Scotland, the smallest district has just about 10 000 inhabitants. The average population in Portuguese municipalities is about 32 000. Portugal and the UK have a tradition of large local authorities, whereas in Sweden the present pattern is the result of territorial reforms carried out in 1952 and between 1962 and 1974. The fragmentation of the French territorial pattern explains the large number of joint authorities of several kinds. Co-operation is not compulsory, except in a small number of cases. But, under certain conditions, a joint authority may be created after a qualified majority vote of the councils concerned. A recent law (February 1992) tried to promote multifunctional co-operation in development schemes. There are only two other countries in Western Europe with a similar pattern: Austria and Switzerland. Nevertheless, local self-government institutions within municipalities should not be overlooked. In Portugal, as in Britain, parishes have some resources and marginal functions. There has been a revival of parishes, which are close to the inhabitants' communities, in recent years, and similar institutions were created in big cities. In Sweden, district councils (*kommundelsnämnder*) (140 in 1993) have been established in 21 municipalities in order to improve the capacity of local government to respond to local needs and to enhance citizen participation (for an evaluation, see: Montin, 1994).

Intermediate level

Regarding the number of tiers of local self-government, Portugal has a single tier system. In the United Kingdom, there is a single tier system in metropolitan areas, since the metropolitan counties have been abolished, and a two tier system in other areas (except the Scottish Islands). But, a boundary reform underway aims at creating a generalised single tier system, subject to a small number of exceptions in certain areas. Sweden has a two tier system, whereby the main county responsibility is healthcare.

France is the only country among the four having established regions as a local self-government level since 1982. The regions' main functions are secondary education (economic management and planning only), labour training, regional development and financial support to public investments within the region. In Portugal, the two regions mentioned are overseas. The administrative regions provided by the Constitution as self-governing institutions have not been created and probably will never be created.

The future of the United Kingdom with respect to this issue is much less clear. Without speaking of Northern Ireland, claims for devolution in Scotland and Wales could lead again to the kind of reform which failed in the early seventies to establish elected regional councils vested with the kind of government responsibilities which are presently carried out by cabinet ministers.

Central government / local government relationships

The four countries also differ in their manner of sharing responsibility between local and central government. Most diverse are the British and French models.

In the United Kingdom, the central government has basically no field services and all the Government's national policies have to be implemented through local government. This remains true despite the fact that the Government has created, during the last few years, a lot of subordinated agencies to implement its policies with regard to local government. In April 1994, at the regional level, department offices were established under the single authority of a regional director who was appointed by the Government. But, the issue is still uncertain.

In France, on the contrary, the Government carries out its policies primarily through the State administration which forms a far-reaching network of field services and agencies all over the territory. This remains true even after the decentralisation reform which considerably increased the autonomy and responsibilities of local governments at all levels. Local governments' participation in Government policies is necessary in many cases. The prefects, appointed by the Government in each département and region, are now, much more than in the past, given large deconcentrated powers, and almost all State field services are subordinated to them.

In Portugal, many services and functions are performed locally by the State's administrations, but there is no deconcentration. In Sweden too, State and local government functions are separate, but most functions are local government functions. Nevertheless, there is still a separate State-county administration.

In fact, the State is, in France and Portugal, a major service provider. Whereas, in Sweden and in the United Kingdom, local government is the major service provider. Again, major public powers are exercised by local government in Sweden and in the United Kingdom, whereas in France and Portugal, they are retained by the State.

Comparative outline of local finance

The following tables will confirm these basic characteristics by economic and public finance data. Data is given according to the same definitions as for Table II.

Main macro-economic values in local finance

***Table* VI**

Central and local government budgets in France, Portugal, Sweden, and the United Kingdom (1992)

Countries	Macroeconomic values	Central govern. budget	Social security fund	Local govern. budgets
FRANCE municipalities, départements, regions, joint authorities, local public corporations	Compulsory payments: - %GDP	20.04%	19.6%	4.06%
	Public expenditure: - bill. FF - %GDP	1 273 18.2%		700.6 10.0%
	Transfers from central budget to local governement: - bill. FF - %GDP among which: * Grants - bill. FF - %GDP * Tax shares - bill. FF - %GDP	- 204 - 2.92%		204 2.92% 204 2.92% 0 0

(Table VI continued)

<table>
<tr><td rowspan="3">PORTUGAL
municipalities</td><td>Compulsory payments:
- mln. Contos
- %GDP</td><td>
3 034.2
26.7%</td><td>
1.296.8
11.4</td><td>
120
1.1%</td></tr>
<tr><td>Public expenditure:
- mln. Contos
- %GDP</td><td>
3 188.6
28%</td><td></td><td>
521.0
4.6%</td></tr>
<tr><td>Transfers from central budget <u>to local governement</u>:
- mln. Contos
- %GDP
among which:
* Grants
- mln. Contos
- %GDP
* Tax shares
- mln. Contos
- %GDP
Transfers from the European Union:
- mln. Contos
- %GDP</td><td>

- 207.9
- 1.83%

- 202.6
- 1.78%

- 5.3
- 0.05%</td><td></td><td>

207.9
1.83%

202.6
1.78%

5.3
0.05%

62.2
0.55%</td></tr>
<tr><td rowspan="3">SWEDEN
municipalities
and counties</td><td>Compulsory payments:
- bill. K
- %GDP</td><td>
314.4
21.8%</td><td>
151.4
10.5%</td><td>
269.3
18.7%</td></tr>
<tr><td>Public expenditure:
- bill. K
- %GDP</td><td>
444.7
30.9%</td><td>
194.7
13.7%</td><td>
383.3
26.6%</td></tr>
<tr><td>Transfers from central and social security budgets:
- bill. K

- %GDP

among which:
* Grants
- bill. K

- %GDP

* Tax shares
- bill. K
- %GDP</td><td>

- 95.1

- 6.6%

- 95.1

- 6.6%

0
0</td><td>

30.1
-14.2
2.1%
- 1%

30.1
-14.2
2.1%
- 1%

0
0</td><td>

65.1
14.2
4.5%
1%

65.1
14.2
4.5%
1%

0
0</td></tr>
</table>

(Table VI continued)

U N I T E D KINGDOM districts of Northern Ireland not included	Compulsory payments: - bill. £ - %GDP	 181 38.2%	 34.5 7.3%	 8 1.7%
	Public expenditure: - bill. £ - %GDP	 112.9 23.9%	 36.8 7.8%	 66.1 14.0%
	Transfers from central budget to local government: - bill. £ - %GDP among which: * Grants - bill. £ - %GDP * Tax shares - bill. £ - %GDP	 - 55.8 - 11.8% - 43.5 - 9.2% - 12.3 - 2.6%		 55.8 11.8% 43.5 9.2% 12.3 2.6%

(Sources: Country reports and OECD)

The table shows that the weight of local government in public finance differs considerably from one country to another. Measured by the level of local public expenditure, it is, by far, the biggest in Sweden. At the other extreme, it is relatively small in Portugal. Local taxes are also very high in Sweden. Local taxes amount, in France, to a significant percentage of the GDP, compared to the level of local public expenditure. As regards revenues, and compared to SIGMA countries, we see that local taxes, as compulsory payments, are always more important as a proportion of the GDP.

Local government revenues

Furthermore, whereas all SIGMA countries finance their local government with tax-sharing, this kind of resource is not praised in the four countries in the survey. There is, in fact, tax sharing only in the UK, in a rather peculiar form. The non domestic rate is levied on all land and buildings used for non residential purposes according to a uniform tax rate, set annually by the Government. The tax yield is redistributed between all districts and counties on a per capita basis, so that the share to local government equals 100 per cent. There is also, in Portugal, very marginal tax-sharing of the VAT. Municipalities are entitled to 37.5 per cent of the VAT on tourism activities. This yields only 1 per cent of local government’s total income. As a result, local government finance is based in the four countries primarily on local taxes and grants.

In Western Europe, tax-sharing is typical for federal or semi-federal states, particularly for financial relations between the federation and member states. In some countries, municipalities are also involved in the sharing. It is practised, in different forms, in Germany, Austria, Switzerland (although traditionally the confederation and the cantons should get their resources from separate taxes) and, more recently, in Belgium and Spain. Whereas, unitary states prefer a mixture of local taxes and central grants. The rationale for this difference is certainly that: 1) federal units have the quality of a state and are, therefore, entitled to the same tax power as the federation; 2) tax-sharing may be preferred because it assumes equal relations between the member states and the federation; and 3) the bulk of the administrative functions carried out by federation members require high yield tax resources that are normally levied nationally to avoid unjustified inequalities in the tax burden between citizens depending on their place of residence.

Table VII gives more detail on the various kinds of resources and their relative importance.

***Table* VII**

Local government incomes in France, Portugal, Sweden and the UK (1992, in % of the total revenue)

Local government revenues	FRANCE (1990)		PORTUGAL		SWEDEN		UNITED KINGDOM	
	Billion FF	%	Million Contos	%	Billion K	%	Billion £	%
Own tax revenues	280.0	40	120	22.4	269.3	67.5	8.0	11.8
Grants - among which EU funds	238.6	34	264.8 62.2	49.4 11.6	79.3	19.9	43.5	58.7
Tax shares	0	0	5.3	1	0	0	12.3	19.6
Loans	70.7	10	30.3	5.7	na	na	na	na
Others	111.5	15.9	115.8	21.6	50.6	12.7	7	9.9
TOTAL	700.8	100	536.2	100	399.2	100	70.8	100

Note: for France, data of Table VII is from the public accountancy division (Ministry of Finance), whereas in Table VI, data is from the National Accountancy (INSEE).

This table shows that the contribution of local taxes to local government revenue is, in all cases, much higher in these four Western European countries than in the SIGMA countries. However, it has to be reminded that, in some countries, local finance is based on grants, with only a marginal amount represented by local taxes (Italy, Netherlands). Local tax revenues are remarkably high in Sweden where the local income tax, a flat rate voted by the local council, provides over two thirds of local government's income. In a quite different system, local tax revenues are very high in France too, representing 40 per cent of the total income. In Britain, they are, by contrast, relatively low. But, this situation is new. In 1989, the local tax revenues were still in excess of 39 per cent of the total local government revenue. The change is due to the failure of the community charge (the *poll tax*) and to the reform of the business property tax. The only local tax is the council tax, a reformed residential property tax levied by each local government at any level at a rate corresponding to its needs, within limits. This replaced the community charge. The non-domestic rate is based on immovable market values of business properties but is fixed by central government. The amount of grants was increased (they amounted to only 46.8 per cent of total local government revenue in 1989) first to reduce the level of the community charge before its abolition, and again to set off the abolished community charge.

The local tax systems in Sweden and the United Kingdom are relatively simple, by contrast to France and Portugal. In the United Kingdom, there are only two taxes, one of them being shared nationally. In Sweden, since the 1991 reform, there is only one local tax; the personal income tax levied locally at a rate voted by the local council. In France, on the contrary, the local tax system is highly complex.

Basically, four direct taxes provide nearly 80 per cent of the total local government revenue; the percentage is 85 per cent for communes, 61 per cent for départements and only 55 per cent for regions. Additionally, there are a number of indirect taxes, the most important of which were transferred by the State to départements (tax on immovable property transfers for payment, tax on motor vehicles) and regions (tax on driving licenses, tax on car registration, additional transfer duties) to offset the devolution of new responsibilities. In Portugal too, local government tax revenues are yielded by a number of taxes, some of them of very small yield. But, the property tax provides 31 per cent and transfer duties 39.5 per cent of all tax revenues. This dispersion makes it difficult for local governments to have their own tax policy by exercising their tax powers.

Portugal is distinguished by the remarkable value of grants from the European Union that its local government receives (11.2 per cent of the total local government revenue). This does not mean that the British and French local governments do not benefit from the EU. But, these grants do not appear, as such, in local government accounts. Furthermore, Portugal benefits relatively more, due to its lesser economic power. Portugal and the United Kingdom have in common the fact that their local finance system is based on grants, amounting to half or more of the whole local government revenue.

Transfer payments

Despite their technical complexity, the grants in the four countries reflect different concepts. However, the effects they are aimed at are often undermined by compromises or by the failure to embrace all aspects of a complex reality. This is probably inevitable. Public finance is, in the first place, a matter of politics and only in the second place a matter of technique.

The clearest concepts underlie the **British and the Swedish grant systems**. In Britain, the revenue support grant (the RSA, 80 per cent of the total of grants for current expenditure) is aimed at equalising the resources of each local authority to spending needs in such a way that, for all services that local authorities must provide, the same level of service can be achieved everywhere. This tends, in principle, to create an almost perfect equalisation since the RSA is equal, more or less, to the difference between the spending assessment and the expected amount of all tax revenues. But, there are also spending limits, both on current and on capital expenditure.

In Sweden, local government is vested with wide tax powers. They are supposed to cover most of their spending with their own tax revenues. In fact, 119 municipalities of 286 have more than 30 per cent of grants in their total resources. Therefore, grants are deemed to compensate tax base disparities and support certain functions of paramount importance from the central government's viewpoint. The 1993 reform tended to return to this simple idea by abolishing a too complicated accumulation of grants, coupled with equalisation charges paid by better off municipalities. But, it has still to be tested. Despite these basic differences, both the British and Swedish local finance systems are oriented towards service provision funding, and, in fact, they seem to respond to the need to cover huge current expenditures. Consequently, they are much less oriented towards investment funding.

In France and Portugal, local government is much less oriented towards providing services, or, more precisely, basic services, which are still provided by the State administration. As a result, local governments have more discretion in the functions they choose to perform. Probably because local government does less, local expenditure is more oriented towards investments.

In France, tax revenues are deemed to be committed to current expenditure. Additional tax revenues were levied for investments and could be supported by a subsidy. At its very origin, the general grant for current expenditure (DGF), the main grant nowadays, was calculated as a replacement income for an abolished tax, with an equalisation component introduced. Later on, the balance, or the compromise, between continuity and equalisation remained a key issue for all reforms to this grant, either implemented or attempted. Other grants, of less importance, were created for different purposes: repayment of the VAT incurred by local governments on local public works, compensation for transferred new responsibilities, support to specific functions (school buildings, for example). For these reasons, it is difficult to find the underlying concept of the French grant system. As far as the present system is concerned, it seems possible to say that grants are based on four general orientations: 1) to provide a revenue supplement; 2) to compensate for sharp tax potential disparities; 3) to cover the costs of delegated responsibilities; and 4) to allocate resources towards priority areas. This latter function tends to prevail over the former limited equalisation of tax bases. It can be appraised as based on a selective assessment of needs.

In Portugal, the grant system is much simpler and more stable. It relies on a general purpose grant which is paid from the Financial Equalisation Fund. Specific grants are, in principle, prohibited in order to protect local autonomy but they are allowed, in exceptional circumstances, as provided by the law. The general purpose grant is allocated according to a combination of eight criteria expressing different factors of costs incurred by municipalities. Variations in costs are supposed to reflect variations in need. There is only a small weighing for tax base disparities.

Less oriented towards service provision, local government spends more on investments in France and Portugal than in Britain and Sweden. The investment expenditure is higher not only in the total local government expenditure, something which is obvious due to the burden of current expenses for services provided, but also when compared to the GDP (for a broader comparison, differentiating government levels, see: Pola / Marcou / Bosch, 1994).

***Table* VIII**

Investment expenditure compared to total local government expenditure and to GDP (1992)

Ratios	FRANCE (1990)	PORTUGAL	SWEDEN	UK
I / D	23.2%	39.5%	5.8%	9.5%
I/ GDP	2.5%	1.81%	1.54%	1.42%

Note: I = brutto investment spending (repayment of the debt not included); D = total local government expenditure

The comparison of transfer payment systems will now be pursued on selected topics. Main experiences from each of the four countries will be put forward and compared with the three other countries.

Equalisation: Two models, two techniques

(a) The assessment of needs: As far as grants aimed at financing the services provided by local government, the main problem to be resolved is the assessment of spending needs by each local government. The various methods that can be used for that purpose raise a lot of difficult questions. What are the needs actually and how can they be measured? What is the purpose of the grant? Is it to provide a support to certain functions, to equalise the level of resources to an estimated level of expenditure for each local government, to equalise tax bases or otherwise? Is the method objective? (for a complete discussion of the subject, see OECD, 1981).

Among the four countries, the United Kingdom has the greatest experience in this matter. It is the only case of a local finance system in which the overall level of resources of each local authority is based on a comprehensive spending need assessment. It is coupled with a strict macroeconomic control on local expenditure. In Portugal, needs indicators are used instead to determine the amount of lump sum support. The Financial Equalisation Fund is not calculated from a hypothetical level of expenditure, but from a hypothetical structure of costs incurred by municipalities, reflected in a series of indicators. As opposed to the previous examples, the French and Swedish general purpose grants are basically deemed to replace a revenue and/or to compensate for inequalities in revenues. However, a smaller part of their total amount is directed towards the compensation of inequalities in costs and needs.

The Standard Spending Assessment (SSA), upon which the Revenue Support Grant is based in Britain, is presented in detail by K. Davey in this volume. We will, therefore, address some specific points to help in the understanding of that system.

Firstly, it is a procedure which is very consistent with two major features of the British local government system. The British local authority is, basically, a service provider. All services essential to citizens are under the financial and managerial responsibility of a local authority. It is also related to the principle of Parliamentary sovereignty. In theory, all functions that local authorities have to perform derive from an Act of Parliament. Any other undertaking would be *ultra vires*. The central government is, therefore, responsible for the availability of resources for the tasks entrusted to local authorities.

Secondly, the SSA is devised for current expenditure only. Specific subsidies are paid to local government for investment, for projects agreed to by the Government, primarily in transportation and housing. There is no spending need assessment for local government's capital expenditure. Rather, an assessment is done with regard to national priorities. However, the calculation of the SSA includes debt service payments and in that way the RSA supports indirectly capital expenditure. The grant gives access to credit approval for borrowing. Furthermore, the RSA is not the exclusive grant for current expenditure. Other grants exist to support specific functions and they have to be spent on these functions. The police grant amounts to 60 per cent of their total but there are also a number of grants for various purposes. Obviously, the corresponding costs are not taken into account in the SSA.

Thirdly, the grant system is a major instrument of control over the level of current and capital expenditure. The first step in the spending need assessment is the determination, by the Government, of the Total Standard Spending, which is the Government's target for local current expenditure within its macroeconomic strategy. It is based on the previous year's level, plus adjustments. The spending need assessment results from the application, for each authority, of a group of indicators to a number representing the expected expenditure for a functional block (education, for example). But, it is also the spending limit fixed for the local authority, subject to a variation of 12.5 per cent. The control on capital expenditure is even tighter, through earmarked grants and credit approval. Yet, the local authority is entitled, through the Spending Need Assessment, to a grant equalising its revenues (based on a standard tax rate for the council tax) to the level of expenditure incurred on average, within the limits of the Total Standard Spending.

The system is very comprehensive. Practically all costs with their differences according to areas are considered. It is also very complex, due to the number, the variety, the evaluation and the weighing of indicators. The method is contentious for several reasons. The main question raised by the practice is that, whereas the idea is to adjust resources to the expenditure required to cover needs, in practice the level of expenditure is determined first and the Revenue Support Grant is then distributed according to an estimated structure of costs and expected tax revenue of each local authority. As a result, the method is, in reality, deflationist, rather than inflationist. Another problem is that, in fact, the needs cannot be measured directly. The choice of indicators that can be measured to reflect needs and weighing is easily subject to criticism.

Some indicators are easy to determine (for example, it is possible to say that education costs are higher where the number of pupils is higher and how much of the total cost it determines), but others are much more controversial and difficult to evaluate, although every change in the weighing will shift an amount of money from one local authority to another (for example, the number of children of foreign origin). Needs are evaluated through costs, which is quite rational so long as the purpose is to cover expenses. But, generally, the costs are not measured. They are estimated, through a regression analysis, based on factors closely correlated to the costs. Furthermore, the approach is conservative, since costs are based on past experience and this tends to underestimate real changes in needs or to take them into account too late.

Despite these criticisms, the merit of the British grant system is certainly that it achieves a high degree of equalisation, since it tends to assure that the same amount will be spent, per unit, for the same task by all local authorities responding to the same conditions, regardless of the disparities in tax revenues. This basic fairness explains why the system is widely accepted despite criticism of individual aspects. Of course, such a system, due to its complexity, can only be implemented if local government resources are based, in a high proportion, on the general purpose grant. Other grants have to be clearly targeted to avoid conflicts with the general purpose grant.

Less ambitious, the Portuguese grant system is, also, much simpler. The allocation of the Financial Equalisation Fund is based on a series of indicators reflecting the structure of costs in municipal budgets, on one hand, and factors determining the variations in costs, on the other hand. It is not strictly based on current spending needs. The selected indicators can reflect, as well, capital spending needs. But, there is little impact caused by local revenues on the level of the grant. Only 5 per cent of the grant is allocated with the purpose of compensating for disparities in tax potential, while 40 per cent is allocated according to the number of inhabitants and 15 per cent as equal payments for each municipality. A stronger equalising element is being discussed but no decision has been taken as yet. Compared with the British system, the Financial Equalisation Fund is aimed at providing support to a minimum level of task performance, without greatly affecting revenue disparities. This contrast reflects also differences of values regarding local government. The pressure for equalisation seems to be much smaller in Portugal than in Britain.

In France and Sweden, the assessment of needs affects only a smaller part of the grants and is based only on a small number of indicators. In Sweden, the 1993 reform of grants abolished most special grants and the new State grant for municipalities is specifically devised to offset disparities in tax bases and structural costs. Central government deliberately abandoned specific grants as an instrument to orient local government activities; the objective of the reform was to give local governments greater freedom in using their resources, and incentive to cut back costs. In France, the decentralisation reform resulted in a diminution of the amount and number of earmarked or targeted grants. Nowadays, only 11 per cent of the amount of grants are earmarked. The general grant for current expenditure (DGF) was never based on a complex assessment of needs. The continuity component of the DGF reflected the level of past expenditure, rather than needs. But, the public policy was to reduce the continuity component in favour of other components of the grant, those aimed at equalisation or at the compensation of specific charges, introducing a limited need equalisation.

(b) Equalisation of tax base disparities: We will focus here on the equalisation of disparities in local tax resources, as an alternative to equalisation of differences in output needs which is matched by grants based on spending need assessment. It is also possible to introduce equalisation in output costs, when such differences are significant (King, 1991: 178). Usually, cost equalisation is coupled, for some tasks, either with spending need or with tax resource equalisation.

There are basically four approaches to equalisation (Davey, 1993: 183): 1) equalisation of tax revenues between local governments themselves (ex: in France between municipalities of the region Ile-de-

France or the regional disparities compensation fund or, in Sweden, for the municipalities subject to equalisation charges before the 1993 reform); 2) reallocation of revenue through the grant formulae in case of excessive tax resource inequalities; 3) allocation of grants based partly on an element compensating below average tax capacity; and 4) compensation of differences in costs, as well as revenue capacity.

It appears from this view that, except in the first approach, equalisation proceeds through grants but can be achieved in a number of very different ways, depending on the structure of resources and on the purpose of equalisation. In fact, all approaches are aimed at compensating disparities in tax revenues, but the last one if equalisation is based on the compensation of differences in costs only. These approaches are not exclusive of each other.

The Swedish grant system is very representative of tax base equalisation through grants combined with equalisation of cost disparities. It is even more so after the reform introduced in 1993 for municipalities.

Since Swedish local governments' main resource is income tax, the grant system has taken care to compensate for budgetary inequalities resulting from the unequal distribution of wealth over the territory. In the previous system, a third of grants was devoted to tax equalisation grants, whereas two thirds of grants were devoted to specific purposes. Additionally, equalisation charges were paid by better off municipalities. The new system, introduced in 1993, for municipalities (not for county councils) brings about a radical simplification. The law abolished most State grants to municipalities and all payments from municipalities to the central government. It replaced them by a single block grant, equal to 75 per cent of the value of all previous State grants. The new block grant is divided into three parts: 1) a revenue equalisation grant; 2) a structural cost equalisation; and 3) a supplement for municipalities (there are 24) experiencing depopulation.

The basic principle of the equalisation grant is to equalise the income tax base. A guaranteed level of tax potential per capita is set yearly by reference to the average tax potential of all municipalities. In 1994, it was set at 128 per cent of the average. Each municipality with a lower tax potential is entitled to an additional tax potential meeting the guaranteed level, so that all municipalities will get tax revenues from the equalised tax potential except a small number of municipalities having a higher tax potential than the guaranteed level which is not capped. Nevertheless, the additional tax potential is subject to a standard tax rate, instead of the tax rate voted by the local council. However, the level of equalisation depends on the guarantied level and on the standard rate fixed by the Cabinet, which depend, in turn, on macroeconomic policy objectives. Additionally, the structural cost equalisation provides a supplement for municipalities incurring above average structural costs due to geographic conditions or to their demographic structure. This supplement will be raised from municipalities with below average structural costs. As a result, the structural cost equalisation costs nothing. It is designed as a zero-sum game where municipalities with low structural costs subsidise municipalities with high structural costs.

Whereas the new revenue equalisation grant amounts to 39.7 billion in 1993, the turnover of the structural cost equalisation amounts to 5 billion K and the supplement for depopulation to 0.2 billion K. The new system has been heavily criticised despite its convincing concept. Most criticism fell upon the structural cost equalisation because of the factors selected and the regression analysis involved to assess differences in the structure of costs. This part of the reform was put under review by the Government from the approval of the reform. This problem is very similar to the spending need assessment. The methods and difficulties are also the same. Other criticism includes the lack of equalisation for municipalities with a tax potential above the guaranteed level and, also, the case of municipalities with a tax rate lower than the standard tax rate, so that they lose out if their tax potential increases.

Before 1989, the grant formulae for the Revenue Support Grant in Britain included a factor to compensate for differences in property tax rateable values. This has been reinstated with the introduction of the council tax, which is also based on property values, after the abolition of the community charge. In Portugal, the tax base equalising component is very small, as already mentioned. In France, equalisation is pursued through the general grant for current expenditure (DGF) and, for the last few years, through tax revenue equalisation. The history of the DGF is marked by conflict between the continuity support and the equalisation component. While the latter was thought, in the initial conception of the grant, to absorb the totality of the grant in the long term, further reforms have limited the impact of the equalisation component. Only the crisis of needy suburbs in recent years has urged the Government, since 1990, to restore the equalisation margin of the grant. More recently, the concern over regional imbalances in the national territory, which could be aggravated by the impact of the single market, led the Government to again reform the DGF in order to reorient part of its resources according the priorities of the *aménagement du territoire*. Therefore, a greater redistributive impact of the DGF can be expected from the next reform. But, for the present, the instability of the grant calculation has been a problem since it has been changed practically every year.

Central government / local government relations; financial aspects of devolution and co-operation

(a) Compensation for the transfer of new tasks: One of the major aspects of the decentralisation reform in France was the transfer of new responsibilities to local governments. The major beneficiaries of these transfers, however, were regions and départements, rather than municipalities. But, the laws organised compensation for the transfers, from the very beginning. This can be a valuable experience for the SIGMA countries where the devolution of tasks upon local government is also on the agenda.

From the beginning, the principle was laid down in the Act of 2 March 1982 that any increased charge on local government, due to the responsibilities transferred, had to be fully compensated by the State through an equivalent transfer of resources (s.102). The details for that compensation were settled in the Act of 7 January 1983 (s.94-98).

In fact, total compensation for charges resulting from the devolution of new tasks has to be considered in a wider scope. For the performance of the new tasks, three kinds of means had to be provided: i) financial resources; ii) personnel for the services concerned and iii) the premises necessary for services transferred. The Act of 7 January 1983 also provided the two latter subjects, but the personnel problem, particularly, could only be solved over the long term.

As regards financial resources, the compensation had to be in line with the time schedule provided by the law (three years) for the effective transfer of new responsibilities. This was, in fact, respected. The law provided for a joint evaluation of the charges incurred by the State budget at the date of transfer. The local governments (that is to say **each** region, département and commune, depending on the task), which were newly competent, had to receive resources equal to this evaluation. The commission in charge of the evaluation consisted of senior civil servants of the ministries concerned and representatives of local governments of each level. It was chaired by a magistrate of the Court of Accounts. The compensation of costs was achieved, in the first place, by the transfer of new tax revenues (to regions and départements) and a grant, the decentralisation grant (DGD), setting off the difference between the revenues from these taxes and the burden resulting from the new responsibilities. Upon the completion of the transfer of tasks, i.e., from the 1986 fiscal year, the total amount of the DGD varies along with the DGF.

This grant (the amount is fixed in the State budget) is broken down into several special contributions (*concours particuliers*) corresponding to each task. For example, for municipalities, there are special contributions for town planning, school transportation in urban areas, health and hygiene services and municipal libraries. For départements, there are special contributions for social benefits, school transportation in land areas, running costs of secondary education (first level), seaports under départements' responsibility and central lending libraries. For regions, there are special contributions for labour training, running costs of secondary education (second level), seashell growing, fishing floats and waterways, so long as the region takes over this responsibility. These various, special contributions within the general decentralisation grant are then divided between regions and départements according to different rules, based on an assessment of needs, indicators and weights, established by the law. They are allocated by the prefect (of the département or of the region, as the case may be) to the beneficiary local government. Spending is not tied but the discretion of the respective local governments is limited since it is a compensation for costs, and, furthermore, because either the task is obligatory (ex. current expenses of secondary schools) or the beneficiaries will claim the amounts earmarked for them in the distribution.

As regards the premises necessary for the services transferred, the law provides for the assignment, free of charge, of the said premises to the newly competent local government, but without any property transfer. This means that the premises of secondary schools, for example, remain State property or municipal property, depending on their origin, but the local government, newly competent, e.g. the département or the region, exercises all rights of ownership, except that it cannot dispose of the premises. By the way, there are special provisions for school premises, but the principles are basically the same in all sectors concerned. If a premise is no longer used for the purpose of the service, it is recovered by the State (other owner government).

On the issue of personnel, agents' career rights were a problem. It was first decided that the State field services in charge of responsibilities now belonging to the regions or départements would be transferred under the authority of their executives. In fact, this was only done for some services, at the département level. The agents followed the service, but remained under their own statute and were still paid by the State. Conversely, a number of agents employed in the State field services were paid by the départements' budgets. Then, after a reform of the public service statute, the right was open to the agents to choose under which authority they preferred working. After this choice was made, the agent was paid by the authority under which he or she was employed, corresponding, in principle, to his or her statute. The general decentralisation grant is then adjusted correspondingly. The transitional period lasted eight years, from 1984 until 1992.

Despite difficulties, the process could be successful. In general, the services transferred received more resources than before so long as the local governments were politically motivated to increase their effort in a sector, as has been the case until now in secondary education. But, in other sectors, problems resulting from decentralisation were not financial problems.

(b) Co-operation between levels of government: The complexity of public policies tends to intensify intergovernmental relations. A lot of public policies involve not only public and private actors, but also several government authorities, with their own resources and their own responsibilities. This evolution conflicts with the need for clarity which is desirable in the management of public affairs to ensure the accountability of officials. This issue is even more crucial when there are several local government levels.

To achieve the co-ordination and the consistency which are much needed in public action, there are, in some countries, increasing tendencies to use contractual instruments. The experiences of France and Portugal must be mentioned here.

In France, contracts between governments have become very common instruments to adjust contributions, mostly financial, to a joint programme. This is a consequence of several institutional changes. There are three levels of local self-government endowed with general competence (although it is disputed by administrative case law for regions) and the delegation of responsibilities from the State to local governments has made co-operation and adjustments much more necessary than in the past. At the same time, co-operation can no longer be imposed. The main instruments are planning conventions signed between the State and individual regions. This procedure was introduced as a complement to the decentralisation reform and to the planning reform. Economic planning declined later, but planning conventions were maintained and became the main planning instruments. They focus on setting up joint programmes funded by the region and the State, and based on an agreement of priorities. The State adjusts its priorities for each region according to the orientations of the *aménagement du territoire* policy. It is even more so for the planning conventions signed for the present planning period (1994-1998). A joint planning convention has been signed with all regions in the Parisian basin. Départements and cities participate in various projects listed in the conventions. Planning conventions mainly concern capital expenditures. The bill on territorial development, which is expected to be adopted by the French parliament in December 1994, will establish a closer relationship between planning conventions, the aménagement du territoire and capital expenditure programming. Planning conventions do not give rise to subsidies or cross subsidies between the parties' budgets, but to co-ordinated credit commitments.

In Portugal, contract programmes are passed by the State with municipalities to support local or regional development policies. They give rise to special grants (by contrast with the French planning conventions) to municipalities for the development of physical infrastructures. The main purpose of the contractual schemes is to provide the national contribution to European Union investment programmes. The special grants are regulated by the law, which determines the conditions of eligibility and the limits of the State's contribution. As a rule, the costs of these investments are shared on a 50/50 basis between State and municipality. Remarkably, programme contracts are published in the Official Law Bulletin, which is not the case in France.

Conclusion

It appears that there is no less diversity in West than in East Europe. This does not mean that there is little for states to learn from each other, only that it is necessary to pay attention to the context of each experience and to the context in which it could be reutilised to avoid failure. A survey also makes clear that the two basic profiles emerging in SIGMA countries' local government finance can also be recognised in the West, be it under very different forms. In most cases, however, the most straightforward use of foreign experiences is to give impulse to critical review of the existing situation in one's own country, helping, thus, to elaborate new responses not merely inspired by the past.

We hope that the reader will also be convinced that the exchange of experiences is worthwhile, not only between West European and SIGMA countries, but also between SIGMA countries themselves and that Western readers will find, in the experiences reported in this book, seminal ideas to improve local finance in their own countries.

Sources

The main source of the present survey is the country reports published in this book and the preliminary reports on the six SIGMA countries prepared by:

Bulgaria: Mrs Valentina Grozdanova, Ministry of Finance,
Czech Republic: Mrs Vera Kamenickova, Ministry of Finance, Financial Policy Department,
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The Country Reports and preliminary reports are therefore not quoted specifically in the text.

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STATE BUDGET SUPPORT TO LOCAL GOVERNMENT IN FRANCE

A Report for the SIGMA Programme

by

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There is no local autonomy without financial autonomy. But, local government finance is part of public finance as a whole, and central government, which is responsible for economic and monetary policy, has, therefore, to keep the evolution of local government finance under control. Countries differ in scope and matter of financial autonomy and in scope and instruments of central government control.

Until the end of the seventies, local government finance was considered in France basically as a "dismemberment" of state finance[2]. Decentralisation in that field began before the 1982 reform, but got from it a new impulse. Today, local councils decide on tax rates. They are free to vote their budget with only subsequent supervision. They are free to borrow. Despite the increasing share of tax incomes in local government resources. State grants further represent an essential part of local budgets, but their purpose has changed over time. National and local tax systems are completely separate in France, and there is no tax sharing between the State and local government. Central - local financial relations are, therefore, essentially based on grants.

An estimate of central government grants

An overview of local government finance as a whole and within the bulk of public finance is necessary before presenting the grant system.

Basic data

Public finance

On a *national accountancy basis,* using consolidated data, local government expenditure[3] exceeds 700 billion FF (1992), i.e 32 per cent of the total public expenditure. Local government expenditure provides 72.1 per cent of the gross fixed capital investment of all public administrations. Their share of compulsory payments is about 6.33 per cent of GDP, of which 4.06 per cent of GDP is directly taxed by local government. The following table shows the relationship between local finance and compulsory payments:

***Table* I**

Local government in compulsory payments

	1985	1987	1989	1992
Compulsory payments (in % * GDP)	44.5	44.5	43.7	43.7
among which allocated to local government	5.7	5.87	5.95	6.33
levied by local government (state grants non included)	3.8	3.87	3.90	4.06

(Source: Direction générale des collectivités locales, ministère de l'Intérieur, data from nation's Accounts)

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[2] L.Philip (1992), "Les garanties constitutionnelles du pouvoir financier local", *Rev. fr. Droit adm.*, 3/1992, p.453.
[3] Administrations Publiques Locales - APUL: local governments without overseas départements, but including various professional bodies (chambers of commerce or of agriculture, and so on).

Data provided on a *public accountancy basis* is not consolidated. When aggregated, double accounts resulting from transfers are not eliminated. This data derives from management accounts voted by local councils after the end of the budgetary year. Since they are split up into all local government levels and their public corporations, they clearly show the financial weight of the respective levels. The following table summarises this information for the 1989 expenditure (in billion FF) and is commented upon afterwards.

***Table* II**

Local government expenditure

Government levels or local government bodies	*Number of units*	*Total expenses*	*Total investment, including subsidies and debt amort.*	*Fixed capital and estate investment*
Communes	36 651	334.7	122.9	85
Joint authorities	18 281	81.9	44.5	28.4
Departments	96	159.2	56.9	26.5
Regions	22	40.4	26.2	7.6
Others	-	51.8	16.9	11.6
Public health and social care institutions (1988)	-	171.1	22.3	15.3
State	-	(1 379.0)	(84.2)	28.9

Sources: Ministère de L'Intérieur, Direction Générale des Collectivités Locales (1993), "les collectivités locales en chiffres. Edition 1993, La Documentation Française, Paris; Budget Closing Law for the Budgetary Year 1989, as regards the State budget.

Data on the State budget is given for reference. Although it does not rely on the same definition, the general relationship is not affected by these differences. Only the State's civil investment expenses of the general budget are included. Public health and social care institutions belong to the local public sector, although they are funded by the Social Security regime, not by local governments. They are provided herein for their comparative value. The category, "Others", includes local public enterprises or public bodies controlled by local governments. Most of them are subject to the control of communes or joint authorities.

This data shows that communes, their joint authorities and other subordinated public bodies carry out the overwhelming part of local government expenditure. Furthermore, it is clear that, at the intermediate level, regions have relatively weak government expenditures compared to departments. Nevertheless, more than half of regional expenditure is investment expenditure, and it is mainly composed of transfers, as is the State investment budget.

If we turn to resources, a significant increase in tax incomes and decrease in transfers is shown:

***Table* III**
Breakdown of local government revenues

	Tax revenues	*Transfers*	*Loans*	*Other revenues*
1984	35.3%	36.4%	12.7%	15.6%
1990	40%	34%	10.1%	15.9%

(Source: Ministère de l'intérieur et de l'aménagement du territoire. Direction générale des collectivités locales (1993), "Les collectivités locales en chiffres", La Documentation Française, Paris.

The breakdown looks very different between the various local government levels (1990):

***Table* IV**
Revenues of each level of local government

	Tax revenues	*Transfers*	*Loans*	*Other revenues*
Communes	41.5%	33.5%	11.4%	13.6%
Joint authorities	20.1%	38.8%	15.5%	25.6%
Departments	54.0%	34.8%	5.7%	5.5%
Regions	55.7%	30.1%	10.7%	3.5%

(Source: idem)

Direct taxes yield 79 per cent of local government's total tax revenue, of which 92 per cent is levied from four main direct taxes: the housing tax (*taxe d'habitation* - *TH*), two property taxes, one on built property (*taxe sur les propriétés fonciers bâties* - *TFB*) and the other on unbuilt property (*taxe sur les propriétés foncières non bâties* - *TFNB*) and the business tax (*taxe professionnelle* - *TP*). The property tax on unbuilt property is typically paid by farmers. The valuation of agricultural land is based on the quality of the land, the type of cultures grown in the area, and agricultural particularities of the region. On properties deemed to be built, e.g. classified in areas where building is allowed, the tax base is evaluated according to the increase in the value of the land observed between the two last five-year valuation periods. Its yield is comparatively low. These four taxes are levied by each local government level, on the same tax base, but according to rates voted by each council. Among joint authorities only urban authorities (*communautés urbaines*) are empowered to levy these taxes. New town joint authorities and recently created town communities (*communautés de villes*) levy the business tax, instead of the member communes. The breakdown of the four taxes appears as follows (billion FF, 1991):

***Table* V**

Main direct taxes in local government budgets

TH:	50.9	23.2%
TFB:	49.7	25.2%
TFNB:	7.7	3.7%
TP:	92.7	47.9%

As regards, indirect taxes, even though they consist of a number of pocket taxes, five of them yield 90 per cent of the total revenue (1991): the département's tax on immovable property transfers for payment (33 per cent), the département's tax on motor vehicles (20 per cent), the tax on electricity consumption (12.5 per cent), the additional tax on property transfers (14 per cent) and the tax on car registration (9 per cent).

Indirect tax revenues are significant for departments and regions because such taxes were transferred to these local governments as financial compensation for their new responsibilities. As a whole, tax revenues transferred to local government for that purpose amounted to almost 42 billion FF for local government in 1993. The tax on immovable property transfers for payment and the tax on motor vehicles were transferred to départements, and they bring in about 35 per cent of the départements' total tax revenues.

Indirect taxes also yield 45 per cent of the regions' tax revenues. The driving license tax was given to the regions in 1972. The car registration tax and the additional tax on property transfers were transferred to regions to compensate for the delegation of new responsibilities. But, communes and their joint authorities draw about 85 per cent of their tax revenues from direct taxes.

The decentralisation reform has revived indirect taxation in local government incomes. There are two main reasons for this phenomenon: 1) these taxes have a relatively balanced distribution of the tax bases throughout the territory in relation to the population; and 2) the State was not inclined to share one of the main national taxes.

All local taxes are collected by the Treasury, a division of the Finance Department, while tax bases are calculated by the State tax administration. Local councils in France have a relatively large tax power, compared to many other European countries, since each council is entitled to vote tax rates and to grant tax reductions, when provided by law. The main problem resides in the tax bases.

All four taxes are based on a rent value calculated from physical data characterising immovable property according to its purpose and its location. The rent value represents the income which should be yielded by the normal exploitation of the property. These values are community based but can become rapidly outdated from market values if their evaluations are not revised or repeated frequently.

Transfer payments from the State budget to local government are in excess of 216 billion FF (1993). Tax revenues transferred from the State to local government (to departments and regions), as compensation for devoluted new responsibilities, are just under 42 billion FF. They cannot be considered as transfers from the State or as tax sharing, since tax bases are local. Rates are fixed by local councils within certain limits, and the totality of the revenues accruing from these taxes is a budget resource for local governments.

Local government

The structure of local government has been given above. The communes and their joint authorities carry out the bulk of local government functions. Despite their rather small size, regional budgets are significant since more than half is devoted to investments, and, specifically, to capital subsidies.

As regards the distribution of responsibilities among the various levels of local government, we consider, as responsibilities for the respective local government levels, only those matters where the local government concerned is empowered to issue enforceable decisions to perform its responsibilities.

Responsibilities of the respective local government levels are based on: i) the general clause of territorial competence, and ii) legal competence in certain matters.

The general clause of territorial competence (*clause générale de compétence*) was first included in the *Municipal Act 1884*: "The municipal council settles communal affairs by its deliberations" (still valid in the present Act). This provision was extended to general and regional councils. It reflects the basic difference in French administrative law between the concept of community, according to which local government levels are devised, and the concept of *établissement public*, or public corporation of public law, which is given only specialised competence. The general clause means that each local government community is empowered to settle any matter within its territorial jurisdiction, provided that this matter has not been vested by the law in another authority, i.e it is presumed to be competent in any matter of local scope, provided this competency is not made unlawful (*ultra vires*) by the special legal competence of another authority.

Specific to the French local government system is the fact that, at present, all three local government levels benefit from the general clause of territorial competence. This makes local government very flexible in light of new problems, but also causes too much competition between local governments in matters where it is not desirable. So, many writers and politicians demand a new clarification in the distribution of responsibilities, i.e an extension of the legal competence fields.

The legal competence of local governments in certain matters is not new. It was the first step in regulating local government responsibilities. But, the decentralisation reform gave it paramount importance, since this entailed the transfer to local government of a bulk of matters previously managed by the State administration. The transfer was organised and scheduled by the Acts of 7 January and 22 July 1983. It was based on the basic idea of developing vocational functions at each level, which had been shaped over time in the past, these being: 1) the commune: land use and equipment for catering to the population; 2) the département: social care, solidarity functions to the benefit of smaller communes in rural areas; and 3) the region: economic development and planning, labour training. Conversely, the State took back some prerogative functions or their corresponding expenses which were, in the past, transferred to local government budgets.

Another idea of this reform was to transfer homogeneous sets of responsibilities, in order to make possible large management autonomy. In fact, this principle can hardly be recognised in the law. In most important matters, responsibility is shared between State and local government or between several local government levels, either to make understanding necessary or because clear-cut sharing was impossible due to the size of local government units or the number of levels.

Main responsibilities transferred are: 1) to communes: town planning and planning permits; 2) to departments: lower level secondary schools (building and upkeeping, current material expenses), social care planning, social care relief, public transportation; and 3) to regions: regional planning and development, labour training, school planning and upper level secondary schools (similar responsibilities to the départements), public transportation (conventions with the national railways) and plan conventions passed with the State.

The Act of 2 March 1982 removed the main legal limits to local government interventions to support local economic development. The main limits are, today, those resulting from the EEC treaty.

Recent reforms have developed situations of joint responsibility between the State and local government. This has occurred in the fields of education, town planning, minimum relief for marginalized people and social housing.

Local government employment reflects the distribution of functions. It amounts to 1 351 000 employees (1992), compared to 2 121 000 in the State service. The difference was even more striking a few years ago when post office and telecommunication employees were in the State civil service (2 844 800 in 1989). Local government employment does not include health employees (in public hospitals). Among local government employees, 1 041 000 are employed by municipalities or their joint authorities.

The grant system

An overview

Transfers account for 34 per cent of local governments' resources. These are budgetary transfers from the State, as far as local government as a whole is concerned. But, there are also budgetary transfers between local governments, like, for example, subsidies from regions and départements to communes or their joint authorities. This section will focus on budgetary transfers from the State to local government.

The origins and purposes of these transfers are very diverse. Some transfers were introduced to compensate for loss in tax revenues, others to finance investment expenses, others for equalisation purposes, others to cover charges in excess of the local government's own income, and lastly, others were introduced to offset the transfer of new responsibilities to local governments.

The following table, provided by the Ministry of Home Affairs, includes all State grants.

***Table* VI**
State budget grants and subsidies to local government

Grants	1993 Budget (million FF)
1. Grants and subsidies for current expenditure	
* General grant for current expenditure (DGF)	92 219
* Special grant for teachers' housing	3 257
* State grant to the National Business Tax Equalisation Fund	1 393
* Grant for elected representative allowances	250
* Miscellaneous subsidies from ministries	4 052
among which the Ministry of Home Affairs	516
Total	**105 171**
2. Capital grants and subsidies (expenditure commitment ceiling)	
* Global investment grant	5 895
* VAT Compensation Fund	21 100
* Driving law fines	1 000
* Miscellaneous capital subsidies of ministries,	3 829
among which the Ministry of Home Affairs	178
* Subsidies from Special Treasury Accounts	1 181
Total	**33 005**

(Table VI continued)

3. Compensation for transferred responsibilities	
* General decentralisation grant	12 921
* Labour training grant	2 931
* Capital block grant to regions' school outlay (DRES)	2 807
* Capital block grant to départements' school outlay (DDEC)	1 388
* Corsica's general decentralisation grant	1 067
Subtotal	**21 114**
Transferred tax incomes	41 934
Total	**63 048**
4. Compensation for tax relief established by the law	
* Business tax compensation grant	23 348
* Counterpart for property tax exemptions	1 800
* Compensation for housing and property tax relief	7 426
* Compensation for miscellaneous legal tax abatements	24 160
Total	**56 734**
TOTAL WITHOUT TRANSFERRED TAX INCOME	**216 024**
TOTAL WITH TRANSFERRED TAX INCOME	**257 958**

Local government's main transferred resource is the general grant for current expenditure (*dotation globale de fonctionnement - DGF*), allocated to communes and their joint authorities and to départements. The main achievements of the decentralisation reform, in the field of transfers, have been the globalisation of a large portion of investment subsidies and the compensation for charges resulting from transferred responsibilities through a general grant, supplementary to additional tax revenues transferred to local government, called the general decentralisation grant (*dotation générale de décentralisation- DGD*). A complete overview of transfers should include the contribution by the State to local government tax revenues. This was discussed in the previous section.

Transfers will be discussed by distinguishing between grants for current expenditure and investment grants.

Grants for current expenditure

The main resource under this heading is **the general grant for current expenditure**. First put into place for a six year period beginning in 1980, it was finalised by the Act of 29 November 1985 with a revised structure (code des communes, art.L.234-1 ff). The DGF is given to communes, joint authorities and départements, but not to regions.

It succeeded a previous grant (the *VRTS*[4]), now abolished, that represented a tax (tax on wage expenses - *taxe sur les salaires*), soon abolished, that was given to communes and départements, and replaced the previous "local tax" (taxe locale), introduced in 1941 and based on retail sales. It is important to be reminded of these steps, because the replacement income (the VRTS) was first to compensate for the loss of the local tax to the communes, and therefore reflected the unequal distribution of that tax revenue. But, the entitlement formulae was to change progressively, shifting from a compensatory logic to an equalisation logic, since the grant aimed at securing all communes, despite tax inequalities, sufficient resources to carry out their duties. The DGF replaced the VRTS half of the way and the equalisation purpose was mitigated. For that reason, the DGF has to be considered, in the first place, as a revenue, and only partly an equalisation grant. That was brought to the fore by the guarantied minimal increase (*garantie de progression minimale*, and now: *garantie d'évolution minimale*) (see below) withdrawn from the bulk of the DGF, and finally suppressed by the Act of 31 December 1993.

For a long time calculated as a portion drawn from the revenue yielded by the value added tax, the general grant is now, according to the Finance Act for 1990 (art.47), defined plainly as a deduction from the State budgetary income. Its amount is calculated each year by applying, to the amount distributed the year before, an indexing coefficient mixing the price index and the evolution of the GDP, if positive. The main reason for the change is the harmonisation of VAT rates in the EC, and, in the long term, it was not possible to maintain the DGF based fictitiously on VAT rates for 1979[5]. This calculation has just been reformed: from 1996 onwards, the DGF will evolve as a sum of the average yearly forecast increases in consumer prices, plus half of the GDP's rate of increase in volume (if positive) (Budget Law for 1994, art.52). For 1994, the DGF is fixed at 98, 143.5 million FF, and will increase in 1995 according to the consumer price index.

Whereas the 1985 reform mitigated the equalisation objective of the DGF, a series of piecemeal reforms between 1991 and 1994 have undertaken to restore the equalisation purpose. The minimal guarantied increase, which maintained privileged situations and squeezed the redistribution margin, was reduced in 1991 and finally eliminated by the 1993 Act. The new allocation rules are oriented towards the compensation of territorial resource inequalities, combined with a needs assessment.

A new margin for redistribution will be generated by the distinction between the lump sum grant (*dotation forfaitaire*) and the development grant (*dotation d'aménagement*). In 1994, each commune will receive as much as the previous year (minus the portion called urban solidarity grant). The next year, it will receive that same sum, augmented by half of the DGF's rate of increase in the State budget. Over the next year, it will still receive the grant from the previous year, augmented as above. In this way, more money will be oriented every year to the development grant, since its amount is calculated by withdrawing the lump sum grant from the total applied to the DGF in the State budget. Then, the development grant will be divided into three shares: for municipal joint authorities, for urban solidarity and for rural solidarity.

The grant for municipal joint authorities is first subtracted from the development grant. Its amount is fixed by the Local Finance Committee, an advisory body of elected representatives in the Home Affairs Ministry. It is allocated to joint authorities empowered to levy taxes. The rest is divided between the urban solidarity and the rural solidarity grants, in such a way that none of these grants are superior to 55 per cent or inferior to 45 per cent of this leftover amount. The expected figures in 1994 are 1 260 million FF for the urban solidarity grant, and 1 billion FF for the rural solidarity grant. The share for joint authorities is

[4] VRTS: Versement représentatif de la taxe sur les salaires.
[5] M.Bourjol, "Le poids de la CEE", *Rev. fr. Fin. publ.* n°38, 1992, p.184-185.

weighed in such a way as to promote co-operation between municipalities and favour the most integrated forms of co-operation.

The urban solidarity grant was introduced in 1991 to support needy suburban municipalities. It is maintained in the new DGF, but the sharing has changed. Municipalities with over 10 000 inhabitants are entitled to this grant, depending on their rank in a synthetic need index (resources and charges) based on tax potential, percentage of social housing, rate of housing occupied by beneficiaries of housing allowances, and revenue per capita. These various elements are weighed in the calculation of the index. Then, municipalities are divided into four categories, each of which is weighed by a multiplier. The grant amount for each municipality is a function of the population, multiplied by the index value calculated for it (weighed by the multiplier of its category), and by the fiscal stress within the limit of 1.3 (see code des communes, art. R.234-7 to 12: Decree of 10 May 1994). Municipalities with under 10 000 inhabitants are entitled to the urban solidarity grant depending on the rate of social housing and tax potential. For each municipality meeting these conditions, the grant amount is equal to the average grant, per capita, in all entitled municipalities with under 10 000 inhabitants, multiplied by their population.

The rural solidarity grant is intended to support small centres in rural areas and needy rural municipalities. It is divided into two parts for this purpose. Different categories of municipalities fulfilling central functions are listed in the law. For each municipality, the grant amount is calculated as a function of population, tax potential and fiscal stress. For deprived rural municipalities, the grant amount is based on the population, weighed by tax potential, road length, school population, and tax potential per hectare.

The rural solidarity grant is co-ordinated with changes to transfer allocations from the National Business Tax Equalisation Fund, which supports investments in municipalities not entitled to the rural solidarity grant, but which perform a structuring role in the area. These funds are allocated as subsidies by the prefect, after consultation with the commission of elected municipal representatives.

As a whole, the new DGF is clearly oriented towards development policy goals (*aménagement du territoire*). Another reform to the DGF was announced by the Country Development Bill (May 1994) to increase the equalisation effect. Immediately, the share of DGF in the Ile-de-France region should be transferred to the urban solidarity grant.

There is also a general grant for current expenditure (DGF) paid to départements (13.8 billion FF in 1993). The principles for its allocation are similar to the communes' DGF before the 1985 reform, but there are specific differences. There is a guaranteed increase, a special grant to the poorest départements (minimal current expenditure grant), and the rest is broken down into two parts: a lump sum grant, and an equalisation grant, which is again divided into two parts with different entitlement indicators. The Act of 13 May 1991 introduced a horizontal equalisation mechanism: wealthier départements (high tax potential and little social housing) have to release part of their DGF to départements poor enough to benefit from the minimal current expenditure grant, for the purpose of improving living conditions in rural areas and "cities facing special social development difficulties" (communes over 10 000 inhabitants with either a high rate of social housing or a lower tax potential). However, the latter will be suppressed step by step from 1995 to 1998, as a result of the 1993 DGF reform, and the resources made available will accrue to the minimal current expenditure grant.

The French experience with the DGF shows the difficulty of promoting resource equalisation between local governments, and reconciling territorial equity with income stability[6]. But, the DGF still remains a crucial revenue for local governments.

Other current expenditure grants should be discussed. The most important is the **general decentralisation grant (DGD**), established by the Act of 7 January 1983 (art.96 ff). It is paid to communes, départements and regions, according to the following principles. Additional expenses, resulting from new functions transferred to local governments are evaluated independently for each local government. First, these expenses have to be met by new tax revenues transferred by the State (see Table VII), and the rest paid for by the general decentralisation grant. Since completion of the devolution process, the DGD is indexed on the evolution of the DGF, subject to deductions for charges taken over by the State. This grant may be spent freely by the beneficiary council, but it includes "special funds"(*concours particuliers*) which result from the costs of certain transferred responsibilities that the beneficiary local government now has to perform. These "special funds" are deemed to finance these responsibilities although spending is not tied in law. Such "special funds" exist for town planning documents, harbours within a département’s competence, communal libraries ... It amounted to close to 13 billion FF in 1993.

Other State grants are for specific purposes (1993). These include the special housing grant for school teachers (FF 3.3 billion), which is, in fact, now a supplement to their wages (school teachers in France are employed by the State, not by local government), the labour training grant (corresponding to the region’s responsibility for labour training), and miscellaneous specific subsidies from various ministries (4 billion FF).

Investment grants

In the past, investment grants were specific grants given by ministries and assigned to specific investments. The first untied spending grant resulted, in fact, from the compensation to local governments for the VAT included in their real investment expenses. This grant is calculated as a percentage of the real investment expenditure. It is included in the State budget as a **compensation fund of the value added tax** (*Fonds de compensation de la TVA*) and is included as income in the investment budget of each local government. Only local governments, their joint authorities and some special bodies under their control and listed in the law are entitled to this compensation, not their subsidiaries (such as mixed economy companies). Also, only direct investments give right to this compensation, not including subsidies or investments for third parties.

To enhance local autonomy in investment expenditure, the Acts of 2 March 1982 and 7 February 1983 provided a **global investment grant** (*dotation globale d’équipement - DGE*) to communes, and a global investment grant to départements, both resulting from the aggregation of specific investment subsidies previously allocated, on a separate basis, by various ministries. Nevertheless, not all specific subsidies were absorbed by the DGE. Regions are not entitled to a DGE. Spending of the DGE is untied.

The DGE to communes was revised by the Act of 20 December 1985 to take into account the special needs of smaller communes. The global amount fixed in the State budget subdivides into two parts, after withdrawal of a special grant for joint authorities. The first part is for communes with over 2 000 inhabitants, or smaller communes which choose this regime. In the first part, grants are attributed according to a participation rate, calculated as follows: each commune receives a grant equal to its estimated real investment expenditure, multiplied by the ratio of the overall estimated amount of real investment

[6] See *Report* 1988 of the Court of Accounts, p.17.

expenditure of communes entitled to that grant on the credit line and included, for this part, in the State budget. This ratio is about 2.3 per cent. The second part breaks down départements according to criteria reflecting need (population, number of communes, roads, tax potential). Then, the prefect will subsidise investment projects submitted by communes and selected by an advisory commission of elected officials. The DGE is now divided equally between the two parts, instead of the previous 60/40 ratio (Act of 6 February 1992).

The DGE to départements is deemed to support investments in the département itself, but also investments subsidies from the département to communes or joint authorities, or other public or partially public bodies. The first part is attributed according to the real investment estimates (participation rate system) and road length, plus an equalisation bonus for poorer départements. The second part is attributed chiefly in proportion to the development and equipment expenses for agricultural land funded by each département. Spending is untied, but the second part will decrease if less money is spent for this purpose over a number of years.

Block grants for secondary school investments are specifically established by the law, and attributed to regions and départements for their respective responsibilities, according to the evolution of their school population and the existing secondary school capacity. These grants must be used for secondary school purposes, and can be used for increased structural capacity in the schools only if the projects have been agreed to by the prefect of the region and if the personnel is appointed by the State authority. In fact, the investment effort by regions and départements for secondary schools has been much greater than the evolution of the block grants. Hence, the State's participation in regions' school investment expenses fell from 77 per cent in 1986 to 39 per cent in 1991[7].

Lastly, **fines** imposed on drivers violating driving laws are allocated to communes for investments in public transportation, traffic facilities and car parks.

If all investment grants from the State to local government are considered, it is clear that the globalization of State subsidies to local government investments, which was a requirement of the decentralisation reform, represents only a rather small part of the general contribution of the State budget to the financing of local government investments (1993, FF billion):

- compensation fund for the value added tax (FCTVA):	21.1
- *global investment grants (communes and départements):*	*5.9*
- secondary school capital block grants:	4.2
- investment subsidies from various ministries:	3.8
- subsidies from treasury accounts:	1.2
- driving law fines:	1.0
- *TOTAL*	*37.2*

An appraisal of central government grants

The appraisal of the central grant system must take into account the following issues: 1) the impact of central government grants on local government finance; and 2) the central-local relationships.

[7] More details in: G.Marcou (1992), "Les collectivités territoriales et l'Education nationale", in: G.Marcou (ed.), "La décision dans l'Education nationale", Institut Français des Sciences Administratives, Presses Universitaires de Lille, Villeneuve d'Ascq.

The impact of central government grants on local government finance

The appraisal must be focused on two issues: the funding of the tasks assigned to local government and equalisation.

Funding the tasks assigned to local government

In principle, all functions carried out by local governments are their own functions. Especially in State - local government relationships, there are extremely few delegated functions (ex. registration of birth and death,...) and they are of little budgetary significance. Some tasks of a purely financial nature are nevertheless delegated to local governments. For example, the département manages the funds involved in the financing of land restructuring, part of which comes out of the State budget, and which is a State responsibility. Also, municipalities pay the housing allowance of school teachers, a payment which is fully set off by the corresponding grant (now it is directly paid to the beneficiaries).

More significant are “obligatory spendings” which are all established by law, and which are duties for the local government concerned. Not only the payment of the salaries to the personnel or of the interest of the debt are obligatory, but also upkeeping the vicinity, or, as a result of a recent case law, secondary schools, or the payment of social benefits by the départements according to the law, for example.

There is no clear relationship between the nature of the spending and the nature of the resources or grants, except in two cases. These are when the grant is deemed to cover basic needs of the municipality and when the purpose of the grant is to compensate for new responsibilities delegated to local government.

The main grant, the DGF, was established to replace a tax revenue. It was a compensatory revenue. It was, therefore, never calculated on the basis of an assessment of needs, but, first of all, on a valuation of the past revenues. The equalisation criteria introduced to correct the inequalities resulting from the former tax revenues, and, as discussed above, the successive reforms to the DGF are all distinguished by the weight they place on compensatory revenue and equalisation.

Nevertheless, the DGF is supposed to finance current expenditure first. This is reflected in the changes that occurred in the indexation of the total DGF amount in the State budget. The indexation of the VAT yield proved to be too advantageous to local government and inflationary. Therefore, it was replaced by an indexation on the value of a lower average salary of a municipal employee. But, this proved to be too limited a resource. Now it has been replaced by an indexation on consumer prices. This shows how current needs are considered in the DGF mechanism.

Some subsidies still exist to help local government meet a minimum standard. These are Ministry subsidies for specific current expenditures. For example, they could be subsidies from the Ministry of Agriculture to modernise slaughterhouses or to take care of and develop municipal forests.

Despite the examples quoted above, grants for current expenditure are in general fungible with local tax revenues and are not assigned to specific tasks.

To the contrary, compensation for the financial burden of new responsibilities devolved to local government is based on an evaluation of corresponding financial needs, even if the payments are not always assigned to a specific purpose.

According to the Act of 2 March 1982, any new transfer of financial charges resulting from the transfer of responsibilities to local government must be fully offset by the transfer of resources corresponding to that burden on the day the responsibilities were transferred. The compensation then evolved, along with the DGF (art.102). The Act of 7 January 1983 specified (art.94) that the financial burden resulting from the transfer of responsibilities had to be compensated for by State allocations to each commune, département or région through resources equal to that burden. During the three year period (1983-1985) provided for implementing the delegation, the amount to be compensated for each transfer of a responsibility had to be evaluated by an independent commission, chaired by a magistrate of the Court of Accounts and including representatives of all kinds of local governments. The compensation resulted from, first, the transfer of tax revenues to the départements and the regions. It was then supplemented, if necessary, by a general decentralisation grant. If the said tax revenues were in excess of the financial burden to be compensated, the difference remained in the State budget. The adjustment had to be revised accordingly after any further transfers of responsibilities.

At the end of the three year period, compensation for at least half of the financial burden had to be achieved through tax revenues (art.95). As appears in Table VI, the tax revenues transferred are much higher than the amount of the general decentralisation grant. According to the law (art.95, al.9 and 10), any change in tax law affecting the tax revenues allocated to départements and regions gives rise to financial compensation. After the end of the three year period, the general decentralisation grant has evolved along with the DGF, while compensatory tax revenues can evolve differently, depending on the economy and tax rates. This schedule has almost been put on hold. The last transfers of responsibilities, in the field of culture, were carried out in January 1986.

As labour training and apprenticeship were devolved to the region, the corresponding burden was offset by the transfer to regions of a grant equal to the money allocated by the State budget at the transfer date (May 1983) (see Table VI, labour training grant) and the employers' contributions for labour training (Act of 7 January 1993, art.85). These credits are shared among regions according to needs indicators (educational structure of the active population, capacity of training institutions). Any changes by the State affecting the financial burden of this responsibility were to be offset.

The recent five-year law on employment (20 December 1993) provides for further transfers to regions in the field of labour training beginning 1 July 1994 (priority training programmes for young people under 26, previously carried out by the State). These new responsibilities are offset by the transfer of a corresponding amount of additional resources. Five years later, regions will have full responsibility in the field of labour training and all State credits still devoted to this responsibility will be transferred to regions.

The provisions regarding financial compensation are inspired by the will to maintain at least the same level of services after the transfer of responsibilities. Whereas each local government is free to spend the money received from compensatory grants or tax revenues as it thinks appropriate, the amount which is allocated to it is the aggregate of (i) the respective responsibilities transferred, which are not compensated for by tax revenues, (ii) and contributions allocated according to different rules depending on the matter. For example, municipalities' duties include: town planning, school transportation in urban areas, municipal hygiene and health services and municipal libraries. As regards départements, the general decentralisation grant is calculated as an aggregate of compensatory valuations for the burden represented by social benefits and health care, school transportation, secondary schools (lower level) and central libraries. Whereas, the burden of sea ports is a contribution allocated separately within the general decentralisation grant. It is similar for the region.

As regards capital expenditure in secondary schools, the block grants to regions and départements were devised as a means to prevent the risk of a lower quality commitment by local governments in that field and to permit the State to carry out a national school policy. In fact, as already pointed out, the contrary has happened. The capital expenditure of both départements and regions in the education field is much higher than the State block grants, calculated on the basis of the State's capital expenditure before the transfer. As a result, it is possible to conclude that the function of the block grants has changed. Originally, it was for compensation and a means to maintain a minimum level of investment policy in the field of education. At present, these grants have become support grants, with equalisation elements for poorer départements or regions.

The compensation of "spillover effects" is not really relevant in France. A remarkable exception is the rural solidarity fund within the DGF (see above). The main reason for this is that the main factor of inequality between municipalities is the unequal distribution of business tax bases. As a consequence, municipalities experiencing charges resulting from spillover effects are often also those which benefit the most from the business tax.

Equalisation

In the French local finance system, equalisation is achieved mainly through the DGF. Despite this purpose, the effects of the DGF are contentious and difficult to asses for many reasons: 1) the very large number of local governments makes it extremely difficult to identify and assess all kinds of situations and 2) the DGF has undergone a number of reforms and adjustments during the past ten years, each reform had to be introduced step by step in order to avoid disturbing the budgetary balance of local governments, and therefore, the DGF could never be implemented totally before being changed.

For many years, the minimal guaranteed increase has been responsible for the DGF's low equalisation impact. This was fixed by the 1985 reform at 55 per cent of the DGF's yearly increase in the State budget. This means that each commune was entitled to receive for the three grants (base grant, equalisation, participation) an amount at least equal to the amount it received the year before, increased by 55 per cent of the rate of increase of the DGF in the State budget. The indicators provided for the allocation to municipalities of the DGF's equalisation grant in the *1985 DGF Act* were shown by simulations to have a strong equalisation effect if applied to the full share of the DGF. But, in fact, the margin of redistribution has never been in excess of 3 or 4 per cent between 1983 and 1991. Moreover, several indicators for the DGF's allocation favoured large cities, and not underprivileged communes. For example, the first portion of the equalisation grant of the former DGF was allocated according to an indicator based on territorial equity principles within the demographic stratum of the commune. There was no equalisation between demographic strata and the base grant was allocated according to an indicator in favour of larger communes. Paris belongs to the stratum of cities with over 200 000 inhabitants. As a result, large cities appear, in comparison to the average, entitled to higher grants, while they would not be so entitled if compared with an average tax potential calculated excluding Paris.

In past years, the yearly redistribution margin available for equalisation never reached 3 per cent of the total amount. It was even more limited because of the progress of co-operation between municipalities creating more joint authorities entitled to the grant. These observations are at the origin of recent reforms. However, according to other observations, the DGF has improved the budgetary situation of most small communes, by covering their minimum administrative costs, thereby making a territorial reform even more difficult[8]. If the average DGF grant is calculated for each municipality and added to tax revenues, a simulation carried out on the 1991 data in one département suggests that the criteria applied would have offset, for all the municipalities of the survey, 40 per cent of the tax potential inequalities (and

[8] A. Guengant / J.-M. Uhaldeborde (1989), *Crise et réforme des finances locales*, PUF, p.179.

as much as 70 per cent for rural municipalities[9]). This last approach neglects the aimed effect and focuses on the impact of the DGF on the bulk of local governments' resources.

Certainly, the problem of tax base evaluation is critical to any equalisation policy, so long as the goal is resource equalisation. The quality of the tax base evaluation is a basic condition, not only to improve the tax yield, but also to assess what has to be equalised or not. The question of which resources have to be taken into account to calculate the grant must be raised. On the one hand, a number of small communes have significant revenues from their properties (woods, etc.) but few tax revenues. They appear poor according to the tax potential index. But, they are not so poor in fact. On the other hand, underevaluation of tax bases is a means of supporting the population subject to the tax. This is so in France regarding the property tax on non built premises.

The question was also discussed, whether equalisation should be based on need assessment or on tax base valuation. Usually, equalisation has been based in France on resources. The 1985 reform introduced indicators of need as equalisation criterion, in order to compensate for the equalisation limitations of calculations based on resources. But starting in 1991, equalisation is again mainly based on resources, while precise need indicators are only calculated for specific purposes. Is there any reason to prefer equalisation based on needs or equalisation based on resources? There is probably no general answer. It will depend on a well founded diagnosis of inequality factors. In France's case, it has been established that 90 per cent of inequalities result from the business tax. This means that equalisation can be based, to a large extent, on tax base inequalities. Nevertheless, it does not rule out the use of need indicators in the allocation of grants for specific needs.

The recent reform dealt with several of these questions. The minimal guarantied increase was removed, the more than proportional weighing of population strata was also removed, the urban solidarity grant was increased and the support to integrated joint authorities was reintroduced in the breakdown of the DGF, thereby making more money available for redistribution.

Central - local relationships

Regarding central - local relationships, central government grants can be appraised based on two issues: i) local autonomy and ii) the control on local government finance.

Local autonomy

There is no doubt that the general evolution of the grant system in the long term has been in favour of local autonomy. This evolution has been accelerated by the decentralisation reform. But, even before that time, the trend towards the globalisation of grants had started. Today, specific subsidies represent only a tiny sum in the bulk of transfer payments. In Table VI, such subsidies include the special grant for teachers' housing, which is, in fact, State compensation for an ancient obligation on the commune to provide teachers' accommodation since the beginning of republican schools. Teachers are State civil servants and this sum is, in fact, part of their salary. The grant for elected representative allowances is a support for small communes' budgets to finance the allowance provided by the law, to elected representatives for their work devoted to town management. Specific subsidies are found in the miscellaneous subsidies from Ministries and subsidies from Special Treasury Accounts, sometimes granted by contract.

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[9] G. Gilbert / A. Guengant (1994), *Les finances locales et l'aménagement du territoire*, DATAR, unpublished report.

Additionally, half of the global investment grant to communes (3.5 billion FF) is allocated by the prefects and earmarked as subsidies for municipalities and joint authorities with fewer than 2 000 inhabitants, ie. less than 1.75 billion FF. Both for current and capital expenditure, specific subsidies amount to 7.15 billion FF, ie. 3.3 per cent of the total transfer payments from the State budget (without transferred tax incomes).

Other transfers are targeted and are more significant. Driving law fines are assigned to municipal budgets and must be spent for the improvement of the road infrastructure or urban transportation (1 billion FF). The labour training grants are compensation grants corresponding specifically to this function, which was delegated to regions (2.9 billion FF). More important are the capital block grants to départements and regions for secondary school investment spending (altogether 4.2 billion FF). Even if all grants, either earmarked or only targeted, are totalled, the sum amounts to 15.25 billion FF, or just over 7 per cent of the total of grants (including driving law fines), and this amount is decreasing (9 per cent in 1989).

Further, a more specialised approach is necessary. The allocation of part of the global investment grants as specific subsidies to small communes and joint authorities was restored in 1985. This occurred due to claims by these small localities that, because the payment was a yearly lump sum, it was useless to them since they do not have an investment every year and when they have an investment, the lump sum is much too small to help them. On the contrary, the new rules, resulting from the 1985 reform, make it possible to adjust the grant to these needs. The prefect is in charge of allocating the grant to a selected project, but it will not make this decision alone. The review of projects submitted by localities is made by a commission composed of elected representatives. In 1992, the share of the global investment grants for small communes and joint authorities was increased to 50 per cent of the total.

The block grants for secondary school investments are based on another concept. The building and repair of secondary school premises is the responsibility of regions and départements. The block grants are a State instrument to retain State influence in the development of the secondary school network. Even if the State's participation in these capital expenses decreases in comparison with the effort pursued by local governments, it remains sufficient in relation to total investment needs. But, this policy is consistent with constitutional provisions according to which the State must provide public, free and non-religiously oriented education at all levels (Preamble of the Constitution of 1946).

As emphasised in the comparative survey, French local government plays an important role in the financing and managing of public investments. Nevertheless, State grants' contribution to local government's capital resources is important. With the block grants for secondary school investments, capital grants amount to 37.2 billion FF, i.e. 17.2 per cent of all grants (current and capital). In 1990, according to last available data, these represented 17.7 per cent (with 28.9 billion FF, current prices) of the local governments' total gross investment expenditure. This contribution is significant, but the major portion of the investment expenditure is financed by local governments autonomously, based on their own resources and borrowings.

However, grants do not exhaust the subject of central - local relationships in financial matters. A number of projects give rise to joint financing agreements between the State and local governments. The main examples are planning conventions signed by the prefects of a region, on behalf of the Government, and individual regions. Conventions reflect an agreement on major investment and policy priorities for regional development. In current planning conventions, which have been signed for the 1994-1998 period, départements and regions contribute to certain projects which are of interest to them. Planning conventions have developed into a major instrument for the policy of “aménagement du territoire” (regional development), although most of the State's investment policy is carried out outside of planning conventions.

Lastly, it must be kept in mind that there are also grants from départements and regions to communes and their joint authorities. While smaller than State transfers, these play an important equalising role which has not been well studied. For example, in 1989, one third of the investment spending of all départements was devoted to investment subsidies to communes or joint authorities. A rough estimate (because there is no consolidation of accounts between communes and their joint authorities) shows that it should amount to 7 per cent of the total investment expenditure of communes and their joint authorities[10].

Control on local government finance

One of the results of the decentralisation reform is certainly that the State's control of local government expenditure has severely diminished. The grant system has only a limited effect on this consequence.

As regards control of the level of local government expenditure, it is true that the State can curb the level of expenditure by freezing or diminishing grants which still represent a significant part in local budgets. But, local councils can also compensate for this measure by increasing their tax rates, which amount to a larger part of their budget than grants, or they can borrow. As far as investments are concerned, the level of local government expenditure is certainly much more affected by the general level of interest rates, which is subject only to the Government's general monetary policy. As a result, the State has limited control over the increase of local government expenditure.

The grant system is no longer a strong instrument by which to orient local government expenditure along national priority lines in certain areas. In fact, this control by the central government is now only possible in the education sector.

However, the State has recovered part of its influence, lost in the grant system, by developing joint financing with local government. Such financing does not appear in the accounts under grants, since it is local spending. But, it binds individual local governments to the State for common purposes, sometimes fixed by law. The planning conventions are an excellent example of this new trend, as already mentioned. Other examples can be given, like the minimum revenue support allowance Act that provides that the State pays the allowances, whereas the départements use 20 per cent of this amount to finance social initiatives to reinsert the beneficiaries into social life (Act of 1 December 1988), the housing rights of persons in need Act, which placed a duty on the department to share, with the State and other institutions, the costs of housing plans. To overcome social segregation in cities, the State will contribute, on the basis of a convention, to financing land purchases by communes which adopt a joint local housing plan (Act of 13 July 1991; this provision is just coming into force).

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[10] For steps on this subject in Ile-de-France see: G. Pola; G. Marcou; N. Bosch (ed.), *Investissements publics et régions*, L'Harmattan, Paris, 1994, p.192.

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STATE BUDGET SUPPORT TO LOCAL GOVERNMENT
IN PORTUGAL

A Report for the SIGMA Programme

by

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The system of local government

Structure

There are three categories of local authorities in Portugal:

- 4220 parishes ("freguesias");
- 305 municipalities; and
- the administrative regions.

Although regional authorities have been provided for in the Constitution, they have not yet been established. They are thus a goal which has not yet been achieved.

However, the freguesias are true local authorities, with elected bodies to represent their citizens. But, the freguesias exercise very limited functions in spheres coming within the control of the municipal authorities and which have been delegated by the municipal authorities, with their technical and financial support. Freguesias can be responsible for the administration of markets, the establishment and management of cemeteries, local tourism (promotion or information), administration of sports facilities, nature parks and recreation areas, pre-primary education buildings, social assistance, refuse collection, maintenance of roads and consumer protection.

The freguesias' most important income source consists of a share in the municipality's income. This amount, cannot be less than 10 per cent of the amount provided to the municipality by the Financial Equalisation Fund (FEF) for current expenditure. The apportionment to each freguesia of this amount is determined according to the following criteria:

- 10 per cent to be divided equally among all;
- 45 per cent directly proportional to population; and
- 45 per cent directly proportional to geographic area.

At the end of the 18th Century, there were 826 municipalities. This number was reduced during the 19th Century. In 1911, there were 291 municipalities and since 1950 only two more municipalities have been created.

On average, Portuguese municipalities have a geographic area of 322 sq. km. and a population of 32 000 inhabitants.

The following practical approach of this report concerns only the municipalities.

Functions

The local authorities' spending level is low. Local government's share of government spending is small; about 10 per cent of the whole public expenditure, excluding social security. While local government outlays increased rapidly in recent years, their share of the GROSS DOMESTIC PRODUCT (GDP) is only 6 per cent, reflecting the limited responsibilities held by municipalities in areas such as education, health, public housing or public security.

Municipalities are responsible for, namely:

- town planning;
- cultural, sports and recreational facilities;
- sewage disposal;
- waste disposal;
- water supply;
- refuse collection;
- public lighting;
- municipal road network;
- pre-primary and primary schools;
- school transport;
- promotion of tourism; aid for tourist development;
- urban public transport;
- environment and nature protection; and
- promotion of the social and economic local development.

The necessity of a radical break with the previous centralised government tradition and the affirmation of the principles of local government autonomy and independence were determinative of various specific choices in the Portuguese local government system after the democratic revolution of April 1974. Firstly, according to the general clause of territorial competence, municipalities are generally competent in matters of purely local interest. The domain and scope of autonomous local government activity are not directly determined by national government. Only where a law gives special competence to an authority other than the municipality in municipal matters are municipalities' powers removed or shared with other authorities. Secondly, there is no legal distinction between obligatory and voluntary expenditures. Thirdly, all functions carried out by municipalities are their own functions. They do not carry out functions delegated by central government.

An overview of the local finance system

Before the Revolution of April 1974, no autonomous local government existed and the system of local finance was based on a discretionary and arbitrary set of grants from the central government, usually earmarked for specific projects. After 1974, the political-administrative system was considerably altered. The Constitution defines the purpose of administrative decentralisation and contains many innovative principles concerning local government.

The Constitution also defines the framework within which financial powers should be exercised, these being:

- local authorities have property and finances of their own; and

- the local fiscal system should be established by law and should provide for the fair distribution of public resources between the state and local authorities (solidarity) and for the necessary correction of inequalities between local authorities of the same level (active equality).

The first *Local Finance Act* was a significant step towards true local autonomy. This law established some fundamental principles:

- local authorities have their own assets and finances, which shall be administered by their respective governing bodies;

- supervision of the management of local assets and finances shall be inspectorial and exercised only in the forms and the cases provided for by law;

- local authorities' financial autonomy is based on the governing body's power to formulate and approve the plans of activities, budgets, balances and accounts, to have their own revenues and expenditures, to manage their assets and to access the capital market;

- any transfer to the municipalities of new functions must be followed by the transfer of the corresponding financial means; and

- the rule prohibiting the allocation of specific grants from the State to local authorities, except in particular cases prescribed by law.

The municipalities' income consists, *inter alia*, of:

a) - local tax revenues;

b) - non-tax revenues:
- the proceeds from fees or charges for services rendered by the municipality;
- inheritances and other gratuities granted to the municipalities;
- income on their own assets;

c) - loans;

d) - transfers from the State, namely a share in the Financial Equalisation Fund (FEF); and

e) - grants allocated by EU structural funds.

The grant system

General purpose grant

The *Local Finance Act* prohibits the allocation of grants or subsidies from the State to local authorities, except in particular cases prescribed by law. This legislation preserves the autonomy and independence of municipalities. The Financial Equalisation Fund (FEF) is the main lump-sum grant, paid by the State to municipalities on an annual basis and corresponds to the amount which must be transferred from the State Budget to the municipalities. The FEF may be spent at the discretion of the recipient authorities.

Each year the *State Budget Act* fixes the amount of the FEF, taking account of the estimated percentage increase in revenue from the value added tax (VAT). This guarantees that the FEF is automatically up-to-date and adequate to the evolution of the economic activity and development of the whole country.

The FEF is apportioned among the municipalities according to the following objective criteria, as defined by law:

a) - 15 per cent to be divided equally among all municipalities;

b) - 40 per cent directly proportional to population;

c) - 5 per cent directly proportional to inhabitants under the age of 15;

d) - 15 per cent directly proportional to geographic area;

e) - 10 per cent directly proportional to the municipal road network;

f) - 5 per cent directly proportional to the number of parishes;

g) - 5 per cent directly proportional to a variable measuring accessibility; and

h) - 5 per cent directly proportional to the fiscal compensation index, based on the differentials between the per capita revenues from local taxes of each municipality and the average per capita revenues in the whole country.

The amount due to each municipality is published as an annex to the State Budget and transferred to municipalities in 12 instalments, no later than the 15th day of each month.

The criteria used to divide out the FEF are, clearly, largely based on indicators reflecting the costs borne by the municipalities, taking into account variations in need. Only the 5 per cent directly proportional to the fiscal compensation index has, as its purpose, compensation for variations and disparities in tax income. We feel that elements a) and h) could be replaced, in a future amendment of the *Local Finance Act*, by a more equalising element that would benefit only those municipalities with the lowest per capita tax bases, thereby reinforcing the equalisation of disparities in local tax incomes.

The FEF is not earmarked for specific expenditures, although *the State Budget Act* does set, each year, the percentages to be assigned to current and capital expenditure. In the case of the latter, the amount must not be less than 40 per cent.

Specific grants

Despite the general principle that the State must not provide specific grants to local authorities, central government may take extraordinary financial measures in exceptional circumstances, legally defined, such as:

- Public disasters;

- Municipalities disadvantaged as a result of extraordinary expenses resulting from central government investments, in particular, roads, motorways, ports, airports, dams;

- Recuperation of construction areas without planning consent, or of areas for urban renewal, when its cost exceeds the municipality's capacity;

- To overcome serious difficulties in the municipal public transport or fire services;

- Creation of new municipalities or parishes; and

- Elaboration of municipal master plans (up to 1992).

The State also awards another type of special grants to municipalities on the basis of contractual schemes, in support of local or regional development policies. This is done by concluding contracts-programmes with the municipalities concerned when the participation of both levels of government proves essential for the practical implementation of investments requiring means exceeding the municipality's technical and/or financial capacity. The types of investments eligible for these contracts-programmes cover a variety of fields, such as:

- Water supply and sewage disposal;
- Protection of the environment and natural resources;
- Transport, infrastructure and communications;
- Culture;
- Sport;
- Education;
- Housing;
- Promotion of economic development;
- Health and social security; and
- Municipal buildings.

Specific grants are given as proportional financing. Municipalities normally share in the investment costs. In general, the municipality's responsibility is close to 50 per cent. The main goal of these specific grants is to provide the physical infrastructure needed to promote development in areas with greater needs and fewer resources and to finance the municipal share of projects supported by EU structural funds. The system of State specific grants to municipalities is regulated by law that lists, for example, the special circumstances by which local authorities may obtain such grants, as well as the eligibility criteria and limits to the State's financial contribution.

The government departments in charge of each sector set the priorities and criteria for selecting projects eligible for funding. In the case of contract-programmes, the rights and obligations of both levels of government must be clearly and explicitly defined. All contracts drawn up are published in the Official Gazette.

In 1993, special grants accounted for less than 5 per cent of total budget transfers from the State to the local authorities. Portuguese municipalities also receive European Union grants through the Structural Funds, and, in particular, the European Regional Development Fund. EU grants account for approximately 12 per cent of total municipal revenues.

Local tax revenues

Portugal's Constitution requires all taxes to be regulated by Parliament. Municipalities do not have the power to create taxes or to define the essential elements of any tax. This power is reserved for Parliament, which determines the incidence, rates, deductions and safeguards for taxpayers. These taxes and rates, applicable to the whole nation, are attributed by law to all municipalities, without any regional differentiation. Local taxes are collected by the State Tax Office of the area and transferred, the following month, to the municipality to which the amount belongs.

The principal local taxes are:

° Rural and urban property tax, the **Rural** property tax represents less than 4 per cent of the total received from property tax;

° Tax on motor vehicles;

° Transfer duties;

° Municipalities also may levy a tax, an additional tax, not exceeding 10 per cent of the proceeds from the corporate income tax, on the portion relative to the income generated in the municipality concerned; and

° Municipalities are also provided with revenues representing 37.5 per cent of the value added tax (VAT) on tourism activities, which represents the only case of tax-sharing.

The system does not provide municipalities with real financial decision-making power. Municipalities have little powers to assess rate, or other concrete aspects, of the bases of calculating each tax, their only freedom being a little discretion over the rate of the **urban** property tax and the additional corporate income tax (in these cases, Parliament determines maximum rates and allows local authorities the discretion to choose the rate, always respecting the maximum).

The property tax is now based on the capital values, (and not, as before, on the rental value, which seem easier to estimate) determined at the central government level, according to State rules.

Control of local government finance

As previously stated, the FEF is applied according to strict and objective criteria. The amount received from the FEF may be spent at the discretion of the recipient municipalities. So, the actual Portuguese main grant system preserves the discretion of local authorities to determine their own spending priorities and does not allow the central government to control the level of local government expenditure.

The specific grants allocated through the contract-programmes method or supported by EU structural funds imply a framework of regional and sectorial aims and strategies. The definition of selection criteria and the determination of sectorial priorities are already defined in advance at the national level. But, the recourse to specific grants also depends on an agreement between both levels of government, a systematic approach and a convergence of points of view in the achievement of an aim accepted by both parties as being a priority interest, without their freedom of decision being denied.

Local government borrowings

Municipalities have access to loans in order to finance their capital spending, namely to finance their share of projects supported by EU structural funds. Short-time loans are authorised to bypass cash-flow difficulties, but at no time shall their amount exceed 10 per cent of the municipality’s share of the FEF. Medium and long-term loans may only be contracted for capital investments, to make social or cultural investments and to consolidate municipal finances. Annual charges (added to the charges on bonds) may not exceed the greater of 25 per cent of its share of the FEF or 20 per cent of its previous year’s investment expenditure.

Municipalities may borrow from any legally authorised credit institution. Most loans are contracted through the "General Deposit Bank" (Caixa Geral de Depósitos), a public sector bank. Loans obtained through private institutions must not result in higher charges or more difficult repayment conditions than those resulting from loans contracted for the same purpose through public banks. All the rules concerning local government borrowing are approved by law. As such, they are not directly linked to grants given by the Central Government.

Municipalities may also issue bearer bonds, in accordance with ordinary law. The Central Bank imposes no restrictions on bonds, other than the general requirements that must be met by economic operators wishing to have access to this form of financing.

BASIC DATA

Definitions:

° The General Government Account includes Social Security, State Budget and municipalities.

° The amounts are in Million contos:

1 Million contos = 1 Billion escudos;

1 Million contos = 5.7 Million US Dollars

1 Million contos = 5.1 Million ECU

° Current expenditure includes debt-interest payments

Capital expenditure does not include capital repayments

Table **I**

TAXES AND SOCIAL SECURITY CONTRIBUTIONS

Million Contos

	1986	1987	1988	1989	1990	1991	1992
GENERAL GOVERNMENT							
Direct Taxes	322.0	319.4	463.3	668.0	764.6	1 002.5	1 238.5
Social Security Contrib.	449.2	602.1	691.3	797.0	949.8	1 139.8	1 296.8
Indirect Taxes	767.9	804.8	1 002.8	1 104.5	1 308.8	1 435.9	1 790.4
TOTAL	1 539.1	1 726.3	2 157.4	2 569.5	3 023.2	3 578.2	4 325.7
LOCAL GOVERNMENT							
Direct Taxes:							
Property Tax	12.1	15.4	19.2	22.4	26.7	33.7	38.8
Vehicle Tax	2.1	2.4	2.8	3.6	4.4	4.7	7.5
Transfer Duties		12.6	22.4	30.7	38.9	41.3	49.5
"Derrama" Surplus on Corp. Income Tax	4.7	7.6	11.2	11.0	16.8	19.8	23.2
Other	0.8	2.5	3.0	3.7	2.1	1.3	1.0
Indirect Taxes:							
VAT/Tourism (shared)	2.5	2.3	3.6	2.9	5.4	4.9	5.3
TOTAL	22.2	42.8	62.2	74.3	94.3	105.7	125.3

Sources: OECD, Bank of Portugal (1992); DGAA (Local Gov.)

Table II

PUBLIC EXPENDITURE

Million Contos

	1986	1987	1988	1989	1990	1991	1992
GENERAL GOVERNMENT							
Current Expenditure	1 787.4	2 023.9	2 342.0	2 683.7	3 347.4	4 114.4	5 030.1
Capital Expenditure	151.9	224.4	267.9	287.7	299.0	357.9	448.0
TOTAL	1 939.3	2 248.3	2 609.9	2 971.4	3 646.4	4 472.3	5 478.1
LOCAL GOVERNMENT							
Current Expenditure	78.2	96.8	118.4	156.5	192.8	237.1	276.4
Capital Expenditure	57.5	77.3	106.7	137.1	148.2	198.7	244.6
TOTAL	135.7	174.1	225.1	293.6	341.0	435.8	521.0

Sources: OECD; Bank of Portugal (1992); DGAA (Local Gov.)

***Table* III**

TRANSFER PAYMENTS TO LOCAL GOVERNMENT

Million Contos

	1986	1987	1988	1989	1990	1991	1992
FROM THE STATE BUDGET							
General Grant (FEF)	78.3	89.5	91.2	107.6	128.4	157.5	180.0
Specific Grants	7.9	8.7	12.7	16.8	19.8	19.6	22.6
TOTAL	86.2	98.2	103.9	124.4	148.2	177.1	202.6
FROM THE EU	1.5	7.0	9.5	13.8	18.7	52.0	62.2

Source: DGAA

Table IV

LOCAL REVENUES AND EXPENDITURE

Million Contos

	1986	1987	1988	1989	1990	1991	1992
RECEIPTS							
General Grant (FEF)	78.3	89.5	91.2	107.5	128.4	157.5	180.0
Specific Grants	7.9	8.7	12.7	16.8	19.8	19.5	22.6
EU Funds	1.5	7.0	9.5	13.8	18.7	52.0	62.2
Charges & Property Inc.	16.8	22.8	29.7	35.9	42.0	56.3	72.3
Taxes	22.2	42.8	62.2	74.3	94.3	105.7	125.3
Loans	4.9	7.1	13.3	16.0	18.6	7.0	30.3
Other	9.3	12.1	16.7	23.0	26.5	50.2	43.5
TOTAL RECEIPTS	140.9	190.0	235.3	287.4	348.3	448.3	536.2
OUTLAYS							
Personnel	43.8	51.7	63.2	85.1	105.0	129.8	147.7
Goods & Services	19.6	26.2	32.8	43.0	51.9	63.4	76.6
Debt-Interest Payments	5.8	5.2	5.6	6.2	9.2	12.6	16.0
Investment	52.4	69.2	95.3	122.1	131.8	174.4	206.1
Capital Repayments	2.3	4.0	5.8	5.1	8.2	9.7	12.1
Other	14.1	21.8	28.2	37.2	43.1	55.6	74.6
TOTAL EXPENDITURE	138.0	178.1	230.9	298.7	349.2	445.5	533.1

Source: DGAA

***Table* V**

LOCAL INVESTMENT BY SECTOR

Million Contos

	1988	**1989**	**1990**	**1991**	**1992**
Land	3.8	3.7	3.3	6.1	6.5
Housing	7.7	13.5	13.6	17.2	17.0
Municipal Buildings	21.1	28.1	29.2	30.6	46.8
Sport, Culture & Education Equipment	5.1	9.2	13.9	23.4	19.7
Social Equipment	0.3	0.5	0.7	0.8	0.6
Transport Infrast. & Streets	14.4	19.4	22.3	30.3	37.6
Sewerage	6.9	8.0	8.6	12.4	14.0
Water Supplies	7.6	9.3	8.3	12.1	15.1
Mun. Roads	14.3	16.4	16.9	22.4	26.5
Waste	0.3	0.5	0.2	0.6	1.2
Transport Equipment	4.7	4.2	3.9	5.5	5.7
Other Equipment	7.4	7.8	8.9	10.5	11.7
Other	1.8	1.5	1.7	2.5	3.7
TOTAL INVESTMENT	95.3	122.1	131.8	174.4	206.1

Source: DGAA

Table VI

PUBLIC EMPLOYMENT

Thousands

	1986	**1988**	**1991**
Local Government	80	80	85
Social Security Adm.	21	20	21
Health	101	107	123
Education	187	210	247
Other	131	127	152
TOTAL	520	544	628

Sources: OECD; Ministry of Finance; DGAA (Local Gov.-1991)

STATE BUDGET SUPPORT TO LOCAL GOVERNMENT IN SWEDEN

A Report for the SIGMA Programme

by

Roger Pettersson

Ministry of Finance

Local government in Sweden

Historical background

Local government has a long tradition in Sweden, but the laws underlying the current system of local government go back only somewhat more than 100 years. The first such legislation is generally regarded to have been the *Local Government Ordinances* of 1862. This reform established rural municipalities on the basis of medieval parish boundaries. Secular affairs became the responsibility of rural municipalities, cities and the county councils, which were established at the same time. Ecclesiastical affairs were, from then on, handled by the parishes of the Swedish State Church.

The reform was brought about by rapid population growth, social transformation, introduction of compulsory elementary schooling and higher ambitions regarding poverty relief. The number of municipalities at that time totalled about 2 500. Since then, major boundary reforms, one in 1952 and the other in 1962-74, have reduced the number of municipalities. The reasons for the reforms were economic change and industrialisation, rapid economic growth, urbanisation and social problems stemming from population movements. This meant shrinking tax resources and declining economic viability for most municipalities.

The importance of local government has gradually increased. Today, local governments are one of the cornerstones of the Swedish welfare state. They account for about 70 per cent of the total consumption and investments in the public sector. Local governments supply a great deal of basic publicly financed services, ranging from medical care and schools to public transportation and technical services, like energy supply and sewage.

The structure of the local government sector

As mentioned above, there are two kinds of local government units in Sweden; the municipality (*kommun*), which is the smallest unit, and the county council *(landsting*), which is the regional unit. The county council normally coincides with the central government's regional administrative unit, the county (län). In addition, the Church of Sweden has a local unit, the parish (*församling*). This report, however, deals only with municipalities and county councils.

Sweden is divided into 24 counties, 23 county councils and 286 municipalities. (The island of Gotland and the second and third largest cities in Sweden, Göteborg and Malmö, do not belong to county councils. In these areas, the municipalities are responsible for tasks usually assigned to county councils).

Sweden has a territory of 450 000 square kilometres and a population of 8.7 million inhabitants. The average population density is 19 inhabitants per square kilometre, but the majority of the population is concentrated in the southern part of the country. Fifty per cent of the population lives in a geographic area representing 3 per cent of the territory, which is the most densely populated area. The population in the three metropolitan areas represents more than 30 per cent of the total population.

There are very large differences among Swedish municipalities, both in terms of population and territory. The most populated municipality is Stockholm, with about 693 000 inhabitants. The least populated is Bjurholm, with less than 3 000 inhabitants. The municipality covering the largest territory is Kiruna, with almost 20 000 square kilometres and the smallest is Sundbyberg, covering 9 square kilometres. In terms of population density, the difference is also very large. Arjeplog is the most sparsely populated municipality (less than 0.3 inhabitants per square kilometre) and the most densely populated is Stockholm (3 706 inhabitants per square kilometre).

Table **I**

Population range			**Number of municipalities**	**Population**
0	-	10 000	64	467 413
10 000	-	20 000	102	1 423 241
20 000	-	30 000	43	1 080 681
30 000	-	40 000	28	970 857
40 000	-	50 000	8	375 315
50 000	-	60 000	14	784 902
60 000	-	70 000	4	270 288
70 000	-	80 000	5	373 555
80 000	-	90 000	4	343 003
90 000	-	100 000	3	285 966
100 000	-	110 000	1	103 367
110 000	-	120 000	2	225 410
120 000	-	130 000	4	495 395
130 000	--		4	1 545 716
			286	8 745 109

The most populated county council is Stockholm with about 1.7 million inhabitants. The smallest is Jämtland, with about 136 000 inhabitants. The average county council serves 349 000 inhabitants.

The legal framework

The basic principles of local self-government are incorporated in the Swedish Constitution (the 1974 Instrument of Government). The importance and special role of local government is emphasised in the Constitution. But, it is mainly expressed in principle so that the extent of local self-government is essentially a political question.

The Instrument of Government states that democracy is to be realised through a representative and parliamentary polity and through local self-government. It also states that the power is exercised by elected assemblies.

The protection of the local right of taxation is also stipulated in the Instrument of Government and is a vital ingredient to self-government. The limiting of the local governments' right to levy taxes is, however, not clearly expressed and often proves to be a controversial question. During the period 1991-93, for example, the State (the central government) imposed a ban on tax rate increases for local governments. The ban, or "tax freeze", was subject to substantial debate. The types of taxes and the definition of the tax base is not regulated in the Instrument of Government.

According to the Instrument of Government the principles regarding taxation, obligations and powers, etc. shall be provided for by law (Acts of Parliament). This means that the Cabinet cannot force local governments to undertake a task without the approval of Parliament.

One such law regulating local government is the 1991 *Local Government Act*. The *Local Government Act* provides a framework for local democracy. It regulates the elected representatives' decision-making role, the organisation, the right to appeal a decision, referendums, financial administration provisions, etc. It also gives the local government the opportunity to finance operations with user-fees.

The *Local Government Act* grants municipalities and county councils a general power to engage in any matters of general concern connected with the geographic area of the municipality or the county council or with their members. Operations performed under the general powers provision are often referred to as voluntary activities, or the free sector.

The largest part of local government operations, however, are those activities based on special legislation. These specially regulated operations for local governments are referred to as compulsory activities.

The tasks of local governments

Accordingly, local governments' tasks can be divided into two distinct categories; those within the general power under the *Local Government Act* and those based on special legislation.

Municipalities

The municipalities have a very broad range of tasks, including important welfare functions, like care of the elderly and all education below university level. They also supply technical services, like garbage collection and water supply, and voluntary operations, like cultural affairs and parks.

***Table* II**

Municipal operating expenditures by different fields, as a percentage of total operating expenditures

	1985	1990	1992
Municipal administration	7	9	9
Labour market and business sector	4	3	3
Land and housing	7	7	8
Transportation and communication	5	5	4
Recreational and cultural affairs	7	7	6
Energy, water and waste management	15	9	7
Education	24	24	23
Social services	25	30	35
Environmental, health and protective services	6	6	5

Social services are available to anyone who needs them. The municipalities are responsible for providing these services under the *Social Services Act* of 1982. They consist mainly of child care, care of the elderly and disabled and assistance to individuals and families with specific problems.

Child care is a municipal activity which has expanded in recent decades. It includes pre-school programmes like: day-care centres, part-time playgroups and family day-care in private homes, as well as leisure time centres for younger school children. Fees are paid by the parents to cover a small portion of the costs.

Care of the elderly is, for the most part, comprised of various forms of domestic assistance and housing accommodation. For example, municipalities provide part-time domestic assistance through municipally-employed "home helpers". They also provide retirement homes or special apartments offering extra service and subsidise transportation. In 1992, the municipalities were given the responsibility for a large part of the medical care for the elderly. This was a county council task before 1992.

According to the *Social Services Act*, municipalities are responsible for helping people who cannot otherwise support themselves. The assistance must provide a reasonable standard of living. This can be done by financial or material help. The law guarantees the right for individuals to receive social assistance. This right can be enforced by bringing legal action in a court.

One of the municipalities' largest and most important tasks is the school system. They are responsible for operating the nine-year compulsory comprehensive school for all children aged 7 to 16 years and most of the upper-secondary school (gymnasium), as well as adult education.

Municipalities are also responsible for land use planning, supervision of construction activity and issuance of building permits. They are also required to eliminate unsanitary conditions, prevent diseases, and control hygienic standards, for example in stores and restaurants. Their environmental protection tasks also include street cleaning and garbage collection.

Fire protection, emergency service, disaster planning and civil defence are other tasks for which municipalities are responsible.

Municipalities also supply their inhabitants with technical services like water and sewage treatment systems and energy supply facilities. These services are, to a large extent, often financed by user-fees.

Also, municipalities are engaged in building and maintaining roads, parking lots and parks, operating public libraries, museums, tourist facilities, operating ports, sport facilities and supporting the work of local voluntary associations.

County councils

***Table* III**

County council expenditures by different fields, percentage of total operating expenditures

	1985	1990	1992
County council administration	3	2	3
Health care	78	77	74
Social welfare programmes	1	1	1
Services for mentally handicapped	8	9	10
Educational and cultural programmes	5	5	5
Miscellaneous programmes	6	6	8

The county councils' predominant task is health care. County councils are responsible for all health care in Sweden. This includes both medical care and preventative health care programmes. County councils are responsible for both outpatient (primary) care and inpatient (hospital) care. Except for a small number of private hospitals the county councils own and operates all hospitals in Sweden. The county councils are also responsible for financing medical care supplied by private practitioners.

The health care system operates on three levels; district, county and region. Primary care is provided mainly at district health centres. County medical care is provided at the county's central or district hospitals, which provide "basic" specialities. Regional medical care is provided at the regional hospitals, which offer all types of specialist care and more advanced medical facilities.

The county councils also provide dental care for children and specialist dental care for adults. Dental care for adults is provided by county councils and private practitioners and is financed by the public dental insurance system.

The county councils are also responsible for psychiatric care and care and assistance to the mentally handicapped. These tasks are, in part, currently being transferred to the municipal social services (in the same way as medical care for the elderly was transferred to municipalities in 1992).

Education in the health care field, except for physicians and dentists, is also provided by the county councils at their nursing schools.

County councils also support various cultural events, like regional music and theatre activities.

Regional and local public transportation systems in each county are generally operated on a large scale by municipalities and county councils through jointly-owned companies.

Organisation and political structure

A basic feature of Swedish local government is that it is managed by directly elected representatives. The elected decision-making bodies are called the municipal council (*kommunfullmäktige*) and the county council (landstingsfullmäktige). General elections to the councils take place every third year, at the same time as the parliamentary election.

The highest executive body in local governments is the executive committee. The executive committee is elected by the council and its tasks are to co-ordinate municipal or county council activities, to be in charge of economic affairs, monitor operations that are carried out by government companies, etc. Most issues upon which the council makes decisions must be handled first by the executive committee.

The 1991 *Local Government Act* gives local governments a greater degree of freedom in organising their local structure and work. Previously, local governments were required to have certain committees, but today municipalities and county councils mainly decide for themselves which committees they want and what their responsibilities should be.

Since the introduction of the new *Local Government Act* there has been a substantial development towards different organisational models. Most changes tend to be towards more market oriented and decentralised solutions.

Local government economy

Local government revenue and expenditure

The total expenditures of the Swedish local governments amounted to 27 per cent of the GDP (Gross Domestic Product) in 1992. Local governments represent 39 per cent of the total public expenditure and accounts for 69 per cent of the total consumption and investments within the public sector.

Table **IV**

Local government revenue and expenditure
Skr billion, current prices

	1975	1985	1990	1992	1992 % of GDP	1994 (1)
Revenue (2)	66.6	228.7	332.8	399.2	28	382.6
Taxes	33.9	123.0	204.9	269.3	19	255.8
State grants	18.9	64.6	81.9	79.3	6	76.4
Other	13.8	41.0	46.0	50.6	4	50.4
Expenditure	70.1	232.7	341.1	383.3	27	370.4
Transfers to households	5.6	16.3	25.5	36.6	3	33.1
Other transfers	7.5	21.8	31.3	42.4	3	38.7
Consumption	47.3	173.2	265.7	282.0	20	278.4
Investment	9.7	21.4	18.7	22.2	2	20.2
Financial balance	-3.5	-4.1	-8.3	16.0	1	12.2
Gross Domestic Product	300.8	866.6	1 359.9	1 439.8		1 501.6

1) Forecast in Supplementary Budget Bill, April 1994

2) Fees are normally subtracted from the expenditures for consumption (according to National Accounts principles) and not included as revenue. This means that they are not included in this table as revenue. In 1992, the fees amounted to Skr 26.4 billion.

The financial balance in the local government sector improved in 1992 to a surplus of about 16 billion kronor after continuous deficits since 1985. The improvement came from a marked decrease in costs, due to an appreciably slower rise in wages and prices and a sharp increase in tax revenue. The asymmetry between revenue and expenditure came from the two-year lag in the payment of tax funds. This meant that the funds paid out to municipalities and county councils in 1992 were based on the situation in 1990, when economic activity was generally high.

Local governments started to cut back on consumption in 1992. This is a tendency that is expected to continue. Employment will probably decrease. Poor development in tax revenues and State grants necessitates further economic restraint.

In order to compare local government finances with those of the central government and the Social Security sector, the figures for 1992 are displayed in Table V:

Table **V**

Central government revenue and expenditure
Billion kronor 1992, current prices

Revenue	377.7
Taxes and charges	314.4
Capital income	40.9
Other	22.4
Expenditure	539.8
Transfers to households	152.1
Transfers to Social Security	30.0
Other transfers	90.6
Grants to local governments	65.1
Consumption	113.1
Investment	16.7
Interest expenditure	72.2
Financial balance	- 162.1

Social Security revenue and expenditure
Billion kronor 1992, current prices

Revenue	233.9
Social security charges	151.4
Central government transfers	30.1
Capital income	52.4
Expenditure	194.7
Transfers to households	160.0
Grants to local governments	14.2
Other transfers	14.9
Consumption	5.2
Investment	0
Interest expenditure	0.3
Financial balance	39.2

Local government employment

About 28 per cent of the labour force works in local governments. Local governments are, thereby, the largest employer within the public sector. Among those employed by local governments 80 per cent are employed in health care, social services and education. Almost 80 per cent of the local governments' labour force are women.

Table **VI**

Total labour force and employment in the public sector
1 000 persons

	1970	1980	1990	1993
Total labour force	3 912	4 234	4 550	3 957
In public sector	805	1 300	1 437	1 316
share, %	21	31	32	33
In local governments	560	981	1 156	1 119
share, %	14	23	25	28

The number of employees in the public sector and in local governments has decreased since 1990. But, since employment has decreased even more in the private sector, the share of the labour force employed in the public sector has increased. During the 1980s, the number of employees increased at a rate of 10 000 persons per year. After 1992, the number of persons employed in municipalities steadily decreased each year.

Local government taxation

Tax bases and tax rates

The largest source of income for the municipalities and county councils is local income tax, which, in 1992, amounted to Skr 270 billion. This means that 67 per cent of total revenues were tax revenues. In an international comparison, a very large part of local government revenues comes from their own tax base. Local government tax revenues in 1992 corresponded to 19 per cent of the GDP.

As mentioned above, the local governments' right to levy taxes is stipulated in the Constitution. The kind of taxes local governments can levy and the definition of the tax bases is not regulated in the Constitution, but must be specified in laws. Limitations on the right to levy taxes are, therefore, a political question to be decided by Parliament.

Since 1991, the local government tax base consists of employment income (including pensions) of the individuals in the municipality or the county council.

Before 1991, the local tax base included corporate income, certain real estate taxation and individual capital gains tax. After a major tax reform in Sweden in 1991, local taxation is a pure taxation of employment income. It includes income in the form of ordinary salaries and wages and other income that is not classified as corporate income. This means that business income earned by individuals (unlike business income earned by corporations) is taxed in the same way as income from employment.

When corporate income was excluded from the tax base and the real estate taxation was abolished, the State paid compensatory grants for a period of time.

The aggregate effects of the 1991 tax reform were increased local tax bases and higher costs for the central government. In order to establish a balance, local governments had to pay an accounting tax to the central government. This payment from local government to the central government was abolished in connection with the 1993 State grant reformation.

Local income tax is not proportional. The same proportion of taxable income is taxed, regardless of the amount of taxable income.

The tax rate each year is decided upon by the municipal councils and county councils. In the past couple of years, there has been a limitation on local governments' right to decide their tax rate. From 1991 to 1993, there was a temporary ban on increases in local government tax rates (a "tax feeze"). This was imposed by the central government in order to control the overall tax burden and to restrict the growth of the public sector. The tax freeze is no longer in force, beginning in 1994, but there is a financial incentive not to raise the 1994 tax rate.

Tax revenues for municipalities and county councils are determined both by the amount of taxable income (the tax base) and the tax rate. There are large variations both in tax bases and in tax rates among different municipalities and county councils. The tax base, per capita, (tax potential) for municipalities vary from 72 per cent to 163 per cent of the average tax base, per capita. The largest tax potentials are found in the metropolitan areas and large cities, and the lowest are those in rural areas, especially in northern Sweden.

Table VII

Relative tax base per capita (tax potential) for Swedish municipalities.
100 = average tax base per capita

Range of tax potential	Number of municipalities	Population
70 - 80	16	157 230
80 - 90	108	1 522 098
90 - 100	105	3 636 207
100 - 110	36	2 000 433
110 - 120	13	380 046
120 - 130	5	924 490
130 --	3	124 605

The tax rate of local government has been raised gradually in relation to the overall expansion of the public sector. The variation of tax rates between different municipalities and between different county council is considerable. The municipality of Täby, which is a suburb of Stockholm, has the lowest total local tax rate, 26.47 per cent and Kristinehamn, in the County of Värmland has the highest, 33.47 per cent. This means that the tax rate faced by citizens varies by 7 per cent depending on where in Sweden they live.

Table VIII

Average tax rates of local governments in Sweden, percentage

Year	Munici-palities (1)	County councils	Total (2)
1970	12.67	8.06	21.00
1975	14.35	10.21	25.23
1980	15.52	12.61	29.09
1985	15.99	13.30	30.38
1990	16.02	13.96	31.16
1994	18.47	11.44	31.05

1) Malmö, Gotland and Göteborg excluded
2) Including parishes

As mentioned above, there was a transfer of responsibilities from county councils to municipalities in 1992. This transfer was accompanied by a transfer of tax rate from county councils to municipalities. Consequently, there is marked shift in the tax rates between 1990 and 1994 as in Table VIII.

Table **IX**

Range of total tax rate, percentage	**Number of municipalities**	**Population**
26 - 27	2	86 237
27 - 28	1	53 509
28 - 29	6	813 106
29 - 30	17	854 073
30 - 31	55	1 826 806
31 - 32	73	2 502 497
32 - 33	99	2 097 924
33 - 34	33	510 957

Tax administration

Tax collection is carried out by the central government through the National Tax Board, which is a central administrative authority. The municipalities and county councils (and parishes) then receive their share of the tax funds from the central government. There is a problem connected to the fact that the definite taxable income (the tax base) of a specific year is not known until one year after the end of the year in which the income was earned. This means that there is a two-year lag before the local governments know their definite tax revenues.

In 1993, the method for payment of these tax funds was changed. Before 1993, the advance tax payments were based on the tax base of the previous year (adjusted for population growth) and the tax rate decided upon for the year in question. The difference between the advance payments and the definite tax revenues was paid in settlement payments when the definite tax revenue was known. The new method for payments is based on a forecast of the average growth of the tax base and the tax rate decided upon for the year in question. The settlement payments are supposed to be smaller. The advantage of the new method is that local government revenues and expenditures are calculated at the price level of the same fiscal period.

Changes affecting the local tax base

Since the tax base is determined by the central government, the question of how to handle gains or losses of tax revenue, resulting from decisions by Parliament, is often raised.

Beginning in 1993, several changes have been made. A number of steps have been taken in recent years to cut State budget expenditures or to raise State budget revenues. These decisions expanded the local government tax base, but, in order to neutralise the effect, the central government introduced a special tax deduction. Since 1993, the effects of decisions to increase or decrease the local tax base have been calculated and neutralised towards the local government sector. The total effect has been calculated for the total sector (the effect of each decision for each local government has not been estimated) and then deducted from the tax payments for every municipality and county council by a certain amount, per capita.

The most important decisions since 1993 affecting the local tax base are:

Decision:	Effect on tax base:
Abolished standard deduction	increasing
Lowered basic deduction	increasing
Introduction of deductible fees	decreasing
Lowered pension benefits	decreasing

The total effect of these, and other, decisions since 1993 has been larger tax bases for local governments.

In order to keep local government tax rates down when the tax freeze was lifted in 1994, the central government refrained from giving a deduction for the lowered basic deduction if the individual municipality or county council did not raise their tax rate. This was a way of giving local governments a financial incentive to keep down the tax burden on the Swedish economy.

State budget support to local governments

State grants to local governments

A substantial part of local government revenues comes from central government grants (State grants). Grants accounted for 26 per cent of municipalities' total revenues in 1992. The corresponding figure for county councils is 15 per cent. All these grants are paid by the central government from the State budget.

The dependency upon revenues from grants varies among different municipalities and county councils. Some municipalities get a little more than 50 per cent of their revenues from State grants, while a few get less than 10 per cent. Most municipalities, however, receive 20 per cent to 35 per cent of their revenues from State grants.

***Table* X**

Share of revenues from State grants	**Number of municipalities**
> 50 %	4
> 40 %	32
> 30 %	119
> 20 %	248
> 10 %	284

Central government grants to local government are given for a great deal of different purposes and in a number of different forms. The central government has attached different purposes with different grants. Giving grants has been a way for the State to steer local governments, either for the purpose of stimulating the extension of prioritised fields and activities or to give weak local governments general financial support.

State grants are usually divided up into general and special grants. Before the reformation of the grant system, carried out in 1993, the majority of local governments' revenues from grants were special grants. Special grants are given both to compulsory and to voluntary operations and are earmarked for special purposes. They are usually related to the scope of the activities and, in certain cases, to its quality. Special grants have often been introduced with the objective of stimulating local governments to expand and maintain certain services. Some special grants have been aimed at supporting local governments as part of the central governments overall economic and labour market policy (fiscal policy).

General grants are aimed at equalising different financial conditions among different local governments, usually due to large differences in tax potential or costs. Quite often, general grants are given to regions traditionally regarded as poor. The grant is not connected to any special activities and can be used by local governments, according to their own preferences. The general State grants are mostly made up of the tax equalisation grants, the new block grant for municipalities.

***Table* XI**

Major State grants to local governments

State grant	Central government fiscal year, Skr billion		
	1990/91	1991/92	1992/93
Tax equalisation grants	18.2	20.8	14.9
New State grant to municipalities	-	-	18.6
Grant for the health-care system (county councils) (*)	15.0	14.5	10.3
Child care	12.2	13.0	11.4
Education	32.7	31.0	22.3
Reception of refugees	2.6	3.4	3.2

*) This grant is partly a transfer from the Social Security sector

General grants are not linked to directives as to their use. Local governments can use these funds to finance their operations in the way they consider best. General grants are often given according to the financial situation of the local governments. They are mostly designed to give general financial support and to even out disparities in financial conditions between local governments.

***Table* XII**

General and special state grant to local governments, percentage share of total grants

	Central government fiscal year			
	1990/91	1991/92	1992/93	1993/94 (*)
General grants	31	31	41	65
Special grants	69	69	59	35

(*) forecast

The tax equalisation system

Before 1993, a tax equalisation system was in place for municipalities. It is still in force mainly for county councils. This system was aimed at reducing the differences in tax potential and costs of local governments. The components of the system were the regular and the extra tax equalisation grant and the general and the progressive tax equalisation charges.

The purpose of the tax equalisation was to enable local governments to maintain a fairly even standard of activities irrespective of factors beyond their control.

The regular tax equalisation grant was paid to municipalities and county councils whose tax potential (tax base, per capita) was below a guaranteed base. This guaranteed base was fixed in advance in law and had a clear profile in terms of regional policy.

In addition, local governments could receive an extra tax equalisation grant upon application to the central government. This grant was paid out in special cases and was supposed to eliminate the shortcomings of the regular grant.

General tax equalisation charges were levied on all municipalities and county councils in order to finance the rising costs of the tax equalisation grants. The charges were paid as a percentage of the tax base. In 1992, the charge was 1.15 per cent for municipalities and 0.92 per cent for county councils.

Municipalities with a very high tax potential also had to pay a progressive tax equalisation charge. This charge is often referred to as the 'Robin Hood-tax'.

The largest tax equalisation grants were paid to municipalities and county councils in the northern parts of Sweden. The last year the tax equalisation system was in effect for both municipalities and county councils was 1992. The cost of the regular tax equalisation grants in 1992 was Skr 15.0 billion for municipalities and Skr 7.1 billion for county councils. Another Skr 231 million were paid as extra tax equalisation grants. Central government revenue from the general tax equalisation charges was Skr 8.1 billion for municipalities and Skr 5.9 billion for county councils. The progressive tax equalisation grant brought in Skr 664 million, and was paid by 41 municipalities.

Special grants

Before 1993, there were a multitude of different special grants. Most of these were tied to specific areas and were paid out based on the produced amount of specific services.

The most important special grants were for schools, childcare and care of the elderly. The following description of the most important grants serves as an example of how special State grants work.

The most important grants, by far, were the special grants for schools. Those grants were earmarked for compulsory comprehensive schools, upper secondary schools and adult education. In the fiscal year 1991/92, these grants amounted to more than Skr 34 billion. The grants for schools had, in 1991, been put together and were paid out as a sector grant, which was distributed according to general criteria and estimated needs. This was a way of adapting the grant system to the ideas underlying the later reformation of State grants in 1993. Before the sector grant was introduced, grants were paid out according to student numbers in different school-years which were supposed to cover teachers salaries, standard amounts per student, special grants for temporary teachers, special grants for education of certain minority groups, amounts per student and teaching hours, percentages of salary costs, etc.

Central government grants to municipalities for child care are typical grants intended to promote expansion of a certain prioritised activity. Parliament had, in 1985, adopted guidelines saying that it should be possible, by 1991 at the latest, to offer every child a place in the municipal child care system. The municipalities received a special grant for every fifteen children registered. The day-nursery had to be open for at least eight hours a day in order to qualify for a grant, which was a way of securing a certain standard in childcare. Also included in the grants were funds for continued education and training of personnel and for special projects for children needing special support. In the fiscal year 1991/92, municipalities received Skr 13 billion for childcare.

Special grants were also given for the provision of domestic assistance in the homes of the elderly and handicapped. Municipalities received an amount based on a standard price per unit of labour actually worked in this service. They also received a grant for transportation services for the handicapped, covering a certain percentage of the costs. In 1991/92, these grants amounted to Skr 3,9 billion and Skr 706 million, respectively.

Municipalities which have reached agreements with the central government, through the Swedish Immigration Board, for the reception of refugees receive compensation for their costs from the central government. These municipalities receive compensation based on a fixed amount per refugee or person applying for asylum. Since the central government is responsible for the reception of refugees, the local governments can be regarded primarily as agents of the central government and this particular grant is compensation for a service that the municipalities are providing, on behalf of the central government.

The grant for the health care system is given to county councils. It was, from the beginning, a special grant paid out mainly according to the amount of services supplied. For example, payments were based on the number of patients and number of days in care. The distribution of the largest part of the grant was changed during the 1980s and is now distributed according to the population and the need for resources, roughly estimated by four indicators (mortality, sick-leave, early retirement and percentage of the elderly living alone). This now means that the grant for the health care system is mainly distributed as a general grant.

Reformation of the State grants to local governments 1993

A new system for State grants to municipalities was introduced in 1993. Some changes regarding the grants to county councils were also made at the same time.

The background is that the local government sector had to be adapted to the economic room available for the public sector in the total economy. The grant system had to be designed to provide incentives to local government to shape operations in accordance with the overall economic situation. In order to make the sector as efficient as possible, the local governments needed more freedom to make their own priorities.

The idea that local governments should have as large a part of the total sum of grants at their own disposal as possible is also a question of improving the conditions for local self-governance.

The central governments' need to direct local governments by financially supporting prioritised activities had also diminished as municipalities reached a satisfactory public service level. There was no need or economic possibility to expand local government operations (as described above, this is the main purpose of giving special earmarked grants).

Since 1993, most of the special grants from the central government to municipalities were abolished, along with the tax equalisation grant in effect at that time. At the same time payments from the local governments to the central government were abolished, like, for example, the tax equalisation charges. A new block grant (called the 'equalisation grant') was introduced to replace old grants. The amount of this new general grant was calculated as the net of the grants being abolished and the former payments from municipalities to the central government.

Since 1993, a reduction in the overall State grant budget was made, as an economic measure, which amounted to Skr 5.2 billion for the municipalities. A reduction of Skr 2.3 billion for the county councils was made for the same reason. Together, the State budget was cut by Skr 7.5 billion beginning 1993.

***Table* XIII**

The State grant reformation 1993, Skr million

State grants that were abolished:	
General grants:	
Tax equalisation grant	15 646
Extra tax equalisation grant	167
Compensatory grant for the abolition of local taxation of corporate income	879
Special grants:	
Child care	13 961
Care of the elderly	6 484
Transportation of the elderly and disabled	552
Road maintenance	836
Education	30 484
Other special grants	412
Payments from municipalities to the central government that were abolished:	
General tax equalisation charges	- 7 464
Progressive tax equalisation charges	- 663
Accounting tax	- 9 267
Expenditures for housing allowances and municipal housing supplement (the responsibility was taken over by the central government)	- 7 145
Net grant	44 882
Cut in budget for State grants	- 5 183
New State grant for municipalities, 1993	39 699

The reform resulted in about 75 per cent of the value of all State grants to municipalities being transformed into a block grant.

When Parliament approved this reform, guidelines were also drawn up for situations when arguments for special grants still should prevail. Special grants should still be used when local governments provide a service for which the central government is primarily responsible. A typical example is when municipalities receive grants for the reception of refugees. In this case, they act as agents of the central government. For supporting time-limited investments, special grants also apply. Another situation is when the central government gives grants to local governments as part of their overall labour market policy.

The new State grant system for municipalities

The new State grant (the equalisation grant) paid on a block-grant basis is not tied to any rules regulating its use. It is to be regarded as a general source of finance and a complementary revenue to tax revenues.

The total cost of the new State grant is decided and fixed by the central government in advance. The distribution of the grant to each municipality is then calculated according to this total budget framework. This means that the total cost is known by the central government in advance and does not deviate from the amount fixed in the State budget. The Cabinet has made a policy statement that the total framework for the block grant for the near future should be fixed in nominal terms.

The overall objective of the distribution of the equalisation grant is to offer municipalities the same financial conditions to provide the same services to citizens.

The distribution of the block grant consists of three parts:

- revenue equalisation, which aims at equalising differences in the tax potential between municipalities;

- structural cost equalisation intended to even out differences in the cost structure that local governments cannot themselves resolve; and

- a supplement paid to municipalities which have a rapid, long term depopulation.

Revenue equalisation

The revenue equalisation system is based on disparities in tax potentials between different municipalities. The tax potential is the aggregate taxable income in the municipality per capita. Differences in tax potential mainly depends on the income level and the percentage of the population with paid employment.

A guaranteed level of tax potential is calculated on the basis of the available budget for the equalisation grant. The level is expressed as a percentage of the average tax potential for all the municipalities in Sweden (which for 1993 was estimated at Skr 91 968 and for 1994 was estimated at Skr 95 192). For 1993, the guaranteed level was 128 per cent and for 1994, it is 125 per cent of the average tax potential. Each municipality is, by revenue equalisation, guaranteed a minimum tax potential. If an individual municipality has a tax potential of 93 per cent, they get an additional tax potential of 32 per cent of the average tax potential. Thus, the lower the municipality's taxation resources, the higher the additional tax potential it will receive. The result is that the sum of the tax potential and the additional tax potential of all municipalities will be equal (except for a few municipalities with tax potentials above the guaranteed level, which will end up with an even higher tax potential).

If the guaranteed level was set to the average tax potential (100 per cent), there would not be an equalisation of tax potential since municipalities with tax potential above the average would have a higher tax potential than municipalities receiving additional tax potential through the revenue equalisation system. The revenue equalisation system does not reduce the tax potential of municipalities with high tax potential (there are no tax equalisation charges in the new State grant system). This means that municipalities can keep tax potentials above the guaranteed level. An equalisation of the average tax potential would require a scheme (like tax equalisation charges) to reduce tax potentials above the average.

In order to fix the contribution from the revenue equalisation, the additional tax potential is multiplied by a tax rate. The tax rate applied in the revenue equalisation system is fixed by the Cabinet.

The largest revenue equalisation grants are received by municipalities with a poor tax potential.

Charts demonstrating the principal workings of revenue equalisation are found in Table I and Table II.

Structural cost equalisation

To create equal financial conditions for municipalities, it is not enough to even out differences in tax potential. Differences in municipal expenditures, to a certain extent, depend on factors beyond the control of the individual municipality. Those differences are due to structural differences, such as age structure of the population and geographical conditions within the municipality.

There are a lot of different conditions that municipalities cannot influence, but that have a considerable impact on municipal costs. The most obvious connection is that between age structure and the demand for public services. The demand for elder care programmes depends on the percentage of elderly people in the municipality. Also, if there is a large number of children and a high rate of labour market participation by women in the municipality, there is an increased demand for child care. A large percentage of children also requires more resources for schools.

Large distances within the municipality increase costs for school buses and domestic assistance for the elderly and disabled. Overcrowding and dense population means higher costs for building and maintaining roads.

The social structure of the municipality also affects the demand for municipal activity, as, for example, social assistance to drug addicts and individuals who cannot support themselves.

The new block grant is a system aimed at equalising such differences in expenditure due to structural differences. In this system, municipalities with structural costs above average gets a supplement to the revenue equalisation grant and municipalities with structural costs below average get a deduction from their revenue equalisation grant. Technically, it is designed as a scheme where municipalities with low structural costs subsidise municipalities with high structural costs. The total turnover of this system is about Skr 5 billion.

It is well known that there are a large number of structural factors affecting municipal expenditure. But, it is difficult to determine what these factors are and what importance each factor should be given in the system. The aim has been to design a system based on objective factors that are impossible for a municipality to influence.

The method that was chosen to determine the factors is based on regression analysis. Factors that might explain the differences in expenditure between municipalities were analysed on the basis of the correlation between the factors and total municipal costs per capita. The factors that were chosen were climate, population density, age structure and social structure.

The result is a structural cost index indicating each municipality's structural costs relative to the average. The range of this index is from 86 per cent to 152 per cent of the average cost.

The largest contributors to the structural cost equalisation are the municipalities in southern Sweden. The average structural cost index is 94 per cent for the municipalities in the County of Halland. The municipalities in the northern parts of Sweden gain the most from the structural cost equalisation. The average structural cost index for the municipalities in the County of Norrbotten is 119 per cent. The variation in the index is mainly due to the climate factor.

Supplement for population reduction

In addition to the main parts of the equalisation grant system, 24 municipalities receive a supplement for depopulation. These supplements amount to about Skr 20 million and are given to municipalities with a population decrease of more than 2 per cent.

Provisional rules for the new State grant

Although the introduction of the system for distributing the new equalisation grant has formally been decided, there are provisional rules in force from 1993 to 1995. The purpose of the provisional rules is to avoid drastic changes in individual municipality's revenues from one year to another, during the interim years. The rules, as they are designed for 1993 and 1994, are supposed to permit a gradual introduction of the new grant system.

The meaning of those rules is that the results (that is the difference between what the municipality got from the old system and what they get from the new grant) may not, for 1993 and 1994, deviate by more than 1.5 per cent per year of total revenues from local tax revenue and state grants. For 1995, the same amount is paid out as in 1994.

Problems connected to the new grant system

When the new grant system was introduced it was already heavily criticised. The concept of a block grant without any connections to actual operations was welcomed and widely accepted. The principles for distributing the grant, however, were subject to considerable debate.

The most criticised feature was the design of the structural cost equalisation. The concept of equalising structural expenditure enjoys strong support, but it has proved very difficult to find the correct factors to explain the differences in cost structure. The system has to be based on factors and methods that are both understandable and practically applicable. The regression analysis used in the current structural cost equalisation was not generally understood and the factors that were chosen are not regarded as explaining the differences in cost structure. When Parliament approved the grant system, a special committee was appointed, by the government, to review this part of the system. The committee suggested a new system for the structural cost equalisation representing a more intuitively understandable method and a more thorough analysis of possible factors. Their proposal is mainly based on calculations of unit-costs for different local government activities and, for some activities, on regression analysis.

Another problem is that municipalities with tax potential above the guaranteed level do not contribute to the revenue equalisation system. There are three municipalities in the country that have a tax potential above the guaranteed level. If the total budget for the equalisation grant is fixed in nominal terms an increasing number of municipalities will be in this situation, because the guaranteed level will decline with economic growth and inflation (which means higher total tax bases). Different suggestions for dealing with this problem have been put forward, but, most of them involve considerable changes to the new system.

An imperfection in the revenue equalisation system is that the fixed tax rate, which is multiplied with the additional tax potential, is higher for some municipalities than their own tax rate. Consequently, they actually gain if their tax potential is decreasing and lose if their tax potential is increasing. This is a result of the fact that the additional tax potential is worth more than their own tax potential. This (minor) problem applied to 29 municipalities in 1994.

The fixed tax rate is different for each county. The reason for this is that the transfer of responsibilities and the consequential transfer of tax rates varied among counties. The different fixed tax rates, however, are a temporary solution. Ideally, structural differences in expenditures (whether they occur in activities that have been transferred from county councils or not) should be handled by the structural cost equalisation. The fixed tax rate applied in the revenue equalisation should be uniform for all municipalities.

In 1994, a parliamentary committee of enquiry was appointed for dealing with the problems mentioned above. At the same time, provisional rules for 1995 were approved by the Parliament. The committee is also going to consider how the grant system for county councils should be reformed.

The grant system for county councils

When the grant system for municipalities was reformed in 1993, there were only limited changes made in the State grants to county councils. One reason for this is that the largest grants given to county councils were already general grants.

The tax equalisation system is still in force for the county councils, although the tax equalisation charges have been abolished.

Six special grants were abolished beginning in 1993, representing a value of Skr 1.3 billion. The grant for the health care system, which is considered to be a general grant, was increased by the same amount. There was also a reduction in the total grant budget for county councils.

The future design of the grant system for county councils has been studied by a commission. These ideas have recently been presented to the parliamentary committee of enquiry, mentioned above, for further consideration.

Table I

This chart shows the principles of the revenue equalisation.

The bottom area represents the own tax revenue which equals the tax potential of the municipality multiplied by the tax rate.

The top area represents the revenue equalisation grant which equals the additional tax potential multiplied by the fixed tax rate.

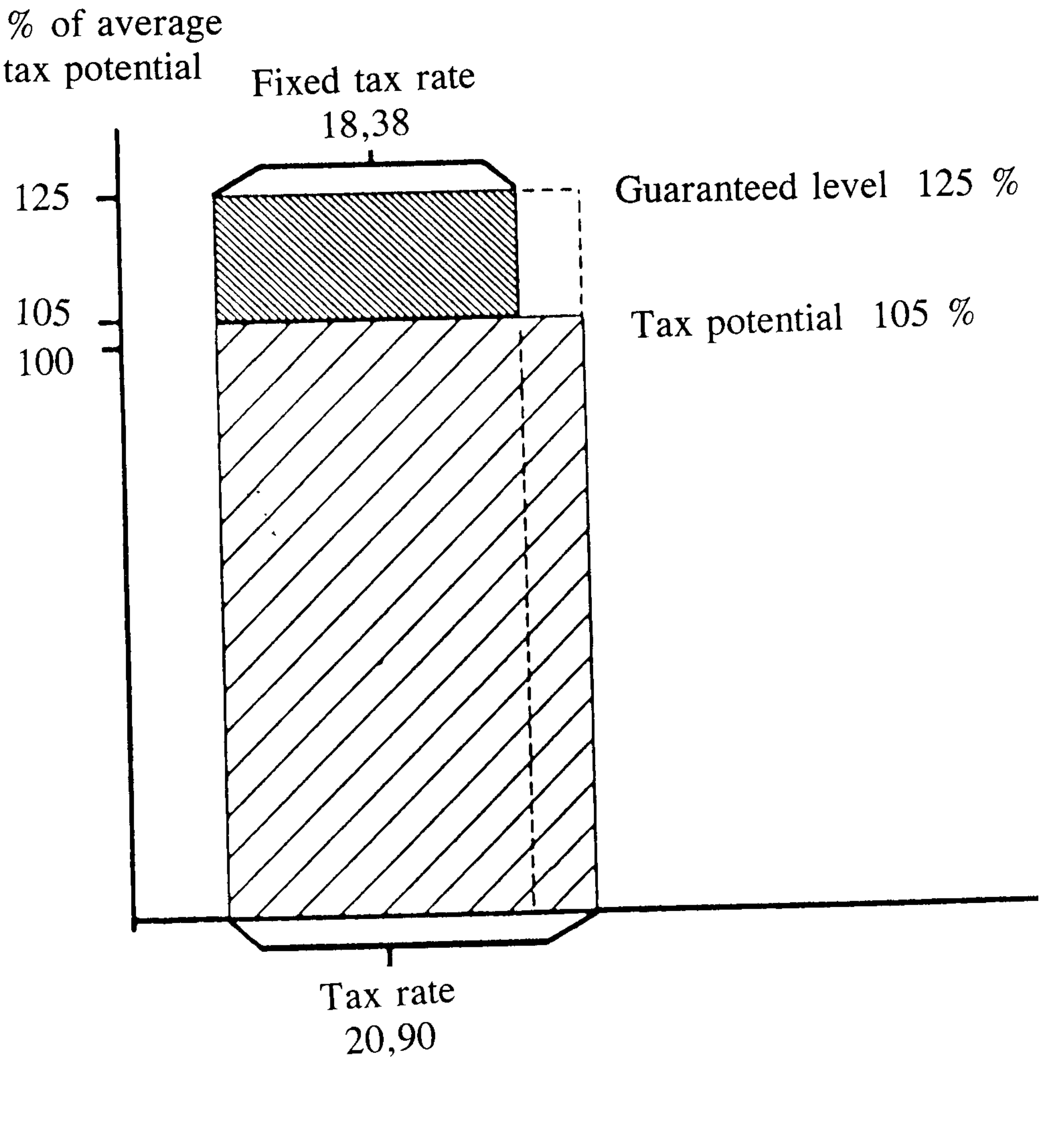
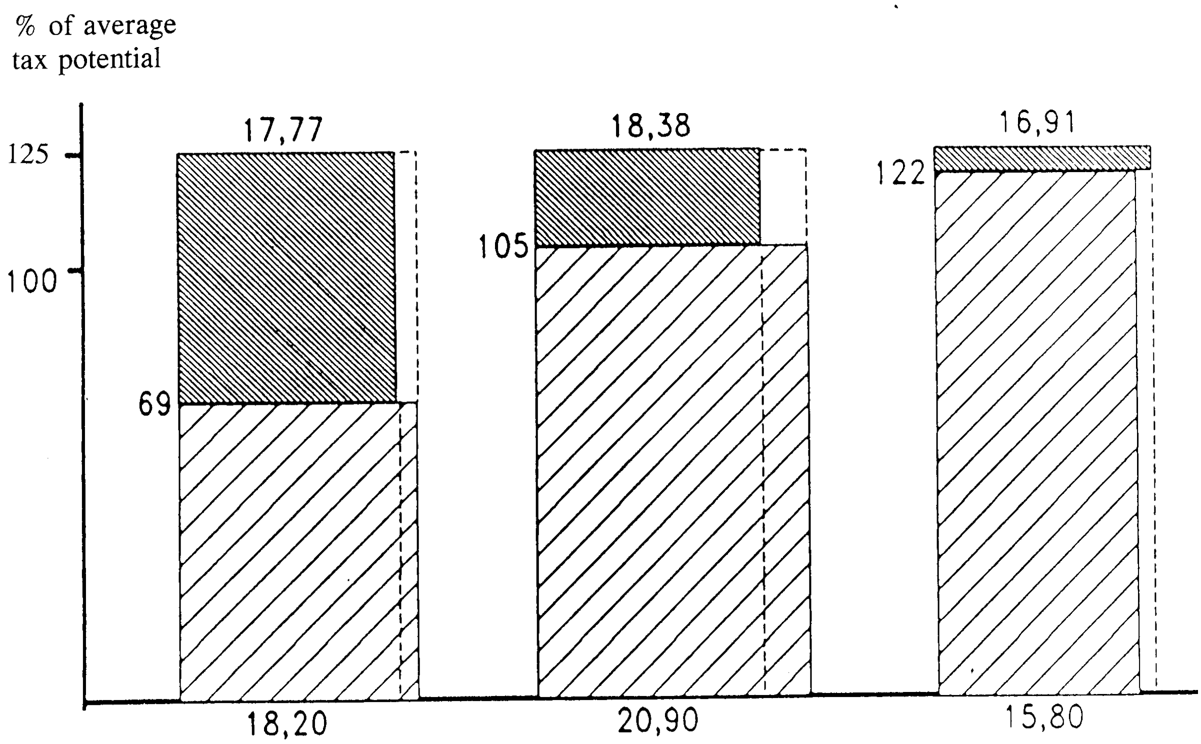


Table **II**

This chart shows the revenue equalisation for three different municipalities.

The use of different fixed tax rates is a temporary solution (see page 123 in the report).



STATE BUDGET SUPPORT TO LOCAL GOVERNMENT IN THE UNITED KINGDOM

A Report for the SIGMA Programme

by

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The system of local government

Structure

Although the United Kingdom has a single Parliament and national Government, England, Scotland and Wales have separate local government systems. They broadly undertake the same functions and are financed on similar principles, but with a different structure of local authorities.

England and Wales

England and Wales are divided territorially into

Greater London comprising 33 Boroughs

6 Metropolitan Counties comprising 36 Districts

47 "Shire" Counties comprising 333 Districts

Greater London and the Metropolitan Counties have only one tier of elected, all-purpose local authority: the London Borough and the Metropolitan District. There are a few single-purpose joint authorities running common services such as police, fire, refuse disposal and public transport at county level, but no county council as such since the abolition of the Greater London and Metropolitan County Councils in 1986.

The Shire Counties have a two tier system with elected, multi-purpose authorities at both County and District levels; (proposals are under consideration to replace this with a single tier, but these have not reached a decision). The relationship between tiers is non-hierarchical. Functions are divided between counties and districts; each has a directly elected council, levies taxes on the same base and receives grants in respect of its statutory tasks.

In rural (and some urban) areas there is a third territorial level known as the Parish, (legally and geographically distinct from the ecclesiastical parish). Parishes are entitled to elect councils, to levy a small tax and spend it on supplements to local services. They have no mandatory duties, however, and receive no financial support from the national government.

Several districts, both metropolitan and shire, have the title of City conferred by Royal Charter. This makes no significant difference to their functions or financial base.

Scotland

Scotland is divided into

9 Regions comprising 53 Districts

3 Islands

Regions have a two-tier system similar to the Shire Counties in England and Wales (though also currently under review). The Islands have single-tier, all purpose authorities.

Size and Population

British local governments serve relatively large areas and populations by international standards. Even the lower tier Shire Districts have an average population just under 100 000. The details of population and geographical size are given in Table I.

Functions

The major statutory responsibilities of local government and their distribution in England and Wales are given in Table II. They include primary and secondary education, police and fire protection, personal social services and highways. (The National Health Service is not a local government responsibility. It operates through deconcentrated Health Authorities and quasi-independent Trusts).

Central-local financial relations

National policy

For the last fifteen years, at least, central-local financial relations have operated within a framework of national economic policy which has sought to restrain levels of public expenditure, public sector borrowing and taxation. These have been reflected in restrictions on local tax rates and total levels of local government expenditure, both current and capital. Some have been implemented through direct legal controls, others through the leverage of the grant structure. At the same time, official policies have generally proclaimed a desire to preserve the discretion of local authorities to determine their own spending priorities within these overall limits.

Taxation

Local taxation has had a chequered history in Britain, with a number of changes over the past five years. Until 1989, local authorities levied a tax on both residential and business property. In 1990, the Government assumed the power to set the rate of the tax on business property and to distribute the proceeds to local authorities on the basis of population, rather than geographic origin. The tax on residential property was abolished and replaced by the infamous Community Charge - a flat rate tax on all adults imposed and collected by individual local authorities. The Charge - popularly known as "Poll Tax" - was extremely unpopular. It was abolished, in turn, in 1993 and replaced by the Council Tax, a modified form of property tax on residential premises.

As a result of these changes, local taxation currently comprises two forms of tax on property; the Non-domestic Rate and the Council Tax.

The Non-domestic Rate is levied on all land and buildings occupied for non-residential purposes, i.e. shops, factories, offices, etc. Valuations are carried out by the National Inland Revenue and the tax rate set annually by the Government at a uniform national level. The tax is collected by district councils, but redistributed on a per capita basis. In two-tier areas the per capita share is split between counties and districts according to the ratio of their Standard Spending Assessments (see below). It is, therefore, a **shared tax,** although distributed 100 per cent to local government.

The **Council Tax** is levied by local authorities on residential properties. Houses and apartments are valued in eight broad bands according to their approximate market value. A tax rate is set for each band, but subject to a fixed statutory ratio between bands. Valuations are carried out by the National Inland Revenue. Each tier of local authority, county, district/borough, parish and joint authority, levies its own rates on the common base, but the cumulative tax is collected and distributed by district/borough councils.

All other taxes in Britain accrue to the Central Government and are not subject to any specific sharing. The main sources are personal and corporate income taxes, excise and customs duties and VAT, together with National Insurance Contributions levied on both employers and employees as a percentage of salary. The distribution of tax revenues between levels of government is shown in Table III.

Agricultural land is exempt from the Non-domestic Rate, but not farm buildings. Foodstuffs are exempt from VAT (except where converted into restaurant meals). In all other respects agricultural workers and activities are subject to the same taxation as other citizens and occupations. For example, farming is subject to income taxation and farm houses to Council Tax.

Expenditure

With major responsibilities in fields such as education, social services, public protection and transportation, local government expenditure represents approximately 27 per cent of all public expenditure and 14.7 per cent of GDP. Local authorities employ roughly 2.8 million people, including teachers and police, representing 8.5 per cent of the national workforce. The distribution of public expenditure between central and local government is shown in Table IV, the functional breakdown of local government expenditure in Table V, and the distribution of expenditure between types of local authority in Table VI.

It is worth mentioning at this stage that the Government has imposed overall restrictions on local government spending in recent years. Current expenditure is "capped" by means of ceilings. Under current restrictions, current expenditures must not exceed the Standing Spending Assessment used for grant calculations (see below) by more than 12.5 per cent. There are also limitations on authorities spending below this, related to the percentage increase year-on-year. There are also restrictions on the levels of capital spending financed through capital receipts or borrowing (but not from reserves or revenue). These are also described below.

Intergovernmental Transfers

Governmental grants have played a major role in financing current expenditure by local authorities, but a lesser part in capital financing. The totals for the last decade are shown in Table VII, and their overall role in the funding of local government are shown in Table VIII. Current grant funding remained fairly constant in real terms until 1991. Then it increased substantially in an effort to reduce the rates of the Community Charge in response to public hostility and the run-up to the 1992 General Election. Capital funding also increased significantly in 1992 as a result of an expanded national road improvement programme adopted for counter-cyclical reasons.

The current grant system

The current grant support comprises a block grant, known as the Revenue Support Grant (RSG) and a number of specific grants. The Revenue Support Grant represents over 80 per cent of current grant support.

Revenue support grant

The key to the calculation of the Revenue Support Grant is the Standard Spending Assessment (SSA). This is the Government's estimate of what each local authority should be spending on running services (excluding capital expenditure, but including debt service), bearing in mind :

- its particular range of functions;

- standard indices of service needs; and

- types of local characteristic affecting service costs.

The Government then deducts from the SSA, in respect of each authority:

(i) its projected share of the Non-domestic Rate; and

(ii) the product of its Council Tax, **if** levied at a uniform standard rate of tax, (i.e. not at the rate of tax actually chosen by the local authority).

The residual deficit constitutes the Revenue Support Grant. As a result, the grant for an individual local authority is:

SSA minus (Non-domestic Rate plus Council Tax at standard rates)

To calculate SSAs, the Government first determines a Total Standard Spending (TSS). This represents the overall target for local government current expenditure within the Government's macro-economic strategy. In practice, it is largely derived historically. The previous year's total is the base, adjusted for (i) inflation (usually projected conservatively), (ii) any transfer of task to or from Government, (iii) any expenditure arising from new national policies, and (iv) efficiency savings which the Government thinks possible. In 1994/1995, for example, the TSS is based on the 1993/1994 total plus 2.3 per cent, adjusted for changes in function.

The TSS is then divided into functional blocks according to the Government's assessment of the relative spending needs of individual local authority functions. The 1994/1995 division is :

	Per cent
Education	40.1
Personal Social Services	15.0
Police	13.6
Highways	4.1
Debt Service	4.5
Fire	2.7
Other Services	20.0
	100.0

Each of these functional blocks of expenditure is then disaggregated to the level of individual local authority by indices relevant to its own characteristics. These are explained in the following paragraphs.

The **Education** component is subdivided into Primary Education (40.2 per cent), Secondary Education (42.8 per cent), Post-16 Education (6.2 per cent), Under 5's Education (5.6 per cent) and Miscellaneous (5.2 per cent). Each local education authority is then apportioned a share of the overall funding for each sub-component according to the following factors :

- relevant age group population;
- additional spending needs, based on numbers of children of lone parent families, families on income support and of foreign origin;
- population sparsity;
- entitlement to free school meals (based on income support); and
- area cost adjustments.

(Area cost adjustments, common to all SSA sectors mainly benefit local authorities in areas with above average labour costs, i.e. London and the South East). The percentage weighting of these factors in 1994/1995 in respect of Primary and Secondary Education is :

	age group %	additional needs %	sparsity %	free meals %	area costs %
Primary	76.4	15.7	1.4	2.1	4.3
Secondary	76.5	16.1	1.3	2.0	4.0

The **Personal Social Services** component is divided into four categories: children (34.5 per cent), elderly people in residential care (17 per cent), domiciliary services to the elderly, and other services (mainly to physically and mentally handicapped people). The portion for children is disaggregated by a Children in Need Index, which is based mainly on the number of children of lone parent households, families on income support, and living in rented accommodation. The subcomponents for services to the elderly are based on weighted population (65-74 = 1, 74-85 = 5, 85+ = 21), multiplied by coefficients representing numbers on income support, with long term illnesses and (in respect of domiciliary services) living alone. The Other Services category is based on the 18-64 population, with weighting for adverse housing conditions and foreign origins.

The **Police** component is calculated according to the numbers of police in each Force approved by the Home Office multiplied by a standard unit cost. It relates to 50 per cent of these costs, the balance being met by specific grant (see below).

The costs of **highway maintenance** are attributed as follows :

	per cent
Weighted road lengths	58.3
Traffic density	22.2
Population (including daytime inflow)	11.1
Incidence of snow	5.5
Area costs	2.8

Road lengths are weighted by an index distinguishing between principal and other roads, and those running through built-up and non built-up areas (i.e. roughly urban and rural).

The **Other Services** allocation is divided between Districts (74.3 per cent), Counties (21.7 per cent), and some minor supports for rail subsidies, flood defence and coastal protection (4 per cent). London Boroughs and Metropolitan Districts get both the district and county allocations for their areas as single tier authorities. Seventy-five per cent of the allocation is based on weighted population calculated according to :

resident population

+ 25 per cent of daily in-commuters
- 25 per cent of daily out-commuters
+ 50 per cent of night-time visitors
+ 16.67 per cent of daytime visitors.

The remaining 25 per cent is allocated according to factors relating to exceptional population density or sparsity and socio-economic conditions. The result of these calculations is a wide range of per capita allocations varying from £103 in shire counties/districts to £277 in inner London boroughs.

The **Capital Financing** element covers local authorities' debt service obligations. It is based on the levels of outstanding debt on loans contracted with approval (the system of credit control is explained in the Capital Financing section below). The resulting expenditure is assessed at 4 per cent of outstanding debt for repayment, plus interest at prevailing average interest rates.

It must be remembered that these calculations are not equivalent to the size of the grant. They yield an assessment of total spending need (SSA) from which the notional product of the Council Tax and the share of Non-domestic Rate are deducted. The residue is the Revenue Support Grant.

Most of the individual indices used for calculating SSAs have not been based on specific costing exercises. They are mainly derived from a regression analysis of local government expenditure in each sector, attempting to identify the relative weight of factors, producing variations in spending patterns.

The SSA formulae analyse the spending needs of local authorities according to the demand and cost characteristics of individual sectors. The resultant grant, RSG, is not hypothecated, however. It is a block contribution to total current expenditure. Local authorities are not obliged to allocate their current budget expenditure according to the sectoral breakdown of their SSA. The latter is a device for determining the relative needs of individual authorities, not for controlling their budget allocations.

Specific grants

Earmarked grants represent just under 20 per cent of grant support to current expenditure. Of these, 60 per cent comprise a Police Grant estimated to meet half the costs of county police forces at staffing levels approved by the Home Office, (the remainder counting as part of SSA). A further 11 per cent reimburse local authority costs in administering the Magistrates' Courts and Probation Services. Fifteen per cent are Community Care grants. These relate to a newly devolved responsibility for subsidising the costs of residential care for elderly people, previously met through the national Social Security system. They are regarded as a transitional funding mechanism, pending absorption of the costs in the Revenue Support Grant. Five per cent support special Government sponsored schemes in the field of education and training. There are also a number of "agency" payments, e.g. for the costs of administering a system of national subsidies to the housing costs of low income persons. Specific grants must, of course, be spent on the subjects for which they are allocated.

Capital Finance

General

The issues of local authority credit and capital grants raised in the Terms of Reference can only be understood within the overall framework of capital finance in British local government. This framework is largely determined by national policy.

The Government's primary objective in the control of local government capital funding is to limit the Public Sector Borrowing Requirement. To this end, it restricts the levels of borrowing by local authorities to those covered by Basic and Supplementary Credit Approvals. It also requires local authorities to devote 75 per cent of receipts from the sale of houses and flats and 50 per cent of receipts from the sale of other assets towards redeeming existing loans (these receipts are substantial in the case of boroughs and districts which are compelled to sell rental housing to tenants wishing to purchase).

Basic Credit Approvals

To achieve these goals, the Government issues Annual Capital Guidelines to each local authority. These estimate capital spending in four blocks: Housing, Transportation, Personal Social Services and Other Services. The projected yield of Capital Receipts (i.e. the balance of 25 per cent from housing sales and 50 per cent from other asset sales), is deducted and the balance constitutes the Basic Credit Approval (i.e. a permitted level of borrowing from whatever source).

The Annual Capital Guidelines, like the SSA in respect of current spending, are based on different sectoral criteria. A total for all sectors is derived from overall national public expenditure targets, and allocated to sectors according to national priorities. The individual sectoral blocks are then disaggregated to individual local authorities' Guidelines by varying criteria. They are briefly:

(1) **Housing**: an index of need, based on factors such as the incidence of homelessness and the condition of the housing stock, but modified by Ministry judgement on the efficiency and effectiveness of local authority housing management.

(2) **Transportation**: proposals from local authorities are assessed according to priorities for improvements to routes of regional/national importance, relief to through-traffic in towns, inner city improvement, road safety, the facilitation of public transport and the structural renovation of roads and bridges.

(3) **Personal Social Services**: weighted population (0-15 = 1, 16-64 = 2, 75+ = 4).

(4) **Education**: additional school places in areas of population growth, reorganisations needed to eliminate surplus school places, improvement of substandard premises.

(5) **Other Services**: Population, except in Metropolitan districts where allocation is based on shares of unemployment.

The Basic Credit Approval authorises local authorities to borrow up to the stated limit, but does not compel them to do so. Nor do they have to follow the sectoral breakdown of the Annual Capital Guidelines. They can spend more funds on one sector and less on another, if they wish. Like the SSA, the Guidelines attempt to determine relative spending needs but not to preempt local priorities. They also exclude capital spending from reserve balances from their restrictions.

Supplementary credit approvals

However, the Government also issues Supplementary Credit Approvals to cover sectoral expenditures, in addition to those included in the Annual Capital Guidelines. These are strictly earmarked for stated purposes, e.g. improvements to waste disposal, special programmes in respect of mental illness and AIDS, and improvements to housing estates. These are meant to implement specific national priorities.

Loan finance

Basic and Supplementary Credit Approvals limit overall levels of borrowing, but local authorities are free within these limits to borrow from whatever source they please. Local authorities are free to issue stocks and bonds, providing they have the consent of the Bank of England, which is mainly concerned with the timing of issues and "queuing". Stocks and bonds normally have fixed maturity dates and are issued at a price slightly below nominal price. Traditionally such stock and bonds were at fixed interest rates, but, since 1977, variable interest rates have been permitted and increasingly offered. They are normally issued at a prevailing market rate, but indexed to the movement in Treasury Bill rates.

The alternative sources of loan finance are banks, internal borrowing (against dedicated reserve funds) and the Public Works Loans Board (PWLB). The latter is a statutory body, whose members are appointed by the Government, but drawn largely from City of London financiers and local government financial managers. The Board borrows money from the National Loans Fund, the channel through which the Government borrows from the market for all public sector purposes. The Board then lends to local authorities and related organisations.

The PWLB's scale of operation provides lending with a marginal advantage in terms of interest rates and some saving in the administrative costs associated with bond and stock issues. In recent years, local authorities have increasingly directed the bulk of their borrowing to the Board, whose loans now represent 71.5 per cent of all outstanding debt by local authorities, compared with only 33.8 per cent in 1982. A further 14 per cent is covered by internal lending, and the balance by banks and the money market. All local authority external borrowing is from the capital market, directly or indirectly, and on market conditions. Most local authorities operate a Consolidated Loans Fund, so that individual loans are not tied to individual capital projects.

Capital Grants

Grants for capital expenditure are only significant in two sectors. The first sector is **transportation**. Local highway authorities (i.e. counties, London boroughs and metropolitan districts) submit annual Transportation Improvement Programmes to Government. On the basis of its assessment of these programmes against its national priorities, the Government awards capital grants, the balance of approved programmes being covered by the Basic Credit Approval. In the case of **housing,** the Government provides funds to enable local authorities to make grants to private houseowners to renovate substandard housing stock.

Administration

The Revenue Support Grant is distributed by the Department of the Environment (the Ministry responsible for local government, housing, physical planning and environmental issues), which is also responsible for the overall system of Capital Expenditure controls. Sectoral ministries (e.g. Education and Transport) allocate earmarked grants and sectoral credit approvals. The overall size of grants and credit approvals and the principles of allocation have to be negotiated with the Treasury (the Ministry of Finance), in view of its overall responsibility for the national budget and macro-economic policy.

Appraisal

Introduction

This appraisal addresses three issues raised by the Terms of Reference. These concern the impact of the state support system on :

(1) the ability of local authorities to finance adequately the tasks for which they are responsible;

(2) equalisation in relation to both expenditure needs and resources; and

(3) the balance between central control and local discretion.

These are all issues which have aroused great controversy in Britain in recent years.

Adequacy of state support

The “agency” functions performed on behalf of central government, such as motorway maintenance and distribution of further education scholarships and housing benefits, are directly and almost fully reimbursed. They do not form part of either local authority budgets or the grant structure (except in relation to their administration costs). Students certainly consider the funding inadequate, but this is purely a matter of national policy and has nothing to do with central-local financial relations.

With these exceptions, it is impossible to distinguish between delegated and autonomous functions. Local government has no general competence, only a wide range of powers and duties conferred by law, with varying degrees of specificity over the standards to be achieved. Most state funding is also multi-purpose by nature. It is not really possible to compare levels of expenditure with state support on an individual functional basis. It is necessary to compare overall spending needs with the overall level of resources available to local government, taking into account grants, the Non-domestic Rate share and the permitted levels of local taxation and borrowing.

The Government would certainly argue that the present level of local government expenditure is the maximum the country "can afford" in the present economic climate, and is "enough" if local authorities are "efficient". These are all qualitative judgements which local government representatives hotly dispute and which are difficult to assess objectively. A number of points can be made, however.

Firstly, SSAs are not based on systematic costs. They are derived from historic aggregates and patterns of allocation. Regression analysis aims to produce relative indices of spending needs, not absolute figures.

Secondly, for local government as a whole, the overall level of expenditure is largely determined by the year-to-year variation in the Total Standard Spending, the size of the overall cake. This largely depends on the Government’s projection of the rate of inflation and possible efficiency savings. Local government has argued strongly in the past that the Government underestimates the rate of inflation. Indeed, it is virtually compelled to do so since official inflation projections are themselves inflationary (being used extensively in wage bargaining). National assessments of potential efficiency savings have been considerably influenced by falling school populations, but these do not, in practice, yield commensurate reductions in educational expenditure.

For individual local authorities, the level of resources is determined both by the overall Total Standard Spending and by changes in the calculation of SSAs, i.e. by the size both of the whole cake and their share. The methods of calculation have changed constantly from year to year, with frequent variations in the weight factors carry, such as "additional educational needs". The Audit Commission has demonstrated the instability of SSAs and criticised the system for its adverse impact on financial planning and management.

Whether the quality of services has benefited or suffered from the system is difficult to judge objectively. Table IV shows that current expenditure has grown in real terms by 19 per cent over the decade to 1992, while capital expenditure has fallen. This might support an intuitive judgement that local authorities have generally been able to respond to rising demand for routine services, but that needs for major infrastructural renovation (of housing or school buildings, for example) are not being adequately met.

Equalisation

The British system attempts a more complete equalisation of needs and resources than any other system. It is intended to enable every local authority to provide the same level of service for the same local tax rates.

Equalising resources is the more straightforward process since local authorities have only one direct tax source, and the base is assessed on a common basis by a national valuation service. Non-tax revenues from charges, leasehold rents, etc. are excluded from the grant calculation, however, and are not 'equalised'.

The system also provides for a strong differentiation of expenditure needs. In 1994/1995 average SSAs' per capita vary between areas as follows:

	£
Shire counties	702
Metropolitan counties	832
London	1,053

There are further variations, some large, between local authorities **within** each category. Per capita SSAs in London, for example, range from £703 in Richmond to £1 627 in Tower Hamlets.

Population weighting by age group is a major factor in the calculation of the largest components of SSAs (Education, Personal Social Services and Other Services) and represents a fairly incontrovertible index of spending need. Certain social indices, particularly the incidence of lone parent households, income support claimants and foreign origins, also play a recurring and substantial role. They are more difficult to connect to actual service costs and their weighting in the formulae is subject to continual change. This suggests a measure of uncertainty about the extent of their significance in service costs. They are also a convenient lever for moving resources between areas.

Central control and local discretion

The Government has continually emphasised that the grant system is designed to establish relative need for state support, but not to curtail local autonomy in deciding on levels and directions of expenditure. A number of features of the system appear to support this claim:

(1) Local authorities can set their tax rates above or below the levels used for grant calculation, and their non-tax revenue does not affect their grant support.

(2) Over 80 per cent of current grant support is not hypothecated. Functional spending needs are assessed in its calculation, but do not have to be carried over into its budgetary allocation.

(3) In the case of capital expenditure and credit controls, a similar position is taken. Sectoral indices are used in setting Annual Capital Guidelines, but their breakdown does not have to be observed by the local authorities.

(4) The apparent objectivity of the grant formulae should protect local authorities from political discrimination.

(5) There are mandatory consultations between the Government and the local authority associations before annual grant settlements, and a good deal of day-to-day negotiation between officials in both camps. The Government has been prepared to accept the Associations' recommendations over some elements of grant distribution completely.

In practice, the freedom of local authorities to determine their **overall level** of spending has been severely curtailed. In the case of current expenditure, the "capping" provisions now impose constraints on almost all classes of authority. SSAs may be only notional, but the Audit Commission has demonstrated the growing convergence of actual budget levels with SSAs. Although they can vary expenditure through the Council Tax rates, these form so small a percentage of their budget that highly disproportionate raises are required to finance increases in spending level.

There is more freedom to vary the **directions** of local spending, and patterns do indeed differ substantially between authorities. However, sectoral ministries and interest groups continually highlight any underspending on particular services in comparison with SSAs, and local authorities fear future restrictions on their discretion, although any intention to impose such restriction is denied by the Government.

Although the Associations are consulted over the grant settlements, their representations have had little impact on decisions over aggregates, as opposed to distribution. (Indeed, their influence over distribution is undermined by differences of opinion and interest between associations). The total size of the Revenue Support and other grants is not indexed to any exogenous factor and Government's discretion is absolute. Moreover, the apparent objectivity of the formulae conceal some highly subjective judgements over the impact of particular characteristics on spending need. Distribution is volatile and does reflect frequent changes in national preference and priority.

Conclusion

It is difficult to fault the logic of the grant support system. As already mentioned, it goes further than any other system in trying to match needs and resources, both systematically and comprehensively. A recent opinion survey showed that most local authorities support the basic design of the system, while complaining about its detailed application to their own circumstances. Despite the erosion of the local tax base and the absence of statutory guarantees, the overall funding system has actually provided local government with expanding resources in real terms over the last decade. Whether these have been sufficient to meet expansion in public needs depends on political judgements over which there can be no consensus. Apparent objectivity has not eliminated political preference, but that will be no surprise to any student of central-local relations.

Central and Local Government Budgets as percentage of GDP, 1992

	Central Government	Social Security	Local Government
Compulsory Payments	34.1	7.3	14.7*
Public Expenditure	23.9	7.8	14.0
Transfers to Local Government	11.8		
of which: Grants	9.2		
Shared Taxes	2.6		

* = including grants

***Table* I**

SIZE AND POPULATION OF LOCAL AUTHORITIES

TYPE OF COUNCIL	NUMBER	AVERAGE AREA SQ. KMS.	AVERAGE POPULATION	POPULATION RANGE
ENGLAND AND WALES				
Shire County	47	3 035	687 815	113 300 - 1537 000
Shire District	333	428	97 079	22 100 - 384 400
Metropolitan District	36	194	309 597	156 300 - 998 200
London Boroughs	33	48	205 024	132 200 - 319 200
SCOTLAND				
Regions	9	8 021	560 767	102 100 - 2344 600
Islands	3	26 527	24 233	19 300 - 31 000
Districts	53	1 362	95 225	10 000 - 715 600

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]

Table II

FUNCTIONS OF LOCAL AUTHORITIES IN ENGLAND AND WALES

FUNCTION	SHIRE COUNTY		METROPOLITAN COUNTY		LONDON	
	COUNTY	DISTRICT	DISTRICT	JOINT	BOROUGHS	JOINT
Social Services	*		*		*	
Education	*		*		*	
Libraries	*		*		*	
Museums & Art Galleries	*	*	*		*	
Housing		*	*		*	
Planning: Strategic Local	*	 *	*[11] *		*[11] *	
Development Control		*	*		*	
Highways	*		*		*	
Traffic Control	*		*		*	
Passenger Transport	*			*		*
Sports Facilities	*	*	*		*	
Parks	*	*	*		*	
Refuse Collection		*	*		*	
Refuse Disposal	*			*[12]		*[12]
Consumer Protection	*		*		*	
Environmental Health		*	*		*	
Police[13]	*			*		
Fire	*			*		*

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]

11 In London and the Metropolitan Counties there are Joint Committees of the Boroughs and Districts to co-ordinate physical planning at county level.

12 Some Metropolitan District and London Borough Councils undertake their own refuse disposal, opting out of the joint arrangements.

13 Police forces are established in each county or group of counties. They are overseen by Police Authorities, which consist two-thirds of members appointed by the constituent Shire County or Metropolitan District Councils, and one-third by representative Justices of the Peace. Police Authorities appoint Chief Constables who have sole operational command of their force. Funding is shared 50:50 between the constituent Councils and the Central Government. London does not have a Police Authority; the Commissioner of the Metropolitan Police is accountable directly to the Home Secretary, the Minister responsible for law and order.

Table III

DISTRIBUTION OF TAXES BETWEEN CENTRAL AND LOCAL GOVERNMENT / 1983-92

£ billion

	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**
CENTRAL GOVERNMENT	80.6	86.6	94.6	99.6	107.8	119.0	130.1	149.9	159.6	161.0
LOCAL GOVERNMENT										
Direct Taxes	12.2	12.8	13.6	15.2	16.8	18.7	20.5	13.8	8.3	8.0
Shared Taxes								10.4	14.0	13.3

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]

Table IV

DISTRIBUTION OF PUBLIC EXPENDITURE BETWEEN CENTRAL AND LOCAL GOVERNMENT / 1983-92

(at constant 1985 prices) £ billion

	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**
Central Government										
Current	127.2	131.7	134.1	135.7	137.1	132.9	131.6	143.7	148.7	158.3
Capital	6.1	6.6	6.9	6.3	5.8	6.4	8.3	13.4	11.6	14.5
Local Government										
Current	37.4	37.8	37.9	39.1	40.0	40.4	40.5	41.7	43.4	44.6
Capital	5.0	5.6	4.5	4.6	4.6	3.1	4.4	5.4	4.5	4.7

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]

Table **V**

LOCAL AUTHORITY CURRENT EXPENDITURE, 1992 BY FUNCTION

GOODS AND SERVICES	**%**
General Public Service	3.8
Public Order	
Police	9.5
Fire	2.1
Law Courts	1.1
Education	33.6
Social Welfare	
Concessionary Fares	0.7
Housing Benefit Administration	0.4
Personal Social Services	9.4
Housing and Community Amenities	5.5[1]
Recreation and Cultural Affairs	3.6
Transport and Communication	3.0
Miscellaneous	3.6
SUBSIDIES	
Passenger Transport	0.5
Other Economic Services	0.5
PERSONAL GRANTS	
Higher Education	4.3
Rent Allowances	10.8
DEBT SERVICE	7.6
	100.0

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]

(1) Excludes maintenance of rental housing and related debt service which is met from rental income.

Table VI

DISTRIBUTION OF LOCAL GOVERNMENT EXPENDITURE BETWEEN LEVELS IN ENGLAND AND WALES, 1993-94

	%
LONDON BOROUGHS	15.5
METROPOLITAN DISTRICTS	21.2
SHIRE DISTRICTS	8.4
SHIRE COUNTIES	49.9
JOINT AUTHORITIES	5.0
	100.00

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]

Table VII

CENTRAL GOVERNMENT GRANTS TO LOCAL AUTHORITIES, 1983-92

(at constant 1985 prices) £ billion

	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**
CURRENT	20.7	21.0	20.4	21.1	21.5	20.3	19.5	21.1	23.9	27.1
CAPITAL	0.3	0.7	0.7	0.9	0.9	0.9	1.7	1.4	1.7	5.3

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]

Table VIII

PERCENTAGE DERIVATION OF LOCAL AUTHORITY CURRENT REVENUES, 1983-92

	1983 %	1984 %	1985 %	1986 %	1987 %	1988 %	1989 %	1990 %	1991 %	1992 %
LOCAL TAXES	33.8	33.8	34.3	35.7	36.6	38.6	39.6	23.2	13.0	11.8
SHARED TAXES								17.5	22.3	19.6
GRANTS	51.9	52.5	51.4	50.9	50.8	48.6	46.7	46.8	53.5	58.7
GROSS TRADING SURPLUS	0.9	1.0	1.0	1.0	0.9	0.9	1.0	1.0	0.6	0.6
RENTS, DIVIDENDS & INTEREST	10.0	9.2	9.6	8.9	8.2	8.3	8.9	7.8	7.3	6.5
MISCELLANEOUS	3.4	3.5	3.5	3.5	3.5	3.6	3.8	3.7	3.3	2.8
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[Source: Central Statistical Office's "Annual Abstract of Statistics, 1994" (H.M.S.O.)]