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Local governance and finance

Regional Seminar on Local Government Reform
and Good Governance at Local Level

Council of Europe and
Organization for Security and Co-operation in Europe
Kyiv, 7-8 December 2011

Basics

- Good local self-governance is one of the key objectives of both the Council of Europe (CoE) and the Organisation for Security and Co-operation in Europe (OSCE)
- The provisions of the *Charter of Local Self-Government* (ChLSG) emphasise the need for a strong, sufficiently well funded, democratic system of local government

Concept of local self-government

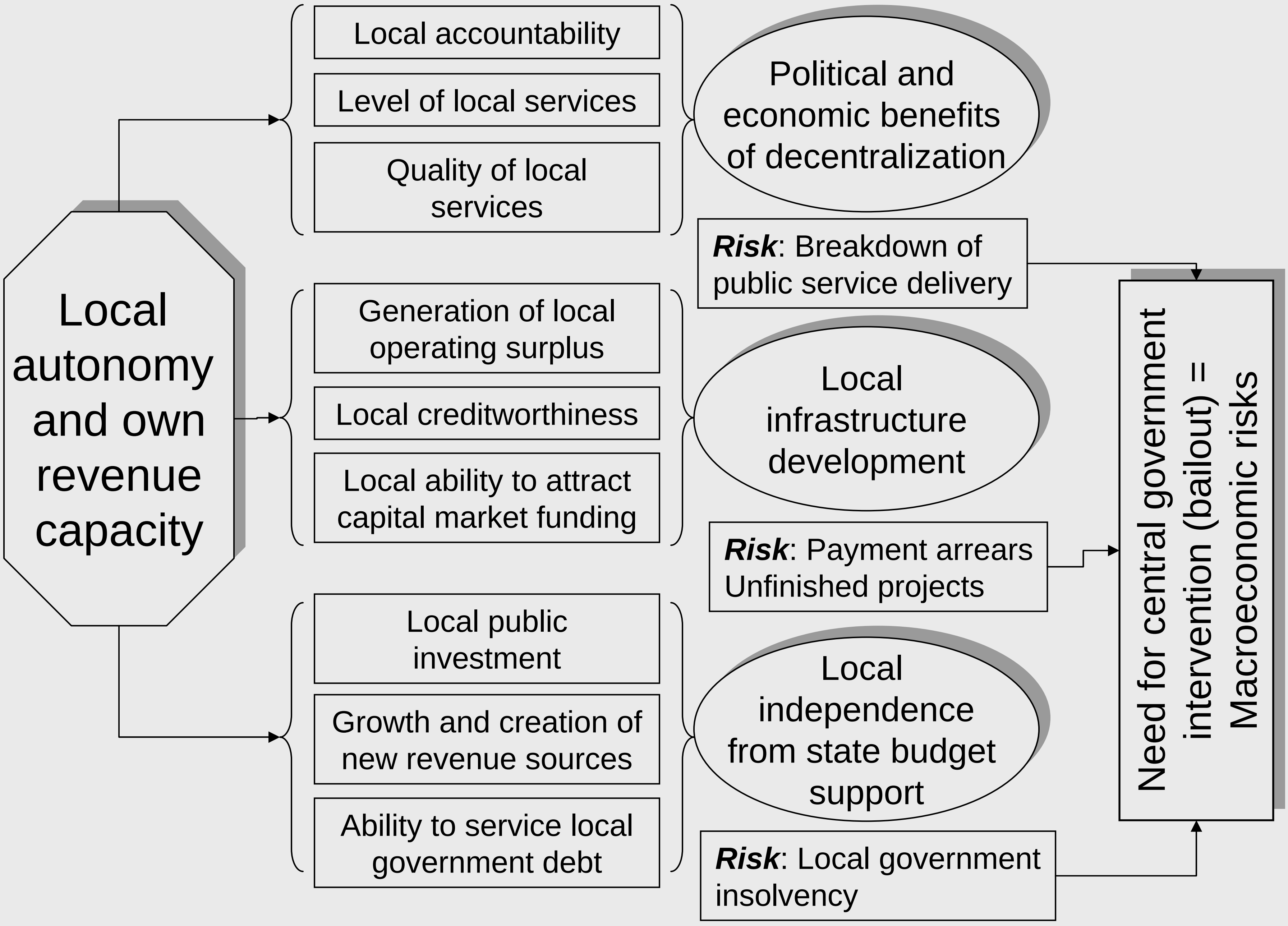
- “Local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population” (Article 3 ChLSG)
- There needs to be an institutional and legal framework to achieve this goal

Lemmata

- No local self-government without fiscal decentralization!
- Intergovernmental financial relations must
  - secure revenue for each tier of government according to the assignment of their responsibilities and standard financial needs (vertical fiscal balance);
  - achieve an equitable distribution among local authorities (horizontal fiscal balance);
  - enhance the efficiency of the public sector.

Financial resources of local governments (Article 9 ChLSG)

- “Local authorities shall be entitled ... to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.”
- “Local authorities' financial resources shall be commensurate with (their) responsibilities ... “ (*fiscal equivalence*)
- “Part at least of the financial resources of local authorities shall derive from local taxes and charges of which ... they have the power to determine the rate.” (*fiscal autonomy*)


Local autonomy and own revenue capacity
Local accountability
Level of local services
Quality of local services
Political and economic benefits of decentralization
Risk: Breakdown of public service delivery
Generation of local operating surplus
Local creditworthiness
Local ability to attract capital market funding
Local infrastructure development
Risk: Payment arrears Unfinished projects
Local public investment
Growth and creation of new revenue sources
Ability to service local government debt
Local independence from state budget support
Risk: Local government insolvency
Need for central government intervention (bailout) = Macroeconomic risks

Dimensions of local tax autonomy

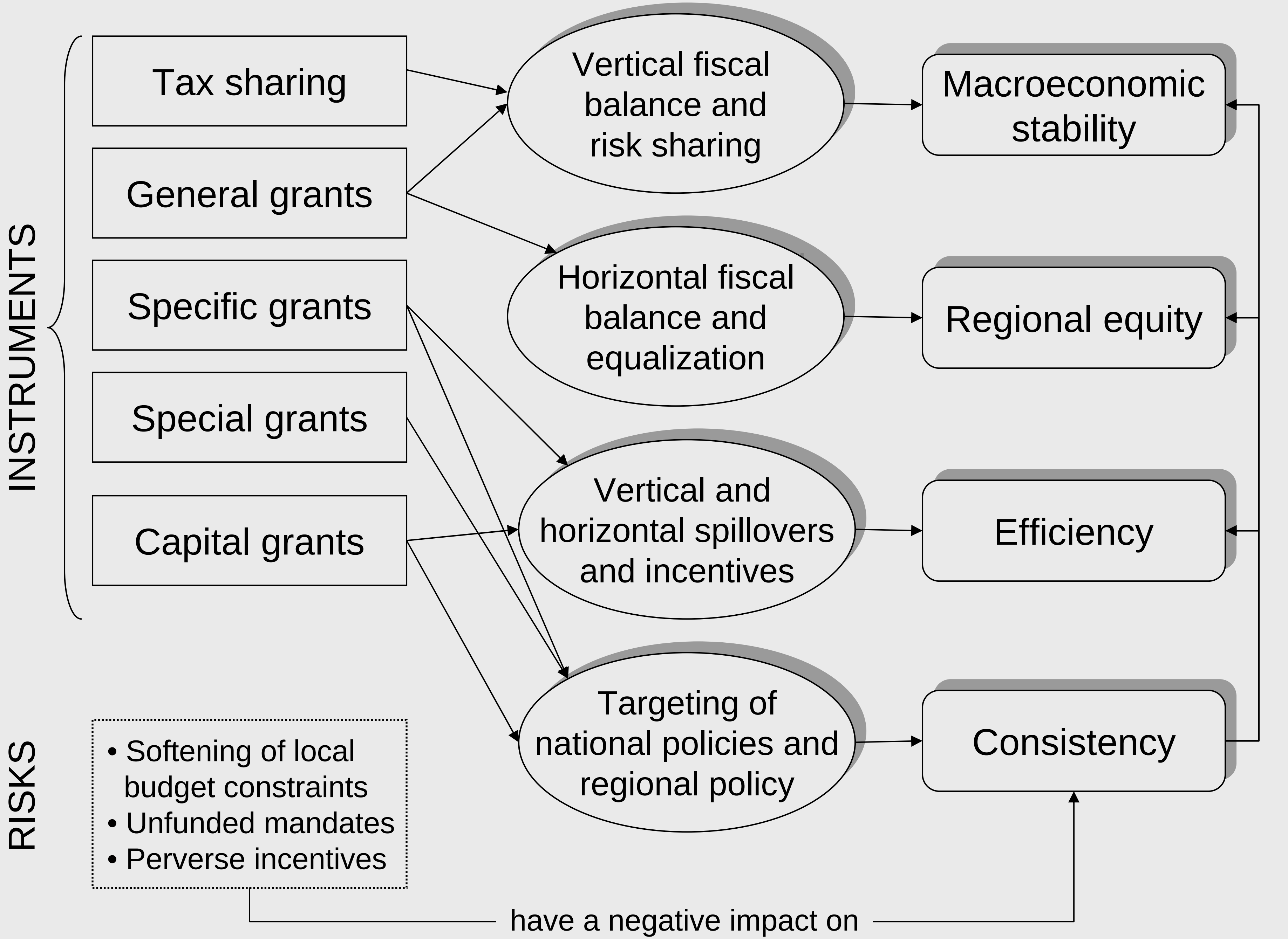
- Their are three aspects of local tax autonomy:
  - Which level controls tax base and tax rate? (tax policy)
  - Which level administers the taxes? (tax administration)
  - Which level is appropriates the proceeds from taxation? (revenue assignment - tax sharing)

Recommendations (2005)1

- “Taxes ... should be assigned to local authorities unless these taxes would exhibit significant horizontal spillovers, entail an inequitable pattern of revenue among local authorities, or discrimination or distorsions among authorities, which warrants these taxes being administered at higher levels of government (subsidiarity principle).”
- “Where taxes are assigned to local authorities, they should also be given some power to intervene in their administration in order to improve their efficiency and to appropriate their proceeds (fiscal autonomy).”

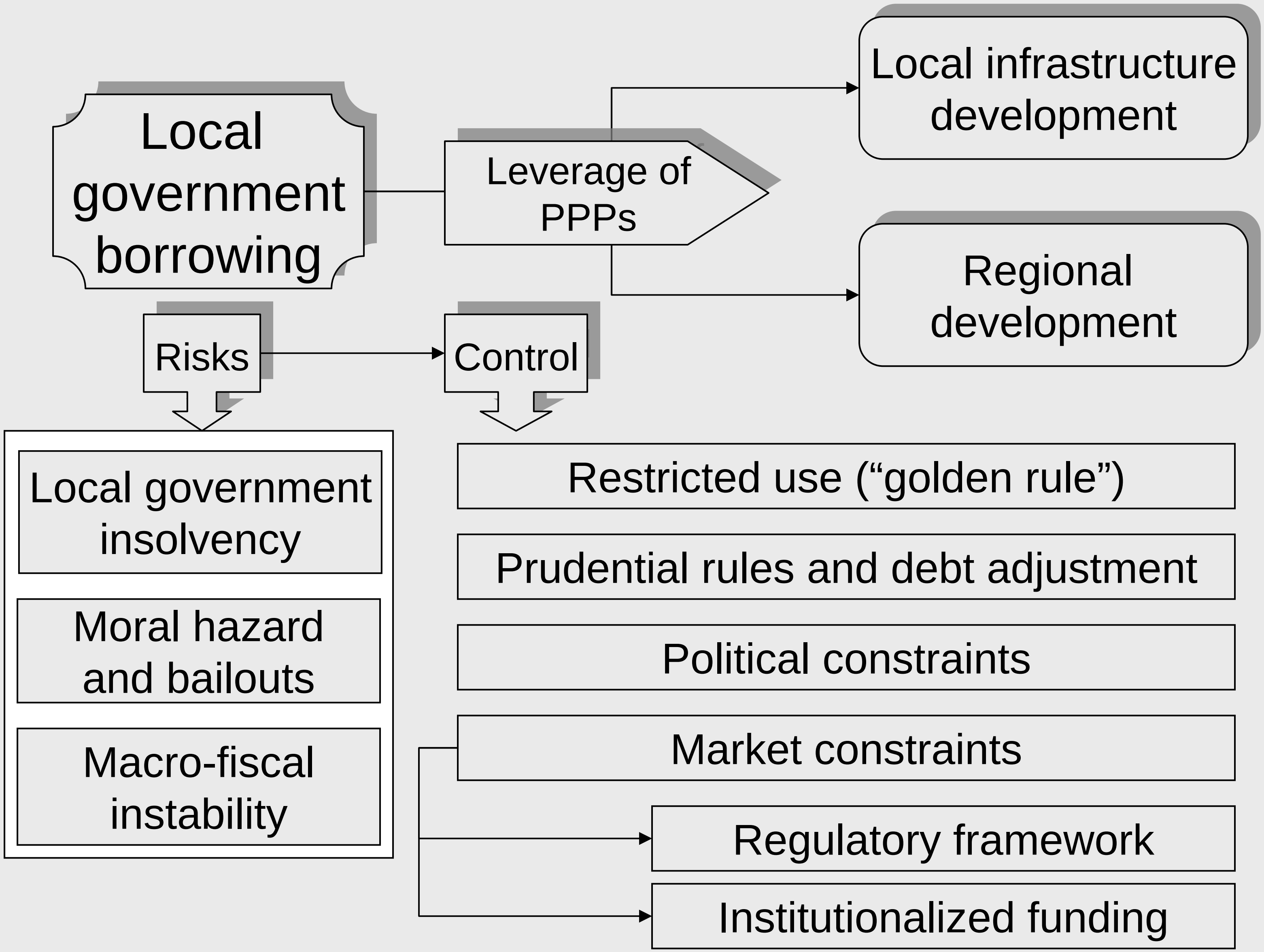
State grants:
A systematic approach

- One must distinguish policy objectives when designing an optimal grants system
  - Some transfers bridge the gap between own local revenue capacity and revenue needs to enable local jurisdictions to exercise their powers (general grants)
  - There may be specific funding where the national government keeps a national policy interest, using local governments as its agents for policy implementation (specific grants)
  - Some grants could also be designed in a way to reveal local policy preferences (e.g. matching grants) or to provide certain policy incentives


INSTRUMENTS
Tax sharing
General grants
Specific grants
Special grants
Capital grants
Vertical fiscal balance and risk sharing
Horizontal fiscal balance and equalization
Vertical and horizontal spillovers and incentives
Targeting of national policies and regional policy
Macroeconomic stability
Regional equity
Efficiency
Consistency
RISKS
• Softening of local budget constraints
• Unfunded mandates
• Perverse incentives
have a negative impact on

Local government borrowing

- Fiscal autonomy includes the right of local governments to borrow
- "For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law." (Article 9 (8) ChLSG)


Local government borrowing
Leverage of PPPs
Local infrastructure development
Regional development
Risks
Control
Local government insolvency
Moral hazard and bailouts
Macro-fiscal instability
Restricted use ("golden rule")
Prudential rules and debt adjustment
Political constraints
Market constraints
Regulatory framework
Institutionalized funding

Public financial management

- Local self-government needs effective PFM
- It starts with an appropriate budget classification, a harmonized budget cycle, budget execution, reporting and control
- It includes asset and debt management in the short and the long run, in particular medium-term planning and budgeting
- This requires substantial administrative capacity at local levels or professional support from outside – senior government or private sector

Thank you

ANNEX

Focus on transfers

Specific CoE recommendation *Rec(2005)1*

- In general, grants should be provided for by law or decided on in the light of clear and stable criteria laid down by law, and ***not*** on a discretionary basis
- Higher authorities' contributions to local budgets should take mainly the form of general grants
- General grants are unconditional in their use
- The grants system should be structured in a way to avoid "grants dependency"!
- Local governments should not be able to influence the amount of grants they receive

General grants: principles

- The total of general grants should
  - cover the <u>standardised</u> cost of discharging delegated tasks and the structural shortfall in local authorities' resources in relation to their statutory responsibilities;
  - take account of special factors (e.g. demographic changes, economic growth, costs); in particular
  - take account of variations in costs generated by decisions taken at national level (salaries and social security costs, minimum standards for local services and environmental protection standards).

Specific grants: principles (1)

- Recourse to specific grants should be restricted to what is necessary to achieve the following
  - (co-)financing capital expenditure as part of balanced, sustainable regional development policies;
  - ensuring that local public services, for which minimum standards exist, are provided at a standardised level throughout the country;
  - offsetting any centrality costs affecting the provision of certain local public services, insofar as they are not compensated for by horizontal transfer mechanisms

Specific grants: principles (2)

- Recourse to specific grants should be restricted to what is necessary to achieve the following
  - financing certain public services that local authorities provide on behalf of the state, or offsetting costs which local authorities incur when discharging responsibilities delegated by other authorities
- Where specific grants are conditional upon financial contributions on the part of the authorities receiving them, the level of such contributions should be flexible so as to take account of the authorities’ financial capacity

Equalisation

- Normally there is a regionally inequitable distribution of tax capacities at the local level
- It poses a problem when assigning tax revenues to lower tiers of government
- Some technical corrections might be required (e.g. some formula adjustment for revenues from business income taxes)
- Tax sharing is inappropriate to address problems of horizontal equalisation
- But equalisation is typically achieved through the grants system, in particular general grants

Equalisation (Article 9 (5))

- “The protection of financially weaker local authorities calls for ... financial equalisation procedures ... to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their .. sphere of responsibility.”

Equalisation guidelines (1)

- Financial equalisation should allow local authorities to provide their citizens, if they so wish, with services of generally similar levels for similar taxation levels
- The equalisation system should compensate, at least in part, for differences in authorities' financial capacity
- The decision concerning the desirable degree of equalisation is an eminently political one

Equalisation guidelines (2)

- Equalisation may be achieved by means of grants from a higher authority (vertical equalisation) or the redistribution of local tax revenues among local jurisdictions (horizontal equalisation), or a combination of both
  - Normally equalisation mechanisms are managed by national governments
  - There are also local equalisation system (especially for urban areas) that compensate, at least in part, for externalities among the municipalities concerned
  - The latter could strengthen inter-municipal solidarity and give local authorities greater independence

Equalisation philosophies

- Equalisation may concentrate on
  - taxable capacity
  - spending needs
  - local government budgets in total
- For fully autonomous entities the focus should be on taxable capacity, and should minimize the interference with local government spending
- Central interventions on spending and central definitions of local spending needs risk to distort local decision making

Taxable capacity

- The equalisation of (standardised) financial capacity should aim at reinforcing a deficient revenue base of a local government measured against a national yardstick (benchmark)
- The aim is to gauge *overall financial capacity*
- The measurement of financial capacity should be based on the assumption that all local authorities levy taxes at the same rates and are equally efficient in assessing and collecting taxes, so that authorities are not penalised for the efforts they make or rewarded for laxity

Equalising taxable capacity

- Equalisation focusing on taxable capacity is prominent in the Nordic countries
  - Sweden equalises the gap between taxable capacity and a national benchmark per capita
  - Denmark runs a similar scheme, but includes additional elements such as for Copenhagen and poorer jurisdictions
- Germany’s models also focus on taxable capacity, but also include a number of needs indicators

Spending needs

- Spending needs should be assessed on the basis of criteria which
  - are objective and which local authorities do not directly control;
  - are unlikely to affect local authorities’ freedom of choice, within the limits of the budgets available;
  - do not penalise local authorities that endeavour to render the provision of services more efficient, or encourage them to indulge in behaviour contrary to the objectives of local accountability and efficiency;
  - take account of demographic, geographical, social and economic features leading to disparities in costs

Approximating spending needs

- Spending needs are addressed in various ways:
  - through separate funds for different types of local governments according to size (e.g. Slovenia), according to type (Germany), or the degree of economic development (Republika Srpska) etc
  - through grants to municipalities “in financial difficulty” (Bulgaria, Estonia, Hungary, Romania)
  - through block grants for local expenditure responsibilities such as education (for instance teachers’ salaries in the Baltic states), or health (Hungary)
  - through special funds for functional responsibilities (e.g. road or water funds in some successor states of Yugoslavia)
  - through formula allocation of a general revenue pool or of special pools (most countries)

Defining the equalisation pool

- The equalisation pool(s) can be formed
  - from central budget allocations (Albania, Germany)
  - from shared revenues
    (most formerly socialist countries)
  - from the more affluent municipalities (Macedonia)
  - from the state budget and the more affluent municipalities (Poland)
  - from all municipalities
    (Denmark; horizontal equalisation)

The definition of local needs

- Equalisation formulae are based on a number of objective criteria with weights attached to each criterion
- The most elementary abstract needs indicator are population or subgroups of the population (pupils, elderly)
- There are also fixed elements:
  - lump sum (for overhead costs)
  - area or population density (for transportation costs)
- Moreover, capacity indicators may be used (number of schools, hospital beds, etc.)

Grants systems of new and prospective EU member states

Survey on tax sharing, general grants, and equalization					
	Base	**Local share %**	**Equalization mechanism**	**Equalization criteria**	**Stability of arrangements**
Bulgaria	PIT (by origin) plus general grant	From general grant	For the general grant (subsidy) there is a formula allocation Some "gap filling"	Expenditure "norms", on the basis of costs and standards for particular groups of services	Varies from year to year
Croatia	50% of PIT, plus CIT, capital transfer tax, and water concession fees (by origin)	Varies. Counties and Zagreb receive additional shares of PIT	21 percent of the tax sharing pool is used for an equalization fund	Expenditure "norms", or minimum financial standards. Additional benefits for war-affected areas and island	Stable
Czech Republic	21% of PIT, VAT, CIT (per capita)	30	Implicit; higher weight for larger towns; separate formula for PIT to regional governments	Abstract "needs" (number of inhabitants)	Variable
Estonia	56% of PIT (by origin)	56	Supplement by central government funds to achieve a fixed benchmark/capita	Population and "gap" of fiscal wealth compared with national average	Stable
Hungary	40% of PIT (by origin)	40	Formula allocation of 90 percent of the PIT share	Formula including various "normative criteria" such as users of public services, beds in homeless shelters and hospitals	Variable, but de facto stable
Latvia	71% of PIT (by origin)	73	Require "richer" municipalities to support "poorer" ones	Population, number of children aged 0-6; and aged 7-18; above retirement age; number of orphans; of elderly in retirement homes	Stable

Grants systems of new and prospective EU member states

Survey on tax sharing, general grants, and equalization					
	Base	**Local share %**	**Equalization mechanism**	**Equalization criteria**	**Stability of arrangements**
Lithuania	30% of PIT (by origin) Capitation based fund for teachers' salaries		Require "richer" municipalities to support "poorer" ones	Abstract "needs"; per capita surplus beyond 165 percent of average is skimmed off, minimal allocation is 65 percent of average	Stable
Macedonia	Shares of the property tax, property sales tax, inheritance and gift taxes		Shared revenue above a fixed ceiling goes into a "surplus fund" to support poorer municipalities	Case by case, plus central government funding (discretionary)	Variable
Poland	30% of PIT (by origin)	30, of which 1 point to powiats, and 1.5 to voivodships	Require "richer" municipalities to support "poorer" ones plus supplement by central government	Per capita share capped at 150 percent of national average	Stable
Romania	22% of PIT plus annually negotiated lump-sum		To counties, which retain 25% for themselves, rest goes to their municipalities	30 percent for tax capacity, 30 percent for area, 25 percent by population, and 15 percent according to other criteria	Can change yearly Not uniform by county
Slovak Republic	30% of PIT (per capita)	94		Abstract "needs" (number of inhabitants)	Stable
Slovenia	35% of PIT (by origin)	35	Supplement by central government for poorer municipalities	Equal level of per capita "relevant spending" minus own revenue. Physical indicators	Can change yearly

Transition problems

- The introduction of a new grants scheme based on *standardized* revenue and expenditures will always deviate from *actual* budget outcomes
- Gap-filling is *not* the appropriate response
- Care should be taken when phasing in the new grants mechanism to avoid budgetary shocks
- Subnational governments can absorb such minor shocks only if they *possess significant own resources* and can *control spending*