

Fiscal Federalism in the European Union

Edited by

Amedeo Fossati
and Giorgio Panella

Routledge Studies in the European Economy



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Fiscal Federalism in the European Union

To what extent should local and regional governments in the European Union be allowed to determine their own fiscal policies?

Fiscal federalism is concerned with whether activities like resource allocation, income distribution and stabilisation policies should be carried out by central government or at a local level. This book explores the core issues of fiscal federalism in the European context. It combines theoretical and empirical analysis in addressing such questions as:

- what sort of fiscal federalism is appropriate in the European Community?
- what are the dangers of more centralisation?
- what are the costs of greater decentralisation?

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Contents

<i>List of figures</i>	ix
<i>List of tables</i>	xi
<i>List of contributors</i>	xiv
<i>Preface</i>	xv
Introduction	1
AMEDEO FOSSATIGIORGIO PANELLA	
PART I Europe and fiscal federalism	13
1 A comparative view of local finances in EU member countries: are there any lessons to be drawn?	14
GIANCARLO POLA	
<i>Introduction: origin and scope of the chapter</i>	14
<i>The patterns of organisation and decentralisation of expenditure at the end of the period: similarities and differences</i>	15
<i>The revenue side of fiscal decentralisation</i>	28
<i>The compared evolution of local finance, 1980–93; the role of reforms thereupon</i>	45
<i>Current developments and debates: what lessons (if any) can be drawn?</i>	47
<i>Appendix A: institutional and organisational changes, 1980–93, by country</i>	55
<i>Appendix B: non-tax revenue in EU countries: the system of grants</i>	57
2 Developing fiscal federalism in Eastern Europe	61
MICHAEL ENGELSCHALK	
<i>Background</i>	61

	<i>Principles of financing of subnational governments in transition countries: the theory</i>	64
	<i>Financing subnational governments in transition countries: current status of reform</i>	66
	<i>Reforming fiscal federalism in central and eastern European countries: lessons and outlook</i>	74
3	Stabilisation policy in the European Monetary Union and fiscal federalism	78
	ALBERTO MAJOCCHI	
	<i>The Maastricht constraints and fiscal policy</i>	78
	<i>The need for quantitative constraints on the deficit</i>	80
	<i>The stabilisation policy in the European economy</i>	82
	<i>The inadequacy of the solutions called for in the Maastricht treaty</i>	85
	<i>The regional stabilisation policy</i>	89
	<i>The size of the Community budget and the growth of own resources</i>	91
	<i>Conclusions</i>	94
	PART II The state of fiscal federalism in Europe	98
4	Fiscal federalism in Austria: facts and new developments	99
	ERICH THÖNI	
	<i>Introduction</i>	99
	<i>Some remarks on Austrian fiscal terms, regional and local government expenditure functions and finance systems</i>	100
	<i>Pros and cons of the development: a politico-economic appraisal</i>	107
	<i>The new consultation mechanism between central, regional and local governments</i>	114
	<i>Final remarks</i>	115
5	Local government in Denmark	118
	JØRGEN R.LOTZ	
	<i>The Nordic model of local government</i>	118

	<i>The rôle of local personal income tax</i>	122
	<i>Local government equalisation</i>	124
	<i>Central control of local expenditure</i>	125
6	Local taxation and intergovernmental fiscal relations in France	128
	GUY GILBERT	
	<i>Introduction</i>	128
	<i>The distribution of taxing powers among tiers of governments</i>	129
	<i>Intergovernmental fiscal relations: equalisation and compensation vs macroeconomic constraints</i>	137
	<i>The reform of local taxation: a prerequisite for fiscal equalisation?</i>	150
	<i>Concluding remarks</i>	155
7	Experiences with German fiscal federalism: how to preserve the decentral content?	159
	HORST ZIMMERMANN	
	<i>Introduction</i>	159
	<i>The basis: two principles of fiscal federalism</i>	159
	<i>Paths to centralisation in Germany</i>	161
	<i>How to retain the decentral content?</i>	167
8	Local governments in Great Britain	174
	DAVID KING	
	<i>Introduction</i>	174
	<i>Great Britain</i>	174
	<i>The structure of local government</i>	175
	<i>Current expenditures and revenues of local authorities</i>	180
	<i>Local taxation</i>	181
	<i>Grants</i>	185
	<i>Working out individual authorities' needs to spend on individual services</i>	189
	<i>Problems</i>	195

9	Towards fiscal federalism in Italy	199
	AMEDEO FOSSATI	
	<i>Introduction</i>	199
	<i>Current popularity of fiscal federalism in Italy</i>	199
	<i>The blocks to achieving fiscal federalism</i>	203
	<i>The problems of Italy</i>	207
	<i>Conclusions</i>	214
10	Fiscal federalism in Spain. Decentralisation: an unfinished task	219
	JAVIER SUÁREZ-PANDIELLO	
	<i>Introduction</i>	219
	<i>The decentralisation process: theory and policy</i>	220
	<i>The autonomous financing models</i>	229
	<i>The financing system of local governments</i>	239
	<i>Final comments</i>	247
11	Fiscal federalism in Switzerland: a survey of constitutional issues, budget responsibility and equalisation	252
	BERNARD DAFFLON	
	<i>Introduction</i>	252
	<i>Institutional issues</i>	253
	<i>The public sector: some facts and figures</i>	256
	<i>Budget responsibility</i>	273
	<i>Tax coordination and harmonisation</i>	274
	<i>Equalisation</i>	281
	<i>Conclusions</i>	285
	<i>Index</i>	293

Figures

4.1	'Functional' share (above 5 per cent of total expenditure)— Länder 1995, excluding Vienna.	105
4.2	'Functional' share (above 5 per cent of total expenditure)—local level 1995, excluding Vienna.	106
5.1	Local consumption expenditure (percentage of general government expenditure, 1994).	118
5.2	Local government revenue in selected European countries (percentage of GDP).	119
5.3	Map showing Denmark divided into municipalities and counties.	120
5.4	Functions, size, etc. of municipalities and counties in Denmark.	120
5.5	Local income tax revenue (per cent of GDP, 1994).	122
5.6	The rate of local and central income taxes in Denmark.	123
5.7	Number of municipalities according to municipal tax rate.	123
5.8	Age distribution of local government expenditure.	124
5.9	Municipal local income tax rates (averages, 1980–97).	126
5.10	Real growth in local government expenditure, 1983=100.	126
6.1	Rate of increase in the TP tax base with respect to GNP increase.	133
6.2	Structure of local business tax base (percentage).	133
6.3	Average equalising performance of the DGF for communes only (out of the communes of overseas territories)—Gini index.	145
6.4	Differences in tax capacities among French communes, 1991.	145
6.5	Differences in extended tax capacity among French communes (tax capacity+DGF), 1991.	146
7.1	Basics of fiscal federalism.	160
7.2	Administrative interaction.	164
10.1	Autonomous communities: level of responsibilities.	222
10.2	Autonomous communities: number of provinces.	224
10.3	Autonomous communities: financial regime.	225
10.4	Spanish expenditure decentralisation.	226
10.5	Spanish revenue decentralisation (aggregated data).	244
10.6	Spanish expenditure decentralisation (autonomous communities financing—pts/habitants).	244
10.7	Spanish expenditure decentralisation (autonomous communities structure).	245
10.8	Spanish revenue decentralisation (local government financing—pts/habitant).	245

10.9 Spanish revenue decentralisation (local governments).	246
10.10 Spanish revenue decentralisation (provincial governments).	246
10.11 Spanish revenue decentralisation (municipal governments).	247

Tables

1.1	Decentralised government in the European Union (numbers of government units at various levels).	16
1.2	Functional distribution of public expenditure by tier of government (per cent) in a sample of OECD countries.	20
1.3	Subcentral services and levels of government: a comparative view from the 15 studies.	22
1.4	Functions of intermediate levels of government according to Owens and Norregaard (1991).	26
1.5	Public expenditure by level of government, 1993 (per cent of GDP).	28
1.6	Revenues received by general government (EU and selected non EU countries).	31
1.7	Revenues accruing to subcentral government in the EU in 1993 (according to OECD sources).	32
1.8	Percentage of all tax revenue received by the various layers of government, 1993.	33
1.9	Main characteristics of local business taxes in the EU (all collected at municipal level).	36
1.10	Main tax sources at subcentral level in the EU.	39
1.11	Compared fiscal decentralisation in the EU (1993).	43
1.12	Shares of the various revenue sources at state and local level, 1980 and 1993.	45
1.13	Incidence on GDP of the various types of revenue, 1980–93 (federal and unitary countries of the EU and USA).	46
4.1	Local governments in the Länder of Austria.	100
4.2	Development and status of GRP (including agriculture) of the Austrian Länder, 1961–92 (selected years); in mio ATS (market prices).	102
4.3	ATS—and percentage composition of (functional) expenditure functions of federal, regional and local governments, 1995.	103
4.4	ATS—and percentage composition of (economic) expenditure functions of federal, regional and local governments, 1995.	104
4.5	Total tax type revenue: selected years.	108
4.6	Total tax type revenue: levels, 1993 and 1995.	109
4.7	Shared taxes (above 5 bio ATS), 1995—allocation-step 1/1.	110
4.8	Shared taxes (selected), distribution keys—allocation-step 1/2.	110

4.9	Total revenue before and after intergovernmental grants: selected years.	111
4.10	'Common/joint task fulfilment': selected examples.	112
4.11	Extra budgetary, special companies: selected examples.	113
5.1	Overview of the structural reforms of local government.	121
5.2	Indicators of municipal expenditure needs in Denmark.	125
6.1	Incomes structure of local governments (in per cent of total incomes).	129
6.2	Structure of local tax receipts—France, 1995 (billions FF).	130
6.3	Tax burden—France, 1986–97 (per cent of GDP).	134
6.4	Evolution of local tax receipts—four major direct taxes (annual rate of increase, nominal values).	134
6.5	Contribution of the three levels of government to the increase in local tax (four main direct taxes) receipts (1985–95)—nominal values.	134
6.6	Rate of increase of local tax receipts by levels of government, 1985–95 (in percentage of increase, nominal values).	135
6.7	Relative contribution of the four major direct taxes to the increase of local tax receipts, 1985–95 (in per cent local).	135
6.8	Increase of total tax receipts, increase in local tax rates—four major local taxes, 1982–93 (in per cent).	135
6.9	Contribution of the central level to direct local tax receipts (billions FF and per cent).	137
6.10	Fiscal transfers to all local governments in selected European countries for various years—1985–90 (in per cent).	138
6.11	Fiscal transfers from central level to regions, departments and communes, and total incomes, 1985–94 (billions current FF).	139
6.12	Structure of transfers to local governments—France, 1996.	141
6.13	Beneficiaries of the major transfers from central government to local governments.	142
6.14	Equalising performance of the DGF (Gini index).	144
6.15	Fiscal transfers to local governments, 1985–96 (billions current FF).	147
6.16	Main characteristics of the TP, 1988–95.	151
8.1	The population of the United Kingdom by country, 1996.	175
8.2	Functions of local authorities in Great Britain.	178
8.3	Local authorities in Great Britain, 1997–8.	180
8.4	Current spending by English local authorities, 1997–8.	181
8.5	Current revenues for English local authorities, 1997–8.	182
8.6	Council tax bands and tax bill ratios for English local authorities.	184
8.7	Control totals for service groups for English local authorities, 1997–8.	188
10.1	Administrative decentralisation in Spain.	221
10.2	Level of responsibilities of autonomous communities.	223

10.3	Quantitative weight of the different AC responsibilities, 1993 (thousands of pts).	223
10.4	Functional classification of consolidated expenditure in the Spanish public sector, 1993 (millions of pts).	227
10.5	Weight of the variables used for determining the PPI for the 1992–6 period.	232
10.6	Structure of revenue in common regime ACs, 1993.	236
10.7	Structure of revenue in ‘foral’ regime ACs, 1993.	238
10.8	Structure of revenue in common regime provinces, 1993.	239
10.9	Structure of revenue in ‘foral’ regime provinces, 1993.	240
10.10	Structure of revenue in common regime municipalities, 1993.	242
10.11	Structure of revenue in ‘foral’ regime municipalities, 1993.	243
11.1	Some general indicators in the Swiss cantons, 1990 and 1994.	257
11.2	Growth of the public sector, 1970–94.	261
11.3	Public expenditures, 1994 (in 1,000 Sfr).	263
11.4	Public expenditures, 1994 (in per cent).	265
11.5	Education expenditures, 1994 (in 1,000 Sfr)	266
11.6	Nature of public expenditures, 1994 (in 1,000 Sfr).	267
11.7	Public revenues, 1994 (in 1,000 Sfr).	268
11.8	Revenue sources, 1994 (in per cent).	269
11.9	Indices of tax burden in the cantons and communes, 1995.	279
11.10	Abstract of Tables 11.1 and 11.9.	280
11.11	Financial capacities of the cantons, 1996–7.	283
11.12	Transfer payments in 1994.	286

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Preface

This book is a collection of essays on local government finance, most of which were presented at the conference 'Fiscal Federalism in Europe', organised by the University of Genova (Istituto di Finanza and Polo Didattico di Imperia) and held in Imperia on 23 May 1997.

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Introduction

Amedeo Fossati and Giorgio Panella

The distribution of responsibilities among the various levels of governments in a federal or unitary system is of increasing interest for economists and politicians alike. The question of whether activities such as resource allocation, income distribution and stabilisation policies should be carried out by central government alone or should be distributed among the various levels of government is of great relevance to many countries. This increasing interest seems to be related to both the reaction of local communities to centralisation due to the globalisation of the economy and the needs of modern economies which favour the development of centralised institutions. In this light the decentralisation of political and economic functions to lower government levels is seen as an instrument to enhance autonomy and efficiency.

The control and financing of lower levels of government is a major concern: building on the experience of countries all over the world, current issues on fiscal federalism examine how to improve the economic and political efficiency of governments. Accordingly, this book combines theoretical and empirical aspects, in so far as its contributions examine the economic rationale of single topics on decentralising revenues and expenditures, and provide both a theoretical framework and practical illustrations derived from the experience of European countries. Whilst many books have examined specific issues in this area, only a few have taken an overall view of both the theoretical and empirical problems of so many European countries, including most central and eastern countries engaged in the transition process.

The major questions being addressed are as follows: (a) what sort of fiscal federalism is applicable to the European Communities?; (b) what is the role of regional governments in the process of decentralisation?; (c) what are the costs associated with greater decentralisation?; (d) what is the real danger of the more or less unobtrusive processes of centralisation?. Hence, the main focus of the book is the different solutions implemented in different countries on the following issues:

- 1 the division of responsibilities between the different levels of government;
- 2 the existing constraints towards the implementation of local tax reform;
- 3 the appropriate taxes to finance local government;

2 INTRODUCTION

- 4 the best tax mix;
- 5 the adjustments required to equalise differences in taxable capacity and spending needs;
- 6 the effect of the relative reliance of local government on locally administered taxes and tax sharing grants in promoting local accountability.

Federalism is a complex phenomenon given the different forms in which it can be implemented: the specific form depends on the environment and institutional context in which it is put forward. In this book an empirical investigation of the division of fiscal activities between central and local government in some EEC countries is conducted to determine whether the factors which are supported on theoretical grounds are important in explaining the variations in the degree of centralisation among these countries.

In the literature the word federalism has been used with different meanings, i.e. federalism as decentralisation of functions and responsibilities (decentralisation or gradualistic federalism); competitive federalism, where central government and lower tiers compete for functions and revenue; cooperative federalism, in which case cooperation among the different levels is a priority objective. We think it important to distinguish between federalism and fiscal federalism. Federalism has a purely political importance, because it derives from the consideration that the existence of more levels of government, each being in some way sovereign in its authority, works as a sort of counterbalance to the power exercised in a democracy. In fact, the division of powers among different levels of government should allow people better to control their elected representatives. Each government level has less power and so the probability of deviant behaviour decreases and, in any case, such behaviour would only affect one level of government. Thus, federalism is to be seen as a tool to bring about political efficiency in democracies.

As for fiscal federalism, it is well known that Musgrave was the first to use the term, followed by Oates. In our view, fiscal federalism is an economic theory, and this theory tries to explain, in economic terms, the existence of different subcentral levels of government. In other words, it tries to answer the following question: Is the existence of different levels of government with more and more restricted territorial authority, due to specific economic reasons? Fiscal federalism suggests that the answer is yes, i.e. such economic reasons do exist and, to be more precise, they are reasons of economic efficiency. Fiscal federalism, in a technical sense, is exactly synonymous with the economic theory of different levels of government, first expressed by Scotto,¹ then independently rediscovered by American authors at the end of the 1950s and afterwards improved and extended by a series of authors.

From the normative point of view, this theory leads to the following results:

- 1 Local public goods must be supplied by the subcentral governments for each territory, as they are able to supply them in a more efficient economic way

- (Scotto; Oates' decentralisation theorem). Efficiency is not only related to spending decisions (the local government can better interpret the wishes of local people), but also to the financing of expenses (those who pay can best express rational choices).
- 2 Expense financing must weigh on local taxpayers through local taxes, not only because the benefit principle tends to approximate efficiency, but also because it requires local administrators to be responsible. The latter know that taxpayers link services with the local taxes financing them. Consequently, if they want to be elected again, they must try to ascertain their electorate's wishes.
 - 3 Central government can more effectively manage the public activity of stabilisation because, in an open market, effects are mainly felt beyond the local boundaries.
 - 4 Redistribution must be dealt with mainly by the central government because, if wealth is differently distributed within the territory, the wider the redistribution circle of application, the more efficiently its aims are reached. However, subcentral governments can be more efficient in distribution, which could bring vertical transfers from the central government to the subcentral levels of government, while the latter are totally or partly appointed to the final redistribution activity.
 - 5 Development policies might be performed, from the point of view of efficiency, both on a central and subcentral government level. On this point, the literature on the subject often gives more and more responsibilities to the local level, as the competition among horizontal levels of government is supposed to be limited, so that its related perverse effects are reduced to a minimum.

The weak points of fiscal federalism theory are first, as local public goods are numerous and, as each of them has its different territorial circle, there should be as many subcentral levels of government as there are goods. As this is unreasonable, local public services must be grouped into two or three subcentral levels of government. As has been noted, this fact causes a series of spillover effects from one area to another, caused by the lack of co-ordination between the one territorial area supplying the service and bearing its cost, and the other territorial areas that use the actual service. To internalise these externalities, transfers among the different government levels are necessary in order to balance marginal costs with total marginal benefit. This brings us to horizontal transfers.

Second, this normative construction—directed to achieving economic efficiency—needs appropriate information about costs, but above all about the benefits of the public services being supplied by local governments. This kind of information is difficult to find, implies a cost, and can only be an approximation. Third—but this is a minor objection—the fiscal federalism theory, which is aimed at explaining the economic reasons leading to the existence of various levels of government, develops as a petition of principle, as its explanation is

implicitly based on the premise that the economic reasons consist in the achievement of efficiency. This theory evolves from this premise as a *normative* theory, and not as a *positive* one: its positive content is related to the hypothesis that public economic intervention actually pursues efficiency, and this is open to doubt.

Essentially, fiscal federalism has nothing at all to do with political or institutional federalism, rather, fiscal federalism gives the following message: if we want efficient public economic intervention, we must organise several government levels characterised by politicians equipped with responsibility. This means that, *on the margin*, voters must be able to link closely the benefits related to *local* public services, chosen by *local* politicians with their relative costs which have been imposed on voters by the politicians through *local* taxes. In this way, through their vote, voters can exert their control in a significant and not simply ideological way, as happened in Italy where, even during administrative elections, people voted for the political party and not for the politician.

The message of fiscal federalism can obviously be applied in principle to federal and unitary states based on subcentral levels of government, because it necessarily implies some degree of freedom within the levels of government, as to both spending and its related cost division choices. However, it stands to reason that such levels of freedom naturally exist in a federal state, but not necessarily in a unitary state, above all regarding choices on cost division, which are essentially taxation choices.

Giancarlo Pola draws on the contents and results of a wide-ranging survey of local finances in the 15 member countries of the European Union, which has recently been carried out by the author and a group of experts on behalf of the EU Commission, XXI Directorate. His chapter is a general comparative study of the state of fiscal federalism in the European Union's countries, an ever-changing situation depending on the dynamics of politico-institutional pressure in the individual countries. As far as the structure of subcentral government is concerned, countries are facing opposite problems: whether to implement fully fledged intermediate levels, or, on the other hand, to reduce the number of local authorities. But the quest for stronger autonomy for local governments is perhaps predominant. With regard to the subject of resources, the most relevant in the European Union at the moment are: (a) the search for an optimal base of local taxation; (b) the problem of equalisation of resources among the various areas; and (c) the fair allocation of the costs of public services between taxpayers and consumers.

In local taxation, there is no doubt that 'work' is always in progress: if there are no changes it is only for lack of agreement on what they should be. As to the devolution of functions to local government, it would appear that decentralisation coexists with large-scale concern for standards and equality of opportunity throughout the national territory, although within a framework of co-operative federalism. Finally, the conclusion can be drawn that the cost of public services

is allocated with an increasing range of private solutions to local public demands or needs.

Michael Engelschalk focuses on fiscal federalism in transition economies. Besides decentralisation of the economies in the former communist countries of Central and Eastern Europe, the decentralisation of government itself became the main target of the process towards a democratic market economy. Efforts to decentralise governments started in most Central and Eastern European countries immediately after the initiation of the transition process. Setting the legal base for fiscal federalism, and so defining the revenue sources for subnational local governments, however, proved to be much more delicate and time-consuming than mere territorial decentralisation. The chapter also illustrates the theoretical principles of subnational government financing in transition countries, and outlines the current state of reform. At present, a pure system of revenue sharing with no decision-making power in the hands of regional and local governments is the predominant element in fiscal federalism in transition countries. With own-source revenues almost non-existent, subnational governments are highly dependent on central government tax policy decisions; at the same time, shaping fiscal federalism means reforming the tax system as a whole and introducing new, market economy-oriented taxes. However, with the key role in reform so far played by the national ministries of finance, tax policy has been highly centralised. At the same time, since the expenditure assigned to subnational governments keeps growing, a system of revenue sharing has been introduced to provide funding for subnational governments. This system is neither adequate nor sufficient from the point of view of subnational governments. Even more than for local governments, the financing of regional governments is an unsolved problem in transition countries and often hinders the decentralisation process. Experience has shown that an unsatisfactory system of subnational government financing can put a severe burden on central government-subnational government relations. In Russia, by 1992 some of the richer regional governments had begun to refuse to transfer taxes collected in their jurisdiction to central government; the typical argument brought forward was that not enough of these revenues flow back to the regional government to finance its own expenditure. The existing situation in the Russian Federation can quite openly be described as a permanent war between regions and the federal centre. The allocation of taxing rights to subnational governments may contribute to avoiding these conflicts, and improve the stability of fiscal federalism.

Alberto Majocchi argues that in the Maastricht Treaty the main problems regarding public finance are considered with reference to quantitative constraints on the size of the member states' deficit. Obviously, this is justified because the objective of the European system of central banks is to maintain price stability: restrictions on the debt capacity at lower government levels exist in almost all countries with a decentralised tax structure. The *no bail out* clause which absolutely prohibits the European Central Bank from buying bonds offered by state, regional or local administrations of the member states does not appear to be

sufficient. In fact, there is an increasing risk of negative external effects on the integrated financial market, even if the national governments have fiscal autonomy, as long as the Union has no effective power of control over member-state behaviour. Thus, the absence of this power of control and direction must be balanced against the imposition of ex-ante constraints. But what really interests Majocchi is the management of the stabilisation policies in the European Union: the effective solution to the problem of stabilisation is the recognition of the Commission as true co-ordinator of the economic policies of the member states, on the one hand, and the launching of a European regional stabilisation fund on the other.

In this case it would be easier for member states in the Union to accept the new conditions imposed by the Stability Pact, with the aim of ensuring monetary stability after the introduction of the Euro by means of respect for constraints which are even more rigid than those in the Maastricht Treaty. If the European Union is mainly entrusted with ruling responsibility with regard to stabilisation policy, while resources come principally from national budgets, then the size of the Community budget could be much lower than in the normal experience of federal states. In effect it seems possible to achieve the objectives of the EMU with a limited-sized budget, equal to around 2 per cent of European GDP, which includes a reserve of around 0.2 per cent of GDP, set aside for the regional stabilisation mechanism.

Erich Thöni discusses the case of Austrian fiscal federalism. As is well known, Austria is a federal country with three levels of government: the federal level, nine states and well over two thousand communes. Besides these there are the so-called 'charter cities', which execute all functions of local government as well as those of the first level of federal and state administration. With the exception of the 'charter cities' and Vienna, all local governments are considered equal as regards the carrying out of their responsibilities, although they vary very much in size, type, economic and administrative capacity as well as in revenue. Vienna (over one and a half million inhabitants) has a special, dual constitutional status as state and at the same time commune. The basic philosophy behind Austrian fiscal federalism can be summarised as 'diversity within strong unity', while public policies, through close co-ordination and co-operation between all levels of government, are oriented towards uniformity in living conditions. Despite formal dominance of the federal government, the Austrian states exercise considerable discretion in their relations with the central power, but especially with the communes. Most federal administration is executed through both the states and the communes; all three levels of government are allowed to intervene in any area of constitutional competence reserved for the other levels, which is done by means of private law arrangements and through companies and public expenditure, especially subsidies. Taxing in Austria is a complex mixture of exclusive and joint or shared sources, although the federal state is dominant. The greater part of revenue at all levels is generated within the joint taxation system, and the sharing itself is carried out in quite a complicated manner. To

finally match fiscal needs with fiscal capacities between the different tiers a wide range of intergovernmental grants is used. Moreover, there is a collection of fiscal arrangements, by which political deals among the different levels result in common execution and/or financing of public tasks. Overall, Austria's fiscal federalism shows many elements of a highly co-operative federalism, formally highly centralised, but significantly decentralised by means of a complex bargaining process between the three levels of government. These negotiations result in a compromise on joint tax sharing, its ratios and criteria for division, and some vertical grants to and from any level with important equalising effects. The present budget restrictions necessary to meet the Maastricht criteria and restore budget flexibility to all levels of government would suggest that reform is needed. However, political and bureaucratic rigidity, the so-called co-operative social partnership and the checks and balances in the Constitution in general make it unlikely that the Austrian financial settlement will be fundamentally changed in the near future.

Jørgen R. Lotz describes local government finances in Denmark and, at the same time, gives a description of the organisation of the local government sector in the Scandinavian countries. The feature which might attract greatest attention is that these countries have the most decentralised public sectors anywhere. Local government is a two-tier system with counties and municipalities. In Denmark counties have no 'regional' functions: in a few cases they have a role in supervising or controlling municipalities. The two levels each deal independently—and directly—with the ministries. The only argument for two levels is the population size needed for the institutions run by the two levels (hospitals for counties and schools for municipalities). Local governments are responsible for nearly all public services to citizens: primary and secondary schools, hospitals, health services, care of the elderly, social assistance. Only the national schemes of old-age pension and unemployment benefit are the responsibility of the central level. One factor which has had a profound effect on the development of local government in the Scandinavian countries is the local income tax. At the turn of the century, it was decided in all the Scandinavian countries to allow local governments to collect their own tax rates on income, in addition to central government rates. The assignment of income taxes to local authorities in the Nordic countries had far-reaching consequences because of their great revenue potential compared to that of property taxes or continental-style business taxes. Two important features of Scandinavian local government can be identified. One is that the function of local government is redistributive: the objective of local politics is to decide how much the local median voter is prepared to pay to help children and the aged. Another feature is the obvious need for local equalisation, solved by equalisation of expenditure needs, but the differences in tax bases are even larger. In the Scandinavian countries there is strong equalisation of such differences. When the public sector is large as well as decentralised, the need for some kind of expenditure control is obvious. In Denmark the solution is for central government and municipal associations to reach annual agreements on

joint 'recommendations' to member authorities. Each year (April–June), the government negotiates with the chairmen of local government authorities. The government agrees to pay a negotiated amount of grants, and local government associations in return agree to recommend to their members not to increase taxes.

Guy Gilbert's contribution features the overall situation both of intergovernmental fiscal relations and of local taxation in France, i.e. the fundamental problems related to the fiscal autonomy of local governments. Although France is still a strongly unitary state, the map of local jurisdictions is highly fragmented, and even if the tax capacity of local entities is uneven, the fiscal powers of the lower tiers of government remain substantial. However, there are large differences in fiscal capacities, as tax bases (mainly a wide-based local tax on business) are concentrated within urban zones. Consequently the need for fiscal equalisation justifies the existence of an extended grants system for local governments: until the 1980s, economic growth presented no difficulties to the distribution of such grants, and local tax rates could be kept at reasonably low levels; in the 1990s however, budget deficits widened at the central level, and local tax rates had to increase owing to the inadequacy of the tax bases. Thus, the regulation of intergovernmental transfers and local tax reform are once again clear priorities on the political agenda: a stabilisation agreement has been imposed on local governments in order to limit the evolution of the overall amount of transfers in the future. In the long run, such an agreement might undermine the equilibrium of local public finances—a long-term solution must surely be reform of the local tax system. But such reform could turn out to be more than minor; drastic measures are probably needed. Two alternative views are being considered at present. The first relies on compulsory recentralisation of the local business tax: in this case, Parliament sets a single tax rate for all French local jurisdictions; the receipts are totally or partially redistributed to local governments according to criteria set by Parliament. This reform is thus similar to the 1990 reform of the Uniform Business Rate in England. The second view relies more on voluntary fiscal co-operation between local units which could, if the incentives were efficient enough, lead to a drastic reduction in the number of taxing entities (100 large urban districts and a few hundred rural districts). Consequently, the present dilemma is that a conservative solution would eventually lead to: (a) substantial local tax autonomy, (b) inadequate local tax bases, (c) huge disparities in tax capacities among jurisdictions and (d) more intergovernmental fiscal grants. But this is perhaps neither desirable nor possible in the present macroeconomic situation. On the other hand, sound reform of local tax bases and of their distribution among the levels of government would lead to a lack of local autonomy.

Horst Zimmermann highlights a serious problem facing German fiscal federalism, namely a major process of centralisation. What is peculiar in the case of Germany is that the nation itself, in its present federal form, only goes back to 1949, while it was formerly a strong unitary state. Since then some minor

amendments have been made to the Constitution, and quite recently some issues have come up for debate and decision, among them the role of the intermediate level (the states) in relation to a strengthened European Union, and the tax mix of local governments. Perhaps the most outstanding fact is that the almost half of a century of German federalism has seen an unbroken process of centralisation, some steps taken quite openly, but most of it in an unobtrusive way, slowly eroding some of the substance of the original decentral decision making. Granted that a strong decentral element is to be preserved, the theme of the discussion is the search, in a federation, for the right place to put this subject on the agenda for debate and political action. Institutions are analysed from a public choice perspective, i.e. based on the hypothesis that people acting in institutions pursue—at least to a considerable degree—their own interests. Exposing such interests might, therefore, make it possible to devise rules to channel this self-oriented activity into the direction of contrasting the centralisation process. As in the central government, federal activities only work top-down and thus against decentral decision making; on the other hand, one doubts that the German constitutional court served as a bulwark against centralising tendencies. The states are very positive about their relations with the federal government: for example, they have organised conferences for state ministers on transportation, the environment, etc., which serve as a substitute for the central government in many respects.

However, in relation to local governments the states themselves act in a very centralist manner: here they are guided by self-interest, similar to the central government. It might appear that local governments are the only level unequivocally interested in more decision-making power; however, while this may be true regarding local functions in general, in the individual sphere the local bureaucrat often likes to collaborate with his or her counterpart at state level, even if the local parliament thinks differently. In short, the major problem seems to be local taxation, since local governments are not particularly interested in tax rate authority, as unconditional grants and an income tax share, of which the local voter is hardly aware, hamper the working of fiscal equivalence. If the latter is considered to be the driving force behind fiscal efficiency at any level of government, then responsibility has to be enforced from above.

David King discusses the structure of local government in the United Kingdom, and especially in Great Britain where, in the last half century, quite radical reforms have been carried out. The peculiar feature is that while other countries are more or less approaching fiscal federalism, here the reforms suggest a drifting away from it. Structural changes have produced untidy results, with a variety of set-ups, so that people have only vague ideas about the way local government operates. Particularly in the last decade or so, many steps have been taken towards reducing financial autonomy, to the extent that tax revenues in the United Kingdom are now among the most centralised in any OECD country. Local taxation problems are discussed—rates, poll tax, the council tax—including tax capping and the business rate; however, David King's interest is

focused on the quite sophisticated grant system and specifically on the revenue support grant. The most controversial part of the revenue support grant calculations is shown to be the amounts, which the government thinks each local authority needs to spend to provide reasonable services, or Standard Spending Assessments. Some details are offered about how the government works out individual authorities' needs for services such as primary education, personal social services, highway maintenance, and so on, which provide insights on how the system works. The conclusion is that the impact of reforms on local government has been to weaken it, both by structural changes and financial changes; with regard to the former, a strong local government would probably need to have joint boards in unitary areas replaced by directly elected authorities. A strong local government would also need more substantial tax-raising powers; however, at the moment, the most that can be hoped for is a relaxation of capping and some small local business taxes. Meanwhile, perhaps the best that can be said is that the current domestic property tax has some interesting novel features, and the system of equalisation grants is second to none in pursuing equalisation.

Amedeo Fossati presents the terms of the lively debate on federalism still going on in Italy. He observes that improving efficiency through fiscal federalism is certainly considered, but the dominant theme is perhaps the emotionally charged proposition that federalism could be an antidote to secessionism. Politicians, however, do not take the latter very seriously, so even if the transition process from unitary to federal state has actually started, it is not yet clear whether it will eventually succeed, or what sort of fiscal federalism is being pursued. On the other hand, co-operative fiscal federalism could be an important vehicle through which northern people's demand for local autonomy could be made compatible with the less developed economy of southern Italy. To introduce fiscal federalism, however, central government must be willing to reduce its activities. Since the foundation of the Italian Republic in 1946 the role of central government has been interpreted in a wide-ranging manner, not only as far as centralism is concerned, but also as regards economic dirigisme. Thus, whilst implementing any reasonable form of fiscal federalism in Italy, the central power would have to change considerably its standpoint and behaviour. However, in evaluating the achievements towards fiscal federalism up to now, it is impossible to perceive little more than an offer of would-be decentralisation. The latter could be simply an attempt to escape autonomous pressures by building a system of relationships between subcentral and central government that actually strengthens central predominance. The ideologies of dirigisme and centralism appear to be particularly exposed to the danger of using decentralisation as a means of defusing the push for autonomy: this seems to be one of the greatest impediments fiscal federalism is facing in Italy at the moment.

Javier Suárez-Pandiello describes the problems which have ensued from the huge decentralisation process which took place in Spain during the last two decades, and the foundations of the autonomous communities, i.e. the new regional level of government introduced by the Spanish Constitution in 1978.

The enormous volume of expenditures passed onto local governments has created considerable tension among the different levels of government, particularly as far as the financing system is concerned. Nevertheless, Spanish decentralisation could be qualified as orthodox from the point of view of expenditure, given that subcentral finance is fundamentally dedicated to allocation objectives.

Local governments are financed with decentralised taxes that present low inter-jurisdictional mobility, while taxes more closely related to redistributive or stabilising activities are not decentralised. However, the 'foral' regime is an exception: two important autonomous communities are financed under the foral system, where local bodies take charge of central state taxes. In general, the tax system offers little incentive to fiscal co-responsibility, especially as regards autonomous communities, in that the regulation of ceded taxes is entirely carried out at central level—not even the rates can be changed. This has created a dangerous asymmetry in the distribution of political costs and benefits derived from government activity: the generalised non-fulfilment of the fiscal equivalence principle has been challenged by the last agreement on autonomous community financing. This has reduced grants but has given autonomous communities some normative powers over ceded taxes, including a portion of income tax. In this way autonomous communities will gain greater fiscal responsibility, but the solidarity principle could be damaged. On the other hand, the resultant extremely large differences both in local expenditure and in taxes per inhabitant between foral and common regime communities are unacceptable from the point of view of fairness, and could create further tension. Different problems are presented by the current criteria for distribution of inter-territorial grants, aimed at bridging the existing gap between expenditure needs and fiscal capacity of the subsidised entity. In particular, it seems urgent to consider some measure of fiscal effort in order to encourage the taking on of fiscal responsibilities. Therefore, it is only fair to point out that the Spanish process of decentralisation is still an unfinished and fundamentally unstable system: according to Suárez-Pandiello, this is due at least in part, to its essentially political origin, i.e. the nationalist desires of Catalonia and the Basque Country.

Bernard Dafflon's chapter deals with the case of Switzerland, where federalism is a relatively complex system of three layers of government, namely the communes, the cantons, and the confederation, all levels being interconnected by many vertical and horizontal relationships. Of such arrangements, perhaps the most peculiar is the extensive use of direct democracy; however, constitutional guarantees are supported by other traditional elements, such as a popular mistrust of global nationwide policies. As a result, the power to decide and finance the provision of public services has remained largely decentralised in cantons and communes, alone or associated in various forms of co-operation. However, the fairly extensive autonomy of local governments is not unlimited, in so far as, in general, cantons have their own constitutional rules with regard to budget and debt limitation. Furthermore, rules

of tax co-ordination and harmonisation do exist at federal and cantonal level, and subcentral jurisdictions act more and more as agencies of the central powers. The communes only have full fiscal flexibility, while fiscal sovereignty belongs to the confederation and the cantons: its exercise, however, is tempered by interjurisdictional competition and the mobility of taxable units, and limited by co-ordination and harmonisation practices. Large differences in the individual fiscal burden in cantons result, primarily owing to different cantonal ideas on tax equity, and to a fairly large amount of autonomy to decide and offer public services. Such differences depend altogether on cantonal disparities in economic potential, and the use of non-benefit taxation by decentralised levels of government. Equalisation schemes intervene in order partly to compensate for differences in the revenue-raising capacities of cantons, but the amount of transfer payments to cantons remains modest owing to the budget responsibility and financial autonomy objectives of the various jurisdictions. There is no claim to obtain identical economic and fiscal conditions across cantonal and communal jurisdictions. The Swiss system of relationships among the different levels of government, while coherent with fiscal federalism theory, seems to be more the result of their specific form of institutional federalism. Comparison and competition between jurisdictions ensures that only those policies which are in the long term accepted by the population can be carried through. The final solution emerges after a continually reviewed selection procedure, which, like a process of trial and error, compares the various approaches. In conclusion, constitutional arrangements and standard economic principles are all founding elements of the Swiss version of fiscal federalism.

Note

- 1 Scotto, Aldo (1952) 'Prime linee di un contributo alla teoria della finanza locale', in *Studi in memoria di Gino Borgatta*, Istituto di cultura bancaria, Milano, reprinted in Scotto, A. (1991), *Saggi di Finanza pubblica*, Milano: F. Angeli.

Part I

Europe and fiscal federalism

1

A comparative view of local finances in EU member countries: are there any lessons to be drawn?

Giancarlo Pola

1

INTRODUCTION: ORIGIN AND SCOPE OF THE CHAPTER

This chapter draws heavily on the contents and results of a wide-ranging survey of 'local' finances in the 15 member countries of the European Union, which was recently carried out by myself and a group of colleagues on behalf of the EU Commission, XXI Directorate, which should be considered the real 'owner' of half the data presented here. A general comparative study was eventually produced by myself on the 15 contributions, the core of which is reported here, with some refinements.

In the studies the qualification 'local' has been applied to both the purely 'local' and to the 'intermediate' (regional) levels of government: the reasons for this choice will be given shortly. The fixed time point used as a benchmark for the comparative analysis is the year 1993: however, enquiries have usually gone back to 1980 as a starting point for the historic survey. Finally, both the revenue and (though to a smaller extent) expenditure side of budgets have been examined but within the revenue side special attention is paid to the taxation element.

During the time span under scrutiny, the control and financing of lower levels of government has been a major political issue in practically all member countries of the EU. Many countries have recently implemented reforms to the ways in which intermediate and local tiers of government are structured and financed. In some cases, these reforms are so radical and include such a reallocation of expenditure functions between levels of government as to cause a transition from a unitary to a federal (e.g. Belgium) or to a quasi-federal (e.g. Spain) constitutional setting. In other cases the changes have only concerned the means of financing, with a strengthening of the local taxation case (e.g. Italy). In yet other cases, both the financing methods and the boundaries of intermediate and local governmental units have undergone changes (e.g. the United Kingdom, Greece).

At the same time, marked changes in the general economic conditions and, as a consequence, alterations in the attitude of most European governments towards public expenditure (at all levels) have taken place. Central governments of all political colours have become increasingly concerned about their degree of control over subcentral levels of expenditure and have tried to instil the ‘virtue’ of accountability in subcentral governments. Most of the times this has been obtained through an intensification of the autonomous tax-raising powers of the lower levels of government, but also through tighter controls of their borrowing. Last but not least, European subcentral governments—like others—have been caught in, and actively involved by, the process of redistribution and ‘equalisation’ of the overall fiscal resources, both in the horizontal and in the vertical sense.

It is within such a framework that the rest of the chapter will be cast.

2

THE PATTERNS OF ORGANISATION AND DECENTRALISATION OF EXPENDITURE AT THE END OF THE PERIOD: SIMILARITIES AND DIFFERENCES

As an inevitable outcome of some centuries of highly civilised history, the 15 countries examined exhibit an intriguing variety of legal and constitutional settings with regard to their forms of government. I consider it appropriate for my purposes to adopt a classification of them which simply takes into account the number and quality of those authorities—endowed with an autonomous power of decision, normally matched by at least a minimal power of raising own revenue (mainly through taxation)—which are called decentralised levels of administration in the French tradition and levels (or tiers) of government in English terminology, which were present in the years 1993–4. Within the subcentral levels of government a distinction is usually drawn between a purely ‘local’ level and an ‘intermediate’ one. However, the term ‘intermediate’ is subject to some ambiguity, since some authors include in it the ‘provincial’ dimension (county, kreis, province, etc.) and some do not, thus aggregating the provincial level of government with the municipal one into the general ‘local’ level. In this chapter I have taken the methodological decision to consider as the ‘intermediate’ tier of government only the ‘regional’ level.

The situation around the year 1993 is depicted in [Table 1.1](#). Separate regional governments are not present in all countries of the European Union. They exist—indeed they form the very essence of them—in the three countries with federal arrangements (Austria, Belgium, Germany). In these countries central government and regional governments share most of the power (including financial power) and responsibilities. Separate regional governments also exist in the three countries in which the Constitution envisages, and the laws have subsequently implemented, a varying degree of operating independence,

Table 1.1 Decentralised government in the European Union (numbers of government units at various levels).

<i>Country</i>	<i>Regional or state government</i>	<i>Local government</i>	
		<i>Upper tier (counties, provinces, departments)</i>	<i>Lower tier (municipalities, districts)</i>
Austria	9	—	2,353
Belgium	3 ^a	9	589
Denmark	—	14	275
Finland	—	—	455
France	26	100	36,000
Germany	16	236	16,000 ^b
Greece	—	—	5,900
Ireland	—	31 ^c	84
Italy	20	108	8,000
Luxembourg	(3)	(12)	118
Netherlands	—	12	636
Portugal	(2)	—	305 ^d
Spain	17	50	8,100
Sweden	—	23	288
UK	—	54	485

Notes

a +3 Communities.

b 117 *Kreisfreie Städte*.

c Country can be considered the only real Irish local government for comparative purposes.

d 4,200 parishes.

responsibility and control to regional authorities (France, Italy, Spain). Here problems of interpretation are present as to what real discretion the regional government has over its own affairs, including fiscal ones. In other words, it is difficult to say in all cases what is sheer decentralisation of centrally determined administrative tasks and what is self-determination.

Local governments (in one or two versions, as explained) exist throughout the 15 countries. They consist of governmental units exercising independent competence in the various urban and/or rural jurisdictions of a country's territory. When local governmental functions are not carried out separately from the administrative structure of another government their activities can be regarded as forming part of the central or regional government to which they belong. Here again the boundary between dependence and self-determination can be very thin. In this sense the literature distinguishes between an 'agency' model and a 'choice' model for local government.¹

The ‘choice’ model is centred on the idea that decentralisation provides scope for local communities to choose different levels of local services and taxes, matching their preferences more closely than if decisions had been made by the central government. ‘Choice’ does not necessarily have to be expressed within the jurisdiction—and in this case it reflects the balance among the preferences of different groups of citizens; it can also be revealed through the mobility of people from one jurisdiction to another. In other words, ‘choice’ models stress the inherent democratic value of any process of decentralisation of power and fiscal authority.

The ‘agency’ model of local government offers a completely different perspective, since it envisages a system of local authorities simply engaged in administrative decentralisation of some of the policy functions of central government. Here the objective of decentralisation is not to ensure that levels of provision are responsive to the preferences and choices of local residents, but to exploit certain advantages of smaller-scale units in the administrative implementation of centrally determined policies.

None of the 15 European intermediate and local tiers of government seems to belong to either of the two ‘pure’ models, except perhaps in the case of the recent experiments of regional government carried out in Greece. All of the real world examples share elements of the two models in a varying degree. To make things more complicated, local government throughout Europe is made up of a wide variety of governmental units, dependent agencies, and/or activities, and may include such diverse entities as counties, municipalities, cities, towns, townships, boroughs, school districts, water or sanitation districts, combinations of contiguous local governments organised for various purposes, etc.²

In light of the above criteria, my final classification of the 15 countries from the point of view of their constitutional-organisational set-ups is the following:

1 Countries where an ‘intermediate’ level of government is active between the central and the local ones. To this category belong:

- the genuine federal states, which in the EU number three—Austria, Belgium, Germany;
- the unitary states exhibiting a regional level, more or less strong and ‘visible’ (France, Italy, Spain).

2 Countries where such an intermediate level is not officially present. This group includes:

- unitary countries where local government is represented by two levels (Denmark, Great Britain, Netherlands, Sweden);
- unitary countries where local government is set at one level only (Greece until 1994, Finland, Ireland*, Luxembourg, Portugal**) (*despite the

formal presence of subcounty administrations; **if ‘parishes’ (*fregueisas*) are not considered fully fledged autonomous authorities).

While the reported outline refers to the current situation, it should be remembered that the picture has not always been the same during the time span covered by the enquiry (1980–1993/4). The main changes in organisation, expenditure and revenue sources of the subcentral governments in the 15 countries will form the content of a following section.

The division of functions between central government and the various layers of subcentral governments is normally regulated by the law in unitary states and by the constitution in federal ones. However, there is no universal principle defining which responsibilities should fall onto intermediate (even in the case of federal countries) or local governments. [Table 1.2](#) collects a sample of situations in both federal and unitary countries in order to show what is the weight of the various sectors of government at the various levels in each one of the two basic institutional conditions. Two facts emerge:

- 1 Local government is normally more expanded in the unitary countries than in the federal ones in all sectors of activity except ‘law and order’: federal countries apparently devolve to the ‘state’ (regional) level some functions normally exercised at the local level.
- 2 Education, health and transport are the sectors where the decrease of central prerogatives is the highest, with the centre retaining a marginal proportion of the entire expenditure.

It is difficult to draw neat lines around the precise ‘jurisdictions’ in charge of services at subcentral levels, since joint actions and competences are often present. Yet attempts to set down classifications do exist. One of them was attached to the previously cited report (Denny, Ridge, Smith (1993): see Note 1) and has been selected for updating in this chapter (see [Table 1.3](#)). Another ambitious comparative table dealing with some 34 basic subcentral functions, albeit confined to the intermediate level of government (an enlarged version comprising also counties and provinces) is contained in the study by Owens and Norregaard (1991) (see [Table 1.4](#)).

The study by Owens and Norregaard reveals that quite outstanding differences characterise not only historically distant unitary countries like Italy and the UK, but also culturally very similar federal countries like Austria and Germany. For most of the functions the intermediate level of government has an obligation—either imposed by a higher tier of government or by the constitution—to provide the service. This, according to the authors, is not true for a large number of functions in the majority of the unitary countries studied. Finally, they have discovered that ‘in unitary countries there is no uniformity in the range of tasks performed by regional governments’: however, this conclusion is—in my view—a consequence of the enlarged concept of ‘regions’ adopted in their analysis.

Coming back to the results of my personal survey synthesised in [Table 1.3](#), I would say that any attempt to exactly fit 15 different situations in general, abstract models (such as: ‘who performs what’) is blurred by at least three factors:

- 1 The distinction between ‘compulsory’ and ‘discretionary’ character of the function performed or service provided at each level (the French and Italian cases come to the forefront here).
- 2 The widespread presence of functions or services shared among layers of government.
- 3 The distinction (much stressed in the Austro-German tradition, but increasingly in the Latin countries as well) between the phases which the public provision of the service undergoes. In these cases, for any given service, legislation may be within the realm (‘competence’) of the central government, administration of the regional government and provision of the local authorities.

Put in other words, the inherent rigidity of the standardisation characterising the information contained in the table does not allow it to fully reflect the variety of situations prevailing in Europe as far as the provision of services at the intermediate/local level is concerned. As a general rule, [Table 1.3](#) confirms what is *per se* intuitive, i.e. that certain functions are—with some exception—always entrusted to local authorities, whatever the extension (if there is one) and role of the ‘intermediate’ level: roads maintenance, public lighting, sewage, sports facilities, parks and recreations, libraries, street cleaning, refuse collection and disposal, basic social welfare.

The information provided can only be commented on in a cursory way: for example, it can be seen that wherever the intermediate level exists, it takes care of many services which would either be left to the local tiers straightaway (this holds for federal as well as for regional governments) or retained by the central level. Particularly when the functions are wide-ranging and the services associated to them multiple, simultaneous involvement of more than one tier seems to be the rule rather than the exception. Another lesson to be drawn from the picture is that central government keeps for itself far greater room than would be expected in local matters, not only in decentralised ‘unitary’ states like the Scandinavian ones, but also in federal/regional countries. Finally, one must pay tribute to the ‘Cartesian’ efficiency of the British case, with its *ad hoc* solutions for each region of the country. Such an example of flexibility and pragmatism remains unrivalled in the EU.

To sum up: [Table 1.3](#) reflects only partially the variability of the conditions under which services are rendered, in that they are tied to the specific political and economic situation of the countries. For example, the more detailed descriptions contained in the individual reports reveal that in some countries

Table 1.2 Functional distribution of public expenditure by tier of government (per cent) in a sample of OECD countries.

<i>Federal countries</i>	<i>Year</i>	<i>General administration</i>			<i>Law and order</i>			<i>Security</i>		
		<i>C</i>	<i>S</i>	<i>L</i>	<i>C</i>	<i>S</i>	<i>L</i>	<i>C</i>	<i>S</i>	<i>L</i>
Australia	1990	51.95	35.02	13.02	15.10	82.35	2.54	100.00	0	0
Canada	1989	59.28	29.20	11.52	0	50.88	49.12	100.00	0	0
Germany	1989	45.96	29.07	24.97	0	79.29	20.71	100.00	0	0
United States	1991	70.29	11.04	18.66	15.79	28.27	55.95	100.00	0	0
Switzerland	1984	39.56	25.75	34.69	0	70.88	29.12	84.19	8.71	7.10
Unweighted average		53.41	26.02	20.57	6.18	62.33	31.49	96.84	1.74	1.42
<i>Unitary countries</i>										
Denmark	1990	63.84		36.18	86.31		13.69	98.80		1.20
France	1990	70.24		29.76	75.95		24.05	100.00		0
Norway	1990	67.44		32.56	81.92		18.08	99.75		0.25
Netherlands	1992	68.61		31.39	66.63		33.37	100.00		0
United Kingdom	1991	77.95		22.05	58.33		41.67	99.85		0.15
Unweighted average		69.62		30.38	73.83		26.17	99.68		0.32
<i>Federal countries</i>	<i>Year</i>	<i>Education</i>			<i>Health</i>			<i>Welfare</i>		
		<i>C</i>	<i>S</i>	<i>L</i>	<i>C</i>	<i>S</i>	<i>L</i>	<i>C</i>	<i>S</i>	<i>L</i>
Australia	1990	27.84	71.99	0.17	51.22	48.01	0.77	90.78	7.95	1.27
Canada	1989	8.38	50.23	41.38	16.66	77.02	6.32	66.31	30.84	2.85
Germany	1989	4.94	73.09	21.97	71.39	13.40	15.21	76.72	11.95	11.33
United States	1991	5.56	43.54	50.90	54.93	32.92	12.15	72.55	19.65	7.79
Switzerland	1984	10.06	55.34	34.60	43.26	34.61	22.13	82.06	11.23	6.72
Unweighted average		11.36	58.84	29.80	47.49	41.19	11.32	77.69	16.32	5.99
<i>Unitary countries</i>										
Denmark	1990	51.12		48.88	7.96		92.04	46.83		53.17
France	1990	63.18		36.82	97.14		2.88	92.19		7.81
Norway	1990	49.46		50.54	43.54		56.46	80.98		19.02
Netherlands	1992	80.19		19.81	85.19		14.81	81.78		18.22
United Kingdom	1991	0		100.00	100.00		0	90.58		9.42
Unweighted average		48.79		51.21	66.76		33.24	78.47		21.53

<i>Federal countries</i>	<i>Year</i>	<i>Housing</i>			<i>Leisure</i>			<i>Transport and communications</i>		
		<i>C</i>	<i>S</i>	<i>L</i>	<i>C</i>	<i>S</i>	<i>L</i>	<i>C</i>	<i>S</i>	<i>L</i>
Australia	1990	31.92	41.61	26.47	28.92	32.51	38.57	22.20	54.32	23.48
Canada	1989	19.15	26.99	53.87	15.53	25.88	58.59	30.56	38.36	31.07
Germany	1989	5.20	23.36	71.44	3.62	28.82	67.56	49.94	23.62	26.43
United States	1991	66.68	7.55	25.76	15.72	12.84	71.44	28.85	43.46	27.69
Switzerland	1984	8.38	23.48	68.14	6.69	30.40	62.91	37.26	39.47	23.28
Unweighted average		26.27	24.60	49.13	14.10	26.09	59.81	33.76	39.85	26.39
<i>Unitary countries</i>										
Denmark	1990	40.56		59.44	41.60		58.40	52.25		47.75
France	1990	20.09		79.91	26.74		73.26	59.78		40.22
Norway	1990	39.89		60.11	38.17		61.83	63.92		36.08
Netherlands	1992	38.29		63.71	14.00		85.91	54.95		45.05
United Kingdom	1991	0		100.00	0		100.00	67.40		32.60
Unweighted average		27.36		72.64	24.12		75.88	59.66		40.34

Source: Bordignon and Giarda (1996).

Notes

C=central level; S=state level; L=local level

technologically complex functions—such as water or gas distribution—are, for the sake of efficiency, contracted out to private firms or controlled by boards with specialised membership. In other cases the private or collective destination of specific services (such as swimming pools) becomes important as to the inclusion of the service inside or outside the publicly funded section of the budget (this happens, for example, in Italy, France, UK).

Furthermore, it does not come out as clearly from [Table 1.3](#) as from the individual reports that the services which account for most of the differences in the financial burdens of subcentral governments—education, health care and welfare—appear to have different treatments and institutional placements in the various EU countries. As far as (primary) educational expenditure is concerned, the European norm (with some exceptions) appears to be that the running costs of the service are covered by local and intermediate governments, while wages and salaries are partially or wholly paid by central government. As regards health care expenditure, conditions vary considerably from country to country. In Italy and the United Kingdom the service is totally public and performed by special units at the regional level. A very similar model is now emerging in Spain. In France and in Germany the health care systems are half public and half private, while hospitals are run mostly at the local level. Nor does the table stress sufficiently the major role of local governments in Scandinavia, where not only

Table 1.3 Subcentral services and levels of government: a comparative view from the 15 studies

(a)

	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland	Italy	Luxem- bourg	Nether- lands	Portugal	Spain	Sweden
Refuse collection and disposal	S/R/L	L(C)	L(C)	L(C)	L(C)	S/R;L(X)	L(C)	L(D)	L(C)	L(C)	L(C)	L(C)	L(C)	L(C)
Slaughterhouses	S/R/L					S/R;L(X)	L(C)	L(D)	L(C)	NA	L(X)	L(C)	L(C)	L(C)
Theatres, concerts	S/R/L	R/L	S+L(C)	S+L(C)	S/R/L	L(M);L(X)	L(C)L(X)	L(D)	L(C);L(X)	L(C)	L(C)	L(C)	R/L	S+L(C)
Museums, libraries	S/R/L	R/L	L(C)	S+L(C)	S/R/L	L(M);L(X)	S/L	L(D)	R/L	L(C)	L(C);S/L	L(C)	R/L	S+L(C)
Parks, open spaces	R/L	L(C)	L(C)	L(C)	L(M)	L(M)	L(C)	L(D)	R/L	L(C)	L(C)	L(C)	S/R/L	L(C)
Sports, leisure pursuits	S/R/L	L(M)	L(C)	L(C)	L(X)	L(M)	L(C)		L(C)	L(C)	L(C)	L(C)	R/L	L(C)
Roads	S/R/L	L(M)	S+L(C)	S+L(C)	S/R/L	L(M)	S/L	L(D)	L(M)	L(M)	L(D)	L(C)	S/R	S+L(C)
Urban road transport														
Ports	S/R/L(X)	R/L	L(C)	L(C)	L(D)	S/R;L(M)	S/L		L(C)	L(M)	L(D)	L(X)	L(C)	L(C)
Airports	S/R/L(X)	S/R/L	L(C)	L(C)	R/L/S	R/L			(1)		S/L	L(X)	L(C)	L(C)
District heating	S/R/L(X)	L(D)	S+L(C)	S	S/R/L	S/R/L			(2)	S/L	S/L			S+L(C)
Water supply	S/R/L(X)	L(D)	L(C)	L(C)	L(M)	L/M			L(C)	L(C)	L(X)			L(C)
Agriculture, forestry, fishing, hunting	S/R/L	L(D)	L(C)	L(C)	L(C)	S/R;L(X)	L(C)	L(D)	L(C);L(X)	L(C)	L(X)	L(X)	L(C)	L(C)
Electricity	S/R/L	L(M)	S	S+L(C)	S/R/L	S/R;L(D)			L(D)	L(C)	L(D)		R	S
Commerce	S/R/L(X)	L(D)	L(C)	L(C)	L(X)	S/L(X)	L(C)L(C)		(1);L(X)	L(C)	L(X)		L(C)	L(C)
Tourism	S/R/L	L(C)	S+L(C)	S+L(C)	NA	S/R;L(M)			L(C)	L(C)	L(C)		S/R	S+L(C)
Financial assistance to local authorities	S/R/L	S	S	S	S/R/L	L(M)			L(D)	L(C)	L(C)		S/R	S+L(C)
	S/R	L(D)	S	S	R/S;R	R/S;R			R;S/R	S/R	L(D);S/L	S	S/R	S

Security, police	S/R/L	L(C)	S	S/L	S/R	L(C)	L(C)	L(C)	L(C)	S/L(1)	S/R	S
Fire protection	R/L	L(C)	L(C)	L(D)	R/L(M)	L(D)	L(C)	L(C)	L(C);S/L	L(X)	R/L	L(C)
Justice		L(C)	S+L(C)		S/R						S/R	S
Pre-school education	S/R/L	C	L(C)		S/R/L(M)	L(C)	L(C)	L(C)			R/L	L(C)
Primary, secondary education	S/R/L	R(L)	L(M)	S/L			L(M)	L(C)		S/L(2)	R	L(C)
Vocational and technical training	S/R/L	L(D)	L(M)	S/R/L				L(D)	R/L		R	L(C)+L(D)
Higher education	S/R	L(D)	S	NA	S/R	S/L	S	L(C)	L(D)		R	S
Adult educational	S/R	L(D)	L(M)	NA	R/L		L(C)	L(C)	L(D)		R	L(C)
Hospitals and convalescent homes	S/R/L(X)	L(D)	L(M)	NA		L(D)	L(C)	L(C)	L(D)	L(D)	R	L(M)
Personal health	S/R/L	L(M)	L(M)	NA	S/R/L(M)			L(M)			R	L(M)
Family welfare												
Services	S/R/L	L(M)	L(M)	NA	S/R/L		L(C)	L(D)	L(M)		L/R	L(C)
Welfare homes	R/L	L(D)	L(C)	NA	S/R/L(M)	S/L	L(D)	L(D)	L(D)		R/L	L(C)
Housing	S/R/L	L(M)	L(C)	NA	R/L(M)		S/L	L(M)	L(M)	S/L	S/R/L	L(C)
Town planning	R/L	L(M)	L(C)	NA	S/R/L(M)	S/L	L(D)	L(M)	L(M)	L(C)(3)	L(C)	L(C)

(b)

	Scotland				Wales				Northern Ireland				England			
	Non-metropolitan								Metropolitan							
	Country	Districts	Joint bodies	Districts	Country	Districts	Joint bodies	Districts	Country	Districts	Joint bodies	Districts	Country	Districts	Joint bodies	Districts
Refuse collection and disposal	L(C)				L(C)				L(D)	L(C)			L(C)	L(X)		L(C)
Slaughterhouses																
Theatres, concerts	L(C)				L(C)				L(D)				L(C)			L(C)
Museums, libraries	L(C)				L(X)				L(D)							
National parks										L(C)			L(C)			L(C)
Parks, open spaces					L(C)					L(C)			L(C)			L(C)
Sports, leisure pursuits					L(C)				L(D)				L(C)			L(C)
Urban road transport	L(C)												L(C)			L(C)
Ports	L(C)															
Airports	L(C)															
District heating																
Water supply	L(X)															
Agriculture, forestry, fishing, hunting																
Electricity																
Commerce	L(C)				L(C)				L(D)				L(C)			L(C)
Tourism	L(C)				L(C)				L(D)				L(C)			L(C)
Financial assistance to local authorities																
Security, police	L(X);L(C)				L(X)				L(D)				L(X)			L(X)
Fire protection	L(X);L(C)				L(X)				L(D)				L(X)			L(X)
Justice																
Pre-school education	L(C)				L(C)				L(D)				L(C)			L(C)
Primary, secondary education	L(C)				L(C)				L(D)				L(C)			L(C)

Vocational and technical training	L(C)					
Higher education	L(C)					
Adult educational						
Hospitals and convalescent homes	L(C)	L(C)	L(D)		L(C)	L(C)
Personal health, environmental health	L(C)	L(C)	L(D)		L(C)	L(C)
Family welfare services						L(C)
Community care						L(C)
Housing	L(C)					
Strategic planning	L(X)					
Town planning	L(C)					
Passenger transport	L(X)			L(C)	L(X)	L(X)

Source: Fifteen studies.

Notes

L(C)=function performed exclusively at the lowest level, i.e. commune, *municipio*, *Gemeinde*, district, etc.

L(D)=function performed at the 'provincial' level, i.e. provincia, departement, country, etc.

L(M)=function performed by both local levels.

L(X)=function performed at the local level by special units or entities, with separate budgets (e.g. hospitals).

R=function performed exclusively at the intermediate level (i.e. Land, Comunidad Autonoma, region, etc.).

R/L=function shared between 'intermediate' and local level.

S/R; S/L=local or intermediate function with a significant share of central involvement.

Italy: (1) Special authorities, (2) Special authorities or private companies, (3) Special operational units (*corpo dei pompieri*), (4) State function, with only marginal involvement of communes, (5) State function, (6) Special authorities at the regional level (IACP).

Portugal: data only for the continent; Azores and Madeira not included.

Sewage												CSO
Garbage												
Hospitals												PCSV
Old people homes												GEO
Social assistance												GEO
Housing												CSV
Fire protection												GEO
Other												PCSO
Transport												
Land												
River												GEO
Sea												GSV
Air												CSV
Planning												GSV
Environment/planning												
Other												

Source: Owens and Norregaard (1991).

Abbreviations: R=regions; C=communities; D=department; P=province; L=canton/land; G=counties; E=exclusively by intermediate levels; S=share with another level; O=higher level of government requires carrying it out; V = discretionary function.

Notes

1 Refers to North Thineland.

2 Refers to a 'typical' canton.

3 Communities and regions treated together=C.

Table 1.5 Public expenditure by level of government, 1993 (per cent of GDP).

<i>Countries</i>	<i>Public expenditures</i>	<i>Central government</i>	<i>Intermediate and local government</i>	<i>Social security funds</i>
Austria	48.4	17.9	13.8	16.7
Belgium	55.2	25.3	8.3	21.6
Denmark	61.1	18.8	33.3	9.0
Finland	59.0	15.7	20.1	23.3
France	50.9	16.4	9.5	25.1
Germany*	45.5	10.8	15.2	19.5
Greece	51.2	27.0	6.4	17.9
Ireland	38.7	19.6	14.5	4.6
Italy	52.9	23.2	15.3	14.4
Luxembourg	40.7	16.1	4.5	20.1
Netherlands	55.9	15.6	20.5	19.7
Portugal	34.7	21.7	3.8	9.3
Spain	40.7	10.6	10.6	19.4
Sweden	67.3	26.2	28.1	13.0
UK	42.7	21.2	16.0	5.6

Source: OECD National Accounts, 1995.

Note

* Includes only West Germany.

the health care system, but most of the welfare schemes, are implemented at the local level. The impact of this very peculiar situation is witnessed by the exceptionally high incidence of local budgets on GDP in Denmark, Sweden and Netherlands, as can be seen from [Table 1.5](#). The various degrees of expenditure decentralisation can also be seen from the comparative table ([Table 1.11](#)) I have worked out directly from the 15 sources, which will be presented and commented on at the end of the next section, since it mainly deals with the revenue side of decentralisation.

3

THE REVENUE SIDE OF FISCAL DECENTRALISATION

3.1

Introduction

With varying degrees of precision, this section reports on the four ‘conventional’ types of public revenue available in each one of the EU member countries to subcentral governments: (a) revenue from taxation; (b) non-tax revenue; (c) revenue from transfers (grants); (d) borrowing.

Dealing with subcentral government, *taxes* (defined as ‘compulsory unrequited payments to government’) can be divided into: (a) ‘own taxes’, over which the beneficiary government has some control (e.g. it can vary the rate, or the base, or both); they can also take the form of ‘overtaxation’ (surcharges) of centrally determined tax base or tax revenue; (b) ‘ceded’ (or devolved) taxes, which are centrally designed and controlled and simply ‘passed over’ to subcentral governments, with minimal or (more often) no involvement of the latter in their administration; (c) ‘shared taxes’, over which the beneficiary subcentral government has little or no influence (except, perhaps, at the political level in determining the sharing ratio): in this respect they are rather similar to general grants.

Non-tax revenues cover all government receipts other than taxes, grants and borrowing. They include fees and charges, property income, proceeds from the sale of public assets, fines, etc. *Grants (or transfers)* can be defined as non repayable, non compulsory receipts from other governments. They can be of two kinds: (a) those tied to a specific project, programme or expenditure (specific grants); (b) those providing general budget support (general or block grants³). *Borrowing* is another means of financing open to all subcentral governments, especially when it is aimed at investment. Again, different rules apply in the various cases as to its extent and limits, and to the nature (private or public) of the lending institutions.

The above distinction is not fully recognised by available statistical sources, the first and most popular being the OECD survey (*Revenue Statistics*). Fortunately, the 1996 edition of the OECD survey—to which I shall refer as a start—is more updated than the previous ones, among other reasons because it includes Belgium among the federal countries and no longer among the unitary ones. On the other hand, the most serious shortcoming of the OECD approach for any study such as this, is that it does not draw any distinction between unitary countries which have a well-defined regional level and those which do not. Furthermore, in the OECD statistics the figures on revenues are only one section of an overall picture which embraces five levels of administration: supranational, central, state, local and social security.

Concerning the whole of the public sector (the so-called ‘general government’) as defined by the OECD sources, it can be observed from [Table 1.6](#) that in 1993⁴ the countries belonging to the European Union exhibited the highest incidence of total revenues (which normally also means total expenditure) on GDP. This is true both of the federal countries (Belgium: 48.1 per cent whereas for the United States the corresponding figure was 33.5 per cent), and of the unitary states (the ‘old’ Europe is the leader, with Denmark and Sweden both over 60 per cent, while Portugal brings up the rear with just 38 per cent and yet surpasses Japan by several points). Tax (including social security charges) sources of revenue have a predominant share in Italy, Luxembourg and Greece among the unitary countries and Belgium among the federal ones. Taxes (as distinct from social security charges) are associated with central government

to the highest degree in Britain and Ireland (around 80 per cent) and to the lowest in Germany, France and the Nordic countries.

Focusing attention on the incidence of the revenues accruing to subcentral (state and local) governments of the EU, [Table 1.7](#) shows that in 1993 Germany held top position among the federal states, while within the unitary countries this position was once again held by the Nordic countries (Denmark, Sweden, Finland), despite their lacking a ‘regional’ level of government. Within total revenues the largest incidence of grants on GDP (all over 70 per cent) was to be found again in Denmark, in the United Kingdom and, above all, in the Netherlands (an example of a highly decentralised country with minimal tax autonomy).

3.2

Subcentral taxation in the EU: general available information

This subsection is devoted to a general overview of the taxation element in the financing of subcentral governments in Europe. Before turning to my own results, a suitable starting point—and a benchmark against which my own results will be set later—is provided by the aforementioned OECD surveys. In order to focus on the proper ‘tax revenue’, which is the one pertaining to central or subcentral levels, it is necessary to dispose of the ‘social security’ and ‘supranational sections’. It can be seen from [Table 1.8](#) that the weight of social security within the public sector can be quite variable in both federal and unitary countries. Germany reaches the top in the first group (nearly 39 per cent), while France has the leadership in the second group (close to 45 per cent) followed, at a suitable distance, by the Netherlands, Italy and Spain. (On the opposite side Denmark is practically alone with a bare 3 per cent.) Supranational governments absorb, on average, less than 1 per cent of the resources in both situations. Of the three EU members officially qualified as ‘federal’ by OECD sources, Belgium exhibits a (much) lower than average share of revenues as far as the intermediate and local level is concerned, while Austria has over 20 per cent and Germany has nearly 30 per cent.

The real ‘proof of the pudding’, however, is not the *share* of total national revenue enjoyed by each governmental level, but the *incidence* the specific tax revenue has on national GDP. Here the two EU federal states for which data are available (Austria and Germany) exhibit an incidence of the two layers combined (7–12 per cent), far higher than any of the unitary countries, again with the outstanding exception of the three Scandinavian countries, where the incidence of local taxation reaches, as in Sweden, 17.3 per cent of GDP.

The widest variations in values in terms of GDP are to be seen within unitary countries (see [Table 1.7](#)). On the one side, there is the outstanding performance of the Nordic countries (Denmark and Sweden with values around 15–18 per cent; Finland with about 10 per cent). This decentralisation of tax revenue appears all

Table 1.6 Revenues received by general government (EU and selected non EU countries).

	<i>As per cent of GDP</i>				<i>As per cent of total revenues</i>					
	<i>Tax revenue</i>		<i>Non-tax revenue</i>		<i>Tax revenue</i>		<i>Non-tax revenue</i>			
	1980	1993	1980	1993	1980	1993	1980	1993		
<i>Federal countries</i>										
Austria	41.2	43.5	6.5	7.5	47.7	51	86.4	85.3	13.6	14.7
Belgium	44.4	45.6	2.5	2.5	46.9	48.1	94.7	94.7	5.3	5.3
Germany	38.2	39.1	5.9	7.4	44	46.5	86.7	84.1	13.3	15.9
Switzerland	30.8	33.2	7.0		37.8		81.4		18.6	
United States	26.9	27.0	5.0	6.6	31.8	33.5	84.4	80.5	15.6	19.5
<i>Unitary countries</i>										
Denmark	45.5	50.3	8.4	10.0	53.9	60.4	84.4	83.4	15.6	16.6
Finland	36.9	45.4	6.1	5.1	43.0	50.5	85.9	89.9	14.1	10.1
France	41.7	43.9	4.3	5.0	46.0	49.0	90.7	89.7	9.3	
Greece	29.4	41.2	3.4	2.0	32.8	43.2	89.7	95.4	10.3	4.6
Ireland (1992)	33.8	36.2	6.6	5.2	40.3	41.4	83.7	87.4	16.3	12.6
Italy	30.2	43.8	2.5	1	32.7	44.8	92.3	97.8	7.7	2.2
Japan	25.4	29.1	0.6	3.4	26.0	32.5	97.7	89.5	2.3	10.5
Luxembourg (1990)	46.3	43.6	8.3	3.0	54.6	46.6	84.7	93.5	15.3	6.5
Netherlands	45.0	47.7	7.4	7.5	52.5	55.2	85.8	86.4	14.2	13.6
Portugal (1992)	25.2	33.4	1.9	4.7	27.2	38.0	92.9	87.8	7.1	12.2
Spain	24.1	35.0	2.8	4.6	26.9	39.6	89.7	88.4	10.3	11.6
Sweden	48.8	50.1	9.8	10.3	58.6	60.4	83.3	83.0	16.7	17.0
UK	35.3	33.4	7.7	5.5	42.9	39.0	82.1	85.8	17.9	14.2

Note

According to OECD definitions, 'local' includes regional (non federal) governments.

Table 1.7 Revenues accruing to subcentral government in the EU in 1993 (according to OECD sources).

Country	Tax revenue (per cent GDP)	Non-tax revenue (per cent GDP)	Grants (per cent GDP)	Total (per cent GDP)	Tax revenue (per cent total)	Non-tax revenue (per cent total)	Grants (per cent total)
<i>Federal countries</i>							
Austria	5.9	3.9	7.4	17.2	46.6	14.4	39.0
	1.1	0.9	0.5	2.5	49.9	32.1	18.0
Belgium	2.2	0.7	3.5	6.4	33.7	11.1	55.2
Germany	8.4	1.6	3.1	13.2	63.7	12.5	23.9
	3.1	3.7	3.4	10.2	30.2	36.3	33.5
<i>Unitary countries</i>							
Denmark	15.5	3.2	14.5	33.2	46.6	9.6	43.8
Finland	9.9	3.9	7.5	21.3	46.5	18.5	35.1
France	4.4	2.0	3.5	9.9	44.4	20.0	35.5
Greece	0.5			0.5			
Ireland	0.9	2.7	8.5	13.1	6.8	20.5	72.6
Italy	1.8			1.8			
Luxembourg	2.7	2.6	2.9	8.2	32.7	31.4	35.9
Netherlands	1.2	3.3	12.1	16.5	7.0	20.0	73.0
Spain	4.4	1.0	2.1	7.5	58.9	13.2	27.9
Sweden	17.3	3.3	5.3	25.9	66.8	12.6	20.5
UK	1.4	2.3	9.2	12.9	10.7	18.1	71.1

Note

According to OECD definitions, 'local' includes regional (non federal) governments.

Table 1.8 Percentage of all tax revenue received by the various layers of government, 1993.

<i>Countries</i>	<i>Central government</i>	<i>Intermediate and local government</i>	<i>Social security</i>	<i>EU</i>
Austria	50.4	21.2	28.5	0
Belgium	59.7	4.7	34.4	1.2
Denmark	65.3	31.0	3.2	0.5
Finland	49.5	21.5	29.0	0
France	44.8	10.0	44.8	0.4
Germany*	31.2	29.4	38.7	0.7
Greece	65.1	1.2	32.9	0.8
Ireland	82.5	2.4	13.7	1.4
Italy	58.9	3.7	37.1	0.3
Luxembourg	65.5	5.9	28.2	0.4
Netherlands	58.1	2.4	38.2	1.3
Portugal	67.4	5.8	26.8	0
Spain	49.4	12.4	37.7	0.5
Sweden	43.9	34.8	21.3	0
UK	77.0	4.1	17.8	1.0

Source: OECD—Revenue statistics, 1995.

Note

* Includes only West Germany.

the more impressive because these countries have no strong ‘intermediate’ level as in France or Italy. The explanation, as said, lies in the heavy burden their local governments carry in terms of social expenditure. At the other extreme are countries like Greece, Ireland, the Netherlands (all ‘unitary’ countries with no intermediate level) and Italy, with values of less than 2 per cent. The low value for Italy, however, is an anomaly due to the particular classification methods adopted by the OECD: in fact Italy’s extensive regional health system has been financed since 1993 by regionally allocated health contributions, amounting to at least 5 per cent of the total national tax (and ‘para-tax’) revenues. Also, an anomaly appears to be the position of the United Kingdom because the revenue of the ‘non domestic rates’ is considered to be ‘non-tax’ revenue, while France and Spain (which have a regional level), occupy an intermediate position (around 4–5 per cent).

According to the same OECD sources, the main components of the tax receipts of subcentral governments (inside and outside the EU) are: tax revenues from income and profits; tax revenues from property; tax revenues from goods and services; ‘other’ tax revenues (mainly business taxation). All the components primarily concern local governments, to which I now turn.

Property taxation Property taxation exists in all EU countries and refers to both land and buildings. Normally both physical and legal subjects are liable for

the tax, with the usual exceptions (public entities and non-profit organisations); legal persons are not liable for the British ‘council tax’. However, in some cases the revenue does not accrue to local governments. The methods of assessing taxable values differ from country to country: in some cases market value (Denmark, UK), in others rental value (Ireland, Portugal), but more frequently *cadastral value* (France, Italy, Luxembourg, Spain) is considered for the purpose. Other countries use mixed parameters (Netherlands, Belgium, Germany). With regard to cadastral value specifically, not all countries apply the same methodology to define it. The same holds for the assessment of taxable assets: market value, capitalisation of rentable value, replacement costs, etc. A common problem for most of the countries is the need to update the values, especially when cadastral ones are used. Quite often revaluations take place after years, sometimes after decades. This deficiency has even been pinpointed by the German Supreme Court as introducing an element of inequity to the whole system of wealth taxation. As a remedy, in many cases certain annual percentage adjustments have been introduced.

According to the OECD sources, the incidence of local property taxation on the GDP of EU countries in 1994 ranged from approx. 0.5 per cent to approx. 2.0 per cent with an average of 1 per cent. At the same time its incidence within the tax revenue of local or intermediate budgets could be either very low (see Germany, Austria, with 5–20 per cent) or practically all-absorbing (Ireland, United Kingdom, with 95–100 per cent).

Income and profits taxation In the majority of OECD countries personal income taxes are either absent at subcentral levels of government or relatively unimportant when compared to the yield from central government income taxes. In the European Union, the current income tax systems take up the following forms:

- Tax-sharing arrangements: lower levels of government are granted a fixed percentage of overall national or regional tax receipts. The distribution of the yield normally reflects the yield of the same taxes within the beneficiary jurisdictions (Austria, Germany—income taxes, Belgium, Spain—income taxes from 1994, Italy—special regions), but sometimes it does not (Germany—VAT, Spain—general grant).
- Separate tax rates: in this situation regional and local governments have the right to decide upon the rate of tax to levy on the taxable income (Denmark) or on the tax paid to central government (‘piggy-backing’) (Belgium).
- Separate rate and allowance structures: here the income subject to tax is, for the most part, the same for central and local income taxation; however, different allowances apply, and each unit of local government applies its rate to the taxable income so determined (Finland, Sweden).

The case of *separate tax systems*, under which the local authority or intermediate government determines the rate and base of the income tax, does not exist in the

EU: in Europe it is only present in Switzerland. The most relevant characteristics of the state and local income tax systems of developed countries, as shown by Owens and Norregaard (1991), are the following:

- as regards the tax base, the main distinction is between those countries where the tax base corresponds to taxable income or tax paid to central government and those where taxable income differs from centrally defined taxable income;
- as regards the rates, in contrast with other experiences (USA, Switzerland, Japan), no country applies multiple (progressive) rates at the local level in the EU;
- most countries use tax relief in their state or local income tax systems, thus surreptitiously introducing a certain degree of progressivity into the proportional tax systems;
- in non-Union countries like Japan, Switzerland and the United States subordinate levels of government are responsible for the assessment and collection of income taxes, in most other Union and non-Union countries (Belgium, Canada, Finland, Norway and Sweden) they are both assessed and collected by central government, in Denmark they are assessed by local government but collected by central government;
- with the exception of Portugal, none of the 15 EU member states levies a tax on profits at the subcentral level; some levy more or less 'unorthodox' taxes of this kind at the local level (e.g. Italy with *ILOR*; Germany with *Gewerbsteuer* (however, see below)). The tax base is usually determined by central governments, although in most federal countries outside Europe intermediate levels of government can determine both the base and the rate;
- the recent adoption of the dual income tax by some Nordic countries, whereby part of profits are taxed at the basic rate applied to income from capital, has certainly decreased the revenues of local governments wherever a revenue-sharing arrangement existed in the field of corporate tax receipts.

Business taxation Business taxes already exist explicitly in six countries: France (*taxe professionnelle*), Germany (*Gewerbsteuer*), Italy (*ICIAP*), Luxembourg, Portugal (*derrama on IRC*) and Spain (*IAE*). In France the tax falls on a portion (18 per cent) of the payroll and on the rental value of fixed assets. There are personal exemptions and the tax bill is deductible from both personal and corporate income tax. In Germany the tax hits the profits and gross capital of enterprises, but not wages (since 1980). The self-employed are not subject and small units enjoy special allowances. In Luxembourg the tax base is given by the (adjusted) sum of assets plus gross profits. In Italy, for each sector of activity, it is the combination of the workplace surface and of taxable profits (subject to a minimum established by central government, but adjustable upwards by the authority) which provides the basis of the *ICIAP*. In Portugal the *derrama* is a surcharge on business income tax (*IRC*) with a maximum rate of 10 per cent. Spain has adopted a somewhat sophisticated version of *ICIAP*, however with

Table 1.9 Main characteristics of local business taxes in the EU (all collected at municipal level).

<i>Country</i>	<i>Name of the tax</i>	<i>Tax payers</i>	<i>Type of tax base</i>	<i>Per cent incidence GDP</i>
Austria	<i>Gewerbesteuer</i> (abolished 1993)	Large firms	Assets, profits, wages	NA
France	<i>Taxe professionnelle</i>	Firm and self-employed	Rental values of assets, 18 per cent of wages	1.4
Germany	<i>Gewerbesteuer</i>	Large firms	Assets, profits, wages	1.6
Italy	ICIAP	Firm and self-employed	Indicators of volume and income of activity	0.2
Luxembourg	NA	Firms	Assets+profits	0.6
Portugal	<i>Derrama</i>	Firms	Profits	NA
Spain	<i>Impuesto sobre actividades econ.</i>	Firms and professionals	Various economic indicators	0.8
UK	Non-domestic rate	Firms	Property	2.0

Source: Own calculation.

Note

In addition to the listed ones, taxes on immovables used by firms and self-employed as inputs can also be considered ‘business taxes’: e.g. the French *taxes fonciers*, the German *Grundsteuer B*, and so on. This approach was already followed in a previous study for the EC Commission.

more—compared to Italy—objective factors included as proxy for the ability to pay of the enterprise.

It must be stressed, however, that the importance of revenues from local business taxation within the budgets of the six countries is quite different from one case to another. The order of magnitude of the revenue reaches 1.5 per cent of GDP in France and Germany, while it is around 0.6–0.8 per cent in Spain and Luxembourg and barely reaches 0.2 per cent in Italy (see Table 1.9).

3.3

Subcentral taxation in the EU: further information from the 15 surveys

More detailed information on subcentral tax revenues in the 15 EU member countries has been obtained from the 15 studies carried out for the EU Commission. There are basically no contradictions between the OECD figures for individual items and those emerging from the studies. However, differences arise

with regard to the nature attributed to some tax revenues and therefore to classification criteria. For example, the OECD surveys are not particularly concerned with the 'autonomous' or 'non autonomous' qualification of the tax yield accruing to a particular layer of subcentral government. The 15 surveys, on the contrary, have tried to draw such a distinction, in order to establish what degree of 'self-financing' characterises subcentral government in each country. The overall comparative results will be exhibited in the next section.

Thus, the first step of the sequence has been to define the degree of 'tax financing' in both local and intermediate budgets and of the way this occurs, by identifying the individual tax sources. The second implies a judgement on the real 'autonomy' of the same tax revenue in terms of base setting and/or rate setting (information that OECD sources do not give). As regards the first step, the main categories of tax revenues found by our surveys to be present at the local level are:

- taxation of income, both in an independent way (the three Scandinavian countries, plus Belgium with the formula of the 'surtax' on national taxation) and in various tax-sharing formulas (all the federal countries plus Portugal and Greece);
- taxation of value added, only in the tax-sharing formula (federal countries);
- taxes on immovables (Spain, Italy, UK, Ireland, Netherlands and, to a relatively smaller extent, France and Germany);
- taxes on business (Germany, France, Spain; to a lesser extent, Italy);
- an impressive variety of other (mostly indirect) taxes, whose bases are extremely diverse and sometimes bizarre.

As to the fiscal resources of the intermediate level, in the European Union these include as main ingredients:

- the sharing of the main national taxes (income and/or value added) in all the federal countries; in Italy with regard to the 'special regions'; and, as from 1994, in Spain in the 'common regime' regions. Tax sharing can also take a reversed form (from regions to the state) in the 'foral regime' cases of Spain;
- 'assigned' (also 'ceded' or 'devolved') taxes (mainly indirect), as is the case with Spain and, since 1990, with Italy. In other words, the central government manages the whole process of a given tax (with or without the help of the beneficiary intermediate government), but fuels the yield to the latter;
- social security (specifically: health) contributions in Italy;
- autonomous direct taxation, within base-sharing arrangements (France);
- autonomous (in varying degrees and forms: France, Italy, Spain, Belgium) or non-autonomous (Germany) indirect taxation.

A synoptic table containing the names of the main taxes accruing (whatever way it is carried out) to subcentral governments in the EU as described in the 15 reports is provided (see Table 1.10).

By setting the amount of tax revenues against that of total revenue a measure of ‘tax dependence’ of the subcentral budget is obtained. Here a rough classification of these ratios is proposed, which distinguishes between high, average and low tax dependence. A ‘low tax dependence’ of a budget means that it relies more on grants and non tax revenues than a ‘highly tax dependent’ budget. However, high tax financing of a budget does not always mean high tax autonomy of the government managing that budget, as the case of German Länder proves *ad abundantiam*.

Consequently, proceeding bottom-up, in the closing years of the period under consideration the situation of the 15 countries with regard to tax financing at local level was the following (see below). One can see that all the high tax content countries finance their local budgets by at least 66 per cent (taxes) and 33 per cent (other means). The average cases range from 40 to 66 per cent. The low ones normally have less than 40 per cent of tax financing.

Countries with a proportion of tax financing of local budgets are as follows:

<i>High</i>	<i>Average</i>	<i>Low</i>
Nordic countries (DK, SW, FL)	Italy*	Greece*
France	Spain	Netherlands*
Germany	Luxembourg	UK*
Belgium	Austria*	Ireland
	Portugal*	

*=the situation has evolved markedly during the period

As for the intermediate level, the six countries involved could be classified as follows, as far as tax content is concerned:

<i>High</i>	<i>Average</i>	<i>Low</i>
Austria	France	Italy up to 1993
Germany	Italy post-1993	Spain up to 1993
Belgium	Spain post-1993	

The second step of the reasoning implies a close scrutiny of what effective degree of free ‘manipulation’ of their tax revenues subcentral governments have in the various countries, since, as we have pointed out, the expression ‘tax financing’ is not automatically to be interpreted as ‘tax autonomy’.

The details of the 15 reports provide the answer, which could be stated in the following terms:

(a) *Local governments:*

- within the ‘high tax content’ group only Germany must be singled out as an ‘average tax autonomy’ case; all the other cases show a high degree of self-determination;

Table 1.10 Main tax sources at subcentral level in the EU.

Country	Main taxes: own (O), shared (S), devolved (D)	
	Intermediate level	Local level
Austria	(S) value added tax, wage tax, income tax; (O) payroll tax, business tax, beverage tax, land tax	(O) payroll tax, business tax, beverage tax, land tax
Belgium	(O) inheritance, tax on games and bets, tax on electronic games, tax on alcohol licence; (S) personal income tax	(O) Surcharges on real estate advanced tax, provincial taxes on a variety of tax base (e.g. economic activities, hunting, arms, etc.) supplementary tax on personal income tax
Denmark		(O) personal income tax, land tax (supplemented, urban areas, by commercial property tax)
Finland		(O) income tax
France	(O) housing tax, property tax on developed land, property tax on non-developed land, professional tax, tax on car licences, immatriculation certificates, tax on driving licences, additional tax on registration right	(O) housing tax, property tax on developed land, property tax on non-developed land, <i>vignette automobile</i> property transfer tax
Germany	(S) income tax, profit tax, value added tax; (D) motor vehicles tax, land transfer tax, wealth tax, inheritance tax, tax on beer	(O) <i>Gewerbsteuer</i> (trade tax), property tax A (agricultural immovables), B (urban immovables); (S) personal income tax; commercial rates
Ireland	—	—
Italy	(O) tax on circulating vehicles, surtax on state registration fees, oil tax; (S) refuse disposal charge; (D) health contributions	(O) communal tax on business and the professions (ICIAP), communal tax on immovables (ICI), tax on garbage collection and disposal (TARSU), fees for occupying municipal space and public areas (TOSAP)
Luxembourg		(O) tax on property, business payrolls and earnings; (S) state tax on income added value and road usage
Netherlands		(O) environmental taxes, surtax on motor vehicles, broadcasting licence fees; tax on immovables, tax on benefits, tax on building sites
Portugal		(D) tax on the purchase of immovable property (SIZA), property tax, tax on business income (IRC)
Spain	(S) (foral regime) income tax, value added tax; (common regime from 1993) income tax; other major taxes, (D) stamp duties, property transfer tax, wealth tax, death duties and gift taxation, gambling taxes)	(D) stamp duties, property transfer tax, wealth tax; (O) tax on property (IBI), tax on motor vehicles, tax on business (IAE), tax on professions
Sweden		(O) local income tax
UK		(D) tax on property (O) council tax

- the same can be said of Austria and Portugal within the ‘average’ tax content group;
- similarly Greece, besides being a case of ‘low’ tax content, also shows a very low degree of tax autonomy, whereas the remaining cases reveal the opposite situation.

The unrivalled European champions in terms of own tax revenues thus remain the Scandinavian local governments, which are characterised by a high tax content and at the same time a high degree of rate-setting power.

(b) At the *intermediate level*, it must be recalled that:

- in Germany tax sharing does not imply rate setting and also the other non shared taxes are totally national in character;
- in Austria and Belgium there is only a very modest quantity of tax autonomy besides shared taxes;
- in Spain no freedom of rate setting is granted to the autonomous communities with regard to shared taxes (not even in the ‘foral’ cases) and the same applies to the *tributos cedidos*;
- in Italy practically all tax and parafiscal revenues (some 60 per cent of the budgets of ‘ordinary’ regions) are, in principle, subject to autonomously determined alterations;
- the same (and even more strongly) can be said of the French regions.

Thus, considering the particular techniques used in tax-sharing arrangements in Austria, Belgium, Germany (and more recently Spain) it must be concluded that the intermediate (regional) governments of Germany and Austria have the least autonomous tax revenues of all the six countries, followed by Belgium. France shows the most autonomous tax arrangements (regions can set practically all the rates of both direct and indirect taxes), while Italy and Spain lie in between, the former being closer to France than to Germany, the latter being in the opposite location.

3.4

Grants and ‘other’ elements of local financing

Grants are a major element of local government financing in the EU. [Appendix B](#), which deals extensively with the issue is provided at the end of the chapter.

Given the political costs implied by raising taxation above what appear to be socially sustainable burdens, and the observed tendency to withdraw open-ended

grants from higher tiers of governments, local governments (in this case intermediate governments are not greatly involved) throughout Europe find themselves increasingly forced to rely on non-tax, non-grant revenues. Included in this very broad item are all sorts of incomes: rents from municipal housing; charges for water consumption or refuse collection (wherever the levy—as in Italy—is not considered a tax); proceeds from the sale of municipal assets; fees and charges for the use of leisure and sports facilities, building licences, parking, occupation of public domain (see especially Italy and Portugal), etc. In accordance with this revaluation of the ‘price’ concept in the provision of public services and in the exercise of public activities there are increasing pressures almost everywhere to set charges and fees above a minimum threshold of cost coverage, quite often as high as the average cost (as in Italy for water supply and private refuse collection).

3.5

The overall quantitative picture of European ‘fiscal decentralisation’ as it was in 1993

It is now time to draw a final quantitative picture of European intergovernmental fiscal/financial relations as they were in the benchmark year 1993. In order to do this it is convenient to use information coming from both external sources (such as the OECD data) and from the ‘standardised’ data provided by the 15 reports.

According to OECD sources (see above, section 1), in 1993 the incidence of subcentral expenditure on GDP was highest in Denmark (33.3 per cent) and lowest in Portugal (3.8 per cent), with only a weak correlation with the incidence of total public expenditure, since Denmark is second only to Sweden with regard to the overall public expenditure/GDP ratio (61.1 per cent against 67.3 per cent), while Portugal has indeed the lowest one (34.7 per cent). In general, it can be said that while the presence of only one local tier of government leads to a low incidence of subcentral expenditure on GDP (see Greece, Portugal, Luxembourg), the opposite is not true: according to OECD statistics both Spain and France—despite their being organised around a regional and a local level—exhibit lower values than the ‘unitary’ Nordic countries.

The same statistical sources indicate that the share of taxation (including compulsory social contributions) accruing to subcentral governments is always lower, and sometimes infinitely lower, than the share of expenditure allocated to them. It was seen in [Table 1.7](#) that the share of intermediate and local taxes in the overall national tax revenue can be as low as 1–4 per cent, but the shares of public expenditure are never so low. Even in the Nordic countries, where over 50 per cent of public expenditure comes from decentralised governments, the share of tax revenues barely reaches one-third of total national tax revenue.

The above information can now be set against that gathered from the 15 surveys and presented in [Table 1.11](#). It must be admitted that the standardisation

of the data is imperfect and some pieces of information are shaky, but the overall results cannot be seriously objected to. The following remarks apply.

1. The data on total and subcentral expenditure provided by the 15 surveys do not coincide with the OECD ones. However, they do confirm that, when measured as percentages of the respective GDPs, the highest figures for subcentral expenditure are to be found in the Nordic countries (Sweden, Denmark, Finland)—with average values over 30 per cent—despite the fact that they do not have an official ‘intermediate’ level of government; in second place are the federal states, Germany (25.1 per cent) and Austria (22.7 per cent) (but not Belgium); finally, the ‘regional’ states Spain (16 per cent) and Italy (14.7 per cent) (but not France). Belgium among the federal states and France among the regional ones are a little below the average values of their category. They are followed by the first of the unitary non regional states, the United Kingdom, with 13 per cent. Greece and Portugal show the lowest ratios.

2. The data confirm that revenues of intermediate governments are proportional to respective competences. They are therefore higher in the federal countries and Spain than in Italy, and higher still than in France, where they are very modest indeed. If the residual category of charges, fees, etc. is left out, and a dividing line is drawn between the resources over which the regions or the Länder have autonomy of decision (basically, freedom to set rates) and those over which they have not (grants, shared revenues, devolved taxes) then one gets the rather surprising result that French regions enjoy more than 50 per cent autonomy over their revenue, Italian regions (1993) only 5 per cent and German Länder (and Spanish autonomous communities) absolutely none! This conclusion must immediately be qualified by recalling that German Länder have substantial political leeway when negotiating their tax-sharing rates from within the Bundesrat, while nothing similar is to be found in France, Spain or Italy.

3. Concerning purely local governments, the absolute volumes of sources are largest in Germany, the UK and France, closely followed by those of the Nordic countries. Again, if one considers all autonomous and all non autonomous resources separately, it is Sweden which exhibits the largest share of autonomous resources of the total (over 60 per cent), followed by France (52 per cent) and Spain (39 per cent). Italy lies in an intermediate position (less than 30 per cent, but this is incommensurably higher than it was the year before, when no tax on immovables was present!). The low positions in local budgetary autonomy of federal countries like Austria and Germany should not cause surprise, since they have chosen to finance local budgets with shared taxes. On the opposite side are the three Nordic countries, Sweden, Denmark and Finland, relying on own income tax rates (where the relatively low autonomy in tax revenues is more than compensated by the high incidence of fees and charges—23 per cent—part of which are similar to taxes and certainly subject to local control).

To conclude, Greece, Germany, Finland and Sweden exhibit the highest incidence of the ‘third revenue’ (charges, fees, etc.) on total revenue.

Table 1.11 Compared fiscal decentralisation in the EU (1993).

Countries	Local level															
	Intermediate (regional) level						Local level									
	1	2	3A	3B	3B	3C	3C	3D	3D	4A	4B	4B	4C	4C	4D	4D
Austria	63.0	22.7	15.5	9.8	63.0	0.2	1	(...)	(...)	20.0	7.4	37.0	2.9	14	1.2	6
Belgium	27.0*	14.7	16.9	16.0	94.0	0.5	3	NA	(...)	7.4	1.7	23.0	2.6	36	NA	9
Denmark	64.0	33.0								38.3	16.9	44.0	17.8	46	3.6	9
Finland	63.0	29.0								21.3	9.3	44.0	7.1	33	4.9	23
France	53.5	9.6	8.4	2.8	33.0	4.7	56.0	0.5	6.0	83.5	30.0	36.0	43.2	52	10.1	12
Germany	34.2*	25.1	215.5	189.1	88.0	0	0	15.6	7.0	161.4	130.2	81.0	26.2	16	37.5	23
Greece	46.2*	2.4								1.7	0.8	51.0	(...)	(...)	0.4	24
Ireland	NA	NA								NA	NA	NA	NA	NA	NA	NA
Italy	55.6	14.5	66.5	60.7	91.0	3.4	5.0	0.8	1.0	45.0	25.0	55.0	13.0	29	3.7	8
Luxembourg	NA	NA								NA	NA	NA	NA	NA	NA	NA
Netherlands	23.0*	19.0								48.3	21.9	45.0	3.4	7	1.6	3
Portugal	47.9	5.6								11.5	10.7	92.0	0.9	8		
Spain	50.0	16.1	45.6	35.3	75.0	0.6	1	NA		30.1	9.4	31.0	11.6	39	42.7	14
Sweden	73.0	36								46.3	8.4	18.0	27.6	60	10.2	22
UK	51.0	13								90.0	70.5	59.0	11.3	12	9.2	10

Source: Fifteen studies.

Notes to Table 1.11

For the meaning of the column headings, see below.

* Social security not included in public expenditure.

(a)=Absolute values; (b)=percentages of 3a or 4a respectively.

NA=not available.

Austria: source taken by Austrian central statistical office—for further clarification see country report on Austria.

Spain: financial expenditure included.

France: gross borrowing in revenue data not included.

Portugal: 1992 data.

Greece: 1992 data.

Column headings

1=expenditure of all levels of government (as per cent of GDP).

2=expenditure of the 'intermediate' at local level (as per cent of GDP).

3A=total revenues of the 'intermediate' level (absolute value in billions of ECU).

3B=revenues of the 'intermediate' level given by the sum of transfers from other levels of government+devalued taxes (*tributos cedidos*) +shared taxes (absolute value in ECU and as per cent of 3A).

3C=revenues of the 'intermediate' level coming from really own (=autonomous) taxes (absolute value in ECU and as per cent of 3A).

3D=revenues of the (intermediate level coming from fees) charges *et similia* (absolute value in ECU and as per cent of 3A).

4A=the same as 3A, for the local (*) level (absolute value).

4B=the same as 3B, for the local (*) level (transfers include both from central and from intermediate levels) (absolute value and as per cent of 4A).

4C=the same as 3C, for the local (*) level (absolute value and as per cent of 4A).

4D=the same as 3D, for the local (*) level (absolute value and as per cent of 4A).

N.B.: Percentage values are rounded to the next unit.

Table 1.12 Shares of the various revenue sources at state and local level, 1980 and 1993.

<i>Countries</i>		<i>Tax revenue</i>		<i>Non-tax revenue</i>		<i>Grants</i>	
		<i>1980</i>	<i>1993</i>	<i>1980</i>	<i>1993</i>	<i>1980</i>	<i>1993</i>
Austria	state	47.3	46.6	13.1	14.4	39.6	39.0
	local	53.2	49.9	30.6	32.1	16.1	18.0
Belgium	local	27.6	33.7	8.5	11.1	63.9	55.2
Denmark	local	38.8	46.6	9.3	9.6	51.8	43.8
Finland	local	45.1	46.5	22.3	18.5	32.6	35.1
France	local	40.9	44.4	17.8	20.0	41.2	35.5
Germany	state	70.2	63.7	11.7	12.5	18.1	23.9
	local	36.0	30.2	33.9	36.3	30.1	33.5
Greece	local						
Ireland	local	7.9	6.8	17.5	20.5	74.6	72.6
Italy	local						
Luxembourg	local	38.8	32.7	13.4	31.4	47.9	35.9
Netherlands	local	5.3	7.0	13.1	20.1	81.6	73.0
Portugal	local						
Spain	local	52.4	58.9	37.8	13.2	9.8	27.9
Sweden	local	57.0	66.8	17.7	12.6	25.3	20.5
UK	local	29.6	10.7	23.6	18.1	46.7	71.1

Source: OECD, Revenue statistics.

4

THE COMPARED EVOLUTION OF LOCAL FINANCE, 1980–93; THE ROLE OF REFORMS THEREUPON

Once again the OECD data on taxation can be a convenient starting point. Table 1.5 above clearly suggests that there is great stability in the shares of tax and non-tax revenues of general government during the whole period, with the remarkable exception of Luxembourg. However, with regard to both federal and unitary countries, the period under scrutiny ends with a slightly greater incidence of revenues on GDP than at the beginning, with Italy and Greece recording the highest increase and the United Kingdom the highest decrease after Luxembourg. Practically both results are due to the tax component of the revenues, which is dominating.

Concerning the revenues accruing to state and local budgets, it can be seen from Table 1.12 that in the 13-year period changes (both positive and negative) in their shares have sometimes been substantial: here of course the record belongs to the United Kingdom, which sees its share of tax revenue decreased by two-thirds. In most cases changes in tax shares are exactly matched by inverse changes in grant shares, but not automatically. Table 1.13 tells the story in terms of incidence on GDP of the same revenue sources. Within federal countries Austria's and Germany's totals have moved by 0.5–1 per cent (less than in the United States). Sectorally, the most relevant increase refers to the incidence of grants at the state level in Germany (+0.9 per cent). Inside the group of unitary

Table 1.13 Incidence on GDP of the various types of revenue, 1980–93 (federal and unitary countries of the EU and USA).

	<i>Tax revenue</i>		<i>Non-tax revenue</i>		<i>Grants</i>		<i>Total</i>	
	<i>1980</i>	<i>1993</i>	<i>1980</i>	<i>1993</i>	<i>1980</i>	<i>1993</i>	<i>1980</i>	<i>1993</i>
<i>Federal countries</i>								
Austria								
State	4.2	4.5	1.2	1.4	3.5	3.7	8.8	9.6
Local	4.6	4.7	2.6	3.0	1.4	1.7	8.6	9.4
Belgium								
State								
Local	1.8	2.2	0.6	0.7	4.3	3.5	6.7	6.4
Germany								
State	8.6	8.4	1.4	1.6	2.2	3.1	12.3	13.2
Local	3.5	3.1	3.3	3.7	2.9	3.4	9.7	10.2
United States								
State	5.1	5.5	1.8	3.0	2.3	2.5	9.2	11.0
Local	3.2	3.7	1.5	1.9	3.7	3.5	8.4	9.1
<i>Unitary countries</i>								
Denmark	13.8	15.5	3.3	3.2	18.4	14.5	35.5	33.2
Finland (1990)	8.0	9.9	4.0	3.9	5.8	7.5	17.7	21.3
France	3.0	4.4	1.3	2.0	3.0	3.5	7.2	9.9
Greece	0.7	0.5						
Ireland	5.0	6.5	2.9	1.8		0.9	7.9	9.2
Italy	0.5	1.8						
Luxembourg (1990)	3.0	2.7	1.0	2.6	3.7	2.9	7.8	8.2
Netherlands	0.9	1.2	2.1	3.3	13.4	12.1	16.4	16.5
Portugal	0.9							
Spain	1.2	4.4	0.8	1.0	0.2	2.1	2.2	7.5
Sweden	15.3	17.3	4.8	3.3	6.9	5.3	27.3	25.9
UK	3.7	1.4	2.9	2.3	5.8	9.2	12.5	12.9

countries the overall incidence of revenues on GDP tends to decrease in half of the countries (Denmark is the most outstanding example), while in the other half there are increases, some of which are very impressive (see Spain, which trebles the figure). Tax revenues exhibit moderate increases everywhere, except Spain. Non-tax revenues show very variable situations, while grants show a general propensity to decrease, with the remarkable exception of the United Kingdom and, once more, Spain.

The above described movements are reflected in the changing shares of each source of revenue within the total: to limit discussion to the unitary country cases, the share of grants decreases almost everywhere in the 12 members of the Union, with the notable exception of Spain, while that of taxation generally

increases or remains stable, with the very anomalous behaviour of the United Kingdom, where the taxation share drops from 30 to 10 per cent!⁵

The evolution of subcentral budgets has been conditioned in some countries by concomitant changes in the organisational and financial set-up of the public sector, and in particular of its local segment. The 15 reports have normally signalled these reforms. In [Appendix A](#) a summarised list of them, by country, is presented.

5

CURRENT DEVELOPMENTS AND DEBATES: WHAT LESSONS (IF ANY) CAN BE DRAWN?

The minimum conclusion that can be drawn at this stage is that subcentral finances in Europe are almost permanently ‘in the making’, being subject to changing politico-institutional pressures and philosophical explications.

Foremost among the issues at stake comes the one related to the structure of subcentral government. Here we find countries facing opposite problems. On one side there is, for example, Portugal which, in spite of an old constitutional commitment, hesitates to set up a fully fledged intermediate (regional) level. On the other side there is Belgium which—after a federalisation process—has shown decreased interest in the provincial level and yet is unwilling to completely abolish it. In the middle lies the United Kingdom, which is committed to a sort of ‘third route’, implying a ‘unitary local government’, at either the country or the district level. Germany, which has already had experience in the field in relation to its Western part (mid-1970s) also appears determined to reduce the number of local authorities (the ‘new Länder’). Greece too can be cited at this stage, since it is just now experiencing its newly created ‘prefectures’ (the provincial level). Two other countries characterised by lively institutional debates are undoubtedly Italy—where the quest for ‘federalism’ has not yet decided which direction to take, whether to strengthen the regions rather than the communes, leaving provinces in the middle of nowhere—and Austria, where stronger autonomy for state and local governments is also urged from many sides.

With regard to resource issues, at least three of them are to the forefront these days in Europe. First, there is a search for an optimal base of local taxation. This issue has been excellently treated by the previous Report drafted for the Commission by Denny *et al.* (1993). Very little can be added here, since there continues to be a quest for systems of local taxation pursuing a variety of objectives: respecting the ability-to-pay principle, removing disincentives to local business, avoiding gross disparities, improving accountability, dividing the cost of local services equally between individuals and enterprises, pursuing environmental aims, etc. Because so many objectives are being pursued, because they are far from compatible, and because priorities vary over time, it is scarcely surprising that local taxation is always ‘under review’, that changes are constant,

and if there are no changes it is due to lack of agreement on what they should be. Among the most significant innovations under way or simply being debated re fiscal matters these days are: (a) in France, the transformation of the *taxe d'habitation* into an income tax at departmental level, plus the abolition of the *taxe professionnelle* and its replacement by a tax on gross value added; (b) in Germany, the abolition of the *Gewerbesteuer* and its replacement either by a tax on gross incomes or a locally differentiated sharing of national income tax or (most recently) value added tax; (c) in Italy, the abolition of a number of local and central business taxes (plus health contributions) and their coverage through a brand new tax on gross value added, the so-called IRAP, to be handed over to the (strengthened) regions. The remaining countries can be divided in two categories: (a) those which are apparently satisfied with their long-term solutions, whether they envisage a high degree (the Nordic countries, plus Belgium-Luxembourg) or a low degree (the Netherlands) of tax autonomy; (b) those which are in the process of digesting the far-reaching reforms just implemented (Portugal, Greece, United Kingdom, Spain: see above) and do not seriously want to engage just now in new adventures on the 'tax front'.

Second, whatever their position in the framework outlined above, practically all countries are engaged in a continuous search for equalisation of resources among the various areas of their territories. This issue is dealt with extensively in [Appendix B](#) on pages 61–2. From that description the conclusion can be drawn that although European tradition attaches a high value to local autonomy, it places it within a framework of 'co-operative federalism'. At variance with other experiences, in the European Union the devolution of major service functions to local government is accompanied by a continuous sense of national concern for standards and equality of opportunity, which is not seen as inconsistent with these values. This is the notion of 'local autonomy' so far prevailing in Europe. However, the national reports do suggest that things are starting to change in several respects: (a) in the unitary states there is an increasing tendency towards financing equalising schemes through horizontal, rather than vertical, transfers (Denmark, Sweden, Finland); France at the regional level; the United Kingdom with regard to the distribution of non domestic rates; (b) in regional or federal states dissatisfaction with the excesses of uniformity is growing (in Germany the discussion was already under way even before reunification; in Spain it has led to the income tax-sharing agreement between autonomous communities and central government; in Italy, turbulence is growing over the 'hyper-equalisation' of the north with the south, to the detriment of the north; much the same is happening between the Flemish and Walloon portion of Belgium).

A third widespread concern in today's Europe regards the fair allocation of costs of public services between taxpayers and consumers. There is nowadays a reaction against what seemed to be a widely accepted philosophy in the recent past, i.e. the subsidisation of basic services, irrespective of consumers' ability to pay. Nowadays local authorities (as well as central governments) in most countries would consider the same behaviour inefficient and inequitable, with

some exceptions (see the case of public transport in France, Germany, Italy). Today in Europe there is a much wider spectrum of private solutions to (local) public demands and/or needs than there used to be in the recent past. In the design of new forms of payment for local services the leaders are the United Kingdom, France, Germany and the Netherlands.

Notes

- 1 See any handbook on the theory of local government. Concerning the European situation, the above distinction has been used by K.Denny, M.Ridge and S. Smith in 'Local Taxation', report to the Commission of the European Communities, June 1993.
- 2 See Owens, J.P. and Norregaard, J., 'The role of intermediate and local levels of government: the experience of selected OECD countries', in D.King and J.P. Owens (eds), *Fiscal Federalism in Economies in Transition*, p. 83.
- 3 For a global picture of the role played in the period 1980–93 by these types of revenues within the OECD member countries, see section 3.
- 4 The table will be recalled in section 3, when the 1980–93 evolution of same variables will be briefly summarised.
- 5 Once again the individual country surveys used for this chapter provide more valuable information, although not for all countries (and, for the countries listed, not to the same extent). Their content can be summarised as follows: *Austria* The expenditure/GDP ratio has kept rather stable on the 20–2 per cent value (35 billion ECU in 1993), and so has the tax burden (taxes have increased almost by the same amount as expenditure, the gap being filled by non-tax revenue).

Belgium Very little can be said, except that taxes and fees have increased faster than the other sources of revenue.

Denmark Exhibits a moderate decrease of the incidence of subcentral expenditure on GDP (from 35 to 34 per cent), and at the same time an increase of the relative weight of taxation within the financing items. Non-taxes and, especially, grants have decreased (in relative terms).

Finland After having increased up to 106 billion ECUs, Finnish GDP (measured in ECUs!) has decreased to 72 billion ECU in 1993. However, local expenditure and revenues have decreased by far smaller amounts, so that their incidence on GDP has gone up by almost 10 percentage points, to 30 per cent! Here it is grants and non-tax revenues that have scaled the boundaries of taxation.

France Again a moderate increase of the expenditure/GDP ratio (+15), which, however, still falls short of 10 per cent. It has been financed to a large extent by new local taxation (+10 per cent), and borrowing, while grants and non-tax revenues have lost ground (–12 per cent).

Germany After a decrease from 22 to less than 20 per cent in 1991, in 1993 the ratio of expenditure to GDP had already rocketed to 25 per cent: the price of reunification. Grants (from 78 to 137 billion ECUs in two years!) and non-tax revenues have financed most of this increase, while the tax proportion has decreased by 6 per cent).

Greece No significant picture available.

Ireland Exhibited data need closer inspection.

Italy Subcentral governments' incidence on GDP in 1993 had reached 14.5 per cent, up 1.5 per cent from 1980. The financing mix has, meanwhile, changed dramatically, starting from 1989, in favour of tax revenues (but the figures—as collected by the Bank of Italy—provide a serious underrepresentation of the real tax revenues of 1993). The open-ended grants have decreased by 14 per cent (by much more if the 'true' tax data were used!).

Netherlands Only data on revenues are available for the entire period, 1990–3. They confirm that the Netherlands is a country of limited local fiscal power.

Spain The increase in the (subcentral expenditure/GDP) ratio is the most dramatic in Europe: from 4.4 per cent (1980) to 19.1 per cent (1993), which is an inch short of the Austrian and German standards. Of course this is due to the creation of the regional level. The process has almost entirely been geared to grants (+28 per cent increase in the share) rather than tax (–14 per cent) and non-tax (–4 per cent) revenues. Of course in absolute terms expenditure is much less impressive (72 billion ECUs, as against 102 billion for France).

Sweden Again a Nordic country, and again a very high expenditure/GDP ratio (29 per cent in 1993, down 1 per cent from 1980). In 1993 a sharp devaluation krona/ECU turned all absolute values for that year downwards. These developments have been associated to a steep increase in taxation (which had reached its pre-devaluation peak in 1992), whose incidence in the financing mix has increased by 16 per cent at the expense of grants and non-tax revenues.

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APPENDIX A: INSTITUTIONAL AND ORGANISATIONAL CHANGES, 1980–93, BY COUNTRY

Austria No patent change in organisation or expenditure patterns. Major tax reform in 1994 with abolition of *Gewerbsteuer* and its replacement by a community tax.

Belgium Major reform in late 1970s with the creation of regions. Basic constitutional reform in 1998 turning Belgium into a federal state. In early 1990s attribution of central tax revenue to regions and communities through tax sharing. Shifting of former central grant to local authorities onto the regions.

Denmark No remarkable changes on the organisation/expenditure side. On the finance side, in 1984 equalising grants cease to be vertical and turn horizontal. In 1987 new formulas adopted for the needs part of the grant.

Finland No substantial changes on the organisation/expenditure side. On the finance side, modification of the local base for income tax following (1993) the introduction of the dual income tax.

France In 1982–3 very important reforms bearing on decentralisation of important competences onto communes, departments and regions (newly created). This continues until 1994—*Rebus sic stantibus*, the expenditure burden of subcentral governments increases by 30–50 per cent with respect to the initial year. On the finance side, in 1981 subcentral governments get the right to vote the rates of the four direct taxes. Throughout the 1980s ceilings and constraints are being set in line with this freedom. Also, the base of the professional tax is subject to reforms. Mid-1980s: the DGF changes from a pure 'revenue-equalising' grant to a 'revenue+needs'—equalising grant. Meanwhile, the central government finances more and more of the local tax bill.

Germany Nothing relevant on the competences/expenditure side until German reunification, 1990. In 1981 abolition of the payroll segment of the tax base for *Gewerbsteuer*, in exchange for the sharing by communes of 15 per cent of income tax. 1993-onwards: increases in the participation by *Länder* to VAT, from 37 to 49.5 per cent. From 1991–5, different application of the equalisation formulas to eastern and western *Länder*. As from 1996, equal treatment of all *Länder* and their local authorities.

Greece Only one tier of local government up to 1993. As from 1994, second tier out of the decentralisation of the central state's peripheral structures. During

the 1980s gradual abolition of minor local levies and replacement by grants and shared central taxes.

Ireland (1991) Local Government Act, to foster action by local authorities aimed at promoting development. (1994) Establishment of eight regional authorities. On the financing side, no particular changes, except a sharp decrease of grants in 1987.

Italy Regional level: 1980 is the first operational year of the National Health Service entrusted to regions. No subsequent relevant innovation on the functional/expenditure side. On the financing side, as from 1990 certain previously national taxes are assigned to the ordinary regions. Starting from 1993, revenue from health contributions is devolved. *Local level:* no remarkable change in the organisational setting until Act 142/1990, which—however—does not provide for changes in expenditure loads. On the finance side: (1982) introduction of equalising grants for local authorities; (1989) introduction of local business tax; 1993 introduction of ICI (tax on immovables); 1987, 1995, reforms of general grants (for both communes and provinces) towards the concept of ‘standardised expenditure—standardised revenues’. Recent moves towards privatisation of local services and progressive reduction of real (and, from 1993, nominal) value of grants.

Luxembourg No relevant change.

Netherlands On the constitutional-expenditure side, no sudden change, but a long series of far-reaching steps towards decentralisation of competences and expenditure. On the financing side, no significant upgrading of the very low role of own taxes. 1984: a new, more sophisticated grant system is introduced.

Portugal (1984) and (1987): Local Finance Acts, following the provisos of the 1976 Constitution. 1987: *siza* becomes a local (‘devolved’) tax. 1988: new property tax. 1986–8: major tax reform, with creation of the IRC (business income tax) on which *derramas* (surtaxes) are paid at the local level.

Spain Regional level: as from 1979, implementation of the new Constitution, with increasing powers and expenditures passed onto the CCAAs. Various modifications of the financing of transferred competences and of the distribution of the general grant. 1990: reform of the Investment Compensation Fund (FCI) to favour poor regions. 1994: start of the new system of financing through a 15 per cent sharing of income tax. *Local level:* (1989) Local Government Act, with definition of compulsory and discretionary services. (1988) Local Finance Act, with the creation of three compulsory taxes: (a) on immovables (IBI); (b) on economic activities; (c) on motor vehicles, side by side with other discretionary taxes.

Sweden On the institutional side the (1991) Local Government Act concedes greater freedom to decide on the administration of the country. The same year the national tax reform introduces the DIT which governs income from capital out of the LIT base. In earlier years there had been a freeze on the rate-setting power of local governments.

United Kingdom No major change on the organisational side except the abolition of the GLC (Greater London Councils) and the metropolitan counties in 1986. New radical changes are envisaged (1994–6) in all parts of the UK following the suggestions of the Local Government Commission for England and other regional indications. On the revenue side: (1989/90) abolition of rates and introduction of community charge; (1992/3) replacement of the latter with council tax. Same years: unification of the rates on business property. (1981) and (1986) major reforms in grants system prior to the final reform of 1990/1, when only the ‘need’ element survives and is actually strengthened through the method of ‘standard spending assessment’ (SSA).

APPENDIX B: NON-TAX REVENUE IN EU COUNTRIES: THE SYSTEM OF GRANTS

The second (but, in several cases, the first) source of finance at subcentral level is provided by transfers (grants) from higher levels of government, i.e., from central government for local and intermediate levels; from central and regional governments for local units.

According to economic literature, grants serve three main purposes in that they

- 1 provide a balance between intermediate and local government revenue and expenditure responsibilities;
- 2 equalise differences in fiscal capacities and/or expenditure needs;
- 3 help modify the provision of social or public goods in accordance with external spillover effects.

In the experience of the EU member countries (but of other countries as well) the first objective is normally achieved through tax-sharing agreements or through ‘block’ grants; the second by an equalisation formula applied to the tax-sharing or grant; the third by specific grants. The objective under (1) implies what is often called ‘vertical equalisation’, that is, an equitable distribution of the overall resources between layers of government.

Most important is the objective under (2), which is also called ‘horizontal financial equalisation’, i.e. the achievement of a more equitable distribution of financial resources between different authorities at the same level. European governments, as all others, are committed to ensuring a reasonable overall balance in the distribution and quality of public services to overcome major differences in the financial capacity of local or regional authorities and, hence, in their ability to provide such services.

Central governments (or regional governments in the case of federal countries) usually try to enhance the financial capacity of those intermediate/ local governments whose taxable capacity is weaker than average or which have

higher than average expenditure needs. As has been pointed out by Blair (1994), the aims pursued by governments in ensuring equalisation can be numerous:

- To compensate for differences either in the per capita tax revenue or in objectively measured expenditure needs or in both.
- To ensure that each authority is able, theoretically, to provide a similar pattern and standard of service while levying the same rate of local taxation (equalisation of the so-called *tax price*).
- To promote more balanced economic development between the different regions of a country.
- To compensate for special burdens falling onto local/intermediate governments.

The objective of equalisation can be achieved through all the various kinds of grants known in the literature: (a) general (or block) versus specific grant, according to whether they may be freely used or used for particular programmes only; (b) matching versus non matching grants, depending on whether they require or not participation in the expenditure by the recipient unit; (c) current versus capital grants.

Not all the 15 reports are equally detailed about the relevant national system of grants. However, the overall information available about European cases allows the following generalisations. First of all, the great variety of situations across Europe:

- With regard to the amount of resources used for equalisation as a proportion of total local or intermediate revenue: in some countries where local taxes are high, the funds are relatively small.
- With regard to the ‘philosophy’ of equalisation: whereas some countries (UK; Denmark; more recently France up to 1993) rely on relatively sophisticated systems for equalising both the per capita tax base and expenditure needs according to objective yardsticks, others (Netherlands, Ireland, Italy until 1994) seem to pay little attention to revenue equalisation. Admittedly, this is not surprising when local taxes account for a very modest part of local government finance. On the contrary, other countries (Germany and up to 1985 France) pay more attention to revenue equalisation than to equalisation of needs.

Some European governments are explicit about the aim of their equalisation system; in other countries equalisation seems to be only a subsidiary aspect of the allocation of government transfers and—insofar as equalisation is consciously pursued—its nature has to be deduced from the distribution criteria which are actually used.

Specific grants are usually paid to support services such as educational and cultural activities, transport, roads, infrastructural works, housing, health and

social services. However, there is a trend in most countries towards replacing specific grants by block grants, both on grounds of local autonomy and with a view to more effective equalisation.

Some equalising schemes provide simultaneous consideration of both revenue and expenditure needs, e.g. the UK, Sweden, Germany and, Italy as from 1995. In other countries (Denmark) two separate schemes exist for the equalisation of the tax base and expenditure needs. In Germany, the method of inter-local equalisation differs from Land to Land, but usually the difference is calculated between the municipalities' needs indicator and fiscal capacity indicator. In Italy a 'standard' expenditure need is calculated (via regression analysis) for each municipality and then a 'standard' fiscal capacity: wherever there is a positive difference, part of it is paid to the deficient authority. The British system is perhaps the most sophisticated of all: the government first assesses how much each local authority needs to spend in order to provide a standard level of service (SSA, standard spending assessment); it then distributes the block grant in such a way as to ensure that each local authority, whatever its tax base, would have to levy the same hypothetical rate of local tax to provide this hypothetical level of services.

Not always do the resources which ensure horizontal equalisation come from the upper tier of government. There are examples in the EU of 'Robin Hood' payments to the poorer authorities by the richer ones: traditionally this has been the case with Denmark, but more recently Sweden has also taken up this practice. The Italian system introduced after 1995 reflects such a philosophy to some degree. Another outstanding example is the French method of equalising local revenues from the 'professional tax' (two compensating funds are financed with the over-standard revenues).

Equalisation in the federal countries of Europe is also achieved through the very tool of tax sharing, when this does not lead to a pure devolution of the tax revenue collected from a given area to the local authorities of that area. In Germany and Belgium a given national proportion of VAT is shared between centre and Länder/regions, yet each Land/region does not receive in proportion to 'its own' VAT. Also the share of income tax accruing to municipalities in Germany is subject to some degree of equalisation, since there is a ceiling to the taxable income per taxpayer going to the municipality. Clearly, no contribution to equalisation comes from a tax-sharing system whereby each territory gets back exactly whatever tax revenue it has produced.

Equalisation of spending needs takes up the most varied shape across Europe, but all try to cope with the disparities which need to be compensated through equalisation. In practically all cases only those disparities are calculated which do not depend on the local authority's (or region's) discretion, but on objective factors. Even the cost differences of a service in two given areas may not be objective, if they derive from discretionary concessions (such as higher salaries) or pure inefficiency. In the search for a scientific answer to these practical

problems Britain has gone farther, perhaps, than any other country: first, with the system based on the GRE, then with the SSA methodology.

In short, the factors called in to explain the differences in spending needs to be compensated are the most disparate: population (all countries); population density (Belgium, Germany); proportion of schoolchildren (Denmark, Germany, France, Netherlands, Spain); number of dwellings (Netherlands, Portugal); altitude (Italy, France, Switzerland), and so on.

A special case of differential in the cost of service provision which is taken into account in some countries (notably Germany, Austria, Italy, Spain and to some extent France) concerns the relationship between cost and size of the municipality. In the equalisation schemes of these countries provision is made for an automatic increase in the financed expenditure progressively tied to the scale of population.

2

Developing fiscal federalism in Eastern Europe

Michael Engelschalk

1

BACKGROUND

Besides the decentralization of the economy in the former communist countries of Central and Eastern Europe, the decentralization of government itself became the main target of the reform process towards a democratic market economy. Efforts to decentralize governments started in most central and eastern European countries immediately after the initiation of the transition process. Examples are the creation of a two-level system of local government in Estonia already in 1989 or the law on local self-government in Hungary, which was one of the first laws approved by Hungary's newly elected Parliament in 1990. In Russia the Federation Agreement, which was signed in July 1992, was the legal basis for the creation of subnational governments in the form of 89 administrative units (oblasts, okrugs, kraiss, Moscow and St. Petersburg as metropolitan cities with oblast status, and autonomous republics). Setting the legal base for *fiscal federalism*, defining the revenue sources for subnational local governments, however, proved to be much more delicate and time-consuming than mere territorial decentralization (and is not finalized yet). A number of reasons can be listed to illustrate the difficulties in this field.

1.1

Fragmentation of subnational governments

As a reaction to the wholesale centralization in the communist period, the decentralization process led to extreme fragmentation with the creation of a one-tier system of subnational government with very small, economically unviable municipalities. In Hungary, only a small number of local governments count more than 5,000 inhabitants, while local governments with less than 1,000 inhabitants are the rule rather than an exception. In the Czech Republic, with a population of slightly more than 10 million, more than 6,000 municipalities have been created, 80 per cent of them having less than 1,000 inhabitants. The increase in the number of municipalities started in 1991 and their number grew

by 50 per cent within two years. Of the 254 local governments in Estonia 156, which means more than 50 per cent, count between 1,000 and 3,000 inhabitants. In the Slovak Republic the law on local self-government, passed in July 1990, established 2,836 municipalities, with a total population ranging from 16 residents in the smallest local government to 441,400 in the capital of Bratislava; only 124 of the Slovak municipalities have more than 5,000 residents. A certain exception in this development can, outside the former Soviet Union, only be found in Bulgaria, where the average population of the municipalities is about 33,000.

The existing micro-local governments have considerable difficulties in providing the services for which they are responsible due to insufficient administrative and budgetary capacity. A recent study in the Czech Republic shows that total revenues of municipalities per inhabitant are considerably lower in small than in larger municipalities; while a local government of 1,000 inhabitants raised less than 8,000 CKR per inhabitant in 1995, a local government of 7,500 inhabitants had almost 12,000 CKR available per inhabitant.¹ With the insufficient fiscal capacity of small local governments, and as voluntary merging proved to be extremely unpopular and amalgamation by the state almost impossible, discussion about the necessity to create a second tier of (regional) local governments was kindled rather early in the decentralization process. All transition economies, even relatively small countries like Slovenia with less than 2 million inhabitants, have at one stage discussed or are still planning the creation of a second tier of local government.² In view of several decades of experience with communist administration, apart from the fragmentation problem a number of reasons were given to justify the need for the creation of an intermediate level of local government: the necessity to break up power to prevent the emergence of new dictatorships, the need to dismantle inefficient national bureaucracies, political congestion at the national level, arguments for regional economic planning to replace national planning which was seen to have failed, and pressures for autonomy from regionally-based cultural or language-based movements.³

However, apart from some countries in the former Soviet Union, especially Russia and the Ukraine, where the introduction of regional local governments could build on the existing oblasts, only a few countries, namely Latvia and Romania, really managed to create a second tier of subnational local governments. Lack of financial resources is one of the main reasons for the non-conversion into practice of the projects to create regional local governments. Financing regional government will become one of the key issues in the fiscal reform process in most transition economies in the near future.

1.2

Unclear assignment of responsibilities

The initial laws on local self-government do not clearly determine the tasks and responsibilities of local governments. Moreover, spending responsibilities are almost never quantified in terms of their cost, making it difficult to address concerns over the adequacy of the local revenue base.⁴ Generally public education and health care are the main expense items in the countries analyzed; between 30 and 40 per cent of local budgetary expenses go to education in many local governments.

Unclear assignment of responsibilities seems in a number of cases to be less a question of deficiencies in the law drafting process than a deliberate political decision. Central governments have shown a trend to reduce budgetary deficits through transferring expenditure responsibilities to the subnational level without making a corresponding adjustment on the revenue side. This continuing lack of clarity creates an obstacle for a detailed system of revenue assignment.

1.3

The ongoing reform process of the tax system

The establishment of local self-government in the transition economies occurred simultaneously with a fundamental reform of the tax system. While the financing of the socialist state should have been guaranteed through profits of state and local enterprises with taxes—mainly a turnover tax for retail sales and a tax on wages—playing only a minor role in the system, taxes now become the major source of state revenues. The process of drafting and implementing new, market oriented tax laws is far from being completed. Laws on VAT, personal income tax and corporate profit tax are still not finally drafted or are being fundamentally revised; revenues these taxes may produce are difficult to estimate. For tax laws which do not have a number one priority for the central government, such as the law on property taxation in most countries, the drafting has, in many cases, not even started.

1.4

The influence of previous practices

Although local governments had no autonomous decision-making power, the transfer of revenues to oblasts and municipalities was part of the communist budgetary system. Defining the amount of local budgets was the result of a complicated process of negotiation which started with local governments estimating their expenditure needs for the next budgetary year. These estimates had to be presented to the higher administrative authority and finally to the ministry of finance for approval. The idea of negotiating subnational revenue sources

without any clear legal guidelines tends to have a continuing influence on fiscal federalism in a number of transition countries.

At the same time, tax collection results remain considerably behind the expected target and voluntary compliance is comparatively low.⁵ The discussion about distribution of available revenues thus becomes more tense and joint efforts of representatives from central and local governments to elaborate revenue assignment models become rare.⁶

2

PRINCIPLES OF FINANCING OF SUBNATIONAL GOVERNMENTS IN TRANSITION COUNTRIES: THE THEORY

All Central and Eastern European countries, including Russia and the Ukraine, decided relatively quickly after the initiation of the transition process to apply for membership of the Council of Europe. Part of the accession process was the signing and ratification of the European Charter of Local Self Government.⁷ Article 9 of the Charter expresses the principle that the legal authority to perform certain functions is meaningless if local authorities are deprived of the financial resources to carry them out. The article therefore stipulates that

- there should be an adequate relationship between the financial resources available to local authorities and the tasks they perform;
- at least part of the financial resources of local governments should derive from local taxes and charges;
- while it is accepted that central or regional statutes may set overall limits to local authorities' powers of taxation, they must not prevent the effective functioning of the process of local accountability.

Transition countries, however, faced considerable difficulties in putting into practice these rules. A Council of Europe expert report which analyzed the reform of local finance in four of the more advanced transition countries⁸ (the Czech Republic, Hungary, the Slovak Republic and Poland), stated for all four countries that, while the local finance system should be consistent with the provisions embodied in Article 9 of the European Charter, this was in practice not the case. The report added that in the case of Poland, for example, many of the conditions for a successful local government financial policy still do not apply. The expert team then elaborated specific recommendations for the further development of a system of local taxes. It recommended that local taxes should be based, if possible, on a local income tax supplemented by a modest property tax, both including the right for local authorities to set their own tax rates. As far as enterprises are concerned, local authorities should enjoy a share in the revenue of the corporate profit tax. The corporate profit tax could be supplemented by a tax including in its base the payroll and capital invested in the community to

<i>Central-level taxes</i>	<i>State-level taxes</i>	<i>Local-level taxes</i>
Value added tax	Individual income tax	Property taxes
Individual income tax	Surcharges on national taxes	Vehicle taxes
Corporate income tax	Retail sales taxes	User charges
Excise taxes	Excise taxes	Licences and fees
Natural resource taxes	Property taxes	
Customs duties	Vehicle taxes	
Export taxes		

compensate for the costs caused by enterprises. On the other hand, the use of local indirect taxes is considered to be less attractive, mainly considering the process towards harmonization of the system of indirect taxation with the existing European Union regulations on VAT.⁹

An expert study financed by the European Union and analyzing a number of assistance projects in the countries of the former Soviet Union considers a real estate tax on the user to be the most appropriate local government tax for countries of the former USSR. The expert team expects that a property tax can provide a substantial source of revenue, that it is easy to assess and collect and that it is relatively easy to introduce.¹⁰

The World Bank extensively analyzed the question of fiscal federalism in a regional study published in 1995.¹¹ Bird, Ebel and Wallich come to the conclusion that, to minimize potential tax distortions, a high degree of national uniformity seems desirable with respect to corporate income tax and value added tax. The border controls needed to implement local value added taxes as a national VAT with differential subnational surcharges would impede interjurisdictional trade and likely be impossible to administer effectively. Assigning corporate taxes to subnational governments would raise resource allocation concerns. While not uncommon in federal systems in market economies (Canada, Switzerland, and the United States), considerations of both administrative complexity and allocative efficiency would suggest that subnational corporate levies should be avoided in transition economies.¹² As suitable taxes for subnational governments the study mentions personal income taxes, retail sales taxes and excise taxes; in addition property taxes as well as taxation of automobiles are considered to be appropriate local own taxes.

A possible system of tax assignment for each level of government has been proposed by Roy Bahl as part of an analysis of intergovernmental fiscal relations in the Russian Federation.¹³ According to Bahl the following assignment rules would be appropriate:

Among academics, special focus has been put on the allocation of revenues from natural resource taxes. The general consensus among public finance academic experts here is that most revenue from resource taxes should accrue to the federal government. The case for federal taxation of resources is threefold:¹⁴ first, revenues from resource rents are volatile, dependent upon output and

especially price, so that a subnational government that depends on revenue from an extractive resource may find its fiscal position dangerously unstable. Second, the uneven geographic distribution of natural resources means that an assignment of resource rents to subnational governments can create large differences in the fiscal capacities of each one. Finally, a third argument for national-level taxation of natural resources is that cash-rich subnational governments could lower taxes on local residents and businesses, make cash payments to residents, or provide an exceptionally high level of public services and subsidize business activity within the jurisdiction, which could distort economic choices and reduce national output. In practice, however, federal countries more often apply a system of sharing natural resource revenues with either separate subnational resource taxes (United States, Canada) or the sharing of revenues from federal resource taxes with the states of origin (Brazil).

3 FINANCING SUBNATIONAL GOVERNMENTS IN TRANSITION COUNTRIES: CURRENT STATUS OF REFORM

3.1 Principles of fiscal federalism in transition economies

A pure system of revenue sharing with no decision-making power at regional and local level over tax base or tax rates is the predominant element in fiscal federalism in transition countries. With own-source tax revenues almost non-existent, subnational governments are highly dependent on central government tax policy decisions and future tax revenues become unpredictable. In addition a gap often becomes obvious between the theoretical sharing system and its practical application.

The Russian ‘Law on the Basic Principles of Taxation’, which was prepared in January 1992, can be cited as a prototype of a tax reform law based on pure revenue assignment ideas. Although the law itself was never fully implemented, it accurately reflects the prevailing ideas of policy makers and politicians on fiscal federalism in the Russian Federation. According to the ‘Basic principles’ the following tax allocation should be introduced:

(a) *Federal government*

Federal government taxes (revenues assigned to federal government, tax base and tax rate set by federal government):

- VAT
- Export taxes

- Customs duties
- Taxes on 'exchange activities'
- Taxes on bank and insurance profits
- Motor vehicle excises

Part of revenues shared with oblasts:

- Natural resource taxes (20 or 40 per cent to federal level)
- Excises on vodka (shared 50–50)

(b)
Oblasts

Regulating taxes (tax base and rate set by federal government, revenues used to balance oblast budgets):

- Personal income tax
- Profit tax
- All excises other than on vodka and motor vehicles

Revenues assigned fully to oblasts, tax rate and base, however, determined by federal government:

- Road fund taxes
- Estate duty
- Gift and inheritance tax
- Stamp duty

Revenues assigned to oblasts, tax rate and base determined by oblasts:

- Property tax
- Forestry tax
- Tax for water use

(c)
Local governments

Twenty-one local taxes are listed in the law with local government discretion to set rates and decide upon tax base (limited only by maximum rates set for many of the taxes). Local taxes include property tax on natural persons, land tax and business registration fee.

3.2

The assignment of specific taxes

Personal income tax

Personal income tax traditionally constituted one of the main sources of local government revenues in Central and Eastern European countries in the pre-transition period. Revenues from the wage tax were—normally at 100 per cent—allocated to subnational governments. After the replacement of the wage withholding tax by a general personal income tax, revenues from this tax continue to provide the bulk of local government revenues in many of these countries. The share of revenues from PIT in total revenues is especially high in the Baltic countries, with 57 per cent in Lithuania in 1996 and 54 per cent in Latvia. At the bottom end of the list we find Hungary (9.7 per cent) and the Ukraine (7 per cent).

It is noteworthy that the Western European examples of PIT as regional tax (as in Switzerland) or local piggy-backing of the central government PIT (as in the Scandinavian countries) have so far not been copied in any of the transition economies. Participation of subnational governments in personal income taxation takes the form of pure revenue assignment with central government control over tax base and tax rate. Revenues from personal income tax are distributed to local governments in the majority of countries on the basis of the residence of the taxpayer. This system leads to considerable inequalities in countries with high regional differences in per capita income and unemployment rate. Even in relatively small countries like Latvia the average level of registered unemployment varies from 4 per cent in the best-off region to more than 27 per cent in some rural areas. As a consequence, the per capita local government income in Latvia ranges between 35 and 57 Lats in economically developed parts of the country, while in one third of local governments it is less than 10 Lats. In the Russian Federation, where the assignment rules have changed several times since the introduction of PIT in 1991, the 'Law on changes to the law on personal income tax', enacted in December 1994, now assigns PIT revenues in the case of wage withholding tax to the local government where the taxpayer is employed rather than resident. This solution actually tends to increase existing disparities.

At the beginning of 1996 the Czech Republic changed its assignment system to reduce these disparities. Up to the beginning of 1996, local governments participated only in PIT. The wage tax, the largest revenue component, was assigned to municipalities according to the yield collected within a district. This part was then distributed to each municipality within the district according to the number of citizens.¹⁵ As the district yield of the wage tax remained within the district, disparities among districts appeared immediately after the introduction of the system and continued to grow over time. To counteract this trend, the central government decided in 1996 to reduce the share of local governments in

the wage tax and to substitute it by participation in revenues from the corporate income tax, which are distributed to local governments on the basis of number of residents.

The effect of the complete control of central governments over the tax base and rate of PIT is that local governments become extremely vulnerable to central government tax policy decisions, especially reductions in tax rates or introduction of exemptions and incentives to encourage investments. When the Latvian government exempted income from personal auxiliary farms, household plots and single family farms from taxation, this reduced considerably the income tax base in rural areas and made a number of local governments in regions where small-scale farming is the major form of employment lose most of their income tax revenues.

The revenue sharing system currently in place in Central and Eastern European countries is, in its effects, not very different from the allocation of non-targeted government grants. The main difference between the two revenue sources is that in the one case, the amount received is in proportion to the amount of personal income tax collected in the territory of the subnational government or paid by resident taxpayers, while in the other, money is redistributed based on certain indicators, which might even correspond better to the public service tasks of the subnational government. Looking at the distributional effects, a higher share from personal income tax favours richer communities, while a higher proportion of central government grants favours the poorer communities.¹⁶

Equipping subnational governments with more decision-making power in the area of personal income tax will be one of the main elements of tax reform in Central and Eastern European countries in the future; the constraints of the necessity to establish a new comprehensive personal income tax system have so far counteracted the decentralization of PIT. The possibility to lower the central government personal income tax rate and introduce an additional local personal income tax now was discussed in Hungary during a national forum on fiscal decentralization in April 1996. Further discussion of this issue will follow. Considering the relatively low mobility of individuals in Central and Eastern European countries, a subnational PIT can be introduced without great risk of tax competition among local governments. In addition, the redistributive importance of PIT, which has been used as an argument against a subnational levy of the tax, is being reduced in practice with the reduction of PIT rates and number of brackets. Personal income tax therefore has the potential, either as pure subnational tax with the tax base fixed by the subnational government, or in the form of piggy-backing on the central government PIT, to become the most important subnational tax in transition economies in the future.

Corporate income tax

Contrary to the position on the allocation of personal income tax to subnational governments, there is general agreement among academics and tax policy experts in ministries of finance that corporate income tax should be levied as a central government tax in transition economies.¹⁷ Both considerations of administrative complexity as well as of allocative efficiency are offered to justify this allocation.

In practice the Russian Federation seems to be the only country where subnational governments have substantial decision-making power on the corporate tax rate (however not on the tax base). Corporate income tax had been introduced in 1992 as a purely national tax; in 1995, however, sharing of the tax base with oblasts was introduced. The tax now has two rates, a national rate of 12 per cent, and a subnational rate, determined by oblasts, of up to 21 per cent. The maximum tax burden therefore is currently 33 per cent.¹⁸

Experience has shown that tax sharing in the area of corporate income tax did not cause any serious problems of tax competition between oblasts. In fact, most of the oblasts have chosen a CIT rate of either the full 21 per cent or close to 21 per cent. An important reason for the lack of tax competition might be seen in the relatively low mobility of businesses in Russia. Enormous regional differences in the availability of infrastructure and skilled labour and in the amount of production costs continue to be much more important in choosing the residence of a business than the CIT burden.¹⁹ The system, however, led to another undesirable result: it caused numerous cases of transfer pricing between head offices and branches in oblasts with lower corporate tax rates. The fact that the Russian tax system does not have any clear formula for the apportionment of profits gives almost complete freedom to business management to decide in which oblast the profits shall be taxable. Subnational corporate profit taxation clearly needs anti-avoidance rules to deal with transfer pricing cases; sales, payroll figures or capital are normally used as weighting factors for the allocation of profits.

Different from the Russian system of tax sharing, a pure revenue sharing of corporate income tax has been introduced in some Central and Eastern European countries. In Bulgaria, local governments get the entire revenues from company profit tax levied on resident municipal and private enterprises as well as a 10 per cent surtax on state enterprises in the jurisdiction.²⁰ Lithuania introduced revenue sharing of corporate profit tax in 1995 to replace the previous sharing of revenues from indirect taxes; revenues from corporate profit tax now account for 11 per cent of local government revenues. Finally, in the Slovak Republic, 3.33 per cent of corporate income tax goes to local governments, with 60 per cent of the local government share distributed to municipalities according to the number of inhabitants multiplied by a coefficient depending on the size of the municipality, and 40 per cent distributed to the place of residence of the corporation.

More than corporate profit taxes, certain business taxes can be thought of as subnational taxes. The German *Gewerbesteuer* or the French *Taxe professionnelle* can be cited as examples here. For the moment, only Hungary seems to have introduced such a tax, which is based on the business turnover of resident enterprises. The business tax continues to be the dominant local tax in Hungary; it is practically used as a public development contribution of companies and enterprises.²¹ Special business taxes have provoked intense discussion among experts in Western Europe in recent years; they have been questioned because they are generally not profit-related and create an additional tax burden for enterprises, which might reduce their competitiveness on the international market. Austria abolished its business tax only a few years ago, and, as part of German tax reform, at least the elements of the tax base of the *Gewerbesteuer* which refer to business capital and not to business profit of the enterprise will be eliminated. Considering this international trend it is somewhat doubtful if business taxes will gain any significant importance in Central and Eastern Europe in the future.

Property taxes

Property taxes are often considered to be the prototype of a subnational tax. They are difficult to evade, the tax base cannot be moved to another location, and there is a direct link between the value of the real property and the infrastructure and services provided by the subnational government. For many transition countries, therefore, the introduction of a property tax became one of the priorities in the tax reform process. It became obvious very quickly, however, that the non-existence of a reliable cadaster system as well as the difficulties in determining the market value of land and buildings would significantly prolong the process to make property tax an important revenue source for regional and local governments. Only Estonia, the Czech Republic and Poland have up to now achieved remarkable results in the taxation of real property. Estonia has successfully completed the first step in the reform process and a market value based taxation of land has been introduced. It raises 1.5 per cent of total tax revenues in Estonia; market value-based taxation of buildings is in preparation. The Czech Republic has just finished a number of pilot studies in selected regions, including a district of Prague, and wants to introduce the new property tax in 1998. In Poland, pilot studies in the region of Krakow have shown that a well developed property tax may contribute up to 25 per cent to local government revenues.

In other countries of central and eastern Europe property tax reform is moving much slower or has even come to a standstill. In Russia, the planned pilot studies in Novgorod and Tver, initiated at the beginning of 1996, have still not started, and current personal assets and land rent taxes seem to cause a revenue loss for the government, because administrative costs are higher than tax revenues. So, while the experience of OECD countries shows that property tax revenues can

have significant importance for subnational governments and that property tax is a suitable type of tax for subnational governments to decide on both the tax base and the tax rate, it will take several years to reform the tax and broaden the application of property taxes in Central and Eastern Europe.

Value added tax

Shortly after the abolition of the communist system, all of the Central and Eastern European countries except for the countries of the former Soviet Union—however including the three Baltic countries—started negotiations with the European Commission about EU accession. The Commission exposed the accession principles in a White Book which contains detailed rules on the changes necessary in the area of indirect taxation. Following the White Book recommendations, all Central and Eastern European countries have introduced an EU type VAT, but also Russia in 1992 and, most recently, the Ukraine followed the EU countries' example. The previously existing sales taxes and turnover taxes have been abolished.

In all countries under consideration VAT has been introduced as a central government tax. This corresponds with the almost unanimous opinion of academics that, taking the example of the European Union, border controls needed to implement subnational VATs or a national VAT with different subnational surcharges would impede interjurisdictional trade and likely be impossible to administer effectively. As practice has shown, the introduction of a VAT was one of the most difficult steps in the tax reform process in transition countries. Political agreement on the tax rate and the number and areas of exemptions was difficult to achieve, and taxpayer information and education was a major challenge for the new inexperienced and poorly equipped tax administrations. To make VAT the draft horse of the new tax system, foreign advisers strongly recommended keeping it as general and simple as possible. Full control of central government over the whole VAT system is an important factor to guarantee this simplicity.

A single-stage retail tax, differing substantially from VAT, would be an appropriate tax for subnational governments in a number of transition economies, especially in most of the countries of the former Soviet Union, which have large regions which are not densely populated, so that the danger of revenue losses through customers crossing the border to buy in lower-tax regions are minimal. In practice sales taxes are uncommon, however; only the Latvian ministry of finance is currently considering giving local governments the right to collect a 'retail trade fee' which, in essence, would be a sales tax.

The existence of a national VAT does not necessarily preclude additional, subnational, single-stage sales taxes which are levied at the retail stage. Canada can to a certain extent be cited as a model for the combination of both taxes. However, for the countries aiming at membership of the European Union it will be difficult to achieve compatibility of retail sales taxes with EU directives.

Excise taxes

Together with sales taxes, excise taxes are prime candidates for subnational taxation. However, the validity of the statement made by Bird, Ebel and Wallich in 1995 that, as sources of revenue for subnational governments in transition economies, excise and retail sales taxes are notable by their absence,²² still holds. Apart from the fact that excise taxes constitute an important revenue source for the central government budget, another explanation for this situation lies, according to Bird, Ebel and Wallich, in the way excises are administered: because excises are levied on the often single-monopoly manufacturer, the excise base would not be broadly distributed across regions. This would mean that substantial administrative reform would be necessary to allocate revenues on the basis of consumption. Without such a reform, excise revenues would only accrue to the few producing localities.²³

The Russian Federation experience with revenue sharing of most excises suggests, however, that these concerns are not necessarily a major obstacle for subnational taxation. According to the current system in place the sharing rate is the same for all oblasts and varies by commodity as follows:

excise on alcohol	50 per cent federal	50 per cent subnational
excise on motor vehicles	100 per cent federal	
excise on energy	100 per cent federal	
excise on beer, leather, furs and other luxury items produced in the Russian Federation		100 per cent subnational
excise on petroleum	100 per cent federal (in theory, in practice shared)	

Allocation of excise revenues to oblasts is made on the basis of production and, as excises on motor vehicles, energy and—at least in theory—petroleum are allocated to the federal budget, does not lead to unacceptable divergence between oblasts. In addition, a production-based subnational excise would reduce the problem of smuggling which is inevitable in the case of consumption-based excises.

Taxation of natural resources

Despite the fact that, like real property, national resources are fixed and cannot be transferred to other jurisdictions, there are strong arguments for national taxation of natural resources. Subnational taxation of natural resources leads to the exportation of a subnational tax, as taxpayers generally will not be residents of the taxing subnational government. Equity considerations can be advanced, as national resources are generally located in only a few regions,²⁴ which may get

revenues far beyond their spending needs, while the majority of subnational governments do not benefit at all from natural resource taxes.

On the other hand, subnational governments point to environmental damage from the exploitation of natural resources, as well as additional costs from the provision of infrastructure necessary for exploitation. In practice, therefore, a sharing of natural resource taxes between national and subnational governments is quite common. In Russia, the discussion about the allocation of natural resource taxes has, in addition to mere tax policy arguments, to bear in mind that most natural resources are located in regions populated by minorities requesting special autonomous status. Most of the resource-rich oblasts are reluctant to consider natural resources as property of the Federation, and they are vehemently demanding taxing rights. In practice, revenue sharing has been introduced not only by regional, but also local governments. In the case of oil and gas revenues the sharing system is as follows:

- Export tax:
 - 30 per cent shared with oblasts
- Production tax (royalty):
 - Production in autonomous region:
 - 20 per cent to federal budget
 - 20 per cent to oblast or republic
 - 30 per cent to okrug²⁵
 - 30 per cent to rayon or city
 - Production in non-autonomous region:
 - 40 per cent to federal budget
 - 30 per cent to oblast or republic
 - 30 per cent to rayon or city
 - Production from continental shelf:
 - 60 per cent to oblast, republic, or okrug
 - 40 per cent to federal budget
- Excise tax:
 - 30 per cent given to producing oblast.

4

REFORMING FISCAL FEDERALISM IN CENTRAL AND EASTERN EUROPEAN COUNTRIES: LESSONS AND OUTLOOK

Shaping fiscal federalism requires a stable tax system with predictable tax revenues. Emphasis in transition countries has, up to now, been put on the reform of the tax system as a whole and the introduction of new, market economy-oriented taxes. With the key role the national ministries of finance play in this reform, tax policy has been highly centralized. At the same time, expenditures assigned to subnational governments are growing. A system of revenue sharing

has been introduced to provide funding for subnational governments. This system is neither adequate nor sufficient from the point of view of subnational governments:

- It does not establish full accountability of subnational governments.
- Revenue flows to subnational governments are unpredictable and long-term budgetary planning is made impossible.
- There is no clear link between revenues allocated to a subnational government and services provided by this government.
- Shared revenues are often insufficient to cover the costs of even vital subnational government services and the subnational governments have no possibility to increase their share.

Even more than for local governments, the financing of regional governments is an unsolved problem for transition countries and often hinders the decentralization process. In Latvia, to mention only one example, the question has been raised, if, instead of maintaining regional governments which depend almost completely on central government grants it would not be more reasonable to abolish them completely.

Experience in Russia has shown that an unsatisfactory system of subnational government finance can put a severe burden on central governmentsubnational government relations. In Russia, already in 1992, some of the richer regional governments (oblasts) began to refuse to transfer taxes collected in their jurisdiction to the central government; the typical argument brought forward was that not enough of these revenues flow back to the oblast to finance oblast expenditures. These oblasts started to negotiate single channel arrangements with the federal government which provide for the region to retain all revenues collected in its jurisdiction and transfer only some agreed amounts to Moscow. Other regions have unilaterally imposed their own sharing rates on the federal government.²⁶ In similar fashion, a few industrialized oblasts in the Ukraine have started to ask for an unproportionate increase in their budget revenues, as most of the tax revenues of the country are generated on their territory. The existing situation in the Russian Federation can quite openly be described as ‘a permanent war’ between regions and the central government. The result is a deformed budget system, a disbalance between authorities and financial resources, as well as an array of other serious discrepancies.²⁷

The allocation of taxing rights to subnational governments, including decision-making power over tax rate and, where appropriate, tax base, may contribute to avoiding these conflicts and improve the stability of fiscal federalism. Personal income tax, excise taxes, property taxes and retail sales taxes are prime candidates for allocation to subnational governments. Future steps in the fiscal reform process in transition economies will need to concentrate more on these issues of allocation of taxing rights. The growing concern in all Central and

Eastern European countries about the deficiencies in fiscal federalism clearly indicates that the time for change has come.

Notes

- 1 Local Budgets According to Municipal Size Categories, in *Moderni Obec*, no. 5, 1996.
- 2 The last example being the Slovak Republic with the 'Law on the self-government of the higher territorial units' which has just been drafted.
- 3 See, for example, A.Coulson and S.Capkova, *A Second Level of Elected Self-government in Slovakia: Notes Based on International Experience*, Birmingham, 1993.
- 4 Bird, Ebel, Wallich, *Decentralization of the Socialist State*, The World Bank, 1995, p. 35
- 5 With a percentage of underground economy as high as 60 per cent in the Ukraine according to 1997 estimations.
- 6 This has especially negative consequences for the design of transfer systems; the case of Lithuania, where it took central and local governments until 1997 to discuss jointly guidelines for a transfer formula is not unique.
- 7 Albania, Croatia, the Czech and the Slovak Republics are the four countries that have not signed the Convention yet.
- 8 Council of Europe, *The Reform of Local Finance in Central and Eastern Europe*, Strasbourg, 1992.
- 9 See the expert report, p. 75.
- 10 Tacis, *Towards Democratic Decentralisation*, European Commission, 1995, p. 153.
- 11 Bird, Ebel, Wallich, *Decentralization of the Socialist State*, Washington, 1995.
- 12 *Ibid.*, p. 42.
- 13 'Revenues and revenue assignment: intergovernmental fiscal relations in the Russian Federation', in The World Bank, *Russia and the Challenge of Fiscal Federalism*, 1994, p. 135.
- 14 See McLure, Wallich, Litvak, 'Special issues in Russian federal finance: Ethnic separatism and natural resources', in Bird, Ebel, Wallich, p. 395.
- 15 The second component of the PIT, income taxation of unincorporated businesses, is passed back to the municipality where the owner of the firm resides, while tax on capital income is assigned to the central government.
- 16 Varfaly, 'Municipal revenues, government subsidies, and regulation of funds', in: OECD/World Bank/Council of Europe, *The Modernization of Local Government Finances and Financial Management in Hungary*, 1996, p. 57.
- 17 Bird, Ebel, Wallich, p. 42 with further reference.
- 18 The figures have changed frequently since the introduction of tax sharing; the maximum tax burden has been reduced from 38 per cent to 33 per cent with a reduction of the federal rate from 13 per cent to 12 per cent.
- 19 For the same reason, the special economic zones created in some parts of Russia and offering generous tax incentives did not result in the expected number of new investments.

- 20 See Bogetic, Z. and Hillman, A.L., *Financing Government in Transition: Bulgaria*, Washington 1995, for more details.
- 21 Hegedus, P., 'Country report for seminar on modernization of local government finances and financial management in Hungary', Budapest, 25–6 April 1996.
- 22 *Decentralization of the Socialist State*, p. 44.
- 23 Ibid.
- 24 In Russia, for example, three oblasts produce 80 per cent of the country's oil and gas.
- 25 An administrative unit that is nationality-based, although in fact populated mostly by native Russians.
- 26 The first regions to declare independence were Tatarstan, Bashkortostan and Yakutia; after special treaties had been signed with Tatarstan and Bashkortostan the tax revenue transfers from these republics increased considerably: in the first quarter of 1994 the federal budget received 2 per cent of taxes collected in Tatarstan whereas at the end of the same year, 14 per cent. The share of VAT payments from Tatarstan increased from 10 per cent to 21 per cent. By the end of 1994, Bashkortostan paid to the federal government 15 per cent of all taxes collected on its territory; see Leontief Centre, *Fiscal Policy and Fiscal Federalism in Russia*, St. Petersburg, 1996.
- 27 Ibid.

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3

Stabilisation policy in the European Monetary Union and fiscal federalism

Alberto Majocchi

1

THE MAASTRICHT CONSTRAINTS AND FISCAL POLICY

In the Maastricht Treaty problems regarding public finance are considered in particular with reference to the definition of an excessive deficit. In fact, Article 104C sets the conditions which a country must respect in order to join Monetary Union, while the actual figures are defined by the Protocol on the procedure for excessive deficits, which calls for: '3% for the ratio between real budget deficit, forecast and current, and gross domestic product at market prices; 60% for the ratio between public debt and GDP at market prices'. It is clear that this aspect of the Treaty is particularly relevant and political debate and public opinion has focused mainly on these criteria. In fact, we can justify setting a value equal to 3 per cent of GDP for the deficit by referring to the 'golden' rule of public finance, on the basis of which current expenditure must be financed by current revenues, while investment spending can be financed by debt. In fact, in the period from 1974 to 1991 public investment in Europe was equal on average to 3 per cent. In reality, this condition of the Maastricht Treaty reflects, on the one hand, a condition that is widespread in local finance systems, where debt—destined to finance investment spending—cannot normally exceed certain levels; on the other hand, it avoids the formation of excessive deficits without linking the financing of the deficit through bonds to the distinction—in large part ambiguous and distorting—between current expenditures and investment expenditures.

A deficit of this size is compatible with the stabilisation of the debt to GDP ratio—which is a prerequisite to avoiding a worsening of the public finance situation in countries taking part in monetary union—at a level that likewise depends on the nominal growth rate of GDP. On the basis of this condition,¹ if the deficit is 3 per cent, then in order to guarantee stabilisation of the debt to GDP ratio at the expected level of 60 per cent, the growth in nominal GDP need only reach 5 per cent. It is no coincidence, in fact, that this was the growth rate reached in Germany during the 1980s. The Maastricht rules thus fit in perfectly with the German situation; moreover, they permit the indirect introduction of a

constraint for the rate of inflation—which the Treaty only sets with reference to the three most successful countries.

The implementation of this rule is thus strongly conditioned by a country's rate of inflation, which influences the result through the nominal growth rate of GDP. Thus, even if we take account of the fact that within the monetary union inflation rates tend to converge—although there are obstacles to predicting the final equilibrium level—it is difficult to claim that a definition of the equilibrium level of the debt which is tied to future inflation is entirely appropriate. From a technical point of view this rule thus appears arbitrary. It has, however, a politically decisive role: on the one hand, it confirms the strong will of European countries to avoid the formation of an excessive stock of debt, destined to weigh down future generations; but above all—and this is the important point—the rule in question represents a necessary condition for obtaining German consensus on the loss of monetary sovereignty.

While recognising the non-absolute value of the Maastricht constraints, we must nevertheless remember that they are subject to a relatively elastic interpretation. In particular, Article 109J establishes that a fundamental condition for joining monetary union is 'the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without an excessive deficit, as determined in accordance with Article 104C(6)'. And where the procedures for realising the mechanisms of multilateral surveillance are defined, Article 104C(2) specifies that a deficit above 3 per cent can be considered not excessive if the ratio 'has declined substantially and continuously and reached a level that comes close to the reference value'; or, alternatively, 'the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value'. Finally, we must consider other factors which are specific to each country, in particular 'whether the government deficit exceeds government investment expenditure' and 'all other relevant factors, including the medium-term economic and budgetary position of the Member States'. At the same time, a debt to GDP ratio above 60 per cent will not be considered excessive if 'the ratio is diminishing at a sufficient rate and approaching the reference value at a satisfactory pace'.

The fact is that the political decision taken at Maastricht was to consider as not excessive the deficits of those countries that have taken substantial steps in the direction indicated by the Treaty and/or are not too far from the reference values. Once a country becomes a member of the Monetary Union, respect of the rules of convergence within the mechanism of multilateral surveillance—in particular as regards excessive deficits—must be assured by the Commission, which nevertheless has rather limited sanctioning power. As a result, these dispositions have been further supplemented by the approval of the Stability and Growth Pact which, in its final form, consists of a resolution approved by the European Council at Amsterdam, committing the member states to avoiding excessive deficits—that is, to guaranteeing a budget in equilibrium or in surplus—and of two regulations approved by the Council. The first regulation calls for

each member state to submit a 'stability and growth programme' to the Council and the Commission as part of the mechanism of multilateral surveillance defined in Article 103(3).

The second regulation approved by the Council concerns the procedure for avoiding excessive deficits and provides that an excessive deficit in terms of the reference value—in balance or in surplus—can be considered exceptional and temporary if it depends on an unforeseeable event, outside the control of the member states in question and which has an important impact on the financial position of the country, or if the excessive deficit is the result of a severe recession that has hit the economy. On the other hand, the Commission can consider a recession severe only if the annual reduction in GDP is greater than 2 per cent. In this case the country in question is automatically exempted from any penalty. If, however, the fall in GDP is between 0.75 per cent and 2 per cent, the decision on the application of any eventual penalty is left to the discretion of the finance ministers.

In fact, if a country exceeds the deficit limit permitted under the Stability Pact, the Council can impose financial sanctions under Article 104C(11). This is basically a non-interest-bearing deposit which the country having the excess deficit must deposit at the European Central Bank, and which is composed of a fixed part equal to 0.2 per cent of GDP and a variable part equal to one-tenth of a point of GDP for each point that exceeds the reference value of 3 per cent. Nevertheless, the upper limit must not exceed 0.5 per cent of GDP. After two years, if no corrective fiscal measures have been taken, the deposit is transformed into a fine. The money from the fine does not go to the Community budget, but is made available to the well-disciplined countries within the Euro area; in fact, it was thought politically inappropriate for Euro mechanisms to benefit countries which do not belong to the Euro area, either because they do not meet the necessary conditions for entry or because of political reasons.

2

THE NEED FOR QUANTITATIVE CONSTRAINTS ON THE DEFICIT

The need to impose quantitative constraints on the size of the deficit within the monetary union appears at first to be justified by the fact that quantitative restrictions on the debt capacity at lower government levels exist in almost all countries with a decentralised tax structure (von Hagen 1991). Article 104C of the Treaty of Maastricht clearly decrees that 'the Member States must avoid excessive public deficits', and this disposition complements the one in Article 105(1) which solemnly reaffirms the principle that 'the objective of the European system of central banks is to maintain price stability'.

To attain this objective the Treaty considers it essential for the debt not to be covered by money supply increases; to this end, Article 21 of the Protocol on the European system of central banks—in conformity with what is provided for in

Article 104 of the treaty—absolutely excludes that the European Central Bank can buy public debt bonds offered by state, regional or local administrations, or other public sector authorities of the member states. This normative provision is strengthened by Article 104B(1), which declares that neither the Union nor the member states can be asked to respond ‘to the commitments made by state administrations, by regional and local authorities, or any other public authority, by any public law body, or public enterprises of any Member States’.

This clause, called the *no bail out*, should avoid the manifestation of negative externalities linked to irresponsible financial behaviour by a member state; in particular, it is meant to avoid the danger that member states in the Union—assuming there will be support from the European Central Bank as a *lender of last resort*—will allow excess emission of public debt bonds. This excess supply could cause an increase in interest rates on the whole European financial market as a result of the fall in value of securities, while the budget situation of the state in question would become ever more serious because of the increase in interest rates.

But the Maastricht Treaty also provides for a procedure to avoid excessive deficits, thereby demonstrating a lack of trust in the effectiveness of the *no bail out* clause. Eichengreen and von Hagen (1995) contest the necessity of this additional condition, since the bail out problem basically involves only those countries without their own taxing capacity. In fact, in this case, if the country in question faces a recession there will be a strong impact on the budget, and the local government, not being able to impose its own taxes, will be faced with a serious financial crisis. The central government will then have to choose whether or not to let the local government fail or to assist it with its own means. In short, ‘different models of vertical tax structures differ in the bail out risk they entail. The stronger is the dependence of the sub-central governments on the resources of the central government, the greater the bail out risk’ (p. 23) and, at the same time, ‘the stronger is the incentive for an excessive deficit because of the assumption of a bail out by the central government if a financial crisis should occur’ (p. 25). Eichengreen and von Hagen also point out that if a political union is achieved, the fiscal powers of the Union would be strengthened and, as a result, ‘political integration might increase the bail out risk rather than lower it, thereby leaving the member-state governments without any other option than to turn to the European Central Bank for aid. This implies that there will be room for fiscal constraints in the future, when political unification is achieved and fiscal powers will be centralised in the European Union’ (p. 26). But for the moment these constraints—in their opinion—are superfluous.

The reasoning of Eichengreen and von Hagen appears to be correct in theory. A structure of fiscal federalism increases the responsibility of the lower government levels, and normally deficits are much more contained (Moesen and van Rompuy 1990). If, vice versa, centralisation increases, the local governments tend to behave as *free-riders*, and there is increasing risk of negative external effects on the integrated financial market. Thus the imposition of constraints on

the finances of the lower government levels appears to be justified. But in reality the European situation is different from the theoretical model of fiscal federalism because, on the one hand, the national governments have a large fiscal autonomy—even if over time the constraints imposed by the process of tax harmonisation tend to increase—while on the other hand the Union has no effective power of control over member-state behaviour, as occurs in states with an effective federal structure. The absence of this power of control and direction—that is, of a real governing of the economy—must be balanced against the imposition of ex-ante constraints, which are part of the Treaty of Maastricht. The conclusion of Eichengreen and von Hagen can thus be reversed: in a federal state the financial autonomy at lower levels of government is perhaps reduced—even if the European experience will certainly be less centralised with respect to the existing federations—but the power of control over member states' finances is increased, and thus at the same time the bail out risk is reduced.

3

THE STABILISATION POLICY IN THE EUROPEAN ECONOMY

Once Economic and Monetary Union is under way, a first important problem concerns the role Community public finance must play in the stabilisation policy. The existence of economic fluctuations is certainly a fact which cannot be denied from an empirical point of view, with important deviations of production with respect to the potential of full-employment output. And if the automatic stabilisers within the economic system are weak or operate slowly, so that the macroeconomic consequences of exogenous shocks persist, there is a strong *a priori* justification for anti-cyclical stabilisation policies. These policies can no longer be effectively managed at the national level—given the degree of interdependence among the various European economies within the internal market. It is then a question of deciding whether, despite the constraints that derive from the globalisation of the productive process on a world scale, it is necessary to have a common stabilisation policy managed at the European governing level.

In reality, in the actual situation the European economy is in, it seems reasonable to assume that the institutional rigidity and structural parameters of the aggregate demand and supply functions are such that substantial and persistent losses of welfare can result from a non-interventionist attitude regarding the economic system. The justification for public intervention in the economy is still tied to the existence of a market failure. In the case of stabilisation policy, the main justification is the fact that labour markets do not reach equilibrium, either through flexible salaries or the migration of the labour force from areas where there is excess supply to those where there is excess demand. Since it does not appear that this situation will change in the short run—and the fact that it would be unreasonable to force the territorial mobility of labour due to the high economic

and social costs that would result—it is appropriate to try to define the conditions that must be satisfied in order to optimise the structure of public intervention at the European level in order to achieve stabilisation.

Once we have determined the need for a stabilisation policy, we must distinguish between two problems regarding the EMU (Majocchi 1996). The first concerns the possibility of achieving a macroeconomic equilibrium at the Community level through an efficient combination of tax and monetary measures—monetary policy in the EMU is by definition directly managed at the European level—if there are shocks that symmetrically affect the European economy as a whole. The second problem involves guaranteeing member states the possibility of dealing effectively with shocks that hit a single country, or general shocks with asymmetrical effects on the various countries.

The problem of the stabilisation of a regional economy becomes particularly important in the EMU, since the member states lose the possibility of utilising the instruments of monetary and exchange policy, while considerable limits to fiscal policy are imposed by both the process of harmonisation, especially in the sector of indirect taxes, and through the conditions set by the Maastricht Treaty concerning the size of the deficit and overall debt. It must be therefore decided which alternative instruments the member states can use to re-establish equilibrium in their economic system which, following a fall in the level of demand, or an increase in the costs of production, must face a fall in output and, as a result, employment.

As far as the stabilisation of the European economy is concerned, choosing which fiscal policy to adopt is particularly relevant, especially if we keep in mind that the statutes of the European Central Bank clearly establish that the management of monetary policy must be aimed only at guaranteeing the stability of prices. Thus, if only fiscal policy is available, the problem which has priority is to determine whether the objectives—politically defined—of stabilisation must be achieved through variations in the Community budget or through the coordination of fiscal policies managed by the member states.

In all existing federations the task of macroeconomic stabilisation is attributed to central government. From a theoretical point of view, the main justification for assigning this function to central government is connected to the fact that, in an open economy, an important part of public expenditure will benefit non-residents through a change in imports, while residents must bear the cost through the increased future taxes needed to finance the increased public debt. Stabilisation thus presents elements of public goods, and as a result the level of stabilisation pursued tends to be sub-optimal.

There is large agreement today among economists about the idea that stabilisation policy must be attributed to central government, a theory which has already been put forth by Musgrave in his assigning of economic functions to public authorities. On the other hand, the MacDougall Report (European Commission 1977) follows along the same lines regarding the role of public finance in the Community. The report came out when conditions were very

different both at the political and theoretical debate level, which at that time was still strongly dominated by the Keynesian view. It is thus appropriate—and necessary—to bring the indications from this report up to date, in light of the most recent theoretical developments, in order to point out some specific difficulties that characterise the situation of the European Union, with the completion of the EMU in view.

A first limit, already mentioned by the MacDougall Report regarding the possibility of a direct assumption by the Community of responsibility for managing the stabilisation policy, already appears to have been overcome with the prospects for the EMU, since monetary policy will become a European-wide responsibility. But the second obstacle regarding the active use of fiscal policy for stabilisation purposes still exists. In fact, the specific element that characterises the situation in the Community with respect to existing federal states is the preponderant weight—with respect to total expenditures—of public expenditures that come from the budgets of the member states compared to those managed by the Community budget—which is equal to only 1.2 per cent of European GDP.

It is generally held that, given the present size of the budget and the rules that govern it—impossibility of closing the budget in deficit (Article 199), lack of flexibility due to the pluriannual planning called for in the 1988 budgetary agreements, the need for the Commission to limit additional spending proposals within the limits of its own resources (Article 201A), in order to control the budget; rules which can be varied only through the unanimous agreement of the Council and with the ratification by the member states (Article 201)—the role of the Commission in the management of European-wide stabilisation policy can consist only in promoting the coordination of member-state fiscal policies.

However, a coordination of this type is to be hoped for even in the case in which the central government is able directly to manage fiscal policy, at least to the extent necessary to avoid perverse effects with respect to the achievement of the objectives of stabilisation policy following pro-cyclical measures in the budget policies of the local governments, which can reduce expenditure or increase taxes during recessions in order to guarantee a balanced budget—and adopt expansionary policies during growth phases, having a budget surplus available to them. But the hypothesis that was accepted in the Treaty on European Union approved at Maastricht calls instead for coordination to be the sole instrument available for economic policy to deal with symmetrical shocks affecting the Community-wide economy.

Thus, if in this case as well the burden of stabilisation falls on the fiscal policy of the member states, we must first decide whether a limited flexibility in budgetary policy should be guaranteed. In fact, at the member-state level, given the impossibility of utilising the monetary policy instrument, anti-cyclical variations in the budget balance, with a surplus during expansionary periods and deficits during recessionary ones, should be greater if the responsibility for stabilisation policy falls entirely on the member states. Second, we must remember

that, to the extent that the completion of the internal market increases the interdependence of the European economy, there is a reduction in the willingness of member states to develop stabilisation policies, since the costs of the policy are borne by their own residents, but the benefits are spread over the entire market. Finally, and most importantly, the effects of a discretionary policy based on the coordination of fiscal measures adopted by the member states tend to occur with a time-lag such that the stabilising potential of this policy is completely neutralised.

The coordination of fiscal policies managed by the member states thus represents a necessary but insufficient condition to guarantee the effectiveness of a Community stabilisation policy in the face of symmetrical shocks having a significant macroeconomic effect on the whole European economy. In this regard, we should mention that already with the EMS there was an asymmetry in the effects of fiscal policy, and thus a deflationary tendency. In fact, when it is necessary to adopt a restrictive fiscal policy—for example, to limit the inflationary effects from an exogenous shock on the cost of inputs—the risk exists that each member state will increase taxes or reduce spending, without considering the induced deflationary effects from similar measures taken in other countries. This risk is mainly connected with the determination to achieve the objectives in any case, no matter what the behaviour of the other partners. In the case of negative exogenous demand shocks—for example, due to restrictive policies by the United States or Japan—the pursuit of expansionary policies will be more difficult because the benefits of the fiscal policy will in any case be partly lost due to the existence of external effects, and because of the fear of playing the role of the ‘locomotive’, with the consequent advantages this brings to those partners who behave as free-riders.

Coordination can certainly reduce the probability of a deflationary tendency in the management of fiscal policy by the member states of the EMU, but given the time-lags required by the political decision needed to get this under way, a recessionary effect can occur in any case on output and employment, because of the automatic stabilising effects and the discretionary measures of fiscal policy. On the other hand, we must emphasise, within the context of problems that arise in reaching an effective political decision, that the weight of the strongest states in defining coordinated measures of fiscal policy is certainly greater—which is normally the case in all confederal political structures. It thus appears to be difficult for the politically and economically weaker member states to set off down this road with great enthusiasm.

4

THE INADEQUACY OF THE SOLUTIONS CALLED FOR IN THE MAASTRICHT TREATY

In short, we see here an important limit of the Maastricht agreement. In fact, Article 103 of the Treaty on European Union states that ‘Member States regard their

economic policy as a matter of common concern and shall coordinate them within the Council', which must define the general guidelines of the economic policies of the member states on the basis of the Commission's recommendations. This indication is further confirmed in Article 130B, on the basis of which 'Member states shall conduct their economic policies and shall coordinate them in such a way as, in addition, to attain the objectives set out in Article 130A'. Thus, the Commission has no autonomous power to conduct macroeconomic policy within the Community and can only work to favour the achievement of coordinated decisions. On the other hand, the Treaty does not even foresee an evolution over time during the succeeding phases of the EMU. In fact, Article 109J of the Maastricht Treaty provides for a precise timetable for launching the single currency; but Article 109E limits itself to establishing that the member states must avoid excessive public deficits. It thus seems clear that there is a need to fill this gap as soon as possible by modifying the provisions of the Treaty regarding the distribution of powers among the member states and the Commission with respect to the management of economic policy.

We can conclude from these observations that the EMU, in a political context which nevertheless is destined to develop in a federal direction, must be enabled to promote an autonomous stabilisation policy by means of adequate reform in the budget policy area which provides for: (a) an increase in the size of the budget, which becomes inevitable also for allocative reasons; (b) a change in the budget rules which guarantees the compatibility with the objective of monetary stability, but at the same time allows greater elasticity in the management of fiscal policy in order to face negative economic trends; (c) the introduction of budgetary instruments which introduce automatic flexibility even as regards tax revenue.

The carrying out of these reforms lays down as an essential condition a strengthening of the budgetary authority—made up of the European Parliament and the Council of Ministers—which must also be given the power to decide on matters concerning the financing of the Community's public expenditures. At present, with a confederal political structure in the Community, the containment in the growth of public spending is guaranteed by strict budgetary rules, and decisions regarding revenue require unanimous agreement by member states; but within an eventual federal-type political union, which is destined gradually to emerge based on the developments contained in the Maastricht Treaty and the launching of monetary union, it is necessary to make sure that the entire budgetary policy, on both the revenue and expenditure side, is democratically governed by joint decision of the two branches of the budgetary authority, obviously according to the norms contained in the Treaty, which impose limits on EMU fiscal policy.

Thus, in the area of stabilisation policy it is necessary to go beyond the indications in the MacDougall Report, which proposed increasing the size of the European budget and at the same time providing it with a certain automatic flexibility through the creation of a European fund for unemployment. In fact,

this solution would have simultaneously resolved the two problems concerning stabilisation: on one side, an increased budget allows for variations in spending—or tax revenues—which are sufficient to counter recessionary or inflationary pressures at the European level; on the other, through the automatic flexibility of the budget it is possible to deal with regional shocks, since a member country of the EMU, even if it is not able to adjust its monetary policy or exchange rate, can automatically stabilise its economy in case of a recession by contributing fewer taxes to the European budget and receiving larger transfers (the opposite would obviously occur in the event of inflationary pressures).

However, the indications in the MacDougall Report—which foresaw the need to increase the Community budget up to 5–7 per cent of European GDP in order to meet the requirements of monetary union—do not appear realistic today, since the report assumes a limited expansion in public expenditures at the European level—even if this is in part compensated for by a parallel reduction in public expenditures at the national level—in a political context in which all the member states are committed to reducing their expenditures, in particular after the launch of the monetary union and the approval of the Stability Pact.

We can thus easily understand why the problem of the stabilisation policy at European level has represented one of the central themes in the new Report (European Commission 1993), written by a group of experts on behalf of the European Commission, which updates the conclusions in the 1977 MacDougall Report in view of the start of the monetary union. Regarding the stabilisation policy at European level, the report's conclusions are entirely conventional since, after noting that the most important limits to stabilising macroeconomic policy are connected with the various time-lags which largely compromise its effectiveness, the report points out that at the European level the only instruments available to the EMU are monetary policy and manoeuvres regarding the external exchange rate of the Euro against the other important world currencies. Both these policies can have automatic stabilising effects on the level of activity. In fact, if there is a relatively stable rate of increase in the money supply, interest rates tend to rise during an expansionary phase, thus putting a brake on the increase in demand (and vice versa during a recession). At the same time, the increase in interest rates causes an inflow of capital from abroad, thereby favouring the appreciation of the Euro against the other world currencies, thus further slowing down the growth in demand. The prevailing opinion among the writers of the report is that, given the positive impact on the general economic situation caused by these automatic stabilisation mechanisms, it is not necessary to activate an autonomous fiscal policy at European level; rather it is enough to promote a coordination of national fiscal policies.

This conclusion can be shared for the most part, but it has a basic shortcoming. It can be accepted because a coordination of national fiscal policies is necessary in any case to avoid the perverse effects which could result from conflicting national fiscal policies. It is inadequate because all the limits regarding time-lags in fiscal policies—which justify a negative conclusion about

the possibilities of managing a fiscal policy aimed at stabilisation through discretionary measures—are even more evident in the case of coordination that—even optimistically assuming an agreement is finally reached—nevertheless requires a long period of time to become operative. As a result, the effects of fiscal policy decisions tend to manifest themselves when the general economic circumstances may have already changed noticeably. The main point is therefore to decide whether, besides being necessary, coordination is sufficient in the absence of other instruments which can be used at European level for stabilisation purposes.

As far as the European stabilisation policy is concerned, the real problem is a political one, and consists in determining which authority can, in the last instance, make fiscal policy decisions. If there is an autonomous authority at European level, then a European fiscal stabilisation policy is possible, even if this will have to be achieved for the most part through the coordination of national fiscal policies. If, however, at European level there is no autonomous decision-making authority, and coordination can be carried out only through reaching the necessary consensus in the Council of Ministers, then there is no European policy but only a sum of national policies. Moreover, in this case the effects of the different national policies can cancel themselves out if the recommendations of the Council are not translated into coherent decisions by each member state. But even in the best-case scenario, where all the countries carry out the recommendations of the Council, the decision-making process will nevertheless require a long period of time, and as a result the effects on the economy will be felt so late that their effectiveness will be substantially limited.

Even in this area the experience of the European Union can thus turn out to be very innovative, given that the stabilisation policy necessarily requires the cooperation of both European and national government levels. In fact, it is neither necessary, nor opportune, to move from a national policy of stabilisation to one managed exclusively at the European level. In fact, given the relative weights of the national budgets and the Community budget, we can with reasonable certainty foresee that the greatest weight for the stabilisation policy will be on the fiscal policy of the member states. But we must be more specific: there will be an effective European policy—as opposed to a sum (ineffective) of national policies—only if at the European level there is both real decision-making power regarding the policies to pursue and adequate instruments to get the member states to respect the decisions that have been made. If this model is realised then the European Union could in fact represent the first example of a truly federal structure in the management of the stabilisation policy, on the basis of the subsidiarity principle sanctioned by Article 3B. But it is clear that the Maastricht Treaty provisions keep us well away from realising this model.

In effect, the solutions identified in the Treaty are limited to a more precise description of the functioning of the multilateral surveillance mechanism. In fact, Article 103(4) establishes the procedure that permits the setting of general guidelines for the economic policies of the member states and the Community. If

a member state does not abide by these guidelines or risks compromising the correct functioning of the Economic and Monetary Union, ‘the Council may, acting by a qualified majority on a recommendation from the Commission, make the necessary recommendations to the Member State concerned’. It is clear that norms of this type are far from recognising effective decision-making capacity at Union level, which would allow a precise definition of the necessary fiscal policy measures through the initiative of the Commission and with the consensus of the European Parliament and member states—by means of a majority decision in the Council of Ministers—and would also attribute real executive power to the Commission to guarantee that the measures decided on actually become operative, through the instruments of the Community budget directly, and indirectly through the cooperation of the member states.

This conclusion thus appears to be quite important, since it points out that the decisive choice regarding the macroeconomic stabilisation policy for the European economy is basically political in nature and implies giving the institutions of the European Union true autonomous ruling power in this area, so that they can make binding decisions for member states regarding the direction of fiscal policy. In truth the alternative is not between a European stabilisation policy and the coordination of national fiscal policies, since a European stabilisation policy necessarily includes the coordination of national fiscal policies among its instruments. Instead the main difference concerns the existence of real decision-making power at the European level: if this power exists the system is effective; if not, as is still the case in the wake of the Treaty of Maastricht, there is no European policy but only a sum of national policies, and this solution is absolutely futile.

5

THE REGIONAL STABILISATION POLICY

The second problem that emerges regarding fiscal policy derives from the fact that, in a monetary union, the member states lose their right to set monetary and exchange rate policies. The theory regarding optimal currency areas reveals that this problem can be easily solved if there is a sufficiently large federal budget, since the effects of a country-specific shock—or a shock with asymmetrical effects—are, to a large extent, automatically absorbed. The automatic flexibility of the federal budget is thus able to guarantee an effective stabilisation policy at regional level despite the loss of two important economic policy instruments. But if the budget is not sufficiently large, or does not possess an adequate level of flexibility, these automatic mechanisms cannot prevent the onset of negative effects from the exogenous shock.

A choice in line with the conclusions of the theory on optimal currency areas, which assumes federal management of a sufficiently large budget, was also put forth in the 1977 MacDougall Report (European Commission 1977). If such a solution is not practicable, the alternative solution is the more flexible use of

fiscal policy instruments. But this alternative is by now unrealistic, especially when we take into account the conditions imposed by the Maastricht Treaty and by the content of the Stability Pact. We should thus carefully evaluate the appropriateness of using alternative instruments that can be implemented at Union level. The objective is to ensure that a country going through a recession is not forced—in order to avoid heavy losses in output and employment—to manage its fiscal policy in such a way as to cause a budget deficit, thus going against the Maastricht prescriptions.

On the basis of the available literature and the actual experience of the states with a federal structure, we can assert that the existence of a centralised budget leads to a reduction in the impact of an exogenous shock on a regional economy of between 20 per cent and 30 per cent. On the contrary, in states like France and Germany, where the mechanisms of interpersonal solidarity are more incisive and the management of unemployment subsidies takes place at central level, the effectiveness of automatic regional stabilisation increases to 35 per cent—reaching 40 per cent in the case of some German Länder that can make ample use of the horizontal equalisation mechanisms of the *Finanzausgleich*.

In general, therefore, these automatic stabilisation mechanisms appear to be adequately able to compensate for the negative effects that could arise for a regional economy hit by an exogenous shock. If the shock is recessionary in nature, then income will be reduced in the region in question, taxes to be paid—national or federal—will fall, and transfers financed by the central budget will increase. As a result, demand will increase in the region suffering from recession, with positive effects on income and employment levels. Similar effects will occur in the event of inflation caused by excess demand. But the occurrence of these effects obviously assumes that the size of the central budget allows for significant variations in revenue and spending levels. Thus the case is different for the European Union, where the size of the budget barely reaches 1.2 per cent of GDP and appears, in fact, to be totally insufficient to guarantee the proper functioning of these automatic stabilisation mechanisms, as the MacDougall Report has already pointed out.

However, the possibility of increasing the size of the European budget to the necessary extent does not seem realistic in the present economic and political circumstances. Keeping this constraint in mind, it is nevertheless possible to obtain similar results with very limited budget resources, if these are specifically allocated to regional stabilisation policy. In particular, we can imagine a solution involving the creation of a budget reserve—as already occurs in the case of the Agricultural Reserve Fund, set up to deal with unforeseeable developments in the exchange rate of the dollar against the ECU—which can be automatically used to sustain the economy of a member state if variations in the employment rate in the country in question are significantly different from the Community average (Majocchi and Rey 1993).

Simulation studies allow us to conclude that if the budget sets aside 0.2 per cent of European GDP to finance an ad hoc mechanism for regional economic

stabilisation, then this will be enough to guarantee the effectiveness of a stabilisation policy for the economies of the member states who are faced with an exogenous shock, thereby avoiding the risk of having to turn in the last instance to a devaluation of the exchange rate (Italianer and Vanheukelen 1993). In particular, the mechanism put forward in the 1993 Report calls for a transfer to member states hit by a recessionary shock equal to one percentage point of GDP for every point that the national unemployment rate differs from the Community average, with a ceiling equal to 2 per cent of the receiving country's GDP. As a result, increases in unemployment above 2 per cent with respect to the Community average are no longer compensated. In any case, this mechanism seems able to guarantee a stabilisation that is equal on average to 18–19 per cent, quite similar to that which generally exists in states with a federal structure (Pisani-Ferry *et al.*, 1993).

The launching of this European regional stabilisation fund—accompanied by recognition to the Commission of a true coordinating power regarding the economic policies of member states—could promote an effective solution to the problem of stabilisation. In this case it would be easier for member states in the Union to accept the new conditions imposed by the Stability Pact, with the aim of ensuring monetary stability after the introduction of the Euro by means of respect for constraints which are even more rigid than those in the Maastricht Treaty. These constraints would in fact be more bearable in the context of an expanding European economy if the member states could also count on the intervention of the regional stabilisation fund to compensate for the deflationary effects of measures targeted at improving the budgetary balance.

6

THE SIZE OF THE COMMUNITY BUDGET AND THE GROWTH OF OWN RESOURCES

An important conclusion from the previous analysis concerns the size of the Community budget. If ruling responsibility with regard to stabilisation policy is mainly at the European level, while resources come mostly from national budgets—and in future we can expect they will come to a large extent from sub-national budgets—then the size of the Community budget could be much lower compared to the normal experience of federal states. In effect it seems possible to achieve the objectives of the EMU with a limited-sized budget, equal to around 2 per cent of European GDP, which includes a reserve of around 0.2 per cent of GDP, set aside for the regional stabilisation mechanism.

Thus the indications of the MacDougall Report, calling for a budget equalling 5–7 per cent of European GDP in the event of complete monetary union, are not being adhered to. Moreover, with a budget equal to 2 per cent of European GDP, around half of the available resources could be aimed at solidarity objectives. In fact, with a budget of this size, an amount of resources equal to 0.4–0.5 per cent could be assigned to structural expenditures—including the cohesion fund

created at Maastricht—and thus to internal solidarity towards the weakest regions; while an amount equal to 0.5–0.55 per cent of GDP could be set aside in the budget for external solidarity, including the European Development Fund.

These indications concerning the structure of the budget open up a new scenario for the development of fiscal policy within a federal-type Union, characterised by a much more important role—in terms of resources directly used by the federal budget—for the equalising objective with regard to stabilisation policy. But there is another aspect to consider, which more directly concerns the Community's institutional development. There will probably be negative reactions to the proposal to increase the size of the Community budget to as much as 2 per cent of GDP from those member states who will have to contribute more to the European Union in a situation where respect for the Maastricht constraints has already imposed large sacrifices. This reaction is understandable, since the states should bear the political cost from the increase in fiscal pressure, while benefits from the expenditures would be attributed to the Union. The way out of this apparent dilemma is to grant, on the basis of the principles of fiscal federalism, an autonomous taxation power to the Union, bringing together in the decision-making process the two branches of budgetary authority: Council and European Parliament. In this way, political and social forces would have the chance to intervene in the process of defining the fiscal policy of the Union, which might decide on an increase in spending only to the extent it is able to guarantee a sufficient consensus to reduce other expenditures or increase fiscal pressure.

In short, some relevant conclusions seem to emerge from this analysis which appear to be of considerable interest for fiscal policy in the EMU. In particular, it seems possible to show that a limited-sized budget would be enough to make the Union function effectively, also through the activation of a regional stabilisation fund for the economies of the member states. Moreover, it is also clear that a budget of 2 per cent of GDP seems sufficient to guarantee an internal and external solidarity policy for the European Union and finance the spending needed to support the new measures foreseen in the context of a policy aimed at promoting the sustainable growth of the European economy, such as that defined in the Delors plan. In fact, if we consider that around one-fourth of the budget—even after the reform of the CAP—is supposed to remain assigned to agriculture, it turns out that, once we have also taken account of spending for the regional stabilisation mechanism, the remaining part of the budget—equal to around 0.2 per cent of European GDP—would be destined for the new policies (research and development, energy, infrastructure, environment) needed to implement the suggestion of the Delors plan, which were approved by the European Council in Brussels on 10–11 December 1993. But it is also important to reform the system for financing the Community budget. All these reforms, however, are conceivable only in the context of a completely reformed Union—which has overcome the democratic deficit that still exists after Maastricht—in which the European Parliament is given effective co-decisional power in fiscal matters as

well, in particular the power to determine—together with the Council, no longer paralysed by the veto right and without executive power, which is reserved instead for the Commission—the necessary taxes to finance spending, according to the classical prescriptions of fiscal federalism.

As far as the development of Community finance is concerned, since the Delors package—approved in 1988 and which defined the financial prospects for the period from 1988 to 1992—has expired, new proposals were put forward by the Commission in February 1992 calling for a growth in Community spending and, at the same time, an increase in Community resources starting from 1.2 per cent of European GDP and rising to 1.37 per cent in 1997. This additional expenditure seeks to achieve three different objectives: (a) half must be set aside for structural spending to sustain economic and social cohesion, the importance of which is reaffirmed in the Treaty of Maastricht; (b) spending on aid for the Third World must grow by 75 per cent during the period in question in order for the Union to play a greater role in the international arena; (c) finally, spending for research and development, as well as the construction of trans-European networks, must significantly increase in order to strengthen the competitiveness of European industry.

The political decision regarding the Delors II package was reached during the meeting of the European Council in Edinburgh in December 1992; at that time the evolution of the Community budget until 1999 was established. Above all, the Community's resources were to remain constant until 1994 and then gradually increase to 1.27 per cent of GDP in 1999. Structural expenditures are destined to grow significantly: regions with a per capita income below 75 per cent of the Community average will receive an increase of two-thirds in transfers of structural funds. As a result, and also taking account of the entering into effect of the cohesion fund called for in the Treaty of Maastricht, the four cohesion countries (Greece, Spain, Ireland and Portugal) will see a doubling in their portions compared to 1992, and a quadrupling compared to 1988, thereby significantly increasing the redistributive impact of the Community budget.

In the period 1992–9 the money set aside for research and development and for the construction of trans-European networks will grow by 30 per cent—with an increase, therefore, that is below the 50 per cent proposed by the Commission, while aid to the Third World will increase by 40 per cent. As far as the structure of the Community's resources is concerned, the decisions reached at Edinburgh do not indicate any significant progress with respect to the past. VAT was reduced by 1.4 per cent to 1 per cent, while the size of the VAT tax base fell from 55 per cent to 50 per cent. As a result, the importance of the so-called fourth resource—proportional to the GDP of each member country—is destined to grow, beginning in 1995.

However, the start on 1 January 1999 of Monetary Union creates a problem regarding revision of the structure of the Community's resources. The objective is mainly to guarantee—overall at least—the proportionality of taxes with respect to the relative wealth of the various member countries. The Edinburgh

agreements represent a step forward in this direction, which nevertheless can only be once and for all assured through guaranteeing the proportionality principle in the management of the fourth resource. In fact, we can also hypothesise the adoption of a progressive formula in the distribution of the Community's tax revenue to each country, considering proportionality as the starting point and progressivity as the finishing point of the tax system.

The introduction of new instruments for tax revenue at the Union level obviously depends on the speed with which the EMU is realised. An additional resource for the Union could be revenue from the energy/carbon tax, which was proposed by the Commission in June 1992, and whose introduction is at present being blocked by the lack of agreement within the Council, mainly due to the hostile position of the British government regarding the recognition of a role for the Union in the management of fiscal intake. At the same time, the Community's budget should also be increased by the right of seignorage tied to the emission of the Euro—the European single currency—as well as by revenue from a withholding tax as part of the harmonisation process of taxes on capital income. Finally, additional revenue could come later on from a Community surcharge tax on corporate incomes—or cash flows (European Commission 1993b).

The definition of new resources allocated to finance the Community budget certainly represents an important point; but we must especially emphasise the fact that the most important aspect from the political point of view is the recognition of the Union's power to define new taxes if new expenditures are foreseen. The decision-making structure in this case must obviously be federal in nature, calling for the intervention—as representatives of the European citizens and the member states—of both branches of the budgetary authority, the European Parliament and the Council. But two points regarding the revision of the policy concerning the Community's own resources must be strongly emphasised: first, the need—on the basis of a fundamental principle of fiscal federalism—to decide an increase in tax revenue each time new expenditures are established, in order to guarantee fiscal responsibility and thus effectiveness at the European level of government; and, second, the urgency of guaranteeing that Community tax revenue follows principles of equity, once and for all rejecting the criterion of the *just return* and foreseeing an evolution of tax revenue initially towards a proportional structure, then becoming progressive in terms of the long-term tax system, so that automatic mechanisms will be used to favour the territorial redistribution of tax revenues as well.

7

CONCLUSIONS

Taken together these considerations allow us to conclude that the development of Monetary Union must be conceived in such a way as to permit the Union to have effective governing capacity for the European economy. In particular, the

revision of the institutional structure of the Union, which is indispensable after the modest progress made with the Treaty of Amsterdam, assumes that a solution should be found along the following lines.

(a) The problem of undertaking a new growth model can no longer be put off, if the desire exists to promote a stable and sustainable recovery of the European economy. The solutions will probably be different depending on the conditions in each country, but it is nevertheless clear which direction to move in. It is essential to modify relative prices so as to orientate the market towards solutions that favour the use of labour and minimise the consumption of environmental resources. Until now fiscal policy in Europe has acted exactly in the opposite direction, by reducing tax on the use of natural resources and increasing fiscal pressure on the use of labour. Lowering the burden of social security contributions—in particular those weighing on unskilled labour—through new tax revenues provided by an energy/carbon tax would achieve this shift in relative prices, thus using the market to achieve a new growth model characterised by less unemployment and more incisive environmental protection.

(b) The concrete achievement of a growth plan for the European economy along these lines obviously assumes a strengthening of the financial resources available to the Union, taking account, however, of the fact that achieving EMU is realistically possible even concerning the size of the budget needed to make it function effectively—in particular, by activating a stabilisation mechanism for the economies of the member states—given that a budget equal to 2 per cent of GDP should be enough to guarantee a solidarity policy inside and outside the European Union, finance the spending needed to support the new policies of the Union, and guarantee a true process of convergence among the economies of the member states. This would assure a coherent context for the creation of new jobs as well as for undertaking the needed measures to manage the necessary adjustments in the labour market in the context of a more incisive and effective social policy.

(c) We must also emphasise the need to strengthen the role of the European Parliament in the budgetary process, by eliminating the distinction between obligatory and non-obligatory expenditures, and by removing the ceiling concerning the maximum rate of growth in non-obligatory expenditures. Moreover, within the EMU the Parliament must also have authority on revenue decisions, according to a basic principle of fiscal federalism. All this assumes a true European government based on democratic mechanisms, in which the political parties, organised on a European scale, have the same influence as the representatives of the member states, in the context of a true federal bicameral system. An analysis of the premises of the EMU thus brings out the need to proceed along the road toward strengthening the federal character of the EMU in order to guarantee the sustainable growth of the European economy, according to the recommendations of the Delors plan.

(d) The policy aimed at promoting the sustainable growth of the European economy requires, to be successful, the collaboration of all levels of government.

The subsidiarity principle, which by now is fully a part of the European fundamental law, implies not only that some powers should be kept at national level, but also that regions and local authorities should be used to a large extent as an optimal level of decision making. This is certainly the case regarding the carrying out of the Delors plan, which requires cooperation among all levels of government to carry out the called for measures. In this regard, the design of an effective system of fiscal federalism certainly represents the necessary first step at the political level to give effective responsibility to lower levels of government and strengthen their capacity to participate in the realisation of a new model of growth which should characterise the European economy at the dawn of the twenty-first century.

(e) Fiscal federalism basically presupposes that each level of government must finance itself largely through its own taxes, while maintaining for the higher level the responsibility of redistributing resources so as to ensure an adequate level of equality in the availability of resources in all areas. In fact, only a system of this kind is able to guarantee at the same time a number of positive effects:

- Efficiency is assured, since each level of government is given responsibility and can spend money only to the extent it is able to convince its citizens that the utility of this expenditure is greater than the cost of the taxes needed to finance it.
- This mechanism represents the only true brake on public expenditure expansion, since for each level of government consensus is maximised if, for a given service, expenditure—and thus taxes on citizens—is minimised.
- Fiscal federalism also promotes equity, since it assumes interregional redistribution of resources in order to guarantee that, through equal fiscal effort, citizens can obtain an equal level of services all over the country.

Note

- 1 The stabilisation condition of the debt to GDP ratio is well known in economic literature: $d = x \cdot b$, where d is the budget deficit as a share of GDP, b is the debt to GDP ratio, and x the nominal growth rate of GDP (De Grauwe 1997).

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Part II

The state of fiscal federalism in Europe

4

Fiscal federalism in Austria: facts and new developments*

Erich Thöni

1

INTRODUCTION

Although there is a saying¹ that ‘each federal system is a case of its own and can be compared only within certain limits’, one can agree that there are, however, common basics and interesting specifics which can be found in each federal system. It is therefore possible to gain deeper insights into the structures of federalism and to see them as an inspiration for other countries’ constitutional reforms or even day-to-day political practice. In this light, the Austrian constitutional framework in terms of fiscal federalism can be considered within a discussion on constitutional reform in Italy.

This chapter first draws attention to fiscal democracy in Austria and tries to clarify some fiscal terms. Second, it discusses regional and local government functions and ‘the necessity for regional co-ordination’. Third, the revenue sources of regional and local authorities are addressed before closing with an appraisal of the new co-ordination mechanism (the so-called ‘consultation mechanism’), established to prevent the unilateral transfer of task fulfilment to lower governmental tiers as well as ‘cost-shifting’ and ‘cost-sharing’ without adequate financing.

The data used in this chapter are primarily those of the last two most important financial settlements (1985 and 1993) but are expanded by the latest figures (where possible). Although selected years were chosen, the data enables us to show the respective trends as well as the given status up to 1995 (the last year accounted for and published by the Austrian Statistical Office).

Table 4.1 Local governments in the Länder of Austria.

Year	Burgen- land	Carin- thia	Lower Austria	Upper Austria	Salzburg	Styria	Tyrol	Vorarl- berg	Total incl. Vienna
1949	317	244	1,584	444	117	977	285	96	4,065
1955	320	241	1,652	444	119	875	286	96	4,034
1960	319	229	1,652	445	119	857	287	96	4,005
1965	319	204	1,650	445	119	808	287	96	3,929
1970	319	204	1,160	445	120	551	287	96	3,183
1975	138	121	558	445	119	546	278	96	2,302
1980	138	121	558	445	119	544	278	96	2,300
1985	138	121	562	445	119	544	278	96	2,304
1990	145	121	568	445	119	544	278	96	2,317
1991	153	128	569	445	119	544	278	96	2,333
1992	164	131	569	445	119	543	279	96	2,347
1993	167	131	569	445	119	543	279	96	2,350
1994	167	131	570	445	119	543	279	96	2,351
1995	168	131	571	445	119	543	279	96	2,353
1996	170	131	571	445	119	543	279	96	2,355

Source: ÖSTAT, *Statistisches Jahrbuch der Republik Österreich*, relevant years.

2

SOME REMARKS ON AUSTRIAN FISCAL TERMS, REGIONAL AND LOCAL GOVERNMENT EXPENDITURE FUNCTIONS AND FINANCE SYSTEMS²

2.1

Fiscal democracy

Austria is constitutionally a federal country with three levels: the federal level or Bund, 9 states or Länder and 2,355 (1996) local governments (communities) or Gemeinden. Table 4.1 indicates the change in structure of local governments over time. After territorial reforms (*Gemeindezusammenlegung, Gebietsreform*) in some Länder of Austria, which considerably reduced the number of local governments (from over 4,000 just after World War II to 2,300 in 1980), the total number has since been increasing (today 2,355), which points to ongoing (local government) 're-engineering'.

Austria also includes so-called charter cities (*Statutarstädte*), which execute all local government, as well as district functions (*Bezirk*). The latter are administrative bodies below the Länder level; they are the first level of federal and state administration. With the exception of these charter cities and Vienna all local governments are considered to be equal in carrying out their responsibilities (*Einheitsgemeinde*),³ although they vary very much in size, type, economic and administrative capacity with respect to development as well as revenue (see Tables 4.1 and 4.2). Vienna (1.54 million inhabitants/ 1991) has a special, dual

constitutional status as one Land of the nine, and at the same time one Gemeinde of the 2,355 (see [Table 4.1](#)).

2.2

Federal, regional and local government expenditure functions

Tables [4.3](#) and [4.4](#) present an overview on expenditure functions of all levels of government in Austria, defined along functional and economic criteria. Drawing attention to the ‘functional’ side of expenditure functions which are fulfilled by the different levels, several crucial functions on each level immediately become obvious (federal level: social welfare, education; Länder: education, health, housing, social welfare; local governments: public services, education, health, roads).

Looking at the ‘economic’ side of the expenditure functions roughly 65–70 per cent of total expenditures is spent on ‘current expenditures’. On the capital expenditure side, the Länder level fulfils a type of banking function in providing mainly for ‘loans’, the federal level obviously spends most (without taking into account its tremendous share of debt repayment) on capital transfers, whereas the local level is the ‘public investor’.

As in other federal countries (USA, Germany, Switzerland), the 1920/9 constitutional law (*Bundesverfassungsgesetz*, B-VG) specifies the ‘sovereign’ federal legislative functions, and the Länder are responsible for the remainder (‘Residual clause’, Art.15 (1) B-VG).⁴ But, despite the formal dominance of the Bund, one should not overestimate the ‘weakness’ of the Länder, especially on the ‘executive side’. Looking at their status more carefully, one recognises that the Austrian Länder exercise considerable discretion in their relations with the Bund, but especially with the Gemeinden. For example, most federal administration is executed through the Länder (as well as the Gemeinden).

This ‘constitutional invisibility’ is actually upgraded by the so-called *Privatwirtschaftsverwaltung* (non-governmental administration), within which Bund, Länder and Gemeinden are allowed to intervene in any area of constitutional competence reserved for the other levels. They do so by means of private law arrangements, through companies and public expenditure, particularly subsidies. This includes all functions, like public hospitals, public housing, public roads and works, cultural and educational activities, social welfare, land zoning and public subsidisation. Some of these activities are of special importance to the Länder; for these see [Figure 4.1](#).

Table 4.2 Development and status of GRP (including agriculture) of the Austrian Länder, 1961–92 (selected years); in mio ATS (market prices).

Year	ATS mio									
	Burgenland	Styria	Carinthia	Lower Austria	Upper Austria	Vienna	Salzburg	Tyrol	Vorarlberg	
1961	3.90	24.60	10.30	30.90	27.40	56.70	8.90	10.90	6.10	
1970	7.90	47.40	22.10	59.80	58.60	115.90	21.70	26.80	14.40	
1980	20.80	122.00	55.80	153.90	156.00	264.50	61.00	74.10	41.60	
1990	38.30	210.70	97.80	280.50	284.30	493.50	117.10	139.80	74.90	
1992	43.30	235.40	110.40	320.20	322.90	567.20	138.50	162.00	86.40	
Index 1961–92 (1961 = 100)	1,110.20	956.90	1,071.80	1,036.20	1,178.40	1,000.30	1,556.10	1,486.20	1,416.30	
Index 1980–92 (1980 = 100)	208.10	192.80	197.80	208.00	206.90	214.40	226.20	218.60	207.60	
Inhabitants*	270,880	1,184,720	547,798	1,473,813	1,333,480	1,539,848	482,365	631,410	331,472	
1	159.80	198.70	201.50	217.30	242.10	368.30	287.10	256.60	260.70	
2	65.60	81.60	82.70	89.20	99.40	151.20	117.90	105.30	107.00	
Index (excl. Vienna) ³	55.60	69.20	70.20	75.70	84.30	—	100.00	89.40	90.80	
Index (incl. Vienna) ⁴	43.40	54.00	54.70	59.00	65.70	100.00	78.00	69.70	70.80	

Source: WIFO-Datenbank, Zeitreihe RWZMINN¹ J; Volkszählung 1991, Statistisches Jahrbuch der Republik Österreich.

Notes

1 GRP/p.p. 1992 in absolute ATS.

2 Deviation from GRP/average p.p. 1992 (average=100) (Index).

3 Deviation from highest GRP/p.p.—excluding Vienna (Index).

4 Deviation from highest GRP/p.p.—including Vienna (Index).

* Census 1991

Table 4.3 ATS—and percentage composition of (functional) expenditure functions of federal, regional and local governments, 1995.

	Federal government in ATS 1000	%	Länder ¹ in ATS 1000	%	Vienna ² in ATS 1000	%	Local governments ³ in ATS 1000	%
Education and schools	67,457,660	7.71	39,301,885	18.03	10,663,186	8.67	21,222,724	12.52
Research and science	28,745,009	3.28	703,150	0.32	48,655	0.04	174,919	0.10
Arts	7,899,127	0.90	4,318,237	1.98	2,139,338*	1.74	4,920,220	2.90
Culture	550,776	0.06	29,735	0.01	*	0.00	196,269	0.12
Health/hospitals	6,709,487	0.77	33,051,905	15.16	23,748,110	19.31	14,310,834	8.44
Social welfare	180,649,346	20.64	20,117,784	9.23	9,810,484	7.98	9,555,944	5.64
Housing (constr.)	24,134,828	2.76	28,594,525	13.11	19,613,242	15.95	606,117	0.36
Roads	15,500,129	1.77	8,815,193	4.04	1,013,314	0.82	12,019,913	7.09
Other transport	46,202,405	5.28	1,103,304	0.51	347,957	0.28	120,158	0.07
Agriculture and forestry	29,842,054	3.41	10,764,466	4.94	872,874	0.71	1,642,359	0.97
Energy/electricity	201,794	0.02	105,602	0.05	*	0.00	55,578	0.03
Industry	20,673,738	2.36	2,146,025	0.98	1,110,299	0.90	1,092,527	0.64
Public services (water, garbage, sewerage, etc.)	3,718,306	0.42	1,286,785	0.59	19,530,306*	15.88	40,855,999	24.11
Private services	5,493,652	0.63	1,270,378	0.58	343,405	0.28	11,787,866	6.96
Defence	20,681,533	2.36	46,844	0.02	11,621	0.01	19,096	0.01
Public security	26,275,662	3.00	845,974	0.39	1,201,645	0.98	4,184,080	2.47
Other administration	390,548,123	44.62	65,532,306	30.06	32,497,353	26.43	46,697,068	27.56
Total	875,283,629	100.00	218,034,098	100.00	122,951,789	100.00	169,461,671	100.00

Source: *Gebärungsübersichten* 1995, own calculations.

Notes

1 Excluding Vienna, excluding intergovernmental transfers.

2 Land and local government, excluding intergovernmental transfers.

3 Excluding Vienna, including intergovernmental transfers.

* Cannot be separated.

Table 4.4 ATS—and percentage composition of (economic) expenditure functions of federal, regional and local governments, 1995.*

	Federal government in ATS 1000	%	Länder ¹ in ATS 1000	%	Vienna ² in ATS 1000	%	Local governments ³ in ATS 1000	%	%			
Personnel/employees	83,950,703	13.70	9.34	64,295,224	40.65	29.49	30,877,348	37.24	25.11	31.59	20.43	
(Current) expenditures for goods and services	72,220,539	11.78	8.03	19,126,465	12.09	8.77	26,549,937	32.02	21.59	33,781,573	34.86	22.54
Interests	93,536,004	15.26	10.40	3,364,070	2.13	1.54	2,009,824	2.42	1.63	4,185,383	4.32	2.79
Transfers (current)	363,198,432	59.26	40.39	71,377,343	45.13	32.74	23,485,552	28.32	19.10	28,329,469	29.23	18.90
I (CURRENT)	612,905,678	100.00	68.16	158,163,102	100.00	72.54	82,922,661	100.00	67.44	96,908,703	100.00	64.67
EXPENDITURES	13,485,893	4.71	1.50	6,044,135	10.10	2.77	11,754,336	29.36	9.56	35,804,157	67.62	23.89
Investment	46,267,895	16.16	5.15	13,040,167	21.78	5.98	10,985,582	27.44	8.93	3,822,518	7.22	2.55
Transfers (capital)	2,606,510	0.91	0.29	45,136	0.08	0.02	3,931	0.01	0.00	2,923,267**	0.79	0.29
Securities/bonds	2,860,548	1.00	0.32	3,240,627	5.41	1.49	2,614,422	6.53	2.13	**	**	**
Shares	3,892,944	1.36	0.43	18,337,306	30.63	8.41	1,800,786	4.50	1.46	585,209	1.11	0.39
Loans												
Debt repayment												
(redemption)	204,839,880	71.54	22.78	6,792,567	11.35	3.12	6,891,730	17.22	5.61	6,900,205	13.03	4.60
Reserves	12,359,291	4.32	1.37	12,371,058	20.66	5.67	5,978,341	14.93	4.86	5,837,127	11.02	3.90
II (CAPITAL)	286,312,961	100.00	31.84	59,870,996	100.00	27.46	40,029,128	100.00	32.56	52,949,216	100.00	35.33
EXPENDITURE	899,218,639	100.00	218,034,098	100.00	122,951,789	100.00	149,857,919	100.00	100.00	149,857,919	100.00	100.00

Source: *Gebarungübersichten* 1995, own calculations.

Notes

1 Excluding Vienna.

2 Land and local government.

3 Excluding Vienna.

* Including intergovernmental transfers on all levels (especially local governments—different to functional composition!).

** Cannot be separated.

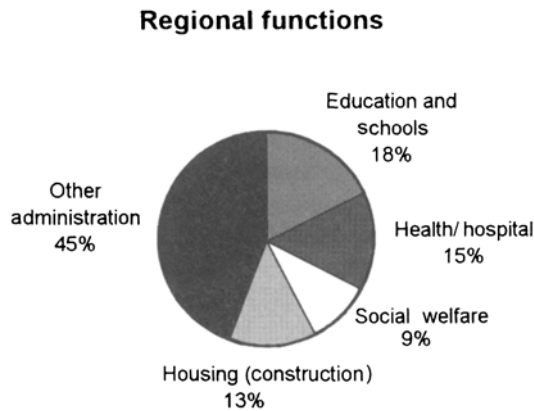


Figure 4.1 'Functional' share (above 5 per cent of total expenditure)—Länder 1995, excluding Vienna (see also Table 4.3).

For the local level the Constitution guarantees 'self-government' within a specific range of competences (B-VG, Art. 115–120). They can be defended before the Constitutional Court. The range is indicated by a 'general clause' ('those matters that belong to the exclusive or predominant interest of the local community and can be performed by it within its own boundaries and within its own administrative capacity' (Art. 118 (2)) and is delimited to precise areas: local elections and civil service, local police, local traffic and roads, local markets, emergency and general rescue services, fire protection, building regulations, local land use planning, cemeteries, elementary schools and school building, hospitals (B-VG, Art. 118 (3)).

Moreover, according to Austrian constitutional experts 'self-government' should be interpreted dynamically and therefore this delimitation 'can never be a closed one'. In practice, the constitutional interpretation and the evolution of responsibilities between the Bund, Länder and Gemeinden has restricted local responsibilities to these delimited areas rather than to the general clause, although the *Privatwirtschaftsverwaltung* also applies to local governments. The main areas of activity therein are water and (partly) energy supply, local transport, sewerage, garbage collection and disposal, (partly) hospitals, sports facilities, public housing, basic social welfare and local subsidies (see Figure 4.2).

As already mentioned, local governments also fulfil administrative functions mandated or delegated by the federal or Länder level. In executing such functions they are supervised by the districts. This fulfilment often has to be financed by the local level, but with little or no local discretion ('cost-shifting' to the local level). Therefore, the significant level of autonomy in expenditure decisions over the above-mentioned range is overshadowed by the delegated functions from Bund and Länder. As a result, the expenditure levels of each

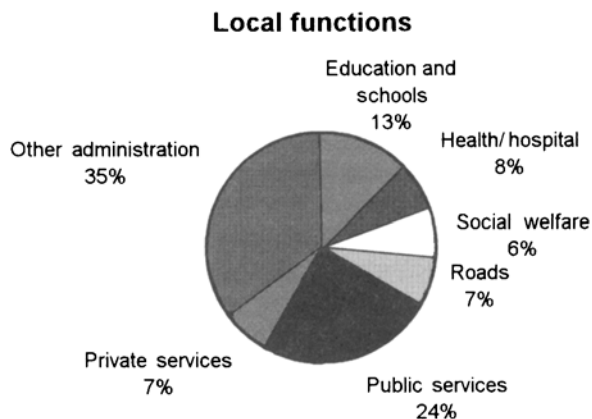


Figure 4.2 'Functional' share (above 5 per cent of total expenditure)—local level 1995, excluding Vienna (see also Table 4.3).

government unit and government level do not necessarily reflect a real measure of their fiscal autonomy.

2.3

Federal, regional and local finance system

It is the special case of Austria that constitutional financial provisions are not laid down in the Constitution. This is done in a separate financial constitution law (first 1922, now *Finanzverfassungsgesetz* (F-VG) 1948). This financial constitution law only assigns taxes to the respective level within an abstract framework of nine types of joint/shared or exclusive/separated/own tax types.

These abstract types then come into operation through the so-called financial settlement laws (*Finanzausgleichsgesetze* (FAGs)), formally legislated by the Bund. However, the decision on the FAG is an example of the Austrian social partnership as regards corporatism and is the result of a complex bargaining process between the three levels (Bund, Länder, Gemeinden). These negotiations result in a compromise agreement on 'joint tax sharing', its ratios and criteria for division, and some vertical grants to and from a level with important horizontal equalising effects, formerly for six years (up to 1985), now usually three to four years (at present 1997 to 2000).

As all these financial laws are formally federal laws, the so-called *Kompetenz-Kompetenz* (ultimate competence) remains with the Bund and therefore decisions are heavily influenced by its interests, coalitions and logrollings. The consequence is an asymmetrical constitutional structure. Economic causes, like the 'Law of Popitz', planning possibilities, the 'need' for federal intervention on reasons of economic stabilisation and redistribution, regional and sectoral federal policies as well as the above-mentioned historical legacy were all supportive.

Taxing in Austria is a complex mixture of exclusive (separated, ‘own’) and joint (‘shared’) sources (see Tables 4.5 and 4.6). With regard to tax legislation the Bund is dominant. Therefore, the financial, especially tax power of the Bund resembles, in many aspects, that of a ‘principal’ with Länder and Gemeinden as ‘agents’.

The main part of revenue of all levels is generated within the so-called joint (shared) taxation system (*Verbundsystem*). This complex joint taxing/ tax sharing (to be distinguished from the US term ‘revenue sharing’, which applies to a type of grants system), forms the basis, with some special sources aside (own taxes, grants, fees and charges, public debt).

The sharing itself is carried out in a complicated manner. In a first step (*Oberverteilung*), the total revenue of a single tax is divided between the Bund, Länder and local communities according to the ratios negotiated for the different taxes (see Table 4.7).

In a second step (*Unterverteilung*) the total ‘state and local community shares’ are divided between the nine Länder and then the total share of local communities per state is divided among its communities (see Table 4.8). Before this, different types of deductions are withheld by the state (*Umlagen*). Finally, to match fiscal needs with fiscal capacities—both specifically defined—between the different tiers as well as the different governments at the respective tiers, a wide range of intergovernmental grants, general, specific and matched in their form, is used.

Table 4.9 shows the revenue effect of the grants’ mechanisms on the respective levels. It compares total revenue before grants to total revenue after grants. This is the so-called secondary distribution and equalisation.

In addition to this official financial settlement, a bundle of fiscal arrangements is provided within which political ‘deals’ between the different levels result in common/joint execution and/or financing of public tasks (*Gemeinschaftsaufgaben, Gemeinschaftsfinanzierungen, Sondergesellschaften*; cost-sharing) (see Tables 4.10 and 4.11).

Overall, Austria’s fiscal federalism shows many elements of a highly ‘co-operative federalism’, de jure (formally) highly centralised, de facto at least partly, but therein significantly decentralised.

3

PROS AND CONS OF THE DEVELOPMENT: A POLITICO-ECONOMIC APPRAISAL

The ‘basic principles’ of the F-VG 1948 state that each government must bear the costs of its own activities (para 2) and that all provisions regarding taxing powers and tax sharing must enable the different levels of government to finance their tasks with revenues from their own sources (para 4). Own-source revenues are those over which governments have full budgetary control, including revenues from joint (shared) taxes which cannot be changed without their consent.

Table 4.5 Total tax type revenue: selected years

Tax	1985			1993			1995		
	ATS mio	%	Index	ATS mio	%	Index	ATS mio	%	Index
Exclusive federal taxes*	117,027	30.7	100	153,739	26.0	131.4	161,515	26.5	138.02
Joint/shared taxes	238,023	62.4	100	390,305	66.6	164.0	401,044	65.9	168.49
Exclusive state (local) taxes	26,480	6.9	100	41,833	7.1	157.9	45,788	7.0	172.92
Total	381,530	100.0	100	585,877	100.0	153.6	608,347	100.0	159.45

Source: *Gebahrungsitbersichten* 1985, 1993, 1995.

Note

* Including shares for special funds.

Table 4.6 Total tax type revenue: levels, 1993 and 1995.

Level	1993				1995			
	Exclusive taxes		Shared/joint taxes		Total taxes		Total taxes	
	ATS mio	%	ATS mio	%	ATS mio	%	ATS mio	%
Federal*	133,657	76.2	252,726	64.7	386,383	68.3	387,095	67.7
Länder ¹	2,522	1.4	62,325	16.0	64,847	11.5	64,186	11.2
Vienna ²	11,807	6.7	31,150	8.0	42,957	7.6	44,836	7.8
Local government ³	27,504	15.7	44,104	11.3	71,608	12.6	76,343	13.3
Total	175,490*	100.0	390,305	100.0	565,795	100.0	572,460	100.0

Source: *Gebärungsübersichten* 1993, 1995, own calculations.

Notes

1 Excluding Vienna.

2 Land and local government.

3 Excluding Vienna.

* Excluding shares for special funds.

Table 4.7 Shared taxes (above 5 bio ATS*), 1995—allocation-step 1/1.

<i>Tax</i>	<i>Revenue ATS bio</i>	<i>Federal %</i>	<i>State %</i>	<i>Local %</i>
Income tax (assessed)	27.5	48,896	27,213	23,891
Income tax (withheld)	120.4	63,414	20,507	16,079
VAT	200.2	69,564	18,700	11,736
Mineral oil excise	24.7	88,559	8,638	2,803
Motor vehicle tax	8.3	50,000	50,000	—
(Total tax revenue)	(608.3)			

Source: FAG 1993, *Gebarungübersichten* 1995.

*This leaves out the following, also shared taxes: capital gains tax, beer excise, alcohol excise, inheritance/gift tax, land transfer tax, land value tax, gambling tax, arts promotion/cultural tax.

Table 4.8 Shared taxes (selected), distribution keys—allocation-step 1/2.

<i>Tax</i>	<i>Basis of allocation among the Länder</i>	<i>Basis of allocation to local government within each Land</i>
Income tax (assessed)	97.5% state tax yields 2.5% local shared tax yields/state	60% local tax yields 40% local business tax yields
Income tax (withheld)	98% state population 2% local shared tax yields/state	100% weighted population
VAT	95.66% state population 0.49% Vienna 2.45% state population (excluding Vienna) 1.44% local shared tax yields/state	39.13% local population 50.00% weighted population 10.87% local business tax yields
Mineral oil excise	25.00% state population 25.00% state area 16.67% state yields of motor vehicle tax 16.67% state road lengths 16.67% local business tax yields	25.00% local population 25.00% local area 16.67% state yields of motor vehicle tax 16.67% state road lengths 16.67% local business tax yields

Source: FAG 1997.

In practice these principles have been eroded through legislation, grants and means like cost shifting and cost sharing. Cost shifting, on the one hand, is a concept within which one level bears or is forced to bear the costs of another level. Cost sharing, on the other hand, is given when more than one level is jointly fulfilling (and financing) a function. Besides, there were numerous extra budgetary, special companies (*Sondergesellschaften*) between the levels founded. Altogether, this led to joint task fulfilment inside and outside the normal constitutional provisions, and to a separation of cost bearing and task fulfilment responsibility (*Finanzausgleichsdilemma*).

Although on the one hand the extensive joint task fulfilment and cost sharing between government levels seems advantageous on economic grounds

Table 4.9 Total revenue before and after intergovernmental grants: selected years.

Level	1985				1993				1995			
	ATS mio		Index		ATS mio		Index		ATS mio		Index	
		%		%		%		%		%		%
Federal level	268,294	70.3	100		406,464	69.4	151.5		418,857	68.9	156.1	
Länder (excluding Vienna)	41,299	10.8	100		64,847	11.1	157.0		67,467	11.1	163.4	
Vienna (Land and local government)	27,550	7.2	100		42,958	7.3	155.9		45,680	7.5	165.8	
Local governments (excluding Vienna)*	44,387	11.7	100		71,608	12.2	161.3		76,343	12.5	172.0	
Note												
*Without fees for local services.												
Total revenue after grants:												
Level	1985				1993				1995			
	ATS mio		%		ATS mio		%		ATS mio		%	
		%		%		%		%		%		%
Federal level	208,810*	56.3			327,667	55.9			333,477	56.4		
Länder (excluding Vienna)	79,964	21.5			131,293	22.4			140,259	21.8		
Vienna (Land and local government)	36,356	9.8			56,407	9.6			60,556	9.6		
Local government associations	1,240	0.3			1,697	0.3			2,209	0.3		
Local governments (excluding Vienna)**	44,344	12.0			69,002	11.8			71,668	11.9		
Statistical difference	316	0.1			-189	0			178	0		

Source: *Gebahrungsübersichten* 1988, 1993, 1995.

Notes

* Including transfers to family support fund.

** Without fees for local services.

Table 4.10 'Common/joint task fulfilment' selected examples.

<i>Land</i>	<i>Project</i>	<i>'Competence'</i>	<i>State share (%)</i>	<i>Other shares</i>
Tyrol	Gymnasium	Federal	above 30	Rest federal level none
	Commercial high school	Federal	100	
Salzburg	Primary schools	Local	30	Rest federal/local
	Commercial high school	Federal	50	Rest federal level
	Gymnasium	Federal	33	Rest school association
	Technical high school	Federal	33	Rest federal/saw-mill association

Source: Thöni 1978.

(internalising external effects, i.e. spillovers, cost degression, flexibility, etc.), it produces effects like the previously mentioned *Finanzausgleichsdilemma* on the other. It is also criticised due to the so-called *Flucht aus dem Budget* (the escape from budget), causing budget erosions and intransparencies.

For quite some time Austrian public law experts have been involved in a deep discussion on the true interpretation and understanding of self-government, self-determination and autonomy.⁵ Self-government in general must be carefully differentiated from autonomy, the former relating to executive (administrative) powers, the latter to legislative powers. Moreover, self-government and autonomy have two facets: on the one hand, the governments need sufficient financial revenue to fulfil their responsibilities, on the other these have to be at their own discretion. It makes no difference whether they fulfil *freiwillige Aufgaben* (voluntary matters, which are fulfilled without a legal 'must') or *Pflichtaufgaben* (obligatory matters, which have to be fulfilled).

Taxing in Austria (with regard to base and rate) seems to be, on the one hand, very co-ordinated because of strong centralisation and a strong tax-sharing system. On the other hand, 'fiscal equivalence' to interlock 'beneficiaries', 'payers' and 'deciders' gets lost. Tax-sharing systems have the great advantage that they provide means to harmonise local and regional revenue differences and reduce the risks of economic fluctuations and their influence upon tax revenues. On the other hand, every tax-sharing system inevitably reduces the independence and 'autonomy' of individual governments and government levels, usually strengthening thereby the 'higher' level. Again, own taxation does sometimes cause important differences in revenues between lower government levels. Distribution and stabilisation arguments, constantly in progress, consequently question this important financing share. Nevertheless, some own taxation remains fundamental for federal systems.

All in all, there is ongoing discussion about the 'centralisation/decentralisation degree'. Moreover, in situations of necessary budget consolidations, as at present (1997), these arguments gather momentum. Furthermore, numerous details of the

Table 4.11 Extra budgetary, special companies: selected examples.

<i>Project</i>	<i>Capital in ATS mio</i>	<i>Shares (%)</i>	<i>Shareholders</i>
Public Hospital, Vienna	20	50.00 50.00	Federal level Vienna
Alpen Road Company, Innsbruck	600	65.00 9.33 25.67	Federal level Land Vorarlberg Land Tyrol
Austrian Motorway Company, Salzburg	1,444	60.596 12.465 4.086 15.859 6.925 0.069	Federal level Land Carinthia Land Upper Austria Land Styria Land Salzburg Land Vienna
International Student Hostel, Innsbruck	1	12.50 12.50 12.50 12.50 12.50 25.00 12.40 0.10	Land Tyrol Land Salzburg Land Vorarlberg Town of Innsbruck Chamber of Commerce, Tyrol Federal level Land Upper Austria German Friends of the University of Innsbruck

Source: Thöni 1978; also *Amtsbehelf zum Bundesfinanzgesetz* 1995, Beilage N.

Austrian FAG are problematic. The weighted population key, measures of financial need and fiscal capacity, and others are disputed in every FAG-negotiation, but as a result of political and bureaucratic rigidity have stayed basically the same over the years.

The long discussed *Bundesstaatsreform* prepared between October 1992 and April 1994, which should have paralleled Austria's EU referendum, was stopped in the autumn of 1994 and again in the autumn of 1995. The most discussed issues were:

- 1 Some new assignment of competences.
- 2 The closing of some gaps between 'beneficiary', 'payer' and 'decider'.
- 3 Changing the 'supervisor system' within the delegated competences.
- 4 A new system of delegated federal administration (*mittelbare Bundesverwaltung*).
- 5 A reform of the Austrian Bundesrat, the Upper Chamber of Parliament.
- 6 A reform of the Austrian High Administration Court, in establishing courts at the Länder level.

7 Some strong decentralisation within the administration: allowing it to organise more details itself, to simplify matters and become more efficient.

At present these steps are being rediscussed, but how far the reform will get one cannot say.

Politicians already acknowledge that this reform should not only become a displacement of functions from one level to the other, but especially should develop a 'more responsible' Länder level within a new federalistic context. However, cries of 'this takes time' are to be heard at the same time.

A new era began with Austria's entry into the EU on 1 January 1995. Although local communities applauded this step, from the beginning they demanded that their rights and revenues should not be cut. Finally, all three levels agreed to a sharing of EU costs (with tangible amendments in the financial settlement). For 1995, Austria calculated EU contributions of ATS 25.6 bio and some internal costs and reductions (agricultural subsidies, tax deficits), totalling roughly ATS 24.2 bio.

4

THE NEW CONSULTATION MECHANISM BETWEEN CENTRAL, REGIONAL AND LOCAL GOVERNMENTS

Despite negotiations on all the FAGs over the course of time, the so-called *Kompetenz-Kompetenz* (ultimate competence) in the hands of the Bund, coupled with the asymmetrically assigned revenue, has led to constant criticism. Therefore, the two levels of government, Länder and Gemeinden, have long since requested that the Bund, before amending tax laws and/or expenditure competences disadvantageous to the former, contacts the partners concerned. However, the Bund itself felt that for reasons connected with distribution and stabilisation policy the co-operation of other levels would be important.

Concentrated around the Maastricht criteria debate and the 'sharing of consolidation necessities of public budgets on all Austrian levels', an important new step to realise fiscal equivalence and responsibility was finally agreed to by all three levels of government. A new consultation mechanism was invented to settle disputes on cost bearing and/or cost shifting with the enactment of new laws and decrees. The final aim would be to intensify cost consciousness at all levels.

In it, Länder and local governments *vis-à-vis* the federal level, and the federal level and local level *vis-à-vis* the Länder would have a veto 'on laws which would ensue in costs' at the respective level. Negotiations in a well-defined governmental, but not parliamentary committee would follow. Should there be no settlement, the one level which decided upon the expenditure would then remain responsible for financing it. Subject to negotiation would be additional necessary expenditures due to the law or the decree above a certain 'bagatelle (insignificance) line' (Bund ATS 15 mio per law and year; Länder ATS 1–3 mio according to Länder size). Legal transfers of EU regulations would be excluded.

Finally, the same mechanisms should follow between all Länder and their local governments and all mechanisms should be coupled with a 'stability pact' agreed to by all levels to share the 'burdens of Maastricht' adequately.

At present this mechanism has political agreement only; however a legal base should soon follow. Nonetheless, there is strong criticism on all parliamentary levels. Parliamentary representatives, particularly at the federal level, claim that their legislative power would be seriously harmed and greatly restricted. Länder and local governments could alter federal initiatives and thereby politics. This is consequential and is to be viewed as one of the cons of the 'governmental (not parliamentary) mechanism'.

Nevertheless, there are also strong advantages. Due to the above-mentioned efforts to achieve the Maastricht criteria, the Austrian fixing of public debt 'elbow-room' between the three governmental tiers demands more intergovernmental co-operation in the future, and this has to be very flexible in the narrow margins given. This is especially true for the Länder and local level, which are fixed at 0.3 per cent to GDP in total (federal level 2.7 per cent). Therefore there is hardly any room for 'misbehaviour' with respect to slips by one government tier *vis-à-vis* the others, except the federal one. This new mechanism leaves room for reaction.

Although the democratic argument on the con side is strong, the political and fiscal arguments on the pro side seem, at least for the present, to outweigh the former.

5

FINAL REMARKS

The basic philosophy behind the Austrian fiscal federalism arrangement can be summarised as 'in part diversity within strong unity', and is characterised by two key elements. First, based on liberalism, but heavily penetrated by welfarism Austria's public policies aim, as do Germany's, but to a lesser degree, at *Einheitlichkeit der Lebensverhältnisse* (uniformity of living conditions). Second, this aim should be achieved through strong co-ordination and co-operation between governments at the respective levels and between the levels.

Nevertheless, with the present budget restrictions to meet the Maastricht criteria and restore budget flexibility to all levels of government, as well as political and bureaucratic rigidity, the so-called co-operative social partnership and the checks and balances in the Constitution in general seem to make it unlikely that the Austrian financial settlement will be fundamentally changed in the near future, though such an outcome would provide solutions to a number of problems.⁶

Notes

- * I would like to express my thanks to Stefan Garbislander for his statistical assistance.
- 1 See Schäffer, H., 'The Austrian Federalism—situation and perspectives', lecture, CNR, Rome 1996, p. 1.
 - 2 This section is largely based on Thöni, E., 'Regional and local government in the European Union: Austria', in EU, *The Committee of the Regions/ Subcommission on Local and Regional Finances*, Brussels 1996.
 - 3 The reason to treat local governments likewise is twofold: intergovernmental equity (*Einheitlichkeit der Lebensverhältnisse*) and pressure to reach minimum standards of administrative sizes.
 - 4 See Pernthaler, P., *Federal Fiscal Relations in Austria*, ANU, Canberra 1983:
 - (a) *Exclusive federal competence in both legislation and administration* (Article 10, Article 14 (Paragraph) 1, Article 14a Absatz 2 B-VG). More than one hundred important functions belong to this type, including all courts (there are no state courts), civil and criminal law, police, armed forces, banks, industry, national roads and rail transport, mining, forests, water supply, hydro power, water pollution and protection, health, social security, unemployment, education services except for elementary and some agricultural education (school building and maintenance are state responsibilities), national economic planning, energy planning, radio and television (national broadcasting system).
 - (b) *Federal legislation, but state administration* (Article 11, Article 14 Absatz 2 B-VG). Only six matters belong to this type, including citizenship, traffic regulation on roads and on non-frontier lakes, social welfare housing, urban redevelopment, and administrative procedures in relation to state competences.
 - (c) *Federal legislation to establish general principles, with states responsible for bylaw legislation and administration* (Article 12, Article 14 Absatz 3 B-VG). Only a few matters belong to this type, including basic social welfare, hospitals, land reform, electricity (except the national grid, national powerplants and emergency policies and planning), school building and maintenance (except for high schools and universities).
 - (d) *Complete state competences in both legislation and administration* (Article 15 Absatz 1 B-VG). Formally this type includes all matters that are not specified as federal competences. This gives the states a residual or general competence, but since most important functions have been specified as federal either by the Constitution or by interpretation, there are only a few matters left for this type of full state legislative and administrative competence. These include some aspects of environmental protection, building laws, town and country planning, hunting, fishing, some aspects of agriculture, theatres, some aspects of youth welfare, sport, tourism, and local government (including local police).
 - 5 The same applies to Germany, although there the discussion seems to be more advanced.
 - 6 A fundamental revision was, for instance, forced by strong claims against the 'weighted population key' (over 1,600 cases by end of March 1990); nevertheless a following constitutional clause 'saved' the key.

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5

Local government in Denmark

Jørgen R.Lotz

1

THE NORDIC MODEL OF LOCAL GOVERNMENT

This is a short introduction to local government finances in Denmark. It is at the same time a description of the organisation of the local government sector in the Scandinavian countries.

These are old kingdoms, dating back more than a thousand years—though the borders in the old days changed frequently, depending on the skill of the different kings. They understand each other's language and their social organisation and culture is very similar. Moreover they are small countries: the population in Denmark is 5.1 million people, in Norway 4.2, and in Sweden 8.4, bringing the total to no more than 18 million inhabitants.

One of the most interesting features of these countries is that they have the most decentralised public sector anywhere (see [Figure 5.1](#)).

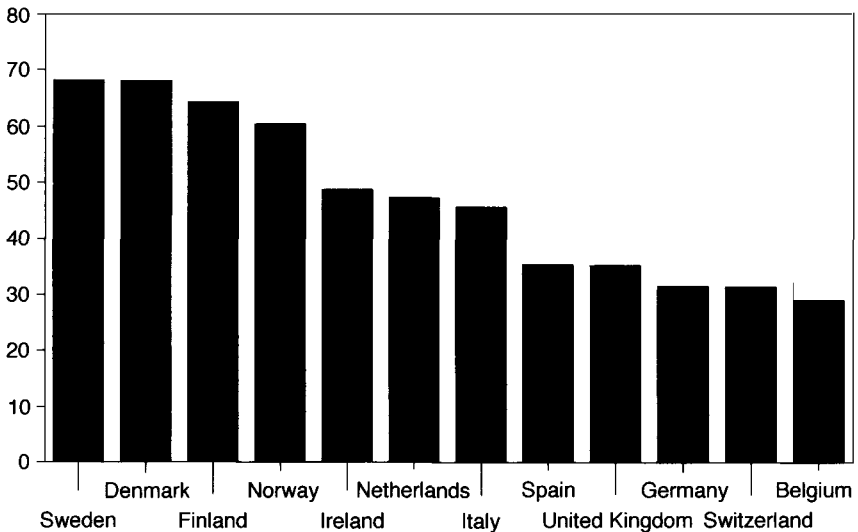


Figure 5.1 Local consumption expenditure (percentage of general government expenditure, 1994). *Source: OECD National Accounts (1996 edition).*

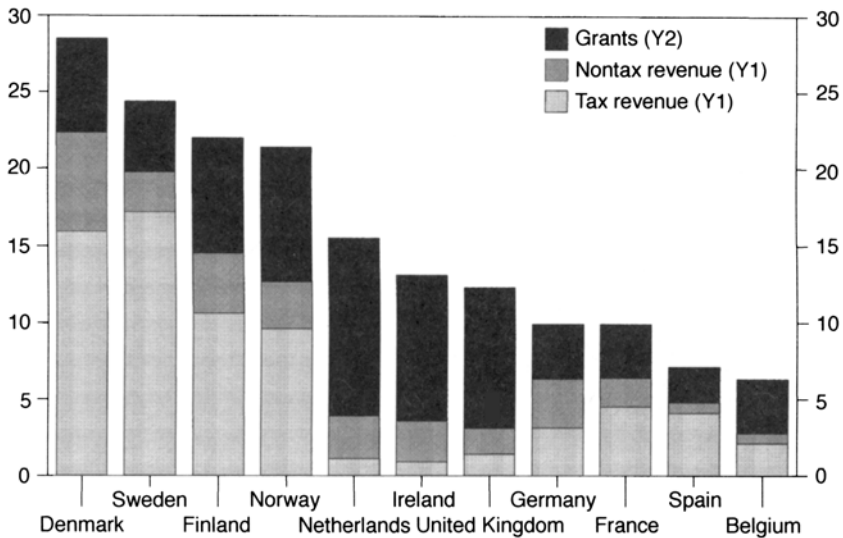


Figure 5.2 Local government revenue in selected European countries (percentage of GDP). Source: OECD National Accounts (1996 edition).

As can be seen in Figure 5.2, the local government sectors create close to 20 per cent of the value added or—perhaps more correctly—they employ about 20 per cent of all employed. Another feature is that the local government sector collects a major part of the financing as taxes. In Denmark, Sweden and Finland this is in the form of true own-tax revenues, while in the case of Norway it is a tax-sharing arrangement only.

I will now turn to Denmark (see Figure 5.3) which should, however, be seen as characteristic of the other Scandinavian countries too. The Scandinavian system of local government is a *two-tier* system with counties and municipalities. The following is an outline of the structure in Denmark—which is very much the same as in the other countries (see Figure 5.4).

Counties have no ‘regional’ functions, but some have a role in supervising or controlling municipalities. The two levels deal directly and independently with the ministries. The only argument for two levels is the population size needed for the institutions run by the two levels (hospitals for counties and schools for municipalities). They are both administered by *elected councils*, which elect the mayors.

In Denmark the smallest *municipalities* number approximately 3,500 inhabitants, while half of them are smaller than 10,000. They are responsible for primary schools, nurseries and kindergartens, social assistance and care for the elderly. The *counties* average about 300,000 inhabitants. They are responsible

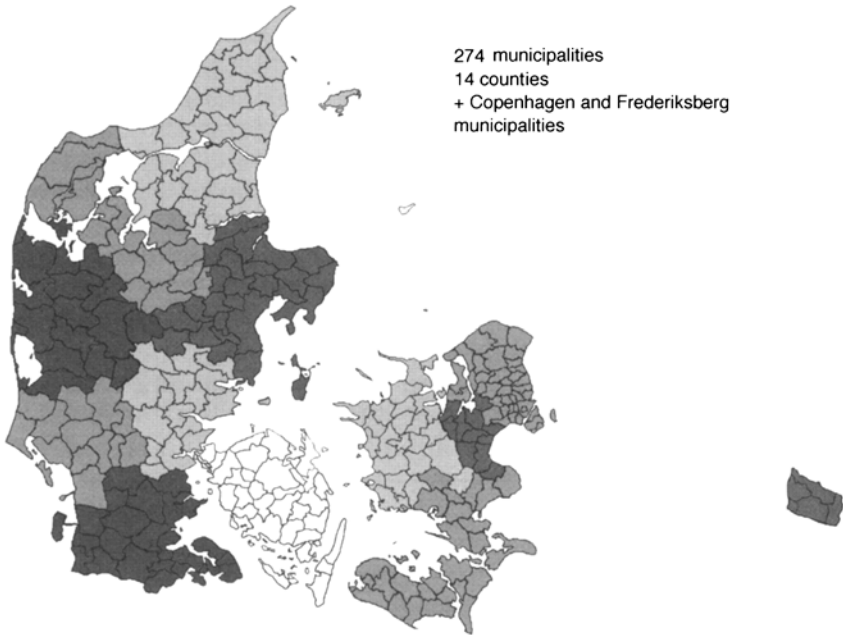


Figure 5.3 Map showing Denmark divided into municipalities and counties.

for medical care and hospitals, specialised social institutions, and education for the 16–19-year-old group. A separate case is that of Copenhagen and Frederiksberg, which together form Central Copenhagen

274 Municipalities

Size

Average size 18,000 inhabitants.
Half of them are smaller than 10,000 people.
The smallest are about 4,000.

Economy

Average turnover per inhabitant D.kr. 32,000.

Functions

Primary schools
Nurseries and kindergartens
Social assistance
Care for the elderly (old age homes, homecare)

14 Counties

Size

Average 300,000 inhabitants

Economy

Average turnover per inhabitant D.kr. 13,000.

Functions

Health insurance
Hospitals
Education for the 16–19 years old
Specialised social institutions

Figure 5.4 Functions, size, etc. of municipalities and counties in Denmark.

Table 5.1 Overview of the structural reforms of local government.

	<i>Denmark</i>	<i>Sweden</i>	<i>Norway</i>
Before reform:			
Number of municipalities	1,388	2,498	744
Number of counties	25	24	20
After reform:			
Number of municipalities	275	278	454
Average size 1990 (1,000)	19	30	9
Number of counties	14	24	20
Average size 1990 (1,000)	370	350	220

totalling 560,000 inhabitants, in that each of them serves as municipality and county at the same time.

It can be seen that local governments are assigned nearly all public services, such as: primary and secondary schools, hospitals, health services, care for the elderly and social assistance, whereas only the national schemes of old-age pension and unemployment benefit are the responsibility of the central level.

The process of decentralisation has, however, posed some problems: the local authorities, for example, needed a certain size area to be able to employ a staff qualified to administer all these sophisticated services. Reforms were rendered necessary, and were carried out in the years before 1980 in all the Scandinavian countries (see Table 5.1). This development has similar features in all three countries, though Norway and Sweden still have some small authorities (small in population but large in square kilometres in the far north).

It would appear that the period of reform of the size-structure of local government in Europe has come to an end. One reason may be that it is not politically possible to change local structures, because this would require an application of central power towards the local populations which would not correspond with modern democratic ideas. Instead of structural reforms, throughout these years we can observe cooperation between small municipalities or even Quangos as in the UK.

The particular features I shall concentrate on in the rest of this short presentation are:

- the use of the personal income tax as a local tax;
- local government equalisation; and
- the control of local government expenditure.

2

THE ROLE OF LOCAL PERSONAL INCOME TAX

If I were asked to mention one thing which has had a profound effect on the development of local government in the Scandinavian countries, it would be local income tax (see [Figure 5.5](#)).

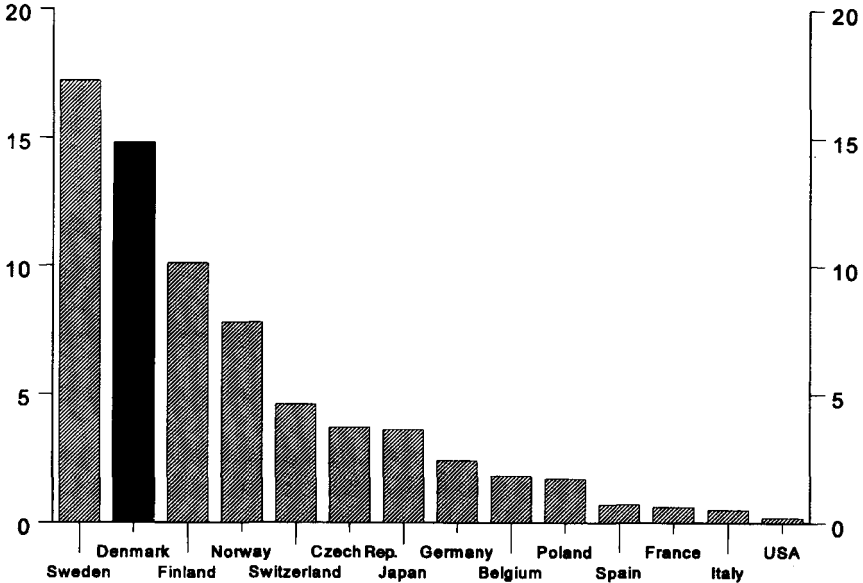


Figure 5.5 Local income tax revenue (per cent of GDP, 1994).

At the turn of the century, it was decided in all the Scandinavian countries—also in Finland and Iceland—that local governments should be allowed to collect their own tax rates on income in addition to the rates of the central government, an arrangement which is now referred to as piggy-backing. Originally, the local tax was on company income as well as personal income, whereas nowadays it is on personal income only (Denmark has maintained a tax-sharing arrangement for company tax).

The assignment of income taxes to local authorities in the Nordic countries had far-reaching consequences because of their great revenue potential compared to that of property taxes or continental-style business taxes. The system works as shown in [Figure 5.6](#). The variation in rates is quite large.

[Figure 5.7](#) shows the rather large differences in municipal rates in Denmark. A variation of about 1½ points for the counties should be added to this. A great number of people in other countries do not believe that this can work. It does, however, work in many countries, not least in Denmark, Sweden and Finland.

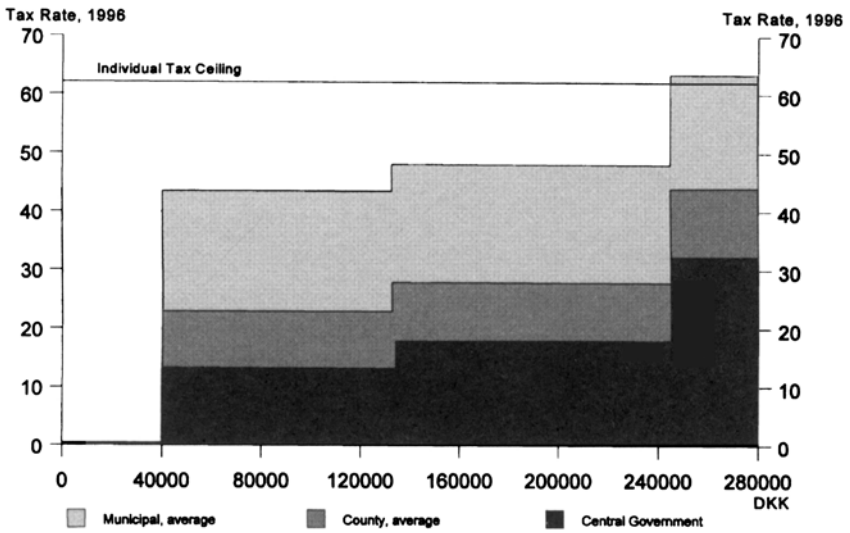


Figure 5.6 The rate of local and central income taxes in Denmark.

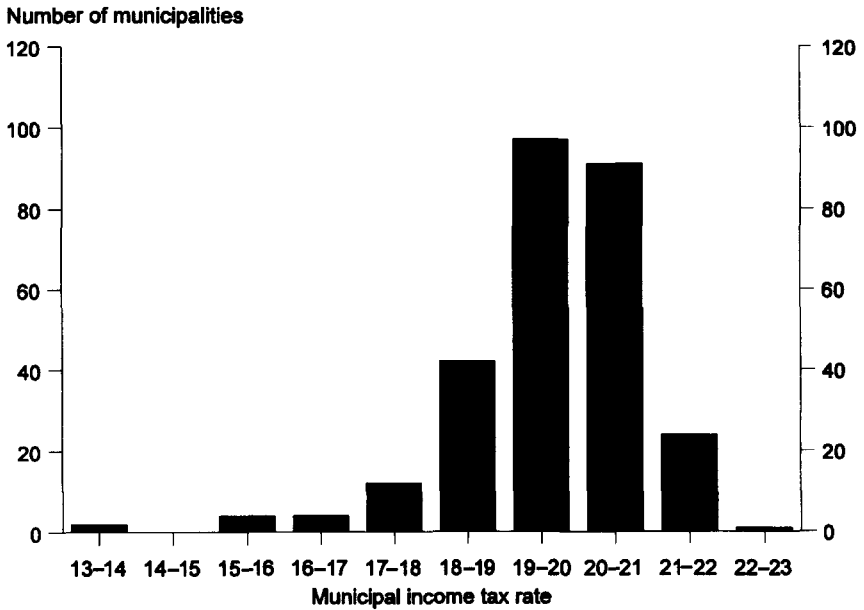


Figure 5.7 Number of municipalities according to municipal tax rate.

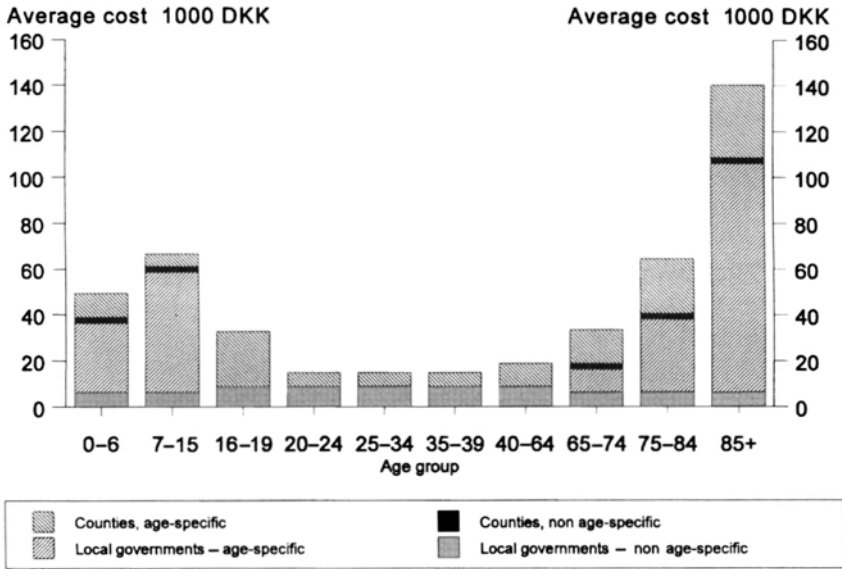


Figure 5.8 Age distribution of local government expenditure.

3

LOCAL GOVERNMENT EQUALISATION

The functions of local governments as already described result in the expenditure profile shown in Figure 5.8. This illustrates two important features of Scandinavian local government. One is that the function of local government—much to the surprise of the uncritical students of Professor Musgrave—is *redistributive*. The task of local politics is to decide how much the local median voter is prepared to pay to help the children and the aged. Another feature revealed by the figure is the obvious need for local equalisation as the situation in any local authority depends on how many children and old people are living there.

In all countries with a decentralised public sector the latter is solved by equalisation of *expenditure needs*. Such needs are filled by elaborate schemes. Table 5.2 illustrates the Danish measure of expenditure needs, which is typical for Scandinavian countries. But the differences in tax bases are even larger and in the Scandinavian countries there is strong equalisation of such differences. The degree of equalisation for the tax base is 95 per cent in Sweden. This means that a rich Swedish municipality will have to surrender 95 per cent of the excess of income per capita multiplied by the average local tax rate to poor municipalities.

Table 5.2 Indicators of municipal expenditure needs in Denmark.

<i>Criteria</i>	<i>Weight 1993</i>	<i>Type of expenses</i>
1 Inhabitants	0.212	Public pensions Employment policy Town development Environment Libraries Public transport Administration, etc.
2 Number of inhabitants 0–6 years old	0.092	Day institutions, etc.
3 Number of inhabitants 7–16 years old	0.227	Schools
4 Calculated cash benefit expenditure	0.056	Social cash benefit
5 Number of 65–74 years old	0.034	
6 Number of 75–84 years old	0.075	Old-age residences
7 Number of 85+ years old	0.056	Old-age care
8 Km of road	0.031	
9 Standardised apartments	0.017	Rent rebate and housing subsidies
10 Number of children of single parents	0.075	
11 Residence criteria	0.075	Politically decided
12 Number of full time unemployed	0.025	according to
13 Number of 20–66 years old women working	0.025	statistical analyses
Total	1.000	

4

CENTRAL CONTROL OF LOCAL EXPENDITURE

When the public sector is large as well as decentralised, the need for some kind of expenditure control is obvious. The Scandinavian countries have found somewhat different solutions to this. Since 1911 Norway has relied on tax-sharing. In Sweden good arguments, a tax freeze in 1994–6, and since then a ‘tax’ on local increases have been used. The solution in Denmark is for the central government and municipal associations to enter into annual agreements on joint ‘recommendations’ to the member authorities, as described below.

Over the last 17 years Danish municipalities and counties have increased the local income tax rate by about 0.4 per cent points annually, in spite of these joint recommendations not to increase local tax rates (see [Figure 5.9](#)). But central government has managed to hold down the rate of growth in local expenditure. This has been done by removing the local sector revenue gains from the tax increases by cutting their grants. Hence, the results shown in [Figure 5.10](#).

It is clear that Denmark is doing well. It is in better condition than Norway and the UK, in spite of the fact that Danish local authorities have free access to personal income tax. Its success can be ascribed to the above-mentioned system of annual agreements with local authorities. Each year (April–June) the

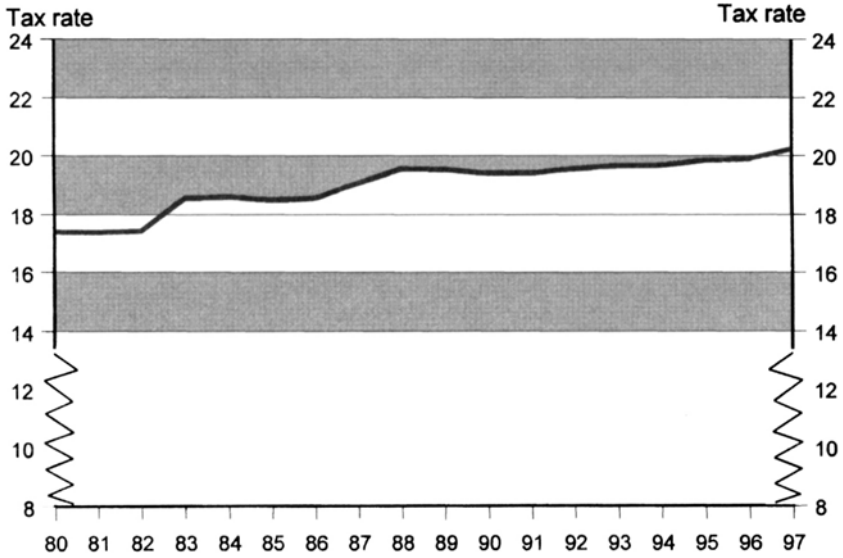


Figure 5.9 Municipal local income tax rates (averages, 1980-97).

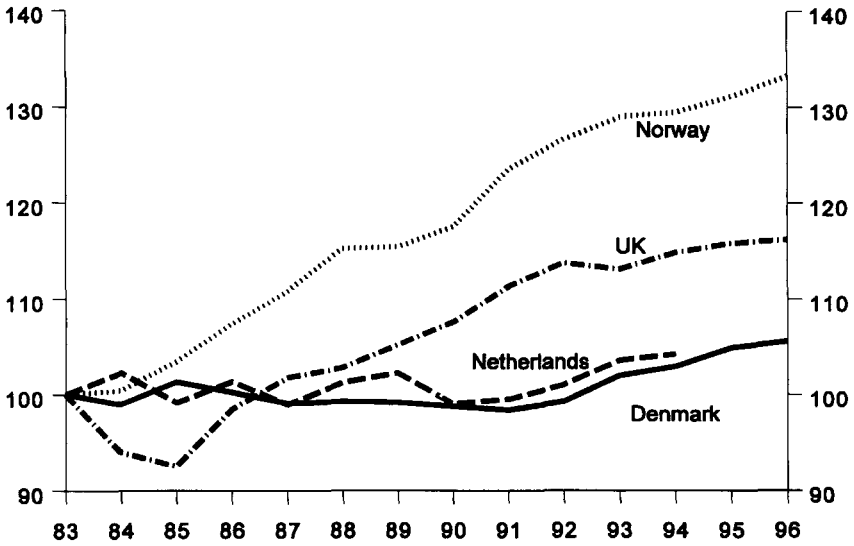


Figure 5.10 Real growth in local government expenditure, 1983=100.

government meets with the chairmen of the local government authorities and agrees to pay a negotiated amount of grants; the local government associations in

their turn agree to recommend to their members not to increase taxes. This is the basic idea, but the negotiations can also take up other issues of interest for the local sector.

6

Local taxation and intergovernmental fiscal relations in France

Guy Gilbert

1

INTRODUCTION

Despite the Decentralisation Acts and the actual decentralisation process since the 1980s, France is still quoted as an extreme example of unitary country, at least in the European context. Consequently, French local governments are not expected to enjoy substantial fiscal autonomy.

However, the facts actually suggest quite the opposite. Even if the map of local jurisdictions (36,000 'communes' at the lower level; about 20,000 special entities including local government syndicates, urban districts, special districts; 100 'departments', 22 regions) is highly fragmented, and the tax capacity of local entities is quite uneven, the fiscal powers of the lower tiers of government remain substantial.

In such a context, intergovernmental fiscal relations in France could not avoid complexity. On the one hand, the large number of local governments necessarily increases interjurisdiction differences in fiscal capacities; it augments the natural concentration of local tax bases within urban zones. Consequently, the need for fiscal equalisation is extremely high and justifies the existence of an extended, efficient grant system for local governments. But, on the other hand, the Decentralisation Acts reinforced the tax autonomy of the lower tiers of government. Local tax bases are (unusually) large in France (including a wide-based local business tax) and the tax rates are largely at the discretion of the local assemblies. This (potential) fiscal autonomy of local governments makes the use of grants as a means of balancing local budgets less necessary, but is also an additional threat to fiscal equalisation. Wealthy local jurisdictions can freely choose to lessen their tax rates in order to finance local public services, while the needy ones cannot avoid increasing their own tax rates. The dynamics of this process lead to greater fiscal imbalance and competition among jurisdictions and necessitate more fiscal equalisation.

The present state of local government finances and that of inter-governmental fiscal relations in France is a direct consequence of the co-existence of these opposite features: a large number of local governments, a wide array of local tax

bases which are unevenly distributed among jurisdictions, and the substantial power of local assemblies in determining local tax rates.

As long as economic growth allowed both the distribution of rather generous equalisation grants, and the limitation of local tax rates consequent to the increase in tax bases, the control of overall relations between central government and the lower tiers of government remained quite simple and efficient. That is basically the story of French local finances in the 1980s. In the 1990s however, things turned in the opposite direction. The macro-economic situation worsened; budget deficits enlarged at the central level; local tax rates increased due to the reduction in the rate of increase of tax bases and under the pressure of fiscal needs resulting from the economic situation. From the central government viewpoint, local finances became ever more threatening in the 'Maastricht' perspective. Thus, the regulation of intergovernmental transfers and local tax reform once again became clear priorities on the political agenda.

The chapter is divided into four sections. The first presents the overall situation of local taxation in France as the very base of the fiscal autonomy of local governments. A second section is devoted to intergovernmental fiscal relations. A third section presents the pending projects of local tax reform in France in the Maastricht Treaty context. It deals mainly with the reform of the 'taxe professionnelle' (TP) following a recent report by the Council for Taxation (1997).

The final section presents some concluding remarks.

2

THE DISTRIBUTION OF TAXING POWERS AMONG TIERS OF GOVERNMENTS

Taxation is the cornerstone of fiscal autonomy of the local governments. The communes, the departments and the regions all benefit from a substantial taxing power. Even if tax sovereignty remains exclusively in the hands of Parliament,

Table 6.1 Incomes structure of local governments¹ (in per cent of total incomes).

	<i>Local taxes</i>	<i>Grants subsidies</i>	<i>Others</i> ²
France	44	25	31
Germany	10	66	24
Spain	17	68	14
The Netherlands	6	90	4
United Kingdom	17	68	15

Source: Council for Taxation 1997.

Notes

1 All levels of subcentral governments (regions+departments+communes+special intercommunal entities).

2 User fees, capital incomes, etc.

Table 6.2 Structure of local tax receipts—France, 1995 (billions FF).

	<i>Communes and Departments special districts (local level)</i>		<i>Regions</i>	<i>Total</i>
Direct taxes	194.9	74.9	21.7	291.5
Housing tax (TH)	38.2	17.1	4.9	60.2
Tax on improved land (TFB)	46.1	19.6	5.3	70.9
Tax on unimproved land (TFNB)	4.8	0.8	0.1	5.7
Local business tax (TP)	85.9	37.3	11.5	134.7
Other direct taxes (including transport- ation tax: VT)	19.8 (18.6)	0.2 —	— —	20 (18.6)
Indirect taxes	11.0	33.1	11.8	55.9
Taxes on property transactions (TPF and DI)	—	16.7	—	16.7
Annual car tax	—	13.4	—	13.4
Tax on electricity	5.2	2.6	—	7.8
Additional tax on immovable transactions	3.5	0.3	3.9	7.7
Car licences	—	—	7.6	7.6
Other taxes	2.3	0.1	0.3	2.7
User fees (jointly collected with taxes)	14.1	—	—	14.1
Refuse collection tax	14.1	—	—	14.1
Land use taxes	3.0	1.0	0.6	4.6
Total	223.0	109.0	34.1	366.0

Source: Ministry of the Interior 1997.

Notes

TH: housing tax on residents; TFB: property tax on residential property; TFNB: property tax on unimproved land; TP: local business tax; VT: contribution of employers to the financing of urban transportation systems; TPF and DI: additional taxes on transactions on immovables.

the tax autonomy of local governments is substantive in France, as compared with other European countries (Gilbert 1996b; Gilbert and Guengant 1991) (see Table 6.1).

Tax receipts represent nearly 55 per cent of the communes' (and special entities) total incomes (see Table 6.2). More than 80 per cent comes from four direct taxes. The TP, a tax based on business income and levied on firms and independent professionals, represents one-half of the direct tax receipts. More

than one-fourth comes from the 'taxe d' habitation' (TH), a tax levied on the occupants and based on the rental values (administratively assessed) of houses; the remainder consists in taxes on land and on immovables ('taxe foncière sur les propriétés bâties' (TFB), and 'taxe foncière sur les propriétés non bâties' (TFNB)).

Besides these direct taxes, local governments benefit from indirect taxes mainly at the departmental and regional levels; the most important are taxes on estates transactions ('additional taxes on transactions and immovables'), an annual tax on car use, and driving licenses.

Since a 1980 act, the elected assemblies at commune, departmental and regional levels vote on tax rates directly. However, local rates decisions are subject to the two following constraints:

- 1 the local tax cannot exceed twice (for the TP) and 2.5 times (for other direct taxes) the respective average rates observed at national level for the preceding year.
- 2 the rate of the TP (and that of the tax on unimproved land) cannot increase (or decrease) by more than twice the rate of variation of the housing tax (or the average rate of variation of taxes on land and housing tax).

Under special circumstances, local governments are allowed to (slightly) increase or decrease their rates outside the constraints listed above.

Contrasting with the relatively wide local autonomy in the determination of tax rates, local power on tax bases is rather limited. The power to create (or to cancel) local tax bases is exclusively given to Parliament (local assemblies can only choose whether to use optional taxes or not). Responsibility for the definition and assessment of local tax bases is also given to Parliament. Local assemblies are only allowed to give some exemptions, insofar as they bear the full fiscal consequences of the exemptions they are responsible for. Conversely, rebates, exemptions and deductions on local taxes decided by Parliament are refunded by a special transfer given to local governments (see above). To sum up, local power to tax is quite wide with respect to tax rates but rather narrow with respect to tax bases (Council for Taxation 1989; Bolliet 1993).

However, these clear-cut conclusions must be more carefully qualified. The possibility given to French politicians to accumulate elected positions (for example, mayor of a city in addition to representative at the National Assembly, or senator, or European representative) blurs the distinction between parliamentary decisions and local politicians' decisions. The French Parliament turns increasingly to a 'tribune of local governments'. Its tax decisions are thus heavily determined by local interest groups and the distinction between parliamentary taxing power on local tax matters, and the taxing power of local assemblies becomes quite nebulous. It is probably more useful to oppose two different ways of exerting local tax power: an indirect one—via Parliament—and

a direct one via the local assemblies. In such a model, the principal opponent of the local tax lobby is not the Parliament, but the Ministry of Finance.

The assessment of the tax based on improved or unimproved land derives from an administrative procedure, not from market prices. This administrative assessment consists in a periodical census of all taxable estates, and in an annual indexation of these administrative values. Because the census procedure is extremely costly, it is also infrequent. Assessment of tax bases is thus rapidly becoming obsolete, resulting in large distortions among taxpayers. These distortions introduce horizontal inequities which an increase in property taxation at the local level make more difficult and less legitimate.

The local business tax (TP) is the main local direct tax (see [Table 6.2](#)). Unlike local property taxes, it is based on reported values declared by taxpayers and introduced in the tax base two years later. The tax base consists in: a fraction (18 per cent) of wages (out of the social security contributions charged to employers); and a fraction of the rental value of structures and equipment involved in production (special deductions are introduced for new investments and for the creation of new jobs). Conversely, there is no allowance for depreciation. In order to limit the tax burden on firms, local business tax liability is capped at 4 per cent (or 3.8 per cent in special cases) of taxpayers' own value-added.

Roughly speaking, the local business tax base is more or less an 'income-type' value-added tax, as the tax base is a proxy of the sum of the income factors' (wages+capital income). The only two major differences are the relative weight of capital income and labour income in the tax base, and the lack of depreciation allowance.

As shown in [Figure 6.1](#), the evolution over time of the (gross) TP base is parallel to that of GNP two years previously. Since 1992, however, the TP base increases faster than GNP does (e.g.+2.5 per cent for GNP in 1994, and+5 per cent for the tax base in the same period). The wedge between these evolutions over time is only due to the rapid increase in the rental value of immovables in the tax base. At present, the relative weight of labour income and capital income (rental value of equipment) in the TP base is roughly 40/60, but meanwhile, these weights are 60/40 in GNP (see [Figure 6.2](#)). The tax base has thus introduced a distorted vision of the value-added, which tends to overweigh capital income, and underweigh labour income.

The overall burden of local taxes has increased steadily over time; it is now close to 7 per cent of GNP (see [Table 6.3](#)). The trend of local tax receipts over time is also quite uneven (see [Table 6.4](#)). The ratio local tax receipts/GNP increases faster than the tax burden on the central state. The respective contribution of the different layers of government (see [Table 6.5](#)) illustrates the importance of the local level, which is responsible for around 60 per cent of the total increase in local tax receipts.

Turning to the relative increase of the three layers of government, the regions, newly created, sharply increased their taxes over the period, as did the special

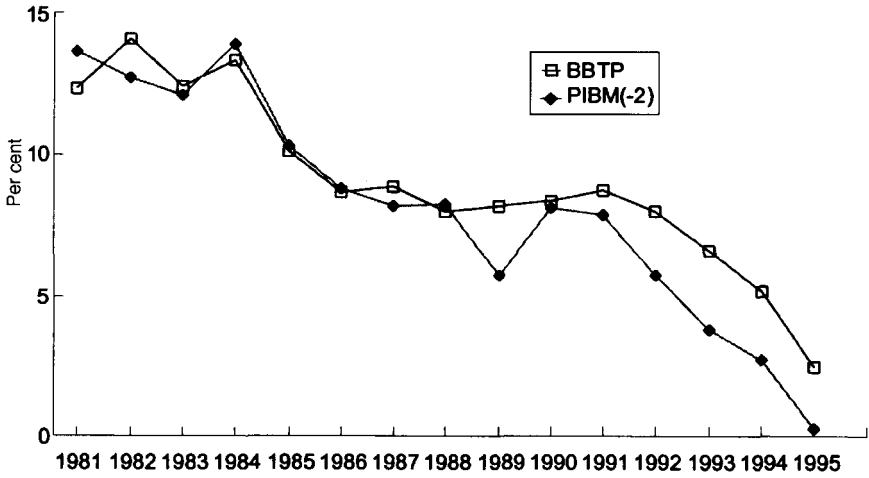


Figure 6.1 Rate of increase in the TP tax base with respect to GNP increase.

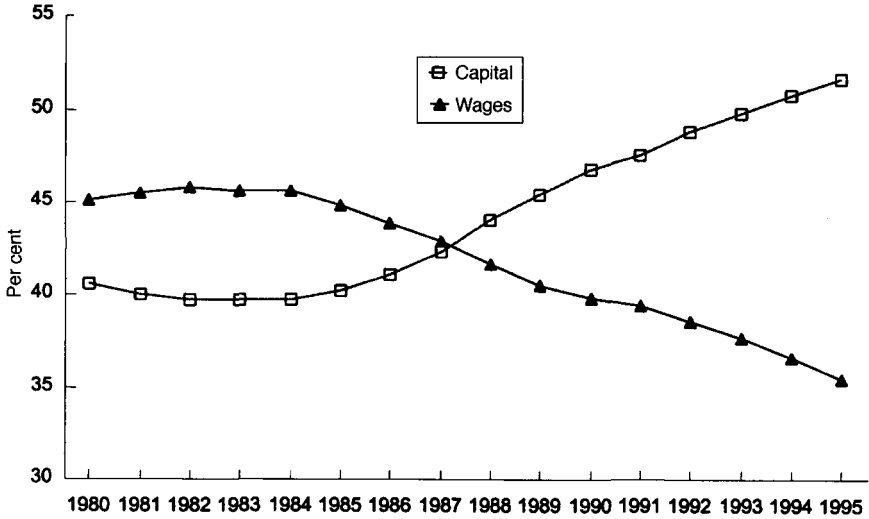


Figure 6.2 Structure of local business tax base (percentage).

districts at the local level (see Table 6.6). But their contribution to the total increase in local taxes remains only marginal due to their relatively small budgets. Finally, an analysis of the contributions of each of the four main direct taxes (see Table 6.7) to the overall increase in taxes, shows that the principal source is that of the TP which amounts to half of the total. Thus, half of the additional local tax burden has been charged to firms.

Another important feature of the evolution of local tax receipts is illustrated by the analysis of the respective contribution of the increase in local tax bases and

Table 6.3 Tax burden—France, 1986–97 (per cent of GDP).

	1986	1990	1997
Social security contributions	19.6	20.1	22.1
Taxes	24.4	23.6	23.3
central level	(17.4)	(16.3)	(15.0)
local governments	(5.8)	(6.1)	(7.0)
EU	(1.0)	(0.9)	(1.0)
Total	44.0	43.7	45.4

Source: National Accounts.

Table 6.4 Evolution of local tax receipts—four major direct taxes (annual rate of increase, nominal values).

Year	Increase (%)
1987/86	+ 0.2
1988/87	+ 6.1
1989/88	+ 7.3
1990/89	+ 10.1
1991/90	+ 9.4
1992/91	+ 5.9
1993/92	+ 9.6
1994/93	+ 8.4
1995/94	+ 5.0

Source: Ministry of the Interior 1997.

Table 6.5 Contribution of the three levels of government to the increase in local tax (four main direct taxes) receipts (1985–95)—nominal values.

Government level	Contribution (%)
Communes (and special districts)	59.8
Departments	27.4
Regions	12.8

Source: Ministry of the Interior 1997.

local tax rates. A first estimation (based on aggregate data) shows that the main role is devoted to the increase of tax bases.² It explains between 80 and 90 per cent of the total increase in tax receipts up to 1986. Since that time, the increase in tax rates explains 20 to 40 per cent of the increase in total tax receipts. In other words, the increase in tax receipts is more and more related to an increase in tax effort (see [Table 6.8](#)).

A more detailed analysis concludes that since 1980, tax rates (at the communes +special districts level) have increased by:

Table 6.6 Rate of increase of local tax receipts by levels of government, 1985–95 (in percentage of increase, nominal values).

<i>Government level</i>	<i>Increase</i>
Communes (including special districts)	+ 86
Departments	+ 96
Regions	+ 360
Total	+ 98.5

Table 6.7 Relative contribution of the four major direct taxes to the increase of local tax receipts, 1985–95 (in per cent local).

<i>Tax</i>	<i>Contribution</i>
TH	20.0
TFB	30.5
TFNB	-0.7
TP	50.2
Total	100.0

Table 6.8 Increase of total tax receipts, increase in local tax rates—four major local taxes, 1982–93 (in per cent).

	<i>Tax receipts</i>	<i>Tax rates</i>
TH	+ 141.0	+ 14.5
TFB	+ 274.5	+ 23.7
TFNB	+ 32.4	+ 13.0
TP	+ 141.8	+ 16.3
Total	+ 159.2	

Source: Gilbert 1996a.

- +23 per cent for the local business tax (TP)
- +18 per cent for the housing tax (TH)
- +15 per cent for the property tax (unimproved land)
- +36 per cent for the property tax (improved land)

The tax increase is thus levied more on the housing sector (owners and/or occupants of buildings and houses) and less on agriculture.

A final important and unusual feature is the contribution of the central level (i.e. the national taxpayer) to local taxes. The direct tax liabilities³ actually approved by local assemblies are not entirely charged to nominal (local) tax-

payers. An increasing proportion is charged (more precisely, is compensated) to the central level and refunded to local governments. The central level compensates local governments for the loss in tax receipts they face in the case of:

- reductions, or exemptions relative to local tax liabilities voted by Parliament (exemptions or reductions for elderly people, widows with low incomes, etc.);
- the reduction of local tax bases and/or the capping of local tax rates voted by Parliament (mainly the reduction of the local business tax base and the capping of individual TP liability to 4 per cent of the value-added).

As shown in [Table 6.9](#), the local tax burden transferred to the central level increased sharply from 1987 to reach 24 per cent in 1995 (and one-third for the local business tax). It doubled in nominal terms from 1987 up to 1995 and now amounts to one-fourth of total direct tax receipts received by local governments. More than two-thirds of these ‘tax expenditures’ come from compensation for the capping of the TP with respect to the value-added.

Up to very recently, a French local government could freely increase its rate (of local business tax for example) without suffering any loss in tax receipts. The local taxpayer who was subject to the capped rate was guaranteed not to be levied for more than the year before; the difference between expected local tax receipts (resulting from the product tax base \times (voted) tax rate) and actual tax liabilities after application of the capped rate was fully compensated for by means of a refund from the central state.

No doubt these large transfers of local tax burden from the local level to the central level contributed to solving the potential crisis of local public finances in the early 1980s. But they also entailed negative consequences (Bolliet 1993):

- The ‘fiscal irresponsibility’ of local governments could result in overspending, waste and inefficient allocation of resources.
- Fiscal autonomy of local governments is lessened, as control over local tax bases progressively applies to narrower bases.
- The increasing tax burden transferred to central level induces the central level to balance the fiscal relations with lower tiers of government in a different fashion. The increase in local tax expenditures is likely to ‘crowd out’ other types of transfers to local governments in a period of fiscal deficits and tight budgetary constraints.

Table 6.9 Contribution of the central level to direct local tax receipts (billions FF and per cent).

	1987	1991	1995
Contributions to the			
Housing tax	7.6	13.1	15.9
Property taxes	3.8	4.2	2.7
Local business tax	22.7	34.6	54.7
Total of central state tax contributions	34.1	51.9	73.3
Total direct tax receipts	169.2	232.9	300.4

Source: Ministry of the Interior.

3 INTERGOVERNMENTAL FISCAL RELATIONS: EQUALISATION AND COMPENSATION VS MACROECONOMIC CONSTRAINTS

The section above illustrates the direct link between the local tax system and the development of intergovernmental transfers. Paradoxically, the development of these fiscal intergovernmental transfers is not only the fiscal consequence of the domination of a prominent and powerful central level, but also the consequence of the liberty and fiscal autonomy left to more than 50,000 local governments in France, distributed over four layers of government.

The recent French evolution of the system of intergovernmental fiscal relations is the irrefutable result of four major historical factors (Uhaldeborde 1996; Blanc 1996):

- 1 the fiscal consequences of the transfer of responsibilities induced by the decentralisation process of the 1980s which raised compensation needs;
- 2 the extreme fragmentation of the map of fiscal jurisdictions which results in substantial differences in tax capacities and fiscal needs, calling for large and efficient fiscal equalisation;
- 3 the complexity of the grants system, which necessitates the simplification and globalisation of the system;
- 4 the rise in public deficits together with the strengthening of macro-economic constraints in the European context dictating an overall regulation of the system of intergovernmental transfers.

Overall perspective

In 1996, transfers from the central state to subcentral levels of government amounted to FF 250 billion (280 billion including tax transfers) which represents 3.7 per cent of GNP. This figure places France in a medium position as compared with other European countries (see Table 6.10). Transfers are less

Table 6.10 Fiscal transfers to all local governments in selected European countries for various years, 1985–90 (in per cent).

	<i>Current transfers/local spendings</i>	<i>Transfers in capital/local spendings</i>	<i>Total transfers/total spendings</i>	<i>Total transfers/total public spendings</i>	<i>Transfers/ GNP</i>
Belgium	53.1	6.0	59.1	11.0	4.1
Denmark	43.6	1.1	44.7	36.4	13.8
Germany	24.0	11.0	35.0	12.2	3.0
France	30.8	5.9	36.7	14.4	3.5
Italy	72.4	14.4	86.8	32.0	12.3
Netherlands	77.1	4.7	81.8	41.3	14.6
United Kingdom	47.0	1.8	48.8	20.3	6.1

Source: EUROSTAT 1990.

important in value with respect to GNP, or with respect to local or total expenditures in France, than in most of the other European countries. The ratio transfers for current expenditures/transfers in capital, is much the same in France as in Germany but quite different to that of the UK, Denmark and the Netherlands.

Since 1987 (the year ending the period of major decentralisation of responsibilities from central to local government) these transfers increased by 4.4 per cent per year on average (in volume). Over the same period, public expenditures expanded in volume at a rate of only 1 per cent. From 1988 to 1994, intergovernmental transfers at the central level increased three times faster than did the budget of the state. Consequently, they now represent 17 per cent of total public expenditures in France (compared with 12 per cent for 1985). Over the 1980s, they grew by an additional point of GNP (3 per cent of GNP for 1980 to 4 per cent in 1992).

These transfers undoubtedly contributed to the increase in local budgets in a significant proportion (see [Table 6.11](#)). For 1985, they contributed by 34.7 per cent to total incomes at the commune level, by 40.1 per cent at the departmental level, and by 21 per cent at the regional level. The 1994 ratios are respectively 30.7 per cent, 31 per cent and 28.3 per cent. Even if the share of transfers in total incomes was gradually reduced in significant proportions at the commune and departmental level (and increased for the regions), transfers have, in any case, contributed to 25 per cent of the increase in incomes at the commune level (one-third for the incomes of special districts over the period 1985–90), to 20 per cent of additional incomes at the departmental level, and 31 per cent at the regional level.

The present structure of intergovernmental transfers is detailed in [Table 6.12](#). The main transfers are:

Table 6.11 Fiscal transfers from central level to regions, departments and communes, and total incomes, 1985–94 (billions current FF).

<i>Transfers to</i>	<i>1985</i>	<i>1991</i>	<i>1994</i>
Communes			
Total transfers	87.8	125.2	134.6
(including DGF)	(56.1)	(73.8)	(79.8)
Total incomes	252.8	373.0	437.9
Special districts (selected)			
Total transfers	24.5	31.8 ¹	n.a.
Total incomes	64.0	83.6 ¹	n.a.
Departments			
Total transfers	49.1	62.2	69.2
(including DGF)	(10.0)	(14.3)	(15.2)
Total incomes	122.4	182.1	223.3
Regions			
Total transfers	3.8	14.8	19.0
Total incomes	18.2	53.5	67.0
Total transfers	178.0	252.4	(272.4) ³
(including DGF)	(66.7)	(88.8)	(99.8) ³
Total local incomes ²	503.5	753.2	n.a.

Source: Ministry of the Interior 1997.

Notes

1 1990.

2 Including all the special districts.

3 1995, special districts excluded.

- DGF (Block grant for current expenditures)
- DGE (Block grant for capital expenditure)
- FCTVA (Refund of VAT charged on the capital expenses of local governments)
- DGD (Block grant for the additional responsibilities transferred from central to local governments)
- DCTP (Equalisation grant for disparities in TC tax bases)

Altogether, they represent more than 80 per cent of total transfers (excluding tax transfers): and the DGF concentrates, alone, 40 per cent of all transfers.

The origin and rationale behind these different transfers are basically twofold: compensation for losses in tax receipts, and participation in the financing of local public services.

Transfers as compensation for tax receipts losses

The origin of the DGF is the substitution of an old (but productive) local tax with VAT. This transfer is considered a simple block grant by the central state, but it is still viewed by local politicians as compensation for a loss in tax receipts they suffered a long time ago (in the 1960s). The present structure of the DGF basically consists in a *per capita* grant (graduated with respect to a population scaling), an *equalisation* grant (related to tax effort and tax capacity), and a *compensation* grant (related to selected needs' indicators (such as road mileage, number of social housings, number of pupils, etc.). In the same vein, the DCTP compensates the local government for tax receipts losses they face due to the limitations set by Parliament on the local business tax.

The participation of the central level in the financing of local services

Some of these transfers are directly linked to the new division of responsibilities among the levels of government resulting from the Decentralisation Acts of the 1980s (block grant for decentralisation (DGD), and specific grants related to the transfer to regions and departments of responsibilities in schools—or training policy). The last important transfer (FCTVA) compensates for the VAT, included in the price of capital goods purchased by local governments, which they are unable to shift onto consumers (see [Table 6.12](#)).

As shown in [Table 6.13](#), almost all these major transfers benefit all layers of government.

Compensation

Expenditures corresponding to the responsibilities transferred to regions, departments and communes in line with the Decentralisation Bills of the 1980s have been compensated for partly by the transfer of taxes to these levels of government (the corresponding tax receipts are estimated at 38.5 billion for 1996) and partly by new block grants for training. However, subsidies in capital are provided to the regions to defray capital expenditures in high schools (DRES), and to departments for expenditures in colleges (DDEC). The corresponding amounts are automatically indexed to the expected rate of increase in public expenditures in capital of the central level.

Equalisation

1. The objective of equalisation of the fiscal capacities of local jurisdictions remained implicit in French legislation up to 1995. Bill no. 95–115 (4/2/95) explicitly recognised this objective for the first time (a complementary report as yet unpublished will provide a precise definition of the equalisation objective,

Table 6.12 Structure of transfers to local governments—France, 1996.

	<i>Billions FF</i>	<i>%</i>
1 Current transfers	113.6	46.8
DGF (block grant for current expenditure)	103.6	
Other current transfers ¹	10.0	
2 Transfers in capital	35.4	14.6
DGE (block grant for capital expenditure)	5.7	
FCTVA ²	23.1	
Other transfers in capital	6.6	
3 Compensation for decentralisation of responsibilities	25.1	10.3
DGD ³	14.2	
Compensation for training policy	5.0	
Compensation for schools	4.9	
Other	1.0	
3.1 Transfers of taxes to local governments	(38.5)	28.3
4 Refunds for local tax expenditures (voted on by Parliament)	68.4	
Local business tax	17.5	
Local property taxes	0.8	
Other tax compensations	50.1	100.0
5 Total (out of tax transfers 3b) (including tax transfers (3b))	242.5 (281.0)	

Source: Ministry of the Interior 1997.

Notes

1 Including compensation for the housing of elementary school teachers, and the contribution to the equalisation of local business tax.

2 The VAT included in the prices of capital goods purchased by local governments is refunded to local governments.

3 This transfer, as well as the other compensation transfers, refunds to local governments expenditures transferred from central government to local ones according to the Decentralisation Bills.

the criteria chosen, the fiscal means mobilised for that purpose, and will finally evaluate the equalising power of the system) (Bernard-Gelabert 1996).

Article 68 of the Bill states that the 'reduction of the disparities in the fiscal means of local jurisdictions, resulting from disparities in incomes and disparities in needs (*charges* in French) is a fundamental objective of the regional planning policy'. For this purpose, all the resources of the jurisdictions included in a region (communes, special districts, departments and the region itself) are totalled and subjected to an equalising scheme.

- The resources considered are not the actual fiscal resources, but the sum of the actual transfers received by jurisdictions from other tiers of government,

Table 6.13 Beneficiaries of the major transfers from central government to local governments.

	<i>Communes</i>	<i>Departments</i>	<i>Regions</i>	<i>Special districts (without separate tax responsibility)</i>	<i>Special districts (with tax responsibility)</i>
DGF	Yes	Yes	No ¹	No	Yes
DGE	Yes	Yes	No	Yes	Yes
FCTVA	Yes	Yes	Yes	Yes	Yes
DGD	Yes	Yes	Yes	No	No
DCTP	Yes	Yes	Yes	Yes	Yes

Note

1 Except the Ile de France region which benefits from a specific DGF.

and of 'tax capacities' in all these jurisdictions (i.e. the actual tax bases times the average rates of taxes observed at national level).

- These fiscal resources are expressed on a per capita basis (i.e. divided by the number of inhabitants of the region) and adjusted according to differences in 'needs' among the jurisdictions. After equalisation, the 'per capita adjusted resources' of any local jurisdiction (or community of local jurisdictions) cannot be less than 80 per cent or more than 120 per cent of the average per capita resource for the whole country.

Three distinctive features must be quoted:

- The territorial unit of this fiscal equalisation is the region; the objective of reduction in potential fiscal disparities is, thus, the lowest possible and the constraint 80–120 is not really binding.
- The equalisation of fiscal disparities *within* a region is left entirely out of this equalisation scheme.
- The equalisation norm considers both tax capacities and other actual incomes of jurisdictions, and fiscal 'needs'.

2. Further steps are required to move towards a more effective fiscal equalisation. The instruments of equalisation must be defined, and a synthetic index of needs and resources must be implemented. The instruments have already been chosen: fiscal equalisation is to be achieved through the reform of the DGF, the DGD, and redistribution of the receipts of local business tax; all these reforms must be completed by the year 2010. In so doing, the choice has been made not to add a new equalisation grant but, wisely, to reform the present system.

The selection of the index of needs and resources is still in process. Several econometric estimates and numerous simulations have already been carried out (Guengant 1996). The results are quite impressive but a number of local

politicians are reluctant to enter into such a technical debate and leave the traditional game of log-rolling on the fiscal parameters of redistribution.

Estimations of the demand function for local public services at the commune level have been carried out by Derycke and Gilbert (1988) and Guengant and Uhaldeborde (1995). Econometric estimates are derived from the usual median voter model (Borcherding and Deacon) in which 'needs' are introduced via the use of a Stone-Geary utility function in which the 'needs' parameters enter as variables and result in a linear expenditure model.

Econometric estimates are obtained on an extended sample of 5,000 French communes. More than 80 per cent of the total variance of per capita expenditures is explained by the model; the parameters have the expected (and significant) signs and transversability conditions are met. The variance in per capita local expenditures among 'communes' is explained for 60 per cent by incomes factors (personal per capita income of the median voter, per capita grants-in-aid received by the commune, and tax share) and 25 per cent by 'needs' factors (combining 'needs' such as population, number of elderly, school-age children, road mileage and unit costs).

3. Three significant steps have already been taken towards more fiscal equalisation. First, a reform of the redistribution scheme of local business tax receipts has led to the creation of a national equalisation fund (Fonds National de Péréquation). It is jointly funded by part of the TP receipts in communes where TP rates are low, and by grants received from the state; the resources of the FNP are available for communes facing both low tax capacities and high tax effort.

The second step has led to the enlargement of the measure of regional tax capacity used for the regional equalisation fund (Fonds de Correction des Déséquilibres Régionaux). The third step will end the exceptional fiscal treatment of the Ile-de-France region (a specific DGF) within a 10-year period, leaving new resources available for two new equalisation funds (DSU: 'block grant for metropolitan solidarity' and DSR: 'block grant for rural solidarity').

4. The more vexing problem remains the evaluation of the equalising power of the actual grant system. Although introduced in the 1995 Bill as a compulsory task, it has only partially been resolved. The only reliable attempts are those made by Guengant (1996) and Guengant and Uhaldeborde (1996) on the equalising power of the DGF accruing to communes.

The objective of territorial equity is well known. It aims at equalising local differences in the purchasing power of local tax bases in terms of local public services. Even if French law does not consider full equalisation as attainable and desirable it is legitimate to measure the equalising performance of transfers in this perspective.

Leaving aside differences in 'needs' (the relevant index being at present unavailable), equalisation performance is measured only in terms of fiscal means. It simply compares the two following vectors:

$$\begin{array}{cc}
 \textit{Before equalisation} & \textit{After equalisation} \\
 \textit{(tax capacity/population)} & \textit{(tax capacity + DGF/population)} \\
 \left[\begin{array}{c} b_1 \\ \vdots \\ b_i \\ \vdots \\ b_n \end{array} \right] & \left[\begin{array}{c} b_1 + G_1 \\ \vdots \\ b_i + G_i \\ \vdots \\ b_n + G_n \end{array} \right]
 \end{array}$$

Table 6.14 Equalising performance of the DGF (Gini index).

<i>Population intervals</i>	<i>1989</i>	<i>1991</i>	<i>1994</i>
0–499	40.04	40.12	39.13
500–999	41.45	41.89	40.71
1,000–1,999	41.12	41.50	39.04
2,000–3,499	37.34	38.55	36.31
3,500–4,999	37.43	39.31	33.68
5,000–7,499	36.27	38.02	33.75
7,500–9,999	39.13	39.19	34.63
10,000–14,999	38.18	38.92	35.41
15,000–19,999	37.44	39.16	37.70
20,000–34,999	36.94	38.47	35.89
35,000–49,999	39.00	37.50	33.38
50,000–74,999	38.10	36.64	33.10
75,000–99,999	32.84	33.74	34.15
100,000–199,999	33.06	34.23	34.22
+200,000	30.85	31.18	34.08
Average equalisation	38.31	38.26	37.65
Marginal equalisation	1.13	0.47	–0.20

Source: Guengant (1996).

These two vectors have 36,500 elements. The comparison leads to the construction of two matrixes, each of them having 36,500 lines and 36,500 columns, and finally to more than one billion differences in local means, pre-and post-equalisation. An easy way to summarise this information is to use the Gini index (G).

The resulting index of equalisation is thus

$$E = \frac{\text{Gini after } E - \text{Gini before } E}{\text{Gini before } E}$$

where the Gini after/before E are respectively the value of the Gini indexes of concentration before/after DGF. This method leads to the following results (see Table 6.14).

The equalisation index reaches close to 40 per cent but has remained at this level since 1988. If one considers the marginal gain (or loss) in equalisation

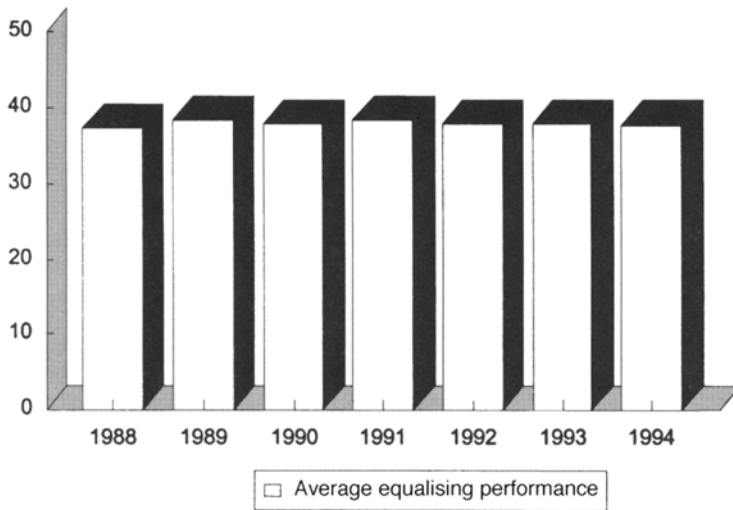


Figure 6.3 Average equalising performance of the DGF for communes only (out of the communes of overseas territories)—Gini index.

from one year to another (marginal equalisation index), it clearly appears that equalisation increases at the margin up to 1979, stops from 1979 to 1995, and is likely to increase in the future, due to the recent reform of the DGF (see Figure 6.3).

Finally, Figures 6.4 and 6.5 illustrate the equalising power of the DGF.

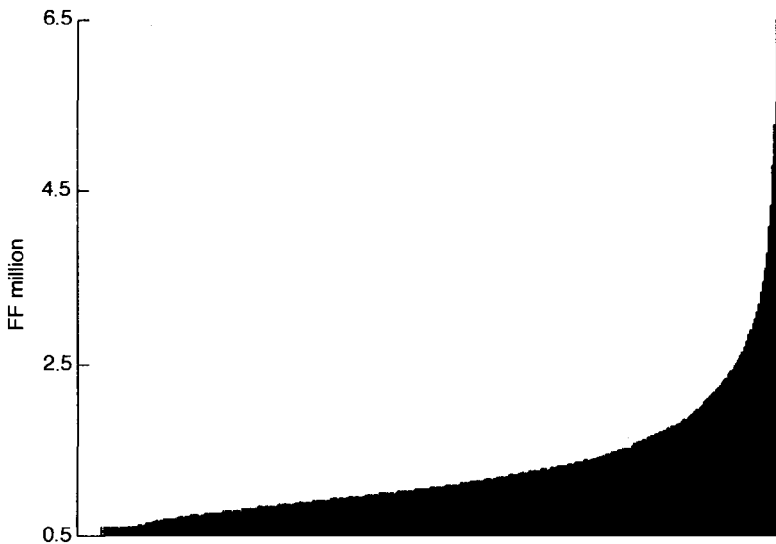


Figure 6.4 Differences in tax capacities among French communes, 1991.

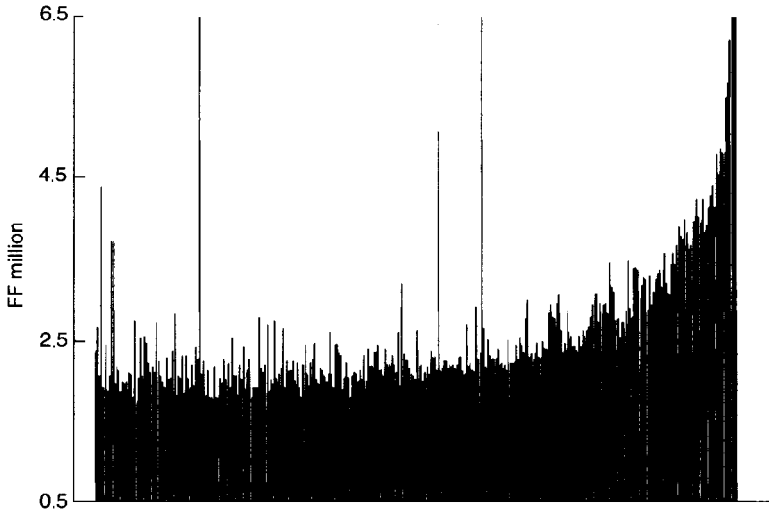


Figure 6.5 Differences in extended tax capacity among French communes (tax capacity +DGF), 1991.

Figure 6.4 represents the distribution of communes ranked by increasing level of per capita tax capacity. Figure 6.5 represents the same figure after adding the DGF to the local tax capacity. The DGF clearly favours the poorest localities, which are guaranteed a 'floor' of extended fiscal capacity (i.e. including DGF) of around 2,000 FF per capita.

The impact of macroeconomic constraints

Recent changes in the system of intergovernmental fiscal relations are not exclusively motivated by compensation or equalisation purposes. They are also linked to the macroeconomic situation and to the attempt made by successive Ministries of Finance to reduce public deficits.

As shown in a preceding section of the chapter, the total amount of transfers to local governments has increased quite rapidly over time. However, a rather surprising feature is that, whether grants were subject to indexation rules or not (see Table 6.15)—the average rate of increase in grants to local governments is approximately the same: respectively 5.2 and 5.3 per cent per year from 1985 to 1996. Thus, the existence of indexation rules (limiting the increase over time of the nominal transfer, as is presently the case for the DGF, DSI, DGE, DGD, DDDFF, DRDES, and DCTP, which represent two-thirds of total grants to local governments) has had no impact on their evolution.

A second remarkable point is the instability from one year to another of the annual rates of increase in transfers over the period. This situation, in all likelihood, has a negative impact on economic efficiency. Local governments as well as the Ministry of Finance could not correctly anticipate grants received and

Table 6.15 Fiscal transfers to local governments, 1985-96 (billions current FF).

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
I Close-ended grants/subsidies												
DGF - Block grant for current expenditure	66,484	67,518	70,693	75,414	84,023	85,356	88,322	92,226	96,219	98,144	99,910	103,524
DSI - Block grant for the housing of primary school teachers		2,651	2,776	2,961	3,299	3,327	3,305	3,322	3,257	3,155	3,025	2,947
FNPTP - Local business tax equalisation grant	3,187	3,443	680	696	746	796	796	807	1,392	1,296	1,385	1,798
FNP - Equalisation grant	0	0	0	0	0	0	0	0	0	0	569	616
DEL - Block grant for local representatives	0	0	0	0	0	0	0	0	250	250	250	259
DGE - Block grant for capital expenditures	3,360	3,802	3,857	4,268	4,597	4,804	5,403	5,619	5,895	5,895	6,089	5,689
DGD - Block grant for the transfer of responsibilities	10,044	11,315	11,312	14,299	15,631	11,562	13,694	13,525	12,921	13,333	13,569	14,158
DGD (Corsica) - (idem; earmarked to Corsica)	0	0	0	0	0	0	0	0	1,067	1,155	1,218	1,267
DGD (FP) - Block grant for local training programmes	1,886	1,978	2,071	2,246	2,504	2,524	2,690	2,810	2,931	3,818	4,726	4,950
DRDES - Block grant for the transfer to local governments of the capital expenses related to schools	0	1,067	2,146	2,976	3,245	3,487	3,845	3,999	4,195	4,405	4,550	4,718
DCTP (out of REI) - Compensation for tax subsidy (local business tax)	0	0	15,178	16,116	16,866	17,516	18,019	17,891	18,923	14,806	15,258	14,132
Total	84,961	91,774	108,713	118,976	130,911	129,372	136,074	140,199	147,050	146,257	150,548	154,059

II Open-ended grants/subsidies													
Refund of VAT on capital purchases	11,703	10,901	12,450	13,041	14,772	18,721	17,350	21,100	21,100	21,100	21,800	22,800	23,100
Fines	521	599	600	530	754	944	850	950	1,000	1,000	1,200	1,300	1,700
Subsidies from central government departments													
for current expenditures	5,089	5,280	3,960	3,712	3,701	4,093	3,697	3,867	4,042	4,042	4,595	4,659	4,440
for capital expenditures	6,760	5,232	4,327	4,636	4,677	5,237	3,507	3,535	3,829	3,829	3,561	3,461	3,113
Treasury accounts	880	920	960	1,000	1,041	1,091	1,106	1,221	1,191	1,191	1,057	1,158	1,249
DCTP – compensation for TP/tax subsidy													
(for new investments and additional manpower)	1,016	1,016	1,016	3,403	3,775	4,270	5,234	4,248	3,925	3,925	3,498	3,017	3,200
Refund of tax subsidy (land tax)	3,704	3,716	3,619	3,500	2,753	2,604	2,602	2,102	1,800	1,800	1,303	998	850
Refund of tax subsidy (property tax)	0	0	0	0	0	0	0	5,900	7,426	7,426	8,416	10,215	12,907
Miscellaneous tax refunds	15,510	11,713	11,019	11,074	12,250	16,540	19,590	20,890	23,588	23,588	30,943	36,799	34,462
Total	45,183	39,377	37,951	40,896	43,723	53,500	53,936	63,813	67,901	67,901	76,373	84,408	85,021
Grand Total	13,014	131,151	146,664	159,872	174,634	182,872	190,010	204,012	214,951	222,630	234,957	239,080	239,080
Transfer of taxes to local jurisdictions													
	21,500	24,713	28,722	31,423	34,660	38,570	38,790	39,700	37,745	38,059	42,598	44,684	44,684
Rates of increase (%)													
I Close-ended grants		8.02	18.46	9.44	10.03	-1.18	5.1	3.03	4.89	4.89	-0.54	2.93	2.33
II Open-ended grants		-12.85	-3.62	7.76	6.91	22.36	0.81	18.31	6.41	6.41	12.48	10.52	0.73
Grand Total		0.77	11.83	9.01	9.23	4.72	3.90	7.37	5.36	5.36	3.57	5.54	1.76
Structure													
I Close-ended grants	65.28	69.98	74.12	74.42	74.96	70.74	71.61	68.72	68.41	68.41	65.70	64.08	64.44
II Open-ended grants	34.72	30.02	25.88	25.58	25.04	29.26	28.39	31.28	31.59	31.59	34.30	35.92	35.56
Grand Total	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: G.R.A.L.E. Annual Report on Local Governments, 1996

transferred. For these reasons, the fiscal Bill of 1995 introduced a new rule of indexation for 'close-ended' transfers only (Pacte de Stabilité Financière, that is, the set of new fiscal rules between the central government and the local governments). It provided that the increase in nominal value of all these 'indexed transfers' (listed in [Table 6.15](#)), for the years 1996, 1997 and 1998 cannot exceed in total the expected rise in the consumer price index used in the relevant fiscal bills.

More precisely, the new indexation scheme applies only to grants in capital (DGE) and the compensation grant for the local business tax (DCTP). For all other grants (DGF, DGD, etc.) included in the Pacte de Stabilité Financière the former indexation rules continue to apply (full indexation on the consumer price index of the current year+half of the rate of increase (if positive) of the preceding year's GNP in real terms). In other words, adjustment to the new indexing rules is entirely borne by the DGE (one-fifth) and by DCTP (four-fifths). In the future, the marginal cost of adjustment will be borne exclusively by the DCTP. Compensation for local disparities in local business taxes is thus likely to disappear in the future.⁴

This Pacte de Stabilité Financière is equivalent to an insurance mechanism. On the one hand, central government guarantees the indexing of these grants for three years, whatever public deficits are. A likely consequence of this guarantee given to risk-averse local governments is the time consistency reinforcement of their local decisions. On the other hand, the guarantee of resources has a price: the purchasing power of the 'close-ended' transfer is fixed for three years, in a less favourable way than preceding years, as the rate of increase in transfers is far above the inflation rate.

The overall cost of this quasi-insurance contract is not easy to estimate. It largely depends on expectations made upon price indexes. For 1996, the 'cost' can be roughly estimated at 3 billion FF (the difference between the transfers local governments were certain to receive under the former system of indexation, and what they are to get under the new rule of indexation). Estimations realised by the Ministry of Finance evaluate the net gain for the Treasury at 5.6 billion FF for 1997, and 8.3 billion FF for 1998. The 'price' paid by local governments for this insurance could thus reach 2 per cent of the transfers received for 1996, 3.5 per cent for 1997 and 5.2 per cent for 1998.

In such a fiscal 'game', gains for the treasury are clear: two-thirds of intergovernmental transfers are indexed to expected consumer prices. In a context of fiscal deficits, and in the Maastricht Treaty perspective, the stability (in real terms) of these transfers is a priority for the stability of public finances. On the other hand, this advantage has a price: the lack of reform of the intergovernmental transfers system, which is left in its 1995 state, even if it largely favours local governments.

Once again, the recent history of intergovernmental fiscal relations in France leads to local taxation issues. We have already seen that the new indexation rule could, within a few years, lead to the disappearance of compensation for

disparities arising from the local business tax. Shouldn't this be a strong incentive to solve the pending question of the TP and reform in depth local taxation?

4

THE REFORM OF LOCAL TAXATION: A PREREQUISITE FOR FISCAL EQUALISATION?

The first section of this chapter emphasised the negative impact of the combination of a rather large degree of autonomy of local governments on tax matters, of a prominent local tax based on business, and a very large number of jurisdictions.

The 'natural' concentration of tax bases in selected areas (mainly urban jurisdictions) introduces large disparities in local tax capacities, which cannot be completely equalised. Thus, local tax capacities per capita range from 1 to 850 for the 'communes'. Ninety per cent of these disparities come from the only local taxation on business (TP+local tax on firms' estates). Moreover, 80 per cent of these differences in local tax capacities reflect inequalities in 'endowments', and not inequalities in the respective performances of local governments (if one considers the location and level of activity of firms as independent of local tax rates, interjurisdictional differences in local business tax bases can be interpreted as differences in 'endowments').

The maximum range for local business tax bases is:

- 1 to 2.2 among regions (Ile de France excluded) or 1 to 3.5 (Ile de France included);
- 1 to 3.8 among departments (Ile de France, departments excluded) or 1 to 6.5, if included;
- 1 to...590,000 among communes.

These differences in tax bases are also reflected in tax rates; here the range is of 1 to 4 among regions; 1 to 6.5 among departments and 1 to 77 among communes. From the view point of the local taxpayer, one must consider interjurisdictional differences in cumulated rates. For the TP, the maximum range is of 1 to 6 among communes, if one considers the cumulated rate of taxation (communes rate+departmental rate+regional rate).

Is it possible to reduce these differences through a reform of local taxation, or, more precisely, reform of the local business tax? (Gilbert 1996a, 1997). This question is once again widely debated in France. The Council for Taxation devoted its latest report (1997)⁵ to the TP and concluded that reform was necessary and must lead to the 'nationalisation' of the tax. Others support a reform leaving more tax autonomy to local governments. But one key point in both cases is the problem of the distribution of local taxes among jurisdictions and its equalisation.

Table 6.16 Main characteristics of the TP, 1988–95.

	1988	1991	1995
Tax base (billions FF)	508	649	800
TP receipts (billions FF)	98	130	167
(including refund by the treasury)	(25)	(33)	(53)
TP liabilities charged to local taxpayers (billions FF)	76	101	120
Average tax rate	15%	15.6%	15%

Source: Conseil des Impôts (1997).

The ‘centralisation’ of local business tax: the route to a compulsory fiscal equalisation

Reform of the TP is probably unavoidable

Twenty years after its creation, the TP still suffers from several shortcomings. It was originally designed as a wide-based tax, levied on the economic activity of firms (and independent workers) so as to provide the main local tax receipts (see Table 6.16). And this is indeed what happened. The TP provides 160 billion FF at present, more than the business income tax does. Tax receipts increased so rapidly that the central government had to introduce a ‘cap’ (3.8 or 4 per cent of the value-added of each taxpayer), in order to limit the tax burden imposed on firms. This cap, however, is a source of distortion, confusion, administrative costs, and tax cheating. Some economic sectors (like banks or insurance companies) have a very low value-added, so the cap is extremely binding and leads to very moderate tax liabilities. This in turn produces a very low average rate of TP with respect to other sectors (like energy or machinery). In addition, the refund of the loss in tax receipts resulting from this tax capping to local governments is extremely costly for the treasury (it amounts to about 20 per cent of total TP receipts at present, that is 31 billion FF, and this figure has doubled in value since 1992). In other words, the TP became the main local tax resource thanks to the contribution of the treasury (or of the national taxpayer).

The tax base is distorted, too elastic over time and generates distortions in the allocation of resources. It does not cover the range of economic activities: some sectors are de jure excluded (agriculture, handicrafts, cooperative sector, marketed activities of the public sector); other exemptions (often temporary) are given for regional development purposes (38 tax-free areas or tax-free districts and 6 in the French overseas territories).⁶ The tax base gives a distorted view of actual economic activity. It basically consists in 18 per cent of wages and the rental value of immovables (buildings, machines, motor vehicles, etc.). But, for firms subject to the capped rate expressed in terms of value-added, the actual tax base is simply the value-added (half of the TP liabilities are de facto assessed on

value-added). Nevertheless, the respective share of capital income and labour income in the TP base is roughly 60 per cent and 40 per cent, compared with the corresponding ratio in the macroeconomic value-added (GNP expressed as the sum of factor costs) which is just the opposite (40 per cent and 60 per cent). More disturbing is the recent evolution of this ratio which emphasises the weight of capital elements in the tax base (55 per cent of the tax base in 1980, 65 per cent in 1995). The reason for this odd phenomenon is simply that the value of immovables considered in the TP basis is based on the original cost without any depreciation deduction. (Even if machinery has greatly depreciated, it continues to be entered at its full original cost in the TP basis.) The high elasticity of the TP base with respect to GNP (1.02 for the past four years) is the direct consequence of this distortion against capital.

This distorted image of the true economic structure of value-added is likely to have consequences on the allocative decisions of firms and results in intersectoral bias against capital intensive sectors and towards service sectors (especially the financial sector).

Piecemeal and gradual reforms of the TP are extremely problematic

The French Council for Taxation has conducted a large number of simulation exercises corresponding to various piecemeal reforms aimed at alleviating the shortcomings listed above. These include reforms such as the extension of the tax base to currently non-taxed sectors, the introduction of deductions for depreciation, the substitution of the 'value-added' or the business net income with the present tax base, the reinforcement of preferential tax treatment for new investments (a measure already introduced in the TP base) or a tax reduction for firms hiring new workers. In general, the simulation results are quite deceptive. On the one hand, the reforms are often difficult to implement because of the narrowness of the communes and the lack of correspondence between the territory of multiple-plant firms and those of taxing jurisdictions. Consequently, they are costly to administrate and often inefficient. On the other hand, they induce large differences among jurisdictions in the distribution of tax bases and thus in tax receipts.

Additional possible means of reform have been explored, aiming for example at reducing the liberty of setting TP rates at the local level: the introduction of a 'tunnel' of tax rates by an increase in the (existing) floor tax rate (presently set at 0.5 per cent) and maintaining a cap rate. Once again, this type of reform is hardly desirable, due to the enormous change it induces in the distribution of tax receipts among jurisdictions.

More radical reforms are needed

The basic problem of the TP, and consequently of all local taxation in France, is not purely fiscal: it is both fiscal (the very nature of tax bases) and territorial (the multiplication of autonomous taxing units—50,000 in the French case).

All the radical reforms examined aim primarily at solving the territorial problem. Some of them involve a compulsory reduction in the number of autonomous taxing entities from 1 in the case of nationalisation/ centralisation to 22 in the case of regionalisation or even some thousands: TP located in multi-commune units. Others consider the possibility of *voluntary mutualisation* of the TP in line with the (existing) system of ‘inter-communality’. A final group considers the consequences of the abolition of the TP and its replacement by another tax, or by additional rates on existing taxes like VAT.

Compulsory mutualisation is the main method of reform explored by the Council for Taxation. This Council was most impressed by a study of the British case (the reform of the uniform business rate in 1990) and the German one (the expected abolition of the *Gewerbesteuer*). The scenario proposed is simply to keep the tax base largely unchanged (but amended by the introduction of depreciation deductibility).⁷ A single tax rate would be set all over the country by a vote in Parliament. A special fund would be created to receive all (or part) of the receipts of the ‘national TP’; these tax resources would be subsequently redistributed among the jurisdictions (regions, départements, communities of communes and communes) according to criteria established by Parliament.

This drastic solution entails several advantages:

- the treasury could more easily control the evolution of the TP, insofar as the government is able to propose the equivalent of ‘the stabilisation agreement’ as it does under the present system;
- the predictability of the tax burden for taxpayers, and that of tax receipts for local governments would be increased;
- compliance costs and costs of administration would be lessened;
- reform of the tax base would be easier to achieve (especially the introduction of a deduction for depreciation);
- the incentive for local governments to compete on TP rates would vanish;
- a more ambitious equalisation policy would be possible, easier to implement and less costly (because of the disappearance of the tax disparities caused by differences in local tax rates);⁸
- if necessary, fiscal incentives for community merging would be easy to introduce in this system.

This ambitious tax reform would have such large-scale fiscal consequences that it could not be introduced suddenly. Gradualism would be necessary in order to balance its effects on individual taxpayers and jurisdictions over time.

Such a reform would raise also several outcomes:

- it would reduce fiscal ‘room for manoeuvre’ for local governments (a clear disadvantage for them, but an advantage from the central government viewpoint);
- it would put more pressure on parliamentary debates relative to indexation and distribution rules of grants to local governments;
- it transfers the adjustment process of balancing local budgets onto narrow-based property taxes, which would remain the only tax instruments in the hands of local governments;
- it places the central government in a difficult position, between pressure groups asking for tax limitation for firms, and local government pressure groups calling for an increase in tax rates;
- it removes or lessens any incentive for local governments to take into account the situation of the firms located in their jurisdiction.

An alternative view is to rely more heavily on voluntary equalisation of TP receipts (Guengant and Uhaldeborde 1995, 1996a, 1996b; Lucas 1996).

A large array of fiscal incentives are already available for local governments which decide to merge or to delegate some of their responsibilities to larger institutional units (syndicates of communes, districts, urban communities). New formulas have been available for this purpose since the establishment of the Regional Development Act of 6.2.92 (communities of towns and communities of communes) (Bouvier 1994). In all, there are more than 19,000 multi-communal units in France at present. More than 1,100 of them, totalling 25 million inhabitants, have separate taxing power. Two alternative taxing regimes are available: an additional one, or a substitutive one. In the case of the former, the multi-communal unit *adds* its own tax rate on local business to that of the communes in the district; as regards the latter, the district *substitutes* its own TP rate with those of the communes. Some fiscal incentives are given to communes entering the substitutive regime.⁹

The actual taxing and spending behaviour of communes differs sharply depending on whether they choose the additive or the substitutive regime. In the first case, one observes that the overall tax burden (communes rates+ district rate) and total public spendings increased; the transfer of responsibilities to the multi-communal entity did not lead to economies of scale and a transfer of tax resources to the community. In the substitutive case, it seems that the overall tax burden remained fairly stable over time.¹⁰

In short, the question of whether this ‘voluntary mutualisation of the TP’ moderates the gradual increase in local public spendings and the tax burden on business is still open. One might think that the voluntary merging of local tax powers is to be encouraged, but it remains only a partial solution to the problem of equalisation.

5

CONCLUDING REMARKS

France occupies a singular position in the European context with respect to multi-unit finance. Direct local taxation is a major source of financing local governments and relies heavily on a wide-based tax on business. This tax base is quite unevenly distributed over the national territory. This 'natural' uneven distribution is magnified by several institutional factors: the extreme fragmentation of local jurisdictions which have been given wide-ranging responsibilities since the 1982 Decentralisation Act, and benefit from substantial tax autonomy.

All these factors lead to huge disparities in fiscal needs and financial means among jurisdictions, which call for a broad efficient system of intergovernmental fiscal relations. The system is indeed large and complex. Its fundamental aims are to compensate for and equalise fiscal disparities. Compensation has probably been achieved to some extent but at the expense of a continuous increase in the amount of transfers to local governments. However, this favourable situation may well not be reachable in the future. The equalisation performance—extremely demanding in the context described above—remains partially unknown. Some preliminary studies conclude that 40 per cent of the per capita differences in local tax capacities could have been equalised through the main block grant (the DGF). But global estimations of the equalising performance of the whole system of transfers are a task for future research.

The present macroeconomic constraints and the perspective of European monetary union requirements (Maastricht parameters) have led to a number of judicious reforms. A 'stabilisation agreement' has been proposed (imposed) by the Ministry of Finance on local governments in order to limit the evolution of the overall amount of transfers in the future. This could lead to potentially important consequences on the equilibrium of local public finances.

The key to a long-term solution of the question of stabilisation of intergovernmental fiscal relations is surely reform of the local tax system. A piecemeal, gradual tax reform appears both inadequate and difficult to achieve with 50,000 jurisdictions boasting a greater or lesser degree of independence. More drastic reforms are probably needed. Two alternative views are presently considered.

The first relies on a compulsory (re) centralisation of the local business tax; in this case, Parliament sets a sole tax rate for all French local jurisdictions: receipts are totally or partially redistributed to local governments according to criteria also set by Parliament. This reform is thus similar to the 1990 reform of the uniform business rate in England. The second view relies more on voluntary fiscal cooperation among local units which could lead, if incentives were attractive enough, to a drastic reduction in the number of taxing entities (100 large urban districts and a few hundred rural districts).

Once again, France is facing the well-known dilemma (Gilbert and Guengant 1991a). On the one hand, a conservative solution which keeps local tax bases inadequate, ensures substantial local tax autonomy and thus huge disparities in tax capacities among jurisdictions, and would eventually lead to more intergovernmental fiscal grants. Is this either desirable or possible in the present macroeconomic situation? On the other hand, a solid reform of local tax bases and their distribution among the levels of government would lead to a lack of local autonomy on taxation.

Notes

- 1 The last census took place in 1970 (for improved land) and 1966 for unimproved land; their results were introduced in the tax bases in 1974. A general revision of the census was completed in 1990, but is not yet in force.
- 2 For a careful analysis of the respective contribution of price increase and volume increase in the augmentation of the tax base, see Guengant 1997.
- 3 Tax receipts are defined as the product of tax bases times the nominal tax rate approved by the local assembly.
- 4 See Guengant and Uhaldeborde 1996b, for selected scenario of evolution of the DCTP.
- 5 A national council of 11 independent experts, which produces public reports on taxation. The last report was published in February 1997 and devoted to the TP.
- 6 Since a 1995 Act, the fiscal instruments of the regional development policy have been reformed. A FNAT (Block grant for regional planning) has been created which consolidates three former funds; three additional funds have been set up FGER (Block grant for rural development); FPTA, FITT and FIVN (Equalisation grants for air transportation and for surface and water transportation). In addition, three new zonings have been created (ZAT (Areas of regional planning), which are eligible for the PAT (Regional planning subsidy), TRDP (Rural development target areas), and ZUS (Urban target areas)). A positive discrimination policy has been introduced which benefits the firms located in these less developed areas through fiscal and financial incentives (Guengant and Uhaldeborde 1995).
- 7 The impact of a reform similar to that of the uniform business rate in the UK (a business tax based only on immovables) has been estimated. The reform entails large changes in sectoral tax liabilities (financial activities benefit from the reform at the expense of energy or distribution bands).
- 8 The Council of Taxation has simulated the consequences of the introduction of an equalisation scheme similar to the German one, in which the grant attributed to a jurisdiction is a function of the 'weighted' number of inhabitants and the weight per capita increases with respect to the number of inhabitants in the local jurisdiction.
- 9 Basically, an increased per capita grant (DGF). For more details see Bouvier 1994, Guengant and Uhaldeborde (various years); Blanc 1996; Council for Taxation 1997.

- 10 Several constraints are imposed on the variation over time of the TP rate: for example, the increase in the TP rate is linked to that of property taxes in the communes the previous year.

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7

Experiences with German fiscal federalism: how to preserve the decentral content?

Horst Zimmermann

1

INTRODUCTION

Germany is a young federation. The constitution ('Basic Law'), but also the nation itself in its present form, only go back to the year 1949, with the result that the constitutional framework is still rather fresh. Just recently some issues have come up for debate and decision, among them the role of the intermediate level (Länder) *vis-à-vis* a strengthened European Union, and the tax mix of local governments.

Throughout these diverse, ongoing subjects an underlying theme can be identified: the almost half of a century of German federalism has seen an unbroken process of centralisation, some steps taken quite openly, but most of it in an unobtrusive way, slowly eroding some of the substance of decentral decision making, which the founding fathers had provided in 1949.

This theme is taken up here. After a brief reflection on the principles underlying the endeavour to have extensive decentral decision making, two subjects are analysed more closely. One is the German experience with 40 years of centralising tendencies in a federal system.¹ The second subject is more general: if long-term centralisation occurs, where is the logical place in a federation to bring this subject onto the agenda for discussion and political action? In Germany this is clearly unsolved, and perhaps other countries, federal or unitary, can profit from this search, provided they want to preserve or introduce a strong decentral element in their fiscal system.

2

THE BASIS: TWO PRINCIPLES OF FISCAL FEDERALISM

In [Figure 7.1](#) a few well-known elements of fiscal federalism theory are assembled. In a large, populous and high-income country with a considerable public sector there exist enough types of publicly provided goods with different 'benefit areas' (R.A.Musgrave) to allow for different levels of government,

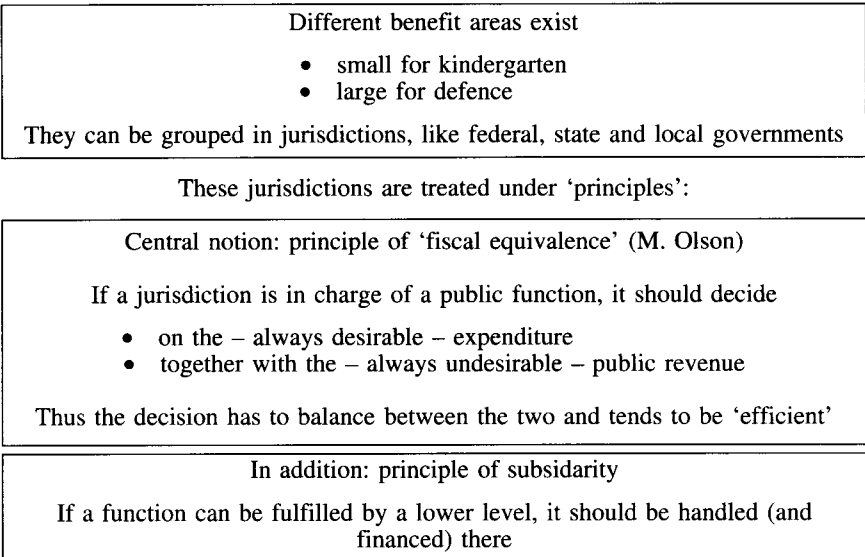


Figure 7.1 Basics of fiscal federalism.

provided that they are deemed desirable on political grounds. Fiscal federalism theory has established that from an economic perspective it is efficient to have decentral decision-making units, if this prerequisite is given. Much of this is based on observed regional differences in preferences, as may be assumed for North versus South in Italy, the USA and Germany, but at least as strongly along ethnic lines like in Belgium or Spain. Subcentral decision making can reduce frustration cost² and enhance grass-roots democracy.

Once subcentral units have been established, in order to reach efficiency in each unit it is necessary, following Olson's principle of 'fiscal equivalence',³ that there be simultaneous decision on two subjects:

- 1 A decision on—always desirable—expenditures. Taken by themselves, for instance if they are financed by a different level of government, expenditures tend to be very large, limited only by the ability to attract funds from somewhere else.
- 2 A decision on—always undesirable—public revenues. Taken by itself this element of public finance would tend to keep a budget very small.

Therefore it is crucial that the decision on the amount of expenditures should be taken by the same—representative—body which is held responsible for financing. Money coming from a different level is 'inexpensive' money and is spent more easily. Functions fulfilled for a different jurisdiction, for instance for

the inhabitants of the adjacent region or community, tend to be reduced below their reasonable level.

Whereas this principle of ‘fiscal equivalence’ will show up several times in the following arguments, a second principle is mentioned mainly here: the principle of subsidiarity. Olson’s principle only clarifies what happens on each level in order to achieve efficient performance in the public sector. Given the fact that many of the empirically observable public functions can be allocated to either of two or maybe even three tiers of government, and given the second fact that there seem to exist in any federation inherent tendencies to centralise over time, a federation should observe a second principle which says that in any case of doubt a function should be handed to the lower of the possible levels of government, and that a function may only be taken up by a higher level if it has been proved that it cannot be adequately fulfilled—even with outside support—by the lower level. This is the essence of what has been the principle of subsidiarity in German social policy, where it was aimed at preserving the social groups of family and neighbourhood *vis-à-vis* the stronger and more encompassing institutions of church and government. Only rather recently the principle has been extended to the discussion of fiscal federalism, and from there it entered the Maastricht Treaty of the European Union.⁴

The following remarks on German federalism, with a view on their applicability to other countries, are organised along the elements of fiscal equivalence: the regionally self-determined expenditures and the concomitant self-determined revenues.

3

PATHS TO CENTRALISATION IN GERMANY

3.1

Regionally self-determined expenditures?

The danger of imprecisely defined functions of the lower levels

The German Constitution of 1949 (Basic Law, BL) decides which functions are to be fulfilled by federal, regional and local governments. In a formal sense it leaves all functions to the regions (Länder),⁵ unless specified otherwise in the Constitution. This ‘unless’ goes very far. First of all, some broadly circumscribed local functions are set aside. Local governments in general are rather badly represented in the Constitution, only some tax revenue is assigned specifically. Second, several federal functions are explicitly mentioned (exclusive legislation, Art. 73 BL), like foreign affairs, currency, defence, etc. Third and most important, Art. 73 and 74 BL list numerous functions as the subject of ‘concurrent legislation’. This means that ‘the Länder shall have the power to

legislate as long as, and to the extent that, the Federation does not exercise its right to legislate' (Art. 72 BL). Though there are some specifications tied to this federal legislation of—otherwise—Länder functions, this did not prevent most of these objects of concurrent legislation being extensively legislated by the federal government over the past 40 years. This is the first of several instances where deliberately open provisions of the constitution have, over time, been the path to strong centralisation in the German federal system.

There is a definite lesson to be learned from this experience: whatever function is to be given to the middle or lower levels, it should be specified in unequivocal terms. The provision should rather limit itself to a small number of regional functions, but should then safeguard them against inroads in this legal territory by the upper levels. If a federal element to an otherwise regional or local function seems necessary, then that element should be specified as precisely as possible. In general a strong 'subsidiarity test' should be introduced, stronger than that which entered the European Union Treaty through the agreements of Maastricht.

These precautions seem the more important in Italy, where no full equivalent to the German second chamber (Bundesrat), which consists of delegates of the state parliaments, seems to exist. It is most important to have a strong representation of the middle and local levels at the central level, which can serve as a real stronghold of subcentral interests, not only in constitutional debates, but also in daily defence of these interests. If even a rather strong institution like the German Bundesrat has not been able to prevent centralisation, it can easily be imagined what the speed of centralisation might be, if strong constitutional guarantees for the lower levels, as far as specific functions are concerned, are also missing.

'Joint tasks' and the conferences of regional ministers

1969 was a year of major changes in the German Constitution, mainly concerning the relations between the three levels of government. As one of the reforms three 'joint tasks' were introduced: regional policy, university construction, and agricultural structural policies. All of these functions had been pure regional functions before. Now federal co-financing was introduced, and the decisions were to be taken by a joint body of federal and state officials. The result was some coordinated effort, but above all much stalemate. The outcome has not been a streamlined unified policy with generally accepted results, but a long straggling process with much compromise.⁶ An example is regional policy. Here, the area where subsidies were permitted was extended to about two-thirds of the country's territory, thus satisfying as many members of the decision-making body as possible. For such reasons disillusion with this new constitutional feature has become widespread in recent years.

At this point it may be useful to mention another, in this case powerful, set of institutions which came into being through daily routine, not through

constitutional provision: the conferences of regional ministers. They organised themselves over time for almost each regional public function like education, environment, transportation, etc. They meet very often, and, though they are not able to issue sanctions, if a member does not follow the agreed policy, the social pressure to comply with such a decision is very strong in Germany. Although these agreements may be very helpful in some fields, like traffic rules, they are hampering innovation in other fields, like school systems.

The lesson to learn from the ‘joint tasks’ is again that, in order to secure the rights of regions, it is better to have separately decided functions, one at the federal level, the other purely at the regional level. Again, if only one element of a function is supposed to be decided nationwide, it should be specified. Joint decisions should be avoided. Ministerial conferences are more difficult to evaluate and deal with. Quite some coordination is advisable between regions, but the—implicit—exclusion of regional parliaments and the tendency to streamline everything (at least in Germany) can become a problem for regional diversity.

A foreign observer would probably note that in spite of their constitutional right to act diversely, all German states act very similarly, for instance through these interregional ministerial conferences. Historians ascribe this to Germany being a ‘late nation’, a term coined by Plessner.⁷ There has been a longing for unity in all of fragmented Germany throughout the nineteenth century. Also, the first draft of the German Constitution in 1949 was much more centralist than what exists now and was ‘softened’ through intervention of the Allied powers. The most obvious result of this tendency is a strong degree of interregional equalisation, both through similar state activity in laws and through equalisation in money terms (see [section 3.3](#) on page 169).

A major negative result of the ‘joint tasks’ and the conferences of regional ministers is the fact that the regional parliament’s agenda has clearly been thinned out (see [Figure 7.2](#)). Joint decisions are by necessity a matter for the executive branch of both federal and regional governments. But whereas the federal government has so many functions to fulfil, not least the new functions ensuing from EU obligations, it is the regional parliament which loses important subjects on which to decide. The conferences of regional ministers are, by definition, administrative bodies. They also pre-empt regional parliamentary decisions. If one regional parliament wants to act on its own in a field, the relevant minister will point to the agreement in the conference and warn of deviations. In [Figure 7.2](#) the arrows show the additional interactions, excluding parliaments from the current processes.

3.2

Regionally self-determined revenues?

As a rule the allocation of revenues should follow the allocation of functions. In a federation, for instance in Germany, this usually occurs through gradual

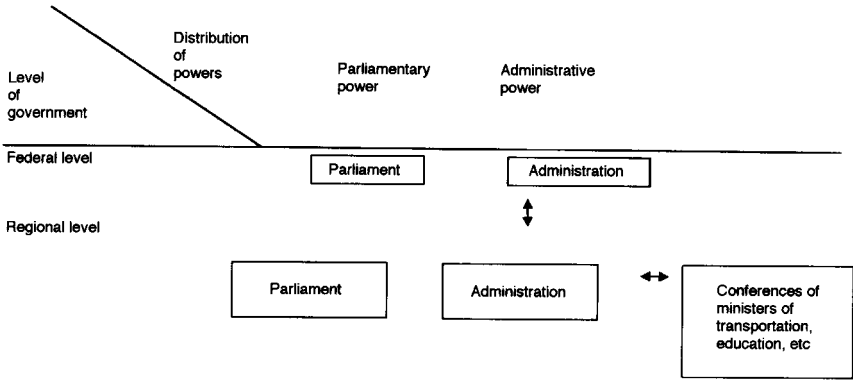


Figure 7.2 Administrative interaction.

constitutional changes. But which type of tax is allocated to which level of government may in turn also influence the budgetary growth and thus the functions. If one level is given those taxes which automatically increase over time, above all income taxes, and the other level receives taxes which tend to stagnate, like property or excise taxes, this will have an effect of its own. In general the criteria which apply to a local tax⁸ (as opposed to a central government tax) can also be used to see whether a specific tax is fit for the regional level or not.

Possibly more important than this sorting out of specific taxes is the question of which type of revenue in general should dominate a regional budget. The different types of revenues can be arranged by degree of fiscal autonomy for the receiving jurisdiction. The top of the scale is marked by a fully decided tax, with decisions on yes or no, on the tax base and of course the tax rate. At the bottom of this scale the conditional grant marks the case where not only the amount of the revenue is insecure, but where even the use of the incoming money is determined elsewhere.

On this scale German regions are in a middle position. There are few federal grants, and almost all of these are actually federal funds meant for the local level, which by German constitutional law may not be extended by the federal government directly to local governments, but have to pass through the state budget.

Regional budgets mostly consist of tax revenue from shared taxes. In general more than 80 per cent of the taxes of all levels in Germany are shared taxes. What is very important in this context is the fact that all of these shared taxes are federally decided taxes: all tax laws are federal.⁹ Most of this resulting tax revenue is received—by regions or communities—on the derivation principle, i.e. they follow the regional origin of the tax revenue. A region receives from a tax the percentage of the tax collected in its particular area. Therefore regions with a strong tax base receive more, and regions with a small tax base less, than the

average. An outstanding feature of the German tax-sharing system is the fact that regions have no right to set the rates for their shares, and neither, as a matter of fact, for their own taxes!

Local governments can set the rates on the real estate tax and the business tax (*Gewerbesteuer*) and only have to hand over some of the revenue base of the business tax to regional and central budgets. Their biggest tax revenue consists of an income tax share, for which they cannot set rates (though the Constitution explicitly permits a law that could provide for this).

What does such strong tax sharing mean for regional and local fiscal autonomy? Tax sharing by regional origin is much better than grants. This has to be pointed out, because very often the notion is put forward that if tax sharing occurs one might as well extend grants instead, with no difference to the receiving jurisdiction. Tax sharing by regional origin means that a region is kept interested in its tax base. It will attract business and people, because in that manner taxes on business and on people will increase, and so will the share which the region receives from this tax base. Moreover, tax sharing can be far better guaranteed in the Constitution than grants, which are usually extended on the basis of annual laws or of constantly changing formulas. The constitutional provisions in Germany have formed one of the major elements in allowing the regions (and in this respect also the communities) to retain a major share in the total German fiscal system.

The biggest disadvantage of German tax sharing is to be seen in the fact that regions cannot set tax rates on all of their shares, and communities cannot set them on their income tax share. This aspect of German fiscal federalism is difficult to explain to a foreign audience which believes in Germany as a federation, above all in the light of the above-mentioned fact that on the side of public functions German regions are, judged superficially, responsible for ‘all functions, unless...’. I do not hesitate to call this a major flaw in the German fiscal system. Having no right to set tax rates, the regions are left with very little fiscal flexibility. They therefore tend to turn to public borrowing more than is necessary, and they are totally free to do so. As a result, we have recently witnessed two cases of bail-out, Saarland and Bremen, which had gone so deeply into debt that they were not able to consolidate their budgets in the medium term. Due to this lack of regional tax rate-setting in Germany, fiscal equivalence cannot work, because the marginal expenditure demands cannot be equalled with the marginal tax bill, as is possible for the federal budget and—within limits—the local budgets.¹⁰

The main lesson to be learned from the revenue side in Germany is that tax sharing has its advantages and disadvantages. The advantages can be seen in the effects on regional incentives and in the chance to safeguard this revenue source in the Constitution. In addition, only one law is necessary, which makes it easier for businesses and people to comply with tax laws. Also the administrative cost is most probably lower than in the USA, for instance, where all three levels of government can levy income tax and where, in major cities, separate tax

administration offices for state, federal and local income taxes exist side by side. Tax sharing is in any case better than a federal grant.

However, if tax sharing becomes a major element in a federation, one must be sure to introduce tax-setting rights for all levels of government. This can occur in the form of piggy-backing, where one level of government accepts the basic structure of the other level's tax and only adds a surtax. A possibility discussed recently in Germany¹¹ works on the given tax-sharing arrangement and would allow each level of government to vary its normal share—probably within limits—up as well as down. So if a region is entitled to receive 30 per cent of its tax base, it can increase or lower the rate which the taxpayer has to pay, within a predetermined limit. In administrative terms, it has turned out that this would not be very difficult to handle in the German system.

The message from the totality of these experiences with German subcentral functions and revenues over the past 40 years is summed up in the notion that whatever you want to allocate to the regions, do it thoroughly, as long as there is a lively constitutional debate. After that you may see decades of inadvertent centralisation, if the history of the USA and of Germany are taken as examples. You will encounter occasional efforts to stem this tide, but successes seem to be only temporary.

3.3

Equalisation—the overwhelming issue in Germany

So far, all aspects discussed in this chapter relate to the vertical allocation of functions, revenues and decision-making power. Even the best possible vertical allocation will not, however, prevent the existence—in Germany as well as in Italy—of

- regions with high tax base and low expenditure need, side by side with
- regions with low tax base and high expenditure need.

Such horizontal differences exist on each subcentral level, and therefore horizontal equalisation is always an additional issue to be dealt with.

For the aforementioned reasons, Germany is heavily distribution-minded, above all in the regional dimension.¹² Horizontal fiscal equalisation between regions, but also between communities, is a feature in the Constitution, and in addition, some federal regional policies for badly-off regions were started up at an early stage.

Equalisation between regions and between communities in Germany is a very complicated matter. The most hotly debated issue is that of the degree of equalisation. In the existing equalisation systems between regions in different federations of the world, Germany is probably the one with the highest degree of equalisation. As a consequence, regions and local governments do not have much fiscal incentive to attract business and people, and they may have a greater desire

to avoid unemployment than to increase tax revenue, if they still want to compete for business and people.

The lesson to be drawn from this is that one should beware of early strong equalisation. It will probably occur later anyway. The United States and Switzerland, however, prove that an advanced federation can also thrive without strong equalisation, and this again is probably easily explained by the different historical background.

4

HOW TO RETAIN THE DECENTRAL CONTENT?

4.1

Increasing centralisation—a particularly difficult problem

During 40 years of German federalism after World War II a continuous process of centralisation has occurred. This is true for the state level *vis-à-vis* the federal government, and even more so for the local level *vis-à-vis* both upper levels of government. The particularly weak situation of the local level is due to two facts. First, the local level is not very well secured in the Constitution, whereas the state level has a great number of specific articles, thus ensuring its strength. Second, the local level has above it two levels, which could assume functions from the local level. Therefore, the question of how the loss of power can be stopped or partially reversed is particularly acute for the local level in Germany, but to a degree the same holds true for the state level.

If this loss of decentralisation is looked at in political terms, it must belong to a set of problems¹³ which are difficult to keep on the political agenda in general, because the problem is acknowledged, but remedies are not easily found. Other major problems in different political fields have actually been solved, at least partially: increasing traffic, for instance, through transportation policy and environmental problems through the new branch of environmental policy. As opposed to these fields of policy, the silent erosion of the federal system apparently belongs to a class of problems which are more difficult to keep on the agenda. They are not 'result-oriented' as are the activities of transportation, environmental or social policies, where the result of any measure can be immediately and directly read from quantitative indicators for the objectives of that policy. In comparison, between any activity to strengthen the decentral level on the one hand, and a later better functioning of public goods provision or democratic decision making on the other, lies a complex process in which many actors have been involved. Besides these specific activities, many other determinants influence the process, and the final degree of achieved decentralisation does not enable us to determine the exact role played by individual institutions. Such 'process-oriented' objectives therefore lead to a

silent erosion of the originally satisfying situation, and they then prompt a flurry of political activity to achieve the objective.

4.2

The acting institutions from a public choice perspective

This situation begs the question of where in the pattern of German institutions the ‘proper place’ would be for this issue to be put on the political agenda. To try and provide an answer, the current institutions are analysed from a public choice perspective. If a loss of decentralisation or a need for stronger decentralisation is discussed in any other country, the institutions of that country would have to be analysed in a similar way, and some problems may resemble those in Germany.

Public choice theory assumes that people acting in institutions pursue—at least to a considerable degree—their own interests. Once these interests are known, it is possible to devise rules to channel this self-oriented activity into a desirable direction. The setting of such rules is the subject of institutional economics and of constitutional economics, of which Nobel prize winner James M. Buchanan is the best-known advocate.

The European Union

For the members of the European Union the institutions in Brussels constitute a new layer of government, even if it is so far very ‘thin’. With respect to the lower levels of government of any member country, the European Union at the moment appears rather as an element of additional centralisation. In many respects it influences the state and local levels, bypassing the central level, and generally speaking it is not to be expected that the rather centralist bureaucratic interest of the European Union could lead to any initiative to strengthen the lower levels of government.

The central government

The central government of any country could be conceived of as being situated above all other institutions and under obligation to serve only the common good of the whole country. In Germany it could then be seen as the current constitutional lawmaker which continues to develop the Constitution (Basic Law) of 1949 with its undoubtedly strong decentral elements.

In Germany the Ministry of the Interior and the Ministry of Finance are supposed to be responsible for questions of the federal system. But the federal Ministry of the Interior has not advocated any decentralisation, and the federal Ministry of Finance has, for instance, explicitly argued against tax rate setting by communities.¹⁴ Instead, it emphasises the unitary component and seems not at all worried about the present state of centralisation.

From a public choice perspective this is understandable. In the current political process the central government issues laws for the other levels of government and hands out money to them, but it itself is not under any influence from these other levels. Federal activities only work top-down and thus against decentral decision making. Undoubtedly, many of the federal functions are necessary, and the original list of federal functions in the Constitution was adequate. But many of the federal decisions are questionable, such as the recent examples of welfare payments and kindergarten provision, but also the federal laws concerning state and local taxes without decentral tax rate-setting authority. Continuous activities of that kind lead to the internalisation of attitudes. It is supported by a still strong German tendency to 'look up to authorities' (the term *Obrigkei*t does not have an equivalent in English!). Such attitudes would be unthinkable in Switzerland or in the United States, where the central government is not usually looked on as the main source for problem solving, and this is also true for public revenue, where lower levels would not lay the blame for temporary revenue shortage on the federal Ministry of Finance in the first place, as happens regularly in Germany.

The constitutional court

The constitutional court, if properly designed, should be intended to serve the whole of the—federal—nation, by highlighting, when looking into questionable laws, unacceptable developments, and by doing this in a way which cannot be overlooked.

But has the German constitutional court (Bundesverfassungsgericht) served as a bulwark against centralising tendencies? When in 1969 three state functions were made 'joint tasks' of both levels (see above), the constitutional court did not oppose this. A constitutional court should certainly not be overburdened with functions because it is not supposed to act politically itself. But has it done enough in the sense of admonition?

The state level

In a federal system states have a two-sided position. In Germany, at least, they are adamant *vis-à-vis* the federal government, for instance by pressing for the change in Article 23 of the Constitution concerning their influence in matters of the European Union. In the second chamber (Bundesrat), they also have a very strong position in many legislative procedures. Last but not least they created the aforesaid conferences of state ministers on transportation, the environment, etc., which serve as a kind of substitute for the central government in many respects, thus changing the weights in the federal pattern. At the same time the German states are victims themselves, as the complaints on the emptying of the state parliamentary agenda show. Stricter central government laws and the handling of

the 'joint tasks' on a purely administrative level have contributed to this development.

Vis-à-vis local governments, however, the states themselves act in a very centralist manner. Here they are guided by self-interest, similar to the central government. They stick to a considerable share of conditional grants, because these allow direct influence. They permit the federal government to reduce local functions, without using their power in the second chamber. Finally, the state laws influence local activity considerably, thus weakening the decentral content of the federal system further.

Local governments

One might expect local governments to be the only level which is unequivocally interested in more decision-making power. Strangely enough, this is not true on all accounts.

It holds true for local functions in general, though in the individual function the local bureaucrat often likes to collaborate with his counterpart at the state level, even if the local parliament has a different opinion. Conditional state grants are a good instrument to increase the importance of the local bureaucrat's individual working field, as opposed to tax revenue and unconditional grants over which the local parliament has full authority.

The major problem, at least in Germany, seems to be on the side of local taxation. The local business tax provides tax rate authority for the local government, but the slightly larger income tax share does not, though the Constitution permits it. Apparently, local governments are not particularly interested in this tax rate authority, and public choice theory offers an easy explanation. Unconditional grants and an income tax share, of which the local voter hardly knows the existence, not to speak of his own contribution, hamper the working of fiscal equivalence: local projects are financed out of money for which the local parliament is not responsible *vis-à-vis* its electorate. The fact that the income tax share as the only tax which connects the individual citizen with his or her local government (apart from the rather small property tax) does not allow tax rate variation, is certainly a major flaw in the German federal system.

A second danger looms large. German local governments lost part of the business tax (that on business capital), and in return received 2.2 per cent of the revenue of the value added tax (VAT). As there is no chance to have a tax rate variation on the local share of VAT, that money comes to local governments in the form of grants tied to local economic activity. The rest of the business tax is under attack from the business side. Although it has recently been secured in the Constitution, it is still imaginable that with the passing of time local governments may be willing to give up that part of the business tax for an additional number of percentage points of VAT. In that case there would be hardly any tax to speak of in the local system where local governments would be able to vary the tax rate and thus live up to the principle of fiscal equivalence.

4.3

The need for enforced responsibility

As such a final system would be compatible with the interests of local government itself (not the local electorate), one cannot expect local government to fight for local tax rate variation. However, if fiscal equivalence is to be considered the driving element for fiscal efficiency at any level of government, then responsibility has to be enforced, and this time certainly 'from above'. Certain rules and institutions have to be changed in order to improve the process.

From this perspective all local taxes should be supplemented by rate-setting authority. On the side of functions, more functions should belong to one level exclusively. One could even consider prohibiting the assumption of a function by a higher level, even if the losing lower level agrees! The German experience shows that during the last half century the regions gave up three functions in 1969 and also agreed to many other federal 'assumptions'. And local governments willingly agreed to give up functions, particularly if they were costly and if at that time it looked as though local budgets would be relieved. In the long run, naturally, both lower levels of government respectively were left with fewer functions to decide upon. And in the long run they also found themselves with less self-determined revenue to spend on their remaining functions, because the allocation of revenues over time followed the fiscal weight of the expenditures necessary to fulfil the functions. Therefore, such a far-reaching rule would prevent the slow erosion of the decentral elements in a federation, because the end of the process, the observable higher degree of centralisation, is usually something which is later looked upon with regret.

To sum up: perhaps regional and local levels should, by constitutional rule, be saved from their own short-sightedness, and forced to practise more fiscal responsibility. To bring any major change like this about, it is ultimately unimportant whether it be a federal initiative, a process started by a high ranking commission, or an intervention by the constitutional court. Generally speaking, there must be some kind of basic discussion in Germany about how local governments in particular, with their weak constitutional basis, can be induced to more responsible decision making, thus balancing additional revenue with additional expenditure. This, after all, is the level which is closest to the citizens, and where democracy can be strengthened most easily.

Notes

- 1 This part, with reference to the Spanish situation, was discussed in Barcelona in 1994. See Zimmermann, H., 'Lecciones para los niveles intermedios de gobierno: la experiencia del federalismo fiscal alemán', in Institut d' Estudis Autònomicos (ed.), *Seminario sobre la corresponsabilidad fiscal y nivelación de recursos*, Barcelona 1995, p. 35ff.

- 2 Pennock, J.R. (1969), 'Federal and unitary government—disharmony and frustration', in *Behavioural Science*, IV: 147ff.
- 3 Olson, M. (1969), 'The principle of "fiscal equivalence". The division of responsibilities among different levels of government', in *American Economic Review*, 59:479ff.
- 4 As to this process and the origin of the principle see Döring, T (1994), *Subsidiaritätsprinzip und EG-Regionalpolitik*, *Schriftenreihe der Gesellschaft für Regionale Strukturentwicklung*, vol. 19, Bonn, p. 23ff. See also Thöni, E. (1994), 'The consequences of subsidiarity in the Maastricht Treaty for fiscal federalism', in Urban, S. (ed.), *Europe's Economic Future*, Wiesbaden, p. 77ff.
- 5 For jurisdictions on the middle level, like Länder, US states, Italian regions, etc., the term 'regions' is used here. The term 'state level' would lead to confusion with unitary countries, where 'state' denotes the central government.
- 6 Scharpf, F.W. (1988), 'The joint-decision trap: lessons from German federalism and European integration', *Public Administration*, 66:239ff.
- 7 Plessner, H. (1982), 'Die verspätete Nation', in Plessner, H. (ed.), *Gesammelte Schriften*, vol. 6, Frankfurt, p. 7ff.
- 8 For the criteria see Zimmermann, H. (1987), 'British and German local business taxes under criteria for a "good" local tax', in *Government and Policy*, 5:43 43ff.
- 9 Only some of the very small among the local taxes are legislated by the states or even the local governments.
- 10 As opposed to the legislative rights and the rights to receive revenue from a tax, the third element, tax collection, can easily be handled by one level only. That level would then, possibly after deducting expenses, hand the other shares to the other levels of government. Thus in Germany most of the shared taxes are administered by the regional level (not the federal level!).
- 11 Hansmeyer, K.-H. and Zimmermann, H. (1993), 'Möglichkeiten der Einführung eines Hebesatzrechts beim gemeindlichen Einkommensteueranteil', in *Archiv für Kommunalwissenschaften*, 32:221ff.
- 12 But it is also true as far as personal income distribution is concerned.
- 13 Zimmermann, H. (1996), *Wohlfahrtsstaat zwischen Wachstum und Verteilung*, München, p. 12ff. for the general notion and 131ff. for the federal dimension.
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8

Local governments in Great Britain

David King

1

INTRODUCTION

Any chapter on fiscal federalism in Great Britain must begin by explaining exactly what Great Britain comprises, and this is done in [section 2](#). [Section 3](#) gives an account of the structure and functions of local authorities in Great Britain, while [section 4](#) gives an overview of local spending and revenues. [Section 5](#) looks more closely at local taxation while [sections 6](#) and [7](#) look more closely at grants. Finally, [section 8](#) ends with a note of the main current problems.

It is worth noting that, since World War II, the United Kingdom has taken a rather cavalier approach to reforming the structure of local government, and has thereby produced more radical reforms than many other countries would dare undertake. It has also, especially in the last decade or so, taken many steps towards reducing financial autonomy, to the extent that tax revenues in the United Kingdom are now among the most centralised in any OECD country. To supporters of decentralisation, perhaps the best that can be said on the financial side is that the current domestic property tax has some interesting novel features, and that the system of equalisation grants is second to none in pursuing equalisation.

2

GREAT BRITAIN

The Parliament in Westminster, London, governs the entire United Kingdom. This comprises four separate countries, England, Scotland, Wales and Northern Ireland, whose populations are shown in [Table 8.1](#). It is the first three of these four countries that between them form Great Britain. The arrangements for local government have always varied slightly between the four different countries. The most different is Northern Ireland where, during the troubles of recent years, the central government has assumed many of the responsibilities that were formerly entrusted to local authorities. The future rôle of local government there is a

Table 8.1 The population of the United Kingdom by country, 1996.

<i>Country</i>	<i>Population (000s)</i>	<i>% of United Kingdom</i>
England	49,089	83.48
Scotland	5,128	8.72
Wales	2,291	4.97
Great Britain	57,138	97.17
Northern Ireland	1,663	2.83
United Kingdom	58,801	100.00

Source: Office for National Statistics, *Annual Abstract of Statistics*, 1998, 8.

matter for the new Northern Ireland assembly for which elections took place in June 1998. Owing to past differences and future uncertainty, this chapter ignores Northern Ireland and instead considers only Great Britain, focusing on England which is the largest country.

3

THE STRUCTURE OF LOCAL GOVERNMENT

3.1

Before 1960

To understand the structure and reforms of local government, it is useful to trace the history of local government very briefly.¹ The earliest boundaries were established over 1,000 years ago in both England and Scotland which were then independent countries. In each case, the king set up administrative areas known as counties. But these counties were not local authorities. Instead, they were simply administrative areas of the central government, and each had a sheriff to implement central government policy. The sheriffs' main function was securing law and order. This system of counties was later extended to Wales and Ireland.

The larger towns disliked being under the control of a sheriff, and in 1130 the town of Lincoln was allowed to opt out of the control of its county's sheriff, on payment of a sum of money direct to the king.² Effectively, this meant that its county's sheriff was now responsible for an area with a 'hole' in it, for he had no jurisdiction in the town of Lincoln. Soon, more and more towns paid to opt out of sheriff control, and they became the first local authorities. Their main functions were those that they took over from the sheriffs. In time, the ancient word 'borough' was reserved for these opted-out towns. The chief advantage to kings of creating boroughs was to secure one-off payments, and many boroughs were created by kings who needed money for crusades.

The power of the sheriffs was also cut by creating parishes in their remaining county areas to do some minor functions. The role of parishes was extended greatly in 1601 when English and Welsh parishes became responsible for the poor. This created a problem with the itinerant poor, who tended to migrate to the most generous areas. This problem was avoided in Scotland where poor people had to seek help from the areas where they were born.

By the late nineteenth century, relief for the poor had become a central responsibility. But, by then, government activity had greatly increased and local authorities acquired new functions. These included housing, education, refuse collection and disposal, fire services, social services, and water and sewerage, as well as increasing roads responsibilities. The new responsibilities were initially given to a plethora of bodies called 'boards', which were effectively single service local authorities. These boards had assorted boundaries which often overlapped.

The government rationalised the system in drastic reforms in the 1890s. Essentially, the aim of these reforms can be seen as an attempt to create a two-tier structure of local authorities, with the upper tier being formed by the old counties which became local authorities for the first time. The government was willing to respect the ancient county boundaries even though some counties were arguably too small. Kinross, for example had just 8,000 people. The lower tier was to be formed by a new set of much smaller, and so much more numerous authorities, called districts. The division of functions between the tiers was to be as shown in column 1 of [Table 8.2](#).

However, a complete reform on this basis would have abolished the privileges of the boroughs. To show respect for them, two amendments to the reform were adopted. First, the largest 90 or so boroughs were allowed to retain complete independence and perform all local authority functions. So these boroughs created 'holes' in the areas served by their surrounding counties, and also in the areas served by their surrounding districts. Second, many smaller boroughs were allowed to be independent of their surrounding districts and perform the lower tier functions themselves. The result was that many counties and districts had one or more holes in the areas they served.

3.2 From 1960 to 1996

By the 1960s it was clear that further reforms were needed. One problem was that the holes created problems. For instance, all the boroughs were responsible for housing and rubbish disposal, yet they often had little space to build new homes or dispose of rubbish. A second problem was that some areas were too small to provide services at a reasonable cost. As noted above, one county had a population of 8,000, and many districts had populations below 2,000. A third problem was that the counties were responsible for social services, and so had to

help families with problems; yet the main problem facing many families was having nowhere to live, and housing was a responsibility of the districts. Reforms took place gradually.³ The first reform was in London in 1965.⁴ Here, a different two-tier structure was established on almost entirely new boundaries. There was one upper tier authority, Greater London, and 33 lower tier authorities. There were no holes in the authorities of either tier. The authorities were all of adequate size for their functions. And, as shown in column 2 of [Table 8.2](#), housing and social services were entrusted to the same tier, namely the lower tier whose authorities have populations of 150,000 or more. Thus this London reform met all the main objections to the 1890s system.

Elsewhere, reforms were done in the 1970s on three different systems.⁵ A few islands off Scotland were given single tier authorities, or ‘unitary’ authorities, which were responsible for all local authority functions. Six large metropolitan areas in England were given two-tier systems identical to that in the London area, with a total of 36 lower tier authorities. Elsewhere, local government was given two tiers with a division of responsibilities similar to what had gone before, as shown in column 3 of [Table 8.2](#). The new authorities were still called counties and districts, except that the upper tier authorities in Scotland were called regions. But their boundaries were almost wholly new, for the new authorities were much larger, ranging up to nearly three million for one region in Scotland. A further feature of the reforms was that the boundaries were drawn up to ensure that there were no holes in the areas covered by any authority.

There were arguably two main problems with these new authorities in the non-metropolitan areas. First, social services and housing were still split between the tiers. Second, the authorities were very large. The government was almost obsessed with a view that there were economies of scale in the provision of local services, and its main aim was to ensure that all authorities could fully capture these economies. For example, there was a view that education authorities had to contain *at least* 200,000 or 250,000 people. No consideration was given to the possibility that large authorities might be, indeed would be, less able to cater for varying preferences, so there was no concern with local authorities being over 250,000. In fact, the result was that, outside London and the six metropolitan areas, education was provided by upper tier authorities that had an average size of some 750,000.

There would have been a case for further reforms in the 1980s to tackle these problems in the non-metropolitan areas. Instead, however, the only reform in the 1980s was the abolition of the upper tier in London and the metropolitan areas. There is little doubt that the government undertook this step because it felt these upper tier metropolitan authorities were spending too much and were of the wrong political persuasion. The abolition meant that some previously upper tier functions were handed down to the lower tier, while others were entrusted to joint boards, that is special one-function bodies run by representatives from each of the lower tier authorities. The current arrangements in these areas are shown in column 4 of [Table 8.2](#).

Table 8.2 Functions of local authorities in Great Britain.

<i>Function</i>	<i>Most areas until 1974^a</i>	<i>London 1965–86 and metropolitan areas 1974–86^b</i>	<i>Most areas since 1974^c</i>	<i>London and six metropolitan areas since 1986^b</i>	<i>Some areas since 1996^d</i>
	(1)	(2)	(3)	(4)	(5)
Education	Upper	Lower	Upper	Lower	Unitary
Secondary roads	Upper	Upper	Upper	Lower	Unitary
Police	Upper	Upper	Upper	Joint board	Joint board
Fire	Upper	Upper	Upper	Joint board	Joint board
Social services	Upper	Lower	Upper	Lower	Unitary
Tertiary roads	Lower	Lower	Lower	Lower	Unitary
Housing	Lower	Lower	Lower	Lower	Unitary
Refuse collection	Lower	Lower	Lower	Lower	Unitary
Refuse disposal	Lower	Upper	Upper	Joint board	Unitary
Water supply	Lower	—	—	—	—
Sewerage and sewage disposal	Lower	—	—	—	—

Notes:

a About 90 large towns had separate authorities responsible for all functions. Police in the London area were handled by the central government. The division between upper and local tiers varied slightly in parts of Scotland. From 1965, different arrangements were made for the London area as shown in column 2.

b The six metropolitan areas lie around Birmingham, Leeds, Manchester, Newcastle and Sheffield. Police in London are provided by the central government. Water and sewerage were provided by the upper tier in London until 1974 when they were taken over by the central government. They have since been privatised.

c This column does not apply to the London area, or to six metropolitan areas of England: see columns 2 and 4; nor does it apply to some islands off Scotland which were given unitary authorities. Water and sewerage were local (upper tier) functions in Scotland until 1996 when they were entrusted to independent authorities. See also column 5.

d This applies to Scotland, Wales and some parts of England.

3.3 The 1996 reforms

By the 1990s, the government felt it should have another look at local government outside the metropolitan areas. There were three main pressures leading to reform.⁶ First, the government had acquired a great enthusiasm for the idea of unitary local authorities which would in principle be responsible for all functions. The government believed that having just one tier would reduce administration costs and reduce confusion. Second, the government wished to remove some of the very large authorities which had been set up in the 1970s, feeling these were too large to be considered local. It added, here, that the new concept of local authorities contracting out some of their services to private providers meant that there was less need to be obsessed with economies of scale than was the case in the 1970s. In turn, contracting out meant that the 1970s authorities were often larger than was needed in the 1990s. Third, the government felt that some new local authorities had not been 'accepted'. The most obvious example was Humberside which had been given parts of two of the old counties, Lincolnshire and Yorkshire, which were on opposite sides of a wide river.

The results of the recent reforms can be seen in [Table 8.3](#). The government imposed wholesale reforms on Scotland and Wales. In Scotland, the unitary island authorities were left alone, while the other upper tier and lower tier authorities were replaced by 29 new unitary authorities with a mean population of 232,000. In Wales, the old counties and districts were replaced by 22 unitary authorities with a mean population of 100,000. In England, London retains its 33 authorities, which have a mean population of 212,000, and the six metropolitan areas retain their 36 authorities which have a mean population of 311,000. Elsewhere in England, a more piecemeal approach was adopted, with a commission looking at different parts of the country in turn. The result is that many two-tier areas were left alone. Thus there are still 35 upper tier counties, with a mean population of 737,000, and below them there are 220 lower tier districts with a mean population of 117,000. In some cases, however, the two-tier structure was replaced by unitary authorities; there are 28 of these with a mean population of 182,000. Some of these unitary authorities create a hole in the area serviced by a surrounding upper tier authority. The new unitary authorities in Scotland and Wales, and also the 28 in England, are not actually large enough for all functions. So here, too, there are some joint boards, as shown by column 5 of [Table 8.2](#).

The reforms of the 1970s and 1990s show that drastic reforms are possible. But this does not mean that the resulting structure is necessarily ideal. Some problems with the current structure are noted in [section 7](#).

Table 8.3 Local authorities in Great Britain, 1997–8.

<i>Area</i>	<i>Total population (millions)</i>	<i>Number of authorities</i>	<i>Mean population authorities</i>
England:			
London	7.0	33	212,000
Metropolitan areas	11.2	36	311,000
Other unitary authorities	5.1	28	182,000
Two-tier areas: upper tier	25.8	35	737,000
Two-tier areas: lower tier	25.8	220	117,000
Scotland	5.1	22	232,000
Wales	2.9	29	100,000

Sources: Table 1, Department of the Environment (1997a); Geographers' Map Company (1997).

4

CURRENT EXPENDITURES AND REVENUES OF LOCAL AUTHORITIES

4.1

Current expenditures

The main published figures for current local authority spending cover only spending from taxes and grants and therefore ignore any spending that is covered by fees and charges. This tax and grant-financed current expenditure of local authorities in the United Kingdom amounts to about 10 per cent of gross domestic product at market prices. Table 8.4 shows the current expenditure of English local authorities in the financial year 1997–8, that is 1 April 1997 to 31 March 1998, and it gives the breakdown of this spending by major service groups.

It is useful to say a little about each expenditure group covered by the table. In the case of education, local authorities provide schools but not post-school education. A small percentage of children attend independent schools, which, of course, are not covered by the table. Also, a small percentage of children attend 'grant-maintained' or 'opted-out' schools. These are schools which were formerly operated by local authorities but which, under the last government, were allowed to opt out of local authority control. These schools are effectively financed by the central government, but it pays the money through the local authorities where these schools are located, and this spending by those authorities is included in their 'other' spending.

Personal social services include services for children in need, elderly people, and others who are handicapped. Police spending covers police in all areas except London where police are provided by the central government. Highway

Table 8.4 Current spending by English local authorities, 1997–8.

<i>Item</i>	<i>£m</i>	<i>£ per head</i>	<i>% of total</i>
Education	18,814	383	32.66
Personal social services	8,804	179	15.28
Police	6,539	133	11.35
Housing benefit	5,862	119	10.17
Environmental services	4,457	91	7.74
Highway maintenance	1,692	34	2.94
Fire services	1,347	27	2.34
Libraries and art galleries	758	15	1.32
Parking and public transport	687	14	1.19
Sports and recreation centres	488	10	0.85
Interest payments	2,185	45	3.79
Other	5,979	122	10.38
Total	57,612	1,174	100.00

Source: Office for National Statistics, *Annual Abstract of Statistics*, 1998, 8, 327.

maintenance covers maintenance only on secondary roads as primary roads are the responsibility of the central government. Housing benefit is a scheme of transfer payments which is paid to poor people to help them pay their rent and help them pay the council tax which they pay to their local authorities. Environmental services chiefly comprise the collection and disposal of rubbish.

4.2

Current revenues

Table 8.4 shows that in 1997–8, English local authorities had a total current expenditure of £57,612 million. Table 8.5 shows how this spending was financed.⁷ The first two items reflect tax revenues, and the next two items reflect grant revenues. These are discussed in the following sections. The final item, other revenue, reflects various minor sources, chiefly drawing on bank balances built up in previous years.

5

LOCAL TAXATION

5.1

Rates

From at least the thirteenth century until the 1980s, the sole local government tax was a property tax called rates.⁸ This was levied on both domestic properties and non-domestic properties at tax rates, known as poundages, set by local authorities. The tax base was the annual, or rental, value of the property concerned. Revaluations were meant to occur every five years, but there were frequently deferrals in revaluations. For example, in England and Wales, there was a revaluation in 1973, but there was not one in 1978, nor 1983, nor 1988. The next one took effect in 1990, when the rates on domestic properties were

Table 8.5 Current revenues for English local authorities, 1997–8.

<i>Item</i>	<i>Revenue (£m)</i>	<i>% of total</i>
Council tax	11,251	19.53
Business property tax	12,034	20.89
Specific grants	11,061	19.20
General grants	22,016	38.21
Other	1,250	2.17
Total	57,612	100.00

Source: Office for National Statistics, *Annual Abstract of Statistics*, 1998, 8, 327–8.

abandoned, so this much delayed revaluation applied only to non-domestic property.

By the 1980s, rates accounted for roughly half of local current spending, and grants for the other half. The half covered by rates was met roughly equally by rates on domestic properties and rates on non-domestic properties.

5.2 The poll tax

In 1989 in Scotland, and in 1990 in England and Wales, the government effectively centralised the rates on non-domestic properties. It simultaneously replaced the rates on domestic properties with a poll tax.⁹ So domestic rates survived only in Northern Ireland. There is little doubt that a major reason for replacing domestic rates was the fact that in any forthcoming revaluation, there would be a substantial redistribution of the tax base between different areas. Officially, however, the case rested on four other arguments.

- 1 The domestic rates burden was very high in areas with high property values, chiefly London and south-east England. This was because the equalisation grant scheme in use attempted to ensure that equal tax rates in all areas would be required for similar spending levels.
- 2 Domestic rates were seen as inequitable. The classic example given was of a single pensioner living next door to a family with two working parents and two grown-up working children. These two households would pay identical rates yet have very different incomes.
- 3 Many people never saw a local rates demand, because this was sent only to one person in each household. It was felt that this could encourage any other voters in the household to vote for lavish services.
- 4 It was argued that local authorities provided services for people, not homes, and it was felt that there was little reason to suppose that people in expensive homes received more valuable services

While all these arguments could be mustered against the domestic rates, it was the philosophy which lay behind the fourth argument that led to a decision being taken to replace it with a poll tax. This poll tax was a flat rate tax on adults, with local authorities setting the tax per head in their areas. However, not everyone really paid the same amount, because means-tested transfer payments were paid to about 30 per cent of adults on low incomes to help pay some or most of the tax. Thus the poll tax was effectively an income tax on poor people, in that it was related to income, and a poll tax for everyone else.

The poll tax was very unpopular, chiefly on the grounds that poor people, or at least those not quite poor enough to receive help, paid as much for local services as very rich people. This argument was perhaps less robust than it seemed, for the poll tax covered only about 25 per cent of local spending, the other 75 per cent being financed by grants. These were in turn financed by central taxes which, taken as a whole, are undoubtedly levied more on rich people than poor people. Nevertheless, the popular perception remained, even when the level of the poll tax was reduced to around 15 per cent of current local spending by virtue of an increase in the level of grants. Ultimately, public pressure forced the poll tax to be replaced in 1992, except of course in Northern Ireland where domestic rates still survive.

5.3

The council tax

In England, Scotland and Wales, the poll tax was replaced in 1992 by a tax known as the council tax. This is a property tax on domestic properties, but it differs from a conventional property tax in several ways, as follows:

- Depending on its capital value in relation to the mean value of homes, each home is placed in one of eight bands, called Bands A to H. Columns 1, 2 and 3 of [Table 8.6](#) show how properties are allocated between the eight bands in England. There are similar procedures in Scotland and Wales, but the bands there relate to the lower mean values of homes in those countries.
- Within any authority, the council tax bill sent to each home in each band is the same. So an English authority, for example, the bill sent to a home worth £161,000 is the same as the bill sent to a home worth £319,000, because they are each in Band G.
- Local authorities set the rate of council tax in their own areas for properties in Band D. Where there is more than one tier, each tier sets its own rate.
- Once an authority has set the tax bill for Band D properties, there is a formula which all authorities must follow to show the tax bill for properties in other bands. This is reflected in the figures in column 4 of [Table 8.6](#). For example, if an authority sends a bill of £1,000 for each Band D property, then it must send a bill of 0.67(£ 1,000) or £670 to each Band A property, and it must send a bill of 2(£1,000) or £2,000 to each Band H property. The bills for each band

Table 8.6 Council tax bands and tax bill ratios for English local authorities.

<i>Band</i>	<i>Range of property values (% of mean)</i>	<i>Range of property values (£)</i>	<i>Tax bills (as a ratio of the bill for a property in Band D)</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>
Band A	Under 50	Under 40,000	0.67
Band B	50–65	40,000–52,000	0.78
Band C	65–85	52,000–68,000	0.89
Band D	85–110	68,000–88,000	1.00
Band E	110–150	88,000–120,000	1.22
Band F	150–200	120,000–160,000	1.44
Band G	200–400	160,000–320,000	1.67
Band H	Over 400	Over 320,000	2.00

do not rise in proportion to the values in that band. For example, properties in Band G are worth about four times as much as those in Band B, but their tax bill is little more than twice as much.

- Properties where there is only one adult, or where there is only one adult who is not a full-time student, are deemed to be ‘one-adult households’ and are entitled to a 25 per cent discount on their council tax bill. Properties where there are no adults other than full-time students are entitled to a 100 per cent discount.

These various features mean that the council tax goes some way towards meeting some of the objections to domestic rates. For example, there is a limit to how much money can be raised from the occupants of very high value properties. In particular, there are safeguards for people in the highest value properties in Band H, in that they pay only three times as much as people in Band A. This reflects the objection to domestic rates that people in high value homes paid greatly more for local services than people in low value homes. Also, the council tax ensures that the single adult living next door to a household with two working adults and two working grown-up children pays a little less than that household.

A curious feature of the council tax is that there is no provision for regular revaluations. The argument is that if there was a revaluation, then most properties would end up in the same band. Nevertheless, it is possible over time that relative property values will change in different areas, and this will not be captured by the tax.

5.4 Tax capping

Until the 1980s, local authorities were free to set whatever tax rates they liked on their taxes. Since then, this freedom has effectively been limited by a system of

capping, although, strictly, capping applies to expenditure rather than taxes. Before each financial year, local authorities have to present proposed budgets to the government for approval. The government can force an authority to reduce its budget, and so effectively force it to cut its planned tax rate.

An authority is likely to be capped if it plans to raise its spending by more than a modest amount in real terms, or if it plans to spend much more than the government deems that it needs to spend to provide its services at reasonable levels.¹⁰ Capping was introduced in an effort to restrain public spending, but it has never been popular with local authorities. The present government is considering some easing of the tight capping regime that it inherited in the 1997 election. But it remains to be seen whether the regime will be significantly eased.¹¹

5.5

The uniform business rate

Local authorities do receive some tax revenue money from businesses, but they do not do so by using a directly set local business tax. Instead, the central government now effectively collects non-domestic rates at a uniform rate. It then divides the money between each area of the country on an equal per capita basis. In an area with two tiers, the tiers share the money that is allocated to that area. Although these receipts show up as tax revenues in [Table 8.5](#), it is really more appropriate to see them as a type of general grant from the central government. The present government is considering allowing individual authorities some discretion over the revenue from this tax.¹²

6

GRANTS

It can be seen from [Table 8.5](#) that local authorities receive both specific grants and general grants. Specific grants are paid for several activities. For example, local authorities really provide housing benefit on an agency basis for the central government, for it gives them no discretion over who is eligible or over how much money eligible people may receive. In return, it pays local authorities a matching specific grant that covers virtually all the costs which they face providing this benefit. Also, there is a grant that covers about half local spending on police services. Grants paid for these two activities account for about half the total of specific grants.

6.1

The basis of the revenue support grant (RSG)

General grants to local authorities are paid on an equalisation grant scheme known as the revenue support grant (RSG).¹³ There are some differences in the RSG arrangements between the four countries, and this chapter concerns

England alone. The Welsh system is very similar. The Scottish system is broadly similar, but rather more complex. The Northern Irish system is simpler because local authorities there have few functions.

The operation of the RSG has four steps, as follows:

- 1 For each authority, the government works out how much money it thinks the authority would need to spend to provide its services at reasonable levels.
- 2 For each authority, the government works out how much money it could raise from the council tax if it set a reasonable rate for Band D properties and so, in turn, for each other band.
- 3 For each authority, the government works out how much money the authority will receive through its distribution of the proceeds of the business property tax.
- 4 For each authority, the government deducts the sums found in steps 2 and 3 from the amount found in step 1 and pays a grant equal to the difference.

The result of this procedure is that any two authorities which provide their services at the levels deemed reasonable by the central government could set the same council tax rates.

6.2

Standard spending assessments (SSAs)

The most controversial part of the RSG calculations is calculating the amounts which the government thinks each local authority needs to spend. These amounts are called Standard Spending Assessments (SSAs). The methods by which SSAs are calculated are laid down by the central government.¹⁴

Although SSAs seek to measure the amounts which the central government thinks each local authority needs to spend to provide reasonable services, the government does not define them in these terms, because it would be open to two sorts of criticism from local authorities:

- 1 Local authorities could criticise the government's view of 'reasonable' services.
- 2 Local authorities could argue that they could not possibly provide 'reasonable' services with the expenditures suggested by the government.

So, although the SSAs show how much the government thinks local authorities need to spend to provide reasonable services, it presents them in a rather different way. This presentation involves the following five steps:

- 1 The government works out a total amount that it thinks it would be appropriate for local authorities to spend on current expenditure. More precisely, it works out an amount that it would be appropriate for local

authorities to spend on current expenditure from taxes and grants, that is to say after allowing for a reasonable income from fees and charges. This amount can be defended fairly vigorously on the grounds that it is consistent with the government's macroeconomic policies.

- 2 The government decides how much of this total could reasonably be allocated to each of the main areas of local authority spending. It actually divides this spending into seven broad groups of services. Local authorities may object to this division, but such objections are generally modest as they only concern an allocation of a fixed overall total.
- 3 The government works out how much of the spending on each of these groups is likely to be accounted for by its relatively modest programmes of specific grants. The remaining amount of approved spending in each group is called a control total. In 1997–8, the aggregate value of these control totals in England was £40,563 million.
- 4 The government apportions each control total between individual local authorities. Some local authorities may complain about the allocation procedures, but any change in the procedures which benefits one authority will hurt another, so complaints will only be made by individual local authorities. There is no point in local authorities getting together as a group to complain about the allocation between them of the seven control totals.
- 5 Finally, the government looks at each individual authority and adds up the amounts allocated to it to calculate its individual total SSA. As noted above, it then deducts the amount that the local authority could reasonably raise in council tax, plus the amount it will get from the business property tax, in order to arrive at its RSG payment.

6.3

The control totals for 1997–8

Table 8.7 shows the control totals that were used in England in 1997–8. The seven broad groups were education, personal social services, police, fire, highway maintenance, 'all other services', and capital financing. The control totals for the first two groups are each divided into a few sub-groups, as shown in the table.

The allocation of the £40,563 million between the various control totals is done by the government with some arguing between its own ministers. For instance the minister of transport wants a large allocation to highway maintenance while the education minister wants a high allocation to education and the social services minister wants a high allocation to social services. There are two reasons why these arguments may seem surprising:

- It may seem odd that central government ministers care about what local authorities do. However, the central government believes that it has an overall responsibility, a belief which is reasonable as most local revenues are secured

Table 8.7 Control totals for service groups for English local authorities, 1997–8.

<i>Item</i>	<i>Amount (£m)</i>	<i>% of total</i>
1a Primary education (children 5–11)	7,699.1	18.98
1b Secondary education (children 11–16)	7,692.9	18.97
1c Post-16 education	1,118.0	2.76
1d Under-5 education	562.0	1.39
1e Other education	768.2	1.89
2a Children's social services	1,754.7	4.33
2b Elderly social services	4,158.2	10.25
2c Other personal social services	1,479.2	3.65
3 Police	3,088.6	7.61
4 Fire	1,237.2	3.05
5 Highway maintenance	1,759.0	4.34
6 All other services	7,209.7	17.77
7 Capital financing	2,036.1	5.02
Total	40,562.9	100.00

Source: Department of the Environment (1997b).

from the government, and ministers want voters to approve of services which relate to their ministries.

- The amounts are used only to calculate SSAs and, in turn, grants. They in no way force local authorities actually to spend those amounts on different services. However, the amounts do set a sort of benchmark, so an increase in the allocation to, say, police at the expense of roads could well lead to some actual redistribution of local spending to police from roads.

6.4

An implication of altering the control totals

The allocation between control totals has an important implication. If there is a reallocation from roads to police, then the total grants paid to authorities with relatively low needs for roads and relatively high needs for police will rise, while the total grants paid to authorities with relatively high needs for roads and relatively low needs for police will fall. So, by changing the allocation, the government can alter the total grant paid to different authorities.

If the government wishes to favour a particular sort of authority, then it may be able to do so by making an appropriate change in the allocation. It is widely thought that governments do manipulate things in this way. There is no doubt that some manipulation goes on, but there is probably much less manipulation than is generally thought. This is because changes which help some authorities that the government wishes to help will usually also hurt some other authorities that it wishes to help. In general, though, Conservative governments tend to help

rural authorities more while Labour governments tend to help urban authorities more.

6.5 Dividing the control totals between authorities problems with regression

The government's biggest task is to allocate each of the control totals between individual local authorities. In the 1970s, much use was made of regression in this process. For instance it was possible to regress actual past local spending on education against a large number of factors to derive an equation which, to some extent, 'explained' the level of spending by individual authorities on education. It was then possible to use this equation to estimate the amount which each authority might reasonably spend, though these amounts would have to be scaled to ensure that they added up to the control total for education. However, regression analysis with many independent variables fell from favour.

The problem with this sort of analysis was simple. There might be, say, six authorities with a high level of immigrant children. These six authorities knew that if they sharply raised their education spending levels, then regression analysis would show that high numbers of immigrant children were associated with high education spending. In turn, these authorities would find that next year's grant formula would regard them as having a high need to spend and would give them high grants.

Regression does still play some part in the procedures. However, it is typically used only in a base year, which is mostly 1990–1, and then it is used only to see the relative importance of a few key factors. To see how present methods work, the next section looks at a selection of the control totals.¹⁵

7 WORKING OUT INDIVIDUAL AUTHORITIES' NEEDS TO SPEND ON INDIVIDUAL SERVICES

7.1 Primary education

Consider, first, primary education. The control total for this service in 1997–8 was £7,699.1 million, as shown in [Table 8.7](#). At the heart of the allocation of this sum between individual authorities, and indeed the allocation of several other control totals, lies the concept of a 'client group'. Essentially, the client group for primary education is the numbers of primary school pupils attending an authority's schools. It is important to focus on these numbers rather than on the numbers of children of school age living in the authority, because some resident children may attend private schools while others may attend schools in other authorities.

The numbers of pupils have to be recorded some time before the financial year begins because the grant payments have to be worked out before the year begins. For primary schools, the numbers are those in attendance 15 months before the year begins.

A simple allocation formula could be used which would divide the control total exactly in proportion to the numbers of primary school pupils. However, the cost of providing a similar level of education in two authorities with equal numbers of school pupils might be different. There are several reasons for this. One is that labour costs might be higher in one authority than another, so that the first authority has to pay a higher wage to attract teachers. The way in which this is taken into account is explained at the end of this section. For the moment, it will be assumed that teachers are paid the same in all authorities.

There are other reasons why costs might vary between authorities, and the SSA scheme allows for three of these in the belief that they are the most important:

- 1 Additional educational needs. Some children have special needs. For example, about 2 per cent of children have to be educated in special schools, perhaps on account of mental or physical handicaps, and the cost of their education is about four times that of ordinary children. Also, within normal schools, special provision must be made for children with special needs, such as remedial teaching. And there are some children who need to be seen by psychologists and other specialists. Some local authorities have far more need for this sort of spending than others.
- 2 Sparsity. Local authorities where the population is sparse tend to have higher costs than other authorities. This is partly because they tend to have smaller schools, and partly because they have to spend more to transport children to and from school.
- 3 Free school lunches. Local authorities are obliged to provide free lunches to all children whose parents rely on state benefits to live. Some local authorities have far more children in this position than others.

To allow for these three factors, the government's first step is to decide how to measure the spending needs they create. It might be thought that the government could simply look at the actual spending by each local authority on the children concerned, that is their actual spending on special needs, school transport and free lunches. But some authorities might have more generous provision for special needs, more lavish transport arrangements, and more costly lunches. What is required are measures of need to spend which are independent of individual authorities' practices.

In the case of additional educational needs, a regression analysis was conducted for a base year, 1990–1, which showed that school education spending tended to be higher in authorities where the following applied: (a) a high proportion of pupils was living with just one parent; (b) a high proportion of pupils was living in families that rely on state benefits to live; and (c) a high

proportion of the resident population was born outside the United Kingdom and a few other countries (specifically the Irish republic, the United States and certain countries in the British Commonwealth, such as Australia, Canada and New Zealand). The regression also found the extent to which the three factors added to primary and secondary education spending. The three factors added to spending in the ratios of about 1.2:1.2:1. In other words, the third factor explained a little less of the variations in spending than the first two. On this basis, given data from each authority, it is possible to derive a single composite index of additional educational needs for each authority.

In the case of sparsity, evidence suggests that costs are higher than normal in sparsely populated areas, and that they are very much higher in very sparsely populated areas which are called 'super-sparse' areas. The sparsity of an authority is measured by the proportion of its population that lives in areas where the density of population is between 0.5 and 4 people per hectare. Super-sparsity is measured by the proportion of its population that lives in areas where the density of population is below 0.5 per hectare. Regression analysis suggests that super-sparsity adds twice as much to costs per pupil as sparsity. So a composite sparsity index allows twice as much for super-sparsity as sparsity. For example, if 20 per cent of an authority's population live in sparse areas and 8 per cent in super-sparse areas, then its overall sparsity index could be defined as 36, that is $20+(2\times 8)$. Of course, many urban authorities have a population density of over 4 people per hectare throughout their area, and so these authorities have no allowance for extra spending on account of sparsity.

The cost of providing free school meals depends on the number of children whose parents rely on state benefits to live. The government itself has data on these numbers.

Once measures of each of the three factors are available for each authority, it is possible to estimate how much spending needs per pupil vary from authority to authority as a result of these factors. Each factor is taken in turn and a regression is estimated relating expenditure to the index for that factor. For example, if E is spending per pupil and A is the index of additional educational needs, then a regression equation $E=a+bA$ is estimated. Then the average national value for A is inserted to see what bA is in a hypothetical area with average additional educational needs. This indicates how much spending for additional educational needs is warranted in an area with average needs. Similarly, it is possible to see how much spending is warranted on account of sparsity in a hypothetical area with an average sparsity index, and how much spending is warranted on account of free school lunches in a hypothetical area with an average need for free school lunches.

On this approach, it is estimated that a hypothetical area with average needs on all three factors, spending the average amount in the country on each pupil, would spend 80.55 per cent on basic education, 15.70 per cent handling additional educational needs, 1.65 per cent handling problems caused by sparsity, and 2.10 per cent providing free school lunches.

Essentially, the government uses this relationship to distribute 80.55 per cent of the control total on the basis of pupil numbers, 15.70 per cent on the basis of the additional educational needs indices for different authorities, 1.65 per cent on the basis of the sparsity indices for different authorities, and 2.10 per cent on the basis of the number of children of parents relying on state benefits. In effect, it allows each authority a different cost per pupil. In all authorities 80.55 per cent of the cost is the same. A further 15.70 per cent, varying between authorities, depends on their additional educational needs indices. A further 1.65 per cent, varying between authorities, depends on their sparsity indices. And a further 2.10 per cent, varying between authorities, depends on the proportion of their children whose parents rely on state benefits.

7.2

Personal social services: children's social services

Children's social services include residential homes for homeless children, foster parents, social work support and special services for mentally and physically handicapped children. The government could allocate its control total of £1,754.7 million in proportion to how much different authorities actually spend, but this would give most money to authorities with the most generous services. To estimate spending need, it would be better to look at the number of children who are helped, but even here there is some room for local discretion. So what is ideally wanted is a measure of the number of children who might need help.

Regression analysis on a sample of authorities with seemingly comparable standards of service has suggested that the number of children who might need help, that is 'children at risk', can be estimated by looking at: (a) the number of children aged under 18 who have only one parent; (b) the number of children aged under 16 who live in rented accommodation; (c) the number of children aged under 18 whose parents rely on state benefits to live; and (d) the number of households with children without a home of their own, as arises when two families share a home. In fact, factor (a) alone seems to explain about 60 per cent of the variation in the number of children at risk.

Suppose, for a moment, that the only factor which causes the number of children at risk to vary between authorities is the proportion of children who live in lone parent families. Define this proportion in area i as L_i . Define the child population of area i as N_i and the number of children at risk in area i as R_i . The government's task is to estimate R_i for that authority. It could use data from a sample of authorities and estimate a regression equation $R/N = a + bL$. From this, R_i in a given authority could easily be estimated as $R_i = aN_i + bN_iL_i$. Essentially this approach is used, except that a composite index is used instead of L to capture all the factors (a) to (d) instead of just factor (a).

In essence, the control total for children's services is then divided in proportion to the estimated number of children at need in each authority. However, some allowance is made for the fact that the cost per child varies a

little between authorities, apparently depending on the ethnic mix of the authority. Also, some allowance is made for the fact that labour costs vary between authorities, as explained at the end of this section.

7.3

Highway maintenance

Primary roads are maintained by the central government. It is only roads of lesser importance that are maintained by local authorities, and these are subdivided into so-called principal roads and minor (or tertiary) roads. The SSA allowances for maintaining both principal roads and minor roads depend on the extent to which they lie in built-up areas and the extent to which they lie outside built-up areas.

Road maintenance costs are divided into two groups: general maintenance costs and winter maintenance costs, the latter covering the clearing of snow and the gritting of roads in icy weather. It is estimated that 91.5 per cent of maintenance costs are covered by general maintenance and 8.5 per cent by winter maintenance. So the highway maintenance control total of £1,759.0 million is divided into these two components.

The general maintenance share could be divided between authorities entirely in proportion to road lengths, but this approach would ignore the fact that heavily used roads need more maintenance. Consequently, much of the 91.5 per cent, in fact 54.9 per cent of it, is divided in proportion to road lengths weighted by road usage. Rather than measure actual usage on every road, standard weights are used as follows: (a) minor roads in non-built-up areas, 1; (b) minor roads in built-up areas, 2; (c) principal roads in non-built-up areas, 1.2; and (d) principal roads in built-up areas, 2.4. However, it is felt that using this method alone would be unfair to authorities with very heavy road usage and also to authorities where there are many pedestrians. So, authorities with roads whose usage exceeds a threshold are entitled to a larger SSA, as are authorities where the ratio of the population of both residents and daytime migrants to road lengths exceeds a threshold. The remaining 36.6 per cent of the 91.5 per cent is distributed to authorities which exceed either or both of these thresholds, with the road usage factor carrying more importance than the density of population factor.

The remaining 8.5 per cent is also distributed in accordance with weighted road lengths, but these weighted lengths are then further weighted in accordance with the average number of days on which snow lies on the roads. And there is a further allowance for authorities where road usage or population density exceeds the thresholds.

Again, some allowance is made for the fact that labour costs vary between authorities, as explained at the end of this section.

7.4 Capital financing

As SSAs refer only to current expenditure, it might seem odd that there is a control total for capital financing. However, local authorities finance most of their capital spending by borrowing, and this final control total refers chiefly to the repayment of their past loans and the interest payments on those loans. The allocation procedures are very complex, but broadly the SSAs seek to cover the amount of repayment and interest that local authorities must pay on their debts, providing that they borrow only such amounts as the government approves, and also that they repay old debts at a rate of 4 per cent per year.

7.5 Area cost adjustments

One further point about SSAs must be noted. In addition to all the factors noted so far, the government seeks to compensate authorities where labour costs are high. So, for each authority in a high labour cost area, the SSA for each service group (other than capital financing) is increased. The high cost areas are those in south-east England, the highest of all being those in central London. The extent to which a high cost authority's SSAs are increased varies a little from service group to service group because some groups involve more labour costs than others. For instance, labour costs are reckoned to account for about 85 per cent of police services and only 65 per cent of road maintenance costs, so police SSAs are raised by a higher percentage than road maintenance SSAs in the authorities concerned. The overall result of these adjustments is that authorities in the London area have SSAs that are 10–15 per cent higher than they would otherwise be, while authorities near London have SSAs that are 5–10 per cent higher than they would otherwise be. Raising these authorities' SSAs above the initially calculated amounts might seem likely to result in total SSAs exceeding the control totals. Balance is restored by reducing the SSAs of authorities in low labour cost areas below the figures initially calculated for them.

This labour cost factor may seem very reasonable, but it has an unsatisfactory effect. Labour costs are high in south-east England chiefly because workers there want compensating for high-cost housing, which results from a high density of population. If local authorities there received no extra SSAs, and hence received no extra grants for their high labour costs, then their local taxes would be higher. This would encourage people to move away which, in turn, would reduce housing costs and so help to ease labour costs. Instead, the payment of higher grants simply perpetuates the problem. Moreover, these grants reduce the extent to which the richest areas of the country transfer money to other areas via the public sector.

8 PROBLEMS

The general impact of the reforms to local government in recent years has been to weaken it. This weakening had been caused both by the structural changes and the financial changes.

8.1 The effect of the structural changes

The structural reforms have led to a weak system of local government for three reasons. First, the new structures are very untidy, with a variety of different set-ups. This may be considered a wise reaction to a country where population densities and traditions vary and where geographical problems such as islands are commonplace. But it also means that people have only vague ideas about the way local government operates, and this weakens the power of local government.

Second, the reforms have never considered that a key purpose of having of local authorities is to allow them to provide public services in ways that vary in accordance with local wishes. Given that there have been three large-scale reforms in the past century or so, it seems a pity that no serious attempt has been made to see how far preferences do vary between areas. Local government would be stronger if the authorities were able to respond more effectively to varying preferences.

Third, the democratic credentials of joint boards are perhaps a little unclear. At the very least, these boards are not directly accountable to the electorates in the areas they serve. This surely weakens their authority. The need for these boards in every area with unitary authorities must call into question the wisdom of having a single tier in those areas.

It is certainly in the single tier areas that changes are most likely. There are soon to be new assemblies for Scotland and Wales. Initially, these assemblies will merely take over some functions now provided by the central government, such as health, higher education and major roads. But they may in time decide to take over also some of the functions now provided by local authorities in their areas, especially perhaps those functions now handled by joint boards. As for London, the government has agreed to have a new body covering the whole of the London area, albeit with limited powers. The idea may in time spread to the other metropolitan areas.

8.2 The effect of the financial changes

On the financial side, there are two main reasons why local authorities have been weakened. First, revenues from genuine local taxes fell from around 50 per cent

of current revenues in the 1980s, when local authorities directly levied domestic rates and non-domestic rates, to around 15 per cent in the early 1990s, when the poll tax was still in place, and they are still under 20 per cent with the council tax, as shown on [Table 8.5](#). This creates a problem known as gearing. As most government grants are lump-sum grants, a typical authority which doubled its tax rate would find its total revenue rising by a mere 20 per cent. Put another way, it would take a 100 per cent rise in tax rates to raise service levels by 20 per cent. In some authorities, which rely particularly heavily on grants, the situation is worse, so that a doubling of tax rates would lead to only a 7 per cent rise in revenue.

Second, local authority spending decisions have been constrained by the use of capping. For, in practice, authorities which plan to raise their services by anything more than a percent or two, or which plan to raise them more than 12.5 per cent above SSA, will find the government preventing them from doing so.

There has been a tendency for all parties to speak favourably about local autonomy when in opposition, and then do nothing to restore it when in power. Indeed, it is hard to think of any act in the last 20 years that has actually strengthened local government. This is odd, given that there is no empirical evidence that centralised countries perform better; indeed, the reverse seems to be the case.¹⁶

8.3 Possible reforms

A strong local government would probably need to have the joint boards in the unitary areas replaced by directly elected authorities, and it is possible that the recent decision to give London an upper tier once again will show the way ahead here. A strong local government would also need more substantial tax-raising powers. Given the large sums that local authorities spend, it is hard to see how they could become substantially autonomous in terms of revenue without having a local income tax, and there is no prospect of that. In the foreseeable future, the most that can be hoped for is a relaxation of capping and some small local business tax. Meanwhile, perhaps the best that can be said is that, if local authorities do have to rely substantially on grants, then the grant system is generally very sound, with the dubious exception of area cost adjustments.

Notes

- 1 For a brief history of local government from early times until the latest reforms, see Watt (1996), 21–38.
- 2 See Stenton (1962), 173.
- 3 For a review of the English reforms, see Redcliffe-Maud and Wood (1974).
- 4 Before making this reform, the government had established a commission to study local government in London; see Herbert (1960).

- 5 Before making these reforms, the government had established one commission to study local government in England, see Redcliffe-Maud (1969), and another to study local government in Scotland, see Wheatley (1969).
- 6 For some insights into government thinking, see, for example, Department of the Environment (1991) and Scottish Office (1992).
- 7 For an overview of local government finance, see Watt (1996), 119–38.
- 8 For a short history of rates, see Foster, Jackman and Perlman (1980), 152–71.
- 9 For a discussion of the poll tax, see HMSO (1986), Gibson (1990) and King (1990).
- 10 See, for example, Watt (1996), 130–3, and Department of the Environment, Transport and the Regions (1998b), 31–4.
- 11 See Department of the Environment, Transport and the Regions (1998b).
- 12 See Department of the Environment, Transport and the Regions (1998a).
- 13 For an overview of the RSG, see King (1990).
- 14 See Department of the Environment (1997b).
- 15 The discussion here is based on Department of the Environment (1997b).
- 16 See King and Ma (1998).

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9

Towards fiscal federalism in Italy

Amedeo Fossati

1

INTRODUCTION

Among the greatest questions concerning public intervention in the Italian economy—those that could interest both the academics and general public through the mass-media—are, on the one hand, the spending-deficit-debt problem and, on the other, fiscal federalism. These two matters are closely connected: the spending—deficit—debt question is depicted as an evil preventing Italy from entering Europe, while federalism, and especially fiscal federalism, is seen as a recipe for salvation.

In [section 2](#), the reasons why Italy talks so much about fiscal federalism are discussed; at a first glance, federalism might seem to be a passing fashion, but in this case there may be something more substantial about the interest in fiscal federalism.

The fundamental problems in achieving fiscal federalism are discussed in [section 3](#): first, the tax autonomy of subcentral governments and, second, the attribution of functions to such different levels of government.

[Section 4](#) deals with what are typically Italian obstacles to achieving fiscal federalism: neo-regionalism, the peculiarities of Italian communes and, above all, the centralism and dirigisme that characterise the so-called second Italian republic even more than the first.

[Section 5](#) is devoted to some short considerations about the present state of progress of fiscal federalism, and what effects it could have on Italy.

2

CURRENT POPULARITY OF FISCAL FEDERALISM IN ITALY

From the economic point of view, the improvement in the efficiency of public administrations is partly responsible for the popularity of fiscal federalism in Italy today, because the Italian system is clearly inefficient and incorporates heavy central government intervention with its endemic powerlessness.¹ As a

matter of fact, fiscal federalism seems to be proposed as a remedy for public inefficiency; nevertheless, it is doubtful whether efficiency has much to do with the interest of Italian politics in fiscal federalism. In fact, one wonders if efficiency worries the political class, even though they talk about it so often. Efficiency is used to justify a fiscal federalism hiding other aims, particularly the decrease in public expenditure at the expense of local government. The recent Italian experience with the kind and degree of taxation autonomy which has already been put into effect during the last few years (for example two local taxes such as ICI, or the recently proposed IRAP), seems to support this statement.

It is common knowledge that the law enacted in 1971 regarding taxation reform led to quite the opposite of fiscal federalism. While waiting for a total reorganisation of the competences of local governments, local taxes were virtually eliminated and their place taken by a system of transfer finance for all the subcentral governments, being therefore inserted into a general context of financial irresponsibility at state level. This statement is borne out by the fact that when taxation reform reached its full application, lasting for longer than 20 years, more than a quarter of the increasing public spending was financed by resorting to public debt. From 1972 to 1991 in particular, the annual deficit ranged from 28 to 35 per cent of public spending. In this way, Italy became the land of plenty for both local and national administrators and for savers. Local administrators, being abundantly fed at central government expense, could present themselves to their voters as mere expense decision makers, although with some budget liquidity constraints. Despite often repeated claims to the contrary, the central government basically maintained the continuity of its political axis behind an appearance of instability,² and could address itself to a politics of social-client expenses with practically no budget constraints. All things considered, savers were happy to collect public debt titles instead of paying for the taxes that should have financed public spending.

As all 'beautiful things and mortals pass and do not stay', this situation eventually gave way to great difficulties. These policies led to the gradual accumulation of a huge public debt, and servicing this debt crowded out the remaining public spending, especially social spending. That is the basic problem, underlined by the Maastricht parameters. In 1992 (i.e. the Amato government), a first remedy was sought for this situation. The central government tried to get out of the need to decrease public spending and transferred part of its obligations to local bodies. This solution was not new to Italy. It brought a renewed interest in local taxation autonomy, and local governments changed their financing technique from derived finance to a re-establishment of their own incomes. In this way, even if local governments welcomed this change only lukewarmly, their financing passed from almost total transfers funding to a relevant percentage of tax incomes that now amounts to about 60 per cent for communes, that is to say within the European standard.

Therefore, taxation autonomy increased with the commendable aim of decreasing public spending, and this is an important characteristic of fiscal federalism. In this way, fiscal federalism was actually used to diffuse the idea of taxation autonomy which, in its turn, was seen as a way to decrease expenses. Therefore, from the point of view of public expenses' control, which has lately been underlined by the effort to reach the parameters fixed by the Maastricht Treaty for entry in the EMU (European Monetary Union), fiscal federalism is very popular. However, it appears more as an easy option than a carefully considered and sought-after design.

So, the most important phenomenon responsible for today's interest in fiscal federalism is linked to the revival of local autonomies. In their time, emerging unitary states restrained local autonomies, sometimes drastically: the crusade against Albigenses is perhaps a far-fetched example, but nonetheless it was a radical repression of local autonomy. Now seems to be the right time—not only in Italy, or Europe, but all around the world—to reverse the situation. From Belgium to Spain, from the UK to Ireland, from Czechoslovakia to Yugoslavia, and so on, a new era has appeared with territorial individualism as its essential component, starting from the acknowledgement that diversity can play an important role during an age of globalism. The Northern Leagues which are springing up in Italy may be considered a local epiphenomenon of a universal tendency.

Secessionism (Bossi's Padania or the Serenissima of Veneto) or the three federate states of Miglio, may appear to be difficult to achieve in today's socio-economic background. But while the electoral strength of the Northern Leagues maintains its present level, it will at least be able to keep on conditioning the politics of governments. On the other hand, it will continue to have a certain degree of strength until remedies are found to heal the disquiet that feeds it. This is probably the reason why all political parties have programmes that welcome fiscal federalism, considered an approximation to federalism and thus, an antidote to secessionism.

On the other hand, local autonomy revival (a social phenomenon with serious political effects), might be expected to be matched by an increased desire for taxation and spending autonomy. This direct link actually exists, but it seems that there is also an indirect one. Fiscal demands are not only addressed to establishing systems where every community can make responsible decisions about its own expenses and incomes, but they are often based on rich communities' desire to get rid of the contribution they pay to poor communities through unitary state mediation. In this sense, Padania shows itself to be in the same position as the Basque countries, Catalonia and Flemish Belgium.³ Hence, the desire for local autonomy helps to increase the popularity of fiscal federalism, but this desire is at least partly the result of a misunderstanding: in some cases, federalism is the word that tends to be highlighted (fiscal is only barely heeded), and its political connotations become the focus point, with the upshot being that it is seen as a first step towards secessionism.

But where fiscal, on the other hand, is highlighted, it is seen as an alleviation of taxation pressure. No comment is necessary on the former interpretation of fiscal federalism, but the latter requires us to note that fiscal federalism has nothing—by itself—to do with the rejection of inter-community solidarity. Think about Australia, where co-operative federalism has been developed to the point of complete equality of fiscal capacities, or think about the *Finanzausgleich* in Germany.

The brand of fiscal federalism generally suggested in Italy,⁴ is certainly of a co-operative kind, so that it is particularly sensitive to the issue of co-operation between rich and poor areas. In other words, huge transfers from the North of Italy to finance the South continue to be mooted. On the contrary, the favourite theme of the Northern Leagues, and the essential reason for their electoral success, is the largely diffused feeling that the Italian state, being very grossly incompetent as a supplier of services, and bringing more and more dirigisme to the economy,⁵ takes too high a percentage of Northern income not only to finance an inefficient and distorted state structure, but also to grant the South a too disproportionate revenue in comparison with the existing feeling of solidarity.

In conclusion, from this point of view, the large demand for fiscal federalism seems to be the result of a semantic misunderstanding regarding self-governing tendencies, which has been used equivocally by a political class acting irresponsibly. Under these conditions, we can only partly expect to increase efficiency, because such egoistic self-governing pressures tend first to give a different answer to the problem of equity, and they do not seem particularly concerned about any global improvement in efficiency. We can only pass over this contradiction when (and if) we reach a reasonable level of fiscal federalism, not only because, from an essentially economic point of view, political federalism in its institutional form can have the same significance as fiscal federalism, but also because a viable institution finds its strength in praxis, that is to say it evolves in a dynamic context while still pursuing its aims.

Finally, a further reason for the increase of interest in fiscal federalism appears to be globalism, namely the diffusion of modern technology, above all in the field of transportation and information. Such diffusion virtually makes frontiers disappear, so that now more than ever, we can really feel ourselves citizens of the world, while firms, no longer held back by borders, are facing stronger and stronger competition. In these circumstances, differences disappear and communities conform to the same pattern of behaviour all over the world. Therefore, with differences disappearing, holism seems to invalidate demands for federalism based purely on diversity and, at the same time, it seems to cancel the power of the state. In fact, the state might be considered outdated in the very idea of sole sovereignty on one's territory.

Nevertheless, under such conditions, any threats to each government level can strengthen its Pavlovian reactions of survival. The central government, being compressed between the vicelike grip of subcentral governments and international pressures and a supranational body (for example the

European Union) could make even greater claims and hide them behind partial and ambiguous concessions that allow some kinds of predominance to survive. At the same time, subcentral levels can accentuate their autonomous view (the Europe of Regions). However, fiscal federalism, being pursued through compromise between opposite spurs, can be the tool of such interests that are more interested in the fight for supremacy than the quest for economic efficiency.

3

THE BLOCKS TO ACHIEVING FISCAL FEDERALISM

3.1

The attribution of functions to the different levels of government

To implement any effective type of fiscal federalism, it is necessary to allocate responsibility for functions to each subcentral level of government, as each government level should justify its existence by marking itself out in relation to what it does. Above, we recalled that standard fiscal federalism theory allocates to each level of government the production of local public goods according to their natural jurisdictions. But this stylisation appears to be very far from reality,⁶ because any actual examples of local public goods are difficult to find. This is due to two lines of reasoning, the first being that pure public goods with a restricted area of competence are very limited; in fact, examples other than night lighting are difficult to find. The second reason is that services provided locally are often mixed goods, that is to say private goods demanded by local consumers, to which people connect a public interest. Then, restricted territorial competence might only be related to the private part of the service, while the public interest could easily be interpreted as a national interest. Nurseries can be taken as one example, or roads, or even education itself. They are rivals to consumption services as they answer individual demands (obviously local) that also include a collective interest for which there is no rivalry in consumption. But public interest is not necessarily local and can be partly considered to fall under the competence of the whole national territory.

On the other hand, after systematically observing the functions to which the different government levels devote themselves, both in unitary and federal states, it emerges that there is no standard rule to be found. The same services are sometimes supplied either on a national level or on a local level; when locally, the same service is often entrusted to different levels of government. For example, while higher education is generally entrusted to central government, in Australia and Switzerland it lies within the competence of the single member states.⁷

If reality suggests a somewhat unhomogeneous distribution among the levels of government, and economic theory simply offers some maxims that cannot be easily applied,⁸ one may follow the guidelines of the European Union and

assume the *subsidiarity principle*. The latter sanctions that functions should be carried out by the lowest possible level of government which, being closer to citizens, can better understand their wishes or preferences. Gradually, higher levels of government are entrusted with those functions that cannot be carried out by a certain level of government. And, in actual facts, the Bassanini law takes the subsidiarity principle as the basis of its administrative decentralisation or ‘federalism with unchanged Constitution’, even if it remains to be seen how these principles will be interpreted by the relative regulations, and what their accomplishing praxis will be.

The attribution of functions to government levels is closely connected with the degree and type of autonomy one chooses to accomplish; to this effect, we must consider two basic aspects: the level of decision-making autonomy and the degree of overlapping of functions among different levels of government. Regarding the former, merely assigning functions is not enough. Some autonomy of expenditure must be provided too, so that local administrators can make meaningful choices. Lacking autonomy, they would simply be the executors of the central government. In other words, autonomy—from the strictly economic point of view—involves a minimum level of autonomous spending capacity and therefore a sufficient degree of freedom to decide about expenditure. As far as efficiency is concerned, autonomy need not necessarily be total or complete: fiscal federalism implementation only requires an appropriate degree of autonomy. On the contrary, any institutional change from a unitary state to federal state can be interpreted as a problem that is exclusively related to the local degree of autonomy, with no regard to any consideration of economic efficiency.

The second matter (the degree of overlapping of functions among government levels) is probably more important than the distribution of functions. From the institutional point of view, the basic problem is whether each government competence is mutually exclusive, or—at worst—all the (higher) levels of government can deal with the functions typical of other (lower) bodies, and, if so, how. We could, for example, specify a certain field where all levels of government can work with regard to certain aspects related to specific territorial interests of their own area. In turn we could leave leading functions (for example legislative) for the higher level, and executive functions to the lower levels of government. We could, again, allow all levels of government to take the initiative about each kind of intervention.

These problems are related to *vertical* competition among the different levels of government, and must be distinguished from *horizontal* competition, as defined by Tiebout and Breton. The latter is sometimes considered the fundamental element of fiscal federalism;⁹ however, others think it may cause perverse effects.¹⁰ Competition among levels of government implies that different levels of government may intervene on the same function, and has both positive and negative effects. The redundancy effect is positive, as it allows any omission or production mistakes of the government level directly involved to be

balanced by corrective measures by other levels of government. But this interferes with horizontal and vertical equity and creates problems about how to co-ordinate the interventions of different levels of government, control by higher levels of government, and conflicts among different levels of government.

The Italian Constitution directly regulates the competences of the state and the regions, equips both state and regions with legislative power, and contextually defines in which matters they can/must exert it. Nevertheless, as regional prerogatives have been repressed during the first 20 years of regional experience, the state has normally ruled on regional matters as well.¹¹ We can only find its logical justification in the need to co-ordinate regional initiatives so that they can coexist harmoniously within a unitary picture. Not only are state laws doing this with greater frequency, they are also codifying the smallest details; in the past this praxis did not cause any conflict precisely because the central and local political classes were essentially identical, but it removed the regional body's activity and *raison d'être*. On the contrary, the first bicameral commission proposed that legislative state intervention regarding regions' competences should be limited to stating fundamental principles of national interest.

In principle, this rule seems to be reasonable, and it could be adopted not only for those areas involving legislative activity, but also to regulate the relationships between levels of government, with particular regard to the relations between central state, communes and regions.

Nevertheless, overlapping competences can cause conflict among levels of government: the level of struggle does not depend on the specific regulations, but on the behaviour of the political classes, and particularly on their degree of homogeneity. Moreover, conflict among different government levels is not solely induced by particular regulations regarding overlapping functions, as there are other causes as well. Even if we entrust each level of government with different competences, the action of each level, aimed at achieving its own institutional objectives, can have intersecting effects. For example, the policy of development has environmental implications, and vice versa environmental policy has development implications, so that some conflicts can derive from entrusting the first policy to a certain level of government and the second to another one.

3.2

Tax autonomy

To introduce a form of fiscal federalism, a sufficient degree of tax autonomy must be considered for subcentral levels of government. As discussed above, we only need a degree of autonomy that allows voters to link local charges with the decisions of local administrators. Tax autonomy is a relative concept that can change over time and space, ranging from the extreme limit where the lower level of government (in a federal state) can introduce any type of tax at its own discretion, to the opposite limit where it only has the power to fix one or more taxable parameters, i.e. the taxable base or a tax rate. An intermediate position,

for example, is where some taxable bases are reserved to the subcentral government, which is then free to impose the most appropriate charges on them.

On the other hand, although it is true that a central government without subcentral levels can theoretically exist, all unitary states today are structured on several levels of government, which are generally characterised both by spending capacity and a certain degree of tax autonomy. Moreover, local administrators are elected using a voting system quite similar to the one used for the election of central politicians. The only difference is that the tax capacity entrusted to local bodies in a unitary state is generally lower than corresponding capacity in federal states. Therefore, tax capacity is the main element differentiating federal and unitary states.¹² However, all states (both unitary and federal) are different from one another, especially as regards the amount of tax autonomy lower levels of government are entrusted with. Using total tax autonomy as one limit and zero tax autonomy as the other, we may ideally classify modern unitary states on the one hand, and federal states on the other. By doing so, we find that unitary states higher in the scale have subcentral levels of government with more tax autonomy than federal state subcentral governments with lower tax autonomy. Therefore, solely from the economic point of view, the only difference between federal and unitary states is the degree, not the quality, as we can order modern states in a continuum according to the tax autonomy assigned to lower levels of government.

Hence, from an economic standpoint, changing a unitary to a federal state is a nominal question: what is more important is the degree of autonomy (of spending and taxing equally) we want to achieve. Of course, this does not mean that there are no relevant political implications. In conclusion, the design of tax autonomy in fiscal federalism also depends on the incidental socio-economic situation, the historical traditions, and as a consequence the degree of autonomy desired. Therefore we cannot find a sole solution regarding, for example, the reserve of taxable bases, the power to create own taxes, parameter fixing, and so on. What is important is that local administrators: (a) have a sufficient degree of freedom so that they can alter local charges in such a way that their constituents do not consider them insignificant; (b) must make transparent decisions about taxes so that their constituents can understand them properly at once, and draw their own conclusions. Finally, to complete the chain of administrators' responsibilities, local taxes must acknowledge taxpayers' and voters' identity. In other words, those who are affected by taxes fixed by local administrators must be one and the same as those who elect local administrators. The ICI tax, for example, has this peculiarity, in part at least; IRAP, on the contrary, does not.

4

THE PROBLEMS OF ITALY

4.1

Centralism and dirigisme as leading ideologies: the trap of decentralisation

Fiscal federalism is not only related to lower levels of government but also, and above all, to central government: to introduce fiscal federalism contextually, the central government must be willing to reduce its activities. In the case of Italy, it means in the first place that we must redesign the institutional role of the central government, more from the point of view of routine proceedings than that of constitutional engineering. The relevant fact is not so much that the 1946 Constitution designed a unitary state, but that since then the role of central government has been interpreted in a very wide-ranging manner, not only as far as centralism is concerned, but also as regards economic dirigisme. On the contrary, economic theory provides some indications in support of free market initiative. And real socialism's poor experience in centralised planning confirms these indications.

As a consequence, subcentral governments should be entrusted with wide margins of freedom, while the central government must renounce most of its traditional demands for the control and direction of those activities that can be decentralised, or entrusted to local authorities. Apart from this, and granted that the central government wants to control and lead peripheral activities, it must be kept in mind that the 'leading and controlling activity must not be considered as simply giving orders and checking that they have been carried out, but also as organising the system so that it can be self-regulating, in compliance with the regulations of cybernetics, so as to naturally achieve the desired purposes'.¹³

Therefore, while implementing any reasonable form of fiscal federalism in Italy, the central power would have to change its viewpoint and behaviour considerably, a change that could prove to be epoch-making. In fact, such a change would mean abandoning the dirigisme and centralism that characterised, and still characterises, the Italian republic. In order to illustrate this feature, one only has to observe Italian parliamentary activity: (a) Italian laws are becoming ever more cumbersome; (b) their number keeps increasing every year; (c) their content shows growing concern for details.

The first consequence of this dirigisme is that most legislative instructions simply cannot be applied, so it is doubtful whether Italy can yet be considered a state of rights. A second consequence is that, in principle, central power will always persist under centralism with perverse effects: even if disregarded, central instructions may prevent local governments from working efficiently. Third, central dirigisme causes overflows with respect to local autonomies, which in their turn could be involved in endemic quarrels with the central power. In the past, central and local power relations were stabilised within a negotiation

context, where transfers from central government were bartered for local autonomy. But this conflict could reach dangerous levels when local bodies recover local tax autonomy.

On the contrary, fiscal federalism implies a change in such a course; in particular, the legislative role of parliament must be dramatically reduced in favour of the executive, and the claim to intervene by law in any particular case, not only at the level of disposition but at an executive level too, must be abandoned, so as to avoid the substitution of the executive in formal terms as well. For example, the budget law should be either approved or rejected, but it should not be reformulated by Parliament. Moreover, laws must be few, clear and short, as they are only required to outline general principles, not to provide the finishing touches as well: in short, legislative obstinacy¹⁴ must be stopped.

Introducing fiscal federalism means the central government executive must significantly reduce the range of functions it deals directly with and, particularly because of the principle of subsidiarity, the functions reserved to central government should be limited in number (for example defence, justice, public order, social security, international relations). Moreover, in view of the subsidiarity principle, central power intervention in local functions should be confined to the sphere of co-ordinating or indicative planning.

As previously stated, it is clear that these implications make it very difficult to introduce fiscal federalism in Italy, since they are very far from the central Italian government *modus operandi*. The main difficulty is not to make constitutional changes, but to reverse the praxis of the central government which has been enlarging its essential ambit more and more. Despite some apparent attempts at decentralisation, the trend to concentrate activities or decisions in Rome has undoubtedly grown over the last 20 years, and this actually helps in some way to justify the Lega Nord slogan 'Rome robber', besides the simple matter of North-South redistribution.

We noted above that one of the most important reasons for fiscal federalism in Italy is the demand for local autonomy. On that subject, when a central political class has to face strong demands for autonomy, it can react by offering decentralisation. From the point of view of economic efficiency, at least, decentralisation partly answers the requirements, but does not solve the problem. Decentralisation is related to the architecture of an organisation with particular reference to the territory. In the particular case of governments (unitary, federal or subcentral), we can talk about decentralisation when a structure that is strictly constructed on a hierarchical line within the territory is substituted by a structure offering greater degrees of freedom, where the periphery essentially acts as the agent of a principal (i.e. the centre). In this case, the centre imposes certain objectives on peripheral structures, but the peripheral structures can make some instrumental choices and take responsibility for them. It is clear that decentralisation is generally more efficient than simple hierarchical dependence, even if it involves more complex control problems, as the latter, in the strict hierarchical relationship of dependence are more simply executed.

A specific form of decentralisation is to charge a lower level of government to carry out some of the central functions: actually, in this case, the lower level of government not only carries on its own functions, but it also acts as peripheral structure of its higher level,¹⁵ thus establishing principal-agent type relationships. Italy has followed this road since the creation of regional bodies. The Bassanini law follows this direction to a large degree by answering a first requisite of autonomy. However, delegation is not an entirely satisfactory answer. The degrees of freedom are only instrumental, and they are only partly related to the choice of the objectives still being determined by the central power. Therefore, the real solution to autonomous pressures is to definitively transfer functions, but this transfer must come, as we said above, together with a consistent degree of tax autonomy, so that the higher government cannot introduce any surreptitious constraints on lower government choices.

Since local autonomy must involve sufficient income autonomy, it is quite evident that the provisions of the Bassanini law, which in essence does not consider the matter of incomes, seem designed to deal with local bodies simply as agents of central power, rather than to designate local autonomies. While this is not contrary to fiscal federalism in itself, neither is it the beginning nor the end of it. Even if, on the one hand, the IRAP tax can actually be an important element of tax autonomy for regions, it has a serious defect from the fiscal federalism point of view, as it hits taxpayer categories that do not necessarily coincide with those of regional voters. In fact, from this point of view it is not particularly helpful, since it could be seen—from the regional autonomy point of view—as a mere technical improvement on health and other taxes that it is supposed to substitute. Thus, if we assess the level of progress towards fiscal federalism, we are faced with little more than an offer of decentralisation.

In conclusion, decentralisation is good for fiscal federalism, but it is not enough. Furthermore, it can hide a bid to maintain central power predominance, and must therefore be critically examined, and its different characteristics ascertained. It can, in fact, be an attempt to escape autonomous pressures by building a system of relationships between subcentral and central government that actually strengthens central predominance. The ideologies of dirigisme and centralism appear to be particularly exposed to the danger of using decentralisation as a means of defusing the push for autonomy: this appears to be one of the greatest impediments fiscal federalism is facing in Italy at the moment.

4.2

Neo-regionalism

Theoretically, while designing any kind of fiscal federalism, each level of government can be structured with the most appropriate characteristics depending on the specific purposes to be achieved. However, there are some limits when implementing fiscal federalism, owing to existing constraints: in fact, links between different levels of government are present. In

Italy, these links are represented by the former three levels of subcentral government with certain functional and institutional characteristics, i.e. regions, provinces and communes. The fiscal federalism proposals advanced up until now mainly start from a consideration of the existing situation, and suggest an empowering of regional institutions. However, a number of proposals are based on a federalism of communes; provinces, on the contrary, do not seem to arouse particular attention, even if their size seems to be suitable, as they are larger than the communes.¹⁶ Therefore, this section only considers those proposals based on regions, hence neo-regionalism; the following will deal with commune-based proposals.

Neo-regionalism appears to be very winning, as it exorcises Po Valley secessionism by simply adjusting the *status quo ante*, and reassures those who fear that change can damage their interests more than continuation. Secessionism is in some way supplanted by federalism, which in its turn is perceived as close to fiscal federalism. Finally, the latter means the simple empowering of a character that is already institutionally established, as regionalism is.

This is not a suitable place carefully to analyse recent Italian proposals concerning neo-regionalism;¹⁷ however, it seems necessary at least to highlight those elements which serve to identify neo-regionalism, namely: (a) the strengthening of regional tax autonomy; (b) regions entrusted with more competences; (c) interregional equalisation. Afterwards, we will briefly deal with the weak point of neo-regionalism, i.e. the possibility that it might continue the pattern delineated by the past behaviour of Italian regions as levels of government.

Strengthening tax autonomy is certainly the most discussed aspect, but the quantitative aspect is in general given greater consideration than efficiency on the margin. In other words, all proposals fret about calculating the amount of transferred expenses and attributing enough incomes, mainly shared taxes and surcharges of central taxes with some outlines of new taxes, generally variants of IRAP.¹⁸ From this standpoint, neo-regionalistic proposals do not seem to worry about re-establishing or implementing tax autonomy. As stated previously, the Italian Constitution did provide regions with some tax autonomy, but during the last 20 years the prevailing interpretation of the Constitution text led to the reduction of such tax autonomy to almost nothing. So, neo-regionalistic proposals seem to start from the autonomous reflection that the expected increase in regions' spending capacity simply means that the regions' own incomes must increase accordingly. Examining the proposals under consideration, this income increase seems to involve for the main part revenues acquired through a diversion of revenues from previous state taxes. This accounts for the specific attention given to revenues from taxes collected in the regional territory, and generally both to participation in the state revenue and the local superimposition of state taxes.

There is no necessity to dwell on this formulation, as it corresponds to actual needs, except to note that we will have to see how it is put into practice. But

there is always a risk that marginal tax autonomy will not be considered good enough, while tax autonomy is essential in fiscal federalism to invest local administrators with responsibility. This mechanism only works when the people administered can easily see taxes, and when related local administrators' decisions are relevant (that is, they have a sufficient degree of freedom). Therefore, tax autonomy can be of a low degree, but it must be very efficient on the margin. In other words, it does not seem that the relationship between local tax incomes and total expenditure need essentially be high, because what is important is that a decision about new expenditure by the local government necessarily involves its financing through increasing local tax charges. This particular matter is somewhat neglected by neo-regionalistic proposals which, as stated above, mainly focus their attention on the quantity of revenue rather than on visibility and degree of freedom of local administrators.

Concerning competences, the various neo-regionalistic proposals differ substantially from each other:¹⁹ as regards the responsibility that regions are entrusted with, they range from maintaining the *status quo ante* (Gallo Commission²⁰) to reversing the current text of the Constitution (first Bicameral Commission). As things stand, the competences of regions are outlined, and remaining responsibilities are in the hands of the state. On the contrary, the bicameral proposal lists the state's competences in detail, while every other matter is left to the regions. As a matter of fact, the only practical effect the first Bicameral Commission achieved was documentation of the issue for the sake of posterity. It has now been substituted by a second commission, about which it can be said that, if the political atmosphere actually changed, the result would be a compromise with very open contents, as the final solution is in the hands of Parliament.

Concerning interregional equalisation, all proposals provide that inter-regional solidarity be maintained through vertical and horizontal transfers. Only the amount to be transferred varies, i.e. from upholding the present state of affairs to providing for some decrease—on full application—that can be recovered by an improvement in efficiency (Giarda 1996). The hypothesis providing largely unvarying transfers from rich to poor regions is clearly reasonable; it is obvious, in the Italian situation, that some expect fiscal federalism to weaken interregional solidarity when fully applied, while others expect the current situation to be maintained. The final result depends on the prevailing political reasoning when reaching the compromise that will open the doors to Italian-shaped fiscal federalism. However, it may be noted that maintaining solidarity transfers at their current levels should, when foreseeing an increase in income in rich regions, allow a decrease in real terms with reference to their GNP.

The element that truly breaks with the past, and which has only been assumed by some of the proposals, would appear to be the idea of changing regions from regulation bodies to managing bodies.²¹

There is no doubt that, if we want to achieve a significant form of fiscal federalism, new regions must be characterised not only by the specific functions

entrusted to them, but by changing their nature and becoming clearly visible to citizens. These new regions should be individualised as operative bodies in the field of services offered to people, not just as an abstract entity with regulating functions only, often directed at lower territorial bodies.

On the contrary, neo-regionalism, viewed as a proposal to revitalise regional institutions by answering the demand for autonomy, seems to involve regions that must be maintained as regulating bodies, by simply enlarging their field of application. This behaviour is rather unpromising, because it is diametrically opposed to the indications of fiscal federalism: efficiency cannot be approximated by those bodies that took as their model the oppressive bureaucracy of the Italian state, by proposing, again on the periphery, the central direction and centralist viewpoint characterising it. The fact is that neo-regionalism could, by simply enlarging existing regions' responsibility, make their current bad efficiency worse, if—as seems likely—the new regions move on essentially the same lines as the old ones.

Another weak point of neo-regionalism (but closely connected with the above) is that it substantially ignores communes, as it is based on regions. On the contrary, communes could play an important role, together with regions, in relieving the central state from supplying those services that can be better managed within restricted territorial sizes.

4.3

The role of communes (town and city governments)

If we accept the subsidiary principle in its totality, the communes become the prime mover or active protagonist of the fiscal federalism that is about to be established. But most of the recent studies, as stated above, still draw on some form of neo-regionalism;²² the Gallo Commission (1996) and Tremonti and Vitaletti (1994) are the only proposals that clearly take communes into consideration. However, while the former favours this approach because it would leave the Constitution unchanged, the latter see the communes as federalism's founding element.²³

Being based on communes, the achievement of fiscal federalism in Italy implies that the number of communes must be dramatically reduced, even before their functions are organised. There are more than 8,000 Italian communes with an average of 7,000 inhabitants each, more or less as in Germany, but the great difference lies in Italy's numerous small communes (for example Rondanina commune counts less than 100 inhabitants). The hilly and mountainous parts of Italy are a primary cause of this characteristic, and the depopulation of mountains caused many absurd situations, as in the example cited above. Fiscal parochialism is only meaningful if the commune is reasonably large, therefore it needs a minimum limit that must not be underscored. Either we can search for assent, by encouraging fusion or voluntary association, or the knot must be undone by imposing different kinds of unification from the centre. But,

obviously, this operation represents a new and huge obstacle to achieving satisfactory fiscal federalism in a short time.

Once this operation has been carried out, we must consider the considerable diversification among communes that will persist; for example an urban commune has very different perspectives to a rural commune: a town with one million inhabitants, for example, has completely different management problems from those of a rural village with 7,000 inhabitants, scattered among ten hamlets. Asymmetrical federalism of communes could be a solution to this kind of problem, where the nearest level of government to the population (the commune) does not have a standard typology, but differs depending on the management problems it has to face. Theoretically, this operation is not difficult, but it can be a source of quarrels among communes to be constituted, and we can easily foresee that, if central government does not comply with local autonomy pressures, it will not promote their appeasement. Italian metropolitan areas seem to be an important precedent when talking about inconclusiveness between centrifugal and centripetal pressure.

As regards commune-based or municipal-based federalism—parallel to defining responsibilities—the question of taxing autonomy assumes primal importance again. When a federal system includes great management responsibilities at municipal level, it has to grant the lowest levels important tax incomes of their own in terms of organisation, and this seems to be very difficult for small bodies like the communes. On this subject, we must remember that the revenue percentage from own taxes is not so important in comparison with total incomes, as is covering marginal spending with local taxes, so as to invest local administrators with responsibility. This means that communes can be financed concurrently by transfers from higher levels of government, without making this aspect disappear, because tax autonomy means degrees of freedom, and it is not necessary to manage taxes directly. In other words, it is more important to have wide freedom in drawing on the tax characteristics, than to establish in advance communal structures addressed to managing local taxes (from defining the taxable basis to the verifying and collecting power), so that administered people can easily work their way back from the tax charge to the decisions of administrators and vice versa.

As tax management need not necessarily be a direct responsibility of the government structure, since communes can hardly be equipped²⁴ for the task, tax management can be undertaken, in a system of contending competition, by private subjects entrusted with the tax service of all territorial bodies, the central state included. Imposing bodies could be assigned control and leading functions only, and even small bodies like communes can be equipped for such tasks.

A second point of considerable importance is to solve clearly the dilemma of exclusive or overlapped competence and, in the latter case, whether all governmental levels, or only the immediately superior, can intervene. No matter which solution is accepted, what is more important is an organisation that

reduces contentious and damaging interference from other levels of government to a minimum.

5

CONCLUSIONS

To conclude, we could ask whether we are proceeding towards a form of fiscal federalism, and whether the speed allows us to presume it will be achieved in a short time. Perhaps a political expert is better equipped to answer this question than an economist; as for myself, I can only say that there are some symptoms, but they do not give wide assurances. An important sign is that today, much more than yesterday, we tend to accept the discussion about federalism *tout court*, as political federalism would necessarily involve fiscal federalism. Another meaningful element is the Bassanini law, but it is ambiguous owing to the decentralisation trap.

More generally, recent Italian political history can be summarised by stating that after the short parenthesis of a right-wing government, the Left entered central government with a moderate programme which included, among other things, some form of fiscal federalism (even if they did not individualise it technically). After one year's experience of government, we can consider as successes the governing proxy to institute the IRAP tax, the Bassanini law and the work of the second Bicameral Commission. Therefore, it may be too early to take total stock of the situation, particularly, as we have already noted, because no constitutional changes are necessary or sufficient to achieve fiscal federalism, intended as an efficient tool for public choices. However, we need truly to renounce central power in favour of autonomies, and from this point of view political discussion seems to be moving within a sort of dialectic penumbra between political federalism, local autonomies and fiscal federalism, which, under the guise of fiscal federalism with unchanged Constitution can hide strongly centralising behaviour, actually opposed to fiscal federalism.

In fact, it is true that the Bassanini law suggests a wide function of decentralisation among the different levels of government, but its whole *modus operandi* appears to be state-planned and centralist. For example, if transportation competences are delegated to communes by virtue of the principles of subsidiarity and responsibility, what is the meaning of contextual provision for all costs to be covered '35 per cent at least', if not to safeguard central government survival, and so weaken local autonomy to make decisions?

The second Bicameral Commission is sending out somewhat ambiguous signals, now that it is concluding its work. While, on the one hand, accepting the idea of fiscal federalism, on enlarging the discussion to political federalism, it is working towards a series of compromises which may, by their ambiguity, be unhelpful. On this subject, we must remember that the Bicameral Commission technically draws up proposals that will be discussed and approved by Parliament;

and hazarding a guess about such approval at this moment is very difficult indeed.

Perhaps progress will be achieved under the decentralisation—fiscal federalism label. It is difficult to foresee whether it will be a serious and efficacious arrangement, or whether the compromise-based political inter-wiring will result in ambiguous, difficult to be applied, and scarcely efficacious action.

If we were to ask ourselves Leo Longanesi's old question reformulated as 'will fiscal federalism save us?', I think that the conflict between autonomous pressure and maintaining central power is the real problem. Thus, a programme formally addressed establishing fiscal federalism is, by itself, an ambiguous one. It might be a programme to enlarge the degree of local autonomy which, in reality, masks the old technique of changing everything so as not to change anything. In a world disposed to easy compromises, as today's Italian politics is, reaching an agreement on a seemingly federal programme is easy, as it can be considered satisfactory both by supporters of central power and those of local autonomies. Specifically, fiscal federalism with unchanged Constitution looks particularly fit to be interpreted by a distrustful observer as a masterpiece of this technique.

On the contrary, if the political atmosphere is really changing, as many think, then fiscal federalism will be inserted into a favourable 'humus', characterised by the essential consideration that organisations in highly dynamic and complex systems must be free to adapt to changes in the environment to achieve their purposes. In this case, our final conclusion may be: yes, fiscal federalism will save us, but it will be more of a natural achievement, the name of which we as yet ignore, than a conscious choice. As stated at the beginning, fiscal federalism is no more than a blueprint for achieving economic efficiency.

Notes

- 1 In its turn, centralism—relating to the various levels of government—finds its first justification in the fact that it should grant a homogeneous standard of local services, and moreover because it should allow financial flows to be controlled.
- 2 It is well known that the average length of each government was shorter than one year, but the coalition in power was constantly (and surreptitiously) supported by the communist party.
- 3 Ragazzi (1994, p. 138) 'many people perceive fiscal federalism as a new and different way to try to solve, or at least to plaster and isolate the problem of the south'.
- 4 See [section 4](#) below.
- 5 Just three examples: (i) art. 19 of law 412/1991 imposes regions with some expenditure limits for 1992 regarding certain matters; (ii) the recent and similar blockage of expense with the decrees of late December 1997; and (iii) the unique treasury account, recently worsened with the so-called Financial law, 1997.

- 6 See Giarda (1996, p. 38): 'theoretical indications about how the government levels must be attributed with the different public functions...detect no univocal solutions and no conclusive reasoning in favour of each of them.'
- 7 In Italy, the Minister of the Interior decree (28.5.93) gives a list of the responsibilities being entrusted to communes (registry office, civil state, statistics, conscription, justice, local policy, primary and secondary education, water service, sewers and purification, municipal street cleaning and refuse disposal service, road networks and public lighting), to provinces (education, security, agriculture, childhood and blind assistance). Concerning provinces, the reform law of local autonomies (142/1990) entrusted them with property, defence, environmental safeguarding and exploitation, water and energy resources, fauna and flora protection. Regions have the duty to regulate (law-making power ex art. 117 Constitution) and act in the fields of health and transportation, with addressing and co-ordinating functions, unlike the other territorial bodies that are managing bodies. But, actually, Italian regions mainly redistribute the transfers they receive to the lower bodies. Such transfers are directed to health and transport services.
- 8 'In economists' tool kit, there is none to enable us to decide without doubt whether a function should be the total competence of central government, local government or an ad hoc (appropriate) authority' (Eusepi 1996, p. 112).
- 9 In this sense, refer to Brosio (1996, p. 20): 'The theory of competitive federalism is, I think, the most important contribution to the general theory of federalism during the last decade.' But horizontal competition can be positively considered from the economic point of view because it tends to form more homogeneous communities through making voters emigrate (voting by feet), or because it only operates virtually by influencing the voters of a certain district through demonstration effects coming from the achievements other administrators obtained in other districts. However, horizontal competition can also cause perverse consequences when spurring the application of strategic behaviour beyond certain limits (for example lowering tax rates to attract production activity). Actually, competition is not an economic value in itself, but rather the *competitive market*. The latter is more characterised by the *lack of strategic behaviour* from economic agents (consumers and producers) who accept the price as a datum, than by competition itself.
- 10 Bordignon and Volpi (1966), p. 146, note that some studies on neo-regionalism consider infra-government competition in a positive way (Agnelli Foundation Projects, Spa Research and Boldrin-Rustichini) while Rossi, Osculati and the first Bicameral Commission think about competition as a 'necessary evil linked to federalism as it prevents the targets of horizontal and vertical equity from being reached'. Also Buchanan and Goetz (1974) cited by Trupiano (1996, p. 58), evaluate competition negatively.
- 11 The constitutional text concerning Italian regions was not applied during the first 25 years of the Italian Republic, as regions were only established in 1971.
- 12 See Peterson (1995, p. 10).
- 13 Fossati, A. (1973), p. 43.
- 14 In a very similar sense refer to Tremonti and Vitaletti (1994), p. 91.
- 15 In accordance with Giarda (1996, p. 44) the delegation of administrative functions 'is an important corollary in a system of fiscal federalism' made possible by art. 118, c. 2 of the Italian Constitution.

- 16 Italian provinces have always had a poor rooting, perhaps due to the few functions they have had in the past: it is sufficient to recall an old bill, whose first signatory was Ugo La Malfa, which had a single article 'Provinces are abolished'; or the recent statements of Tremonti and Vitaletti (1994, p. 69) 'Provinces have no important functions, they are useless...'. On the other hand the metropolitan areas, similar enough to provinces in dimension (in Italy at least), seem to have failed: refer to Bruzzo and Pelloso (1996, p. 199) and Bardini, Petrovich and Rizzi (1996, p. 221).
- 17 We are only considering the most relevant ones, particularly Garda, the first Bicameral Commission, the Agnelli Foundation, the Gallo Commission, the Lombardia Region, the CNR. Refer to Bordignon and Volpi (1996) and Bosi (1996) for a critical comment.
- 18 Refer to Ceriani (1995, p. 59 and following).
- 19 As an extreme synthesis, in accordance with the Agnelli Foundation, the regions' competences should include: primary and secondary education; civil disability benefits; shows and cultural goods; civil protection; agriculture, public building, development policies; equalising transfers to local bodies (Ragazzi, 1996 p. 48); Bicameral: refer to Trupiano, p. 35: besides health and transportation also education, assistance, culture and local finance, and also all those not explicitly entrusted to the state. Forte, p. 272 of Giardina, Osculati and Rey (1996), gives a list of all the functions currently given to regions.
- 20 In spite of some ambiguities. For example the Gallo Commission (1996) started by saying that they wanted to think about a fiscal federalism characterised by 'decentralisation not only on the matters of expenditure and multi-level diffusion of decision-making power, starting with the normative power of imposition; higher political and management responsibility to local administrators' (pp. 7/8). However, after such statements they ended up saying that 'for now regions' competences will not change' (p. 11).
- 21 This proposal characterises the first Bicameral Commission work, but it was a dead letter after new political elections. On this subject refer to Manfredi (1994, p. 41) and Mor (1992, p. 362).
- 22 The Agnelli Foundation, when proposing maxi-regions, suggest unifying Abruzzi and Molise, and unifying Liguria and Piemonte again, i.e. taking Liguria back to the time of the Congress of Vienna.
- 23 This should be the first stage of federalism and, conversely, regions or maxi-regions should be the second, as provinces are considered by the authors useless bodies to be abolished.
- 24 As the past experience of family tax is showing us.

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10

Fiscal federalism in Spain

Decentralisation: an unfinished task

Javier Suárez-Pandiello

1

INTRODUCTION

Over the last two decades Spain has undertaken an important decentralisation process involving large areas of public sector management. In 1975 (which marked the death of General Franco and the beginning of the democratic transition) central government managed 85.07 per cent of public expenditure, excluding social security. Twenty years later, in 1995, it only managed 58.84 per cent, in spite of having increased the weight of the public expenditure from 16.41 to 28.14 per cent of GDP.¹

The task of decentralising this volume of expenditures has created much institutional tension regarding the building of the constitutional framework and the development of a set of rules on the one hand, and the more pragmatic events of daily management among the different governments concerned on the other. These tensions have been especially noticeable in the field of the financing system.

In this chapter I intend critically to summarise this process and the present state of affairs. To this end, the chapter will be divided into four parts. First, I will briefly describe the general characteristics of the Spanish administrative system and try to identify the main determinants of the administrative and fiscal decentralisation process in Spain, and its political and economic explanations. The second part will outline both models of financing the autonomous communities, which compose the *ex-novo* regional level of government introduced by the 1978 Spanish Constitution, and the most original contribution to the decentralisation process. The third section will feature the local government financing system. I will be concentrating on the financing of municipalities, but I will also refer to provincial and insular governments. In the final part I will present my conclusions and point out some 'loose ends' to be taken up in the near future.

2

THE DECENTRALISATION PROCESS: THEORY AND POLICY

Until 1978, the date when the current Spanish Constitution was approved, the Spanish public administration was essentially characterised by rampant centralism, with central government assuming control of practically all public expenditure.

The administrative structure until then rested on the division by provinces of the country made on the Napoleonic model by Javier de Burgos in 1833. Nevertheless, the provincial level of government lacked relevant responsibilities and this, linked to its political use during the dictatorship through the civil governors, resulted in its being converted into a simple instrument of political design on the part of central government, in search of interterritorial uniformity.

The democratic Constitution of 1978 dramatically modified this situation by consecrating the principle of territorial autonomy and self-management. As I have previously stated, this Constitution introduced a new level of government (autonomous communities, hereafter ACs), based on common historical, cultural or economic characteristics which manage a set of political responsibilities according to the traditional division of powers, without changing the existing provincial model. Thus, they have been able to put in place their own legislative chambers, composed of members elected by the ballot box. They can also execute their own policies in matters set forth according to the Constitution and the respective Statutes of Regional Autonomy, and have their own High Court of Justice.

The new autonomic structure was originally conceived, in the beginning a parallel structure of the old provincial one, so that each AC would group together various bordering provinces. Meanwhile, the already democratised provincial institutions (deputations and insular councils) would have their own part in the decentralising network with the municipalities as the last link. But this process of decentralisation did not succeed in establishing a harmonious, well-balanced model of regional division. On the contrary, historical reasons together with different political aspirations at a territorial level, produced a rather casuistic regional model with conflicting functions and financial set-ups within the different ACs. Table 10.1 summarises the present state of territorial decentralisation in Spain, based on the three principal levels (central, regional and local).

The first two levels (central and regional) are more 'political', in the sense that they maintain the institutions that exercise the traditional distribution of power (legislative, executive and judicial), while the local level (provincial and municipal) completely lacks legislative and judicial institutions. More particularly, the central government has exclusive power in matters of defence, foreign affairs, economic stabilisation and social security with regard to pensions and unemployment subsidies. The central government also has responsibilities in

Table 10.1 Administrative decentralisation in Spain.

		<i>First level</i> Central government state
<i>Second level</i> 17 autonomous regions (or communities)	According to their financing system	<ul style="list-style-type: none"> 2 Foral regime communities (Navarra and Basque Country) with a particular, more autonomous system 15 Common regime communities with a general (but fundamentally dependent on central government) system
	According to their responsibilities	<ul style="list-style-type: none"> 7 High responsibility communities which manage education and health services (Andalucía, Basque Country, Canary Islands, Catalonia, Galicia, Navarra and Valencia) 10 Low responsibility communities with no management of education or health services
	According to the number of provinces in their territory	<ul style="list-style-type: none"> 6 One-province communities where provincial governments do not exist and regional governments have assumed their responsibilities (Asturias, Cantabria, Madrid, Murcia, Navarra and Rioja) 11 Multi-province communities where provincial governments exist and assume their own responsibilities
<i>Third level</i> Local governments	50 county councils (provincial governments – deputations and islands)	<ul style="list-style-type: none"> 3 Foral provincial governments (Álava, Guipúzcoa and Vizcaya, in the Basque Country) with a special, more autonomous financial system 47 Common regime provincial governments with a general (but essentially dependent on central government) financial system
About 8,000 municipal governments (city councils)		

Source: Suárez-Pandiello (1996).



Figure 10.1 Autonomous communities: level of responsibilities.

public order, although it shares policing responsibilities with the regional governments of the Basque Country and Catalonia.

As to the regional level of government (AC), Table 10.1 shows three types of grouping based on certain characteristics. First, we can classify governments according to the number of responsibilities held and dimension (see Figure 10.1). In this sense there are seven communities whose size exceeds the rest. Four of them (Andalusia, Catalonia, Galicia and Euskadi or Basque Country) have had recognition of the right to assume a larger responsibility range since the beginning of the autonomous process. Justification for this relates to their status as 'historical' communities, because their Statute of Autonomy dates back to the second Spanish Republic during the 1930s. The other three ACs with wide responsibilities have obtained their present rôle through expansion within a slower, constitutionally designed process. Table 10.2 summarises the main responsibilities assumed by both groups and Table 10.3 gives a quantitative idea of this.

Basically, the difference with regard to public expenditure between the two groups of ACs is that the communities with a higher level of responsibilities assume more responsibility for education and health, while in the remaining ACs the central government is attempting to administer those needs. Nevertheless, there are certain differences even among the ACs that are regarded as having the

Table 10.2 Level of responsibilities of autonomous communities.

<i>Level of responsibilities</i>		<i>Responsibilities</i>
HIGH	LOW	<p style="text-align: center;">COMMON</p> <ul style="list-style-type: none"> • Forestry, agriculture, livestock and fishing in internal waters • Town-planning and housing • Roads • Ports and airports excluding commercial activity • Hydraulic exploitation, channels and irrigation • Environmental protection • AC monumental patrimony, encouragement of cultural and regional languages, libraries, museums and conservatories • Self-government institutions • Internal trade-fairs, sport promotion and tourism
		<p style="text-align: center;">EDUCATION</p> <ul style="list-style-type: none"> • Management of the education system at all levels <p style="text-align: center;">HEALTH</p> <ul style="list-style-type: none"> • Provision of medical and pharmaceutical assistance

Source: Monasterio and Suárez-Pandiello (1998), p. 59.

Table 10.3 Quantitative weight of the different AC responsibilities, 1993 (thousands of pts).

<i>Responsibilities</i>	<i>Low</i>	<i>High</i>	<i>All common regime AC</i>	<i>% of total</i>
Common	503,369,354	569,302,739	1,074,672,093	18.18
Education	985,123,696	1,297,263,618	2,282,387,314	38.61
Health	1,181,709,325	1,372,359,753	2,554,069,078	43.21
Total responsibilities	2,672,202,375	3,238,926,110	5,911,128,485	100

Source: Monasterio and Suárez-Pandiello (1998), p. 59.

same level of responsibilities, since the statutes that govern the responsibilities of each region have been adopted individually via different processes.²

The second classification is based on the number of provinces that make up the ACs, and here we must distinguish between one-province or multi-province (see Figure 10.2). This distinction is relevant in that the one-province ACs have assumed the responsibilities and financial resources previously held by the provincial deputations, which have since disappeared as territorial entities so as to avoid administrative duplicity. On the contrary, the multi-province ACs have a constitutional obligation, to maintain the provincial deputations, as well as their responsibilities and financial system, though some Statutes of Autonomy give the right to the AC to legislate in local matters.



Figure 10.2 Autonomous communities: number of provinces.

Finally, the third classification looks at differences within financial systems, the basis of which is the acknowledgement of historical constitutional rights for the Basque Country and Navarra (see Figure 10.3). The particularities of this financial system will be taken up in a later section.

At local government level, the Spanish public administration is made up of two fundamental institutions. They are the provincial deputations (*consejos* and *cabildos* in the islands) and town councils or municipalities, both constitutionally honoured institutions which are required to be maintained, with the exclusion of the aforementioned provincial deputations in the case of the setting up of the one-province ACs. Nonetheless, other types of organisms of local character can be created (associations, metropolitan areas, consortiums, etc.) to deal with specific types of public services. Municipalities, both because of their number and because they are the institutions nearest to the citizens, play the leading part in the local public sector.

Though the Constitution provides for the division of powers between the state and the ACs, it does not refer to the responsibilities corresponding to local governments. These powers are regulated in a particular Local Government Act, which establishes a minimum level of obligatory services per size of municipal



Figure 10.3 Autonomous communities: financial regime.

population. Larger populations require more services. Thus, municipalities are obliged to provide the following services:

- In all municipalities: public lighting, refuse collection, road cleaning, domestic drinking water supply, sewage, public road maintenance and developments and food and drink control.
- In municipalities with a population of over 5,000, additionally: public parks, public library, markets/fairs and waste treatment.
- In municipalities with a population of over 20,000, also: civil protection, promotion of social services, fire prevention and fighting, public sports facilities and a slaughterhouse.
- Finally, in municipalities with a population of over 50,000, in addition to the above: collective urban passenger transport and environmental protection.

Furthermore, the following responsibilities are given to provincial governments:

- Co-ordination of municipal services to guarantee an adequate level thereof.

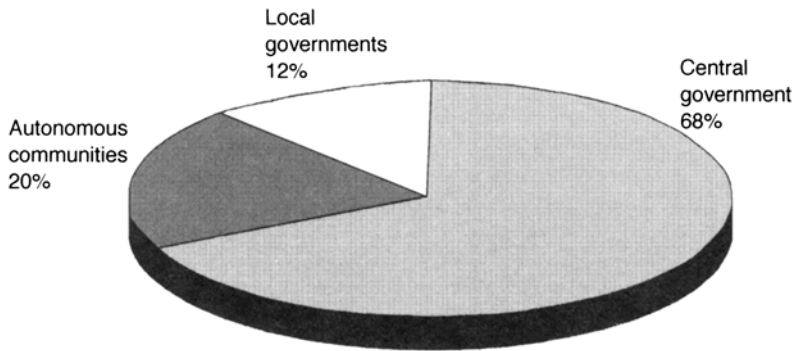


Figure 10.4 Spanish expenditure decentralisation.

- Legal, economic and technical aid to municipalities, particularly to those with reduced economic and management capacity.
- The provision of supra-municipal public services.
- Generally speaking, the fostering and administering of the specific interests of the province.

However, it should be made clear that in most cases, responsibilities are shared by the central government and regional governments, i.e. major roads and transportation, housing, social services and development policy. Similarly, the local governments intervene equally—to a certain extent—in the provision of these services. In turn, regional, provincial and municipal governments share responsibility for cultural activities and sports facilities as shown in [Figure 10.4](#) and [Table 10.4](#).

Even so, if we are to label the origin of our fiscal decentralisation process, I think that ‘political’ is the correct adjective. To understand the reason for this choice, it is necessary to refer back to Spain in the second half of the 1970s, just after General Franco’s death. We may recall the various forces pressing for change in a moment of increasing political turbulence, due to the end of an authoritarian regime. Perhaps the most important factor in the context of our topic was the political action of some very powerful nationalist groups in two particularly relevant regions (Catalonia and Basque Country). These groups, whose political convictions ranged from the conservative right to the radical left, were linked by a common desire to obtain a wide measure of self-government, and thus greater responsibilities over their territories. Consequently, the *Estado de las Autonomías* (Autonomous State) was developed from the need to meet those demands without creating inadmissible territorial discriminations.

Therefore, as against the economic arguments based on fiscal federalism theories,³ such as the Barzel and Oates⁴ theorem, some problems have been generated in the evolution of the system due to its political origin and, more concretely, to the open character designed by the Constitution. Thus, there was

Table 10.4 Functional classification of consolidated expenditure in the Spanish public sector, 1993 (millions of pts).

	Central government consolidated total	%	Autonomous communities consolidated total	%	Local governments consolidated total	%	Public sector consolidated total	%
1. General services	371,458	34.9	198,777	18.7	493,736	46.4	1,063,971	100.0
2. Defence, civil protection and citizens' safety	1,232,328	80.5	69,043	4.5	229,496	15.0	1,530,866	100.0
3. Social security, protection and promotion	9,274,071	91.7	477,333	4.7	358,186	3.6	10,109,441	100.0
3.1. Social security and protection	8,972,103	93.3	370,265	3.8	275,574	2.9	9,617,942	100.0
3.2. Social promotion	301,968	61.4	107,068	21.8	82,612	16.8	491,500	100.0
4. Production of public goods of a social nature	2,758,273	33.8	3,869,813	47.5	1,521,024	18.7	8,148,961	100.0
4.1. Health	1,566,058	43.8	1,890,394	52.8	122,428	3.4	3,578,880	100.0
4.2. Education	996,718	38.5	1,444,824	55.8	149,269	5.7	2,590,811	100.0
4.3. Housing and town planning	72,472	9.4	251,267	32.6	446,018	58.0	769,608	100.0
4.4. Community welfare	24,008	4.4	108,559	19.9	414,106	75.7	546,525	100.0
4.5. Culture	77,244	14.4	139,427	26.1	318,371	59.5	535,192	100.0
4.6. Other community and social services	22,070	17.2	35,341	27.5	70,832	55.3	128,094	100.0
5. Production of economic goods	1,348,194	53.4	739,188	29.3	435,580	17.3	2,522,961	100.0
5.1. Basic infrastructures and transport	929,763	49.3	550,402	29.2	405,010	21.5	1,885,175	100.0
5.2. Communications	166,716	93.2	7,605	4.3	4,623	2.5	178,795	100.0

5.3. Agrarian infrastructure	38,026	19.8	134,357	69.7	20,280	10.5	192,812	100.0
5.4. Scientific, technical and applied research	181,330	81.9	38,175	17.3	1,789	0.8	221,443	100.0
5.5. Basic and statistical information	32,359	72.5	8,500	19.0	3,728	8.5	44,587	100.0
6. General economic regulation	595,138	66.7	157,172	17.6	139,576	15.7	891,887	100.0
6.1. Economic regulation	280,793	56.0	101,103	20.1	119,743	23.9	501,640	100.0
6.2. Commercial regulation	121,235	75.7	19,087	12.0	19,684	12.3	160,155	100.0
6.3. Financial regulation	193,110	83.9	36,982	16.1	—	0.0	230,241	100.0
7. Economic regulation of productive sectors	902,176	69.6	332,836	25.7	60,841	4.7	1,295,704	100.0
7.1. Agriculture, livestock and fisheries	682,970	79.2	167,611	19.4	12,228	1.4	862,659	100.0
7.2. Industry	134,506	48.5	119,445	43.1	23,263	8.4	277,214	100.0
7.3. Energy	8,500	27.2	13,421	43.1	9,245	29.7	31,166	100.0
7.4. Mining	59,946	87.7	8,202	12.0	298	0.3	68,297	100.0
7.5. Tourism	16,254	28.8	24,157	42.9	15,956	28.3	56,218	100.0
9. Grants to public administrations	798,985	88.8	50,552	5.6	50,403	5.6	899,939	100.0
10. Public debt	4,028,477	80.7	408,589	8.2	556,068	11.1	4,993,134	100.0
TOTAL NON FINANCIAL EXPENDITURE	19,589,149	66.7	6,179,533	21.0	3,618,695	12.3	29,387,377	100.0
TOTAL EXPENDITURE	21,309,099	67.8	6,303,153	20.0	3,844,761	12.2	31,457,013	100.0

Source: Ministry of Economy and Finance: The decentralisation of public expenditure in Spain (1984-93).

an implicit agreement that at the end of the process central government would manage approximately 50 per cent of public expenditure only, the rest being managed—25 per cent each—by ACs and local governments. Nevertheless, the lack of an explicit agreement about the ceiling of responsibilities to be reached by ACs together with the concurrence of responsibilities in several levels of government has produced a series of juridical conflicts and inefficient duplicities of bureaucratic organisms. Moreover, the financial system has been affected by these issues, and perhaps it is there that the perception of these problems has been greatest.

Taking into account the principles of economic rationality, a financial system which was consistent with the spending needs for each level of government, based on the volume of assumed responsibilities,⁵ would have to be established. Therefore, the estimation of those needs and their determinants should be the basis on which a system of stable financing in a dynamic sense would be built. However, in the Spanish case the evolution of the system was strongly conditioned by political components, which have led to the maintenance of a special system of financing (foral) exclusively for two communities. In the case of the others, a financial schema subject to five-yearly revision has been perpetuated, but only the allotment of the increments in financing is subject to discussion. Consequently, this arrangement has been based in good measure on ‘ad hoc’ conditions and has impeded the consolidation of a stable financing system. I will dedicate the following pages to describing the foundations of the different financing systems.

3

THE AUTONOMOUS FINANCING MODELS

Moving towards fiscal decentralisation has necessarily implied the provision of enough resources to subcentral levels of government to face a growing range of obligations. In concrete terms, it was necessary to create *ex-novo* for the ACs (new intermediate level of government) a financial system which would satisfy their expenditure needs, in view of the new responsibilities that had been constitutionally assigned to them. As I have previously indicated, historical and, mainly, political reasons resulted in two of the new ACs (Euskadi and Navarra) diverging from the common or ordinary financing system and maintaining a special and more advantageous system (the foral regime). For the rest of the territories (the 15 remaining ACs), a new financing system was built using the so-called methodology of effective cost.

3.1

The common regime system

It is habitual to say that the Spanish financing system of common regime ACs is integrated by three blocks of resources, known as sufficiency block, solidarity

block and autonomy block. This separation is useful, since it makes it possible to isolate the different objectives that the various financial instruments seek to cover, although the three blocks do not constitute independent compartments as some interrelations exist among them.

The sufficiency block

The sufficiency block contains the basic instruments of the system, that is to say, those by which the covering of the effective cost of the services transferred to ACs should be guaranteed. Roughly speaking, the effective cost methodology implied that after the transfer of responsibilities from central government the financial resources of ACs should be commensurate with the benefit of services previously made by central government to the same level of covering. As a consequence, each responsibility should be evaluated (quantified or its effective cost calculated) and upon transferral to an AC, should be accompanied by the instruments needed to finance it. In practice, the lack of a reasonably developed system of costs accounting has fostered a situation whereby the effective cost is an 'agreed cost' between central and autonomous governments in mixed transfer commissions.

The revenues integrating the sufficiency block have so far originated from two sources: (a) ceded taxes (CT), and (b) a share in central government taxes (*Porcentaje de Participación en Ingresos del Estado* or PPI), by applying a percentage to central government tax revenues (CGT).

From the beginning, the management and collection of a group of previously centralised taxes has been in the hands of common regime ACs. The object was to endow them with a degree of financial autonomy, but the normative capacity of those ceded taxes was not complied with. The taxes ceded were tax on net wealth, inheritance and gift taxes, property transfer tax, stamp duties and the gambling tax. Initially, taxes on luxury goods and other consumption taxes, levied on the destination principle, were also ceded to the ACs. However, the disappearance of those taxes following the incorporation by central government of the value added tax in 1986 led to a reduction in the fiscal bases of the ACs, and an increase in the dependence on central government grants.

Thus, shares in central government taxes have, in practice, come to be the real base of the system, due to their quantitative importance. They have not, however, taken the form of territorial participation in the actual collection of certain taxes, as happens, for example, in the German case, but have rather taken on the appearance of a system of unconditional grants.

At the beginning of the decentralisation process (transitory stage, until 1987), two serious problems developed due to the direct link between these two financial instruments and the effective cost (EC) of transferred services. On the one hand, the equation

$$\alpha = \frac{EC - CT}{CGT}$$

suggested that an increase in CT would automatically reduce the value of α . Thus, the ACs did not have any incentive to improve the management of ceded taxes because the only purpose of α was to cover the effective cost of transferred services.⁶ Otherwise, the methodology of effective cost involved maintaining services at the same level of covering as that prevailing before decentralisation. Consequently, any AC wanting to increase this level of covering should do so using different sources of financing linked, basically, to the autonomy block. We will examine those resources later.

Awareness of these problems led to a renewal of the prevailing philosophy. Consequently, once the system of financing was established, an automatic evolution mechanism for shares in central government taxes was instituted. To do so, a set of criteria were established on the basis of three general approaches. The first was distributive in character and weighed different indicators of expenditure needs related to the responsibilities assumed by each community. The other two had a redistributive quality and, in this case, fiscal effort and relative poverty variables respectively were weighed.⁷ The efficacy of the new mechanism was to be examined over a five-year period (1987–1991) and revised at the end. Subsequently, a percentage of participation in central government taxes for each common regime AC was established for the year 1986. Taking this as a starting point, the amount that would correspond to each AC could be calculated as follows:

$$PIE_N = PPI_i \cdot ITAE^* \cdot IE$$

where PIE_N was the amount sought for the year N.

PPI_i was the participation percentage of i AC.

$ITAE^*$ were structurally adjusted central government tax revenues for the base year 1986. (*ITAE—Ingresos Tributarios del Estado Ajustados Estructuralmente*. These consist of state taxes, including those used to finance social security, but excluding taxes ceded to ACs and those assigned to finance the European Union.)

IE was the prevailing rate of evolution: as a general rule the variation in $ITAE$ can fluctuate between a maximum established in the evolution of nominal GDP and a minimum guarantee as the evolution of the equivalent expenditures of central government.

Basic financing for the period 1987–91 was calculated in this manner and the same reasoning lies behind the revised model for 1992–6. Only slight modifications were incorporated for the quinquennium, and these related to expenditure needs indicators and the total volume of revenue to be added to the system. Successive agreements concerning the revision system have been adopted by an advisory body, created for co-ordination between central and

Table 10.5 Weight of the variables used for determining the PPI for the 1992–6 period.

Low level of responsibility communities		
Population	64.00%	} 100%
Insularity	0.40%	
Surface area	16.60%	
Geographical dispersion	2.00%	
Administrative units	17.00%	
Tax effort	1.82%	
Relative poverty	2.70%	
High level of responsibility communities		
Population	94.00%	} 100%
Insularity	1.50%	
Surface area	3.50%	
Geographical dispersion	0.60%	
Administrative units	0.40%	
Tax effort	1.82%	
Relative poverty	2.70%	

autonomous governments. This organism is the Council of Fiscal and Financial Policies (Consejo de Política Fiscal y Financiera or CPFF), and it is composed of the AC ministries of finance and the central government ministries of finance and public administration. Once this body reaches agreement, it is ratified by Parliament before being put into effect.

Table 10.5 shows the weight of the different indicators taken into consideration before distribution of the PPI in the period 1992–6.

The feature of the system most open to criticism was the ACs' lack of fiscal responsibility. It can be easily deduced from the schema presented that the instruments to guarantee the financial sufficiency of these governments (therefore most of the resources) left them with little autonomy to accommodate their mixes of revenues. Indeed, as I have previously indicated, after the tax cession the autonomous governments themselves collected and administered these taxes. However, central government continued to hold regulative power over them: it determined tax bases, rates, exemptions and deductions. The consequence of this was very strong financial dependence on central government, which was considered negative both from the point of view of effective autonomy as regards public management, and that of responsibility and accountability in the eyes of citizens/voters. Recognition of this problem led to the inclusion of the need to increase the fiscal responsibility of ACs in the financing agreement for the period 1992–6, and the task of studying the question was delegated to a working group. As a consequence of this, on 7 October 1993, the ACs included a share in the personal income tax (IRPF) for the 1994 and

1995 tax years. As the end of 1995 brought no definitive system, the share was extended until 1996, with the same criteria applicable as in 1995.

The financial effects of sharing were neutral in 1993, since the sharing is conceived as a deposit on the general or PPI grant:

$$PPI_{O93}^i - 0.15IRPF_{93}^i = PPI_{N93}^i$$

Where PPI_{O93}^i = PPI according to the old system (in 1993 in community *i*)

$IRPF_{93}^i$ = resources accruing from the tax liability of personal income tax (IRPF) (in 1993 in community *i*)

PPI_{N93}^i = new PPI (in 1993 in community *i*).

The previous relationship was conditioned by the fact that in 1993, $PPI_{O}^i > 0.15IRPF^i$. Since the ACs of Aragón, Balearic Islands and Madrid did not meet this condition, the percentage share was set at 10 per cent in Aragón and 5 per cent in the Balearic Islands and Madrid.

Since 1993, the evolution of the new share (PPI_N) has continued to depend on the same variables in force at that time. On the contrary, the evolution of the share in IRPF depends on the real growth in the amounts declared by the residents of each autonomous community. However, and to make sure that the new financing system did not spawn winners and losers, maximum and minimum limits were set on growth in variations of the resources derived from the new financing system. This means that all the communities will have greater resources, and those that make a greater tax effort through IRPF will derive greater benefit from the change, albeit with a maximum limit.

Nevertheless, progress in matters of fiscal responsibility with the share on income tax was very poor. Because central government continued to have the authority to fix tax bases and rates, this new financial instrument became, in practice, another kind of unconditional grant. Finally, at the end of April 1996, shortly after the last national elections, the winning party—Partido Popular (PP)—and the Catalan nationalist party—*Convergència i Unió* (CiU)—established an agreement to undertake far-reaching reform of the regional financing system in matters of fiscal responsibility. In substantive terms, it will be possible to increase the AC percentage share in personal income tax up to 30 per cent. In addition, and most importantly, the ACs will have the right to establish the basic elements of the ceded taxes, such as rate and deductions, including the power to modify the tax rates on their share of income tax.⁸

The solidarity block

Once covering of the effective cost of assumed responsibilities was guaranteed, it became clear that it was necessary to face the problem of disparities in the endowment of stocks of public capital along the territory, which was a source of considerable inequity among the people living in the poorest regions. In order to do this, and to cover the solidarity block, a number of primarily conditional

grants linked to investment projects were set up. Among these, the most important is the Interterritorial Compensation Fund, whose endowment is made using 30 per cent civil investment budget of central government as a basis. This fund is only distributed among the poorest autonomous communities, those whose per capita income does not reach 75 per cent of the European Union mean. The distribution criteria include population (87.5 per cent), migratory balance (1.6 per cent), unemployment (1 per cent), surface area (3 per cent) and population dispersion (6.9 per cent). Furthermore, as distribution is calculated following the above criteria, the result is corrected with the inverse of income per inhabitant of each region and those living in the islands. More specifically, the ICF distribution formula is as follows:⁹

$$ICF_i = \left[\left(0.875 \cdot \frac{P_i}{\sum P_i} + 0.016 \frac{MB_i}{\sum MB_i} + 0.01 \cdot \frac{U_i}{\sum U_i} + 0.03 \frac{Sr_i}{\sum Sr_i} + 0.069 \cdot \frac{NP_i}{\sum NP_i} \right) \cdot Q + 3.624 \cdot \left(\frac{P_i}{\sum P_i} - \frac{GDP_i}{\sum GDP_i} \right) \cdot Q \right] \cdot I_i$$

where ICF_i is community i 's share in the Interterritorial Compensation Fund

P_i is the population of community i , in mean values of the last five years,

MB_i is the migratory balance of community i , defined as the mean of the internal migratory balance plus the mean of outbound migration for the last ten years, taking zero value if $MB_i > 0$,

U_i is the number of unemployed in community i , in mean values for the last available five years,

Sr_i is the surface area of community i ,

NP_i is a measurement of population density

GDP_i , in average values for the last available five years,

I_i is the correction factor for the insularity variable corresponding to community i , so that the sum corresponding to the autonomous community of the Canary Islands by virtue of the rest of the criteria increases by 63.1 per cent, whereas the amount for the other communities falls proportionately and,

Q is the total volume of ICF to be distributed.

Other main financial instruments obtained by the ACs to cover solidarity objectives are the investment agreements between central and autonomous governments (essentially matching grants) and the European Structural Funds. Besides these, the Spanish system includes another financial instrument, the special assignments of equalisation, from central government budget, whose theoretic function is to cover major insufficiencies in the provision of basic

public needs detected in a territory. The reality is that this instrument has never been implemented.

The autonomy block

Finally, a community may want to augment the level of covering for the services it provides, either by increasing the quantity or improving the quality. To meet this demand, the Spanish system possesses some financial instruments linked to autonomy block. These instruments are known as own taxes, and differ from ceded taxes, surcharges and borrowing. Own taxes are limited by the following binding conditions, which in practice make their use very difficult.

- Avoidance of double taxation, i.e. do not tax bases already taxed by central government.
- Avoidance of fiscal exports: do not tax income or goods outside the autonomous community.
- Maintenance of the unity of the interior market, i.e. do not obstruct free input and commodity flow.

In view of these limitations, the main taxes created by ACs consisted of taxes on gambling (eight ACs have established a tax on Bingo), taxes on under-productive land (put in place by three ACs, with fiscal—and other—objectives) and a number of environmental taxes. In any case, the financial weight of the own taxes of ACs is very slight.

Surcharges may be made on central income tax and ceded taxes with two limitations: the nature of the taxes surcharged must not be modified and the tax collection of central government must not be reduced. For instance, if we want to surcharge central income tax, the personal and progressive character of that tax must be preserved, and the surcharge cannot be deducted from central tax. In practice, no community has ever established a surcharge, due perhaps to the lack of political incentives to do so in moments of increasing tax pressure at both central and local levels. All communities have chosen to cover their autonomous desires by borrowing, which has become the only instrument of true income autonomy.

However, some apparently severe restrictions have been placed on the capacity of ACs to borrow, in order to avoid potential macroeconomic problems linked to the expansion of autonomous debt. Of these, three can be highlighted:

- 1 An allocation limit, i.e. ACs can only borrow to allocate it to investment projects or cover transitory (less than a year) treasury needs.
- 2 A maximum quantitative limit: the sum of all financial charges (interests and amortisation) linked to borrowing must not exceed 25 per cent of their current income.

Table 10.6 Structure of revenue in common regime ACs, 1993.

	<i>Millions of Pts</i>	<i>%</i>
1. Tax revenue (A+B+C+D)	837,834	14.77
A. Ceded taxes	658,642	11.62
Tax on net wealth	61,692	1.09
Inheritance and gift taxes	88,371	1.56
Property transfer tax	216,866	3.82
Stamp taxes	141,008	2.49
Gambling tax	150,705	2.66
B. Own taxes	74,773	1.32
Gambling tax	17,146	0.30
Excise tax on oil products	26,707	0.47
Water taxes	30,657	0.54
Under-productive land tax	263	0.00
C. Surcharges	10,604	0.19
On gambling tax	4,279	0.08
On municipal business tax	6,325	0.11
D. Other tax revenue	93,815	1.65
2. Fees, user charges and public prices	151,310	2.67
3. Grants	4,610,707	81.31
General (PPI)	1,772,694	31.26
Specific	2,838,014	50.06
Health and social services grant	1,520,079	26.81
FCI (Fund of interterritorial compensation)	163,844	2.89
European funds	242,770	4.28
Central grants to local governments	548,682	9.68
Other grants	362,640	6.40
4. Other revenue	70,603	1.25
Total non-financial revenue (1+2+3+4)	5,670,454	100.00

Source: Ministry of Economy and Finance: Budgets of Autonomous Communities 1993 and Report on Autonomous Communities financing in 1993.

3 Direct authorisation: ACs must have explicit authorisation from central government to borrow in foreign capital markets (foreign currency) and put autonomous public debt securities into circulation.

In practice, a number of ACs have at times ignored the first two limits without being penalised. Moreover, the increasing use of borrowing by ACs throughout the last decade, together with the need to meet the convergency criteria laid down in Maastricht, have made it necessary to add new limits to autonomous

debt and deficits. For this purpose a new agreement was reached, whereby all ACs agree to set a ceiling to their annual debt and deficit and, in exchange, central government automatically approves all borrowing operations for which its authorisation is legally necessary (see [Table 10.6](#)).¹⁰

3.2

The ‘foral regime’ system

I have now summarised the main points relating to the financing system of ‘common regime’ ACs. Fundamentally, the other system—‘foral’—is a reversal of the pattern of financial relations between the central government and common regime ACs. Whereas the latter depend on grants (the result of their traditionally scant financial autonomy), the ‘foral’ system is based on an agreement whereby the respective ‘foral’ territories—the *Concierto*, in the Basque Country, and *Convenio*, in Navarra—take charge of the main taxes of the state tax system. These ACs have a margin of financial resources to transfer a sum to central government by way of payment for state services provided in their ‘foral’ territories: the quota (*el Cupo* as it is known in the Basque Country, or Contribution, in Navarra).¹¹ Nevertheless, own management of the ‘agreed taxes’ logically means a higher degree of financial autonomy. Better management of these taxes would in turn create possibilities of improving services to the ‘foral’ governments, because the quota is not linked to their receipts.

A vertical tax imbalance is produced between levels of government as a result of their matching their respective tax powers with expenditure requirements, in accordance with the current system of responsibilities. Consequently, the ‘foral’ territories have a greater taxing capacity than would really be necessary for the financing of their responsibilities, which is exactly the opposite in the case of the common regime ACs. This explains why the flow of grants between levels of government goes from the central government to common regime ACs, in one case, and in the other, from the ‘foral’ territories to central government.

The systems of privileges applied in the Basque Country and Navarra are inherently similar. Nevertheless, there are certain small differences between them. Perhaps the most significant of these stems from the different character of the two ACs. It is therefore important to be aware that the real ‘foral’ authorities—those with taxing power—are the provincial governments (historical territories, in constitutional terminology). Due to this, the structure of internal relationships in the Basque Country entails a degree of complexity that does not occur in Navarra. The reason for this lies in the fact that Navarra is a one-province community, where the province as a separate administration has disappeared, and its responsibilities assumed by the autonomous community.

In practical terms, the tax and financial relationship between the Basque Country and central government is based on a pact (the Economic Agreement or *Concierto Económico*). Thus, the organs pertaining to the ‘foral’ system of the historical territories (Basque Provinces) of Álava, Vizcaya and Guipúzcoa, over

Table 10.7 Structure of revenue in 'foral' regime ACs, 1993.

	<i>Basque Country</i>		<i>Navarra</i>	
	<i>Millions of Pts</i>	<i>%</i>	<i>Millions of Pts</i>	<i>%</i>
Taxes	1,409	0.26	144,925	74.34
Fees, public prices and fines	19,108	3.50	9,018	4.63
Grants	519,080	95.02	31,103	15.95
From provinces	450,214	82.41	–	0.00
Others	68,866	12.61	31,103	15.95
Other revenue	6,688	1.22	9,896	5.08
Total non-financial revenue	546,285	100.00	194,942	100.00

Source: Ministry of Economy and Finance: Budgets of Autonomous Communities 1993.

the 'agreed taxes'. According to the provisions of the Economic Agreement, attributing not only management responsibilities to the competent 'foral' system body, but also tax regulatory capacity can effect agreement on each tax. In this case it would be dealing with 'agreed taxes' (*impuestos concertados*) through autonomous regulations and all others through common regulations. The 'agreed taxes', in any case, include all central government taxes, except special taxes (excises),¹² social security contributions (payroll taxes) and import taxes.

The Basque Country's favourable vertical tax balance deriving from the Economic Agreement is subsequently adjusted through payment of the quota, conceived as a contribution towards non-assumed general state responsibilities. Since the services provided by the state in the Basque Country depend at all times on the power sharing in force during the period in question, the quota is adjusted when a transfer of power takes place.

Besides what might be termed the external fiscal relationships of the Basque Country, articulated by means of the quota, there is also a considerable flow of internal fiscal relations. These take the form of grants from the 'foral' system provinces towards the autonomous community of the Basque Country and the Basque municipalities. Obviously, in the case of Navarra, internal relations are limited to the links with Navarran municipalities.

Furthermore, apart from the 'agreed taxes' (or grants received from the 'foral' provinces in the Basque Country), their main resources, the foral regional governments are also financed by other revenues received in their capacity as autonomous community. As an example, specific grants to finance health and social services, grants from the European Structural Funds and income from property and borrowing are additional sources for financing foral ACs (see Table 10.7).¹³

Table 10.8 Structure of revenue in common regime provinces, 1993.

	<i>Millions of Pts</i>	<i>%</i>
Taxes	70,624	12.68
Surcharge on municipal business tax	28,895	5.19
Fees, public prices and fines	61,913	11.12
Fees and user charges	7,414	1.33
Public prices	35,670	6.41
Betterment levies	256	0.05
Fines and other revenues	18,573	3.34
Grants	409,983	73.62
From state	337,965	60.69
From ACs	40,866	7.34
Other	31,152	5.59
Other revenue	14,348	2.58
Total non-financial revenue	556,868	100.00

Source: Ministry of Economy and Finance: Budgets of Local Administrations 1993.

4

THE FINANCING SYSTEM OF LOCAL GOVERNMENTS

As previously outlined, the structure of Spanish local government comprises two levels, provincial and municipal. In practice, only the municipal governments can collect their own taxes, albeit being closer to citizens. Provincial governments are totally dependent on grants from other levels of government (apart from the possibility to fix a surcharge on the municipal business tax), especially since the introduction of VAT to the central sphere of VAT (1986) which took away some important provincial tax receipts.¹⁴ This clearly does not affect the foral ACs, whose structure of income is completely different in that they come under the 'agreed tax system'. In Tables 10.8 and 10.9, some quantitative and qualitative information is provided re differences in revenues in all 'common' regime and 'foral' regime governments.

Turning attention to municipal governments, following the reform of their financial system in 1988, local sufficiency centres on two basic financial mechanisms similar to the components of the sufficiency block in the common regime ACs' system. These instruments are own taxes and a share in central government taxes. Furthermore, Spanish local governments can access other resources such as those derived from the exploitation of their own property, as well as resorting to credit. The own taxation of Spanish municipalities is based on the availability of three compulsory taxes collected by all the municipalities—

Table 10.9 Structure of revenue in 'foral' regime provinces, 1993.

	<i>Millions of Pts</i>	<i>%</i>
Taxes	691,121	89.71
Surcharge on municipal business tax	802	0.10
Other taxes	690,319	89.56
Fees, public prices and fines	28,567	3.71
Fees and user charges	740	0.10
Public prices	5,966	0.77
Fines and other revenues	21,861	2.84
Grants	36,536	4.74
From state	13,714	1.78
From ACs	15,626	2.03
Other	7,196	0.93
Other revenue	14,222	1.85
Total non-financial revenue	770,770	100.00

Source: Ministry of Economy and Finance: Budgets of Local Administrations 1993.

two voluntary taxes and a third (voluntary) which remains from the old financing system. The compulsory taxes are property tax, business tax and motor vehicles tax. The voluntary ones, meanwhile, are the tax on increments in urban land value and the tax on buildings, plants and works. The latter was formerly known as tax on sumptuary expenses, which at present only taxes private exploitation of hunting and fishing grounds. In all cases, municipal governments can establish the tax rate between a set of upper and lower limits; the top rate depends on the range of population in the municipality (the greater the population, the greater the rate). In practice, this system gave municipalities more fiscal autonomy than that possessed by autonomous communities: municipal governments obtain roughly 50 per cent of their financial resources from taxes, while the figure for common regime ACs barely reaches 15 per cent (both including fees and user charges).

Spanish municipalities enjoy a broad degree of autonomy for the purpose of raising their own taxes (roughly 60 per cent of the total). Despite this, the fact that central government retains the main tax components as far as collecting power is concerned (income tax, value added tax, etc.) makes the introduction of a powerful system of grants indispensable by way of guaranteeing the constitutional principle of sufficiency. In Spain, this system is largely based on a general grant which is often given the somewhat confusing name of state revenue sharing (PIE—Participación en Ingresos del Estado), and whose design is very similar to that of the tax sharing percentage (PPI) obtained by the autonomous communities (ACs). What both (autonomous and local) have in common is that

they are general and unconditional grants from the state and they do not share in the territorial collection of state taxes. Nevertheless, there is an important difference between them which must be pointed out. While both command the freedom to dispose of resources as they will, they are at odds as regards determination of the amount, since the bases for establishing the latter are different, and therefore involve implicit and distinct distributive consequences.

There is, moreover, an additional difference between the sharing of ACs and that of municipalities. Where each AC has its own percentage, determined in relation to the criteria analysed above, the share of municipalities constitutes a general fund,¹⁵ which in a second phase is distributed among the 8,000 municipalities, on the basis of other criteria.

More in particular, once the basic conditions of the system have been specified for a precise time period (five years), the definitive quantity is established in accordance with the Central Budget Act. In 1988 an initial definitive financing was set for municipalities. This was used to calculate the percentage share they would be entitled to in the course of the five-year period, in line with norms analogous to those established for the ACs, which means that the same base (central government taxes) and the same rules of evolution were fixed. This is how the share of municipalities in central government taxes for the year N (PIE_N) is defined,

$$PIE_N = PPI \cdot ITAE^* \cdot IE$$

where PPI is the percentage share of municipalities (as a whole)

$ITAE^*$ are structurally adjusted central government tax revenues (pre-defined) for the base year

IE is the prevailing rate of evolution.

The only difference in the rate of evolution (IE) with regard to the one used for the ACs is the fact that the minimum guarantee (variation in equivalent central government expenditure—GEE) is replaced by the increase in the consumer price index (inflation) between the periods considered. This is because the use of the GEE makes no sense at municipal level due to the different nature of its spending powers. The Local Finance Act is therefore seen to guarantee autonomy in the granting of the main source of general grants.

Once the overall sum of PIE has been set, it must be distributed among the different municipalities. Once again, the Local Finance Act draws on the Central Budget Act to establish specific criteria, even when a series of general rules are in place. The practical embodiment of these distribution criteria implemented by successive Central Budget Acts takes the form of three basic points:¹⁶

- 1 The special treatment afforded to the municipalities of Madrid and Barcelona is maintained, which entails guaranteeing an increase in their financing outside the general fund, by the application of the prevailing rate of evolution to their financing. Furthermore, special compensation is

Table 10.10 Structure of revenue in common regime municipalities, 1993.

	<i>Millions of Pts</i>	<i>% of total</i>
Taxes	913,354	35.87
Property tax	419,952	16.49
Business tax	208,082	8.17
Motor vehicles tax	135,188	5.31
Tax on increment of urban land	48,778	1.92
Tax on buildings, plants and works	76,140	2.99
Fees, public prices and fines	502,857	19.75
Fees and user charges	176,585	6.94
Public prices	201,296	7.91
Betterment levies	28,869	1.13
Fines and other revenue	96,107	3.77
Grants	1,016,850	39.94
From state (PIE)	719,630	28.26
From ACs	185,017	7.27
From provinces	63,917	2.51
Other revenue	113,063	4.44
Total non-financial revenue	2,546,124	100.00

Source: Ministry of Economy and Finance: Budgets of Local Administrations 1993

introduced for municipalities integrated within the metropolitan area of Madrid and those that comprise the metropolitan area of Barcelona.

- 2 Each municipality is guaranteed a minimum financing which consists of a standard increase on the previous year's (excluding the compensations mentioned in the preceding paragraph).
- 3 Once the above quantities have been deducted, the remaining PIE is distributed among the municipalities in accordance with the three general criteria provided for by the legislation, to wit:
 - 70 per cent depending on the number of inhabitants in each municipality, pondered by a series of coefficients as per strata of population, the top being 2.85 for municipalities with over 500,000 inhabitants and the bottom 1 for those below 5,000.

Table 10.11 Structure of revenue in 'foral' regime municipalities, 1993.

	<i>Millions of Pts</i>	<i>% of total</i>
Taxes	60,154	23.88
Property tax	21,279	8.45
Business tax	13,930	5.53
Motor vehicles tax	8,742	3.47
Tax on increment of urban land value	4,006	1.59
Tax on buildings, plants and works	10,463	4.15
Fees, public prices and fines	43,558	17.29
Fees and user charges	20,929	8.31
Public prices	12,931	5.13
Betterment levies	803	0.32
Fines and other revenue	8,895	3.53
Grants	133,504	53.00
From state (PIE)	4,033	1.60
Other revenue	14,670	5.82
Total non-financial revenue	251,886.05	100.00

Source: Ministry of Economy and Finance: Budgets of Local Administrations 1993

- 25 per cent depending on the number of inhabitants, weighted according to the average tax effort of each municipality in the year prior to the revenue-sharing year, and
- The remaining 5 per cent depending on the number of general basic education school units, both pre-school and special, existing in public centres where the property belongs to the municipalities, or depending on the upkeep and maintenance expenses payable by them.

As I have said earlier, apart from these incomes, Spanish municipalities can also obtain resources from other origins, such as specific grants, interest on patrimony, share of ACs income, fines and public or private loans. Tables 10.10 and 10.11 show the revenue structure of municipalities in common regime and foral regime territories respectively. Finally, Figures 10.5 to 10.11 show additional information about Spanish fiscal decentralisation.

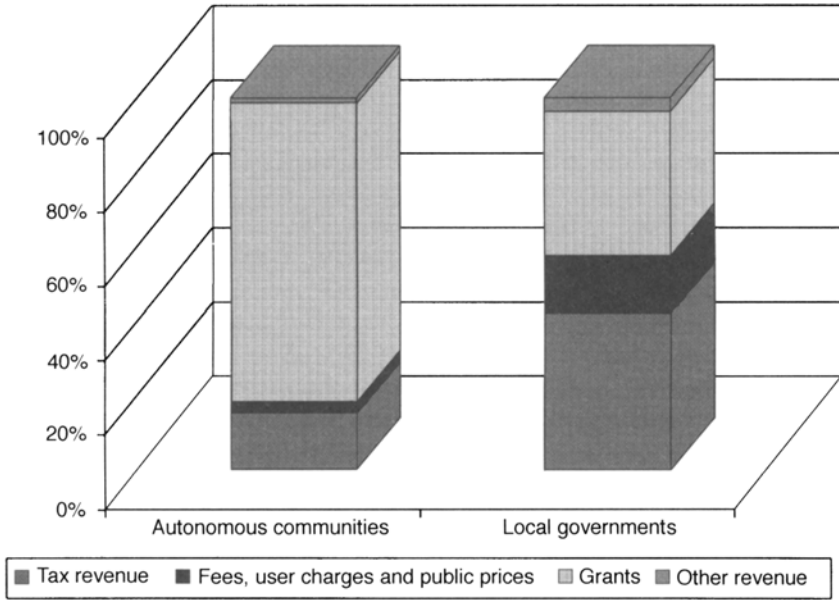


Figure 10.5 Spanish revenue decentralisation (aggregated data).

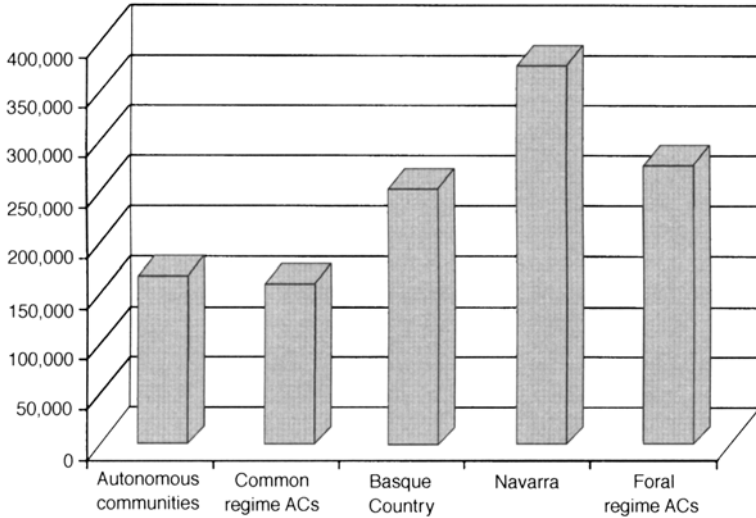


Figure 10.6 Spanish expenditure decentralisation (autonomous communities financing—pts/habitants).

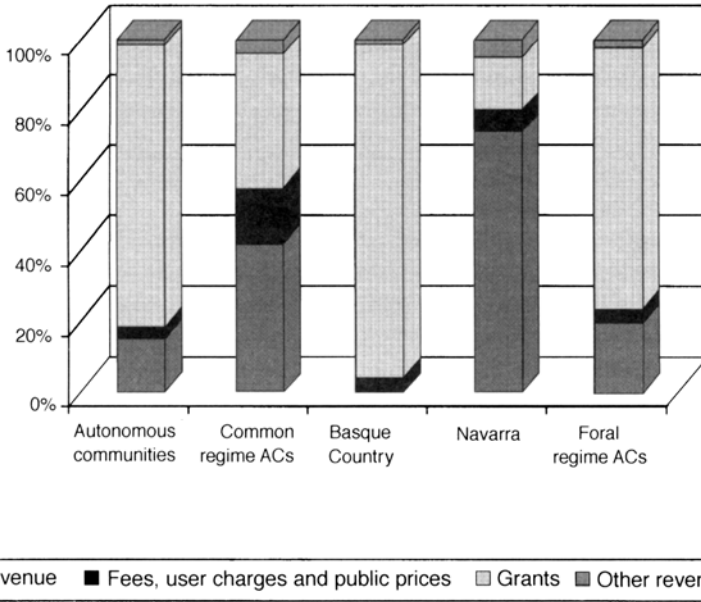


Figure 10.7 Spanish expenditure decentralisation (autonomous communities structure).

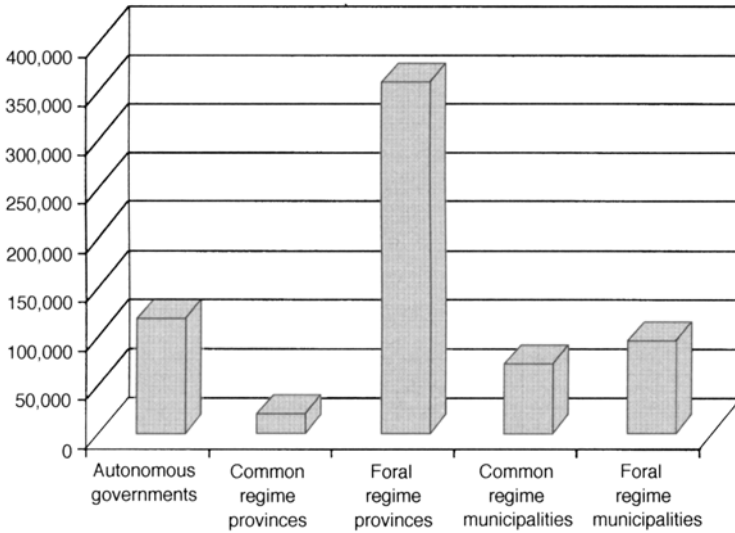


Figure 10.8 Spanish revenue decentralisation (local government financing—pts/ habitant).

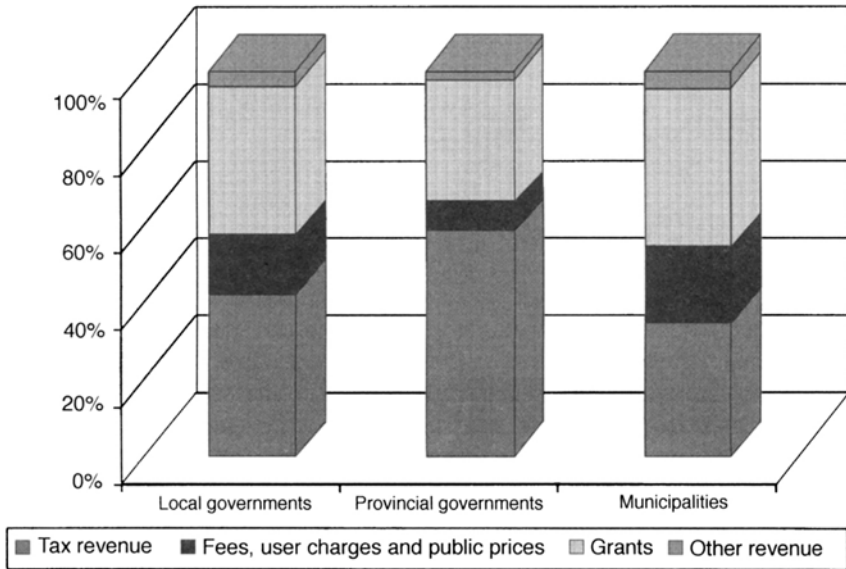


Figure 10.9 Spanish revenue decentralisation (local governments).

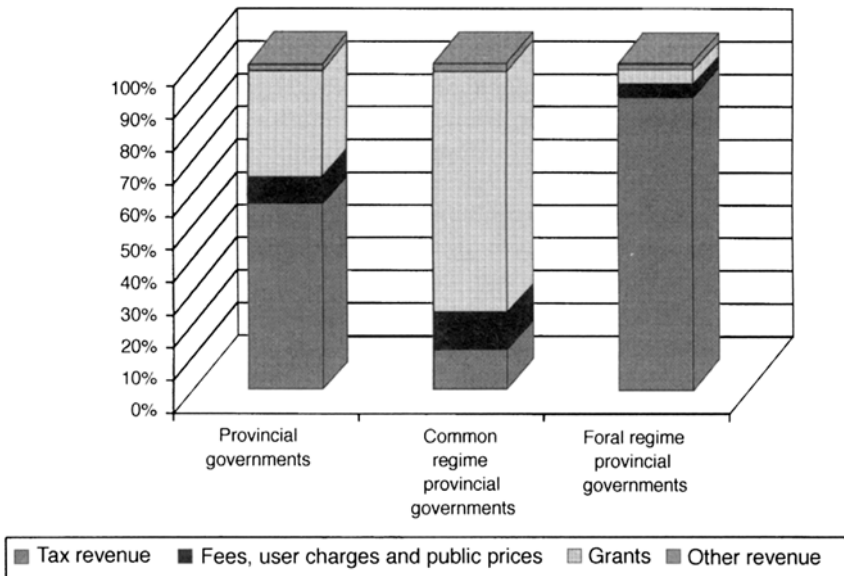


Figure 10.10 Spanish revenue decentralisation (provincial governments).

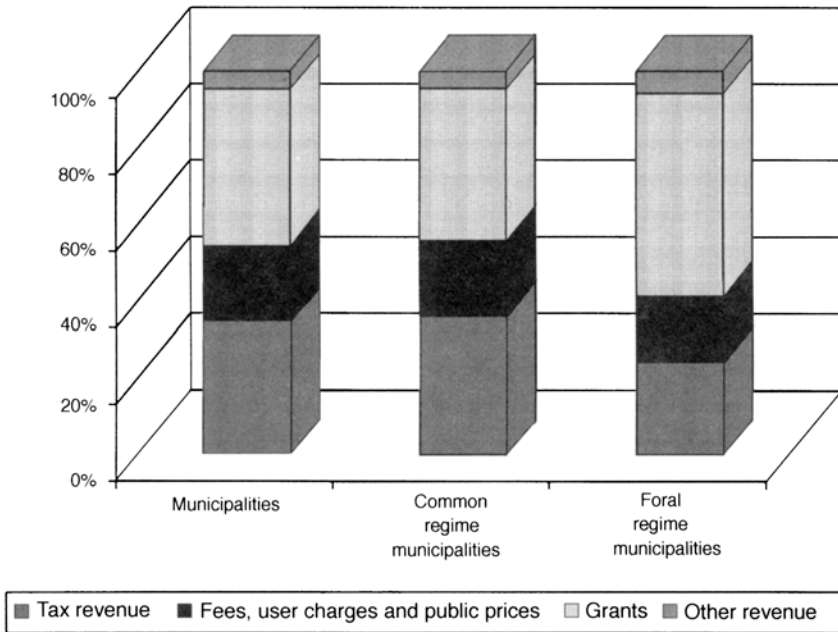


Figure 10.11 Spanish revenue decentralisation (municipal governments).

5

FINAL COMMENTS

As we have seen up to this point, Spanish general government has experimented over the last decade with a major decentralisation process, which has resulted in an increase of almost 25 percentage points due to the participation of subcentral bodies in the management of public expenditure. Such decentralisation could be qualified as orthodox from the point of view of expenditure, given that subcentral finance is fundamentally dedicated to allocation objectives.

From the point of view of income, fiscal decentralisation in Spain also respects to a high degree fiscal federalism theory guidelines, where the main decentralised taxes were on bases with little capability of inter-jurisdictional mobility (personal and real property taxes for example). Taxes more closely related to redistributive or stabilising activities were not decentralised (income tax or corporation tax for example)¹⁷ with the exception of foral regimes. But the system chosen in the Spanish case has left some loose ends, which need to be dealt with. For instance, the Spanish system gave little incentive to fiscal co-responsibility, above all at the level of ACs. Without doubt, the possibility that these had to relate their tax demands to their needs of expenditure were minimal. The regulation of ceded taxes was therefore carried out at central level (not even the rates could be changed) and the requirement of non-assessment of taxable

factors already subject to central taxation greatly limited the possibilities of creating new taxes. The only path so far unexplored has been the application of surcharges as an option to fiscal co-responsibility. This created a dangerous asymmetry in the distribution of political costs and benefits derived from public actions, where subcentral levels benefited from the popularity gained by providing a larger quantity and better quality of services without bearing the cost that taxation demands suppose. This generalised non-fulfilment of the fiscal equivalence principle (Olson 1969) seemed unalterable in the Spanish system of fiscal federalism, where autonomous surcharges continue unused.¹⁸ An attempt to overcome this was made with the last agreement on AC financing, by including as a new ceded tax a portion of income tax and by giving ACs some normative powers over ceded taxes (income tax too). At the same time, the total volume of general grants (PPI) was substantially reduced. ACs will thus be compelled to assume a much greater level of fiscal responsibility (they will win in autonomy), but the solidarity principle could be damaged.

Apart from this, the differences between foral regime and common regime territories in expenditure per inhabitant and financing are unacceptable from the point of view of fairness. The existence of territories that are fiscally privileged could create considerable tension during consolidation of the decentralisation process, where financial reactions are unpredictable. It is therefore vital to reduce the complexity of the financial system of subcentral governments by reducing the number of financing instruments and giving them a more permanent character, so avoiding continuous negotiation between levels of government and consequent political tension.

Finally, too many discrepancies have arisen regarding the distribution criteria of inter-territorial grants, mainly those related to local level.¹⁹ From a theoretical point of view, it seems reasonable to expect that the general or unconditional grants should bridge the existing gap between expenditure needs and fiscal capacity of the subsidised entity. It also seems fair to incorporate some measure of fiscal effort to encourage the taking on of fiscal responsibilities or popularity costs by those above-mentioned entities. In this sense, an appropriate measure of expenditure needs is essential to design a correct distribution mechanism, just as an analysis of the historical determinants of expenditure²⁰ would help to improve the formulas.

To conclude, I would like to mention two things that always come to the fore in debates about our fiscal federalism system: its creation and limitations. First, I must point out that the Spanish process of decentralisation continues to be an incomplete and fundamentally unstable system, due, in my opinion, to the fact that its origin was political rather than economic. I take the view that the nationalist desires of two particularly important regions (Catalonia and the Basque Country) and the need to fulfil those aspirations without generating strong inequities with respect to the other territories were the foundation stones of the autonomous state. Moreover, the lack of explicit political agreements about the arrival point (the upper limit of responsibilities to be assumed by ACs) has set

the process in a framework of severe uncertainty, which has delayed its completion. However, although with partial agreements only, it was possible to decentralise a very significant amount of the public sector (20 per cent as a mean and close to 30 per cent in some communities) in a very short time, which, in my opinion, is a positive aspect.

From a more technical point of view, and referring only to the financial system, it is important to remark that there is periodic controversy over the trade-off between the two main principles that should be preserved: the autonomy principle versus the solidarity principle. This occurs at five-year intervals, when the system undergoes revision. I have noted that historically regional financing was—paradoxically—only slightly autonomous on a day-to-day basis, and very dependent on central grants. The latest reforms have made a strong attempt to modify this aspect by transferring to ACs more normative powers on ceded taxes, and by adding to these a share in income tax. However, this change has resulted in dissent among some of the poorest communities, who have appealed to the constitutional court. In essence, these governments declare this reform to be unfair, in that the richest regions can collect more income with lower tax rates; moreover, the cession of a share in income tax to ACs will reduce central government income to redistribution purposes. On the contrary, the rest of the communities support the new system by arguing that it increases the fiscal co-responsibility. As the two positions become politically incompatible, the question can be asked which side will eventually win, and what the financial system of the future will be. For the moment, the question is open, and to use Bob Dylan's phrase, 'the answer is blowing in the wind'.

Notes

- 1 Obviously, if we take social security spending into account, these figures increase considerably. In particular, social security expenditures were 9.66 per cent of GDP in 1975 and 19.09 per cent in 1995.
- 2 At the moment, nevertheless, there is a process ongoing whereby ACs with a low level of responsibilities can take over responsibilities pertaining to health and education. In concrete terms, all ACs have already assumed responsibilities in higher education and it is expected that in 1999 the transference process in matters of education will be concluded.
- 3 See Oates (1972), King (1984) or Rubinfeld (1987), to cite but a few works which have become classics in the field.
- 4 Which argued for the superiority of decentralised provision of public goods under some general assumptions. See Barzel (1969) and Oates (1972).
- 5 As is well known, the more common principles of fiscal federalism suggest that subcentral levels of government be fundamentally devoted to providing public goods and services according to their jurisdictional size.
- 6 The Madrid AC was deprived of ceded taxes at the very beginning, since their presumed collection would overcome the effective cost of the transferred services.
- 7 For a more detailed analysis see Monasterio and Suárez-Pandiello (1998).

- 8 For a more detailed examination of the changes relating to the autonomous share in income tax, see Zabalza (1994), Perez (1995) or Bosch, Suárez-Pandiello and Espasa (1996).
- 9 A wide-ranging revision of the principles and the time evolution of the ICF can be had from Biescas *et al.* (1992). For a more summary version, Monasterio and Suárez-Pandiello (1998), [Chapter 6](#).
- 10 A more detailed analysis of this point, and, in general, of regional and local debt can be found in Álvarez Corbacho, Monasterio and Suárez-Pandiello (1998).
- 11 Note that the differential sphere of the foral system refers exclusively to revenue (financing system). Regarding expenditure, both the Basque Country and Navarra are autonomous communities with a high level of responsibilities (as demonstrated in [Table 10.1](#)).
- 12 Recently, a new agreement was reached, which also includes excises in the 'agreed taxes' with the Basque Country.
- 13 For a more technical and comprehensive explanation of the foral system see Zubiri & Vallejo (1995), Monasterio & Suárez-Pandiello (1998) or Bosch, Suárez-Pandiello and Espasa (1996).
- 14 These provincial taxes were the surcharge on the old business trading tax (multi-phasic tax) and the tax on the production of electric power.
- 15 With the exception of the big metropolitan cities (Madrid and Barcelona) which have an independent share.
- 16 For a more detailed and critical analysis see Suárez-Pandiello (1996).
- 17 See Musgrave (1983).
- 18 In this sense some theories could be a subject of contrast, such as the one proffered by Grossman (1989). In his view, after the abandonment of the fiscal equivalence principle there was a—not necessarily explicit—political agreement, between central government and subcentral ones to exchange grants for votes.
- 19 See, for example, Suárez-Pandiello (1996).
- 20 For the Spanish case, see Monasterio and Suárez-Pandiello (1989), Bosch and Suárez-Pandiello (1994) and Bosch and Suárez-Pandiello (1995).

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11

Fiscal federalism in Switzerland: a survey of constitutional issues, budget responsibility and equalisation

Bernard Dafflon

1

INTRODUCTION

This chapter deals with the institutions and actual problems of fiscal federalism in the case of Switzerland. It is divided into five sections. Starting with a short summary of the constitutional issues which have relevance to Swiss decentralised public finance (section 2) and a description of the main components of the fiscal structure (section 3), it develops in three directions: budget policy (section 4), taxation (section 5) and fiscal equalisation (section 6).

Since the Constitution of 12 September 1848, Switzerland has been, in institutional terms, a relatively complex system of three layers of government: (a) the communes, at the local level, (b) the cantons, at the intermediate level and (c) the confederation, at the national level, which are interconnected by many vertical and horizontal relationships. At the end of 1996, there were 26 cantons and 2,940 local governments or communes.

In the past three decades, Switzerland has out-performed most European democracies in terms of overall fiscal restraint and minimising the centralisation of fiscal power. Constitutional arrangements, at federal and cantonal levels, certainly explain this performance. The subsidiarity principle—which recommends that competence in the provision of public services should be vested to the lowest possible level in the fiscal hierarchy—has probably been more scrupulously respected in this country than in most other federations because of both constitutional guarantees and a traditional mistrust of global nationwide policies. As a consequence, the power to decide and finance the provision of public services has remained largely (and jealously) in decentralised hands, in cantons or communes, alone or associated in various forms of cooperative federalism. However, the fairly extensive autonomy of cantonal and local governments for their finance is not unlimited. Competition between jurisdictions is a first limit. Second, many cantons have introduced their own constitutional rules with regard to (balanced) budget and debt limitation (section 4). Fiscal competition is partly softened by rules of tax coordination and harmonisation (section 5). Autonomy in public expenditures, direct access to

many revenue sources and, above all, differences in the cantons' economic potential have led to relatively important regional disparities, expressed in the fiscal burden of the cantons and in their financial capacity. These disparities are at the core of the Swiss equalisation policy, although there is no claim for perfect equality between cantons or communes ([section 6](#)).

2

INSTITUTIONAL ISSUES

In fiscal federalism, institutions play an important role in shaping the relations between the layers of government. It is therefore of interest to shed some light on the working of the institutions in Switzerland, particularly on the rules and principles which govern the assignment of functions and revenue sources to decentralised jurisdictions. Two sets of institutions are essential to the working of federalism in Switzerland: constitutional guarantees in the vertical division of power and horizontal cooperation between governments at the cantonal and communal levels.

2.1

Constitutional guarantees

Vertical division of power

The Swiss federal system emphasises the sovereignty of subcentral jurisdictions, i.e. the cantons and the local communities. This sovereignty is derived from the federal and cantonal constitutions, which contain not only the tasks of each government level, but also their right to levy taxes. Thus, the assignment of competences and revenue sources is guaranteed at each level of government.¹ The vertical division of power, intended to prevent stable majorities from being able to exploit minorities, is strongly safeguarded in the Constitution (Knapp 1986; Zimmermann 1987). The federal Constitution of 1874 guarantees the cantons' autonomy in all the spheres in which the Constitution does not explicitly provide for the federal government's competence. Each new competence for the centre therefore requires a constitutional amendment, which necessitates the consent of both a majority of the voters and a majority of the cantons. The autonomy of the cantons is also guaranteed by the legislative power with two chambers. The National Council is elected on the basis of population in the cantons; the Council of States is composed of two representatives from each canton.

Fiscal/financial arrangements are discussed either at federal-cantonal levels or at cantonal-local levels. The federal government addresses itself always and exclusively to the cantons. It cannot bypass cantonal governments to address local governments either to impose or negotiate fiscal or financial matters or the

provision of public services. The inverse is also true: local governments cannot bypass cantonal authorities; they have no direct access to federal bureaux or institutions. In this way, federal decisions concern the canton only; and each canton organises communal competences on its own. This vertical division of power leaves a high degree of autonomy to the cantons. They have their own fiscal systems which are independent of the federal system. The cantons are therefore able to set their own tax rates, and they decide on the provision of public goods and services on their own. Although the modification procedures are long and complex, each voter/ taxpayer in a canton or in a commune is able in the end to compare the costs and benefits of the public activity under consideration and to decide on the amount of public expenditure in a vote or in a referendum.

Direct democracy

Direct democracy participation is provided in most cantonal constitutions for the communes so that citizens themselves may take part in the decision-making process on all important political and economic issues. In local public finance, this competence concerns: current budget, individual investment items of the capital budget, annual tax coefficients, user charge regulations (taxation according to the benefit principle in general), local public property sale or purchase, horizontal cooperation in the form of intercommunal association or special purpose district for the joint production of public facilities, and the merging of communes.

Initiative and referendum

When democracy is representative, which is the case in a large majority of the cantons and in large cities, voters express their preference about political and economic issues mainly via referenda, which may be brought up for vote several times during a year.² Together with popular initiatives, these institutions play a role of moderator for cantonal and local governments, as all important public decisions are usually subject to voters' approval. At the local level, the most common items which might be included in the initiative or the referendum procedure are: individual investment items of the capital budget, taxation, user charge regulations, property sales, cooperation in intercommunal associations or special purpose districts, and the merging of communes.

Audit competences

Parliamentary audit competences of some sort exist in all representative democracies. More interesting is the case of direct democracy. The communal assembly of citizens, or the communal 'parliament' where it exists, elects a finance committee for the length of the political term. The committee has not

only traditional audit competences, but also all the powers to investigate financial matters without warning. In some cantons, if necessary, it may lodge a complaint against individual members of the local authorities for misuse of public funds.

Obviously these institutions of the federal system do not have a unique purpose of (economic) efficiency in the performance of expenditures and taxation. The more direct and democratic the institutions are, the better is their general capacity to strengthen the system of checks and balances, by both dividing and sharing political decision-making power. They give citizens/voters/taxpayers multiple access to government, increase their capacity to control budgets and reduce political and bureaucratic leeway in rent-seeking behaviour. In Hirschman's terminology, they not only have the 'exit' (Tiebout-style mobility), but also the 'voice' solution. The outcomes are that the growth of government activity has been significantly lower than in representative democracy (Pommerehne and Schneider 1978), the size of government is limited (Pommerehne 1978) and public expenditures are driven by the demand side (Kirchgässner and Pommerehne 1990).

2.2

Cooperative federalism

The federal and cantonal Constitutions permit intensive horizontal cooperation at cantonal and communal levels of government. This horizontal cooperation is important for the principle of fiscal equivalence (Olson 1969), so that the circles of deciders, beneficiaries and payers coincide. The cantons and communes are free to conclude agreements with one another on cooperation in the most varied areas and so establish themselves the optimum size of area necessary for the performance of government tasks, for example the provision of certain public goods, from university funding (intercantonal cooperation) to school districts and water provision (intercommunal cooperation). At the local level, the main incentives for intercommunal cooperation are, traditionally, economies of scale and regional spillovers and, more recently, limited managerial skills in many small municipalities, especially when local governments function as production agencies for the centre (cantons or confederation), as for example in the field of environmental policies. The multiplicity of intercommunal special purpose districts has created many institutional problems: a democratic deficit in the regime of communal assembly, higher information and participation costs for individual citizens who henceforward belong not only to one commune but to several other 'clubs', strategic blockages of votes by negotiating communes when a qualified majority is required, and the like (Della Santa 1996). Despite these inconveniences, it may be precisely this executive flexibility of federalism which has long made it resistant to attempts of centralisation on the part of the federal government *vis-à-vis* the cantons, or on the part of the cantons *vis-à-vis* the communes. It also explains why so many small communes can survive

without merging and why the compulsory merging of too small communes is not easily accepted by the citizenry (Dafflon 1996a).

Moreover, horizontal cooperation between the cantons has taken a form which was not foreseen in the Constitution. When the need for a nationwide policy arises, fiscal federalism in theory suggests that this should be realised at the centre, by the federal government. This is not always the case in Switzerland where the cantons have organised themselves horizontally in a set of powerful committees, the so-called Conferences of Cantonal Ministers, one for each department in the administrative division of government executives, of which the Conference of the Cantonal Ministers of Finance (CCMF) is the most influential. From a constitutional point of view, fiscal/financial relations between the federal government and the cantons cannot be tailored according to individual cantonal particularities or wishes. Equality of treatment applies, except within the equalisation law. Although each canton could challenge or negotiate individually fiscal/financial arrangements with the federal government, no single canton would have much chance of succeeding in modifying fiscal/financial arrangements for its own objectives, since any change applies (and indeed should be acceptable) to the other cantons. Within the conferences, the cantons negotiate common policies without interference from the centre, then present a common package to the federal government. The conferences have been successful in negotiating global financial packages in which the point of view of the cantons differs from that of the federal government.

The objective of the CCMF is to discuss fiscal/financial matters which are of common interest to all or a large number of the cantons. It has been organised not so much to coordinate and harmonise fiscal and financial affairs of the cantons (horizontal relations), than to intervene more persuasively in federal-cantonal relations and to interfere in federal-only fiscal and financial matters. The conference is not a constitutional institution. Yet, fiscal matters cannot be decided at the federal level without previous consultation of the CCMF. It is a powerful pressure group, regularly consulted by the federal finance administration. It plays an important role in shaping federal finance, the federal tax system and has a dominant position in federal-cantonal equalisation policies (Dafflon 1995).

3

THE PUBLIC SECTOR: SOME FACTS AND FIGURES

3.1

General indicators

Table 11.1 gives five general indicators about the organisation and economy of each canton: the number of communes, the surface in km², population, national income in the cantons (NIC), (total and per capita) and public expenditures and

Table 11.1 Some general indicators in the Swiss cantons, 1990 and 1994.

Cantons	Number of communes	Surface km ²		1990 Population		1994 Cantonal NIC		Public finance in the cantons, 1,000 Sfr*				
		3	4	5	6	7	8	9	10	11	12	
Zoug	11	207	84,908	428	7,003	77,966	41	619,124	553,192	-65,932	9	
Bâle-Ville	3	37	191,797	5,335	12,209	60,810	18	3,439,265	3,277,861	-161,404	28	
Genève	45	246	375,957	1,578	20,143	51,317	11	5,613,340	4,910,931	-702,409	28	
Zurich	171	1,661	1,150,546	700	65,332	55,307	21	8,097,705	7,323,188	-774,517	12	
Subtotal I		2,151	1,803,198	838	104,687	-		17,769,434	16,065,172	-1,704,262	17	
Bâle-												
Campagne	73	428	230,112	549	11,817	47,382	24	1,799,978	1,704,492	-95,486	15	
Schaffhouse	34	298	71,697	247	3,261	44,352	22	479,823	470,994	-8,829	15	
Argovie	232	1,395	496,280	372	22,778	43,797	18	2,862,844	2,753,666	-109,178	13	
Thurgovie	179	863	205,946	252	8,648	39,467	21	1,153,992	1,061,484	-92,508	13	
Nidwald	11	242	32,628	147	1,614	46,179	24	209,090	198,797	-10,293	13	
Vaud	385	2,822	583,625	211	27,451	44,954	22	4,992,741	4,347,458	-645,283	18	
Glaris	29	681	37,648	58	2,011	51,367	22	293,358	295,030	1,672	15	
St-Gall	60	1,951	420,268	224	17,522	39,854	22	2,368,610	2,369,463	853	14	
Soleure	130	791	226,655	299	8,712	36,966	7	1,280,028	1,225,774	-54,254	15	
Schwyz	30	852	110,526	139	4,975	41,655	28	520,974	528,576	7,602	10	
Tessin	247	2,738	286,725	109	11,646	39,167	27	2,296,197	2,320,720	24,523	20	
Berne	412	5,932	945,573	161	36,368	38,215	12	6,366,507	5,893,079	-473,428	18	

Appenzell Rh. Ext.	20	243	51,740	223	1,898	35,141	9	309,072	300,301	-8,771	16
Lucerne	107	1,429	319,525	235	13,331	39,525	27	2,018,049	1,903,296	-114,753	15
Grisons	213	7,105	170,411	26	7,621	40,577	15	1,389,981	1,390,498	517	18
Fribourg	259	1,591	207,751	138	8,648	38,735	27	1,700,294	1,637,193	-63,101	20
Subtotal II		29,361	4,396,840	150	188,301	-		30,041,538	28,400,821	-1,640,717	16
Neuchâtel	62	717	160,609	229	6,473	39,241	16	1,327,951	1,216,916	-111,035	21
Appenzell Rh. Int.	6	173	13,573	85	476	33,109	12	92,942	101,706	8,764	20
Obwald	7	481	28,813	64	1,067	34,377	13	242,317	238,912	-3,405	23
Valais	163	5,213	248,313	51	8,408	31,545	5	1,955,825	1,781,284	-174,541	23
Jura	82	837	65,697	82	2,183	32,363	9	735,519	658,182	-77,337	34
Uri	20	1,058	33,650	34	1,362	38,728	32	342,613	337,850	-4,763	25
Subtotal III		8,479	550,655	65	19,969	-		4,697,167	4,334,850	-362,317	24
Total	3,021	39,988	6,750,693	174	312,957	44,474	18	52,508,139	48,800,843	-3,707,296	17

Sources: *Annuaire statistique de la Suisse*, 1995, p. 30; *La Vie économique*, 12/1994, pp. 46-8 and 7/1996, p. 48; *Dépenses et recettes des cantons*, A.F.F., Berne, 1996:27 and 31.

Notes

Column 1: ranking of the cantons according to their indices of financial capacity 1994-5.

Column 3: without lakes and glaciers.

Column 8: rate of growth of per capita NI in the individual cantons between 1980 and 1994 in real values (current NI values have been deflated by the indices of consumption prices).

Column 9: total current (43,826 million Sfrs) and capital (8,682 million Sfr) expenditures.

Column 11=columns (10-9): the total deficit is lower than total capital expenditures.

Column 12=columns (9+6).

(*) Values for the cantons only: the public expenditures of the communes amount to 72 per cent of the cantons' total; communal public revenues to 76 per cent (see Tables 11.3 and 11.7).

revenues. Marked differences exist in the organisation of local government, number of communes, size, population and national income, that one probably does not find in other federations (Frenkel 1986). The area of the smallest canton (Bâle-Ville; 37 km²) is 0.5 per cent of the area of the largest (Grisons; 7,105 km²). The population in the least populous canton (Appenzell Rh. Int.; 13,573 residents) is 1.2 per cent of that in the most populous (Zurich; 1,150,546 residents). In 1994, the canton with the highest NIC was Zurich, with a total of 65,658 million Sfr., that is 21 per cent of the national NIC for 17 per cent of the population. The variance in per capita NIC is rather large: from 77,966 Sfr. in Zoug to 31,545 Sfr. in Valais, that is a ratio of 2.5 between the two cantons with the highest and the lowest per capita NIC (or a range from 175 points to 71 points, with an average 100 points=43,704 Sfr.).³ There are also:

- Marked differences in the growth of per capita NIC between 1980 and 1994 (in real values): in 14 of the 26 cantons, the rate of growth was higher than the average 18 per cent (1.3 per cent annual growth rate for the 14-year period), with a maximum of 41 per cent and a minimum of 5 per cent.
- Rather important differences in the public expenditures of the cantons and the size of the cantonal public sector expressed in proportion of NIC: from 9 per cent in Zoug to 28 per cent in Bâle-Ville and Geneva and to a record 34 per cent in the Jura.

This latter comparison must be interpreted with caution. Bâle-Ville is a 'town-canton' with only 3 communes in the same urban area. Therefore the canton plays a central role in policy coordination and in the production of public services and amenities. The production of public services is centralised in order to internalise urban benefit spillovers. The canton of Jura, with 82 (too small?) communes has a low financial capacity. The canton, therefore, stands in for a certain amount of services which cannot be privately sponsored or paid, and these expenditures weigh more heavily on the less developed cantonal economy.

3.2

Size and growth of the public sector

Table 11.2 shows the size and growth of the public sector over the period 1970 to 1994. In 1994, total public expenditures amounted to 131,722 million Sfr. or 32 per cent of gross national product (GNP) (without social security; 39 per cent with social security insurances). In proportion to GNP, the size of the public sector is still quite low compared to other countries in Europe. The growth of public expenditures was relatively important between 1970 and 1980 both in relative and absolute values. It has continued to grow over the past decade (1980–90) in absolute amounts, but the relative share of the total public sector in GNP has remained stable at around 28 per cent. It has regained in proportion over the last four years, partly because the economic situation has deteriorated. The rates

of growth of public expenditures for each layer of government followed the same trend over the whole period. The actual shares of the Confederation, the cantons and the communes in total public expenditures correspond in aggregate values to 31, 40 and 29 per cent; they have not changed over the years.

3.3 Public expenditures

The distribution of tasks has continually changed over the 150 years of the Confederation's existence. The 'optimum' division of competences between the three levels of government is of course never definitive and the question of which tasks should be assigned to which level of government has never been finally answered (Dafflon 1992). It may be explained in terms of subsidiarity and centralisation.

Total expenditures for each function performed by the three levels of government are summarised in [Table 11.3](#). Responsibility is shared, to some degree, by the three layers of government in almost all fields of public intervention. Obviously, the confederation is solely responsible for foreign affairs and to a lesser extent for national defence (87 per cent). But other items, like education, culture, sports and recreation, health, environment, transportation and roads, generally remain the responsibility of the cantons and the communes.

If we look at which governmental tier is the biggest spender in single items (see [Table 11.4](#)), the *communes* have the highest share in budget items: environment (61 per cent)⁴, culture, sports and recreation (60 per cent), administration (46 per cent); the *cantons* in the following expenditure items: public order (66 per cent), health (55 per cent) and education (54 per cent). The *Confederation* has an exclusive position in foreign affairs (100 per cent) and a dominant position in defence (87 per cent). It has the largest single share, although the cantons and the communes together spend more, in the following functions : economy (49 per cent), finance (49 per cent), social affairs (45 per cent) and transportation (43 per cent). However, the exclusive competence of one layer of government in a function (as indicated *al contrario* by a value 0 in [Table 11.3](#)) occurs only in a few cases: otherwise, the division of powers and the principle of subsidiarity apply. Thus, general functions must be subdivided. In social affairs in general, for example (see [Table 11.3](#)), the federal government plays an important role, though not dominant. The division of functions shows that its role is dominant in social security only (old-age pensions, invalidity, and illness insurance) (75 per cent); individual social aid is more important in the cantons and communes (respectively 38 and 43 per cent); and the other social insurances (mainly family allowances) in the cantons (52 per cent). This type of vertical assignment exists for almost all subfunctions. It differs also within each individual canton between cantonal and local governments.

Table 11.2 Growth of the public sector 1970–94¹

	1970		1980		1990		1994		G ⁶
	Sfr.	P ³	Sfr.	P	Sfr.	P	Sfr.	P	
Confederation	7,834	32	17,532	32	31,616	31	41,341	31	428
Cantons	9,533	39	21,926	39	41,116	40	52,508	40	451
Communes	6,840	29	16,476	29	30,245	29	37,873	29	454
Total	24,207	100	55,934	100	102,977	100	131,722	100	444
% GNP ²	22.0		27.7		27.6		31.7		

Source: *Finances publiques en Suisse 1994*, AFF, Berne 1996, pp. 2–3.

Notes

1 Public expenditures, in millions Swiss francs (Sfr).

2 Without double imputation and without social security.

3 Per cent share of each level of government in total public expenditures.

4 Growth rate over the period 1970–80.

5 Growth rate over the period 1980–90.

6 Growth rate over the period 1970–94, current values.

Subsidiarity

The fundamental principle in the distribution of tasks between the various levels of government is subsidiarity. Competences are vested at the local level and can be transferred to the cantonal level only in so far as the lower level is no longer in a position to provide a service 'efficiently'. In most cantons, a constitutional amendment decided by popular vote or, at least, a law decided by the cantonal parliament, sometimes subject to referendum, is necessary. The same principle is valid between the cantonal and federal levels. A transfer of competence from the cantons to the federal government must be passed by constitutional law, with a double majority vote of the people and the cantons.

Opinions diverge about which 'efficiency' criteria are appropriate for the organisation (and reorganisation) of functions within the three layers of government.⁵ Economies of scale, homogeneity of preferences, spillovers and congestion costs, are generally accepted as efficiency criteria (Dafflon 1992). The criteria of financial capacity and budgetary resources are disputed by poorer governments which argue that they ought to receive more equalisation payments. The resulting allocation of expenditure functions and of policy making within the communes, the cantons and the confederation does not obey simple rules that ensure neatness, tidiness and smoothness. Instead, an elaborate system of checks and balances limits horizontal and vertical coercion, which has led to the budgets of the different levels of government becoming increasingly entangled. Education is a good example of the subsidiarity principle. Total expenditures in [Table 11.4](#) show that the main responsibility lies at the cantonal level, with around 54 per cent of total public outlays. However, when various functions are distinguished within education ([Table 11.5](#)), one sees that kindergartens and public schools are principally in local hands, while cantons hold control of the others. Except to a certain extent for universities,⁶ the federal government does not intervene very much.

Centralisation

[Table 11.2](#) shows the relative shares of each level of government in total public expenditures for the period 1970 to 1994. These figures give almost stable proportions of the division of the public sector among the three layers. In 1970, the proportions were 32 per cent for federal outlays, 39 per cent for cantons and 29 per cent for communes. In 1994, these percentages were respectively 31, 40 and 29, which represents a slight increase of the cantons' share to the detriment of the confederation. Taking these results at face value, one would mitigate the assertion of centralisation in the expenditure side of the budgets. But centralisation creeps in in the ways in which cantonal and communal governments perform, which can be described as 'agency' or 'choice' models. In the last 25 years, the federal government has increasingly confined itself to the issuing of framework laws and has delegated the implementation of nationwide

Table 11.3 Public expenditures, 1994 (in 1,000 Sfr).

<i>Function</i>	<i>Confederation</i>	<i>Cantons</i>	<i>Communes</i>
Administration	1,342,838	2,645,541	3,351,095
Public order	449,920	4,280,592	1,768,372
police	103,343	2,042,385	750,603
justice	84,152	853,750	22,622
fire defence	0	55,868	515,409
other	262,425	1,328,589	479,738
National defence	5,935,411	460,132	428,553
army	5,723,093	236,101	82,169
civil defence	212,318	224,031	346,384
Foreign affairs	2,113,766	0	0
Education	3,102,511	13,534,566	8,496,831
kindergarten	0	316,515	517,817
public schools	21,471	5,280,110	6,555,939
special schools	0	482,509	384,212
professional teaching centres	550,694	2,343,682	851,719
teachers, schools	0	408,676	16,434
colleges	11,813	1,558,337	69,186
higher technical schools	106,086	506,605	24,574
universities, research	1,776,684	2,283,639	6,046
others	635,763	354,493	70,904
Culture, leisure and sports	287,965	1,096,556	2,072,428
culture	143,331	494,107	809,592
sports	95,311	130,703	700,127
leisure	49,323	471,746	562,709
Health	169,847	8,596,548	6,772,227
hospital	7,451	6,287,670	4,791,313
others	162,396	2,308,878	1,980,914
Social affairs, solidarity	10,688,477	8,170,477	4,775,795
old-age pensions	3,929,752	719,558	160,930
invalidity insurance	2,337,956	837,683	138,609
illness insurance	1,411,922	580,179	105,882
other insurances	1,909,744	3,132,195	773,171
social houses	190,684	233,138	141,917
homes for old-age pensioners	0	173,836	798,533
individual social aid	908,419	1,884,583	2,135,908
others	0	609,305	520,845
Transportation and roads	6,176,363	5,354,905	2,979,831
roads	2,837,296	4,270,494	2,372,934
railways	2,208,061	56,497	1,082
regional public transportation	658,236	988,566	590,563
others	472,770	39,348	14,852
Environment	636,597	1,500,872	3,345,250
water	0	40,379	112,425
sewage and water purification plants	210,326	558,286	1,588,047
garbage collection and disposal	16,865	201,447	843,683
land planning, zoning	265,668	529,692	233,203
others	143,738	171,068	567,892
Economy	4,124,159	3,316,630	906,563
agriculture	3,474,881	2,195,094	205,644

<i>Function</i>	<i>Confederation</i>	<i>Cantons</i>	<i>Communes</i>
Economy (Continued)			
forestry	207,106	429,888	555,785
others	442,172	691,648	145,134
Finance	6,313,394	3,551,320	2,975,769
equalisation	0	593,838	253,277
revenue-sharing	3,071,765	546,182	0
public debt interest and management	3,198,629	2,278,609	2,698,809
others	43,000	132,691	23,683
Total	41,341,248	52,508,139	37,872,714

Source: *Finances publiques en Suisse 1994*, AFF, 18/1996, Berne, pp. 24, 44 and 76.

functions to the cantons (which in turn have often transferred the tasks onto their communes)—the ‘agency’ model. One of the most impressive examples of this is the implementation of federal environmental legislation. The federal government only issues normative legal rules. The cantons have to give impulses to their implementation, coordinate (public) provision and control the results. The communes are the executive agencies. Incitative conditional grants are distributed along the way⁷. Health is another illustration of the ‘agency’ role of the cantons and the communes. The federal government is responsible for only a tiny proportion of health expenditures (around 1 per cent), mainly because health insurance is governed by a federal framework law, but implementation of the law has remained in the hands of the cantons in the main (55 per cent) and of the communes (44 per cent).

At the lowest level, there is continual dispute in the Swiss cantons about the effective extent of autonomy in local public expenditures, first and foremost because no single measure of independence is appropriate (Wolman 1990) so that the cantons and the communes have divergent claims. A second difficulty in measuring a decentralisation concept is that fiscal-financial relations between local and cantonal governments vary from one canton to another according to the 26 cantonal Constitutions. Yet, the general trend in all the cantons has been that (a) under the constraint of a current balanced budget, the ‘choice’ role of the communes has made more and more way for the ‘agency’ role and (b) the change in the relative weight of the two roles is inversely related to the population size of the communes: larger municipalities have been better able to maintain a higher proportion of the ‘choice’ role.⁸

Considering subsidiarity from the viewpoint of the macroeconomic role of government, one can refer to the classification of public expenditures in [Table 11.6](#). Consumption and investments dominate at the local level which raises the problem of stabilisation policies, attributed exclusively to the centre in orthodox theory of fiscal federalism. Cantonal budgets are allocated principally to personal and administrative expenditures, whereas financial transfers are predominant in the federal budget.

Table 11.4 Public expenditures, 1994 (in per cent).

Function	Confederation		Within Cantons		Confederation	Between Cantons		Communes
	Confederation	Communes	Confederation	Communes		Confederation	Communes	
Administration	3	9	5	9	18	36	46	
Public order	1	5	8	5	7	66	27	
National defence	14	1	1	1	87	7	6	
Foreign affairs	5	0	0	0	100	0	0	
Education	7	22	26	22	12	54	34	
Culture, sports	1	5	2	5	8	32	60	
Health	~1	18	16	18	1	55	44	
Social affairs	26	13	16	13	45	35	20	
Transportation	15	8	10	8	43	37	20	
Environment	2	9	3	9	12	27	61	
Economy	10	2	6	2	49	40	11	
Finance	15	8	7	8	49	28	23	
Total	100	100	100	100	31	40	29	

Source: Own computation from Table 11.3.

Notes

Within=proportion of the function in the budget for a government layer (vertical).

Between=proportion of each of the three layers for a single function (horizontal)

Table 11.5 Education expenditures, 1994 (in 1,000 Sfr).

<i>Education function</i>	<i>Confederation</i> Sfr.	%	<i>Cantons</i> Sfr.	%	<i>Communes</i> Sfr.	%
Kindergarten	—		316,515	38	7,817	62
Public school	21,471	0	5,280,110	45	6,555,939	55
Special school	—	—	482,509	56	384,212	44
Professional school	550,694	15	2,343,682	62	851,719	23
Teachers' school	—	—	408,676	96	16,434	4
College	11,813	1	1,558,337	95	69,186	4
Technical school	106,086	17	506,605	79	24,574	4
University	1,776,684	44	2,283,639	56	6,046	0
Other	635,763	60	354,493	33	70,904	7
Total	3,102,511	12	13,534,567	54	8,496,831	34

Source: *Finances publiques en Suisse 1994*, AFF, 18/1996, Berne, pp. 25, 45 and 77.

Table 11.6 Nature of public expenditures, 1994 (in 1,000 Sfr).

<i>Nature of public expenditures</i>	<i>Confederation</i>	<i>Cantons</i>	<i>Communes</i>
Current account			
Personnel	4,997,444	20,221,705	14,581,573
Consumption	5,376,415	5,813,177	7,201,654
Interest	3,079,444	2,169,427	2,344,586
Other	3,071,765	1,140,020	253,277
Grants-in-aid and reimbursements			
public sector			
Confederation	0	19,257	0
cantons	4,978,807	414,481*	3,134,669
communes	0	3,813,538	848,453*
semi-public sector	9,162,741	2,532,010	668,447
foreign countries	1,633,155	0	0
private sector	3,560,733	8,116,943	3,713,306
Capital account			
Own investments	826,253	5,113,984	5,322,188
Loans and contributions	1,510,652	1,581,496	85,566
Grants-in-aid and reimbursements			
public sector			
Confederation	0	2,902	0
cantons	2,755,999	6,694*	65,934
communes	44,007	1,012,826	84,973*
semi-public sector	227,633	325,710	129,985
private sector	116,197	636,490	315,036
Other	0	8,654	56,493
Total	41,341,245	52,508,139	37,872,714

Source: *Finances publiques en Suisse 1994*, AFF, 18/1996, Berne, pp. 20, 40 and 72.

Note

* Without double imputation; this amount is not included in the total.

3.4

Public revenues

In 1994, public revenues of the Confederation, the cantons and the communes amounted to 120,600 million Sfr. 1994 was the fifth year since 1985 when total revenues were not sufficient to cover total public expenditures at each level of government. The total deficit runs to 11,122 million Sfr which represents almost 3 per cent of GNP.⁹ Details of public revenue sources are given in Table 11.7.

Taxation is the most important single source of revenue for the three levels of government (Table 11.8). The tax system contains a certain degree of flexibility and consequently determines the volume of financial resources which can be used by the member states and municipalities themselves, thus the extent of their autonomy.

Table 11.7 Public revenues, 1994 (in 1,000 Sfr).

<i>Sources</i>	<i>Confederation</i>	<i>Cantons</i>	<i>Communes</i>
Taxes on income and wealth	14,492,121	22,949,721	17,609,526
Income of individuals	5,929,007	15,785,881	13,100,712
Wealth of individuals	0	1,559,983	1,276,800
Corporate profits	2,587,656	2,487,666	1,440,872
Corporate capital	361,439	825,514	495,983
Immovable property	0	152,383	407,221
Capital gains	85,760	581,512	584,786
Inheritance and gifts	0	996,087	80,256
Transfer of immovable property	0	560,695	222,896
Withholding tax	3,507,640	0	0
Stamp duties	2,023,619	0	0
Consumption or expenditure taxes	16,935,531	1,433,545	81,130
Turnover	9,378,175	0	0
Tobacco	1,200,938	0	0
Customs and imports duties	1,215,646	0	0
Motor fuel and petrol	4,274,254	0	0
Motorways voucher	346,856	0	0
Motor vehicles	0	1,367,568	0
Entertainments	0	29,278	39,201
Dogs	0	7,739	15,840
Others	519,662	28,960	26,089
Fiscal monopolies, licences	242,518	538,474	116,513
Revenues from public property	1,684,654	1,925,860	2,547,136
Interests, dividends	1,284,039	881,751	767,122
Rents	43,782	294,546	1,047,686
Others	356,833	749,563	732,328
Revenue sharing	3,687	3,431,764	1,136,332
Federal direct tax	0	3,048,258	—**
Withholding tax	0	347,959	—
Military tax	0	35,547	—
Others	3,687	—	—
Grants-in-aid	22,158	11,681,760	6,203,441
Federal grants-in-aid	0	7,700,367	53,224
Cantonal	22,158	421,175*	4,826,362
Communal	0	3,200,601	933,426*
Others	0	359,617	390,429
Indemnities and sales	1,254,347	7,446,179	10,218,994
Administration fees	256,251	1,144,583	353,037
Sales of products and services	280,688	3,997,180	6,870,120
Sales of property	22,573	7,474	78,536
Reimbursements	75,110	188,939	614,345
Others	619,725	2,108,003	2,302,956
Total	34,635,016	48,986,128	36,979,646

Source: *Finances publiques en Suisse 1994*, AFF, 18/1996, Berne, pp. 22, 42, 74, 141, 143, 145.

Notes

* Without double imputation; this amount is not included in the total.

** Subtotals are not given.

Table 11.8 Revenue sources, 1994 (in per cent).

	<i>Confederation</i>	<i>Cantons</i>	<i>Communes</i>	<i>Total</i>
Direct taxation	42	47	48	46
Consumption and expenditure taxes	49	3	–	15
Fiscal monopolies, licences	1	1	–	1
Public property	5	4	7	5
Revenue sharing	–	7	3	4
Grants-in-aid and reimbursements	–	23	14	14
from the Confederation	–	16	–	–
from the cantons	–	–	13	–
from the communes	–	6	–	–
Indemnities and sales	3	15	28	15
Total	100	100	100	100

Source: Own computation from Table 11.7.

General characteristics

The main characteristics of the fiscal-financial system are the following:

- Each level of government and each government within the same level has direct access to many, but at least two major revenue sources. Direct access is important in order to maintain financial autonomy.
- The main consumption and expenditure taxes are exclusive and belong to the federal level.
- In the Confederation, direct taxation (which is joint taxation with the cantons and the communes) is also important (42 per cent), but (exclusive) taxation on consumption and expenditure is even more important (53 per cent).¹⁰
- For the cantons and the communes, taxation of individual income and wealth and of corporate business profits and capital ('direct taxation') is the major source of revenue (47 and 48 per cent). Taxation on motor vehicles is cantonal; the communes can levy minor taxes on dogs, entertainment and games.
- For the communes, revenues from public property (7 per cent) and from sales and indemnities (28 per cent) including user charges, are in total the second most important revenue source. However, these sources are limited: the former, due to federal legislation on rent control; the latter, owing to case law of the Federal Court of Justice with regard to the *quid pro quo* rule in benefit taxation (the total amount of user charges for one single function cannot exceed total costs, i.e. user charges must be genuine costs-prices for public services, and not disguised taxes).

The cantons and the communes have a rather low dependence on transfer payments. In 1994, the cantons received only 23 per cent of their revenues from the Confederation (16 per cent in the form of conditional grants and 7 per cent from revenue sharing), and the communes only 16 per cent from the cantons (13 per cent in the form of conditional grants and 3 per cent revenue sharing). For the cantons, the net 'tax/transfer payments' ratio, as King observed (1984:185), is 2.3, whereas the 'proper public resources/transfer payments' ratio is 3.6. These ratios give some idea of the dependence of cantonal finance on federal transfer payments. They are slightly higher than those computed by King for Canada and the USA. The usual interpretation is that the Swiss cantons do not depend much on federal payments.

Fiscal sovereignty

The concept of fiscal sovereignty concerns both the ability of a government to decide which taxes it should raise and direct access to fiscal sources. The extent of fiscal sovereignty can be measured in the following sequences of choice:

- 1 ability-to-pay principle (taxes) versus benefit principle (user charges);
- 2 the object of taxation;
- 3 the circle of taxpayers (including the definition of the taxpaying unit);
- 4 the computation of the tax bases (for example, for the taxation of income: the definition of gross income, adjustments to taxable income, itemised deductions, exemptions);
- 5 the tax rate schedules (and the amount of deductions and exemptions in the example at 4 above);
- 6 the annual coefficient of taxation;
- 7 tax collection;
- 8 rule over tax dispute.

Full fiscal sovereignty comprises numbers 1 to 8 in the list above. *Partial fiscal sovereignty* exists where a government can decide 1 and some but not all items listed between 2 and 5. *Tax flexibility* means that a government can at least decide on the coefficient of taxation (6) but has no access to defining the kind of taxes it can raise. *Compulsory taxation* qualifies taxation where a government has no choice over 1 to 6 and must raise taxes (or user charges) according to the regulations set by a higher level of government.

In Switzerland, tax sovereignty lies primarily in the cantons and secondarily in the confederation to such an extent that it is stated in the federal Constitution. The cantons are largely free to structure and frame their tax system and to decide the tax burden. This freedom is restricted only by case law that prohibits, in particular, double taxation or unjustified tax rebates. In addition, the cantons are bound by an article in the federal Constitution which allocates indirect taxation (on consumption or expenditure—VAT) exclusively to the centre and another

that forbids taxes in the form of tariff barriers which could impede the free movement of goods between the cantons.

The vertical apportionment of direct taxation between the three levels of government is rather complex and often left implicit. It has been admitted that the federal share should not exceed one fourth of total direct taxation. Minimum taxable income should be higher than in the cantons and the tax rate schedule more progressive. Yet, the cantons receive back 30 per cent of the federal direct tax in the form of revenue sharing, of which 13 per cent is affected by intercantonal fiscal equalisation (see below [section 6.2](#)). In this situation of joint taxation, tax sovereignty means that there are 27 laws, with obvious problems of competition, coordination and harmonisation (Dafflon 1986).

The autonomy of communes to manage their finance varies from one canton to another. In principle, the cantons regulate the financial room for manoeuvre of their communes by establishing budget principles, uniform accounting models, taxation rules and debt limits. Local governments have a limited fiscal sovereignty in that they can choose between ability-to-pay tax and user charges where appropriate. They are, however, tied to the tax system of their canton. For many taxes, local governments have only fiscal flexibility: they must apply cantonal laws and limit their decision to the annual coefficients of taxation in percentage of the canton's taxes.¹¹ Local taxation is also compulsory for a limited number of taxes. If a commune chooses to raise user charges and fees, it can also define the main components (items 2 to 6 above), but within the limits set by case law of the Federal Court of Justice (Knapp 1982:358–64).

The objectives of fiscal sovereignty are:

- 1 To enable each level of government and each government within a level to finance its own budget independently and according to its own criteria. This includes the capacity to finance public services in response to the preferences of its own electorate (the 'choice' model) as well as those expenses which correspond to minimum standard (merit) goods and services set by a higher level of government (the 'agency' model), net of conditional grants.
- 2 To decide redistributive policies: first, in selecting ability-to-pay or benefit taxation; second, in choosing the magnitude of redistribution, for example, through the tax rate schedules or the amounts of exemptions and deductions on income tax (subject to the limits described in [section 5](#)).

Direct access to many revenue sources

An important characteristic of fiscal sovereignty is direct access to many (fiscal) sources. In [Table 11.7](#), several finance sources are listed for the federal government, the cantons and the communes respectively. Direct access to a number of diversified fiscal or non-fiscal sources secures regular annual receipts compared with a situation where a government can rely on one tax only. It enables a better distribution of the fiscal burden and avoids exasperating

particular categories of taxpayers in the case of higher fiscal needs. This can also be understood in view of the low dependence of the cantons on transfer payments from the federal government and of the communes on transfer payments from the cantons. This is observed in [Table 11.8](#) from the percentage of the various categories of revenue for the three levels of government. In 1994, the cantons received 7 per cent of their total finance from federal revenue sharing and 16 per cent from federal grants-in-aid and reimbursements. Thus, a total of 23 per cent is financed by federal transfer payments. The communes received only 16 per cent of their revenues from cantonal revenue sharing (3 per cent) and grants (13 per cent). These percentages do not represent a very high degree of financial dependence compared to other OECD countries. Yet, creeping centralisation has been a reality for the last ten years: these proportions were well below 20 per cent for the cantons and 15 per cent for the communes in the early 1980s. But these proportions contrast with the degree of centralisation in public expenditures, which is much higher because the agency role of decentralised governments has gained in importance during the last decade.

Tax administration

In principle, each level of government and each government within a same level may have its own tax administration. However, in order to reap economies of scale and to gain coherence in tax practice, many formulas exist for cooperation between the three tiers of government. Thus the cantons have a legal obligation to collect the federal direct tax (FDT) on individual income, corporate profits and capital and on capital gains. They also participate in managing the federal withholding tax and stamp duties. But since there are 26 cantonal tax laws and as many tax administrations, and no tutelage of the federal government over state and local tax administration, there exist 26 ways of managing the FDT. In addition, because the powers of the state tax administrations are limited to the territorial area of the state to which they belong, whereas economic activities may spill over cantonal limits, decentralised tax administration creates problems and conflicts. These have been solved in the first place by negotiations between the cantons, eventually (and more often) through case law of the Federal Court of Justice. And yet a federal law on the harmonisation of cantonal direct taxation was enforced on 1 January 1993 to introduce some order in the cantons' taxation for neutrality and equity reasons. Within the following eight years, the cantons must adapt their own tax legislation to a unique, common framework (see also [section 5](#) below). At local level, no such difficulties exist. In most cases, the communes can only decide annual tax coefficients for the various accessible tax sources, but have no access to defining the kind of tax they raise: it is a 'take-it-or-leave-it' situation. In many cantons, the communes can contract with the cantonal tax administration to collect communal taxes.¹²

4

BUDGET RESPONSIBILITY

The Swiss cantons have their own Constitutions, independent power over their budgets, their own financial resources and, above all, they have the power of taxation. Cantonal autonomy in the area of fiscal policy contrasts with the budget principles and rules of taxation to which member states in other federations are subject. Legislative authorities at the federal level, in the 26 cantons and in every single municipality must decide the budget (current+capital) before the beginning of the year and, of course, keep books recording revenues and expenditures. Since the mid-1980s, budget and bookkeeping techniques have been harmonised. Annual budgets as such does not give a legal base for expenditures and taxation. Budget items must be founded on particular laws that have been debated separately in Parliament and enforced prior to the budget discussion.

The federal Constitution does not impose budget principles on the cantons. There is no federal constraint on deficit financing, except that all tiers of government have no access to borrowing from the Central Bank. The main *external* limitation on budgetary sovereignty of the cantons is intrinsically *competition* with other cantons: if a canton pursues an inefficient fiscal policy with a poor cost-benefit relationship, individuals and firms move to another canton ('exit', in Hirschman's terminology); alternatively, voters use initiatives and referenda in order to obtain a modification of the 'public goods/tax' mix in comparison to that of other cantons ('voice'). Competition is even more important at the local level, particularly between communes in the same urban conglomeration.

The fairly extensive autonomy of cantonal and local governments for their finance is not unlimited. There are also *internal* limitations in cantonal Constitutions or legislations. Two rules are generally respected: at the level of the cantons in their own financial laws, and in the communes under cantonal supervision (Dafflon 1996b). The first rule is concerned with the requirement of a more or less *balanced budget* for providing goods and services. Due to financial regulation, for most local and cantonal governments it is quite difficult to run or to accumulate deficits in their (current) budgets. If a large budget deficit occurs, taxation would have to be increased. Should a local authority not follow this rule, the cantonal government might decide to raise the annual coefficient of taxation in place of the commune.¹³ The second rule concerns borrowing and *debt limitation*. Public debt is allowed in many cantons only for financing capital expenditures, and if the local and/or cantonal government has the financial capacity to pay the interest and amortisation of the debt out of its current budget. The rates of amortisation are fixed according to the kind of investment and its possible length of use (pay-as-you-use finance). This of course requires a distinction between the current budget, which must be balanced, and the capital budget, which can be financed by borrowing.

These two quite strict requirements express the principle of *accountability* or *budgetary responsibility*. They must be viewed in the perspective of financial autonomy and access to own revenue sources as described above. On the one hand, cantonal and local governments have a fairly large (though diminishing) amount of autonomy to decide and offer public services, and direct access to taxation. On the other hand, it is expected that these governments will act in a responsible way and will finance without excess borrowing what they are asked to produce, either by law ('agency') or in response to their electorate's own demands ('choice'). This is definitely a classical approach to fiscal federalism (Tollison and Wagner 1986). The interests of the public debt of the cantons in 1993 (Table 11.6) represented on average 6 per cent of total cantonal own revenues; and 8 per cent for the communes.

5

TAX COORDINATION AND HARMONISATION

The extensive freedom in shaping the tax system enables each of the cantons to determine the tax price level for a specific bundle of public goods and services within its own jurisdiction. In the theory of fiscal federalism, cantons and communes may use their tax systems to compete for firms and individuals to migrate to another canton or commune. Yet, fiscal sovereignty is not unlimited. Allocative inefficiencies would arise if decentralised jurisdictions were to adopt widely varying forms of taxation. Each individual and business firm would have an incentive to move to that jurisdiction whose particular tax system gave him or her the best tax break. Under a non-neutral tax system, the location of individuals and productive capital might be guided by particular pecuniary advantages afforded under varying kinds of taxes irrespective of public provision. But tax competition between jurisdictions has no efficiency properties comparable to pure market competition; it is rather in the nature of oligopoly (Tulkens 1985: 45). Furthermore, it is not possible for subcentral jurisdictions to decide a sharp redistributive policy through taxation. Acceptance of this policy will not only vary on ethical grounds, but also depend on the mobility of individuals and business enterprises, i.e. their capacity to avoid, through voting-with-their-feet, the incidence of high redistributive taxation. Minimising these distortions calls for a substantial degree of coordination and tax harmonisation, that is for a cooperative effort to secure a system of taxation that minimises excess burden and yields a desirable pattern of incidence (Oates 1972:145).

In the Swiss situation, Frey (1981) and Weber (1992) show that tax-induced migratory movements are small. Not only the price-service ratio of public policies, but a number of other private determinants influence the choice of residence or location. Legal entities know that they can obtain a tax break in almost any new location, even though this is neither formally nor officially publicised. In addition, with initiatives and referenda, the citizens have not only an 'exit', but also a 'voice' solution. Since tax coordination has existed for many

years, problems of tax harmonisation have been discussed in terms of neutrality and in the context of reducing administrative and implementation costs, rather than from an equity point of view.¹⁴

5.1 Tax coordination

Vertical coordination

Vertical coordination concerns the assignment of tax authority to the various levels of government. It should be clear *which* jurisdiction is entitled to tax *which* items from *which* taxpayer. Attention must be given to the geographical distribution of tax yield. A good tax under subcentral authorities should have a tax base that is widely and evenly distributed throughout the country (King 1984: 210–11).

Referring to [Table 11.7](#), one can see that in Switzerland vertical coordination is obtained partly through the attribution of exclusive tax sources to each level of government according to the doctrine of separability of sources. This is clear for consumption and expenditure taxes where there is no overlapping of tax bases between the confederation, the cantons and the communes. On the other hand, personal income, corporate profits and capital are jointly taxed at the three levels. Vertical coordination between federal and cantonal levels is obtained in two ways: a moderate taxation at each level so that no single government exhausts the entire tax capacity; and, the assessment of priority, first to the cantons, then to the communes and lastly to the Confederation.¹⁵ Vertical coordination between the cantons and their communes is secured because, as explained in [section 3.4](#), local governments have no sovereignty on these matters, but only tax flexibility.

Horizontal coordination

Horizontal coordination serves to apportion tax competences and tax yields among jurisdictions at the same level where the tax base has its origin in several communes or cantons. In Switzerland, this has been obtained through case law of the Federal Court of Justice. Two objectives have been pursued: avoidance of double taxation, and, preventing taxpayers with taxable activities in more than one jurisdiction from avoiding the progressivity of the tax rate schedules through geographical splitting of the tax base. Although the technical rules are rather intricate (Dafflon 1986:32–6), horizontal coordination applies itself along the following general guidelines :

- income (profits) taxes are entirely paid in the canton (communes) of residence;

- income obtained in other jurisdictions is assessed according to the rules of the jurisdiction of residence;
- taxation of income obtained in more than one jurisdiction cannot be higher than taxation of the same total income acquired in the jurisdiction of residence alone;
- immovable property is taxed in the jurisdiction where it exists;
- when corporate or independent business takes place in several jurisdictions, the tax yields are distributed between those jurisdictions according to financially measurable components of the activity (for example: turnover, volume of sales, total insurance premiums for insurance companies).

5.2

Tax harmonisation

Different jurisdictions at the same level of government will generally find it desirable to adopt at least roughly similar systems of taxation. There are three reasons, two of which pertain to the criteria of fiscal neutrality. First, where the interjurisdictional mobility of certain economic units is of a high degree, taxation of these units, if it is employed, should be of similar form across the jurisdictions. Second, the rates at which these units are taxed locally should not vary greatly among the jurisdictions except to the extent that differences in rates correspond to differences in benefits to these units from the services provided. In this way allocative distortions in both resources' use and incidence resulting from the tax system itself can be kept to a minimum, consistent with other fiscal objectives of the individual jurisdictions (Oates 1972:147).¹⁶ Third, harmonisation simplifies tax perceptibility and minimises administration and implementation costs.

Formal tax harmonisation concerns any attempt to bring the various tax systems decided independently by each jurisdiction towards a uniform system and a unique definition of the tax bases (numbers 2 to 4 in the sequence of choice in [section 3.4](#)). As a result, information and transaction costs are reduced for those who pay taxes in several cantons, administrative and implementation costs are reduced for the tax departments and litigious cases decrease.

Real tax harmonisation is obtained when allowances, amounts of deductions and exemptions and tax rate schedules are identical in all jurisdictions. Such harmonisation is at variance with the federal principle and has never been on the political agenda in Switzerland.

In Switzerland, the problem of formal tax harmonisation arises exclusively for those taxes that are simultaneously raised by the two higher levels of government—federal and cantonal. At the cantonal level, formal tax harmonisation has been realised over the years for two reasons. First, collection of the federal direct tax (FDT) on personal income, and on corporate profits and capital is assigned to the cantons. Consequently, for obvious reasons of reducing administrative and implementation costs, and thanks to effort-minimising bureaucrats who were reluctant to control several tax return forms (at least federal and cantonal forms)

for one and the same taxpayer, there have been very strong bureaucratic incentives at cantonal level to adopt rules and income concepts (gross income, adjusted gross income, taxable income, itemised deductions and allowances) similar to those of the FDT. Second, more and more taxpayers, corporate or individual, are active outside their canton of residence, or own immovable assets in another canton, thus pushing for uniformity of the various rules of taxation (not any less for uniform tax return forms) in order to reduce administrative and legal costs. Nowadays, formal harmonisation is partly achieved by federal legislation, introduced in 1993 and 1995.

The federal law on the harmonisation of direct taxation at cantonal and communal levels, which has been in force since 1 January 1993, provides a framework within which the cantons (and the communes if they have more than fiscal flexibility) must define their direct taxation laws, particularly with regard to tax liability of persons and legal entities, assets and tax periods. Standardised tax declaration forms are being introduced, much to the relief of people liable for tax in more than one canton. The cantons are obliged to adjust their tax legislation within eight years, that is by 31 December 2000. Subsequently the law will apply directly wherever cantonal tax law has not been brought into line with it. However, since the cantons will still be able to define their own tax scales, tax rates and amounts of allowances and deductions, wide variations in taxation levels within Switzerland will remain. Thus, harmonisation remains formal and will solve problems in terms of administrative costs, and not in terms of tax neutrality.

The federal law on direct federal tax took effect on 1 January 1995. Matching the provisions of this law with the previous one has ensured vertical harmonisation of direct taxes at the three levels of government.¹⁷ At the communal level, formal and real tax harmonisation has been achieved except for the annual coefficient of taxation which depends on the balanced budget requirement. Tax competition is on the agenda of most communes, especially because of inter-jurisdictional mobility within urban areas.

5.3

Fiscal burden in the cantons

It should be clear, at this stage, that tax harmonisation does not imply perfect uniformity in the rates and forms of taxation across the jurisdictions. The consequences of cantonal, and to some extent communal, tax autonomy is that the tax burden can differ substantially from one jurisdiction to another according to their view about the tax system, the combination of ability-to-pay and benefit principles, and the progressiveness of rate schedules. Additional reasons are that the cantons provide varying levels of consumption of public services and have significant differences in the unit cost of providing public services at comparable minimum standards. The cantons also have significant differences in levels of income and wealth (computed from [Table 11.1](#), indices of per capita NIC in

individual cantons vary between 71 points in Valais and 175 points in Zoug compared to an average of 100 points). It is in the nature of fiscal federalism that the use of non-benefit taxation by decentralised levels of government, cost differences in public provision and wide variations in NIC introduce disparities in tax liabilities and, with it, some inefficiencies and inequalities. This is to be expected and can be accepted in so far as 'efficiency' is not only 'economic' but refers to the general capacity of federal institutions to strengthen the system of checks and balances (as, for example, against autonomy; Wiseman 1990:120) and in so far as those disparities are not too blunt and remain within politically acceptable limits. But significantly higher tax rates (and possibly inferior public services) in some poorer jurisdictions may lead to the need for substantial equalisation payments (see next section).

Table 11.9 gives the indices of tax burden for five categories of taxes in the cantons and the communes, which together amount to 91 per cent of total cantonal and communal fiscal revenues. Reliable measures of the relative cantonal and communal tax burden are needed for several reasons. First, the cantons and the communes must know how much revenue they are capable of raising without too heavy a tax burden in comparison with one another. Second, it is also important to have an idea of the ability and willingness of the cantons and the communes to raise revenue and, in relation to the requisite of a current balanced budget, to develop warning-systems of financial stress. Third, if equalisation is needed—it is argued—the recipient governments should not receive financial aid without a minimum effort in taxation. But, however useful these data may be, one must be careful in interpreting tax burden. Two government units may differ in their tax burden indices not only because they wish to provide different levels of public service (the 'choice' model), but also because they use relatively different amounts of debt and non-tax revenues (user charges); differences may also reflect lower financial capacity (in NIC per capita) or differences in the unit cost of provision of public services.

Table 11.9 shows that an individual can pay as much as two or three times the amount of tax on the same income and wealth, depending on where he lives. Even neighbouring cantons sometimes have considerable permanent differences in tax burden (Weber 1992:248): for example, in the cantons of Zurich and Zoug for individual income taxation (79.8 and 54.1 points against a national average of 100), or Bâle-Ville and Bâle-Campagne (109.4 and 89.2 points). Table 11.9 also presents two further interesting pieces of information:

- 1 Min/max ratios differ from one tax source to another, and compared to the financial capacity of the cantons. The min/max ratio is 2.5 for NIC per capita (see Table 11.1, column 7), and 2.3 for the global indices of tax burden (Table 11.9, column 7). But it varies between 2.3 and 6.2 for individual tax sources and figures differ widely from one canton to another for each sort of tax, so that one may conclude that differences in the

Table 11.9 Indices of tax burden in the cantons and communes, 1995.

Cantons 1	Individual		Legal entities		Motor vehicle 6	Global index 7
	Income 2	Wealth 3	Profit 4	Capital 5		
Zurich	79.8	52.1	108.1	84.3	100.4	82.9
Berne	120.4	103.0	91.0	106.6	130.9	117.8
Lucerne	114.8	169.6	87.5	95.5	98.2	115.6
Uri	95.5	61.3	97.4	142.4	80.5	92.0
Schwyz	87.9	77.3	89.8	96.0	90.4	87.7
Obwald	123.3	121.3	92.6	74.0	77.2	118.2
Nidwald	73.6	44.6	99.7	41.3	85.2	74.2
Glaris	110.6	111.3	114.0	185.2	110.4	115.5
Zoug	54.1	62.9	57.3	58.9	86.4	57.3
Fribourg	130.2	200.2	100.2	107.9	107.9	130.6
Soleure	97.7	80.5	96.3	99.7	92.5	96.8
Bâle-Ville	109.4	114.8	107.4	126.5	85.4	110.3
Bâle-Campagne	89.2	84.7	99.2	170.8	112.3	92.3
Schaffhouse	107.8	82.6	106.8	77.7	66.5	104.4
Appenzell Rh.-Ext.	111.9	83.5	107.1	120.3	107.0	107.8
Appenzell Rh.-Int.	103.6	82.6	96.4	90.0	103.1	100.6
Saint-Gall	99.3	88.7	94.3	93.8	109.7	98.2
Grisons	87.7	101.1	145.5	141.6	132.2	102.2
Argovie	98.7	97.5	101.6	107.8	78.3	98.6
Thurgovie	94.6	133.2	93.6	110.7	73.3	97.1
Tessin	91.2	73.8	120.9	125.9	92.1	96.2
Vaud	103.0	156.0	107.7	101.9	123.9	108.1
Valais	117.6	276.6	104.5	137.1	56.0	124.9
Neuchâtel	124.2	128.4	144.5	111.8	97.8	125.5
Genève	109.5	115.9	121.7	101.9	71.1	110.9
Jura	128.8	141.1	102.7	111.6	124.9	127.0
Average	100.0	100.0	100.0	100.0	100.0	100.0
max/min ratio	2.4	6.2	2.5	4.5	2.4	2.3

Source: *Charge fiscale en Suisse 1995*, Administration fédérale des finances, Berne 1996, pp. 62, 76, 94 and 97.

Note

The indices of tax burden are computed in the following way. For each tax, several standard specifications are assessed. For example, for personal income taxation, four categories with various incomes are considered: single person, married persons without children, married persons with two children, old-age pensioners. For each category, the amount of cantonal, communal and church taxes paid in the capital town are computed. Each category is weighted in the global index according to the importance of this source in the total revenue in each canton. The average is given the value of 100 points; all indices are proportionally calculated.

economic situation of the individual cantons, expressed by NIC per capita, do not entirely explain differences in the tax burdens.

Table 11.10 Abstract of Tables 11.1 and 11.9.

<i>Cantons</i>	<i>NIC per capita</i>	<i>Expenditures per capita</i>	<i>Tax burden</i>			<i>Vehicle</i>	<i>Global</i>
			<i>Income</i>	<i>Wealth</i>	<i>Profit</i>		
Berne	38,215	6,733	120	103	91	131	118
Uri	38,728	10,181	95	61	97	81	92
Fribourg	38,735	8,184	130	200	100	108	130
Tessin	39,167	8,008	91	74	121	92	96
Neuchâtel	39,241	8,268	124	128	145	98	125
Thurgovie	39,467	5,603	95	134	94	73	97
Lucerne	39,525	6,315	115	170	88	98	116
St-Gall	39,854	5,635	99	89	94	110	98

Consider, for example, the eight cantons in Table 11.10 with almost identical NIC per capita. The indices of taxation of individual income and wealth in Berne and Uri (indice for income taxes > indice for wealth taxes) present exactly the inverse tendency from those in Fribourg (indice income taxes < indice wealth taxes). Neuchâtel and Lucerne, which have heavier-than-average indices for income tax but almost the same NIC per capita have adopted divergent practice for the taxation of profit from legal entities: the burden is much lower in Lucerne (88 points) than in Neuchâtel (145 points). In the cantons of Lucerne, Fribourg and Neuchâtel, the burden of tax on wealth is much heavier than on motor vehicles. Heavier taxes do not correspond to higher per capita public expenditures. With 10,181 Sfr. of per capita public expenditures, the index of global tax burden in Uri is 92 points, whereas with 6,315 Sfr. of per capita public expenditures, Lucerne's index goes up to 116 points. The main conclusion is that these cantons, with almost identical NIC per capita, distribute the tax burden of each revenue source differently compared to the average burden: but these differences reflect cantonal preferences in taxation more than disparities in income per capita and taxable items or differences in per capita public expenditures.

- 2 For each ratio, the min or max canton of reference is a different canton, except for Zoug, which appears three times with the minimum. Cantons with minimum indices are: Zoug on income and profit, Nidwald on wealth and capital and Valais on motor vehicles. Cantons with maximum indices are: Fribourg on income, Valais on wealth, Grisons on profit, Glaris on capital and Grisons again on motor vehicles. This seems to indicate that the cantons definitely have different ideas, first, on the relative tax burden within each tax source that can be asked from their own taxpayer compared to the average taxpayer across the cantons and, second, on the relative burden of taxation which can be asked from each revenue source. There is no nationwide concept of uniformity of individual tax burden, as in the case of Germany for example.

6 EQUALISATION¹⁸

The differences in the cantons in terms of size, geography, population and economic potential are so great that, without equalisation measures, fiscal federalism would perform under regional disparities which would be intolerable. Therefore, the federal government intervenes to correct the primary distribution of resources between the cantons with three main policy measures: fiscal equalisation, agricultural aid policy and assistance to mountain areas, with the purpose of strengthening structurally weak regions.¹⁹ It is necessary, at this point, to stress the fact that, in Switzerland, there are no constitutional provisions and no claims from cantonal governments or the citizenry that equalisation measures should compensate entirely for differences between the cantons in order to obtain identical economic or fiscal conditions. The pragmatic objective is to render regional disparities politically acceptable so that remaining differences do not endanger the cohesion of the confederation.

The most direct means for reducing cantonal disparities is through fiscal equalisation measures,²⁰ i.e. payments from the federal government to the cantons with the purpose of reducing differences in fiscal capacity. At the local level, many cantons have introduced intercommunal equalisation, with similar ends and means. According to the 1959 federal law on equalisation, the original objective was to enable the cantons to provide minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than in others. Equalisation related to policies aimed at correcting fiscal imbalance, whether it resulted from differences in the revenue-raising capacities of the cantons or because, in some jurisdictions, the relative unit cost of providing some defined levels of services was above the national average. Eventually, the fiscal capacity approach dominated the other question of unit cost, in particular because of the difficulty in defining needs, average versus minimum provision and relative costs, which induced strategic behaviour by recipient governments. As a result, three out of four arguments in the formula for computing the financial capacity of the cantons (see [section 6.1](#)) now refer to revenue-raising abilities. From the very beginning, equalisation has excluded differences in cantonal outlays for services other than or above minimum standards and differences in the progressivity of the tax rate schedules that reflect the concept of income redistribution or the mix between benefit tax and ability-to-pay tax at cantonal level. There are, today, in Switzerland, three programmes which include equalisation. All have in common the fact that they relate to the financial capacity of the cantons.

6.1

Financial capacity of the cantons

The actual formula for computing the financial capacity of the cantons has four components, given in [Table 11.11](#):

- 1 The NIC (national income in individual cantons) per capita (column 2), as a measure of each canton's financial resources. This component is weighted 1.5 times in the computation of the total index.
- 2 The inverse of the tax burden of the cantons and the communes (column 3), as described in the previous section.
- 3 The per capita tax revenues of the cantons and their communes, from different tax sources, weighted by the indices of tax burden in order to obtain comparable values (column 4). This component is also weighted 1.5 times in the total index.
- 4 An approximation of the cantons' expenditure requirements, taking into account population density and the relative importance of each canton's agricultural surfaces in mountains and in plains (column 5).

The average value of each component, for the 26 cantons, is given as 100 points; all indices are proportionally calculated. The total index for each canton is the weighted average (column 6), proportionally corrected in such a way that the lowest single index is given the value of 30 points (column 7). With this formula, the min/max ratio is 7.6 points in 1996/7, from the canton Jura with 30 points to the canton Zoug with 228 points. The formula results in a relative expansion of the financial capacity scale in which the cantons are positioned comparative to their relative place with regard to per capita NIC (column 2), where the min/max ratio is 2.5 points between Zoug and Appenzell Rh.-Int. In consequence, the equalising effects of equalisation payments are reinforced.

6.2

Federal equalisation programmes

Three federal equalisation programmes have been developed since 1959 for the benefit of the cantons: conditional federal grants-in-aid to the cantons, revenue-sharing of certain federal tax revenues, and contributions of the cantons to certain federal social security expenditures.²¹

Conditional (specific) federal grants-in-aid

Many items of cantonal expenditures benefit from federal specific grants. For most aided functions, the rate of grants has two components: (a) a basic rate, which may be said to represent the federal interest in minimum standard requirements for cantonal public services and which varies according to

Table 11.11 Financial capacities of the cantons 1996–7.

<i>Cantons</i>	<i>NIC per capita 1993 (× 1.5)</i>	<i>Inverse of tax burden 1991/4 (× 1)</i>	<i>Tax revenues 1992/3 (× 1.5)</i>	<i>Expenditure requirements (× 1)</i>	<i>Weighted average</i>	<i>Total index</i>
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>
Zurich	128.16	116.17	125.89	108.86	121.22	157
Berne	84.94	83.80	85.42	94.63	86.79	64
Lucerne	86.76	97.45	85.74	102.04	91.65	77
Uri	87.06	95.41	70.97	73.79	81.25	49
Schwyz	93.97	117.05	85.70	85.13	94.34	85
Obwald	78.40	89.07	70.56	76.86	77.87	40
Nidwald	109.73	120.70	95.56	82.70	102.27	106
Glaris	101.59	92.99	82.88	76.83	89.30	71
Zoug	176.91	139.46	157.23	96.48	147.43	228
Fribourg	89.99	72.85	79.01	96.54	84.58	58
Soleure	87.22	94.16	88.22	103.69	92.90	79
Bâle-Ville	126.56	90.04	131.86	110.93	117.72	148
Bâle-Campagne	104.15	111.44	108.86	106.20	107.43	120
Schaffhouse	99.16	99.37	91.56	110.94	99.28	98
Appenzell Rh-Ext.	82.81	99.27	81.39	82.33	85.58	61
Appenzell Rh-Int.	70.00	95.05	75.59	71.13	76.91	38
Saint-Gall	88.27	107.99	93.96	98.79	96.02	89
Grisons	91.73	97.22	91.79	70.00	88.50	69
Argovie	97.80	106.07	90.05	110.46	99.66	99
Thurgovie	86.19	107.19	90.45	110.42	96.51	91
Tessin	86.19	89.66	102.37	85.65	91.63	77
Vaud	97.10	88.28	99.71	106.20	97.94	94
Valais	78.65	71.40	70.49	80.65	75.15	33
Neuchâtel	86.10	71.31	82.12	88.92	82.51	53
Genève	117.56	84.45	130.46	110.99	113.49	136
Jura	72.77	70.00	70.00	84.72	73.77	30
Switzerland	100.00	100.00	100.00	100.00	100.00	100.00
max/min ratio	2.5	2.0	2.5	1.6	2.0	7.6

Source: Ordonnance du 22 novembre 1995 fixant la capacité financière des cantons pour les années 1996 et 1997, RS 613.11, AF, Berne, 1995, FF pp. 5,209–5,213.

Note

The computed indices are not directly comparable with the corresponding figures in Table 11.1 (per capita NIC) and Table 11.7 (indices of tax burden) because of each series, the lowest result is given the value of 70 points and all other numbers are proportionally computed through a specific formula. One cannot say *a priori* whether this adjustment reinforces or reduces equalising effects. It depends on whether, in the first calculation, the original min/max ratio, i.e. the original differences in the relative position of the cantons, was higher or lower. For example, in the case of per capita NIC, the lowest index in 1993 was that of Appenzell Rh.-Int. with 72.6 points: the adjustment to minimum 70 points will increase in this table (column 2) the difference (reinforcement). In the case of the inverse of tax burden, the lowest index for 1993 is that of Valais (100.00:146.00=68.49): the adjustment to 70 points reduces the difference. This calculation is valid for columns 2 to 5. Then, a second correction intervenes in computing the total indices, since the lowest weighted average is given a value of 30 points: for Jura, the weighted average is $(72.77 \times 1.5) + 70.005 + (700.00 \times 1.5) + 84.72 = 73.77$ points), which is brought down to 30. On this rather complex mechanism, and its consequences for equalisation, see Dafflon 1995.

incentives or other technical criteria (economies of scale, spillovers, congestion costs); (b) an equalisation supplement, inversely related to the index of financial capacity of the recipient canton.

This type of fiscal equalisation is mainly vertical, from federal to lower levels of government. It is regulated by many special laws. The grant formula, for most aided function is:

$$S_i^j = S_{\min}^j + \left[\frac{120 - E_i}{60} - (S_{\max}^j - S_{\min}^j) \right]$$

where S =rate of grant

j =aided function

i =canton $i=1 \dots 26$

E =index of financial capacity

max=maximal rate of grant

min=minimal rate of grant

$E_i=120$ for $E_i > 120$

$E_i=60$ for $30 \cdot E_i \cdot 60$

that is for $E_i=120$, the rate of grant is S_{\min} ; for $E_i=60$, the rate of grant is

S_{\max} .

Revenue sharing

The share of the cantons in the federal government's tax revenue derives from several sources, but three revenue-sharing programmes only have equalisation effects: revenue sharing in the federal direct tax (FDT), the withholding tax (WT) and part of federal customs duties on petrol and motor fuel (DC) (see following list). Historically, revenue sharing was generally implemented in order to compensate for fiscal imbalance when a cantonal revenue source was centralised (Customs, alcohol monopoly, coinage, stamp duties) or partly shared with the centre (direct and withholding taxation). With time, the main revenue-sharing programmes have been connected with equalisation repayments.

- 1 The cantons receive 30 per cent of the *federal direct tax* (income, corporate profits and capital). Seventeen per cent is allocated on the basis of origin, defined as the residence of taxpayers, and 13 per cent according to financial capacity, in an exponential formula ($2.71828 \exp. (-E_i^k)$) with the number of inhabitants serving as a multiplicand.²²
- 2 They also receive 10 per cent of the *withholding tax*, net of collection costs: 5 per cent is allocated according to population, and 5 per cent is reserved to the cantons with indices of capacity $E_i < 100$, in the forms $(100 - E_i)$ and $((100 - E_i)^2)$, the number of inhabitants serving as a multiplicand.
- 3 The federal government reimburses to the cantons part of its revenue from *customs duties and excises on petrol and motor fuel*. Half of the receipts

from the 'normal' duties and the total so-called 'supplementary' duties are exclusively attributed to road expenditures. Twelve per cent out of this amount is reimbursed to the cantons: as general payments for 0.93 and for international alpine roads for 0.07. Out of the 0.93, 0.42 is allocated to equalisation for cantons with indices of capacity $E_i < 100$, in the form $((100 - E_i)^{1.4})$ with total cantonal expenditures on roads serving as a multiplicand.

Cantonal contributions to social security

The third category of transfer payments which include equalisation concerns the cantons' contributions to three federal social security programmes: old-age and survivors insurance (AVS), the disabled pension scheme (AI) and family allowance in agriculture (AFA). Total payments of the public sector are:

<i>Programme</i>	<i>Participation of the public sector</i>	<i>Federal</i>	<i>Cantonal</i>
AVS	20% of total expenditures	17%	3%
AI	50% of total expenditures	37.5%	12.5%
AFA	Total annual deficit	2/3rd	1/3rd

6.3

Importance of the transfer payments

The importance of the three equalisation programmes for 1994 is shown in [Table 11.12](#). Payments from the federal government to the cantons were 6,306 million Sfr. or 15 per cent of total federal expenditures. This amount corresponded to 13 per cent of total public resources of the cantons, or 4 per cent for specific grants, 9 per cent for revenue sharing. Cantonal participation to federal social security expenditures amounted to 1,541 million Sfr. or 2.9 per cent of the cantons' total expenditures. However, only parts of the payments include equalisation, also given in [Table 11.12](#). On the whole, they represent 2,670 million Sfr. or 42 per cent of total transfer payments from the federal government to the cantons and 122 million Sfr. or 8 per cent of total cantonal contributions to federal social security expenditures. For the 26 cantons, the net equalising part amounts to 4,764 million Sfr. and corresponds to 10 per cent of total cantonal revenues.

7

CONCLUSIONS

In conclusion, we may summarise the main features of public finance in Switzerland in the following points :

Table 11.12 Transfer payments in 1994.

<i>Programme</i>	<i>1000 Sfr.</i>	<i>Equalising proportion %¹</i>	<i>Sfr.</i>
1. Federal specific grants ²	2,016,226	43	861,893
2. Revenue sharing	4,289,351	42	1,808,033
FDT	3,048,258	43	1,310,751
WT	347,959	50	173,979
DC	433,257	40	173,303
BNS	405,499	37	150,000
Military tax	35,547	0	0
Tax on alcohol	18,831	0	0
Confederation and cantons (1+2)	6,305,577	42	2,669,926
3. Cantonal contributions (3)	1,541,435	8	121,877
AVS	700,880	8	56,070
AI	799,500	8	63,960
AFA	41,055	4.5	1,847
Total (1 + 2 - 3)	4,764,142		

Source: Federal specific grants: amounts delivered by the Federal Department of Finance; FDT, WT, *Military tax*: *Finances publiques en Suisse 1994*, AFF, Berne, 1996, pp 26–7; DC: Office federal des routes; BNS: Rapport de gestion 1994; Tax on alcohol: Régie des alcools, Rapport de gestion et compts 1993/1994; AVS, AI: *Zahlenspiegel des Sozialen Sicherheit der Schweiz*, Ausgabe 1995, OFAS, pp. 34–44; AFA: amounts delivered by the federal department of social insurances

Notes

1 Equalising proportions are evaluated on the basis of the 1991 estimated results (Dafflon 1995:198) since the revenue-sharing formulas have not changed.

2 Only federal specific grants paid to the cantons which contain an equalisation supplement have been taken into consideration. The equalisation proportion has been given by the Federal Finance Administration from its own calculations. It corresponds to the results that the author has obtained for 1991 from his own estimation (Dafflon, 1995:299).

- Total public expenditure without social security represented 32 per cent of GNP in 1994, which is moderate in comparison to other European countries.
- Responsibility is shared between the three levels of government in almost all fields of public intervention, with the result that the budgets of the three levels of government are becoming increasingly entangled. However, the principle of subsidiarity is a strong guideline for the assignment of functions in the fiscal hierarchy, as the example of education expenditures shows. But creeping centralisation is intervening more and more, changing the 'choice' role of subcentral jurisdictions to an 'agency' role. At the local level, more populous municipalities are in a better position to resist this change.

- The main revenue sources of the public sector are direct taxation on individual income and wealth and on corporate profits and capital, followed by expenditure taxes and user charges. But the respective proportions of these receipts vary for the three levels of government.
- Cantons and communes have low dependence on transfer payments. 77 per cent of the cantons' revenues and 84 per cent of the communes' revenues are own revenues. These figures contrast with a higher degree of centralisation in public expenditures.
- Fiscal sovereignty belongs to the confederation and the cantons. Yet, its exercise is tempered by interjurisdictional competition and the mobility of taxable units, and limited by coordination and harmonisation practices and law. The communes have no authority over taxation, but have full fiscal flexibility.
- Budget responsibility is required at the three levels of government. It means that current budgets should be balanced, borrowing can only finance investments and that only limited transfer payments are available. This is a classical approach to public finance. In addition, direct access to many revenue sources is essential.
- In addition to cantonal disparities in economic potential, the use of non-benefit taxation by decentralised levels of government, different cantonal ideas on tax equity and a fairly large amount of autonomy to decide and offer public services result in large differences in the fiscal burden of individuals in the cantons as shown by the indices of cantonal fiscal burdens for various tax revenues.
- Equalisation schemes intervene in order partly to compensate differences in the revenue-raising capacities of the cantons. But the amounts of transfer payments to the cantons remain modest owing to the objectives of budget responsibility and financial autonomy of the various jurisdictions. There is no claim to obtain identical economic and fiscal conditions across cantonal and communal jurisdictions.

The Swiss experience introduces pragmatism in fiscal federalism. Financial and budgetary autonomy of decentralised governments permits them to engage in specific public policies, alone or in many forms of horizontal and vertical cooperation. Comparison and competition between the individual jurisdictions ensure that only those policies which are in the long term accepted by the population can be carried through. The correct solution is not declared *ex ante* as binding, but emerges *ex post* after a selection procedure, which, like a process of trial and error, has compared the various approaches with one another. This selection procedure means that policies in the most diverse areas can be continually reviewed, without it being necessary to specify in advance the right solution—which no one knows anyway (Blöchli and Frey 1993:237). In this procedure, the elements of direct democracy and constitutional economics play a crucial role: constitutional guarantees in the vertical division of power, initiative

and referendum, the principle of subsidiarity, fiscal sovereignty, access to many revenue sources, and a low dependence on (equalising) transfer payments are the indispensable ingredients of fiscal federalism.

Notes

- 1 However, a large number of public expenditures of the cantons are arranged according to federal law, in which case the cantons have only residual autonomy and act rather as 'agencies' for the centre.
- 2 In all the cantons, constitutional or legislative initiatives are possible, in the first case with a minimum number of citizens' signatures between 1 and 30,000 according to the canton, and in the second case with a minimum number of signatures between 1 and 12,000. In 18 cantons, each investment item above a minimum amount (varying from 250,000 Sfr. to 25 million Sfr. according to the canton) is submitted to compulsory referendum. In 16 cantons, a referendum is also compulsory for new recurrent expenditures above a minimum amount (varying from 25,000 Sfr. to 2 million Sfr.).
- 3 See also [section 6.1](#). At that time, the annual average exchange rate of the Swiss franc was 1.37 US dollars and 1.62 European ECU.
- 4 The percentages refer to the assignment of functions between the three layers of government in [Table 11.3](#) (horizontal lines). For example, for the function 'administration', total public expenditures were 7,339 million Swiss francs, of which 46 per cent are communal outlays, 36 per cent cantonal and 18 per cent federal.
- 5 Walsh, 1993: p. 32–5 summarises the normative arguments. Wiseman (1989) argues that efficiency criteria must be related to the capability of strengthening political checks and balance through appropriate procedures and not to the tax-and-expenditures outcomes as such.
- 6 Universities are cantonal and receive federal conditional grants. The largest part of 1,777 million Sfr. (1,238 million=72 per cent) goes to the two federal polytechnics in Zurich and Lausanne.
- 7 From 1960 to 1990, public expenditures for waste water sewage and depuration plants amounted to 32 milliard Sfr. Local governments paid 63 per cent of the total bill, the cantons 26 per cent and the federal government 11 per cent. A. Baranzini, 'Structures et coûts des stations d' épuration en Suisse et gestion efficace des eaux usées', *Swiss Journal of Economics and Statistics*, 1996, 4/1: 515–38.
- 8 My own calculation from a sample of communes in the canton of Fribourg is based on the proportion of total outlays of the current budget that the communes must spend for functions and services which are fixed at minimum standards by the canton (or the confederation). This proportion varies between 30 and 50 per cent according to the population size of the commune. It is around 30 per cent for the larger communes with 2,000 inhabitants or more; and around 50 per cent for municipalities with 500 inhabitants, with variations that are approximately proportional between these sizes. The percentage increases and becomes rapidly prohibitive for communes with less than 500 inhabitants, so that one might question what autonomy remains. Furthermore, these percentages are probably

underestimated because they do not take into account the financial cost of public debt for the investments that are required by federal or cantonal laws, as for example in environmental policies (Dafflon 1996a).

- 9 Without the social security deficit. In 1993, the deficit was 15,784 million Sfr. or 4 per cent GNP. This result did not respect one of the Maastricht criteria, namely that the total deficit of the public sector, including social security, should not exceed 3 per cent of GNP.
- 10 The turnover tax which is levied on consumer goods and private investment outlays was replaced on 1 January 1995 by the value added tax (VAT) at a rate of 6.5 per cent on consumer goods and services.
- 11 Consider, for example, the taxation of individual income. The amount of cantonal tax that an individual taxpayer owes is $T_{\text{cantonal}} = t \times B \times k$, where t is the tax rate selected from the tax rate schedule according to the value of B , the tax base; k is the annual coefficient calculated so that the cantonal budget is balanced. At the local level, in most cantons, the communes only have a tax flexibility, which means that they can choose their own value for k in $T_{\text{communal}} = T_{\text{cantonal}} \times k$, in order to balance their own budget.
- 12 In the canton of Fribourg, the cost for a commune is 1.5 per cent of net tax revenues. The cantonal tax administration collects communal taxes and acts for the commune in all aspects of tax litigation. The tax proceeds are paid to the commune on a monthly base.
- 13 For example, in September 1994, the Council of State (executive government) of canton Berne imposed on the commune of Berne (the capital city of the canton and also the federal city) an increase of the tax coefficient from a multiple of 2.2 to 2.4 of cantonal direct taxes levied in the commune. The reason was that the electorate of the commune had rejected for the third time the 1994 budget, which presented a deficit and required for balance an increase in taxation. In Fribourg, the canton controls the books and public debt of the communes on a yearly basis. It intervenes if the current account is not balanced or if amortisation of the debt by effective reimbursement is not sufficient according to legal minimum rates. Cantonal intervention takes several forms, but it can go so far as to impose a higher tax coefficient on the commune at fault in order to restore its financial situation.
- 14 It is significant that all initiatives for a uniform nationwide system of taxation on income and wealth of individuals and on corporate profits and capital have been rejected in popular votes because it would restrain the fiscal flexibility of lower levels of government and increase their dependence on transfer payments. Differences in cantonal and communal tax burden are viewed as the price of autonomy (Dafflon 1986).
- 15 With the enforcement of VAT on 1 January 1995, and with it, the extension of expenditure taxation to services, the most orthodox federalists claim that the joint attribution of direct taxation to the confederation and the cantons should end. There should be a crystal-clear order in taxation under the slogan: 'VAT is federal/direct taxation is cantonal'.
- 16 Since tax breaks are used in all cantonal regional development policies, they do not really give a net advantage to one region over another, which results in a typical prisoner's dilemma situation.
- 17 For a general survey of the very diverse and often complex aspects of Swiss tax laws, updated to the situation in force from 1995 onwards, see Coopers and

- Lybrand (1995), *Taxation in Switzerland*, with the Schweizerische Treuhandgesellschaft, Berne. A chapter deals with avoidance of international taxation with respect to direct taxes and death duties.
- 18 This section is a very short summary of research undertaken by the author for the Swiss National Fund of Research and published in 1995 (Dafflon 1995).
 - 19 However, Blöchliger and Frey (1993:231) note that there is no overall coordination of regional equalisation measures, and there are also a number of measures with indirect redistributive effects which exacerbate regional disparities. For example, though central government procurement is not intended to be redistributive in nature, it benefits mainly industrialised cantons with already higher-than-average NIC (Jeanrenaud 1985).
 - 20 Other regional measures, mostly in the form of conditional grants, are addressed either to individual or private firms within delimited regions or to the regions for themselves or for the communes within their jurisdiction. Regions do not necessarily coincide with cantonal frontiers. Usually, the regions group a number of neighbouring communes with some geographic similitudes (all the municipalities in a valley, or alongside the same border of a river, for example). Some regions are intercantonal, which creates coordination problems when the respective cantonal Constitutions or legislations do not contain identical rules. There are no automatic supra-cantonal rules to observe, so that cooperative federalism is negotiated from case to case.
 - 21 Intercantonal equalisation also exists, principally as contributions for regional spillovers. One example is the contributions of cantons without universities for cantonal universities. At the local level, many systems of revenue sharing and grants-in-aid function between the cantons (not all) and their communes. A number of cantons have also developed horizontal equalisation mechanisms in which the fiscally strong communes provide direct support for the fiscally weak municipalities.
 - 22 Detailed revenue-sharing formulas are given in Dafflon (1995:99, 112 and 131).

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Index

- accession to the EU 71
- accountability 15, 272–7
- additional educational needs 190–4
- additive taxing regime 153
- administration, general 19
- ‘agency’ model 17, 262
- ‘agreed taxes’ 237–1
- Agricultural Reserve Fund 90
- aid to the Third World 92–6
- allocation of functions *see* functions
- Aragón 232
- area cost adjustments 193–7
- assignment of responsibilities, unclear 62–5
- audit competences 254
- Austria 5–6, 55, 99–21;
 - entry into EU 112;
 - expenditure functions 101–9;
 - finance system 106–16;
 - fiscal democracy 99–5;
 - new consultation mechanism 114–19;
 - politico-economic appraisal 107–17
- autonomous communities (ACs) 218, 244, 247–1;
 - financing models 226–41;
 - multi-province and one-province 222–7;
 - structure 219–32;
 - see also* Spain
- autonomy, local:
 - Austria 107–17;
 - comparative view 36–40, 42, 48;
 - degree and type of 203;
 - Germany 165–9;
 - Italy 200–3, 203, 208–11;
 - vs solidarity in Spain 248–2;
 - Switzerland 270–4;
 - tax autonomy *see* tax autonomy
- autonomy block 234–9
- Bahl, R. 65
- bail out risk 80–1
- balanced budget 272
- Balearic Islands 232
- Barcelona 241
- Barzel, Y. 225
- Basque Country 223, 226, 237–1;
 - see also* Euskadi
- benefit areas 158–3
- Bernard-Gelabert, M.C. 140
- Bird, R.M. 65, 72
- Blair, P. 57
- Blöchliger, H. 287
- block grants 57, 58;
 - France 138, 139–3, 143–9, 146;
 - see also* grants/transfers
- Bolliet, A. 135–40
- boroughs 175–9
- borrowing 29;
 - debt limitation in Switzerland 272–7;
 - Germany 165;
 - restrictions in Spain 234;
 - see also* deficits
- Bouvier, M. 153
- Buchanan, J.M. 168
- budget, EU 89–3;
 - size of 90–7
- budget reserve 90
- budget responsibility 15, 272–7
- budgetary authority (EU), strengthening 85–9

- Bulgaria 62, 70
 Burgos, J.de 219
 business taxation:
 comparative view 35–7;
 France 130, 132–6, 132–8, 143, 149–7;
 Germany 170;
 Great Britain 185;
 transition countries 70;
 see also corporate income tax, profits
 taxation
- cadastral value 30–5
 cantons 251, 253–7;
 Conferences of cantonal Ministers 256;
 contributions to social security 285,
 286;
 financial capacity 280–6;
 fiscal burden 277–3;
 general indicators 256–62
 capital financing 193
 capping, tax 184–8, 195
 ceded taxes 28;
 comparative view 37, 38;
 Spain 229, 232, 236, 247
 central control of local expenditure 124–30
 centralisation:
 expenditures in Switzerland 262–70;
 Germany 158, 161–9, 167;
 local business tax in France 150–7;
 problem of increasing 167
 centralism 206–11
 charges and fees 40–2, 42, 48–48
 charter cities 101
 children's social services 192
 'choice' model 16–17, 262
 close-ended grants 146–1, 146
 cohesion fund 92–6
 common regime system 224, 226–9, 247–1;
 autonomy block 234–9;
 solidarity block 232–7;
 sufficiency block 229–6
 communes 251;
 Italy 209, 211–16
 comparative view of local finance 3–4, 14–
 59;
 current developments and debates 47–
 48;
 evolution of local finance and role of
 reforms 44–8;
 expenditure patterns 15–28, 41–3, 117;
 grants 29–3, 40–2, 44–7, 57–2;
 institutional and organisational changes
 55–9;
 overall picture of fiscal decentralisation
 in Europe 41–5;
 revenue patterns 28–44, 44–8, 118;
 subcentral taxation 30–40
 compensation 139–3, 140
 competences *see* functions, responsibilities
 competition:
 among levels of government 203–7;
 between communes in Switzerland 272
 competitive federalism 1
 compulsory mutualisation 152–7
 compulsory taxation 270
 concurrent legislation 161
 conditional federal grants-in-aid 282–7,
 286
 Conference of the cantonal Ministers of
 Finance (CCMF) 256
 Conferences of cantonal Ministers 256
 conferences of regional ministers 162–7
 constitutional court 169
 constitutional guarantees 253–8
 consultation mechanism 114–19
 control, central 124–30
 control totals 187–2;
 dividing between authorities 188–2;
 implications of altering 187–1;
 working out authorities' expenditure
 needs 189–7
 Convergència i Unió (CiU) 232
 cooperative federalism 1, 202;
 Switzerland 255–9
 coordination of fiscal policies 82–8, 87
 coordination of taxes 274–8, 274–9, 277–3
 corporate income tax 69–2;
 see also business taxation, profits
 taxation
 cost sharing 107
 cost shifting 107
 Council of Europe 64
 Council of Fiscal and Financial Policies
 (CPFF) 231
 Council of Ministers 85–9

- council tax 183–7
 Council for Taxation 149, 151, 152
 counties:
 Denmark 118–5;
 Great Britain 175–9
 customs duties 284
 Czech Republic 60, 68, 71
- Dafflon, B. 255, 256, 260, 262, 272, 274
 DCTP (compensation grant for local business tax) 139, 140, 140, 146
 debt/GDP ratio 77–1
 debt limitation 272–7;
 see also borrowing, deficits
 decentralisation 1, 2;
 of expenditure in EU 15–28;
 overall view of fiscal decentralisation in EU 41–5;
 of revenue in EU 28–44;
 Spain 219–32, 242–9, 248;
 trap of in Italy 206–11
 decision-making autonomy 203
 deficits:
 avoiding excessive 79;
 defining excessive 77–1;
 Italy 200;
 need for quantitative conditions 79–4;
 see also borrowing
 Della Santa, M. 255
 Delors plan 92, 95
 Delors II package 92–6
 democracy:
 direct 254;
 fiscal 99–5
 Denmark 6–7, 55, 117–30;
 central control of local expenditure 124–30;
 local government equalisation 122–9;
 Nordic model of local government 117–5;
 personal income tax 121–6, 123, 124, 126
 Denny, K. 18, 47
 derivation principle 164
 Derycke, P.H. 143
 development policies 2
 devolved taxes *see* ceded taxes
- DGD (block grant for decentralisation) 138, 140
 DGE (block grant for capital expenditure) 138, 140, 146
 DGF (block grant for current expenditure) 138, 139–3, 143–9
 direct democracy 254
 direct taxes:
 France 130–4, 133–9
 dirigisme 206–11
 distribution 2;
 see also equalisation, redistribution
- Ebel, R.D. 65, 72
 econometric estimates 141–6
 Economic Agreement 237
 education 19, 19;
 Great Britain 179, 181, 189–4;
 Switzerland 262, 262
 efficiency 2–3, 95, 198–2
 Eichengreen, B. 80–4
 energy tax 93
 enforced responsibility 170–4
 equalisation;
 comparative view across EU 48, 57–2;
 Denmark 122–9;
 France 140–9, 149–7;
 issue in Germany 166;
 Great Britain 185–9;
 Italy 210–14;
 special assignments of 233;
 Switzerland 280–8, 286;
 see also grants/transfers
 equalisation performance 143–8
 equity 96
 equivalence, fiscal 160–4
 Estonia 60–4, 71
 European Central Bank 79, 80, 82
 European Chart of Local Self-Government 64
 European Commission Report 1993 86–87, 90
 European Monetary Union (EMU) 4–5, 77–96
 European Parliament 85–9, 95
 European Union 30, 168;
 accession to 71;

- budget 89–3, 90–7;
 - revision of institutional structure 94–9;
 - size of budget and growth of own resources 90–7
- Euskadi 223, 226, 237–1;
 - see also* Basque Country
- excessive deficits 77–1;
 - procedure for avoiding 79
- excise taxes 72–5, 284
- expenditure 95–9;
 - central control 124–30;
 - Denmark 122–9, 124–30;
 - functions and levels of government in Austria 101–9;
 - Great Britain 179–4;
 - patterns across EU 15–28, 41–3, 117;
 - regionally self-determined in Germany 161–7;
 - Spain 225–32;
 - Switzerland 259, 260, 260–70
- expenditure needs:
 - Denmark 124 124;
 - equalisation of 58–2, 124, 124;
 - Great Britain 189–7;
 - index of needs 141–6;
 - Spain 225–32

- FCTVA (compensation for VAT) 138, 140, 140
- federal countries 17–30;
 - incidence of revenues on GDP 44–7;
 - organisation and decentralisation of expenditure 17–28;
 - revenue 28–30
- federal direct tax (FDT) 284
- federalism:
 - meanings of 1
- fees and charges 40–2, 42, 48–48
- financial capacity of cantons 280–6
- financing, principles of 64–8
- fiscal decentralisation *see* decentralisation
- fiscal democracy 99–5
- fiscal equalisation *see* equalisation
- fiscal equivalence principle 160–4
- fiscal federalism:
 - principles 66–9, 158–4;
 - theory 1–3
- fiscal policy:
 - Maastricht constraints and 77–2;
 - and stabilisation of German economy 82–8
- fiscal sovereignty 270–4
- foral regime 224, 226, 237–1, 247–1
- formal tax harmonisation 276–80
- France 7–8, 48, 55, 127–61;
 - centralisation of local business tax 150–7;
 - compensation 140;
 - Decentralisation Acts 127;
 - distribution of taxing powers among levels of government 129–40;
 - equalisation 140–8, 149–7;
 - impact of macroeconomic constraints 145–53;
 - intergovernmental fiscal relations 136–53;
 - participation of central level in local finance 140–4;
 - reform of local taxation 149–7;
 - Regional Development Act 153;
 - transfers as compensation 139–3
- free school meals 190–4
- Frey, R.L. 274, 287
- functions:
 - allocation in Great Britain 176, 177;
 - allocation in Italy 203–7;
 - allocation in Spain 224–9, 226–1;
 - comparative view of distribution 18–28;
 - danger of imprecisely defined for lower levels 161–5;
 - distribution in Austria 101–9;
 - distribution in functions (*continued*) Switzerland 260–6, 262;
 - enforced responsibility in Germany 171;
 - see also* responsibilities

- Gallo Commission 210, 211
- GDP:
 - incidence of revenue on 44–7;
 - incidence of tax revenue on 30, 30
- general administration 19
- Germany 8, 48, 55, 70, 77–1, 158–76;

- Basic Law 161, 163;
- central government 168–2;
- constitutional court 169;
- imprecisely defined functions of the lower levels 161–5;
- institutions from public choice perspective 167–3;
- issue of equalisation 166;
- 'joint tasks' and conferences of regional ministers 162–7;
- local governments 170;
- need for enforced responsibility 170–4;
- paths to centralisation 161–9;
- problem of increasing centralisation 167;
- regionally self-determined expenditures 161–7;
- regionally self-determined revenues 164–9;
- retaining decentral content 167–4;
- state level 169;
- two principles of fiscal federalism 158–4
- Giarda, P. 210
- Gilbert, G. 143, 149, 155
- Gini index 143
- globalism 202
- 'golden' rule of public finance 77
- gradualism 151
- gradualistic federalism 1
- grants/transfers:
 - Austria 107, 107;
 - comparative view over EU 29–3, 40–2, 44–7, 57–2;
 - France 135–40, 136–53;
 - Great Britain 185–92, 195;
 - Italy 210;
 - Spain 232–7, 236, 240;
 - Switzerland 267–3, 282–8, 286;
 - transition countries 68–1;
 - see also* equalisation
- Great Britain 9, 56, 173–197;
- area cost adjustments 193–7;
- capital financing 193;
- current expenditures 179–4;
- current revenues 181, 195;
- effect of financial changes 195;
- effect of structural changes 194–8;
- expenditure needs 189–7;
- grants 185–92;
- highway maintenance 192–6;
- local government before 1960 175–9;
- local government from 1960–1996 176–81;
- local taxation 181–8;
- 1996 local government reforms 177–3;
- personal social services 192;
- possible reforms 196;
- primary education 189–4;
- structure of local government 175–83
- Guengant, A. 141, 143, 155
- harmonisation of taxes 271, 274–8, 276–83
- health care 19, 19
- highway maintenance 179, 181, 192–6
- horizontal competition 203
- horizontal coordination 274–9
- horizontal financial equalisation 57
- housing expenditure 19
- housing tax 130–4, 132–8;
- see also* property taxation
- Hungary 60, 69, 70
- Ile-de-France region 143
- income taxation *see* corporate income tax, personal income tax
- indexation rules 145–53
- indirect taxation 64, 71–6
- institutions:
 - comparative view of reforms 55–9;
 - German in a public choice perspective 167–3;
 - reforms needed in EU 94–9;
 - Switzerland 253–9
- intercommunal equalisation 280;
- see also* equalisation
- intergovernmental transfers *see* grants/transfers
- intermediate (regional) government 15–17, 42;
- functions of 18–19;
- revenue 37, 38, 38, 40, 42;
- transition countries and 62;
- see also under individual countries*
- interregional equalisation 210–14;

- see also* equalisation
- Interterritorial Compensation Fund 233
- Italianer, A. 90
- Italy 9–10, 48, 56, 198–21;
 - attribution of functions to different levels of government 203–7;
 - Bassanini law 203, 208, 213–17;
 - blocks to achieving fiscal federalism 203–8;
 - centralism and dirigisme as leading ideologies 206–11;
 - current popularity of fiscal federalism 198–5;
 - first Bicameral Commission 210;
 - neo-regionalism 208–14;
 - problems 206–16;
 - role of communes 211–16;
 - second Bicameral Commission 210, 214;
 - tax autonomy 200–3, 204–8, 209–13
- joint boards 178, 179, 195
- joint recommendations 126
- joint tasks:
 - Germany 162–7;
 - joint task fulfilment in Austria 107, 107, 107
- King, D. 270, 274
- Kirchgässner, G. 255
- Knapp, B. 271
- labour costs 193–7
- Latvia 68, 72, 74
- law and order 19
- Lithuania 70
- local autonomy *see* autonomy;
 - tax autonomy
- local business tax *see* business taxation
- local government 42;
 - expenditure patterns 18–28;
 - models of 16–17;
 - Nordic model 117–5;
 - revenues 37, 38, 38–1, 42, 44;
 - see also under individual countries*
- London 178, 177, 195
- Maastricht Treaty 4–5, 83, 89, 161;
 - constraints and fiscal policy 77–2, 79–3;
 - inadequacy of provisions 85–88
- MacDougall Report 83, 86, 89, 91
- macroeconomic constraints 145–53
- Madrid 232, 241
- Majocchi, A. 82, 90
- metropolitan areas 178
- ministerial conferences, regional 162–7
- Ministry of Finance 168, 169
- Ministry of the Interior 168
- Moesen, W. 81
- municipalities:
 - Denmark 118–5;
 - Spain 239–9;
 - transition countries 60–4
- Musgrave, R.A. 1, 83, 158
- national equalisation fund 143
- natural resource taxes 65–8, 73–6
- Navarra 223, 226, 237–1
- needs, index of 141–6;
 - see also* expenditure needs
- neo-regionalism 208–14
- no bail out clause 80
- non-interest-bearing deposit 79
- non-tax revenue 28–30, 44–7
- Nordic model of local government 117–5
- Norregaard, J. 18, 19–7, 34–6
- Northern Leagues 201
- Norway 121, 124
- Oates, W.E. 1, 225, 274, 276
- oblast taxes 67
- OECD surveys 29, 30–4, 36, 41
- Olson, M. 160, 247, 255
- open-ended grants 146
- optimal currency areas 88–2
- organisation patterns 15–28, 55–9
- overlapping competences 203–7;
 - see also* functions, responsibilities
- Owens, J.P. 18, 19–7, 34–6
- own taxes 28;
 - comparative view 36–40;
 - Spain 234–9

- Pacte de Stabilité Financière 146
 partial fiscal sovereignty 270
 Partido Popular (PP) 232
 payment for services 40–2, 42, 48–48
 personal income tax:
 comparative view 34–6;
 Denmark 121–6, 123, 124, 126;
 Germany 170;
 Spain 231–6;
 transition countries 64, 67–69
 personal social services 179, 181, 192
 PIE (*Participación en Ingresos del Estado*)
 240–6
 piecemeal reforms 151
 piggy-backing 122, 165–9
 Pisani-Ferry, J. 90
 Plessner, H. 163
 Poland 71
 politicians, local 3
 poll tax 181–6
 Pommerehne, W.N. 255
 popularity of fiscal federalism 198–5
 PPI (*Porcentaje de Participación en Ingresos del Estado*) 229–6
 pragmatism 287
 primary education 189–4
Privatwirtschaftsverwaltung 101, 105
 profits taxation 34–6, 64, 69–2
 property taxation:
 comparative view 30–5;
 France 130–4, 132–8;
 Great Britain 181–5, 183–7;
 transition countries 64–7, 70–3
 provincial governments:
 Spain 222–7, 224–9, 238–2, 240, 246
 public choice perspective 167–3
 public goods 2;
 see also functions, responsibilities

 rates 181–5
 real estate taxation *see* property taxation
 real tax harmonisation 276, 277
 recession 79
 redistribution 2, 95–9;
 Denmark 122–9;
 see also equalisation
 referenda 254

 regional equalisation fund 143
 regional government *see* intermediate
 (regional) government
 regional ministers, conferences of 162–7
 regional policy 162
 regional self-determination 161–9
 regional stabilisation fund 90
 regional stabilisation policy 88–3
 regionalism 208–14
 regression analysis 188–2, 190–4, 192
 research and development 92–6
 resources, natural:
 taxes on 65–8, 73–6
 responsibilities:
 division in France 140–4;
 levels in Spain 221, 221–6, 224–9;
 need for enforced responsibility in
 Germany 170–4;
 neo-regionalism in Italy 210;
 unclear assignment in transition
 countries 62–5;
 see also functions
 revenue:
 autonomous regimes in Spain 226–41;
 comparative view 28–44, 44–8, 118;
 direct access to many revenue sources
 271–5;
 grants and ‘other’ elements 40–2;
 Great Britain 181, 195;
 local governments in Spain 238–9;
 overall picture of fiscal decentralisation
 41–5;
 regionally self-determined in Germany
 164–9;
 subcentral taxation in EU 30–40;
 Switzerland 264–5;
 transition countries 63;
 see also grants/transfers, non-tax
 revenue, tax revenue
 revenue sharing:
 Switzerland 284, 286;
 transition countries 66–9, 74–7
 revenue support grant (RSG) 185–9
 Rey, M. 90
 Ridge, M. 18
 Russian Federation 4, 71, 74–7;
 CIT 69–2;
 excise taxes 72–5;

- Federation Agreement 60;
 - Law on the Basic Principles of Taxation 66–9;
 - Law on Changes to the law on personal income tax 68;
 - natural resources tax 73–6
- Schneider, F. 255
- Scotto, A. 1
- secessionism 201
- security 19
- selection procedure 287
- self-determination, regional 161–9
- self-government 105, 107;
- see also* autonomy
- separate tax systems 34
- shared taxes 28–29;
- Austria 106–13, 107–17;
 - comparative view 34, 36–40, 59;
 - Germany 164–9;
 - Spain 229–6
- shocks 82–7
- Slovak Republic 62, 70
- Smith, S. 18
- social security 30;
- cantonal contributions 285, 286
- social services, personal 192
- solidarity block 232–8
- solidarity principle 248–2
- sovereignty, fiscal 270–4
- Spain 10–11, 56, 218–54;
- autonomous financing models 226–41;
 - autonomy block 234–9;
 - Central Budget Act 241–6;
 - common regime system 224, 226–9, 247–1;
 - Constitution 1978 218, 219;
 - decentralisation 219–32, 242, 244–9, 248;
 - financing system of local governments 238–9;
 - foral regime system 224, 226, 237–1, 247–1;
 - Local Finance Act 241;
 - Local Government Act 224;
 - solidarity block 232–8;
 - sufficiency block 229–6
- sparsity 190–4
- special assignments of equalisation 233
- special companies 107, 107
- specific grants 57, 58;
- Switzerland 282–7, 286;
 - see also* grants/transfers
- stabilisation 2
- stabilisation policy 4–5, 77–96;
- inadequacy of provisions in Maastricht Treaty 85–88;
 - Maastricht constraints 77–2;
 - need for quantitative conditions on the deficit 79–4;
 - regional stabilisation policy 88–3;
 - role of EU public finance 81–8;
 - size of EU budget and growth in own resources 90–7
- Stability and Growth Pact 5, 78–2, 90
- Standard Spending Assessments (SSAs) 186–90, 189–7
- structural reforms:
- Austria 112;
 - comparative view 47, 55–9;
 - Great Britain 175–83, 194–8;
 - Scandinavian countries 121
- structure of subcentral government:
- Austria 99–5;
 - comparative view 15–17, 47;
 - Denmark 118–5;
 - France 127, 131–5;
 - Germany 161–7, 168–3;
 - Great Britain 175–83;
 - Italy 204, 208–16;
 - Spain 219–32;
 - Switzerland 251, 253–9;
 - transition countries 60–4;
 - see also* structural reforms
- subsidiarity principle 95, 160–4, 203;
- Switzerland 251, 260–6
- subsidiarity test 162
- substitutive taxing regime 153
- sufficiency block 229–6
- super-sparsity 190–4
- surcharges 234, 236, 247
- Sweden 121, 124
- Switzerland 11, 251–94;
- budget responsibility 272–7;
 - Constitution 1874 253;

- constitutional guarantees 253–8;
 - cooperative federalism 255–9;
 - equalisation 280–8, 286;
 - federal equalisation programmes 282–8, 286;
 - federal law on the harmonisation of cantonal direct taxation 271;
 - financial capacity of the cantons 280–6;
 - fiscal burden in the cantons 277–3;
 - importance of transfer payments 285;
 - institutional issues 253–9;
 - public expenditures 259, 260, 260–70;
 - public revenues 264–5;
 - public sector 256–75;
 - size and growth of public sector 259–3;
 - tax coordination and harmonisation 274–83
- tax administration 271
- tax assignment in transition countries 65–74
- tax autonomy:
- comparative view 36–40, 42;
 - France 129–3;
 - Italy 200–3, 204–8, 209–13;
 - Spain 237;
 - Switzerland 270–4
- tax capacity 144–9
- tax capping 184–8, 195
- tax coordination 274–8, 274–9, 277–3
- tax dependence 37–38
- tax financing 37–38
- tax flexibility 270
- tax harmonisation 271, 274–8, 276–83
- tax revenue:
- Austria 106–13;
 - comparative view 28–40, 41, 42, 44–7;
 - EMU and EU resources 93–7;
 - general available information for EU 30–7;
 - Germany 164–8;
 - Great Britain 195;
 - information from surveys 36–40;
 - Scandinavian countries 118, 121–6;
 - Spain 226–49;
 - Switzerland 264–2;
 - see also* ceded taxes, own taxes, shared taxes, *and under individual taxes*
- tax-setting rights 165–9, 170–4
- tax sharing *see* shared taxes
- taxation 2, 3;
- local in Great Britain 181–8;
 - optimal base for local taxation 47–9;
 - principles for transition countries 64–8;
 - reforms in France 149–7;
 - reforms in Italy 200;
 - reforms in transition countries 63;
 - tax burden in Swiss cantons 277–3
- taxing powers:
- distribution among levels of government in France 129–40
- Third World, aid to 92–6
- Tollison, R.D. 274
- trans-European networks 92–6
- transfers *see* grants/transfers
- transition countries 4, 60–77;
- assignment of specific taxes 67–74;
 - federal government taxes 66;
 - fragmentation of subnational governments 60–4;
 - influence of previous practices 63;
 - local government taxes 67;
 - oblast taxes 67;
 - ongoing reform of tax system 63;
 - principles of financing subnational governments 64–8;
 - principles of fiscal federalism 66–9;
 - reforming fiscal federalism 74–7;
 - unclear assignment of responsibilities 62–5
- transport and communications 19
- Tremonti, G. 211
- tribune of local governments 131
- Tulkens, H. 274
- Uhaldeborde, J.M. 143
- Ukraine 71, 75
- uniform business rate 185
- unitary authorities 178, 177, 179
- unitary countries 17–30;
- incidence of revenues on GDP 44–7;
 - organisation and decentralisation of expenditure 17–28;

- revenue 28–30, 30
- United Kingdom *see* Great Britain
- United States (USA) 165
- value added tax (VAT):
 - Germany 170;
 - transition countries 71–4

- van Rompuy, P. 81
- Vanheukelen, M. 90
- vertical competition 203–7
- vertical coordination 274
- vertical division of power 253–7
- vertical equalisation 57
- Vienna 101
- Vitaletti, G. 211
- voluntary mutualisation 152, 153
- von Hagen, J. 79, 80–4
- voters:
 - control and 3

- Wagner, R.E. 274
- Wallich, C. 65, 72
- Weber, L. 274, 278
- welfare 19, 19
- White Book 71
- withholding tax 284
- Wolman, H. 262