

Part IV: Fiscal decentralisation in the EU – main characteristics and implications for fiscal outcomes

SUMMARY

In recent years, EU policymakers have increasingly raised the concern that the behaviour of subnational governments may be one of the factors hindering the achievement of budgetary targets at general government level. This issue has captured increasing interest, in part because subnational governments' responsibilities with respect to the provision of public goods and services are expanding and they are being assigned additional revenues to finance their spending. Budgetary targets set within the EU fiscal surveillance framework apply to the whole of general government – which consists of central government, subnational governments and social security funds whereas the responsibility for their achievement rests solely on central government. This Part of the report aims at assessing the extent and main features of fiscal decentralisation across EU Member States as well as the relationship between fiscal decentralisation and fiscal outcomes at general government level. It attempts to determine whether and under what conditions decentralisation can worsen overall fiscal balances. The Part is structured along three chapters.

Chapter IV.1 provides a cross-country comparison of fiscal decentralisation according to a set of indicators that are constructed using Eurostat data. It characterises EU decentralisation arrangements according to the following aspects: (i) the size of expenditure decentralisation, (ii) the size of revenue decentralisation, (iii) the composition of expenditure decentralisation by government function (e.g. education, health care etc.) and by type or economic function of expenditures (transfers, investments etc.), (iv) the composition of subnational revenues, essentially distinguishing taxes and transfers from the central government, (v) the degree of subnational financial responsibility (the share of subnational expenditures covered by subnational taxes and fees, as opposed to transfers).

The Chapter shows that there is a trend towards increasing fiscal decentralisation across most of the EU from both the expenditure and revenue sides, albeit with heterogeneity across countries. The statutory classification of countries as federal or unitary only imperfectly reflects the effective degree of decentralisation, as significant decentralisation can also exist in formally unitary countries (for instance, Nordic countries.) Across the EU, transfers slightly predominate over taxes as main revenue source of subnational governments. The rate of coverage of subnational expenditures by tax revenues is relatively low (less than 50% in most Member States) and has not increased on average since 1995 even if the trends are very diversified across Member States. The revenue composition is a key aspect as a greater reliance on own resources compared to transfers should strengthen the incentives of subnational governments to behave in a fiscally responsible way. Subnational deficits are not negligible in several Member States, with Spain having the highest deficits. Conversely, subnational debt levels are mostly low and generally correspond to less than 10% of GDP in most countries, although Belgium, Spain and Germany have higher levels. The actual size of subnational fiscal imbalances is to some extent masked by the tendency of central governments to provide additional transfers to cover the gap between expenditures and revenues of subnational governments.

Chapter IV.2 enriches the assessment by comparing and contrasting key elements of national fiscal decentralisation arrangements across the EU based on country descriptions compiled by

ECFIN services. This exercise provides significant added value by covering several aspects which cannot be captured through quantitative data, such as the number and legal status of the different subnational tiers, the effective degree of subnational tax autonomy (as opposed to simple assignment of receipts from national taxes), the different typologies of transfers and the criteria used to determine their amounts and the fiscal rules and budgetary procedures applying to subnational governments (including the monitoring, enforcement and possibilities of bailouts of subnational entities in fiscal distress).

The Chapter highlights that EU Member States have generally increased their decentralisation in recent decades – and this is also true of traditionally centralised countries. Some common patterns emerge with respects to the functions that are more frequently devolved to subnational tiers. These include not only functions with a markedly local dimension (e.g. local networks and infrastructure, local economic development and territorial planning) but, in several cases, also education, social protection, environment protection, housing and health care, albeit often with shared competence with the central government and/or with responsibilities restricted to the implementation of national regulations. Autonomous subnational taxes are quantitatively important in several EU Member States, mainly those which are more decentralised in general and property tax is the most widespread own revenue source of subnational governments.

The weight of shared taxes (without subnational government having the freedom to change tax parameters) is large in most New Member States (but also in AT, PT, EL and BE) and mainly concern the sharing of the personal income tax. Transfers account for a significant share of subnational revenues in a majority of Member States. General transfers often coexist with those earmarked to specific expenditures such as investment spending. Funds are generally allocated on the basis of spending needs and to correct for differences in revenue-raising capacity across subnational entities (equalising transfers). This may weaken subnational governments' incentives for cost-effective provision of services and fiscal discipline. In terms of their overall budgetary discipline, subnational governments are in most cases subject to rules constraining their fiscal behaviour, such as 'golden' rules restricting deficits to capital expenditures or numerical borrowing limits. Budgetary coordination across government tiers exists in more decentralised countries, although its effectiveness in achieving national fiscal targets depends on its design and implementation. Generally, default of subnational entities in fiscal distress is *de facto* ruled out, although central government 'bailout' often comes at the price of much tighter central control on subnational policies.

Chapter IV.3 analyses the relationship between fiscal decentralisation and fiscal outcomes of general government. This is done by testing the impact of the main indicators of fiscal decentralisation introduced in Chapter IV.1 on the primary balance, expenditures and revenues of the general government in the EU through econometric regressions. Results show that (i) expenditure decentralisation leads to a higher primary balance, through lower expenditures and higher revenues; (ii) the impact of fiscal decentralisation largely depends on the way subnational governments are financed: if their revenues come predominantly from taxes and fees (and, among those, from autonomous taxes) the effect of decentralisation on the budget balance is improved, whereas if they mainly come from transfers decentralisation is more harmful for the fiscal balances; (iii) high coverage of subnational expenditures with taxes and fees (rather than with transfers) is associated with an improved budget balance, reflecting a negative effect on expenditures and a positive one on revenues; (iv) with respect to fiscal rules applying to subnational governments, borrowing rules appear to partly

counteract the adverse effect of transfers on fiscal balances, whereas no significant effect is found for balanced budget rules.

Overall, the analysis in this part suggests that fiscal decentralisation is not harmful for budgetary discipline at the general government level *per se*, although it is likely to have an adverse effect if predominantly financed by transfers from the central government and if not matched by subnational governments having the responsibility for financing the expenditures through their own taxes and fees. This is in line with theoretical predictions underlining the risk of a 'soft-budget constraint' associated with a high reliance on transfers, as subnational governments can justify their deficits by the lack of own revenue sources and so credibly threaten the central government to drastically cut their services if the centre does not provide them with additional transfers. Therefore, the policy concerns over possible adverse implications on budget balances should not focus on decentralisation as such but on a 'bad' design of decentralisation, i.e. one which is not accompanied by subnational financial responsibility. Finally, comparison of existing cross-country data with information in country descriptions underlines the complexity and multi-dimensionality of national fiscal decentralisation arrangements in the EU and highlights the fact that the cross-country data are not sufficiently rich to provide a comprehensive overview of the different aspects of fiscal decentralisation and the implications that it can have for budgetary discipline and economic efficiency.

Chapter 1: Main trends of fiscal decentralisation in the EU.

0. Introduction

According to a large literature and several economic indicators, there is a widespread trend across advanced economies, including many EU Member States, to increasingly shift the responsibility for key public sector's functions from the central government to subnational sectors of government. Although the extent and pace of this process varies across countries, it is no longer confined to federal countries and increasingly involves traditionally centralised ones.

With respect to a specific government function, the transfer of competence can be either partial, i.e. the central government retains the responsibility of the overall regulation while assigning the task of management and implementation to subnational governments, or total. Moreover, decentralisation does not only concern the expenditure side but also the revenue one, with subnational governments being increasingly assigned a number of revenue sources, mainly in the form of grants and taxes, in order to match, at least partially, growing expenditure responsibilities with corresponding means of financing. This Chapter aims at describing the extent of fiscal decentralisation across EU Member States based on Eurostat data. It covers both the expenditure and revenue side of decentralisation. For both sides it provides evidence on the aggregate extent of decentralisation (subnational governments' shares in total revenue and expenditure of general government), as well as a more detailed assessment based on available break-downs of aggregate data.

With respect to expenditures, the relative weight of subnational governments across different government functions (health, social protection etc.) and types of expenditures (consumption, wages, capital expenditures etc.) is assessed. However, available data do not allow to assess whether the competence assigned to subnational governments on their share of expenditure is total or partial. With respect to subnational governments' revenues, the break-down between taxes and transfers from the central government is provided. Unfortunately, Eurostat does not provide data on the share of "own-source" taxes of subnational governments, i.e. taxes which are set at subnational level, as opposed to tax revenues which are simply transferred from the central government, e.g. within tax sharing agreements. Similarly, no further breakdown of transfers, e.g. general vs. earmarked, is available¹.

Moreover expenditure and revenue data are compared in order to assess whether and to what extent decentralisation of spending functions has been matched by provision of adequate means of financing to subnational governments. Finally, the developments of debt and deficit at subnational level are also described.

¹ However, information on both of these aspects is to some extent provided by country fiches describing fiscal decentralisation arrangements in individual EU Member States. These have been compiled by ECFIN services based on a common template and questionnaire and are available in Annex 1. Chapter IV.2 below provides a summary of them. Furthermore, the OECD Secretariat produced indicators on effective tax autonomy which are used in the analysis of chapter IV.3 below.

1. Decentralisation of expenditures

1.1. Overall degree of decentralisation

The overall decentralisation of public expenditure is commonly measured by the share of subnational governments in general government expenditure. In order to properly interpret this indicator, as computed based on Eurostat figures, a qualification is needed. For most EU Member States, Eurostat only provides a break-down of total public expenditure by three sectors; i.e. central government, subnational government and social security. This means that throughout this part the 'subnational government' sector encompasses all subnational tiers of government (i.e. municipalities, provinces, counties, regions etc.); although in most Member States 2 or even 3 subnational government tiers exist. Only for four countries, three of which are federal by Constitution (i.e. DE, AT and BE) and one (ES) largely regionalised, a further break-down between local and state government is provided (where 'state' is distinct from 'national' and captures the intermediate layer between central and local government, i.e. *Länder* in DE, *Comunidades Autónomas* in ES etc.)

Table IV.3.1 displays the share of expenditure of subnational governments in total expenditure by the general government (columns 2 to 6) and as a percentage of GDP (columns 7 to 11). Figures are shown in levels for the earliest and latest year available (i.e. 1995 and 2010, respectively) and for 2007 and as changes over the 1995-07 and 2007-2010 period in order to single out the impact of the sovereign debt crisis. Charts IV.3.1 and IV.3.2 plot the same figures in level for 2010 and in terms of change over the 1995-2010 period, respectively, in order to ease cross-country comparison.

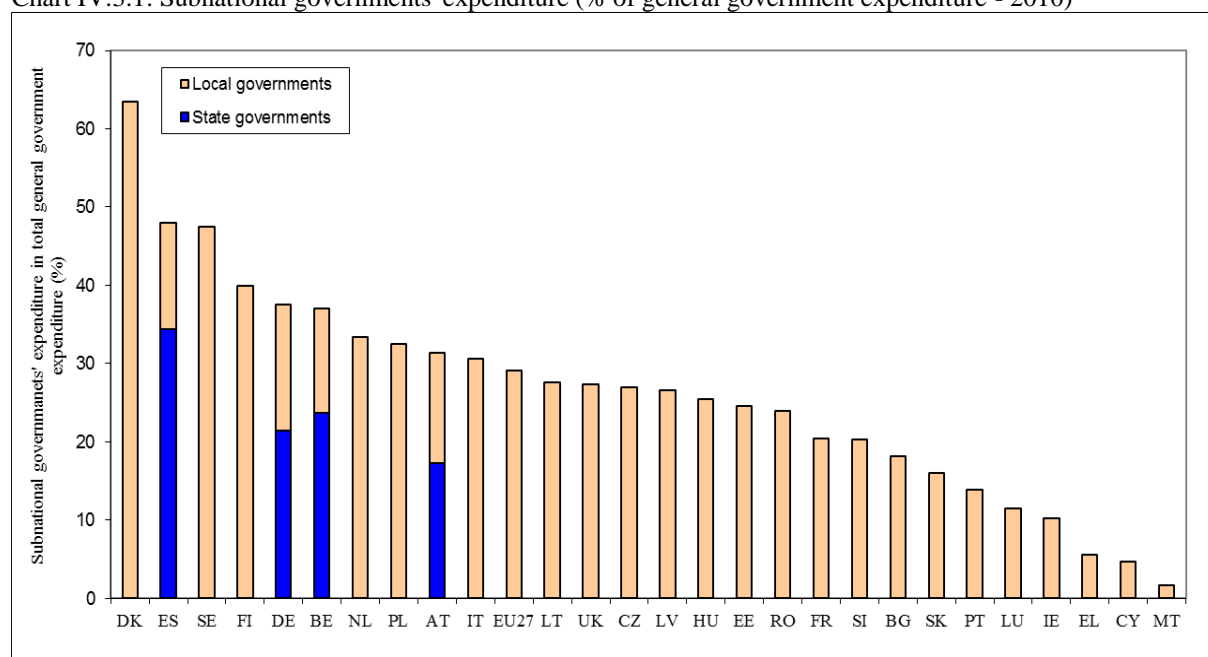
Table IV.3.1: Share of subnational governments' expenditure in the EU

	Share of subnational governments expenditure in general government expenditure					Subnational governments expenditure in % GDP				
	1995	2007	2010	Change 95-07	Change 07-10	1995	2007	2010	Change 95-07	Change 07-10
AT	31,4	30,6	34,5	-0,8	3,9	17,7	14,9	18,1	-2,8	3,2
BE	33,0	37,1	37,0	4,1	-0,1	17,2	18,0	19,7	0,8	1,7
BG	23,7	16,9	18,2	-6,9	1,3	10,8	6,7	6,9	-4,1	0,2
CY	4,2	4,6	4,8	0,4	0,2	1,4	1,9	2,2	0,5	0,3
CZ	19,2	26,1	27,0	6,9	0,9	10,2	10,7	11,9	0,5	1,2
DE	33,2	37,9	37,5	4,7	-0,4	18,2	16,6	18,0	-1,6	1,4
DK	53,7	63,3	63,4	9,6	0,1	31,8	32,1	36,9	0,3	4,8
EE	26,7	27,8	24,6	1,1	-3,2	11,0	9,5	10,0	-1,5	0,5
EL	4,2	5,5	5,6	1,3	0,1	1,9	2,6	2,8	0,7	0,2
ES	33,1	49,9	47,9	16,8	-1,9	14,7	19,6	22,0	4,9	2,4
FI	30,5	39,6	39,9	9,1	0,3	18,7	18,8	22,1	0,1	3,3
FR	17,6	20,7	20,5	3,1	-0,3	9,6	10,9	11,6	1,3	0,7
HU	23,5	23,2	25,4	-0,3	2,2	13,1	11,8	12,6	-1,3	0,8
IE	31,1	19,6	10,2	-11,4	-9,4	12,7	7,2	6,8	-5,5	-0,4
IT	24,1	31,3	30,7	7,2	-0,6	12,6	14,9	15,4	2,3	0,5
LT	24,1	24,0	27,6	-0,1	3,6	8,3	8,3	11,3	0,0	3,0
LU	13,4	12,2	11,5	-1,2	-0,6	5,3	4,4	4,9	-0,9	0,5
LV	19,2	31,0	26,6	11,8	-4,4	7,4	11,1	11,8	3,7	0,7
MT	1,5	1,4	1,6	-0,1	0,2	0,6	0,6	0,7	0,0	0,1
NL	40,2	34,0	33,3	-6,3	-0,7	22,7	15,4	17,1	-7,3	1,7
PL	18,9	31,4	32,5	12,4	1,2	11,0	13,2	14,8	2,2	1,6
PT	11,6	15,1	13,8	3,5	-1,2	4,8	6,7	7,1	1,9	0,4
RO	12,0	25,5	23,9	13,5	-1,6	4,1	9,8	9,8	5,7	0,0
SE	37,8	46,9	47,5	9,0	0,7	24,6	23,8	25,1	-0,8	1,3
SI	14,5	19,8	20,4	5,3	0,5	7,6	8,4	10,2	0,8	1,8
SK	13,1	17,6	16,0	4,5	-1,6	6,4	6,0	6,4	-0,4	0,4
UK	25,8	28,5	27,4	2,7	-1,1	11,3	12,5	13,8	1,2	1,3
EU27	---	29,2	28,9	---	-0,3	---	13,3	14,6	---	1,3

Source: own calculations from Eurostat.

According to this measure Member States differ largely in the extent of expenditure decentralisation. In 2010 DK ranked at the top with about 63% of total expenditure being carried out by subnational governments. ES and SE come next with 47-48%, followed by FI, DE, BE, NL, PL, AT and IT with figures ranging between 30 and 40%. At the opposite end of the spectrum are MT with a share of only 1.6%, CY (4.8%) and EL (5.6%), as the least decentralised MS, and IE, LU, PT, SK and BG with shares ranging from 10 to 20%. Clearly these figures suggest that the extent of expenditure decentralisation is not only affected by the institutional framework but also by the geographical and demographic size of the country. As for the institutional architecture of the country, it is interesting to observe that decentralisation is relatively larger not only in constitutionally federal countries but also in a few unitary ones such as the Nordic countries, NL, PL and IT².

Chart IV.3.1: Subnational governments' expenditure (% of general government expenditure - 2010)



Source: own calculations from Eurostat.

As regards the pace of decentralisation, Chart IV.3.2 shows that since 1995 a large majority of EU Member States have increased the share of public expenditure carried out by subnational governments, with the exception of IE³, NL, BG, EE and LU where the subnational share decreased⁴, and AT, MT and CY where it remained by and large stable. The increase in decentralisation has been particularly pronounced in ES, PL, RO, SE, DK and FI where the subnational share rose by about 10 pp or more. Chart IV.3.3 plots the aggregate level of government expenditure (as a share of GDP) against the subnational government share of total expenditure, both referring to 2010⁵. There appears to be a positive, albeit weak, correlation

² IT should in fact be considered a highly regionalised country in light of several reforms introduced over the past two decades.

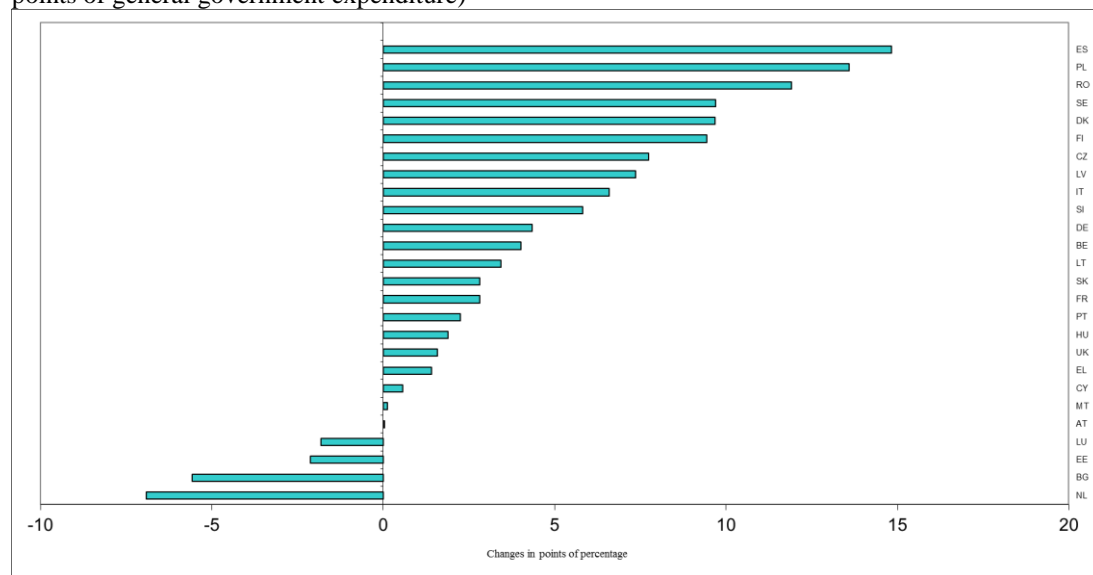
³ In Chart IV.3.2 the Irish figure is of 2008 to correct for the exceptional increase of total public expenditure in 2009-10 due to measures aimed at the recapitalisation of the banking sector.

⁴ See below 2.2 for a discussion on the change in the share of local governments' expenditure by function. In IE the figure in chart IV.3.2 is mainly driven by a sharp reduction of the local government's share in health care expenditure. Moreover, chart IV.3.5 below shows that the largest reduction in the local governments' share in investment expenditure by the general government between 1995 and 2010 occurred in IE and NL.

⁵ Except for IE (2008), see footnote 2.

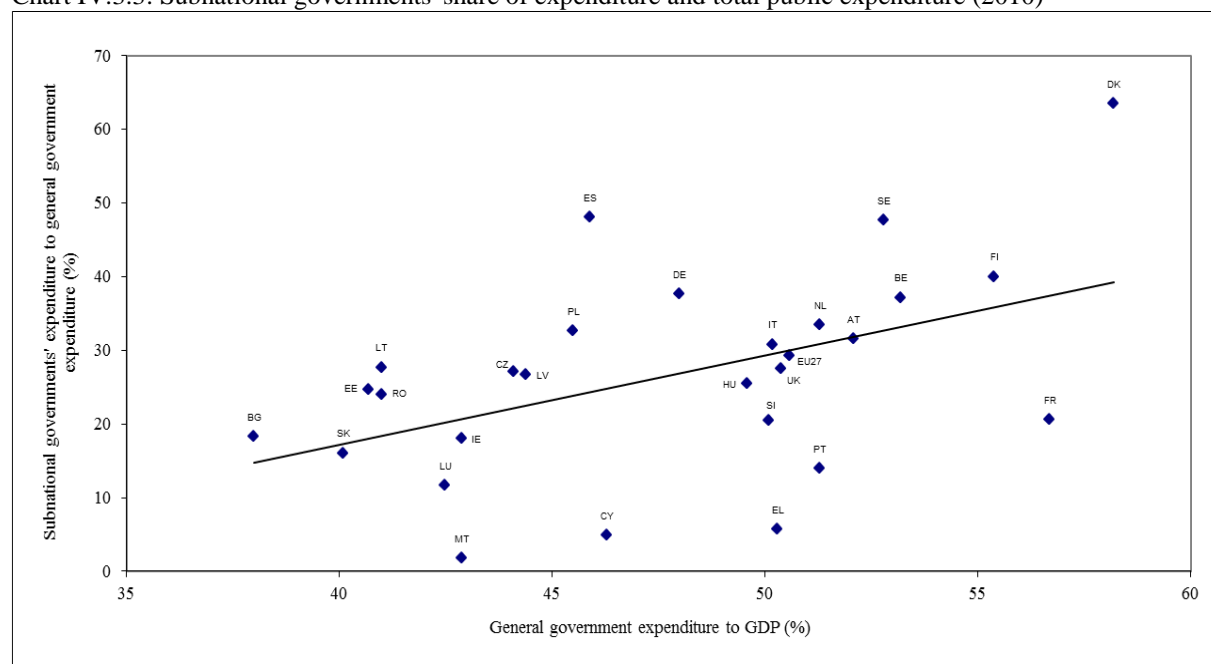
between these two variables, providing some *prima facie* evidence that decentralisation may be related to a larger overall weight of the public sector in the economy.

Chart IV.3.2: Change in the share of subnational governments' expenditure between 1995 and 2010 (percentage points of general government expenditure)



Source: own calculations from Eurostat.

Chart IV.3.3: Subnational governments' share of expenditure and total public expenditure (2010)



Source: own calculations from Eurostat.

1.2. Composition of subnational governments' expenditures

Eurostat figures on public expenditure by sector of government can be further broken down by government function (cofog), although data availability does not go beyond 2009. This allows to assess whether expenditure decentralisation is predominantly concentrated in specific functions. Chart IV.3.4 plots the share of subnational government expenditure over

total expenditure *by function* in 2008⁶ (all government functions considered by Eurostat are shown⁷). For each function the average, minimum and maximum figures for the EU are shown⁸. Table IV.3.2 shows the subnational governments' share of expenditure in each of the 9 functions by Member State in 2009 and in 1999⁹.

As the Chart shows, the most decentralised functions are Environment protection and Housing, for which between 70 and 80% of total expenditure is undertaken by subnational governments (EU average), followed by Recreation, culture and religion and Education, with an average share higher than 50%. This pattern is to a certain extent in line with economic rationale, as several expenditure items included in these functions concern services to be organised on a fairly small (i.e. subnational) scale and where heterogeneity of subnational preferences is likely to be more pronounced, i.e. waste management, housing and community developments, water supply, street lightning, recreational and sporting services, nurseries etc. On the other hand, the least decentralised functions are General public services¹⁰, Health and Social protection¹¹ with a subnational government's share lower than 30%. Comparing the average EU figures for 2008 with those of 2002¹² (also shown in the Chart) it appears that the relative weight of subnational governments across functions has been relatively stable over time (a slight reduction is observed for Environment protection, Housing and Economic affairs and a slight increase for Health).

Chart IV.3.4: Subnational governments' expenditure by function (% of general government expenditure by cofog) – EU average, minimum and maximum, 2008 (and 2002)

⁶ 2008 is chosen instead of 2009 as the average EU figure is not available for the latter year.

⁷ With the exception of defence, for which the share of local governments is basically zero.

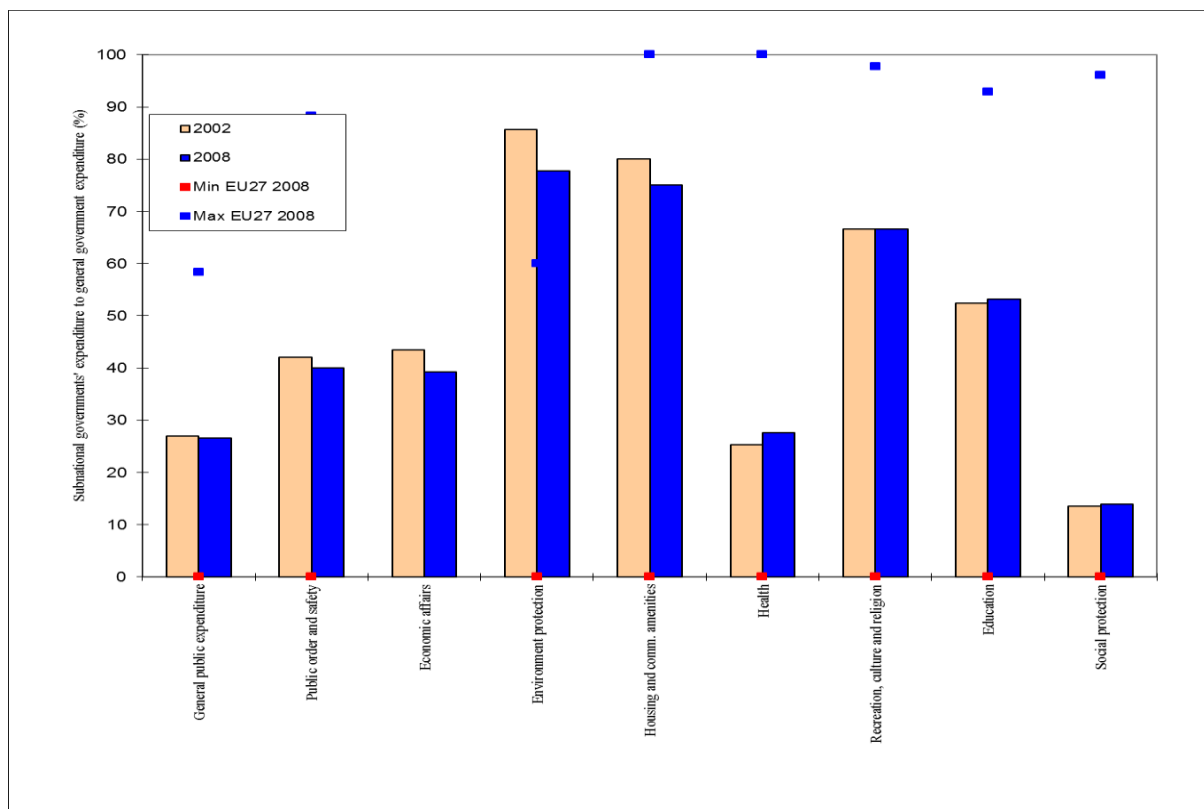
⁸ E.g. in the EU on average about 40% of public expenditure on public order and safety is carried out by local governments and, across EU Member States, this share ranges from a minimum of zero to a maximum of more than 90% (see table IV.3.2 for details on country data).

⁹ The earliest year available for all Member States except LT (2000), PL and RO (2002).

¹⁰ General public services cover administrative expenditure of public bodies, general services, debt service, basic research and foreign aid.

¹¹ In principle, at least part of social expenditure falls within the 'social security' sector included in the Eurostat breakdown alongside central and local governments. According to the definition in national accounts the sub-sector of social security includes central, state and local institutional units whose principal activity is to provide social benefits. Hence figures on local governments' expenditure for social protection may underestimate its actual size. However, the situation may differ by country due to their legal and administrative architecture.

¹² The earliest year with available data for the breakdown by function.



Source: own calculations from Eurostat.

However, average EU figures mask a large variation across Member States. As shown in the Chart, for all functions the minimum figure for the subnational expenditure share varies from zero to less than 10%, whereas the maximum one varies from 50-60% (general public services, economic affairs and social protection) to 90-100% (all remaining functions). As regards the more detailed assessment by Member States (see Table IV.3.2) the key findings for 2009, by function, are the following.

- *General public services*: subnational governments have the largest weight in DE, FI and AT and the lowest in CY, MT, LT, IE and DK
- *Public order and safety*: largest subnational governments' weight in DE (88%), BE, ES and UK (41-43%), lowest in CY, EE, EL and MT (0).
- *Economic affairs*: largest share in ES, BE, DE and IT (50-60%), lowest in CY, MT and EL.
- *Environment protection*: largest share in BE, CY, CZ (100%), ES, FR, PL, PT and RO (85-90%), lowest in MT, LV, FI and EE.
- *Housing*: highest in BE, EE, ES and PT (100%), lowest in MT, CY and EL.
- *Health*: highest share in DK, ES (more than 90%), SE (83%), IT and FI (around 60%); zero (or close to) in CY, CZ, EL, IE, MT, SK, UK and FR.
- *Recreation*: highest share in BE, DE, ES, NL, PL and RO (close to 80% or more), lowest in MT, EL, CY, BG, LU and HU (less than 40%).
- *Education*: highest subnational share in ES, DE (96%), BE (85%), SE (74%), LT and EE (60-64%), lowest in CY, MT, EL (0-3%), PT and IE (10-18%).
- *Social protection*: highest share in DK (52%), SE, (25%), BE, DE, FI and UK (18-20%), lowest in CY, MT (0), BG, CZ, EE, EL, FR, HU, IE, IT, LT, LU, LV, PL, PT, RO, SI and SK (less than 10%).

As regards the *change* in shares of subnational expenditures by function between 1999 and 2009, taking as a threshold a 10pp difference, the largest variation are observed for i) Housing, with an increase in BG, SE, SK (30+pp), AT (20-30pp), DK, FI, PT and SI and a decrease in IT (32pp), LV, EL, LT (20-30pp) and LU; ii) Environment, with an increase in SK (39pp), CZ (20), DK and PT and a reduction in SE (50pp), BG, DE, HU (30-40pp), AT, EE, LT and LV; iii) Recreation, with an increase in SK, BG (20-30pp), PT, LT, IT and ES and a reduction in EL (36pp) and DE (11pp); iv) Health, with an increase in ES (32pp) and large reductions in IE (54pp) and BG (41pp); and v) Economic affairs, with an increase in CZ, EE, ES, SI and SK (never exceeding 15pp).

Table IV.3.2: Share of subnational governments' expenditure by function (% of total general government expenditure by cofog) – 2009

	General public services			Public order and safety			Economic affairs			Environment protection			Housing and comm. amenities		
	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points
AT	35,2	37,3	2,2	12,5	17,6	5,1	42,9	44,8	2,0	83,3	66,7	-16,7	53,3	75,0	21,7
BE	15,3	16,9	1,6	40,0	42,9	2,9	62,7	55,6	-7,2	100,0	100,0	0,0	100,0	100,0	0,0
BG	7,8	9,2	1,4	4,5	6,5	1,9	14,0	22,5	8,5	90,0	58,3	-31,7	50,0	85,7	35,7
CY	6,1	7,1	1,0	0,0	0,0	0,0	0,0	0,0	0,0	100,0	100,0	0,0	16,0	13,6	-2,4
CZ	32,6	28,8	-3,8	4,3	9,5	5,2	23,2	35,9	12,7	70,0	90,0	20,0	50,0	45,5	-4,5
DE	49,5	58,4	9,0	93,8	88,2	-5,5	51,0	54,0	3,0	100,0	62,5	-37,5	81,8	77,8	-4,0
DK	10,7	8,8	-1,9	10,0	8,3	-1,7	36,1	42,4	6,3	42,9	60,0	17,1	25,0	42,9	17,9
EE	18,0	15,8	-2,2	0,0	0,0	0,0	23,3	37,7	14,5	50,0	36,4	-13,6	100,0	100,0	0,0
EL	8,9	12,1	3,1	0,0	0,0	0,0	2,7	3,5	0,8	80,0	83,3	3,3	50,0	25,0	-25,0
ES	17,4	21,9	4,5	42,1	42,9	0,8	50,0	60,0	10,0	88,9	90,0	1,1	100,0	100,0	0,0
FI	25,8	37,5	11,7	21,4	20,0	-1,4	20,7	27,5	6,8	33,3	33,3	0,0	50,0	60,0	10,0
FR	21,7	25,8	4,1	16,7	23,1	6,4	35,0	30,6	-4,4	85,7	88,9	3,2	75,0	81,8	6,8
HU	15,9	18,0	2,2	5,0	9,1	4,1	11,1	16,7	5,6	75,0	42,9	-32,1	90,9	92,3	1,4
IE	4,0	6,8	2,8	11,8	5,0	-6,8	32,6	23,8	-8,8	66,7	62,5	-4,2	80,0	82,6	2,6
IT	17,2	22,2	5,0	10,0	10,0	0,0	48,8	50,0	1,2	80,0	80,0	0,0	90,0	58,3	-31,7
LT*	8,1	7,5	-0,5	4,8	5,0	0,2	11,5	12,5	1,0	100,0	83,3	-16,7	100,0	80,0	-20,0
LU	14,7	18,5	3,8	11,1	10,0	-1,1	25,6	18,0	-7,6	50,0	58,3	8,3	55,6	45,5	-10,1
LV	30,2	24,1	-6,2	3,8	9,5	5,7	18,6	27,8	9,2	33,3	18,2	-15,2	92,9	66,7	-26,2
MT	9,9	0,0	-9,9	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
NL	20,5	24,1	3,6	40,9	36,7	-4,2	50,0	45,3	-4,7	80,0	80,0	0,0	69,2	76,9	7,7
PL**	18,9	19,7	0,8	12,5	14,3	1,8	48,7	42,1	-6,6	83,3	85,7	2,4	76,5	83,3	6,9
PT	10,1	15,7	5,6	5,9	4,3	-1,5	31,9	34,2	2,3	71,4	85,7	14,3	90,0	100,0	10,0
RO**	18,9	19,7	0,8	12,5	14,3	1,8	48,7	42,1	-6,6	83,3	85,7	2,4	76,5	83,3	6,9
SE	23,1	27,4	4,3	15,4	14,3	-1,1	28,9	32,7	3,8	100,0	50,0	-50,0	53,8	87,5	33,7
SI	15,3	19,0	3,7	5,9	5,9	0,0	15,1	25,0	9,9	42,9	54,5	11,7	50,0	66,7	16,7
SK	7,4	22,8	15,4	3,7	4,2	0,5	6,5	18,2	11,7	18,2	57,1	39,0	36,4	66,7	30,3
UK	12,3	12,7	0,4	50,0	41,2	-8,8	28,6	26,0	-2,6	66,7	54,5	-12,1	62,5	31,0	-31,5
EU27	---	19,4	---	---	27,8	---	---	33,3	---	---	77,8	---	---	64,3	---

Source: own calculations from Eurostat.

* 1999 data is replaced by 2000; ** 1999 data is replaced by 2002.

Table IV.3.2 (cont.d)

	Health			Recreation, culture and religion			Education			Social protection		
	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points	1999	2009	Change in % points
AT	43,1	37,4	-5,7	63,6	72,7	9,1	45,7	47,1	1,4	13,5	12,8	-0,7
BE	4,8	4,4	-0,3	90,0	92,9	2,9	86,8	84,7	-2,1	17,2	20,0	2,8
BG	50,0	9,1	-40,9	14,3	37,5	23,2	60,5	55,6	-4,9	5,8	4,4	-1,4
CY	0,0	0,0	0,0	22,2	23,1	0,9	0,0	0,0	0,0	0,0	0,0	0,0
CZ	1,4	3,9	2,5	60,0	64,3	4,3	48,3	49,3	1,0	7,9	9,7	1,8
DE	6,3	6,8	0,5	100,0	88,9	-11,1	97,9	95,8	-2,0	18,7	19,4	0,7
DK	95,7	97,7	2,1	56,2	52,9	-3,3	52,6	48,8	-3,8	47,1	52,6	5,5
EE	18,9	19,8	0,8	40,9	45,8	4,9	42,7	59,7	17,1	7,6	5,6	-1,9
EL	0,0	0,0	0,0	50,0	14,3	-35,7	3,4	2,4	-1,1	0,0	2,2	2,2
ES	60,4	92,8	32,4	71,4	82,4	10,9	79,5	96,1	16,5	7,5	11,0	3,5
FI	63,6	59,8	-3,8	64,3	64,3	0,0	50,6	50,0	-0,6	15,2	18,2	3,0
FR	1,4	1,2	-0,2	72,7	70,6	-2,1	26,2	31,2	5,1	5,5	8,1	2,6
HU	25,3	20,2	-5,1	37,5	37,5	0,0	50,0	47,2	-2,8	10,4	7,1	-3,3
IE	54,2	0,0	-54,2	50,0	50,0	0,0	20,4	17,6	-2,7	12,6	4,1	-8,5
IT	61,1	60,8	-0,3	44,4	55,6	11,1	28,6	26,0	-2,6	3,1	3,1	0,0
LT*	21,5	21,4	-0,2	33,3	46,2	12,8	68,3	63,8	-4,6	9,6	6,0	-3,6
LU	0,0	0,0	0,0	42,1	35,0	-7,1	22,0	22,2	0,2	1,3	0,7	-0,5
LV	22,5	27,8	5,3	50,0	50,0	0,0	50,0	53,3	3,3	5,1	6,3	1,2
MT	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
NL	5,3	4,3	-0,9	84,6	80,0	-4,6	48,1	50,0	1,9	14,0	10,3	-3,7
PL**	23,2	29,9	6,7	75,0	78,6	3,6	45,8	48,8	2,9	5,2	7,5	2,3
PT	5,0	5,6	0,6	46,2	63,6	17,5	7,8	10,4	2,6	1,7	2,3	0,6
RO**	23,2	29,9	6,7	75,0	78,6	3,6	45,8	48,8	2,9	5,2	7,5	2,3
SE	83,6	82,8	-0,8	78,9	75,0	-3,9	63,7	73,7	9,9	25,0	25,6	0,6
SI	13,1	10,3	-2,9	46,7	42,1	-4,6	38,4	38,7	0,3	2,9	4,1	1,3
SK	1,3	0,0	-1,3	20,0	45,5	25,5	21,4	47,5	26,0	1,9	3,6	1,8
UK	0,0	0,0	0,0	50,0	50,0	0,0	47,1	45,2	-1,9	19,6	20,5	0,9
EU27	---	39,0	---	---	66,7	---	---	41,5	---	---	25,0	---

Source: own calculations from Eurostat.

* 1999 data is replaced by 2000; ** 1999 data is replaced by 2002

Similarly to Table IV.3.2 above, Table IV.3.3 below provides figures for the share of subnational government expenditure *by economic function* (i.e. compensation of employees, transfers, capital expenditure etc.). Across EU Member States, the share of subnational governments is higher for expenditure on intermediate consumption (more than 50% in AT, BE, CZ, DE, DK, ES, FI, IT, NL, PL and SE), compensation of employees (more than 50% in BE, DE, DK, ES, FI, HU, NL, PL, SE and between 45 and 50% in UK, LV, LT, CZ and AT) and investments (50% or more in AT, BE, CZ, DE, DK, ES, FI, FR, HU, IE, IT, LT, LV, NL, PL, SE, SI, SK and UK).

On the other hand, the weight of subnational governments is generally low for interests' expenditure (as most public debt is issued by the central government) with the exception of EE (100%) and DE (44%), followed by ES, SE, NL, RO, LV and DK (10-20%); social benefits, with the exception of DK; other current expenditures, with figures always below 20%, except for DE (31%); and capital transfers, with the exception of BE, AT (50% or more), ES, DE, RO, FR and IT (between 25 and 40%). The subnational share in the expenditure for subsidies shows larger variation (it is 50% or more in IT, CZ, DE, AT, DK and ES).

The above evidence on the average composition of subnational expenditures by economic function across the EU is to some extent consistent with recommendations from the "classical" fiscal federalism literature on the optimal assignment of main government functions across sectors of government. According to this literature, two out of the three

economic functions of government identified by Musgrave's classification, i.e. income redistribution and stabilisation of macroeconomic shocks, should be assigned to the central government, leaving only public goods allocation to subnational governments (insofar as such public goods have a strictly subnational dimension)¹³. The larger subnational weight in intermediate consumption and investments and the lower one in social benefits are by and large consistent with this recommendation.

Table IV.3.3: Share of subnational governments' expenditure by economic function - 2010

	Intermediate consumption	Compensation of employees	Interest	Subsidies	Social benefits	Other current expenditures	Capital transfers	Investment
AT	51,1	45,4	3,8	52,9	17,4	18,5	50,0	70,0
BE	69,2	77,0	8,3	20,0	12,7	16,0	57,1	88,2
BG	38,7	30,1	0,0	7,7	0,0	1,5	0,0	29,8
CY	8,8	5,0	7,1	0,0	0,0	2,7	0,0	18,4
CZ	51,6	47,4	0,0	63,2	4,1	5,9	14,3	71,9
DE	70,8	78,5	44,0	60,0	15,3	30,7	35,3	85,7
DK	65,7	71,7	10,5	53,8	71,1	3,6	14,3	61,9
EE	38,7	38,7	100,0	27,3	3,4	4,2	16,7	45,8
EL	14,5	10,7	0,0	0,0	0,0	0,9	0,0	20,7
ES	80,4	78,2	19,0	50,0	17,5	19,5	37,5	71,8
FI	64,6	73,6	7,1	13,3	9,6	3,6	0,0	68,0
FR	43,1	26,1	4,2	41,2	4,3	11,4	28,6	74,2
HU	43,0	50,5	2,4	18,2	3,3	2,9	12,5	66,7
IE	24,6	15,4	0,0	0,0	5,0	1,7	0,9	64,9
IT	69,5	42,3	4,5	63,6	13,6	3,4	27,3	71,4
LT	37,5	47,3	0,0	0,0	7,4	1,0	0,0	51,1
LU	32,4	21,3	0,0	11,8	0,5	3,6	0,0	39,0
LV	31,9	45,5	11,1	28,6	6,6	12,8	0,0	74,4
MT	6,6	0,7	0,0	0,0	0,0	0,0	0,0	4,5
NL	59,3	66,3	15,0	26,7	7,8	1,9	17,2	65,7
PL	58,1	57,4	3,8	16,7	7,1	3,9	18,2	58,9
PT	32,0	17,2	3,1	14,3	3,2	7,6	7,1	45,9
RO	33,8	34,7	12,5	16,7	7,3	2,3	33,3	37,9
SE	64,9	76,7	18,2	40,0	21,2	5,0	0,0	50,0
SI	31,9	33,9	0,0	13,6	2,6	3,3	7,1	57,1
SK	40,8	39,0	0,0	23,1	0,5	3,5	0,0	64,0
UK	37,4	46,1	6,5	33,3	11,9	0,0	9,1	50,0
EU27	54,3	52,3	14,3	46,2	12,4	11,1	24,0	65,4

Source: own calculations from Eurostat.

Given the relatively large weight of subnational governments in general government investments, as highlighted by Table IV.3.3 above, Chart IV.3.5 below provides evidence on the change in the subnational share of government capital expenditure¹⁴ by plotting the figures for this variable in 1995 (horizontal axis) and 2010 (vertical axis). These figures correspond to the sum of the expenditure on investments and on capital transfers (last two columns in Table IV.3.3), which is a more appropriate way to capture the total contribution of the general government to capital formation¹⁵. The Chart should be read having in mind the decreasing trend in overall investment expenditure by the government observed in most EU Member States during recent years.

The share of subnational authorities in general government capital expenditure amounts to 50% or more in 11 Member States (BE, ES, FR, FI, DE, IT, AT, NL, HU, PL and DK)

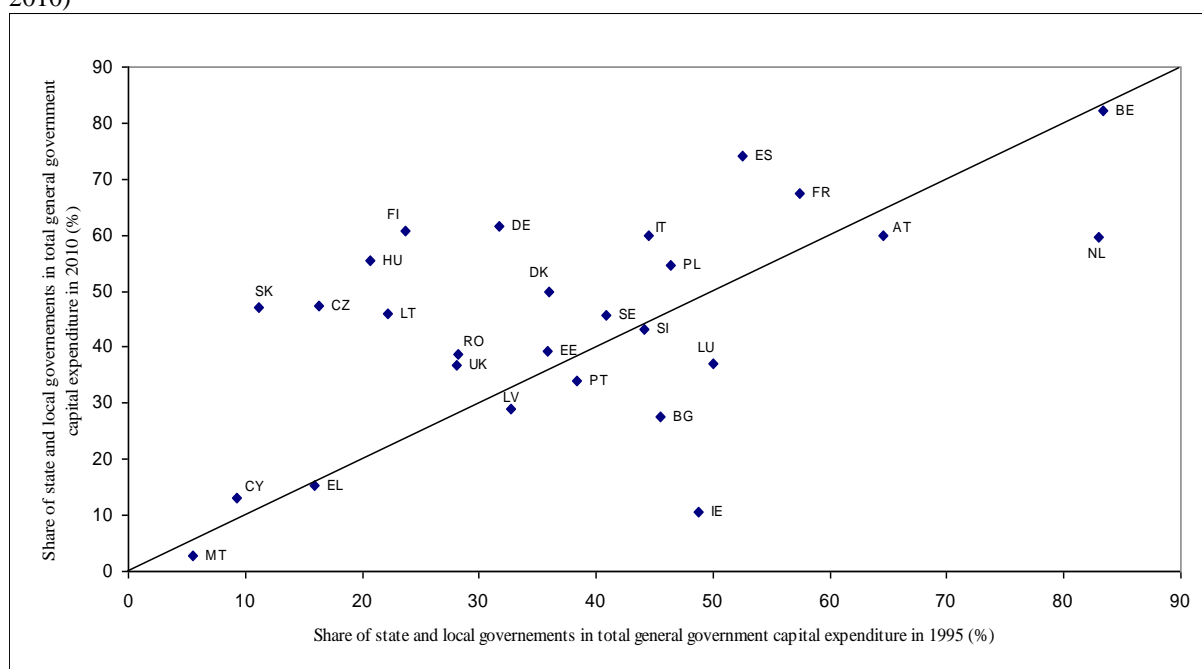
¹³ Musgrave, R. A., 1959. *The theory of public finance*. New York: McGraw-Hill. Oates, Wallace E., 1999. *An essay on fiscal federalism*. Journal of Economic Literature, Vol. 37, No. 3 (Sep., 1999), p. 1120-1149.

¹⁴ Figures in the chart are computed by summing up expenditures in capital transfers and investments (last two columns in table IV.3.3 above).

¹⁵ This mainly relates to the fact that capital transfers also include capital injections granted by the government to state-owned enterprises which invest in networks and infrastructures (e.g. railways). These enterprises may be classified out of the general government sector if they operate as market operators, hence the investments they undertake would not be accounted if only looking at figures on government expenditure on investments.

including all the most decentralised ones in terms of aggregate expenditure. As the Chart shows, this share increased in a majority of Member States (i.e. 16 out of 27, lying above the 45 degree line) between 1995 and 2010, with the increase being particularly pronounced in FI, DE, HU, SK, CZ, LT and ES. On the other hand, subnational governments' contribution to public investments decreased significantly in IE, NL, BG and LU.

Chart IV.3.5: Subnational governments' share of investment expenditure by the general government (1995 and 2010)



Source: own calculations from Eurostat.

2. Decentralisation of revenue sources

2.1. Overall degree of decentralisation

This Section discusses fiscal decentralisation in the EU from the revenue side. Firstly, it assesses the overall degree of revenue decentralisation and the extent to which the broadening of subnational governments' competences (and corresponding expenditure responsibilities) are matched with corresponding financial means. Secondly, it discusses the composition of subnational governments' revenues, by focusing on the relative weight of two main sources, i.e. taxes and transfers.

The degree of public revenues decentralisation is commonly measured by the share of subnational governments' revenues in revenues of the general government. These are defined as revenues collected by or transferred to subnational governments. Table IV.3.4 below provides figures for this variable for EU Member States. The format is the same as in Table IV.3.1 above on the share of subnational governments' expenditures, i.e. figures are presented both in levels (for 1995, 2007 and 2010) and changes (from 1995 to 2007 and from 2007 to 2010 in order to single out the impact of the recent economic crisis) and are complemented by the corresponding figures as percentage of GDP. Figures for 2010 are also displayed in Chart IV.3.6 to ease cross-country comparison.

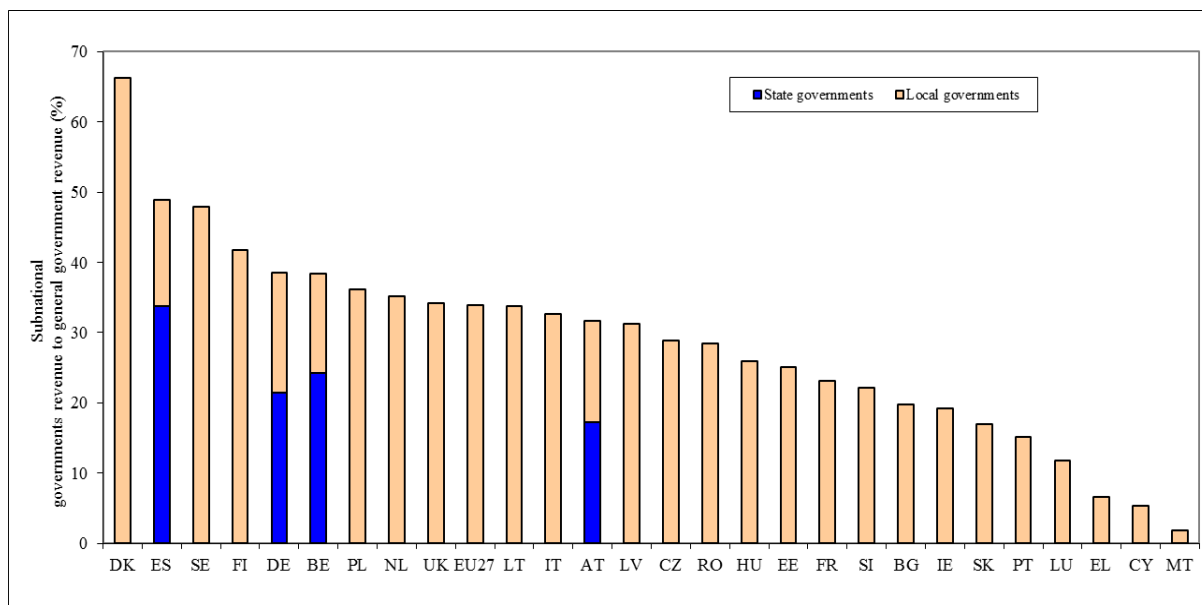
As shown in the Chart, in 2010 DK ranked at the top with two thirds of total public revenues being raised by or assigned to subnational governments, followed by ES, SE (close to 50%), FI (42%) and 9 Member States (including a few unitary ones) with figures ranging from 30 to 40% (BE, DE, PL, NL, UK, LT, IT, AT and LV). On the other hand, subnational revenues make up less than 5% of total government revenues in MT, EL and CY, 12% in LU, 15% in PT and 17% in SK. Subnational revenues account for 37% of GDP in DK, between 20 and 25% in SE and FI, between 15 and 20% in BE, ES, DE, NL, AT and IT. The share of subnational governments in total public revenues has increased in the 1995-2010 period in the majority of Member States (17 out of 27). The increase has been particularly pronounced (i.e. by more than 10 pp) in RO, PL, LV, ES and SK, followed by DK and LT (around 8-9%, fully concentrated in the crisis years), whereas a sharp decrease (by more than 10pp) has occurred in IE and NL (the whole of it concentrated in the *pre*-crisis period).

Table IV.3.4: Share of subnational governments' revenues in the EU

	Share of subnational governments revenue in general government revenue					Subnational governments revenue in % GDP				
	1995	2007	2010	Change 95-07	Change 07-10	1995	2007	2010	Change 95-07	Change 07-10
AT	34,1	31,5	31,6	-2,6	0,1	17,2	15,0	15,2	-2,2	0,2
BE	34,9	37,9	38,5	3,0	0,6	16,6	18,2	18,8	1,6	0,6
BG	22,4	16,1	19,8	-6,3	3,6	8,4	6,6	6,9	-1,8	0,3
CY	3,7	4,2	5,4	0,5	1,1	1,2	1,9	2,2	0,7	0,3
CZ	30,3	27,5	29,0	-2,8	1,5	12,2	11,1	11,4	-1,1	0,3
DE	36,8	39,1	38,8	2,3	-0,4	16,7	17,1	16,9	0,4	-0,2
DK	57,8	57,2	66,3	-0,6	9,1	32,6	31,8	36,8	-0,8	5,0
EE	24,8	24,7	25,2	0,0	0,5	10,5	9,0	10,3	-1,5	1,3
EL	5,2	6,1	6,6	1,0	0,5	1,9	2,5	2,6	0,6	0,1
ES	37,6	46,5	49,0	8,8	2,6	14,0	19,1	17,8	5,1	-1,3
FI	36,1	35,3	41,7	-0,8	6,4	20,0	18,6	21,9	-1,4	3,3
FR	18,8	21,0	23,2	2,2	2,2	9,2	10,5	11,5	1,3	1,0
HU	28,2	25,7	25,9	-2,6	0,2	13,3	11,7	11,7	-1,6	0,0
IE	33,2	19,1	19,2	-14,1	0,1	12,9	7,0	6,8	-5,9	-0,2
IT	28,3	32,2	32,5	3,8	0,4	12,7	14,8	14,9	2,1	0,1
LT	24,3	23,8	33,7	-0,5	9,9	8,0	8,0	11,4	0,0	3,4
LU	13,5	11,8	11,8	-1,8	0,1	5,7	4,7	4,9	-1,0	0,2
LV	19,7	29,2	31,3	9,5	2,1	7,3	10,4	11,3	3,1	0,9
MT	1,7	1,5	1,8	-0,2	0,3	0,6	0,6	0,7	0,0	0,1
NL	48,3	33,5	35,3	-14,8	1,8	22,8	15,2	16,3	-7,6	1,1
PL	23,1	33,0	36,3	9,9	3,3	10,0	13,3	13,6	3,3	0,3
PT	13,4	15,6	15,1	2,1	-0,4	4,9	6,4	6,3	1,5	-0,1
RO	13,1	26,9	28,5	13,8	1,6	4,2	9,5	9,7	5,3	0,2
SE	42,2	43,9	48,0	1,7	4,2	24,3	23,9	25,3	-0,4	1,4
SI	17,7	19,6	22,1	1,8	2,5	7,8	8,3	9,8	0,5	1,5
SK	6,9	18,5	17,0	11,7	-1,5	3,1	6,0	5,5	2,9	-0,5
UK	28,9	30,2	34,2	1,2	4,1	11,0	12,4	13,8	1,4	1,4
EU27	---	32,3	33,9	---	1,6	---	15,5	16,2	---	0,7

Source: own calculations from Eurostat.

Chart IV.3.6: Subnational governments' revenues (% of general government revenues - 2010)

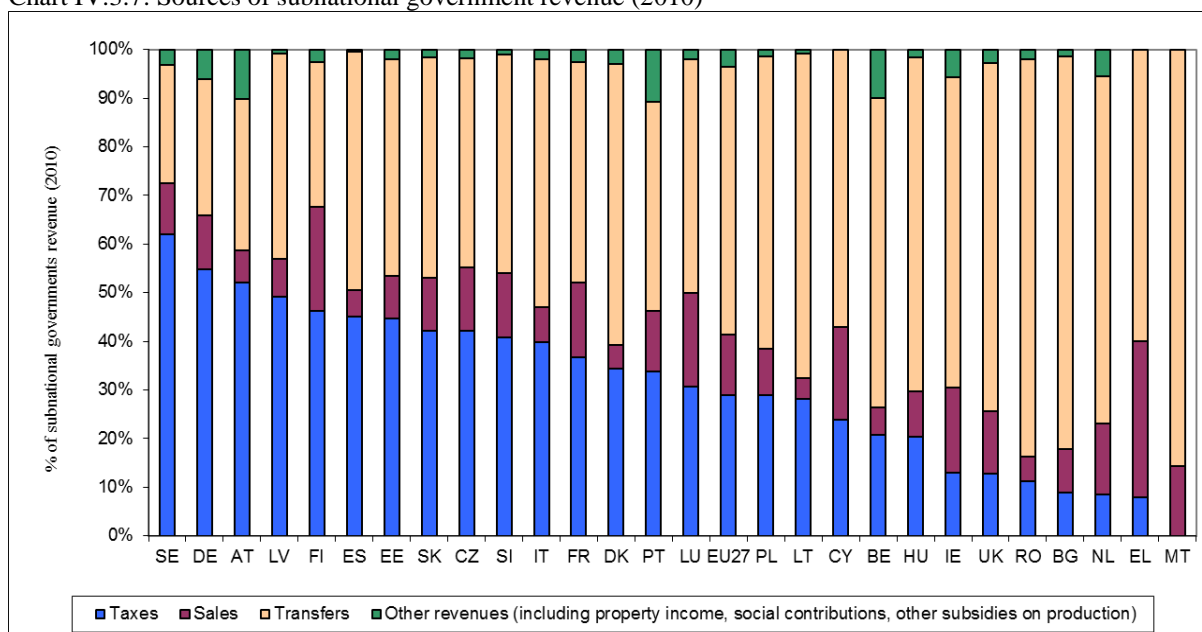


Source: own calculations from Eurostat.

2.2. Break-down of subnational governments' revenues: tax vs. transfers

In terms of composition of revenues, subnational levels of government rely on two main sources, i.e. taxes (which can be either set at subnational level or assigned from the central government) and transfers from the central government. Other sources, albeit much less important in quantitative terms, are fees paid by service users and property income. The use of borrowing by subnational governments is covered in Section 5 below. Chart IV.3.7 below shows the break-down of total revenues of subnational governments by four main sources; i.e. taxes, transfers, sales (i.e. fees or charges on services provided) and other revenues (including property income, other subsidies etc.) in 2010.

Chart IV.3.7: Sources of subnational government revenue (2010)



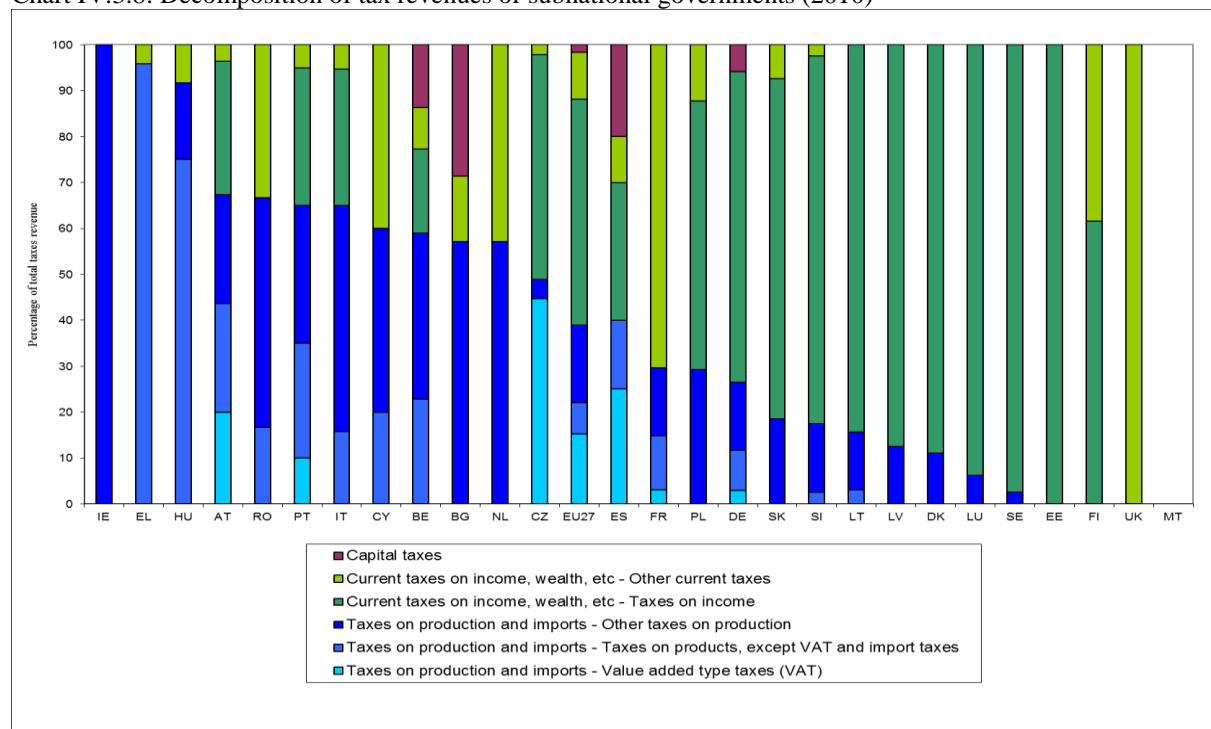
Source: own calculations from Eurostat.

These figures suggest that on average subnational governments across the EU rely slightly more on transfers than on taxes as their main source of financing. Taxes account for 50% or more of total subnational governments' revenues only in 4 countries, i.e. SE (more than 60%), DE, AT and LV, and for 40 to 50% in FI, ES, EE, SK, CZ, SI and IT. At the opposite end of the ranking, the tax share is 0 in MT, less than 10% in EL, NL and BG and from 10 to 20% in RO, UK, IE, HU and also in a federal country such as BE. Transfers make up more than half of subnational government revenues in 14 countries (PL, LT, CY, BE, HU, IE, UK, RO, BG, NL, EL, MT, DK and IT). Finally, fees and charges generally account for a much lower share than taxes and transfers, with a maximum of 21% in FI.

Chart IV.3.8 below shows the break-down of *tax revenues* of subnational governments by type of tax (income tax, property tax, VAT etc.) in 2010. It allows to highlight cross-country differences with respect to the predominant type of tax which is assigned to subnational governments. Taxes on income and wealth account for 70% or more of total tax revenues in 13 countries, including some of the more decentralised such as SE, FI, DK and DE, as well as the UK, LU, the Baltics, SK, SI, PL and FR. Within this group of countries, this share is almost entirely accounted by income taxes alone (be it personal or corporate) with the exception of UK and FR where wealth taxes (including property taxes) make up all or most tax revenues of subnational governments.

Wealth and property taxes are an important source also in FI, NL, BG, CY and RO. On the other hand, taxes on production and imports are predominant in 11 MS (IE, EL, HU, AT, RO, PT, IT, CY, BE, BG and NL), albeit not including VAT, except in AT and PT. In CZ and ES the weight of production taxes and of income/wealth taxes is quantitatively similar, with a significant role of VAT. Taxes on capital are generally not assigned to subnational governments except in BG, ES and, to a lesser extent, BE and DE.

Chart IV.3.8: Decomposition of tax revenues of subnational governments (2010)



Source: own calculations from Eurostat.

3. Expenditure vs. tax decentralisation, vertical fiscal imbalances

The literature on fiscal decentralisation highlights that own-source revenues, i.e. subnational taxes, are a more efficient financing tool for subnational governments than transfers from the centre. If the bulk of subnational expenditure is financed via own-source taxes, the reasoning goes, subnational public services are paid by the community which benefits from them and so their costs will be fully internalised by subnational policy-makers. Conversely if transfers are the predominant source of revenues of subnational governments, the cost of subnational services is partly borne by other subnational communities via the national budget, leading to excessive expenditure at subnational level.

However, it should be recalled that there are also a number of economic arguments militating against a full financing of subnational expenditures via taxes assigned to subnational governments, restoring some rationale for (properly designed) transfer schemes. These include i) economies of scale and degree of complexity in tax collection and administration; ii) geographical mobility of tax bases (e.g. capital and investments) and the associated risk of tax competition among subnational governments to attract them; iii) tax exportation, i.e. risk that the subnational tax burden falls on non-residents (i.e. not benefiting from subnational services financed by those taxes); iv) reduced stability of subnational governments' revenues against business cycle fluctuations.

Clearly, the weight of these arguments, especially as regards ii), varies by the type of tax. The normative literature on fiscal decentralisation is fairly consensual in recommending keeping personal income and corporate income taxation at central level, while taxes on immovable bases such as property tax and fees on subnational services would be more suitable for subnational governments. VAT is often mentioned to be too complex to administer for subnational governments¹⁶.

As mentioned above, existing data on subnational tax revenues do not allow to capture the effective degree of subnational governments' autonomy in setting tax rates and bases, as they generally include also tax receipts which are transferred (totally or partly) from the central to the subnational government, with no leeway for the latter to adjust the main tax parameters. This implies that part of tax revenues of subnational governments may also be subject to the same adverse incentive effects as grants.

With the above mentioned caveat in mind, an indicator of vertical fiscal imbalance, capturing the share of subnational governments' expenditure which is *covered by subnational taxes* has been computed. The assumption is that the lower is the gap between subnational taxes and subnational expenditures, and so the lower is the reliance on complementary transfers from the central government to finance these expenditures, the more efficient is the relationship between different levels of government in terms of incentives for fiscal discipline and prudent expenditure behaviour¹⁷.

This indicator is presented in Table IV.3.5 and Chart IV.3.9 below. In Table IV.3.5 figures are shown in levels for 1995 and 2010 and in changes from 1995 to 2010. The Chart plots figures

¹⁶ IMF (2009), 'Macro-Policy Lessons for a Sound Design of Fiscal Decentralisation', Fiscal Affairs Department. Blöchliger, H. and Petzold, O., 'Taxes and Grants: on the Revenue Mix of Sub-Central Governments', Working Paper, OECD Network on Fiscal Relations Across Levels of Government.

¹⁷ Rodden, J., G.S. Eskeland and J. Litvack (2003), *Fiscal Decentralisation and the Challenges of Hard Budget Constraint*, The MIT Press. Eyraud, L. and L. Lusinyan (2011), 'Decentralising Spending More than Revenue: Does it Hurt Fiscal Performance?', *IMF Working Paper* 226.

in level for the same two years in order to ease cross-country comparison. The key findings are that in 2010 tax decentralisation fell short of matching expenditure decentralisation across the EU. Only in two countries (SE and DE) subnational tax revenues covered more than half of subnational expenditures, followed by AT, LV, EE, FI and CZ, with a figure ranging from 40 to 50%, and SI, IT, ES, FR, SK and DK, with a share ranging from one third to 40%.

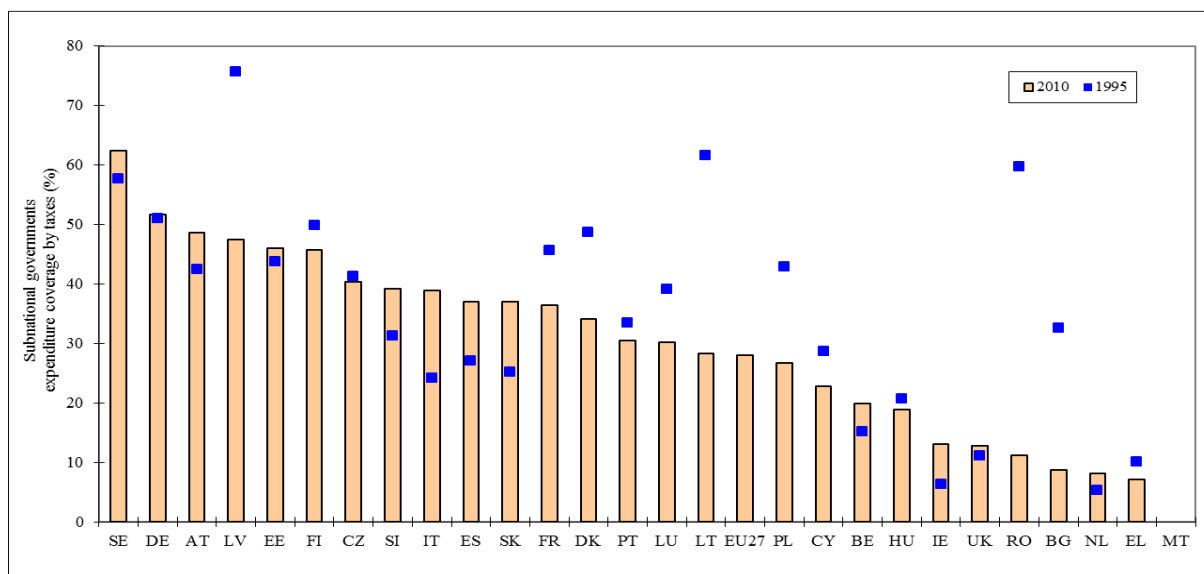
Overall, there is no systematic pattern across the EU with respect to the change in tax coverage of subnational expenditures between 1995 and 2010, although reductions are slightly more numerous and tend to be larger than increases. Tax coverage decreased sharply in RO, LT, LV, BG (by more than 20pp) PL and DK; and increased in ES, IT, SK (by more than 10pp) and AT, IE, SI and SE (by 5 to 10pp).

Table IV.3.5: Coverage of subnational governments' expenditure by subnational tax revenues

	1995	2010	Change in the coverage (in points of %)
AT	42,2	48,6	6,4
BE	15,1	19,9	4,8
BG	32,4	8,7	-23,7
CY	28,6	22,7	-5,8
CZ	41,2	40,3	-0,8
DE	50,9	51,7	0,7
DK	48,6	34,1	-14,5
EE	43,6	46,0	2,4
EL	10,0	7,1	-2,9
ES	26,9	37,0	10,2
FI	49,8	45,8	-4,0
FR	45,5	36,4	-9,0
HU	20,6	18,9	-1,7
IE	6,3	13,0	6,8
IT	24,0	38,9	14,8
LT	61,4	28,3	-33,1
LU	39,0	30,2	-8,8
LV	75,6	47,5	-28,1
MT	0,0	0,0	0,0
NL	5,2	8,1	2,9
PL	42,7	26,7	-16,1
PT	33,3	30,6	-2,8
RO	59,5	11,2	-48,3
SE	57,5	62,5	5,0
SI	31,2	39,2	8,0
SK	25,0	37,0	12,0
UK	11,0	12,9	1,8
EU27	---	28,0	---

Source: own calculations from Eurostat.

Chart IV.3.9: Coverage of subnational governments' expenditure by subnational tax revenues (1995 and 2010)



Source: own calculations from Eurostat.

4. Deficit and debt of subnational governments in the EU

This Section reviews data on deficit and debt of subnational governments across the EU in order to assess their contribution to the overall budget balance and borrowing of the general government. The economic rationale for some degree of borrowing by subnational governments may be implied by the need to finance investments in subnational capital endowments, given the generally significant share of public capital expenditure undertaken at subnational level across the EU (see above). Table IV.3.6 provides data on the subnational governments' deficit as a percentage of GDP. Figures are decomposed for local and state governments for DE, AT, BE and ES¹⁸. Figures are in level for 1999 (i.e. the earliest year available) and 2010 and in terms of changes from 1999 to 2010. In each case the Table also includes the corresponding figures for the deficit of the general government to have a better idea of the contribution of subnational governments to the latter. The subnational governments' deficit in 1999 and 2010 is also shown in Chart IV.3.10 below.

In 2010 the largest subnational deficit, by far, is observed in ES, i.e. about 4% of GDP, most of which (3.5 pp) generated by state governments. PL, AT, DE and BE follow with a subnational deficit of 1% of GDP or slightly more, with, again, a large share of state governments, i.e. from twice (AT) to more than four times (DE) that of local governments. Figures ranging from 0.5% to 1% of GDP are observed in SK, HU, NL, PT, CZ, IT and LV. On the other hand, a subnational governments' surplus is observed in SE and LT, together with balanced subnational budgets in LU, IE, CY and BG. In ES half of the general government deficit is generated by subnational governments, followed by DE, BE and AT where the share is around one quarter.

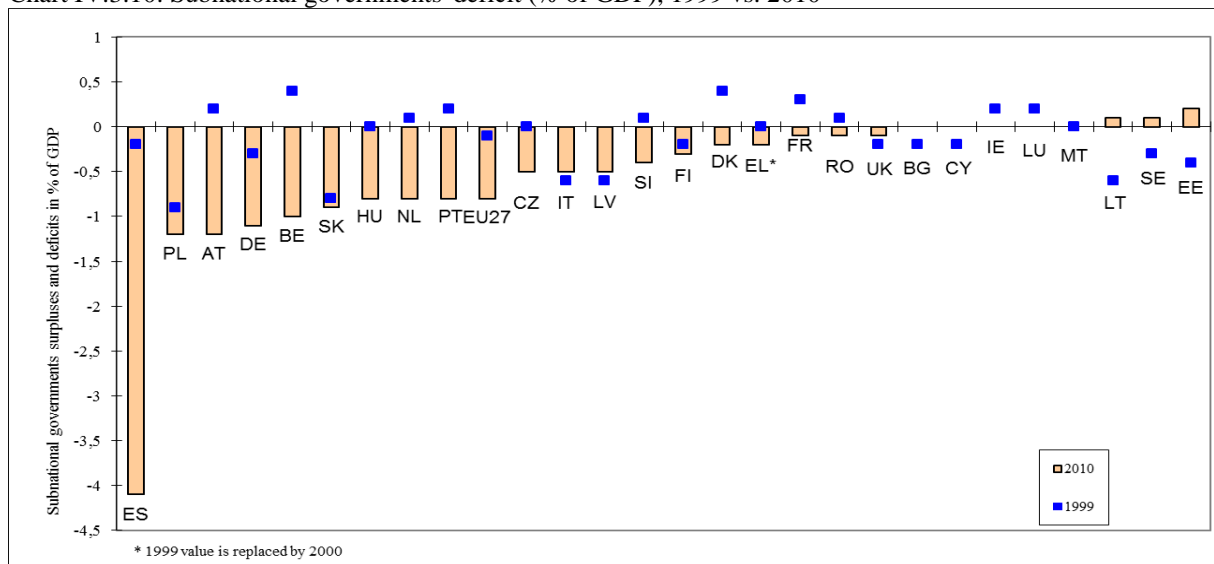
Table IV.3.6: Subnational governments' deficit vs. deficit of general government (% of GDP)

¹⁸ In this case figures for local and state governments are shown separately for the five countries for which this is possible as it is especially relevant to see which layer of government contributes more to the deficit of general government in federal countries.

		1999		2010		Change in points of %	
		State or local governments deficit in % of GDP**	General government deficit in % of GDP**	State or local governments deficit in % of GDP**	General government deficit in % of GDP**	State or local governments***	General Government***
AT	Local governments	0,0	-2,3	-0,4	-4,4	-0,4	-2,1
	State governments	0,2		-0,8		-1,0	
BE	Local governments	0,0	-0,6	-0,3	-4,1	-0,3	-3,5
	State governments	0,4		-0,7		-1,1	
BG		-0,2	0,1	0,0	-3,1	0,2	-3,2
CY		-0,2	-4,3	0,0	-5,3	0,2	-1,0
CZ		0,0	-3,6	-0,5	-4,8	-0,5	-1,2
DE	Local governments	0,2	-1,6	-0,2	-4,3	-0,4	-2,7
	State governments	-0,5		-0,9		-0,4	
DK		0,4	1,3	-0,2	-2,6	-0,6	-3,9
EE		-0,4	-3,5	0,2	0,2	0,6	3,7
EL*		0,0	-3,7	-0,2	-10,6	-0,2	-6,9
ES	Local governments	0,0	-1,2	-0,6	-9,3	-0,6	-8,1
	State governments	-0,2		-3,5		-3,3	
FI		-0,2	1,7	-0,3	-2,5	-0,1	-4,2
FR		0,3	-1,8	-0,1	-7,1	-0,4	-5,3
HU		0,0	-5,5	-0,8	-4,2	-0,8	1,3
IE		0,2	2,7	0,0	-31,3	-0,2	-34,0
IT		-0,6	-1,9	-0,5	-4,6	0,1	-2,7
LT		-0,6	-2,8	0,1	-7,0	0,7	-4,2
LU		0,2	3,4	0,0	-1,1	-0,2	-4,5
LV		-0,6	-3,9	-0,5	-8,3	0,1	-4,4
MT		0,0	-7,7	0,0	-3,6	0,0	4,1
NL		0,1	0,4	-0,8	-5,1	-0,9	-5,5
PL		-0,9	-2,3	-1,2	-7,8	-0,3	-5,5
PT		0,2	-2,7	-0,8	-9,8	-1,0	-7,1
RO		0,1	-4,4	-0,1	-6,9	-0,2	-2,5
SE		-0,3	0,9	0,1	0,2	0,4	-0,7
SI		0,1	-3,0	-0,4	-5,8	-0,5	-2,8
SK		-0,8	-7,4	-0,9	-7,7	-0,1	-0,3
UK		-0,2	0,9	-0,1	-10,3	0,1	-11,2
EU27	Local governments	0,0	-1,0	-0,3	-6,5	-0,3	-5,5
	State governments	-0,1		-0,5		-0,4	

Source: own calculations from Eurostat.

Chart IV.3.10: Subnational governments' deficit (% of GDP), 1999 vs. 2010

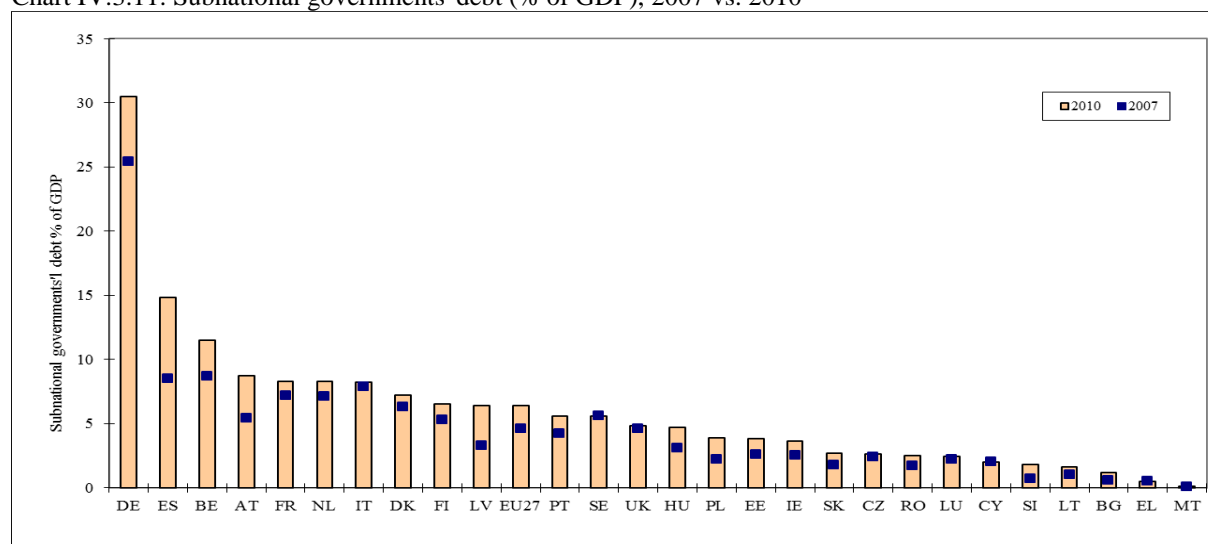


Source: own calculations from Eurostat.

Compared to 1999, the budget balance of subnational governments is generally worse in 2010, with a few exceptions (i.e. LT, SE, BG, CY, UK, IT and LV). The largest deterioration is observed in ES (almost 4 pp of GDP), followed by AT, BE (1.4pp), PT (1pp), NL (0.9pp), HU and DE (0.8pp).

Chart IV.3.11 below provides data on the stock of debt of subnational governments as a percentage of GDP across the EU. As the break-down of debt data by sector of government is only available from 2007, the Chart compares figures of 2010 and 2007, which is still useful to assess whether the recent recession has led to significant debt accumulation at subnational level. In 2010, the largest subnational debt is observed in DE, i.e. about 30% of GDP, followed by ES (15%), BE (12%), AT, FR, IT and NL (around 8%). At the opposite end of the ranking, subnational debt is not larger than 2% of GDP in MT, EL, BG, LT and SI. Some increase compared to 2007 is generally observed, albeit being sizeable only in ES, DE, AT and LV.

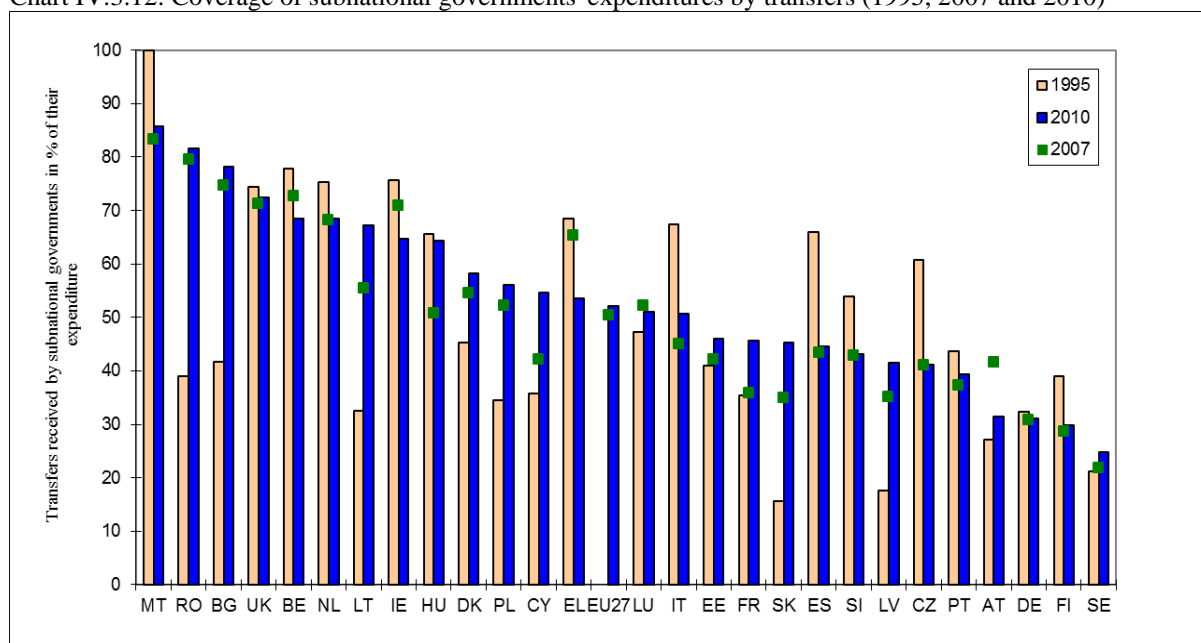
Chart IV.3.11: Subnational governments' debt (% of GDP), 2007 vs. 2010



Source: own calculations from Eurostat.

It is reasonable to expect that data on subnational deficits may underestimate the actual size of fiscal imbalances at subnational governments' level, since the central government may be forced to, at least partly, cover a rising gap between subnational expenditures and revenues with ex-post balancing transfers. This effect is often mentioned in the literature, and linked to the fact that a large share of expenditure may be mandated by national legislation so that subnational policy-makers can claim to have limited control on it, leading to heightened pressures on the central government to provide additional resources. In order to check whether this effect played a role in the EU, especially during the recent economic crisis, Chart IV.3.12 plots figures for the coverage of subnational expenditures by transfers from higher levels of government (i.e. the size of transfers as percentage of subnational expenditures) in 1995, 2007 and 2010.

Chart IV.3.12: Coverage of subnational governments' expenditures by transfers (1995, 2007 and 2010)



Source: own calculations from Eurostat.

No general trend towards an increase in subnational governments' reliance on transfers during the sovereign debt crisis (i.e. between 2007 and 2010) is found in the data, although such an increase is observed in CY, HU, FR, LT, SK and, to a lesser extent, LV, IT, EE and DK, suggesting that some pressure on central governments to provide additional resources to the subnational ones may have occurred in these countries. The reverse has occurred in AT, EL, IE and BE. During the previous period (i.e. 1995 to 2007) transfers dependence decreased in 13 Member States, and particularly so in CZ, ES, IT and HU, and increased in 10, with the increase being more significant in RO, BG, LT, SK, AT and DK.

Overall, evidence does not suggest that at EU level subnational governments' deficit has been systematically "hidden" behind ex-post transfers from higher level governments, although this probably occurred in a few countries. Reform processes aimed at increasing the share of tax revenues assigned to subnational governments in a number of countries may have counteracted the above mentioned risk.

5. Conclusions

This Chapter has analysed evidence on the extent and key features of fiscal decentralisation in the EU. It covered expenditures and revenues (both on the aggregate and in terms of composition) as well as borrowing of subnational governments. Data show that, on average across the EU, subnational governments have a large share of fiscal responsibilities within general government and that this share has been increasing in most Member States during the 1995-2010 period. This trend concerns both expenditures and revenues and is not confined to countries with a federal structure from the legal point of view.

In terms of revenue composition, subnational governments' still rely heavily on transfers from higher level governments in most Member States, which may lead to adverse incentives in terms of fiscal discipline via 'soft-budget constraints'. On the other hand, the weight of tax

revenues assigned to subnational governments has increased in a few countries. The subnational share of general government deficit has generally increased in recent years, including some of the most decentralised such as ES, AT, DE and BE although there is no one-to-one link between subnational deficit and decentralisation as shown by the cases of DK and SE.

In Chapter IV.2 below, aspects of decentralisation which cannot be assessed via Eurostat data will also be to some extent covered based on country-specific analysis providing descriptions of fiscal decentralisation arrangements across the EU. Such aspects mainly include the effective tax autonomy of subnational governments (e.g. distinguishing genuine subnational taxes from assignment of revenues of national ones), the type of transfers and fiscal rules and budgetary frameworks applying to subnational governments. Furthermore, a more precise analysis of the impact of the various aspects of decentralisation considered in this Chapter as well as others (e.g. effective tax autonomy and fiscal rules) on fiscal outcomes of the general government is carried out in Chapter IV.3 below.

Chapter 2: National fiscal decentralisation arrangements – a description based on country-specific analysis

1. The content of country-specific analysis on fiscal decentralisation arrangements

Following the description of the extent and main aspects of fiscal decentralisation in the EU based on available data in Eurostat carried out in Chapter IV.1, this Chapter presents more in-depth description of national fiscal decentralisation arrangements, based on country-specific analysis for all 27 EU Member States. The Chapter highlights main commonalities and differences across the EU, whereas the full country-specific analysis is contained in country fiches which are available in Annex 1.

Compared to information in the previous Chapter, those provided in the fiches are more qualitative and institutional. Fiches have been compiled based on a common template and questionnaire; information provided can be distinguished in four main building blocks:

1. overall institutional description of the system, i.e. number of government tiers, indications of main laws and reforms which have shaped the current system, constitutional status of subnational government tiers etc.
2. Areas of competence and size and composition of expenditures of subnational governments. This includes indications of the functions which are devolved to subnational tiers and, as far as possible, the extent of subnational autonomy in setting standards of services within the devolved functions.
3. Financing of subnational governments. This includes a description of the composition of subnational revenues across own sources (essentially subnational taxes), shared taxes (i.e. national taxes the receipts of which are totally or partly allocated to subnational government tiers) and transfers.
4. Budgetary frameworks and fiscal rules applying to subnational governments.

Points 3 and 4 are those which enrich information provided in Chapter IV.1 to a larger extent. Point 3 allows, firstly, to distinguish genuine subnational taxes, where subnational authorities are free to change, fully or partly, tax rates and/or bases, exemptions etc., from taxes which are simply shared between the central and subnational government sector. Secondly, it provides information on the allocation formulas of shared tax revenues and transfers from the central government, i.e. whether they are somehow based on costs of services to be provided by subnational governments or compensate for differences in fiscal capacity across them (horizontal equalisation). Thirdly, it distinguishes different types of transfers, e.g. general or earmarked.

Point 4 briefly describes, among other things, the difficulties encountered with ensuring fiscal discipline at subnational level, by highlighting recent changes in the budgetary framework; it also refers to monitoring, sanctions and enforcement of subnational fiscal rules, the role of the ministry of finance or other public bodies in this area and the possibility of bailing-out subnational entities in financial distress.

2. A summary of main patterns of fiscal decentralisation in the EU based on country-specific analysis

This Section summarises the main patterns of fiscal decentralisation arrangements across EU Member States based on the description contained in country fiches covering each Member State (see Annex 1). The focus is on the main commonalities and differences across the EU, or across groups or clusters of Member States as regards the four main elements listed above.

The reader should be aware that an exhaustive comparison of country systems in this field would be an immense task, both for the sheer amount of information that need to be collected and analysed and for the novelty of this exercise at EU level, and hence is beyond the scope of this Chapter. The focus here is rather on providing a preliminary overview based on a first attempt to systematically collect qualitative information for all Member States. A more established tradition for reviewing national systems in this field exists at the OECD Secretariat, which set up a Network on Fiscal Relations across Levels of Government which has been active already for a few years by now.

2.1. General considerations on the role and weight of subnational governments across the EU

As it could be easily expected, there is a large variation in the depth and main features of fiscal decentralisation across EU Member States, reflecting the different status recognised to subnational governments in the national Constitutions. A first demarcation can be drawn between federal or highly regionalised states such as DE, AT, ES, BE and IT, on the one hand, and unitary states, on the other. However, it is quite striking to see that the constitutional definition of a country as federal or unitary only imperfectly reflects the actual weight of subnational government tiers in the delivery of public services and their ability to raise revenues.

Actually, all EU Member States, including the smallest ones such as MT, CY and LU, set up some form of subnational government (i.e. municipalities) with autonomous and democratically elected institutions, as opposed to decentralised articulations of central administration. Secondly, several Member States, albeit not being statutorily federal, assign a very large role in terms of public service delivery and revenue raising capacity to subnational governments, in some cases even larger than in constitutionally federal countries, see for instance Nordic Member States such as DK, SE and FI as opposed to AT.

Thirdly, there appears to be a general trend towards increasing rather than decreasing decentralisation of state functions to subnational authorities and this move also concerns countries with a strong centralised tradition, such as FR, which has enacted several legislative reforms between the 1980s (Defferre laws) and the 2000s to create new layers of subnational governments and strengthen the existing ones, or the UK which has created devolved authorities in Scotland, Wales and Northern Ireland and is currently discussing an agenda for 'localism' to increase subnational authorities' leeway in taking decisions over their share of expenditure.

Fourthly, across the EU it is very common to have more than one tier of subnational governments, with the exception of smaller countries such as CY, LU, EE, LV, SI, FI and BG,

where municipalities are the only subnational level. Other countries have either two tiers of subnational governments¹⁹ or three tiers²⁰ (DE, IT, ES, AT, PL, FR, BE, SE and UK²¹). In a few cases special entities exist for capital cities²² and the division of tiers is not the same across the whole national territory, e.g. in UK and IE²³. In BE the specific ethnic situation motivated the creation of two different types of upper subnational tier, i.e. regions (Brussels, Wallonia and Flanders) and communities, the latter reflecting the three language groups existing in the country (French, Flemish and German-speaking).

An issue mentioned in a few fiches is the excessively small scale (in terms of population) of municipalities which prevents them from maximising efficiency in the provision of their services (e.g. HU, FR and AT). Attempts to overcome this problem are made by gradually increasing the average size of municipalities by cutting their number or encouraging mergers (FI, NL) or by setting-up inter-municipal associations to jointly provide certain services (FR, IE). This suggests that insufficient exploitation of economies of scale in providing public services may constitute a serious challenge for setting up an effective decentralised system.

2.2 Expenditures of subnational governments

As far as the government functions that are devolved to subnational tiers are concerned, a number of common patterns can be highlighted. Services that are typically provided on a smaller geographical scale and need to be better tailored to subnational preferences, such as subnational infrastructures and utilities, including roads, subnational public transports, water and heating supply, waste management, housing, subnational economic development and territorial planning are generally attributed to municipalities, which is consistent with the normative literature on fiscal federalism. At the same time, in a majority of Member States subnational governments also have at least partial competence over education, social protection/social services and environment protection.

Their involvement over education may concern, according to the country considered, pre-school services (i.e. nurseries) but also primary and secondary education and vocational training (DE, BE, ES, CZ, SK, AT, Baltics), whereas higher level education (i.e. universities) are normally excluded from subnational competence (except in DE and BE). In case a two or three-tier subnational structure exists, responsibilities can be further split between municipalities, often being in charge of nurseries and primary schools, and provinces/counties, managing secondary schools (e.g. SK). As regards social protection, subnational governments are often attributed fairly limited tasks such as providing social assistance services to vulnerable people such as elderly, homeless and disabled²⁴ (e.g. IT, LT, LV and EE). However, in a few countries their tasks also include actual payment of welfare benefits to individuals (DK, FI, SE, LT), which are in some other cases managed by autonomous social security agencies (DE, IT).

¹⁹ I.e. municipalities and regions or counties

²⁰ Including municipalities, provinces/counties and regions/states.

²¹ Including devolved authorities of Scotland, Wales and Northern Ireland.

²² E.g. in UK, LT, LV, EE.

²³ In UK 'unitary authorities' are the only subnational tier in certain areas whereas in others shire counties exist which are further subdivided into districts. Similarly, in IE two tiers exist in rural areas (town and county councils) and only one in urban areas (city councils).

²⁴ E.g. organising shelters or structures for care of the elderly.

As regards the management of health care systems, subnational governments have a relatively important role in IT²⁵, AT, ES, PL, DK²⁶, SE and FI, where they are in charge of the actual provision of medical services within hospitals. In some countries, e.g. LV, LT and EE, responsibilities of subnational governments in this area are more limited as, although the latter may have the ownership of hospitals, these are actually financed and run by specialised agencies (e.g. the Health Insurance Fund in Estonia) or by health insurance companies. Still in these countries municipalities are responsible for organising some 'ancillary' services, such as transport of patients to the health establishments, and may be liable to cover excess expenditures of establishments of their ownership.

When discussing the attribution of specific functions to subnational governments it is important to distinguish cases where they have full competence, i.e. they are free in designing the corresponding policies subject to compliance to national laws, from cases where they are only in charge of implementing national guidelines and regulations²⁷. Although information in the fiches on this aspect is very limited, the overall impression is that subnational governments tend to enjoy large autonomy in setting policies concerning subnational community services and utilities (e.g. road networks, subnational transports, waste disposal etc.). On the other hand, when they have responsibilities in the areas of health care, education and social protection (e.g. payment of social transfers) they are to a large extent bound by national rules and guidelines²⁸, including in highly decentralised countries such as, for instance, ES²⁹. In these cases national standards often aim at ensuring homogeneous level and quality of services throughout the country.

In a few Eastern Member States (e.g. PL, BG, SI) an explicit distinction is made between 'own' competences of subnational governments, where the latter retain a larger degree of freedom (i.e. economic affairs, culture and recreation, subnational networks and utilities, nurseries), and competences 'delegated' or 'transferred' from the central government, on which the latter remains responsible for overall regulation (e.g. social protection, education, health care).

A last observation on the expenditure side concerns the existence of shared competences between the central and subnational layers of government. This is especially relevant in DE, a federal country with a large role of Länder and where most legislation is passed as concurrent legislation of the federation and the Länder, except for social security where policies are shaped by the federation and education, which is Länder's competence, and AT, where the competence on health care is essentially split between the social security system, which regulates the activity of family physicians, and states, which run hospitals with a large margin of autonomy³⁰.

²⁵ In IT health care is almost completely devolved to regions, and account for 80% of their expenditure. In turn regions account for 2/3rds of total sub-central expenditure.

²⁶ In DK it is the responsibility of regions.

²⁷ Including those contained in ministerial decrees, circulars etc.

²⁸ E.g. on the eligibility to benefits, teachers' qualifications, number of pupils per class, minimum services in health care etc.

²⁹ Exceptions are Nordic countries where subnational autonomy is large even in these three domains.

³⁰ In the case of AT, in particular, transferring workload from hospitals to family physicians, which would allow significant savings, has so far been hindered by this division of responsibilities.

2.3 *Financing of subnational governments - own taxes, shared taxes and transfers*

Moving to subnational governments' revenue sources, an important distinction to be made is the one between Member States that grant to subnational governments the possibility to raise their own taxes, with at least partial freedom to change key tax parameters, and those that do not.

Autonomous taxes are an important revenue source for subnational governments in SE, FI, DE, where there is concurrent legislative competence of Länder and federation on most tax matters, ES, BE, IT, FR (albeit more for municipalities than for departments and regions), BG, PL (only for municipalities), CZ (only for municipalities), CY, HU, DK (only for municipalities) and LU. Conversely, own taxes of subnational governments have a low weight in AT, LT, EE, IE, UK, NL, RO, SK and PT and, finally, there is basically no subnational tax autonomy in MT, SI, EL and LV.

The tax which is more often assigned to subnational governments with autonomy in setting its rate and/or base is the property or real estate tax, which is levied on buildings and/or land and on domestic and/or business properties. This is the case in all countries except in MT, EL and LV, although even in the latter two countries receipts of the property tax are at least partly assigned to subnational governments. This tax is commonly assigned to municipalities. In a few Member States, such as DE or BE, upper subnational tiers (Länder and regions, respectively) are also entitled to tax properties.

Subnational governments are also generally allowed to levy taxes on vehicles (or vehicle registration), on donations/inheritances, gambling and on subnational economic activities such as public markets, although such sources normally represent a small share of subnational revenues. In a few cases, subnational governments are also entitled to autonomously raise taxes on corporate income or subnational business taxes. This is the case in IT (with the regional tax on productive activities, the IRAP³¹), ES (for municipalities), DE, PL, CZ, HU, PT and LU. Finally, the tax on personal income largely remains a national tax (albeit quite often its revenues are shared with subnational governments, see below) across the EU with only some exceptions, i.e. DE, ES, SE, FI and DK. The VAT remains everywhere a national tax, except for a regional sur-tax in BE (see below).

In some cases, subnational tax autonomy is granted via the possibility to raise surtaxes on national taxes. Regional and municipal surtaxes on personal income exist in IT and BE (with leeway to change the rate within a band in IT); BE also allows a regional surtax on VAT and municipal and provincial surtaxes on the regional real estate tax. A municipal surtax on corporate income exists in DE and a provincial surtax on car registration in NL.

Therefore, the conclusion can be drawn that despite large historical and institutional differences across the EU, general patterns in the assignment of own tax powers to subnational governments exist and they are by and large consistent with recommendations from normative fiscal federalism literature. This especially concerns the use of real estate tax as a subnational own revenue source almost everywhere in Europe, as real estates and properties constitute an a-cyclical and immobile tax base and hence are not associated with

³¹ Italian regions have the power to increase or reduce by 1 pp the basic IRAP rate (see fiche of Italy in Annex 1).

risk of tax competition among subnational governments and of large volatility of tax receipts (see Chapter IV.1). Similarly, the prevalent assignment of personal income tax and of VAT to the central government is in line with economic arguments related to cyclical volatility of revenues from those taxes, redistributive objectives of tax policy, tax spill-overs beyond subnational boundaries and administrative complexity which all contribute to make these revenue sources less suitable for subnational governments.

Additionally, it is important to underline that assignment of own taxes to subnational governments does not imply that the latter are responsible for collecting revenues from those taxes. Tax collection mostly remains a task of the central government, which eventually transfers to subnational governments the amount of tax revenue they are entitled to based on residence of tax-payers or other criteria (see below).

Besides autonomous taxes, EU subnational governments and especially municipalities also collect other types of own revenues, such as user charges/fees on services³². These account for a normally minor share of subnational revenues, with some exceptions such as FI, IE and EE (see also Chapter IV.1). From the reading of fiches it appears that it is sometimes difficult to draw a line between fees and autonomous taxes. A reasonable criterion should be that fees, unlike taxes, are prices to be paid in return to specific services. Further own revenues sources are those from subnational properties.

The second category of subnational revenues is shared taxes. In order to avoid confusion with autonomous taxes, in this exercise shared taxes only include receipts of national taxes which are fully or partly assigned by the central government to subnational governments, with the latter having no autonomy in setting tax parameters. This implies that cases where central and subnational governments share receipts from a tax but subnational governments also have, at least partly, the power to set its rate or base, falls within the category of autonomous taxes. This is to a large extent the case of DE and ES³³

With this definition in mind, tax sharing is an important revenue source for subnational governments in BE (for the upper tier, i.e. regions and communities), AT, LV, LT, EE, RO, PL, CZ, SK, EL, HU, PT, SI and LU. On the other hand tax sharing without subnational autonomy in setting tax parameters has a relatively small weight in DE, ES³⁴ (except for municipalities in both countries³⁵), IT, DK, FI, IE, UK, FR, whereas it is basically absent in MT, CY, SE, NL and BG. In several cases, the sharing of personal income tax receipts plays a significant role, i.e. in BE, LV, LT, EE, RO, PL, SK, EL, HU, PT, SI. Sharing of VAT is important in BE, ES, IT, CZ, EL, PT and LU, whereas corporate income tax is shared in DK, FI, PL and PT. Property taxes (on either buildings or land) are shared in UK (on business properties), EE, LT, LV and EL. Other shared taxes are the vehicle tax (IE, LU), inheritance tax (LT), a gambling tax and natural resource tax (LV) and excise on alcohol-tobacco (ES,

³² E.g. water supply, sewerage, heating supply, issuance of permits for certain profession/economic activities, construction activities or use of land

³³ In DE and ES tax sharing and subnational tax autonomy largely go together. In DE tax matters mostly fall within concurrent legislation of the Federation and the Lander and at the same time the main taxes (income tax, corporate tax and VAT) are shared between the two tiers in similar proportions. In ES personal income tax rates are composed of two parts, one set by the central government and the other set by autonomous communities. The same applies for allowances and exemptions.

³⁴ See footnote 4.

³⁵ In ES municipalities that are capitals of provinces or communities get a share of personal income tax, VAT and alcohol-tobacco excise. A small part of personal income tax and VAT is allocated by Länder to municipalities in DE.

LU), electricity tax (ES). In AT the proportions in which tax revenues are shared between central government, states and municipalities are set every six years through negotiations between the three government tiers.

The third and last main category of subnational revenues are transfers from the central government. They can be divided in two categories, (i) general transfers, i.e. those which finance subnational expenditures without obligation as regards the specific function/ item for which they have to be used; (ii) transfers earmarked to finance a specific function or item of subnational expenditures.

General and earmarked transfers, taken together, are the main revenue source for subnational governments (accounting for half of their revenues or more according to the fiches) in MT, UK, IE, NL, BG, IT, DK, BE (for municipalities and provinces), LT, CZ (for regions), PL. They are quantitatively important, albeit to a lower extent, also in CY, SK, RO, AT (for states, less for municipalities), LV, EE, FR, PT, HU, LU and CZ (for municipalities). The incidence of transfers compared to own taxes and shared taxes is instead quite low in ES, DE, BE (for regions and communities), AT (for municipalities), SE, FI, SI and EL.

Normally, general and earmarked transfers coexist. This is the case in BE, SE, DK, FI, EE, IE, UK, NL, MT, CY, BG, FR³⁶, PL, CZ and HU although the distinction between the two types is not always straightforward based on information in the fiches. In some cases all transfers are by and large earmarked (RO, LU, PT, SK and LV). In several Member States earmarked transfers are devoted to subnational capital/infrastructure expenditure³⁷ (LU, SI, HU, CY, PL, BG, FR, UK, IE, EE, LV, DE for municipalities), education (LV, IE, UK, PL, CZ, SK, PT, LU for nurseries) or social expenditures (PT, CZ, NL, UK). In a few new Member States, own revenues mainly finance autonomous subnational functions whereas transfers are used to fund state-delegated functions³⁸ (CZ, BG, LT, SK).

Quite frequently transfers are allocated to subnational governments based on equalisation criteria, i.e. aiming at ensuring uniform levels and quality of services across different subnational entities within the country. This is normally done in two ways: (i) providing subnational governments with sufficient resources to fulfil their expenditure obligations (vertical equalisation) and (ii) compensating for differences in revenue-raising capacity and cost of service provision across subnational entities (horizontal equalisation).

Equalising transfers exist in DE, ES, SE, LV, FI, LT, EE, IE, UK, NL, RO, BG, PL, SI, PT, FR and HU. The amounts assigned to the different subnational governments are set via specific allocation formulas normally based on demographic variables (mainly population size³⁹ and age structure) and economic variables (e.g. unemployment rate), which allow to compute expenditure needs in the various subnational entities, as well as on measures of tax capacity. The formula can be more or less complex depending on the Member State; additional allocation criteria used are number of properties, geographical size of the

³⁶ Transfers are divided between current and capital expenditures, the former category being admittedly very broad to qualify as earmarked transfer.

³⁷ The latter mainly including improvement of networks and infrastructures linked to government functions carried out by subnational governments, e.g. roads, school buildings etc.

³⁸ Albeit with some subnational co-financing with own resources.

³⁹ E.g. size of transfers being determined as a lump sum per inhabitant.

subnational entity, remoteness of local areas, length of roads network etc. In DE⁴⁰ and ES⁴¹ the equalisation system is articulated in different steps.

However, the equalisation formula can be applied not only to the allocation of transfers, but also to that of shared tax revenues (these cases were included in the list of countries in the previous paragraph), making the distinction between these two categories of revenues not always clear cut. This is the case for the allocation of VAT revenues in DE, of the personal income tax in SI and HU, and of a joint pool of taxes, which are put together in subnational funds and then redistributed to subnational governments, in ES, PT, EL and LU.

Allocation of transfers based on expenditure needs and independent of the quality and efficiency of service provided tend to discourage the adoption of cost-saving or efficiency enhancing measures by subnational governments. Although this problem is pointed out in several fiches, no Member State, except DK (see 2.3 below), appears to have introduced mechanisms to correct this feature. This being said, it should be pointed out that formulas based on "presumed" costs, measured by demographic or socio-economic indicators, would still be preferable in terms of incentives than systems which simply cover the amount of expenditures claimed by subnational governments. This is illustrated by recent experience in IT⁴², which plans to move from historical to 'standard' costs of services as main criterion for subnational financing, and NL, where reimbursement of subnational claims for social expenditures has been replaced by assignment of fixed (formula-based) amounts of resources.

Another problematic feature of a transfer-based system is the tendency to largely reduce the amount of transfers to subnational governments during 'bad' economic times while keeping subnational obligations to provide services unchanged. This may force the central government to eventually provide 'extraordinary' transfers aimed at covering widening subnational deficits or cope with special economic difficulties, hence further discouraging subnational governments to behave in a fiscally responsible way (by, for instance, raising own taxes to cover the gap created by reduced transfers).

⁴⁰ DE operates a strong system of fiscal equalisation among the Lander aimed at ensuring equivalent living standards across them. This is essentially achieved by a complex system of VAT receipts redistribution in three steps, (i) vertical redistribution (from centre to lander) of part of VAT to Lander with below-average tax revenues, (ii) horizontal transfers from lander with above average fiscal capacity to those with below-average fiscal capacity, (iii) supplementary federal transfers to lander with lower fiscal capacity. This system allows to largely compress cross-Lander differences in per capita revenues. Municipalities also receive vertical (from their Land) and horizontal (from richer municipalities) transfers to minimise differences between their fiscal capacity and their expenditure needs.

⁴¹ ES also has an elaborate system of transfers with multiple steps to ensure uniform access to social services across all *Comunidades*. Firstly, all Autonomous Communities contribute 75% of their tax revenues to a Guarantee Fund which is then redistributed among them based on their funding needs for 'essential public services'. Secondly, supplementary transfers are provided by the central government to those Autonomous Communities with residual financing needs through the Global Sufficiency Fund and through other funds aimed to further reduce differences in financing capacities.

⁴² In IT a far reaching reform to deepen the system of fiscal decentralisation is currently being implemented (starting from 2009), implying major changes also for the financing of subnational governments: (i) introducing the 'standard cost' principle, rather than the 'historical cost' one to determine subnational expenditure needs, so that subnational entities providing services at higher costs will have to raise additional resources to cover them; and (ii) the introduction of equalisation transfers across subnational governments to compensate for differences in fiscal capacities.

2.4 Fiscal rules, budgetary arrangements and bail-out possibilities of subnational governments

The remaining part of this Section summarises main facts with respect to fiscal rules applying to subnational government across the EU, their monitoring and enforcement, the supervisory role of the central government, the possibility for subnational governments to borrow, the procedures to be followed in case a subnational government falls in financial distress, the budgetary coordination across different tiers of government. A number of conclusions can be drawn after looking at information in country fiches on all these aspects

Fiscal rules apply to subnational governments in most EU Member States. The most widespread type of rule is the golden rule, whereby subnational governments are entitled to borrow exclusively to finance investments, although it is in some cases extended to cover borrowing linked to temporary revenue shortfalls and repayment obligations of existing debt. Another type which is quite recurrent is a borrowing limit, often formulated as a threshold on the amount of liabilities which can be assumed by a subnational government in a year or as a threshold on annual debt service obligations, both generally expressed as percentage of subnational revenues.

Limits to the total stock of subnational debt are less common, although in some cases borrowing is allowed only if the accumulated debt is below a specified threshold. Surprisingly, statutory limits on subnational expenditures are mostly non-existent across the EU. However lack of control of growth of subnational expenditures is in some cases, e.g. ES, pointed out as adversely affecting the achievement of fiscal targets of general government, calling for the introduction of such ceilings. In DK binding expenditure limits for subnational governments were introduced in 2011 after a long trend of increase in subnational expenditures.

As opposed to statutory thresholds on fiscal aggregates, across the EU it is quite common to have some form of budgetary coordination across different government tiers. This essentially consists in annual negotiations and adoption of targets for the budget balance and, in some cases, expenditures and revenues of both the central and subnational government tiers. These are more common in more fiscally decentralised countries. They are in some cases called Internal Stability Pacts (IT, AT) and in general imply monitoring of compliance to targets by the central government (typically the ministry of finance) and can imply a range of sanctions for non-compliance.

The existence of a system of internal budgetary coordination appears to positively contribute to fiscal discipline at general government level; in some cases (PT, HU) it is precisely the insufficient coordination/exchange of information across levels of government which seems to be one of the causes of fiscal slippages at subnational levels. In the case of PT, this occurred via a systematic overestimation of revenues by subnational governments. However, internal stability pacts are not a panacea, as their effectiveness depends on a number of implementation details, such as the time horizon for fulfilment of fiscal targets (if multi-annual, deficit in one year can be offset by surplus in another year), automaticity of sanctions, variability and degree of ambition of targets and their scope of application (the whole subnational sector vs. individual subnational entities, the latter clearly being stricter).

As for monitoring and sanctions in case of breach of fiscal rules or negotiated targets by subnational governments, across the EU these alternatively include the prohibition to issue

new debt, the need to ask authorisation for it, the need to introduce corrective measures within specified timeframes under enhanced supervision of the ministry of finance, cuts in revenue allocation from transfers or shared taxes. The most elaborate example of the latter is provided by DK, which has recently made its block grant to subnational government partly conditional to fulfilment of expenditure targets and no increase of own taxes by municipalities.

In any case, it is interesting to observe that there is no generalised prohibition to borrow for subnational governments, although this is often restricted to investment financing (see above). In spite of this fact subnational debt level have remained fairly low across the EU with some exceptions (e.g. PT, NL, DK). However, ability to borrow by subnational governments is in some cases restricted to loans from commercial banks or, in the extreme, only from the state treasury, whereas issuing bonds in capital markets is prohibited. In some cases, subnational governments can issue bonds or obtain loans exclusively through a special public body, e.g. the municipal finance corporation in FI, which is backed by joint guarantee from all municipalities in the country.

If subnational governments experience serious financial problems, in several cases they fall under strengthened surveillance by the central government and they have to negotiate with the latter, sometimes via special joint committees or boards, a stabilisation plan to restore fiscal sustainability. In other cases they are put under forced administration by the central government. Generally there is no formal procedure for insolvency or default of subnational governments. The overall impression is that, despite the frequent lack of formal guarantee by the central government on subnational financial obligations, a subnational default is de facto ruled out across the EU and the central government eventually intervenes to provide 'exceptional' transfers to bail-out the subnational entity in financial distress. The latter can in fact threaten to drastically cut service provision or argue that its spending obligations are mandated by national legislations and hence oblige the central government to cover its debt. In the extreme, this may occur as a result of legal actions in the constitutional court (as was the case for some Länders in DE).

In some cases, the application of subnational fiscal rules has been circumvented by the practice of subnational governments to delegate the provision of some services to external enterprises of which they hold the ownership, totally or partially, as such enterprises are often out of the scope of application of those rules implying that their liabilities were not counted within the amount of debt or borrowing of subnational governments.

In several cases complex budgetary procedures are foreseen for subnational governments (apart from coordination with the national budget as mentioned above), detailing all the steps for drafting, adoption and monitoring of subnational budgets, typically including an important role of subnational elected assemblies, the obligation to communicate the adopted budget to the ministry of finance, attribution of tasks of monitoring execution and carrying out ex-post checks to external bodies⁴³ or auditors. A problem with such bodies may be their lack of full political independence as they are sometimes appointed by subnational policy-makers.

3. Conclusions

This Chapter has summarised main patterns of fiscal decentralisation arrangements across the EU based on individual country fiches compiled for all 27 Member States. It showed that

⁴³ E.g. the stability council (for Lander) and supervisory agencies (for municipalities) in DE. These bodies also formulate budgetary forecasts at the beginning of the budgetary process.

cross-country data available in Eurostat and described in Chapter IV.1, albeit rich, fail to capture all aspects and details of different national systems, and that country descriptions provide a useful set of complementary information.

National systems across the EU show a significant degree of heterogeneity reflecting historical and institutional specificities. However a number of largely common patterns emerge, such as a rising importance of subnational levels of government as providers of services, including the attribution of responsibilities in important functions such as education, social protection and health care, albeit mostly with the task of delivering the services with regulation being largely left with the national level, the varying degree of availability of own resources (i.e. taxes set autonomously) or shared taxes compared to transfers across the EU, the fact that the constitutional status of subnational governments (i.e. federal vs. unitary countries) does not necessarily match the actual fiscal/budgetary weight of subnational tiers, the systematic attribution of certain revenue sources (e.g. property taxes) to subnational entities.

This Section also highlighted that the existence of subnational tiers with at least some expenditure and revenue autonomy does create a number of challenges for overall efficiency of public services and fiscal discipline at the general government level. Divergences of spending and financing responsibilities, allocation of revenues often based on 'presumed' costs of services without rewarding efficiency gains, lack of or badly designed fiscal budgetary coordination across sectors of government, *de facto* impossibility to allow a default of a subnational entity which behaved in a fiscally irresponsible way, insufficient scale of subnational entities to efficiently run services, are all features which may weaken subnational incentives to run services in a cost-effective manner and to positively contribute to achieve national budgetary targets.

Finally, subnational governments are often subject to fiscal rules, especially golden rules (borrowing allowed to finance investments) and borrowing limits, which again underline a general need to constrain subnational fiscal behaviour, and are also generally put under some form of monitoring by the central government (especially the ministry of finance), which is often substantially tightened in case they fall in fiscal distress or deviate from agreed targets negotiated with the central government.

Chapter 3 – Fiscal decentralisation and fiscal outcomes

0. Introduction

In this Chapter the relationship between fiscal decentralisation at national level and fiscal outcomes of the general government, is analysed, based on the different indicators of decentralisation, which were presented and described in Chapter IV.1. The purpose is to assess whether devolving expenditure functions and revenue sources to subnational entities, which has generally occurred across the EU over past years as shown in Chapters IV.1 and IV.2, may have adverse consequences on overall fiscal balances of the general government due to a loss of control of the central government on subnational fiscal behaviour and lower incentives for fiscal discipline at subnational level. This concern is very relevant and increasingly raised by EU policy-makers given that fiscal policy governance at the EU level and, with the recently adopted Fiscal Compact (see Part II), at the national level, is based on general government definitions.

The fiscal outcomes considered are the budget balance and expenditures and revenues, taken separately. The analysis is done in two steps. Firstly, correlations between decentralisation and fiscal outcomes are presented and analysed in order to have *prima face* evidence on the budgetary impact of decentralisation. Secondly, the relationship between indicators of decentralisation and fiscal outcomes is also estimated via regression analysis.

1. Fiscal decentralisation and fiscal outcomes: theoretical considerations

Theoretical priors can be highlighted as regards the sign of the effect of different dimensions of fiscal decentralisation on the main fiscal aggregates of the general government, according to the fiscal federalism literature (see among others Oates, 1999 and 2006; Blöchliger and Petzold, 2009; Blöchliger and King, 2006; Blöchliger and Rabesona, 2009; IMF, 2009; Neyapti, 2010; De Mello, 2007; Darby et al., 2002). However, in most cases the net impact is *a priori* ambiguous as a result of conflicting arguments.

Decentralization of expenditures

The decentralisation of expenditures could have either positive or negative effects on the fiscal balance. The government balance is expected to improve via lower expenditures due to:

- (1) A more efficient expenditure allocation as public good provision by subnational governments is better tailored to subnational needs and preferences.
- (2) Competition across subnational governments with respect to the technology and methods of production of public goods, which encourages them to select and adopt the more cost-effective ones.
- (3) Failure to internalise positive spill-overs of public expenditures to citizens of other subnational communities.

On the other hand, there are arguments pointing to an increase in expenditures due to decentralisation on expenditures with adverse implications for the primary balance, i.e.:

- (1) Decentralisation may prevent the exploitation of economies of scale in the production of public goods.

(2) Decentralisation entails unnecessary multiplication/overlapping of administrative procedures, especially due to shared competences across different territorial levels of administration over the same government function and unclear division of responsibilities among them.

(3) Lower productivity of subnational administration compared to the national one, due to greater capability of the latter to attract a more skilled labour force.

(4) Greater proximity of subnational policy-makers to subnational interest groups, which make the former more sensitive than national policy-makers to lobbying for increased expenditures from the latter.

Overall, the prediction of economic theory is that the impact on expenditures and the primary balance is a priori ambiguous. Moreover, a significant share of subnational governments' expenditures is likely to be mandated by national directives and legislation, leaving only limited room for subnational governments to affect their overall size and evolution. If that is the case, expenditure decentralisation taken at face value would not tell much on the effective devolution of spending powers to subnational governments, and could then have no real impact on the magnitude of expenditures.⁴⁴

Decentralization of revenues

Decentralisation of revenue sources can also affect fiscal balances. The literature generally underlines that if subnational governments can finance a large part of their expenditures with their own revenue sources (taxes and fees) they have stronger incentives to behave in a fiscally responsible way, with positive effects on the fiscal balance of the general government. The following arguments can explain this effect:

(1) Subnational governments are more accountable to subnational voters on the way they manage their resources as the link between public services provided at subnational level and the taxes raised to finance them is stronger.

(2) The central government can more easily resist pressures of subnational governments to cover an excess in their expenditures as the latter have sufficient revenue autonomy to deal with their expenditure obligations on their own.

(3) Subnational policy-makers have a stronger incentive to provide high quality public services in order to contribute to greater economic growth in their community, as they would get the resulting dividend in the form of higher tax receipts, although the strength of this argument varies according to the type of tax devolved to subnational authorities.⁴⁵

On the other hand, if subnational governments largely rely on transfers from the central government to finance their expenditures, they can easily justify large unfunded expenditures with the lack of own revenue sources and threaten to scale down public service provision, which is often mandated by national legislation, eventually forcing the central government to intervene to bail them out. This implies that subnational governments face a 'soft-budget constraint', with adverse effects on the general government fiscal balance.⁴⁶

⁴⁴ On the other hand, evidence from country fiches suggests that subnational governments are often assigned also increasing decision-making powers on devolved expenditures (see Chapter IV.2.)

⁴⁵ It is likely to be weaker for property taxes than for local income or business taxes.

⁴⁶ However, a counter-argument is proposed in some papers. A larger weight of transfers may give the central government a stronger lever to control the fiscal behaviour of subnational governments and, hence, reduce the risk of subnational fiscal slippages. This effect should be especially relevant if most transfers to subnational governments are earmarked to specific expenditures, leaving little leeway to subnational governments to decide upon their use.

Moreover, in presence of equalising transfers, i.e. transfers which are allocated in such a way as to fill the gap between expenditure needs and own revenues of subnational entities and hence imply some degree of redistribution from the richer to the poorer of them, subnational governments may fail to internalise the cost of financing additional expenditures, thereby contributing to expenditure and deficit bias.

Finally the composition of subnational expenditure by government function and economic function, normally a neglected aspect in the fiscal federalism literature, may also weigh on the impact of decentralisation on fiscal outcomes. A higher relative weight of subnational governments in expenditure items more affected by demographic and political pressures, such as health care and social protection, may have an adverse effect on fiscal balances, since subnational governments may have lower incentives or ability to counteract such pressures.⁴⁷ The same reasoning can by and large be extended to cases of strong decentralisation of expenditures on compensation of employees and social benefits. This effect can be tested by using figures on the breakdown of expenditure decentralisation by functions (such as health, education etc.) or economic category, which were also discussed in Chapter IV.1.

Overall, although a number of theoretical predictions can be drawn from the literature about the impact of fiscal decentralisation on fiscal outcomes of the general government, they are often conflicting as regards its sign, implying that this is ultimately an empirical question. Therefore, the remainder of this Chapter turns to the empirical analysis of these issues. In Section 2 stylized facts will be presented. Then, in Section 3 the main hypotheses derived from theoretical predictions are reformulated and qualified based on the stylised facts (Subsection 3.1 below) and then tested through regression analysis.

The effect of fiscal decentralisation can be tested by using the indicators which were introduced in Chapter IV.1 to describe the extent and main characteristics of fiscal decentralisation across the EU. These indicators are:

- i) Expenditure decentralisation, defined as the percentage of subnational governments' expenditures in total expenditures of the general government;
- ii) Own revenue decentralisation, defined as the percentage of subnational taxes and fees (i.e. subnational own revenues) in general government revenues;
- iii) Revenue decentralisation, defined as the percentage of subnational revenues (including transfers) in general government revenues (this indicator will be used exclusively in the Section on stylised facts and not in the one on econometric analysis);
- iv) The percentage of tax revenues in subnational revenues;
- v) The percentage of transfers from the central government in subnational revenues;
- vi) Subnational expenditure coverage by own revenues, defined as the percentage of subnational expenditures covered by subnational taxes and fees.⁴⁸

⁴⁷ For instance, subnational administrations may lack the technical expertise to anticipate the future evolution of health expenditure or may have less political will to curb health expenditure because they would assume that the central government would eventually intervene to provide additional funding for such a politically and socially sensitive expenditure item.

⁴⁸ The latter measures the decentralisation of revenues relative to expenditures. The complement to one of this indicator, i.e. the share of subnational expenditure not covered by own subnational revenues is generally called 'vertical fiscal imbalance', as it captures the gap between expenditures and own revenues of subnational governments which must be covered either by transfers or subnational borrowing. It follows from the above considerations that a lower vertical fiscal imbalance should lead to a 'harder budget constraint' for subnational governments, with positive effects on fiscal balances.

- vii) Transfer dependency, defined the percentage of subnational expenditures covered by transfers.

2. Stylised facts on decentralisation and fiscal outcomes

2.1 *Pair-wise correlations between fiscal decentralisation and fiscal outcomes*

This Subsection presents evidence on pair-wise correlations between fiscal decentralisation and general government fiscal outcomes in order to identify a few stylised facts before moving to econometric analysis of the fiscal impact of decentralisation in Section 3 below. The data sample used consists of annual data covering all EU27 Member States in the period 1995–2010.⁴⁹

The first exercise consists of a comparison of average values of main fiscal outcomes, across high and low decentralisation subsamples of the data. To do this, the data are divided into two subsamples, with values of the different decentralisation indicators lower and higher, respectively, than their overall sample average.⁵⁰ The exercise is undertaken for four indicators of decentralisation mentioned in Section 1 above: expenditure decentralisation, own revenue decentralisation, subnational expenditure coverage by own revenues, share of transfers in subnational revenues. The comparison is carried out for the following fiscal variables: primary balance, cyclically-adjusted primary balance, primary expenditures and total revenues of the general government, in order to assess the correlation of decentralisation with both the net fiscal balance and the spending and revenue side, separately. Results are shown in Table IV.3.1.

Table IV.3.1: Fiscal outcomes of general government (% of GDP), averages for observations with low and high values of different indicators of fiscal decentralisation (EU27 Member States, 1995-2010 period)

		pb	capb	exp	rev
Expenditure decentralisation	Low	-0.8	-0.9	35.6	39.1
	High	1.3	1.2	39.8	44.5
Subnational expenditure coverage by own revenues	Low	-0.2	-0.2	36.0	39.6
	High	0.6	0.4	38.9	43.3
Own revenue decentralisation	Low	0.0	-0.3	35.9	39.8
	High	0.7	0.7	40.2	44.7
Share of transfers in subnational revenues	Low	0.5	0.4	38.8	43.2
	High	-0.1	-0.2	36.0	39.6

Source: Commission's services.

Notes: pb = primary balance of general government, capb = cyclically adjusted primary balance of general government, ch_debt = yearly change of debt-to-GDP ratio of general government, exp = primary expenditure of general government (% of GDP), rev = total revenues of general government (% of GDP).

The following patterns emerge:

⁴⁹ This is the longest time period with available data by sector of government in Eurostat, except for the breakdown by functions (cofog) which is shorter, see below.

⁵⁰ For instance, in the case of the indicator of overall expenditure decentralisation, the sample is divided between observations where the value of this indicator is below or above its sample average.

- i) High expenditure decentralisation goes together with a higher primary balance on average, higher (primary) expenditure and higher revenues of general government⁵¹. The same occurs with own revenue decentralisation.
- ii) High subnational expenditure coverage by own resources is associated to higher primary balance, higher (primary) expenditures and revenues although the difference is smaller than between low and high decentralisation of expenditures.
- iii) Conversely, a higher share of transfers (or a lower share of own revenues) in subnational revenues is associated to lower primary balance, lower primary expenditure and lower revenues.⁵²

These main messages are by and large confirmed by computing correlations between country averages for the 1995-2010 period of the decentralisation indicators considered and country averages over the same period of the primary balance, expenditures and revenues.⁵³

However, comparisons of fiscal outcomes across low and high levels of a single decentralisation indicator do not control for the fact that different aspects of decentralisation may go together. It is quite likely, for instance, that decentralisation of expenditures goes together with decentralisation of own revenues and larger subnational responsibility to cover their expenditures with their own resources. Therefore, it is possible that the positive effect of expenditure decentralisation on the primary balance is in fact due to the greater subnational financial autonomy and responsibility which may often go with it. Controlling simultaneously for the fiscal impact of different decentralisation variables requires econometric analysis, which is carried out in Section 3 below; however two simpler exercises can already shed some light on these issues:

(1) Looking at the relationship between different aspects of decentralisation to test whether expenditure decentralisation tends to be accompanied by greater subnational responsibility on the revenue side and a lower reliance on transfers and to assess how the different aspects of revenue decentralisation considered so far (revenue decentralisation, share of taxes, share of transfers and subnational expenditure coverage by own revenues) tend to be combined with each other.

(2) Computing averages of fiscal outcomes for low vs. high expenditure decentralisation controlling for high vs. low levels of the different indicators of revenue decentralisation.

Both exercises are carried out in the remainder of this Section.

⁵¹ +2.1pp of GDP for the primary balance, +4pp for expenditures and +5½pp of GDP for revenues.

⁵² Looking at the link between decentralisation and the magnitude of subnational governments' expenditure (not shown), data show that the latter is significantly larger when decentralisation of either expenditures or revenues is higher than average. Less obviously, it is around 2pp higher on average when subnational expenditure coverage by own-resources is *higher* and transfer dependency *lower*.

⁵³ The figures are not shown. Specifically, across the EU the average of both expenditure and own revenue decentralisation is positively correlated with the average primary balance, cyclically adjusted primary balance, primary expenditures and revenues in the 1995–2010 period. The correlation coefficients are always in the range of 0.5-0.6. The average rate of coverage of subnational expenditures by subnational own resources is positively correlated with primary expenditures and revenues, whereas both expenditures and revenues are negatively correlated with subnational dependency on transfers. As for the mix of revenue sources of subnational governments, the average share of taxes in total subnational revenues is positively correlated with expenditures and revenues.

The upper part of Table IV.3.2 below compares the average values of the indicators capturing the different aspects of revenue decentralisation for low vs. high decentralisation of expenditures, whereas the bottom part compares the average shares of taxes and transfers in subnational revenues and the average level of subnational financial responsibility (i.e. coverage of their spending with own revenues) for low vs. high revenue decentralisation.⁵⁴

The Table shows that higher expenditure decentralisation is on average associated with higher revenue decentralisation, both including (first column) and excluding (second column) transfers, higher rate of coverage of subnational expenditure by own revenues, as well as a higher share of taxes and a (marginally) lower share of transfers in subnational revenues. Moreover, revenue decentralisation is accompanied by a higher share of taxes and a lower share of transfers in subnational revenues, as well as by higher subnational expenditure coverage with own revenues.

Table IV.3.2: Conditional means of selected indicators of fiscal decentralisation for high vs. low expenditure and revenue decentralisation

Expenditure decentralisation	Revenue decentralisation	Own revenue decentralisation	% of transfers in subnational revenues	Subnational expenditure coverage by own revenues	% of taxes in subnational revenues
Low	0.17	0.08	0.53	0.45	0.32
High	0.37	0.18	0.50	0.49	0.39
Revenue decentralisation (transfers included)			% of transfers in subnational revenues	Subnational expenditure coverage by own resources	% of taxes in subnational revenues
Low			0.53	0.46	0.32
High			0.51	0.49	0.38

Source: Commission services.

These findings are by and large confirmed by pair-wise correlations between the mean values of decentralisation indicators by country in the 1995–2010 period.⁵⁵

Overall, it appears that expenditure decentralisation, own revenue decentralisation and subnational responsibility to cover their expenditures with their tax revenues and fees tend to go hand-in-hand across the EU. Moreover, in countries where total revenue decentralisation is high, taxes tend to be more important than transfers as subnational revenue source. These findings imply that simple relationships between individual aspects of decentralisation and fiscal outcomes should be interpreted with caution, without inferring too easily causal effects and that it is important to look at the effects of different decentralisation aspects simultaneously. A first attempt to do this is done with the exercise mentioned in point (2) and discussed below, whereas an econometric analysis is carried out in Section 3.

⁵⁴ I.e. the share of all revenues of subnational governments, including transfers from the central government, in general government revenues (see above). This indicator differs from own revenue decentralisation by the inclusion of transfers.

⁵⁵ These are not shown. The correlations between decentralisation of expenditures, on the one hand, and decentralisation of own revenues (taxes and fees), share of taxes in subnational revenues and subnational expenditure coverage with own resources are all positive and significant. Also, overall revenue decentralisation (including transfers) is positively correlated with the share of taxes in subnational revenues and negatively correlated with the share of transfers, although it is significant only in the first case.

Table IV.3.3 below compares the average values of primary balance, expenditures and revenues across the two sub-samples with low and high expenditure decentralisation, *conditional on low or high level of own revenue decentralisation, subnational expenditure coverage by own resources and shares of taxes and transfers in subnational revenues*. Compared to Table IV.3.1, this exercise allows to better disentangle the relationship between expenditure decentralisation and fiscal outturns from the one between the different aspects of revenue decentralisation and fiscal outturns.

Table IV.3.3: Conditional means of fiscal outcomes of general government (% of GDP) for low vs. high expenditure decentralisation, controlling for low vs. high values of other decentralisation indicators (by column) - EU-27 Member States, 1995-2010

Expenditure decentralisation	Own Revenue decentralisation		Own Revenue decentralisation		Own Revenue decentralisation	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-0.62	-2.42	35.55	35.63	39.13	38.50
High	1.67	1.20	37.11	40.96	41.73	45.77
	Subnational expenditure coverage by own resources		Subnational expenditure coverage by own resources		Subnational expenditure coverage by own resources	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-1.23	-0.52	34.61	36.30	37.70	40.10
High	0.93	1.65	37.52	41.39	41.74	46.53
	Transfers (% subnational revenues)		Transfers (% subnational revenues)		Transfers (% subnational revenues)	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-0.57	-1.20	36.30	34.54	40.10	37.60
High	1.62	0.97	41.38	37.52	46.50	41.77
	Taxes (% subnational revenues)		Taxes (% subnational revenues)		Taxes (% subnational revenues)	
	Low	High	Low	High	Low	High
	Primary balance		Primary expenditure		Total revenues	
Low	-1.01	-0.58	35.08	36.26	38.39	40.00
High	1.12	1.48	37.47	41.07	41.77	46.08

Source: Commission services.

Notes: the Table should be read in the following way, taking the example of the first four figures in the top-left corner (primary balance): the sample is broken down between observations with lower and higher than average expenditure decentralisation. Each of these subsamples is then broken down across cases with lower and higher than average own revenue decentralisation, so that the relationship between own revenue decentralisation and the primary balance can be isolated from the relationship between expenditure decentralisation and the primary balance.

As regards the primary balance, the following patterns emerge:

- (i) Restricting the analysis to observations with low own-revenue decentralisation, low subnational expenditure coverage by own resources, low share of taxes and low share of transfers in subnational revenues, moving from low to high expenditure decentralisation is associated to an increase in primary balance.
- (ii) For high levels of expenditure decentralisation, moving from low to high own revenue decentralisation is associated to a decrease of primary balance, contrary to findings in the first Chart.
- (iii) For high levels of expenditure decentralisation, moving from low to high share of transfers in subnational revenues is associated to a decrease in primary balance, whereas

moving from low to high subnational expenditure coverage and from low to high share of taxes in subnational revenues goes together with an increase of the primary balance.

As regards expenditures and revenues:

- (i) For low levels of own revenue decentralisation, subnational expenditure coverage and share of taxes and transfers in subnational revenues, moving from low to high expenditure decentralisation is associated to both higher expenditures and revenues.
- (ii) Once the level of expenditure decentralisation is high moving from low to high own revenue decentralisation, from low to high subnational expenditure coverage by own resources and from a low to high share of taxes in subnational revenues is associated with a (quite sizeable) increase in expenditures and revenues.
- (iii) Once the level of expenditure decentralisation is high, moving from low to high weight of transfers in subnational revenues is associated with a decrease in expenditures and revenues.

2.2 Conclusions on stylised facts on the link between fiscal decentralisation and fiscal outcomes

Overall, preliminary evidence based on comparing average fiscal outcomes in the EU for low vs. high fiscal decentralisation, looking at both the expenditure and revenue side of the latter, suggests that:

- (1) Decentralising expenditures does not appear to increase government deficit. On the contrary, it is associated with improved primary balance. This relationship is strengthened if accompanied by a large rate of coverage of subnational expenditures by own resources (i.e. taxes and fees) and a high weight of taxes in subnational revenues. Conversely this relationship is attenuated if transfers from the central government account for a large share of subnational revenues.
- (2) Expenditure decentralisation appears to go together with higher expenditures and revenues and this link is strengthened if accompanied by a large coverage of subnational expenditure with own resources, large share of taxes in subnational revenues, whereas it is weakened in case of a large share of transfers in subnational revenues.

These facts appear to confirm the argument that subnational governments do not fully exploit economies of scale in public goods provision and tend to generate inefficiencies via overlapping and duplications of administrative procedures, leading to higher expenditures in more decentralised countries. However expenditure decentralisation is also associated with higher government revenues and this appears to more than offset the relationship with expenditures, resulting in a net positive link between expenditure decentralisation and the primary balance.

All these relationships seem to be strengthened if expenditure decentralisation is accompanied by larger financial responsibility of subnational governments⁵⁶ and a larger share of taxes in their revenues whereas they are partly counteracted if transfers account for a large share of subnational revenues. This appears to confirm the prediction that if subnational governments have to finance most of their spending with their own taxes and fees and these make up most of their revenues they tend to raise more revenues to cover their expenditure needs, whereas a large reliance on transfers creates a soft-budget constraint on subnational governments, reducing the positive effect of expenditure decentralisation on the primary balance.

2.3. Stylised facts on decentralisation of individual expenditure functions and fiscal outcomes

This Subsection complements the discussion in Subsections 2.1 and 2.2 above, by presenting the main stylised facts on the link between expenditure decentralisation in individual government functions (i.e. education, public order, health care etc., see Chapter IV.1) and fiscal outcomes based on comparison of conditional means as done in Subsection 2.1. Essentially, the goal is to assess whether the main messages on the relationship between decentralisation and fiscal outcomes are enriched by looking also at the break-down of decentralisation by functions. For simplicity, no charts or tables are shown in this Subsection and only the main findings are briefly presented and discussed.

- (1) Looking at the relationship between the total expenditure in each function and its degree of decentralisation suggests that there is no systematic relationship between these two variables, except for social expenditure and, to a lesser extent, health care. Social and health care expenditures are on average around 4pp of GDP and 1pp of GDP higher, respectively, in countries where such functions are highly decentralised.
- (2) Looking at the relationship between decentralisation by function and the primary balance of the general government conditional on a high level of total expenditure decentralisation (in order to control for the effect of overall decentralisation) suggests that decentralising general services and education is associated with a lower primary balance, whereas higher decentralisation of health, economic affairs and social protection goes together with a higher primary balance.
- (3) Repeating the exercise in (2) for expenditures and revenues (instead of the fiscal balance) suggests that overall expenditure decentralisation is no longer associated to higher total expenditures if education, social protection and health remain centralised, whereas it is associated to substantially higher expenditures if these three functions are decentralised. Similarly, expenditure decentralisation is no longer associated to larger total revenues when social protection and education are relatively centralised.

The same caveat as for evidence presented in Subsection 2.1 also applies to stylised facts on the relationship between decentralisation by function and fiscal outcomes, i.e. no conclusions on causal effects should be drawn from them as their robustness should be tested with econometric analysis. In any case the above stylised facts suggest that the fiscal impact of total decentralisation of expenditure and of its composition by function should be tested at the same time. The next Section turns to econometric analysis of the effect of fiscal decentralisation on fiscal outcomes.

⁵⁶ They cover a large part of their expenditures with their tax revenues and fees.

3. Regression analysis of the impact of decentralisation on fiscal balance

3.1 *Model specification and main hypotheses*

This Section presents an econometric analysis of the impact of fiscal decentralisation on the primary balance of general government and on primary expenditures and revenues, taken separately. The model used is the fiscal reaction function – an equation which tests the impact of the outstanding government debt ratio on the primary balance after controlling for a number of macroeconomic and institutional variables. The basic underlying assumption is that governments are fiscally responsible and hence react to increasing (decreasing) levels of accumulated debt by increasing (decreasing) the primary balance. This methodology has become quite widespread in the empirical literature on fiscal policy (see Bohn (1998) and European Commission (2011a)) and has also been used recently to investigate the budgetary impact of fiscal decentralisation (Eyraud and Lusinyan (2011) and Escolano et al., (2012).)⁵⁷

Therefore, this Section presents and discusses estimates of fiscal reaction functions for the EU enriched with the indicators of fiscal decentralisation previously discussed. The dependent variable of the model is alternatively the primary balance, primary expenditures and total revenues of the general government. As discussed in Section 1 above, it is difficult to formulate clear cut predictions on the impact of the different aspects of fiscal decentralisation on fiscal outcomes as theoretical arguments are often conflicting. However, the literature presented in Section 1 above and the stylised facts discussed in Section 2 suggest a list of main hypotheses to be tested with regression analysis.

(1) Expenditure decentralisation may lead to larger primary expenditures due to a number of reasons such as less exploitation of economies of scale, duplication and overlapping of administrative procedures, lower productivity of subnational administrations as they are less able to attract more skilled civil servants and greater proximity of subnational policy-makers to subnational interest groups.

(2) The net effect of expenditure decentralisation on the primary balance should depend on how the former is combined with revenue decentralisation. Essentially, stylised facts suggest that if decentralised expenditures go together with large financial responsibility of subnational governments to cover them with their own resources (i.e. taxes and fees assigned to subnational governments) and taxes account for a large share of subnational revenues compared to transfers, there should be no adverse effect on the primary balance (or possibly even a positive one) as subnational governments are encouraged to raise more revenues to cover their larger expenditure responsibilities. On the other hand, the combination of high expenditure decentralisation with a strong reliance on transfers from the central government would be more harmful for fiscal balances as subnational governments would face a soft budget constraint and are likely to be less concerned about balancing their expenditures with their revenues.⁵⁸

⁵⁷ Both these papers use decentralisation indicators similar to those considered here.

⁵⁸ As explained in Chapter IV.1, figures on the shares of taxes in subnational revenues do not distinguish autonomous taxes, i.e. on which subnational governments are allowed to change main tax parameters, from the assignment of revenues from national taxes to subnational governments. This may prevent to fully capture the 'true' degree of subnational financial autonomy. Hence, a robustness check for the hypothesis (2) above, is carried out estimating the effect of an indicator of 'true' subnational tax autonomy compiled by the OECD

(3) The effect of total expenditure decentralisation on fiscal outcomes may differ according to the specific expenditure item which is decentralised. Decentralisation of health-care, social protection, education or general services may be particularly likely to lead to larger expenditures and/or a worse fiscal balance.

(4) Finally, a greater share of subnational expenditures covered by subnational own taxes and fees (low vertical fiscal imbalance) implies greater financial responsibility at subnational level as the central government can more easily resist pressures to 'bail-out' subnational entities if the latter are endowed with sufficient own resources to finance their expenditures. In these situations there should be a positive effect on the fiscal balance, reflecting a positive effect on revenues and a negative effect on expenditures. However, descriptive evidence discussed in Section 2 suggests a positive effect on both expenditures *and* revenues which needs to be tested through econometric analysis.

(5) As for own revenue decentralisation – the share of subnational own revenues (taxes and fees, as transfers are excluded from own subnational revenues) in general government revenues – theory does not provide clear predictions on its impact on fiscal balances. On the one hand, a high value on this variable means that subnational governments have more own resources to cover a given amount of expenditures, leading to better fiscal balances. On the other hand, this variable tells us nothing on the relative size of subnational own revenues *compared to their expenditures* which is probably a better way to capture subnational incentives to behave in a financially responsible way. Moreover, the impact of own revenue decentralisation may also differ based on whether it goes together with a high or low share of transfers/taxes in subnational revenues' similarly to the case of expenditure decentralisation discussed above.

3.2 *Regression results on the effect of decentralisation on the primary balance*

The first set of estimates test the impact of decentralisation on the general government primary balance (as a share of GDP). The number of independent variables (apart from decentralisation) is limited in order to keep the specification of the model parsimonious, and includes (i) the lagged debt-to-GDP ratio, (ii) the lagged output gap to control for the budgetary effect of cyclical fluctuations, (iii) the occurrence of legislative election in the year.⁵⁹ Further control variables are included in the regressions for expenditures and revenues (see below).

Then, the different decentralisation indicators are included to test the above hypotheses (see Subsection 3.1 above): expenditure decentralisation,⁶⁰ own revenue decentralisation⁶¹ the share of taxes and transfers in subnational revenues and the share of subnational expenditure

Secretariat. The indicator measures the share of subnational tax revenues on which subnational governments can change the rate and/or base. However, this exercise implies a substantial reduction of available observations as non-OECD EU Member States are not included. Moreover, this indicator has not been computed with annual frequency and is available only for 1995, 2002, 2005 and 2008, implying that the assumption of constant tax autonomy had to be made for missing years in order to compute regressions.

⁵⁹ This is systematically found to have good explanatory power of the developments of fiscal balances (see among others Mendoza and Ostry, 2008 and Gali and Perotti, 2004).

⁶⁰ Percentage of subnational governments' expenditures in general government expenditures.

⁶¹ Percentage of subnational governments' own revenues (taxes and fees) in general government revenues.

that is covered by subnational own revenues. Moreover, as the above hypotheses (points 2 and 5) also concern the impact of combinations of different aspects of decentralisation, the following interactive terms (i.e. the product of two variables) are also included in the regressions:

- (i) Expenditure decentralisation and the share of transfers in subnational revenues;
- (ii) Expenditure decentralisation and the share of taxes in subnational revenues;
- (iii) Own revenue decentralisation and the share of transfers in subnational revenues;
- (iv) Own revenue decentralisation and the share of taxes in subnational revenues.

As in Section 2 above, the sample includes all 27 EU Member States and covers the 1995–2010 period. As the model specification considered includes lagged dependent variable among the explanatory variables⁶² estimations are carried out with the Least Squares Dummy Variables Bias-Corrected estimator (LSDVC, Bruno, 2004), which corrects for the bias of Fixed Effect estimators in dynamic panel data models, i.e. panels which include the lagged dependent variable.

Results of estimates for the primary balance are shown in Table IV.3.4. The lagged debt has an expected statistically significant positive coefficient in all except the simplest specification of the model, suggesting the existence of a debt-sustainability motive in the setting of fiscal policies, whereas the lagged output gap has a negative and significant coefficient suggesting some degree of pro-cyclicality of fiscal policy across the EU. The occurrence of elections has, as expected, a negative and significant impact on the primary balance.

As for the indicators of decentralisation, expenditure decentralisation has a positive and statistically significant effect on the primary balance, whereas own revenue decentralisation has a negative and significant effect. Subnational expenditure coverage has a positive and significant effect on the primary balance, which is in line with expectations.⁶³

Expenditure decentralisation interacted with the share of transfers in subnational revenues has a negative effect on the primary balance (columns 2, 10, 12 and 13) whereas it has a (further) positive effect if interacted with the share of taxes in subnational revenues (column 3). This confirms the expectation that expenditure decentralisation has a more favourable impact on the primary balance if accompanied by a large share of own taxes and fees in subnational governments and a small share of transfers from the central government.

The interactive term of own revenue decentralisation⁶⁴ with the share of taxes in subnational revenues, has a positive and significant coefficient (columns 6 and 8). Such an effect approximately offsets the negative effect on primary balance of own revenue decentralisation *per se*. On the other hand, the interactive term of own revenue decentralisation and the share of transfers in subnational revenues has a negative and significant coefficient (column 9). The shares of taxes and transfers have, respectively, a positive and negative effect on the primary balance also when included individually (columns 4 and 5).

⁶² This is the case, for instance, for the primary balance as it is commonly found to exhibit a high degree of time persistence

⁶³ In order to test whether the impact of decentralisation changes with the strictness of subnational fiscal rules, subnational expenditure coverage is also interacted with the strictness of balanced budget rules and debt rules applying to subnational governments. The resulting coefficients are statistically insignificant in both cases (not shown).

⁶⁴ As explained in Chapter IV.1 these own revenues are taxes and fees or charges levied on local services.

Finally, as explained above, a robustness check of the impact of the weight of subnational taxes on the fiscal balance was carried out by estimating the effect of 'true' tax autonomy, i.e. the weight of taxes for which subnational governments can change rate and/or base (see above). This is captured via three interactive terms:

- (i) Share of subnational tax revenues on which subnational governments can exert autonomy multiplied by the share of taxes in total subnational revenues; this would capture the share of 'truly' autonomous revenues (column 13);
- (ii) Expenditure decentralisation times the term (i), in order to test the joint impact of large decentralisation on the spending side and large 'true' revenue autonomy (column 11);
- (iii) Share of subnational expenditures covered by subnational taxes and fees times the share of subnational tax revenues on which subnational governments can exert autonomy; this would capture the coverage of subnational expenditures by effectively autonomous revenues (column 12).

Results confirm expectations: greater 'true' tax autonomy improves the primary balance as all the three terms have a positive and significant coefficient.⁶⁵

Table IV.3.4: Regressions on the effect of fiscal decentralisation on the primary balance of general government (LSDVC estimator, EU27, 1995–2010)

	1	2	3	4	5	6	7	8	9	10	11	12	13
VARIABLES	Pb												
L.D	0.03*	0.03***	0.03**	0.03*	0.03**	0.03**	0.02*	0.03**	0.03**	0.03***	0.04**	0.04***	0.04***
L.og	-0.1**	-0.12***	-0.1**	-0.09*	-0.09**	-0.08*	-0.06	-0.05	-0.06	-0.09	-0.08	-0.1**	-0.1**
Expdec.	0.12**	1.19***	0.13**	0.22***	0.28***	0.22***	0.4***	0.47***	0.52***	1.22***	0.57***	1.2***	1.2***
Revdec	-0.12*	-1.15***	-0.43***	-0.36***	-0.45***	-0.81***	-	-1.27***	-0.5***	-	-	-1.7***	-1.7***
Expcov							0.19***	0.18***	0.16***	0.17***	0.37***	0.3***	0.3***
Expdec* trsf		-1.12***								0.89***		0.76***	0.74***
Ele	-0.45*	-0.43*	-0.44*	-0.44*	-0.37	-0.42*	-0.29	-0.28	-0.25	-0.3	-0.31	-0.26	-0.26
Expdec* tax			0.34**								-0.02		
% tax				0.08***									
% trsf					-0.11***								
Revdec* tax						0.87***		0.73***					
Revdec *trsf									-	1.15***			
Tax *auton													0.06**
Expdec *tax*auton											0.04***		
Expcov* auton												0.05***	
Obs.	405	405	405	405	405	405	405	405	405	405	297	297	297

⁶⁵ Moreover, when the term (ii) is included the interactive term of expenditure decentralisation and the share of taxes in subnational revenues is no longer significant (column 11), suggesting that it is the true tax autonomy rather than the share of tax revenues assigned to subnational governments as such which improves fiscal balances.

Number of panel	27	27	27	27	27	27	27	27	27	27	21	21	21
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Source: Commission services.

List of variables: pb = primary balance of general government (% of GDP), L.D = lagged stock of debt of general government (% of GDP), L.og = Lagged output gap (% of potential output), Expdec = expenditure decentralisation, Revdec = own revenue decentralisation, Expcov = coverage of subnational expenditures by own resources, Expdec*trsf = expenditure decentralisation*share of transfers in subnational revenues, Ele = legislative elections (1 if elections occurred in the year, 0 otherwise), Expdec*tax = expenditure decentralisation*share of taxes in subnational revenues, % tax = share of taxes in subnational revenues, % trsf = % of transfers in subnational revenues, revdec*tax = own revenue decentralisation* share of taxes in subnational revenues, revdec*trsf = own revenue decentralisation* share of transfers in subnational revenues, tax*auton = share of taxes in subnational revenues*share of autonomous taxes in subnational tax revenues, expdec*tax*auton = expenditure decentralisation*share of taxes in subnational revenues*share of autonomous taxes in subnational tax revenues, expcov*auton = coverage of subnational expenditures by own resources* share of autonomous taxes in subnational tax revenues

***, **, *: coefficient estimates statistically significant at the 1, 5 and 10% level, respectively.

Table IV.3.5 presents the results of a model similar to the one used for Table IV.3.4, but enriched with the addition of terms interacting overall expenditure decentralisation with the decentralisation of expenditures in three government functions, i.e. health care, social protection and general services (columns 1 to 3) in order to test the hypothesis in point 3 above. These terms all have negative and significant coefficients, implying that if overall expenditure decentralisation is positive per se for the primary balance, this effect is partly counteracted if accompanied by large decentralisation in general services, social protection and health.⁶⁶ This was already detected among the stylised facts in Section 2 only for general services.

Interactive effects between overall expenditure decentralisation and decentralisation by *economic* function are also tested for public consumption, compensation of employees and social benefits (columns 4 to 6.) The coefficients for the first and the third term are insignificant, whereas the coefficient on employee compensation is positive and significant, suggesting, quite surprisingly, that a large subnational share in the expenditure for compensation of employees improves the positive effect of overall expenditure decentralisation on the primary balance.⁶⁷ The other indicators of decentralisation retain the usual sign and significance.

Table IV.3.5: Results of regressions with the primary balance of general government as dependent variable and decentralisation by government function and by economic function included among regressors (LSDVC estimator, EU27, 1995–2010)

	1	2	3	4	5	6
VARIABLES	pb	pb	pb	pb	pb	pb
L.D	0.0530***	0.0483***	0.0358***	0.0335***	0.0286**	0.0333***
L.og	-0.154***	-0.148***	-0.152***	-0.128***	-0.131***	-0.116***
Expdec	1.414***	1.315***	1.529***	1.215***	1.018***	1.148***
Revdec	-1.297***	-1.288***	-1.340***	-1.151***	-1.151***	-1.144***
Ele	-0.504**	-0.474*	-0.518**	-0.425*	-0.395*	-0.448**
Expdec * trsf	-1.191***	-1.123***	-1.348***	-1.127***	-1.119***	-1.108***
Expdec * decHealth	-0.123***					

⁶⁶ The same test was carried out also for decentralisation of education expenditures, which turned out to be insignificant.

⁶⁷ Clearly, it is quite difficult to interpret this finding as there are no clear economic reasons on why local governments should be more disciplined than the central government in their wage expenditures.

Expdec. * decSoc		-0.242**				
Expdec * decGS			-0.528***			
Expdec. * decCons				-0.0788		
Expdec * decWag					0.417**	
Expdec. * decSocBen						0.188
Observations	382	382	383	405	405	405
Number of panel	27	27	27	27	27	27

Source: Commission services.

List of variables: see Table IV.3.4 above. New variables added: Expdec * decHealth = expenditure decentralisation * subnational share of general government expenditure for health care, Expdec * decSoc = expenditure decentralisation * subnational share of general government expenditure for social protection, Expdec * decGS = expenditure decentralisation * subnational share of general government expenditure for general services, Expdec * decCons = expenditure decentralisation * subnational share of general government expenditure for consumption, Expdec * decWag = expenditure decentralisation * subnational share of general government expenditure for compensation of employees, Expdec * decSocBen = expenditure decentralisation * subnational share of general government expenditure for social benefits.

***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.

3.3. Regression results on the effect of decentralisation on expenditures and revenues

Expenditures

Regressions were also estimated with general government primary expenditure (as a share of GDP), instead of the primary balance, as the dependent variable (see Annex 2). The model is adapted relative to the one for primary balance with the addition of inflation and trade openness as further control variables (Eyraud and Lusinyan (2011).) Focusing on the decentralisation indicators the following findings can be highlighted:

- (i) Overall expenditure decentralisation has a negative and significant coefficient, suggesting that expenditure decentralisation per se tends to *decrease* the magnitude of overall expenditures of the general government.
- (ii) Subnational own revenue decentralisation has a positive and significant effect on expenditures.
- (iii) The interaction between expenditure decentralisation and the share of transfers and of taxes in subnational revenues have a *positive and negative* effect, respectively (both significant).
- (iv) The same is found for the interaction between own revenue decentralisation and the share of transfers and taxes in subnational revenues, respectively.

These findings contradict the stylised facts discussed in Section 2 above, which suggested a positive correlation between expenditure decentralisation and total expenditures. This confirms the need to interpret stylised facts based on simple correlations with special caution and the importance to check their robustness through econometric analysis. This finding also disconfirms the hypothesis (1) above and confirms opposite arguments proposed in the literature whereby decentralising expenditures should increase public sector efficiency due to better tailoring of public services to subnational preferences and 'healthy' competition and mutual learning across subnational governments on the most efficient ways to provide public services.

Stylised facts in Section 2 also suggested that large subnational financial responsibility, a large share of taxes in subnational revenues and a lower share of transfers were also

associated to higher expenditures, whereas the reverse is found in the above regression which properly controls for the impact of several variables. In other words, whereas from the stylised facts it seemed that the positive effect of high subnational financial responsibility and high subnational taxes/low transfers on the primary balance only came from the revenue side, the regression shows that it also comes from restraints on expenditures, which is more consistent with literature predictions.

As regards the functional composition of expenditures, the interactive term of expenditure decentralisation with decentralisation by function has a positive and significant coefficient only for expenditure on general services, meaning that if overall decentralisation leads per se to lower expenditures this is partly undone by large decentralisation of general services. Therefore, stylised facts suggesting a specific role of decentralisation of health, education and social protection in affecting expenditures are not confirmed.

Revenues

Finally, the impact of fiscal decentralisation on revenues was estimated through regressions with, alternatively, general government revenues and the tax burden (both as shares of GDP) as the dependent variable to add a further robustness check (see Annex 2).⁶⁸

Expenditure decentralisation does not appear to have a significant effect on revenues or on the tax burden. On the other hand, own revenue decentralisation has a negative and significant effect, whereas its interaction with the share of transfers becomes insignificant and its interaction with the share of taxes in subnational governments has a positive and significant effect on the tax burden only. Similarly the interaction between expenditure decentralisation and the share of transfers in subnational revenues is insignificant, whereas the interaction with the share of taxes is positive and significant. The subnational expenditure coverage by own resources has a positive and significant coefficient.

Overall it appears that the impact of decentralisation is stronger on the expenditure than on the revenue side, although two dimensions of it also affect revenues in a way which is consistent with their impact on primary balance and expenditures. These are the decentralisation of own revenues, which according to these results increases spending and decreases revenues, thereby adversely affecting fiscal balances from both sides, and the subnational expenditure coverage by own resources, which decreases expenditures and increases revenues, hence positively affecting fiscal balances from both sides. Also, a high relative weight of taxes in subnational revenues appears to (weakly) improve revenues for a given level of expenditure and revenue decentralisation.

4. Fiscal rules, decentralisation and fiscal outcomes

This Section complements the analysis carried out so far by looking at the role of fiscal rules constraining the fiscal behaviour of subnational governments. Data used are the indexes of strictness of such rules computed by DG ECFIN based on information provided by the Member States.⁶⁹ Essentially, the aim is to assess two aspects:

⁶⁸ To check for the possibility that tax revenues may be more affected by the economic incentives created by the governance structure of a country.

⁶⁹ http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

(1) Whether fiscal rules constraining the behaviour of subnational governments are used more frequently in highly decentralised countries and whether there is a tendency to adopt a specific type of rules (i.e. balanced budget vs. debt rules) at subnational level.⁷⁰ As regards the first question, it is logical to expect that when subnational governments have more fiscal power on both the expenditure and revenue side central governments attempt to constrain their behaviour via fiscal rules.

(2) Whether the relationship between fiscal decentralisation and fiscal outcomes changes in presence of strict subnational fiscal rules so that rules act as a substitute to subnational financial responsibility/large reliance on taxes as a tool to increase fiscal discipline.

As regards question (1), Table IV.3.6 below, looks at whether different dimensions of fiscal decentralisation go together with stricter fiscal rules at subnational level.

Table IV.3.6: Strictness of fiscal rules applying to subnational governments, averages for observations with low and high values of different indicators of fiscal decentralisation (EU27 Member States, 1995-2010 period)

Expenditure decentralisation	Strictness fiscal rules – subnational gov.	Strictness debt rules – subnational gov.	Strictness balanced budget rules – subnational gov.
Low	1.9	1.2	0.6
High	4.9	1.1	2.4
Own revenues decentralisation			
Low	2.6	1.3	0.7
High	4.4	0.9	2.7
Subnational expenditure coverage by own subnational revenues			
Low	3.5	1.6	1.0
High	3.2	0.8	1.9
% of taxes in subnational revenues			
Low	3.3	1.7	0.7
High	3.4	0.6	2.2
Transfer dependency			
Low	3.2	0.7	2.0
High	3.6	1.7	0.9

Source: Commission services

The Table shows that subnational fiscal rules tend to be much stricter when expenditure decentralisation and own revenue decentralisation are high. As for the type of rules used, on average, balanced budget rules applying to subnational governments are much stricter when expenditure and own-revenue decentralisation are high, as well as when the tax share in subnational revenues and the subnational financial responsibility⁷¹ are high, while they are looser when transfer dependency is higher. On the other hand, strictness of debt rules does not change significantly with expenditure decentralisation; however it is correlated with the other decentralisation indicators with opposite sign compared to balanced budget rules, i.e. debt rules are looser with high own revenue decentralisation, high expenditure coverage with own subnational revenues and high share of taxes in subnational revenues, whereas they are stricter when transfer dependency is lower.

⁷⁰ As regards the second point, it is expected that balanced budget rules should be more frequently used than debt rules at subnational level as subnational governments are quite constrained in their possibility to issue debt anyway (e.g. due to lower access to capital markets).

⁷¹ High expenditure coverage with own resources.

Overall, fiscal rules applying to subnational governments are stricter in more fiscally decentralised countries, in line with expectations. With respect to the type of rules applying to subnational governments, balanced budget rules are stricter in countries with higher subnational financial responsibility and greater reliance on taxes compared to transfers, whereas debt rules are stricter in the opposite case.

This appears to disconfirm the substitutability story as far as balanced budget rules are concerned, i.e. they are not used to correct for weak subnational fiscal discipline in case of high transfers and vertical fiscal imbalances. On the other hand, the argument may be valid as far as debt rules are concerned. Moreover, this finding raises the hypothesis that the positive effect of financial responsibility and high taxes/low transfers on the fiscal balance found in Section 3 above may in reality be due to the more frequent use of balanced budget rules constraining subnational behaviour.

These hypotheses were tested through regression analysis (see Table IV.3.7 below). The above model with the primary balance as dependent variable was enriched by including the strictness of rules applying to subnational governments (column 1), its balanced budget rule and debt rule component (column 2 and 3, respectively). Further tests were carried out with interactive terms testing the joint impact of balanced budget rules and, respectively, expenditure decentralisation with high share of taxes in subnational revenues and the subnational expenditure coverage by own resources (columns 4 and 5 respectively, to test whether the effect of the latter variables is in fact due to the fact that they tend to be accompanied by balanced budget rules), the joint impact of balanced budget rules and, respectively, expenditure decentralisation (column 6) and own revenue decentralisation (column 7) and the joint impact of debt rules and expenditure decentralisation with large share of transfers in subnational revenues (column 8, to test whether decentralisation with large transfers is less harmful for fiscal balance if accompanied by debt rules).

Overall, regression results suggest that strictness of fiscal rules in general and of balanced budget rules in particular applying to subnational governments do not affect the impact of fiscal decentralisation on the primary balance. Specifically, the positive impact of subnational financial responsibility and a large reliance on taxes compared to transfers does not appear to be due to their positive correlation with the presence of balanced budget rules applying to subnational governments, as all the corresponding interactive terms are insignificant. On the other hand, debt rules applying to subnational governments appear to have a positive effect on fiscal balance on their own (column 4) and to slightly counteract the negative budgetary effect of expenditure decentralisation accompanied by large transfers.⁷²

Table IV.3.7: Results of regressions on the effect of fiscal decentralisation and fiscal rules on primary balance and expenditures of the general government (EU27, 1995-2010, LSDVC estimator)

	1	2	3	4	5	6	7	8	9	10
VARIABLES	pb	pb	pb	pb	pb	pb	pb	pb	primexp	primexp
L.D	0.03**	0.0289**	0.0346***	0.0289**	0.0294**	0.0283**	0.0287**	0.0337***	-0.0234*	-0.0223*
L.log	-0.0691*	-0.0691*	-0.0750*	-0.0681*	-0.0667	-0.0702*	-0.0681	-0.0947**	0.174***	0.179***
Expdec	0.398***	0.400***	0.403***	0.397***	0.399***	0.402***	0.396***	1.232***	-0.782***	-0.790***
Revdec	-0.995***	-1.004***	-1.012***	-0.995***	-1.000***	-1.001***	-0.988***	-1.494***	0.936***	0.951***
Expdec * tax	0.292**	0.328**	0.311**	0.333**	0.315**	0.337**	0.327**			

⁷² See positive and significant coefficient of the corresponding interactive term in column 8.

Expcov	0.190***	0.187***	0.197***	0.186***	0.190***	0.186***	0.186***	0.176***	-0.0850***	-0.0850***
frilg	-0.0376									
fribbr		-0.137								
fridr			0.183*						-0.240**	
Expcov * fribbr					-0.00164					
Expdec * fribbr						-0.00403				
Expdec * trsf								-0.910***	0.662***	0.682***
Revdec * fribbr							-0.00565			
Expdec * trsf * fridr								0.0100*		-0.0130**
Expdec * tax * fribbr				-0.00550						
Ele	-0.282	-0.286	-0.288	-0.299	-0.290	-0.296	-0.297	-0.288	0.0739	0.0553
L.infl									0.0358***	0.0354***
TO									-0.539	-0.625
Observations	405	405	405	405	405	405	405	405	401	401
Number of panel	27	27	27	27	27	27	27	27	27	27

Source: Commission services

List of variables: see Table IV.3.4 and IV.3.6 above, new variables added: frilg = strictness of fiscal rules applying to Subnational Governments (SNG), fribbr = strictness of balanced budget rules applying to SNG, fridr = strictness of debt rules applying to SNG, Expcov * fribbr = coverage of subnational expenditures by own resources * strictness of balanced budget rules applying to SNG, Expdec * fribbr = expenditure decentralisation * strictness of balanced budget rules applying to SNG, Revdec * fribbr = own revenue decentralisation * strictness of balanced budget rules applying to SNG, Expdec * trsf * fridr = expenditure decentralisation*share of transfers in subnational revenues* strictness of debt rules applying to SNG, Expdec * tax * fribbr = expenditure decentralisation*share of taxes in subnational revenues* strictness of balanced budget rules applying to SNG.

***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.

Finally, in order to test if the positive effect of debt rules occurs via the expenditure side, two further tests were carried out by enriching the model for primary expenditures discussed in Section 3 above with the two terms capturing the impact of debt rules (see above). Results show that debt rules have a negative and significant effect on primary expenditures (column 9) and that they reduce the positive impact on expenditures of expenditure decentralisation accompanied by large transfers (column 10).

Overall, the conclusion is that, while balanced budget rules do not change the relationship between decentralisation and fiscal outcomes, debt rules applying to subnational governments reduce the negative effect on the fiscal balance of a large weight of transfers in subnational revenues, and this effect occurs through the expenditure side.

5. Conclusions

Although it is highly challenging to summarise in a few lines all the analysis shown in this Chapter, a number of key points can be highlighted as regards the effect of fiscal decentralisation on general government fiscal outcomes.

(1) Expenditure decentralisation per se appears to be associated with better fiscal balances compared to cases of low decentralisation. This reflects a negative effect on expenditures whereas the effect on revenues is not significant according to regression analysis. This finding lends support to a few economic arguments proposed in the literature which underline that subnational governments should be more able to tailor public goods to subnational

preferences and that competition and mutual learning among subnational governments should help them select more cost-effective techniques for the production of public goods. This should in turn lead to more efficient expenditure in more decentralised countries *ceteris paribus* with positive effects on the primary balance.

(2) The revenue side of decentralisation plays a key role in shaping the net effects of decentralisation on fiscal outcomes. Regression results suggest that expenditure decentralisation accompanied by low subnational financial responsibility to cover their expenditures with their own resources (i.e. taxes and fees) and by a large share of transfers from the central government in subnational revenues is likely to be overall detrimental for the fiscal balance. On the other hand, the budgetary effect of decentralisation is more favourable if it goes together with a large coverage of subnational expenditures by own resources and a large weight of taxes in total subnational revenues. This result reflects effects on both the expenditure and (albeit to a lesser extent) the revenue side.

This result confirms literature predictions which underline that if subnational governments largely depend on transfers from the central government they would be subject to a soft-budget constraint as they would take it for granted that possible excess spending from their part would be eventually covered by a 'bail-out' from the central government. On the other hand, if they can raise sufficient own resources to cover most of their expenditures and the weight of transfers is low the central government can more easily resist bail-out pressures. Moreover, in the latter case subnational policy-makers are more accountable to subnational voters as the link between subnational taxes paid and subnational public goods delivered is stronger which also exerts a disciplining effect on subnational governments fiscal behaviour.

(3) This conclusion is strengthened by the finding on the positive effect on the primary balance of 'effective' tax autonomy, i.e. of a large weight of taxes on which subnational governments can exert autonomy with respect to the rate and/or the base. This suggests that the positive effect of decentralisation on primary balance is improved not only if subnational tax revenues are high and transfers low but also if subnational governments can set those taxes autonomously.

(4) The most puzzling result concerns decentralisation of own revenue sources, i.e. a high share of tax revenues and fees assigned to subnational governments in total general government revenues, which has an adverse effect on the primary balance, reflecting an increasing effect on expenditures and a decreasing one on revenues. On the one hand, this contradicts the idea that devolving relatively large own revenues sources to subnational governments is positive for fiscal discipline which would follow logically from the above mentioned arguments on the benefit of subnational revenue autonomy, responsibility, avoiding soft-budget constraints etc. Upon closer reflection, though, this variable is less suitable than those discussed in point 2 above to capture those aspects as it tells nothing on the size of own revenues relative to subnational expenditures and on the relative weight of transfers vs. taxes and fees in subnational revenues. This does not yet explain the fact that it has an adverse effect on the budget balance, though, rather than being simply insignificant. Further research would be advisable on this issue.

(5) Finally, divergences between stylised facts based on simple or conditional correlations and results of regression analysis, in particular with respect to the impact of expenditure decentralisation, subnational financial responsibility and the relative size of taxes vs. transfers

on expenditures, highlight the need to simultaneously control for several features of fiscal decentralisation to disentangle their impact on the fiscal outcomes of the general government.

(6) As for the impact of rules constraining the fiscal behaviour of subnational governments; stricter debt rules appear to affect positively the primary balance via restraints on expenditures. Moreover, they partly alleviate the negative effect of expenditure decentralisation combined with a large share of transfers in subnational revenues, suggesting a partial substitutability between debt rules and subnational fiscal responsibility/large share of own resources as a tool to encourage fiscal discipline. On the other hand, the budgetary impact of fiscal decentralisation does not appear to be affected by stricter balanced budget rules applying to subnational governments.

Overall, it appears that fiscal decentralisation matters for fiscal outcomes and that the interplay between the expenditure and the revenue side of it is crucial to determine its net effect on fiscal balances. Overly pessimistic statements, often heard recently, on a generalised fiscal deterioration caused by increasing fiscal decentralisation across the EU do not seem to find support in the data. This may have occurred in some Member States, but probably not as a result of decentralisation *per se* but of a 'bad' design of decentralisation, i.e. one which does not ensure strong financial responsibility of subnational governments.

Annex 1: national fiscal decentralisation arrangements in the EU – country fiches

AUSTRIA

1) General description

Austria is a federation, where government responsibilities are shared among three different territorial levels: federal, regional (9 states) and local (2357 municipalities). As in other similarly organised countries, the reasoning behind the federal structure is that it provides increased efficiency from the decentralisation of allocative functions and that public services should be produced and financed in accordance with the preferences of the residents of the area that enjoys the benefits⁷³. Compared with the degree of fiscal decentralisation in other countries, Austria is moderate in terms of the share of sub-national government outlays in total general government spending (34% in 2010) and at the lower-medium end when it comes to the contribution of sub-national governments' own revenue to total public sector revenue (2%)⁷⁴.

The relations between the three layers of government in Austria are defined by the Fiscal Constitutional Law (1948) and governed by the periodically negotiated Fiscal Equalisation Law (Finanzausgleichsgesetz - FAG) and the Austrian Stability Pact (ASP). The three layers of government coordinate their medium-term budgetary plans in the FAG, which allocates the revenues to territorial authorities for the period of six years (previously four years). The law specifies the types of taxes that are to be shared among the three levels of government, as well as the proportion at which they are to be divided among them. Revenues from most of the tax categories are collected by the federal government and then distributed to the three levels according to the key agreed on in the FAG negotiations. A part of the revenue from the shared taxes is withheld before the distribution to the various levels of government and earmarked for special purposes, e.g. financing of family benefits. The FAG also determines the horizontal distribution of revenues at the regional and local level. The rules set out in the FAG are rather complex and lacking in transparency. Not only are revenues from most individual taxes shared among the three territorial levels in fixed proportions, but also decision-making in many areas is divided among various levels of authority. Revenue-raising and spending responsibilities for different activities do not reside within the same level of government. In its present form, the system does not encourage the agents involved to use resources in the most efficient way and keep firm control over spending. Therefore, there is considerable potential for increasing efficiency in the public sector.

2) Government spending

Austria's Fiscal Constitutional Law defines the spending competences of the federal government, the main ones being tertiary education, parts of social policy (family allowances and private sector pensions), unemployment benefits, internal security, justice, foreign policy, defence and national infrastructure. The competences not listed by the Constitution fall in the remit of the states. These include: social assistance, health care (hospitals), parts of primary

⁷³ Balassone F. and D. Franco (2005), *Fiscal federalism in Fiscal Policy in Economic and Monetary Union*, Edward Elgar, Cheltenham, UK

⁷⁴ Bergvall, D. et al (2006), *Intergovernmental Transfers and Decentralised Public Spending*, OECD, Journal on Budgeting, Volume 5, No. 4

and secondary education, environment and regional infrastructure. Communes are responsible mainly for local planning, the functioning of local infrastructure (roads, waste and water management) as well as for providing such services as obligatory education, kindergartens, old peoples' homes etc. The problem with the Austrian municipalities lies in the fact that many of them are very small (more than half of them have less than 5000 inhabitants), which makes the provision of local services very costly.

A marked weakness of the set-up of inter-governmental relations in Austria lies in the fact that in many areas the decision-making, funding and spending responsibilities are shared by different levels of government. Streamlining of these competences could potentially result in significant efficiency gains and reduction in public expenditure. The most notable examples here are health care and education systems.

The Austrian health care system is organised in a fairly complex way. The social security system funds practising physicians. In terms of hospitals, the federal government sets out framework conditions, but the real decision-making powers lie with the states, even though they provide less than half of the government outlays for hospitals (the rest comes from social insurance as well as from the federal and local governments). In running hospitals, the states and municipalities do not always pursue an exclusively health services provision agenda. There are also economic and political interests at stake, which make closing down of redundant hospitals literally impossible in many cases. Since different actors are responsible for the in-patient and out-patient services, there is no incentive to move workload from costly hospitals to practising physicians whose services are cheaper. The number of hospital stays in Austria is one of the highest among the OECD countries. According to the federal audit court, hospital services worth more than 1% of GDP should be shifted from the hospital service to practising physicians⁷⁵.

The financing of the education system is also highly controversial. The federal government is responsible for the curriculum and funds teacher salaries to a large extent. The latter, though, are formally employed by the states, which have far-reaching competences in terms of organisation of schooling (among others the determination of pupil numbers per class and teaching periods). Such division of competences does not encourage effective allocation of resources. In fact, cross-country efficiency analyses show that Austria spends roughly the same amount on education as other economies (i.e. Finland), but the performance in PISA is relatively poor.

3) Financial arrangements

The three layers of government coordinate their medium-term budgetary plans in the FAG, which allocates the revenues to territorial authorities, usually for the period of six years. The law specifies the types of taxes that are to be shared among the three levels of government, as well as the proportion according to which they are to be divided among them. Most of the tax categories are collected by the federal government and then distributed to the three levels according to the key agreed on in the FAG negotiations. A part of the revenue from the shared taxes is withheld before the distribution to the various levels of government and earmarked for special purposes, e.g. financing of family benefits. The federal government receives about 73% of the remaining revenue from the shared taxes. The states and municipalities get about

⁷⁵ *Vorschläge des Rechnungshofes zur Verwaltungsreform und zum Bürokratieabbau*, Positionen Reihe 2007/1, August 2007

15% and 12%, respectively⁷⁶. A significant part of the shared revenue that flows to the regional and local governments is earmarked for special spending activities. Some of these flows require co-financing by the sub-national authorities. As a last step, the FAG determines a horizontal distribution of the revenue at the regional and local level.

Own tax resources (generated and collected within a given state or municipality) constitute a significant part of the local government revenue. However, the only significant tax parameter, which municipalities can set autonomously, is the real estate tax rate. Own tax resources are negligible in the case of the states, indicating a very low degree of tax autonomy. In fact, by international standards Austria is one of the countries where the share of own tax in the regional government's revenue is the lowest (about 2% of the total)⁷⁷. On the one hand, economic theory suggests that the central government should collect taxes from tax bases that are more mobile, more sensitive to cyclical factors and less uniformly distributed⁷⁸. On the other hand, though, splitting the funding and spending powers, like in Austria, weakens the cost-benefit relationship associated with public services, thereby reducing the allocative advantages of a federal structure⁷⁹.

The FAG also defines rules governing the inter-governmental transfers which in 2009 constituted 41%, 16% and 27% of the total revenues of the regional authorities, local authorities and social security funds respectively⁸⁰. The system of transfers was established to ensure that each level of government has at its disposal sufficient means to carry out the tasks assigned to it by the legislation. However, these transfers make the fiscal relations between the three layers of government overly complex and in many instances disincentivise efficient use of funds. The FAG negotiated in 2008 introduced the conversion of some of the transfers from the federal government to the state and local governments into revenue shares which are devoted to certain activities (e.g. housing assistance scheme and road maintenance). This introduced some transparency to the most opaque part of fiscal federal relations, but further steps toward simplification of the system are needed.

Austria's Federal Budgetary Law enables the federal finance minister to enter into credit transactions on behalf of the states through the Austrian Federal Financing Agency (AFFA). The Agency carries out a quarterly survey of the states' financial needs. The amount of debt issued by the federal government for the financing of the states cannot surpass 20% of total general government expenditure in the given year. In the period 2009-2011 about 4.4% of the potential amount was used on average⁸¹. Austria's Fiscal Constitutional Law gives the states the competence to adopt legislation regulating credit operations of the communes. As a general rule, municipalities are only allowed to take loans in order to cover extraordinary expenditure. However, the conditions which govern granting the approval for drawing debt by communes differ significantly between states in terms of e.g. which types of transactions have to be notified and starting from which amount. Nevertheless, a common feature is that in most states, the credit approval conditions concerning cities are more lenient than those regarding smaller local governments on the assumption that the former are equipped with superior

⁷⁶ Fuentes, A. et al (2006), *Reforming federal fiscal relations in Austria*, OECD, Economic Department Working Papers no. 474

⁷⁷ Schratzenstaller, M. (2007), *Undurchschaubares Transfergeflecht* in der Standard, 25 October

⁷⁸ Balassone F., Franco, D. (2005), *Fiscal federalism in Fiscal Policy in Economic and Monetary Union*, Edward Elgar, Cheltenham, UK

⁷⁹ Oates, W. (1972), *Fiscal Federalism*, New York: Harcourt Brace Jovanovich

⁸⁰ *Öffentliche Haushalte in Österreich* (2010), editor G. Steger, Verlag Österreich, Vienna

⁸¹ *Refinanzierungsmöglichkeiten der Bundesländer über die OeBFA* (2011), presentation by M. Oberndorfer, Vienna, November

know-how in terms of debt risk management⁸². The AFFA plays only advisory role for the municipalities.

4) Fiscal rules

The Austrian Stability Pact (ASP), which prescribes deficit/surplus targets (so-called “stability contributions”) to the federal, regional and local governments, was first set up informally in 1996 in the context of Austria’s preparation for entering the euro area, which required significant fiscal consolidation. The ASP was meant to solve the asymmetry created by the high degree of decentralisation of fiscal policy responsibilities at national level on the one hand and the introduction – at the European level - of rules (i.e. Stability and Growth Pact) on the other, assigning responsibility for the general government balance solely to central governments. In 1999, this enforcement mechanism was formalised for the first time. Its successors were then adopted for the 2001-2004, 2005-2008, 2008-2013 and 2011-2014 periods. The FAG foresees financial sanctions in case a State does not ratify the ASP. Once ASP is ratified it fixes the amount of the sanction in case of non-compliance, which takes the form of an interest-bearing deposit. If in the following year the respective target is not reached, the deposit is supposed to be transferred to those governments that are in compliance. However, if the target is achieved, the deposit would be reimbursed. The sanction option has never been used under the Pact as it covered all deviations from numerical targets (negative deviations were compensated by positive deviations).

The ASP is a useful tool aimed at involving all levels of government in the consolidation of public finances. In providing for legally-enshrined budgetary commitments across various government levels, Austria can be considered as a benchmark in the EU. Nevertheless, it should be noted that after an initial stage of general compliance with the Pact in the years 1999-2002, slippages occurred in individual years at all levels of government. However, since according to the ASP's rule the targets were met on average within the duration of the subsequent Pacts, the sanctions foreseen by the ASP have never been used. Initially budgetary surpluses were meant to make up only for the slippages in the past and were not supposed to be carried over to future years. Subsequently, the initial approach towards carry-overs was criticised as pro-cyclical and carry-over of surpluses was admitted with the aim of reaching the goals on average within the duration of the Pact. It should be noted that, striving to fulfil their obligation under the ASP, sub-national governments resorted to some methods that went against the spirit of the Pact, such as reclassification of public entities, transfer of real assets to various federal and regional real estate companies, etc. These were, however, not accepted as part of the stability contributions. Following the recent financial and economic crisis, the discrepancy between the ASP goals and the budgetary outcomes became so significant that the goals were revised in March 2011. This revision was accompanied by strengthening of the enforcement mechanism of the Pact, which consisted among others in shifting the focus back to attaining the budgetary goals in individual years, enhancing the role of the Court of Auditors and making the launch of the sanctioning procedure automatic. This should increase the effectiveness of the Pact, but at the same time it should be noted that the revised budgetary goals under the 2011-2014 Pact were significantly less ambitious than those in the past. In the Pact editions between 2001 and 2010, the local and state governments were required to run balanced budget or come up with surpluses, respectively, whereas now deficits (albeit gradually decreasing) are allowed on both levels. Also, the federal government now has the right to close its books with much higher deficits than in the past (average deficit of 2.5% of GDP in the period 2011-14 versus 1.2% of GDP in the years 2001-2010).

⁸² Grossmann, B. and E. Hauth, (2009), *Kommunales Risikomanagement und Aufsichtsbehördliche Kontrolle in Österreich*, Studie im Auftrag des Staatsschuldenausschusses, April 2009

Currently, the latest edition of the ASP is being renegotiated yet again in order to align it with the debt brake ("Schuldenbremse") introduced in December 2011, which limits the structural federal government deficit to 0.35% of GDP starting in 2017. The original attempt to anchor the debt brake limiting the structural general government deficit to 0.45% of GDP in the Constitution failed due to insufficient support by the parliamentary opposition parties. In spite of the lack of the constitutional status i.e. not having bearing on sub-national authorities, the states committed to respect it too. This is supposed to be reflected in the updated goals of the ASP, which should be agreed on in May 2012.

5) Need for reform

The need for reform of the set-up of the fiscal relations between the three layers of government in Austria has been discussed for decades. Numerous experts' groups put forward various proposals as to how to simplify these relations and adjust them to the changed economic reality. In spite of the general consensus on the issue, the implementation of the suggested reforms has so far been very limited. The most urgent problem which needs addressing is the fragmentation of the various competences between the three levels of government. It seems that without bringing together the decision-making powers with funding and spending competences in a given area, the system will continue discouraging cost-cutting and efficient use of public means. The streamlining of competences should be accompanied by significant expansion of the tax autonomy of the sub-national authorities in order to strengthen the latter's accountability to voters and tax payers. The complicated system of transfers between the federal, regional and local authorities, which has grown over time to such an extent that it is almost completely opaque, should be substantially simplified to allow analysis of flows between the three layers of government. The division of responsibility for certain areas as well as the general formulation of goals of the FAG should be reviewed in order to bring it up to date with today's economic reality and in particular with its international context⁸³. Last but not least, merging small municipalities and improving the legal environment for cooperation between them (in particular across different states) could significantly contribute to raising the efficiency of provision of local services.

⁸³ *Grundlegende Reform des Finanzausgleichs: Reformoptionen und Reformstrategien* (2011), Technische Universität Wien, Vienna, January

BELGIUM

1. General description

Since 1970, five constitutional reforms have gradually transformed the Belgian unitary state into a federal state made up of three tiers of subnational government: six federated entities (three linguistic communities⁸⁴ and three territorial regions⁸⁵), 11 provinces and 589 municipalities. Regions and communities have legislative and administrative competences, while provinces and municipalities have administrative powers and implement upper levels' legislation. Belgium therefore has one of the most far-reaching levels of decentralisation in the EU. Although the decentralisation process has already transferred a considerable number of competences to the subnational levels, federalisation does not seem to have reached its endpoint as the federal government formed in December 2011 plans a sixth constitutional reform and a further transfer of competences.

Since the first constitutional reform of 1970, the Belgian Constitution explicitly stipulates the existence of communities and regions. From that moment on, several waves of reform (1980, 1988-1989, 1993, 2001) have transferred a considerable number of competences and hence spending authority to those federated entities. The distribution of competences among the federal state and the federated entities has been anchored in the Constitution. The federal government has spending power for all competences that do not expressly come under the authority of regions or communities. Regions are competent in areas linked to their territory. Communities are responsible for person-related matters. The distribution of these competences leads communities and regions to realise almost 24% and provinces and municipalities approximately 13% of total general government expenditure (12.7% and 7.2% of GDP)⁸⁶.

The transfer of the corresponding financial means is for the federated entities regulated by the 1989 Special Financing Act, which was amended by the Special Act of 13 July 2001 to take into account the further decentralisation of competences. This has extended the fiscal autonomy of the federated entities but has also led to a complex system of grants, shared and own-source tax revenues. The type of revenue from which subnational governments can benefit differs considerably from one tier to another. Communities benefit from shared tax revenues (mainly personal income tax and VAT) and from some non-tax revenues, whereas regions do also perceive own-source tax revenues, like registration duties, property and vehicle taxes (8.9% of total general government revenues or 4.3% of GDP). Local authorities, i.e. provinces and municipalities, do not share taxes with the federal level but benefit from own-source tax revenues, general and earmarked grants. Their revenue represents 7.5% of total general government revenues or 3.6% of GDP.

2. Government spending

A substantial number of government functions were devolved to subnational entities in Belgium. In 2010, local authorities were in charge of EUR 25 billion of public spending

⁸⁴ The German-speaking Community, the French-speaking Community and the Flemish Community

⁸⁵ The Wallonia Region, the Brussels-Capital Region and the Flemish Region

⁸⁶ 2009 data providing from the OECD Fiscal Decentralisation database

(13.8% of total public expenditure) and federated entities of EUR 53 billion (28.9% of total public expenditure). As often subnational governments are only in charge of part of a government function, the remaining competences that were not expressly attributed to one of the sub-levels stay under the authority of the federal state. As a result, most of the government functions are scattered among the different government tiers.

At local tier, subnational governments are mainly involved in general public services, education, social protection and public order and safety. Provinces have spending power in certain person-related areas, like secondary and higher education, and are responsible for the general affairs of the provinces. Municipalities' spending competence includes local planning, elections and registration, as well as police and some social protection functions, like public social welfare centres.

At the level of the federated entities education is by large the most important spending item, followed by economic affairs, social protection and general services. Those competences that are person-related were mainly attributed to the communities, whereas territory-linked areas are under the competence of regions. Hence, communities are highly involved in education, as they finance large parts of primary, secondary and higher education. Regions are largely involved in economic affairs like agriculture and transport, as well as in environmental protection and housing.

The federal state remains largely in charge of general public services and it is the only government tier competent for defence matters. The federal state spends almost two thirds of its budget on general services, while approximately 5% is spent on defence. Although health is a person-related service and is therefore expected to be part of the communities' responsibilities, it is the federal state that has the largest spending power with respect to that economic function.

The federated entities and local authorities are autonomous in designing and implementing policies in the areas of competence which were attributed to them⁸⁷. Once a responsibility is transferred to a subnational government, the federal state no longer has power to act or intervene regarding this matter.

An analysis by type of expenditure highlights that more than 85% of expenditures are linked to current expenditures at all government levels. The remaining part of expenditures is related to the reimbursement of capital and the payment of interest costs.

3. Financial arrangements

Throughout the several constitutional reforms, subnational governments have gained a lot of fiscal autonomy, not only from an expenditure but also from a revenue point of view. The

⁸⁷ Areas of competence of communities include cultural matters, education (except for determining the beginning and end of compulsory schooling, minimum conditions governing the granting of diplomas, and the pension plan), services offered to individuals, the use of languages in respect of administrative matters, teaching and contacts between employers and their staff, intra-Community and international cooperation, including the conclusion of treaties, in respect of cultural matters, teaching and services offered to individuals.

Areas of competence of regions include economic policy, including assistance in respect of investment and employment, employment, transportation, public works, financing of sub-ordinate powers, scientific policy pertaining to their fields of jurisdiction, energy, wastewater treatment and the protection and distribution of water, policy governing waste and environmental protection, monuments and sites, foreign trade, agriculture, international relations from the standpoint of the Regions' fields of jurisdiction.

Special Financing Act of 1989 sets the pillars for revenue allocation to the federated entities and guarantees that the latter have the means to exercise their competences. At local tier, regions regulate the funding of the local authorities and can introduce limits (regarding type and rate) on taxes set by municipalities. Hence, municipalities and provinces are subject to different financing rules, according to the region in which they are located. Whether at federated or local level, subnational financing is done through tax revenues, as well as through grants from the upper government level. All subnational entities also have the possibility to borrow.

Municipalities and provinces depend for almost half of their financing on grants from the regions. Those grants are allocated to municipal and provincial funds or are earmarked to specific projects. Local authorities are also financed through own-source taxes, which are mainly surtaxes on the federal personal income tax, the regional traffic tax and real estate tax for municipalities and on the regional real estate tax for provinces. Often the upper government level determines the tax base and the local authority sets the rate of the surtax. Local authorities are also free to levy other local taxes, like waste and leisure taxes. Other local revenues include interests received and fee revenues, which account for approximately 18% of total revenues.

The financial autonomy of communities and regions differs considerably. Both communities and regions benefit from shared tax revenues and grants from the federal state. Only regions, however, levy their own-source taxes. The latter amount to approximately 16% of the federated entities' total revenues and include real estate taxes, registration duties, inheritance taxes and vehicle taxes. Regions are entirely free to set the tax base and tax rate of those regional taxes. Although the federated entities have the right to collect the taxes themselves, tax collection is ensured by the federal state. The lion's share of the regions and communities' revenue comes from shared taxes, i.e. a fraction of the proceeds providing from the personal income tax and the value added tax, collected by the federal state. On top of this fraction, regions can decide to levy surtaxes on those federal state taxes. Additional means, amounting to almost 11% of total federated entity revenue, are transferred from the federal to the federated level in the form of grants. Those include grants for foreign students, for the Brussels-Capital Region, as well as a compensatory grant for abolishing the radio-television licence fee.

The increasing budgetary autonomy of subnational governments also includes the right to run deficits and to borrow accordingly. Although in the past budgetary correcting mechanisms and equalising transfers existed at almost all government levels, now only an automatic compensation mechanism remains regarding health spending by the federal government.

4. Fiscal rules

The project of joining the EU Economic and Monetary Union in 1992 gave Belgium an incentive to reduce its deficit and its debt ratio, which was the highest in the EU at that moment. In order to do so, the country engaged in a thorough reform of its fiscal framework. Two independent fiscal bodies (the National Account Institute (NAI) and a new section of the High Council of Finance (HCF)) were established to give the federal and federated governments advice on public finance issues. Moreover, numerical fiscal rules were

introduced from 1990 on to monitor the budget balance, the expenditures and the revenues of the federal government, as well as of some subnational governments.

The institutional part of the renewed fiscal framework has proven crucial, as with the increased fiscal autonomy of the subnational governments it guaranteed a coordination of the fiscal policies of the different government tiers. The annual budget recommendations of the HFC's advisory section were at the basis of budgetary conventions which acted as "internal stability pacts" by setting the medium-term budgetary targets for the different government tiers. Although never used, it allowed the federal level to impose borrowing limits to the regions in case they did not respect their budgetary targets. Regions cannot be liable, however, for providing fiscal surpluses to offset a potential federal deficit.

The rule-based part of the reformed fiscal framework turned to be more problematic, as the improvement of the federal deficit and the debt ratio relaxed the fiscal tension from the end of the 1990s on. Several fiscal rules at federal, regional and local level adopted earlier on, were abolished. As a result, only the federal ceiling for health spending and the regional budget balance rule were kept in place. This fiscal framework, however, may change following the sixth constitutional reform which was agreed upon in autumn 2011.

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BULGARIA

1. General description

Bulgaria is a unitary state. Article 136 of the Constitution ratified in 1991 enshrines the principle of local self-government. The Local Self-Government and Local Administration Act was passed the same year, providing the legislative framework for the 264 Bulgarian municipalities.

According to the Constitution, the territory is divided into regions and municipalities. While a region is defined as an administrative unit in charge of conducting the national policy for regional development and ensuring of harmony of national and local interest, the municipality is the only subnational level of the general government with fiscal autonomy. Municipalities have the right to cooperate in a way they can better protect their own interest. They are defined as legal entities in which government citizens participate directly and through elected bodies. Municipalities, in contrast to regions, possess their own budgets and are entitled to permanent revenues by law. According to 2010 figures, total spending by municipalities amounted to only 6% of GDP, around 16% of total public expenditure. In turn, in the same year municipalities' revenues also amounted to 6% of GDP, representing 18% of total revenues of the general government.

The National Association of Municipalities was constituted in 1996 and nowadays represents to all municipalities. Besides its contribution to developing the legislative framework applied to municipalities, the Association also makes proposals on their respective section of the draft budget. Since 1996 there have been ongoing efforts to deepen the decentralization process.

2. Government spending

According to the Local Self-Government and Local Administration Act there are two different types of powers devolved to municipalities. These are the State delegated services and the local services.

State delegated services comprise the management and financing of a number of services, of which the State retains the responsibility to define the main policy principles, such as the type of services, the quality and the eligibility criteria thereof. According to the functional breakdown of public expenditure (COFOG) these delegated services to municipalities include **education** up to the secondary level, **social protection** services, such as family and child support and care for the elderly, **healthcare** and **culture**. However, the devolution of powers in the area of healthcare have limited to the ownership and maintenance of health care institutions in that since 2001 they have been transformed into *legal entities under the meaning of the Commercial Law with state or municipal ownership*.

By contrast, municipalities have **own responsibilities** in some areas of **general public services, housing and community amenities** (public utilities and networks such as urban heat, electricity and water supply), **economic affairs** (urban public transport, construction and maintenance of roads, building and upkeep of public buildings and territorial development), **environmental protection** (including also sewerage and waste collection) and **recreation culture and religion** (public libraries, tourism, some cultural activities and sports facilities).

3. Financial arrangements

Municipalities are financed by three main sources, notably own revenues: including own local taxes (patent tax, property taxes, other taxes) and nontax revenue and assistance (revenue and income from property, local fees, fines, penalties, and forfeits, concessions, other nontax revenues).

The annual State Budget Law grants the provision of financing for current expenses in activities delegated by the state entirely with funds from the general subsidy for state-delegated activities, while the local activities are financed by own revenues, consisting of local taxes and fees, non tax revenues, as well as transfers from the Central Bank for local activities, including common equalising subsidy and transfer for winter maintenance and snow cleanup.

3.1. Own revenues

Tax revenues sum up to 35.8% of total revenues in municipal revenues in municipal budgets on 31 December 2010. According to data from the report on municipal budget cash implementation, tax revenues, donations and aid sum up to 64.2% of own municipal resources on 31 December 2010. Revenues from municipal fees have the largest share of non tax revenues and donations in municipal budgets in 2010 – 69.3%.

Municipalities have full powers on local fees and taxes. The Municipal Council determines the tax levels in line with the conditionalities, order and limits set by the Law on Local Taxes and Fees.

3.1. Expenditures

The expenditures on the activities delegated by the state to the municipalities and on the local activities are being distributed relatively equally, but municipal financing is predominantly with funds from transfers and interactions with the central budget – approximately 57% of total municipal revenues. Subsidies from the central budget for local activities finance 18-25% of expenditures on local activities. Subsidies from the central budget for activities delegated by the state finance approximately 98% of the expenditures on state activities. Municipal own resources finance predominantly local activities (over 90%) and co-finance delegated activities. In the common municipal expenditure structure on 31.12.2010, according to data from the report on municipal budgets, activities delegated by the state total 49%, co-financing with own resources – 2.3%, and the remaining 48.7% are expenditures on local activities.

The expenditures on the state-delegated activities are finances through state transfer, determined by standards used for shaping the total amount of funds needed and as criteria for their distribution to the municipalities. The budget of each function delegated by the state is determined by established standards and natural indicators determined by the sectoral ministries. The standards are worked out in working groups consisting of representatives of the corresponding sectoral ministry, the Ministry of Finance and the National Association of Municipalities in the Republic of Bulgaria. This ensures comprehensible and transparent distribution of funds to the municipalities and ensures predictability in financing.

3.2. Grants from the central government

The transfers to municipalities are made on the basis of entirely comprehensible criteria.

The targeted transfers amount to 90% compared to the non-targeted ones. The targeted transfers consist of: general subsidy for the activities delegated by the state, funds for winter maintenance, the target subsidy for capital expenditures (including: road maintenance and other expenditures whose purpose is determined by the municipal council), for co-financing municipal projects, funds for compensating travel expenditures (for students, pensioners, military handicaps) and other targeted transfers.

Municipal capital expenditures are financed through a targeted subsidy distributed to projects by the municipal councils. In addition, a target subsidy is assigned to ecological projects and for maintenance and construction of municipal roads at parameters determined by the annual State Law Budget. The target subsidy is distributed on the basis of comprehensible criteria on population – weight 40%; number of cities/towns – weight 40%; municipal territory – 20%.

Additionally the municipalities receive transfers (within the limits of 8-17% of the total transfer size) for financing activities on specific programmes (for example: managing environmental activities, etc.).

Non-targeted transfers consist of an equalizing subsidy assigned to municipalities to provide services to the public, as its size is approximately 7-9% of the total transfer structure. The total amount of the equalizing subsidy is determined according to the rule in Art. 34, p. 5 from the Law on Municipal Budgets (valid since 2005), namely “The size of the general equalizing subsidy cannot be smaller than 10% of the report on own revenues of all municipalities for the previous year”. The subsidy is distributed to the municipalities according to a mechanism consisting criteria determined annually by the Minister of Finance and the National Association of Municipalities in the Republic of Bulgaria (Art. 34, p. 4 from the Law on Municipal Budgets). The mechanism for determining the municipal subsidies from the central budget is an annex in the State Budget Law. The municipalities are potential beneficiaries on four of the seven Operational Programmes financed by the Structural and Cohesion Funds in the EU (SCF). In order to be approved for financing, the municipal projects should meet all the criteria set by the European and Bulgarian legislation.

4. Fiscal rules

Municipals departments' monitoring – The Municipal Debt Law limits local government borrowing to financing of infrastructure investment and rollover of previously accumulated debt. There are no limits on the amount of borrowing of local governments; however there are limits on the debt service payments. Current observation of municipal debt amount is in place. Legislative changes were introduced from the beginning of 2011. According to the Municipal Debt Act: “Art 12. (1) (Amended 2010, effective 1.01.2011) The annual amount of payments on the debt during each particular year may not exceed 15 per cent of the sum total of revenues from own sources and the block equalizing grant under the last audited report on the implementation of the budget of the municipality.” (**Guarantees rule**) By the end of 2010 it was 25 per cent. “Article 17a. (New 2010, effective 1.01.2011) (1) The Municipal Council may not adopt decisions to assume long-term municipal debt after the expiry of 39 months of its election.” The nominal value of the guarantees may not exceed 5% of the abovementioned sum.

The debt rules have been very efficient in fostering the decrease of the consolidated debt in good economic times and preventing the accumulation of debt at local government level.

Coverage and exclusion: Municipal debt includes the principal, interests and commissions excluding: (i) non-interest loans from the central budget made available to the local governments in order to finance projects and programmes co-financed by the EU funds until their reimbursement; (ii) debt to the Fund for Local Authorities and Governments (FLAG) aimed at providing bridge financing for co-financed with the EU projects; and (iii) debt assumed under the “Loan Agreement for Structural Programme Loan between the Republic of Bulgaria and the European Investment Bank” (pursuant to § 15 of the Transitional and Final Provisions of the 2011 State Budget Law) .

When in previous periods the accumulated municipal debt or guarantees exceed 15% and 5%, respectively, of the sum of total own revenues and the total balancing subsidy under the last audited report for the municipal budget execution, local governments cannot issue new debt or grant new guarantees until the requirements of the rules are complied with. To prevent the accumulation of liabilities that should be serviced beyond the term of the local governments, they could issue long-term debt only in the first 39 months after their election.

The Ministry of Finance is monitoring the application of the rules based on a public registry for municipal debt, securities and guarantees. The content and quality requirements for the information provided in the registry are fixed by the Ministry of Finance.

The rules have been amended and further strengthened in 2010 in order to preserve fiscal sustainability and avoid an accumulation of municipal debt and guarantees in particular by insulating local governments’ liabilities from the impact of political cycles. However, it is important to ensure that the capacity of highly indebted local government to provide the most important public services is not impaired.

5. Other relevant institutional features

Municipalities have total independence in forecasting their own revenues, as they conform to the level of local taxes determined by the municipal council regulations within the limits set by the Law on local taxes and fees. The expenditures forecasts for local activities shall be according to the strategies, forecasts and programmes for municipal development adopted by the municipal council, in line with the trends in the amount and types of public services provided and according to the resources available to the local government.

The preparation of the municipal draft budget is organized by the municipal mayor in cooperation with the town and regional mayors. The revenue administration assists the municipality in determining the size of the annual and monthly revenues.

The municipal budget determines and provides funds for financing local and state-delegated activities.

The municipal mayor submits the draft budget for public debate by the local community. The municipal mayor submits the draft budget to the municipal council within 30 workdays after the State Budget Law for the corresponding year has been made official.

The municipal council adopts the municipal budget within 45 workdays after the State Budget Law has been made official and in accordance with the common budget classification. The municipal draft budget is presented at the local branches of the Court of Auditors and at the Ministry of Finance within one month after it has been approved by the municipal council.

Municipal (local) structures, their structural units and economic subjects applying budgets, budgetary and non-budgetary accounts and funds according to the Municipal Budget Law are included in the scope of budget enterprises defined in para. 1 from the Additional provisions in the Accounting Law.

In addition, the Minister of Finance approves annually the Single Budget Classification as an accounting framework for cash basis reporting.

Municipalities and all budget enterprises report on the incoming and outgoing funds on a cash basis according to the Single Budget Classification. This report is the basis for periodic (monthly, quarterly and annual) report on the cash implementation of budget and non-budget accounts and funds.

The annual report on the budget and nonbudget accounts and funds cash implementation is a part of the annual financial report.

According to the Municipal Budget Law the municipality prepares a budgetary forecast giving the parameters of municipal revenues and expenditures for the next three years. The municipal mayor presents at the Ministry of Finance a forecast for the amount of own revenues and local expenditures for the budgetary year, as well as the municipal intentions for debt accumulation in the following year.

6. Overall assessment

The process of decentralization, started in 2002, continues in 2012 as the main priorities and goals are set in the long term programme document Decentralization Strategy (2006-2015). It is related to conducting national policy for improving the territorial management and it determines the directions for distributing jurisdiction and financial resources among the central, regional and municipal level of government, aiming at a providing public services more effectively. In 2010 the Council of Ministers adopted updated Decentralization Strategy and a Programme for the period 2010-2013 including measures, responsibilities and deadlines for implementation, such as for example giving more authority to the local government in relation to the transfer of special and professional schools without national importance.

Each year the Council on public government decentralization prepares a report using an adopted system of indicators for monitoring evaluating the implementation and results of the Decentralization Strategy.

The policies in the budget aim at creating opportunities for sustainable and balanced municipal development.

Regarding tax policy and local budget revenues, the trend toward higher municipal financial autonomy is clearly visible in light of the provided full municipal authority in administering local taxes and the authority to determine independently the size of these taxes according to the conditions set in the Law on local taxes and fees.

CZECH REPUBLIC

General description

Overview

The Czech Republic is a unitary state with two tiers of subnational self-governments: 14 regions (kraj) defined as "higher autonomous local government units" and about 6250 municipalities (obce). Prague has a special statute as both a municipality and a region.

The existence of regions and municipalities is recognized in the constitution articles 99-104 stating that the Czech Republic is divided into municipalities which are the basic units of territorial self-administration. Higher units of territorial self-administration are regions.

Recent institutional reforms

The most recent major reform took place in 2000 and entered into force in stages in 2001 and 2002. In 2001 14 new regions were established from the already existing administrative districts (okres) that existed since 1996. This led to a substantial inequality in terms of size of individual regions that was greater compared to the period 1949-1960 when similar regions existed as well. At the end of 2002 the administrative districts were abolished and their responsibilities were transferred.

Government competencies (spending)

There is a distinction between autonomous responsibilities and delegated responsibilities. In terms of the autonomous responsibilities, subnational governments have considerable legal freedom to handle questions of local interest in compliance with the law. Delegated responsibilities are executed in line with central government policy.

Regions

Regions are autonomously responsible mainly for upper secondary education, the regional road network, regional economic development and planning, and healthcare. Similar areas are also the most significant in terms of spending. Education requires around 60% of total spending by regions while almost 20% of total spending is devoted to transport and infrastructure.

Municipalities

Municipal autonomous responsibilities include education (pre-elementary and primary schools), the provision of local social and welfare services (retirement homes, homes for disabled etc.), environment (water and waste management), public housing, local roads, city public transport, territorial planning, urban hygiene and others. In terms of spending, transport and infrastructure together with housing and education are the most significant elements of the overall spending.

Education

A municipality is obliged to create conditions for pre-school education in the last grade prior to commencing compulsory school attendance and conditions for compulsory school attendance of children. For such purposes a municipality can establish or close down a nursery and a primary school. Also, a municipality may establish and close down certain special types of schools such as artistic primary schools etc.

A region is obliged to ensure conditions for secondary and tertiary professional education. For such purposes a region can establish and close down secondary schools and tertiary professional schools.

Infrastructure/Transport

Management, maintenance and repair of highways and category I roads is provided on a central level by the Road and Motorway Directorate of the Czech Republic. Category II and III roads are owned by regions that are responsible for their management, maintenance and repair. Municipalities own local roads. Subnational governments have also number of responsibilities in terms bus and railway public transport.

Healthcare

The conditions for establishment and management of a healthcare facility are prescribed by law in accordance with uniform national guidelines. At the same time, health care facilities can be established not only by the Ministry of Health, but also by regions, municipalities, and private bodies.⁸⁸ Subnational governments also provide guidance and coordinate in areas such as medical emergency service and medical and first aid, the quality of health care, the training of health professionals, central purchasing of pharmaceuticals and medical supplies and number of others.

Social services

There is a rather complex system of shared responsibilities in social services. Subnational governments, among other things, identify the needs of providing social services, ensure adequate availability of social facilities and cooperate together in preparing and implementing medium-term development plan for social services. Municipalities were also responsible for accepting applications for certain social benefits and determining the adequacy and level of these benefits. However, as of 2012 Regional branches of the Labour Office of the Czech Republic are responsible for granting and disbursing these benefits.

Financial arrangements

Revenues of municipalities and regions can be divided into tax revenues, non-tax revenues and transfers.

Tax revenues include both shared taxes and non-shared taxes. Shared taxes include personal income tax, corporate income tax and value added tax. These taxes are collected centrally and are subsequently redistributed to regions and municipalities. Since 2008, new criteria were introduced for redistribution of shared taxes to municipalities. These are based mainly on the size of the population and also on the geographical size of municipality. The 4 biggest cities are excluded since they have special coefficients. In terms of regions, the law directly determines the share of individual regions on the total amount of shared taxes.

Non-tax revenues include items such as interest income, revenues from renting property, own entrepreneurial activity etc.

Finally, transfers represent a complicated system of various earmarked and non-earmarked items. In terms of delegated responsibilities, the central government provides a contribution to both regions and municipalities specifically aimed at these responsibilities. However, the funds provided do not fully cover all the costs and both municipalities and regions need to pay

⁸⁸ In terms of hospital, there were 166 hospitals in the Czech Republic of which 19 were set up by the Ministry, 24 by regions and 17 by municipalities in 2010. The rest includes either hospitals managed by other entities (such as ecclesiastical) but also hospitals that were turned into private companies. However, these private companies were mostly set up by a region or a municipality which now act as the only shareholder. (Institute of Health Information and Statistics of the Czech Republic - www.uzis.cz)

the rest of the costs from other sources. The current system doesn't allow the central government to control the use of the funds or to obtain any feedback about efficiency etc. As a result, the contribution to cover delegated responsibilities can be spent on other purposes.

Revenues of municipalities

Municipalities derive about one half of their revenues from taxes that include both shared and non-shared taxes. In terms of shared taxes the value added tax is the most important one accounting for about 40% of overall tax revenues. Non-shared taxes include real estate tax and a special type of corporate income tax in cases when the municipality itself is a taxpayer. The rate of real estate tax can be partially affected by municipalities through a system of certain coefficients. Apart from these, various fees and charges are included in tax revenues. These include fees and charges related to environment, municipal waste, gaming machines, dogs etc. These own sources represent only about 14% of total tax revenues.⁸⁹ There is also a tax incentive scheme by which municipalities are motivated to encourage entrepreneurship and employment in their territory in order to raise their tax revenues.

Transfers represented about 36% of total revenues in 2010 of which almost 40% were provided by the Ministry of labour and social affairs and over 10% by the Ministry of Education.

Revenues of regions

The largest part of revenues for regions is represented by transfers that accounted for almost 64% of total revenues in 2010. The vast majority of this, almost 90% of all transfers and loans from the state budget, was provided by the Ministry of Education.

Tax revenues only include shared taxes and accounted for 32% of overall revenues in 2010. The value added tax is again the most important contributor accounting for over one half of overall tax revenues for regions.

Education

Funds from the state budget are provided for activities of schools and school facilities to be used for salaries and other non-investment costs. These funds from the state budget are provided on the basis of the real number of pupils or students and other criteria. The funds are transferred from the centre to individual regions that transfer them directly to individual schools.

A municipality or a region cover the expenses of school facilities established by a municipality or a region with the exception of expenses paid from funds provided from the state budget (i.e. subnational governments provide operating subsidies directly to schools).

Transport

The biggest contributors in terms of providing funds are the State Fund for Transport Infrastructure (90%) and the Ministry of Transport. In terms of railway transportation, regions receive contribution from the state to cover the losses from maintaining public transport. However, this contribution is not sufficient and in recent years the major part of the losses had to be covered from the regions' own budget. Regions also receive contributions to cover losses in the intra-regional bus transport which does not include city public transport that is funded from the budgets of individual municipalities.

⁸⁹ Ministry of Finance, 2010

Healthcare

Healthcare facilities are mainly financed by health insurance companies. For example hospitals, in terms of financing the most demanding element of the system, received over 80% of their overall revenues from health insurance companies in 2010. Operating subsidies are provided by regions or municipalities and, in terms of hospitals, they accounted for 2% of total revenues in 2010. The rest represents other revenues including revenues from sold goods etc. Besides hospitals, subnational governments also provide operating subsidies to emergency medical service facilities, special medical institutes and other facilities.

Social services

Until 2012 the largest part of the funds provided by the state to municipalities was used as benefits (material need, care allowance) transferred to the citizens. However, Regional branches of the Labour Office of the Czech Republic are responsible for disbursing these benefits as of 2012. The state also contributes to the financing of social service facilities in the form of subsidies to finance current expenditures. While regional authorities are involved in financial control and use of grants provided by the government, both regions and municipalities also provide further grants to finance current and other expenditures of social service facilities.

Deficit/debt

Budgets of subnational governments do not have to be balanced as long as the deficit is financed either by surpluses from previous years or by loans or bonds.

In 2010 the debt of municipalities was about 2% of GDP. Almost one half of this sum was caused by the 4 biggest cities. Smaller cities have to be much more careful in running deficits. Recently there were certain cases of smaller municipalities having problem with their deficit cause by excessive investments co-financed by EU funds.

In terms of regions, their overall debt was much lower, only about 0.5% of GDP.

In terms of fiscal rules, the Ministry of Finance calculates monitoring indicators, such as total liquidity and the share of non-own resources to total assets, and sends a letter to municipalities that do not comply with certain criteria. The list of municipalities with insufficient criteria values is sent to relevant regional authorities. Municipalities should explain reasons for not achieving the pre-defined values. Ministry of Finance submits information on municipalities' management to the government annually at the end of September.

The government is currently discussing a reform of fiscal framework which would also affect fiscal rules targeted at subnational governments. In addition, a reform of the system of shared taxes is also currently under discussion.

DENMARK

1. General description

Denmark is a unitary state where the central government is predominant. However, the Constitution of 5 June 1953 establishes the principle of municipal autonomy under supervision of the state.

The administrative structure in Denmark consists of three tiers including the national government, regions and municipalities. The scope of both local layers is governed by national legislation.

On 1 January 2007, the Local Government Reform came into force. The number of municipalities was reduced from 271 to 98 by mergers, and the 13 counties were abolished and replaced by 5 regions. A reform of the grant and equalisation system was carried out, which takes into account the new distribution of tasks.

Provision of public welfare service is predominantly carried out by the municipalities and partly by the regions. National legislation stipulates which services and to some extent a minimum quality of the services local government is to provide.

Municipalities' activities are financed through the municipal income tax and land value tax and transfers from the state in the form of block grants and reimbursements of specific expenditures. In addition, municipalities have significant revenues from user charges, while interest income and borrowing also contribute to municipal finance. Municipalities have autonomy to vary certain tax rates (municipal income tax and municipal tax on land value).

Regions rely entirely on a block grant from the central government and activity-based funding from the central government and the municipalities.

Every year, typically in June, the government sign an agreement on the following year's budgets in the municipalities and the regions with the municipalities' national association (Kommunernes Landsforening) and the regions national association (Danske Regioner), respectively. The agreements include boundaries for service and investment costs as well as targets for total local taxes. This practice has been in place since 1979. It should be noted that the agreements are signed for municipalities and regions as a whole, allowing a certain room for manoeuvre for the individual municipality/region. This also creates uncertainty of the overall enforcement of the agreements. Since the local government reform of 2007, the central government was given a clearer role in overseeing efficiency in the provision of municipal and regional services. In recent years the collective agreements have been supplemented by automatic mechanisms to ensure enforcement of the agreed level of local government spending and municipal tax collection.

In 2010, total spending by local government amounted to 38.2% of GDP – around 2/3 of total public spending (including income transfers and capital investments). Total local government revenue excluding borrowing stood at 38.0% of GDP (including transfers from central government).

2. Government spending

The division of tasks between administrative levels and the responsibilities of municipalities and regions are defined in a variety of legislation on different subjects (rather than a law defining local responsibilities).

Municipal responsibilities include: social services (including income replacing transfers); child care; compulsory education; special education for adults; rehabilitation and long-term care for the elderly; preventive health care; nature and environmental planning; local business services; promotion of tourism; participation in regional transport companies; maintenance of the local road network; libraries; local sports and cultural facilities; and a responsibility for employment, shared with the central government.

The new regions took over responsibility for health care from the counties, including hospitals and public health insurance covering general practitioners and specialists, pharmaceuticals, etc. The regions also have a number of tasks involving regional development.

In 2010, total spending by local government amounted to DKK 670 billion or 38.2% of GDP – around 2/3 of total public spending (including capital investments). 96% of local government spending was to cover current expenses. Municipalities account for the vast part of local government spending.

Local government responsibilities mainly concern the practical provision of public goods, whereas the regulation of their (eligibility, quality and other requirements) is to a large extent determined by the central government. Municipalities are responsible for paying all income transfers to citizens and in some cases decide on eligibility according to nationally defined criteria. Municipalities are partly or fully reimbursed by the central government for their expenditures for income transfers. The rate of reimbursement varies among types of income transfers to provide appropriate incentives to municipalities, it is set by the central government, with local governments having no influence on it, and periodically revised.

3. Financial arrangements

In 2010, total local government revenue excluding borrowing stood at DKK 665 billion or 38.0% of GDP (including transfers from central government).

Municipalities' activities are financed through the municipal income tax and land value tax and transfers from the state in the form of block grants and reimbursements of specific expenditures. In addition, municipalities have significant revenues from user charges, while interest income and borrowing also contribute to municipal finance.

The number of taxation levels was reduced from three to two in the 2007 reform, since the regions, unlike the counties, no longer have the authority to impose taxes. Their revenues consist of block grants and activity-based funding from the central government and the municipalities.

DKK 232 billion or 35% of total local revenue was raised by municipal taxes in 2010.

Central government transfers and grants represented 59% of total revenue in 2010. These falls into three categories: block grants, (partial) reimbursement of specific current spending and compensation for transfer of responsibilities.

The remainder stemmed from the sale of goods and services, asset management and extraordinary revenue.

Net borrowing of local governments varies around 0 and amounted to 0.2% of GDP in 2010.

The local taxes are:

- Municipal income tax account for around 85% of local tax revenues. Municipalities are in principle free to set the tax rate as they wish. In 2012, the average municipal income tax rate is 24.923%. The lowest rate is 22.7% and the highest 27.2%. The tax base is defined by the parliament.
- The municipalities levy a tax on the property's land value (on average land value represents about ¼ of the total property values). Municipalities can vary the rate between a minimum of 16‰ and a maximum of 34‰. The average tax rate is 24‰ in 2012. Commercial properties and some public buildings also pay municipal tax on land value.
- Moreover, business properties pay municipal reimbursement duty on the building value and the land value.
- Finally, the municipalities receive 3/25 of the corporate income tax paid by companies in their jurisdiction.

The central government collects the local taxes and reimburses local governments monthly.

The average municipal income tax rate has increased constantly since 1971. In the same period, the tax base has also been broadened. The increase in the average municipal income tax rate partly reflects increased expenditures and taxation agreed in the annual agreement on the economy of the municipalities and partly reflects breaches of the agreed levels of expenditures and taxation.

The total tax revenues of municipalities as a whole is stipulated in the annual agreement between the central government and the municipalities' national association on the following year's budgets. Municipalities can change the balance between the income tax and the property value tax within the agreement.

However, since the agreement is between the central government and the municipalities collectively, there is no guarantee that the sum of the municipalities' actions will fulfil the agreement. Since 2007, the collective agreements have been supplemented by automatic mechanisms to provide incentives to the individual municipality and ensure enforcement of the agreed level of local government spending and municipal tax collection (see Section 4).

The Ministry of Economics and Internal affairs and the Ministry of Finance are responsible for the surveillance of the local entities budgets and accountings and handles block grants and equalisation, municipal taxes and municipal and regional borrowing.

Since the local government reform of 2007, the central government was given a clearer role in overseeing efficiency in the provision of municipal and regional services.

4. Fiscal rules

Three main fiscal rules are in place along with general requirements for the budgeting and accounting at local government level to control the spending of local governments.

Conditional block grants

With effect for the year 2009, a part of the block grant to the municipalities (DKK 1 billion) was made dependent on the total budgeted public expenditure by the municipalities as a whole keeping within the agreement.⁹⁰ In 2010, after the accounting of municipal expenditures in 2009 showed a substantial excess spending compared to the budgets, the conditional part of the block grant to the municipalities was increased to DKK 3 billion from the year 2011 and the conditionality was broadened to also cover the accounted expenditures.⁹¹ If the municipalities as a whole exceed the budgeted expenditure in 2011 and beyond, the block grant for the following year is reduced with the same amount (up to DKK 3 billion). The conditional block grant is reduced collectively for the municipalities as a whole in case of infringement of the 2011 budgets. For 2012, however, 60% of the possible reduction will be applied to the individual municipality exceeding the budget with the remaining 40% reduction collectively.

Tax mechanism

As part of the strengthening of management of local spending and to keep the municipal tax revenues constant in real terms, a mechanism to reduce the block grant to municipalities in case of increases in municipal taxes was introduced from 2009.⁹² If the municipalities as a whole increase tax revenues in the budget (through overall increased rates of the municipal income tax, land value tax and reimbursement duty on business properties), the extra municipal revenues will be clawed back through a combination of individual and collective reductions in the block grant. The individual reduction of the block grant will amount to 75% of tax increase in the 1st year in each municipality increasing taxes in the budget (if the municipalities as a whole increase taxes in that year) with the collective reduction representing the remaining 25% in the 1st year. In the 2nd and 3rd year following a tax increase, the individual and collective reduction both amounts to 50% of the tax increase. In the 4th year following a tax increase, the block grant of the individual municipality increasing taxes is 25% of the increase, while the collective reduction is 75%. In subsequent years, an overall municipal tax increase in year 1 lead to collective reduction of the block grant of 100% of the tax increase.⁹³ This mechanism allows individual municipalities autonomy over their tax rates while ensuring better enforcement of the overall municipal spending and taxation level.

Spending ceilings

To further strengthen the control of public expenditures and ensure that fiscal targets are implemented, in March 2012 the government will present a bill introducing a framework and

⁹⁰ L 172 (2007-082).

⁹¹ L 219 (2009-10).

⁹² L 173 (2007-082).

⁹³ For 2009 and 2010, the individual reduction amounted to 75%/50%/0% in the 1st, 2nd and 3rd year, respectively, in each municipality following a tax increase. The collective reduction thus represented 25%/50% in years 1 and 2 respectively and 100% in subsequent years. An extra year with 50%/50% individual/collective reduction was added as of 2011.

detailed rules for a new fiscal surveillance system. This new fiscal surveillance system will include binding expenditure ceilings for the state, municipalities and regions, respectively. The expenditure ceilings will each year be defined for a rolling four-year period and is to be adopted by the parliament. State, municipalities and regions must stay within the ceilings each year. New economic sanctions will be introduced to support compliance with the expenditure ceilings.

Borrowing

Municipalities have access to borrowing (including issuing bonds) and are allowed to issue guarantees under certain limitations.⁹⁴ Municipalities and regions can issue bonds in capital markets through their common credit institute (kommunekredit). Municipalities are allowed to take loans corresponding to the sum of expenditures in the fiscal year for specific purposes: 1) capital expenditures, 2) paying off existing loans and 3) the costs of deferred property values taxes granted to pensioners.

Furthermore, the central government establish minor loan pools for specific purposes which the government wish to support in the annual agreement about the following year's budget between local governments' association and the central government. In 2012, these specific loan pools amount to DKK 1.6 billion for the municipalities.

Municipalities can issue loan guarantees. The amount of the loan guaranty is fully subtracted in the municipality's' allowed loan amount. However, this is not the case for loan guaranties for social housing.

Municipalities' entering into rental- and lease agreements is perceived as borrowing when the lease / rental agreement replaces a capital expenditure and causes a deduction from the total borrowing limit.

Regions have more restricted access to borrowing than the municipalities.⁹⁵ As a general rule, regions can only borrow or issue guarantees following a dispensation by the Ministry of Economics and Internal affairs. Regions may, however, without ministerial approval take up loans and issue guarantees for certain specified capital costs. Regions may only enter into rental- and lease agreements after approval by the Ministry of Economics and Internal affairs.

For both municipalities and regions, the portion of loans of partnerships, cooperatives, limited liability companies, private foundations etc. with participation of municipalities/regions is deducted from the municipality's' allowed loan amount. Sale and lease-back contracts require the approval of the Ministry of Economics and Internal affairs.

A liquidity rule stipulates that the liquidity of municipalities and regions measured over the last 12 months cannot be negative (time deposits and bonds are included in the balance).

Municipalities and regions had a gross debt of DKK 123 billion in 2010.

Local entities in financial difficulties can be put under administration of the Ministry of Economy and Internal affairs.

⁹⁴ BEK nr 1238 af 15/12/2011.

⁹⁵ BEK nr 1299 af 15/12/2011.

1 Introduction

Germany is a federal state, in which the federal entities – the *Länder* – are the primary units to carry state powers. Five, together with the Eastern part of Berlin, have acceded to the Federation in 1990. These entities display considerable heterogeneity. Berlin, Hamburg, and Bremen are city-states;⁹⁶ among the others, territories range from 2,500 km² (Saarland) to 70,500 km² (Bavaria), populations from 1,000,000 (Saarland) to 17,800,000 (North-Rhine-Westphalia, NRW), and population densities from 71 (Mecklenburg-Vorpommern) to 524 (NRW). The German constitution – *Grundgesetz* or Basic Law, BL hereafter – stipulates that “the exercise of state powers and the discharge of state functions is a matter for the *Länder*” unless otherwise specified by the Basic Law (Art. 30 BL). Its federal organisation is a constituent characteristic of Germany that enjoys special constitutional protection: the Basic Law rules out any constitutional amendment that would affect the division of the Federation into *Länder* and their participation on principle in the legislative process (Art. 79 (3) BL).

This Chapter provides an overview of the decision-making powers, spending responsibilities, and the assignment of revenues of the different sectors of general government – the Federation, the *Länder*, the municipalities, and the institutions of statutory social insurance – in Germany. Section 2 reviews the legislative, executive, and spending responsibilities by sectors of general government (Sections 2.1 to 2.3) respectively. Section 3 provides an account of revenue raising competences by sectors of general government (Section 3.1) as well as cross-sector transfers and equalisation transfers specifically (Section 3.2). Section 4 portrays the elements of fiscal governance applying to public deficits and debt (Section 4.1) as well as mechanisms that improve co-ordination and fiscal planning across sectors of general government (Section 4.2). Section 5 concludes with a summary assessment of the German framework of fiscal federalism in view of fiscal stability.

2 Responsibilities for the design, execution, and financing of policies by sectors of general government

2.1 Legislative powers of the Federation and the *Länder*

Legislative powers are assigned to the *Länder* unless conferred on the Federation by the Basic Law (Art. 70 BL); in practice, both the Federation and the *Länder* play an important role in the legislative process. Concerning the legislative power of the Federation, the Basic Law distinguishes matters within the exclusive legislative power of the Federation (Art. 71) from matters which fall under concurrent legislative powers of the Federation and the *Länder* (Art. 72): in matters of the former, the *Länder* may legislate insofar as they are authorised by a federal law; in matters of the latter, the *Länder* may legislate as

⁹⁶ Berlin and Hamburg consist of a single administrative unit. Bremen consists of the municipalities of Bremen and Bremerhaven.

long as the Federation has not exercised its legislative power (Art. 72 (1)).⁹⁷ As a general rule, federal law takes precedence over Länder law (Art. 31 BL). In the adoption of federal law, Länder are represented by a constitutional body called *Bundesrat*, that comprises Länder government representatives, as opposed to the *Bundestag*, the genuine legislative body of the Federation. In certain areas including those with financial implications on the Länder, the adoption of federal legislation requires the consent of the Bundesrat. In all other areas, the Bundesrat has the right to suspend legislation, which can be overruled by the Bundestag though. Constitutional amendment requires a Bundesrat majority of two thirds.

Most legislation in Germany is passed by the Federation and the Länder under concurrent legislation. Art. 73f. of the Basic Law specifies matters of exclusive legislative power of the Federation and of concurrent legislative power of the Federation and the Länder respectively. Exclusive Federation legislation extends over foreign affairs and defence, citizenship, migration, currency and measurement, customs and trade, federal railways, and postal and telecommunication services. Concurrent legislation covers a broad area comprising civil and criminal law, court organisation and procedure, public welfare, economic legislation including industry, energy, commerce, banking, and insurance, labour law including employment agencies, as well as social security, including unemployment insurance, educational grants and the promotion of research, agriculture, urban real estate matters, economic aspects of hospitals, shipping, road traffic, and long-distance highways, most issues of environmental protection, regional planning, and state liability. Initially a small fraction, laws passed under concurrent legislation covered more than half of the federal legislation passed in the 1990s. Concurrent legislation has often been difficult because of the frequent mismatch of political majorities in the Bundestag and Bundesrat, though. The fiscal federalism reforms of 2006 and 2009 realigned legislative powers somewhat to revert centralisation. Areas of legislation that have remained under Länder competence to date include education policy, municipal law, police law (except the Federal Office of Criminal Investigation), and the construction of roads (except federal motorways). In practice, most policy areas are shaped by joint legislative decision-making of the Federation and the Länder, notable exceptions being social security where policy is designed by the Federation, and education, which has remained under Länder competence (information from the ECFIN country questionnaire).

Municipalities are granted by power of the Basic Law the right to regulate all local affairs on their own responsibility, within the limits established by law. However, municipalities cannot issue fiscal legislation themselves. Instead the main provisions governing the planning, structure, execution and accounting of local authority budgets are codified in the Local Authority Codes and in the local government constitutions of the Länder.⁹⁸ In order to regulate the individual aspects of local authority budgets, the Interior Ministers of the Länder have enacted several ordinances, compounded by special decrees. In particular, the Local Authority Budget Ordinance prescribes, among other things, how the budgets are to be structured. Local authority budgets are executed on the basis of the budget by-law, which must be adopted by the municipality anew each year. That by-law establishes the budget proper, the ceiling for short-term borrowing and the tax rates.

⁹⁷ Concurrent legislation established by the Federation still allows for variance enacted by the Länder in certain areas; while in others, the Federation may legislate only to the extent that the establishment of equivalent living conditions or the maintenance of legal or economic unity renders it necessary to do so (Art. 72 (2) BL).

⁹⁸ Bundesministerium der Finanzen, (2008), p. 77.

As of 1999 the Länder envisaged replacing the traditional cameral system by introducing a system of double-entry budgeting and accounting, compounded by a reformed cash-based governmental budgeting and accounting system, and adopted this from 2003 onwards.⁹⁹ The underlying idea of this far-reaching reform was to base budgeting system on the actual consumption of resources rather than cash flows. The first states to have implemented the new system are North Rhine-Westphalia, Hesse, Lower Saxony and Saxony-Anhalt. Baden-Württemberg, Brandenburg, Mecklenburg-Western Pomerania, Rhineland-Palatinate, Saarland und Saxony have also committed themselves to introducing double-entry accounting. Schleswig-Holstein and Hesse permit their local authorities to choose between double-entry bookkeeping and an extended cameral accounting system. In deviation, the Free States of Bavaria and Thuringia plan to retain the traditional cameral accounting system, but also to allow their local authorities to introduce double-entry bookkeeping on a voluntary basis.

2.2 Executive powers of sectors of general government

As a general rule, federal laws are executed by the Länder in their own right, unless provided for differently by the Basic Law (Art. 8ff. BL). Some federal legislation is also to be executed by the Länder on federal commission (Art. 85 BL). The federal government is in charge of oversight of the execution of federal laws by the Länder. The Federation is not entitled to assign governmental tasks to the municipal level (Art. 84 (1) BL). The Federation executes laws through its own administrative bodies specifically in the areas of foreign service, federal financial administration, federal waterways and shipping, policing activities related to the protection of the constitution and to dangers towards Germany's external interests, social insurance institutions with jurisdictions extending over several Länder, armed forces and federal defence administration, air transport administration, sovereign functions of post and telecommunications, central banking, federal waterways, inland shipping extending over several Länder, and maritime shipping, as well as in matters on which it has legislative power and may establish own administrative bodies (Art. 87ff. BL). In some areas – the peaceful production and use of nuclear energy, air transport administration, and rail transport administration – the Länder may be assigned the execution of legislation under exclusive federal competence on federal commission or in their own right respectively (Art. 87ff. BL). In addition, there are special rule for the administration of federal waterways and motorways (Art. 90 BL).

The Basic Law allows for some tasks that fall under the joint responsibility of the Federation and the Länder, the so-called joint tasks (*Gemeinschaftsaufgaben*) (Art. 91a ff. BL). Joint responsibility is assigned for two tasks principally innate to the Länder: the improvement of regional economic structures and the improvement of the agrarian structure and of coastal protection (Art. 91a (1)). Joint tasks are such on condition that they are important to society as a whole, and federal participation is necessary for the improvement of living conditions (Art. 91a). Besides, co-operation of the Federation and Länder is provided for in matters of scientific research with supra-regional relevance and the promotion of research facilities and projects (other than higher education institutions), projects and research at such institutions, the construction of large scientific installations, and the assessment of the performance of education systems in particular (Art. 91b BL). Voluntary co-operation of the Federation and the Länder is further provided for in the area of construction and operation of

⁹⁹ Ibid.

information technology systems (Art. 91c BL). Besides, concerning basic support for job-seekers, the Federation or the Länder or municipalities and their associations responsible according to Land law respectively shall generally co-operate in joint institutions (Art. 91e).

In the area of social security, public tasks are delegated to autonomous institutions under public law. The pillars of the German statutory social security system comprise health insurance, pension funds, accident, long-term as well as unemployment insurance respectively. Since 2005, federal and regional insurance agencies are organised in a common umbrella association at the federal level, *Deutsche Rentenversicherung*. Health insurance is provided by statutory carriers, each of which operates a long-term care fund as well. Statutory accident insurance is provided by occupational associations as well as public associations organised on territorial grounds. Unemployment insurance is provided by the Federal Employment Agency. The respective institutions enjoy administrative autonomy including financial and organisational self-government; control of legality is carried out by the Federation (and by the Federal Ministry for Labour and Social Affairs specifically) unless the scope of the activity extends over no more than three Länder (Art. 87 (2) BL).

Executive responsibilities of municipalities include notably public utilities such as the supply of water, gas, electricity, heating, refuse collection and wastewater services. They also include various aspects of town planning including land use and permission to build, road construction, green spaces, public transport. Apart from these mandatory tasks there are also voluntary ones such as the operation of cultural entities (theatres, opera houses, museums), sports facilities, or multifunctional municipality halls. Apart from these various tasks pertaining to local self-government there are also tasks having been transferred upon municipalities by the federal or state government, including notably the tasks of the Registrar's Office, but also tasks relating to youth, schools, public health, social policy including the support of long-term jobseekers (in most cases jointly with the Federal Employment Agency, in some even alone).

2.3 Spending responsibilities of the sectors of general government

As a general principle, among the Federation and the Länder, spending responsibility for a government tasks is matching administrative responsibility (Art. 104a (1) BL).¹⁰⁰ Tasks carried out on federal commission are financed by the Federation (Art. 104a (2) BL). If money grants are to be administered by the Länder on the grounds of a federal law, the Federation may pay for part or all of such grants.¹⁰¹ The apportionment of expenditure on joint tasks is governed by special rules (Art. 91a ff. BL). Of the expenditures on the improvement of regional economic structures, 50 per cent have to be borne by the Federation. Of expenditures on improvement of the agrarian structure and of coastal preservation, the Federation has to bear at least one half of the expenditure, in the same proportion in each Land (Art. 91a (3) BL). The apportionment of expenditures related to co-operation in the area of education and research and of information technology systems has to be regulated by

¹⁰⁰ The link between administrative and financial responsibility is bidirectional: if a law provides that the Federation assumes at least 50 per cent of the expenditure, it will be executed by the Länder on federal commission (Art. 104a (3)). Federal laws that establish expenditure on money grants or in-kind benefits by the Länder – be it on federal commission or in their own right – require Bundesrat consent (Art. 104a (4)).

¹⁰¹ Examples of such laws are the Federal Training Assistance Act (*Bundesausbildungsförderungsgesetz*), the Housing Benefit Act (*Wohngeldgesetz*), and the Federal Parental Benefit and Parental Leave Act (*Bundeselterngeld- und Elternzeitgesetz*), where the Federation bears 65, 50, and 100 per cent of the funding respectively (Bundesministerium der Finanzen 2010, p. 14).

agreement (Art. 91b (3) and Art. 91c (2) BL). Concerning expenditure related to basic support for persons seeking employment, if the respective tasks are executed by municipalities or associations of municipalities (at their request), the expenditures have to be borne by the Federation (Art. 91e (2) BL). Further, the Federation may grant financial assistance to the Länder for particularly important investment (*Finanzhilfen für Investitionen*, Art. 104b BL). Conditions for such grants are that the investment falls under the legislative remit of the Federation,¹⁰² it is necessary to avert a disturbance of the overall economic equilibrium, equalise economic capacities within the federation, or promote economic growth (Art. 104b (1)). Such investment grants can only be temporary and have to be provided in descending annual contributions. Special rules also apply to fiscal consequences of international relations and obligations respectively. Specifically, the costs of occupation and internal and external burdens resulting from war are to be borne to the Federation (Art. 120 (1) BL). Costs stemming from a violation of obligations assumed under international or supranational law are assigned in accordance with the internal allocation of competencies and responsibilities between the Federation and the Länder (Art. 104a (6)). Of the costs arising from the breach of SGP provisions that transcend one specific Land, 15 per cent are assigned to the Federation, 35 per cent to the Länder as a whole, and 50 per cent to those Länder that have caused the fiscal burden (Art. 104a (6) BL).

As a rule, the Federation and the Länder bear the administrative expenditure of their own authorities each (Art. 104a (5) BL). Such expenditures therefore have to be distinguished from purpose-related expenditure. As an exception, if tasks related to basic support for persons seeking employment are executed by municipalities or their associations, all expenditure has to be covered by the Federation, including administrative expenditure (Art. 91e (2) BL).

As in the case of the Federation and the Länder, as a general principle, spending and executive responsibilities match. Note that, in contrast to the federal and Länder levels, where there is one budget, local authority budgets are divided into an administrative budget and a capital budget.¹⁰³ The capital budget shows the revenue and expenditure affecting capital formation (including investment expenditure, new loans and loan repayments), while the other payment flows that do not affect capital formation are included in the administrative budget. Finally, the social insurance carriers bear their spending responsibilities under administrative autonomy.

3 Arrangements determining the revenues of the sectors of general government

3.1 Legislative powers of taxation and apportionment of tax revenue

The assignment of taxing powers and tax revenues in Germany rests upon the principle that sectors of general government must have their means to meet the mandated tasks; powers to legislate on taxes are assigned to the Federation, the Länder, or both (Art. 105 BL). Exclusive legislative powers are conferred to the Federation with respect to customs

¹⁰² Exceptions to the confinement of investment support to the legislative remit of the Federation are allowed in cases of natural disasters or exceptional emergency situations beyond governmental control with substantial harm to state fiscal capacities.

¹⁰³ Bundesministerium der Finanzen, (2008), p. 77.

duties and fiscal monopolies. The Federation enjoys concurrent legislative power with respect to all other taxes where it receives part or all of the revenue, or on condition that the establishment of equivalent living conditions or the maintenance of legal or economic unity renders federal regulation necessary (Art. 72 (2) BL). The Länder have legislative powers with regard to local taxes on consumption and expenditures, and may besides establish the rate of the tax on acquisition of real estate.¹⁰⁴ Bundesrat consent is required for federal legislation on taxes where part or all of the revenue goes to the Länder or municipalities. The financial autonomy of the municipalities guaranteed by the Basic Law includes the right to a source of tax revenues upon economic ability and the right to establish the rates of taxation of these sources (Art. 28 (2) BL). However, unlike in the higher levels of government, local authorities are bound by principles relating to the raising of revenue.¹⁰⁵ Specifically, under the said principles, the revenues necessary to meet municipal obligations are to be generated firstly by means of special charges (fees, contributions, charges under private law), to the extent that this is reasonable and necessary, for services provided. Thereafter, these services are to be financed by taxes insofar as the other sources of revenue (including transfers from reserves, cost refunds, general financial grants from the Länder) do not suffice. Only as a last recourse, funds may be obtained by borrowing.

Tax revenues are distributed among sectors of general government under separate apportionment or shared apportionment. Under separate apportionment, customs duties, taxes on consumption unless not regulated differently, taxes on transactions related to motorised vehicles, taxes on capital transactions and insurance, and the surtax on income tax and corporation taxes among others are federal taxes (Art. 106 (1) BL). Revenue from the property tax, the inheritance tax, the motor vehicle tax, taxes on certain transactions, and taxes on beer and gambling establishments goes to the Länder (Art. 106 (2) BL). Municipalities receive revenue from taxes on real property, trades, and from local taxes on consumption and expenditures. By apportionment, the income tax, corporation tax and VAT are joint taxes: their revenues accrue to the Federation, the Länder, and the municipalities in different quantities (Art. 106 (3) BL). The Federation and Länder receive income tax and corporation tax revenues in equal shares (Art. 106 (3) BL). Based on federal legislation requiring Bundesrat consent, a share of the income tax revenue has to be distributed to the municipalities according to the taxpaying ability of the inhabitants.¹⁰⁶ The apportionment of VAT (turnover tax) revenues to the Federation and the Länder is determined by federal law with Bundesrat consent, in line with expenditure needs established by multi-annual planning and the aim to achieve a fair balance and ensure the uniformity of living standards (Art. 106 (3) BL). Of the Länder VAT share, at least 75 per cent is distributed among the Länder according to their populations (*Umsatzsteuer-Vorwegausgleich*); the remainder is distributed within the framework of horizontal equalisation (*Ergänzungszuweisungen*) (Art. 107 (1) BL, see below).¹⁰⁷ Part of VAT revenue also goes from the Länder to their municipalities, based on a formula reflecting geographical and economic factors (Art. 106 (5a) BL). Finally, Länder legislation has to establish a share of the joint tax revenue to accrue to municipalities; it may also assign part of other Länder tax revenues to them (Art. 106 (7) BL). As a result of the above system of joint tax apportionment, the Federation and the Länder receive 50 per cent of

¹⁰⁴ Municipalities have the right to establish the rates on taxes on real property and trades (Art. 106 (6) BL).

¹⁰⁵ Ibid.

¹⁰⁶ The same law provide the municipalities with the right to establish supplementary or reduced rates with respect to their share of the tax (Art. 106 (5) BL).

¹⁰⁷ This apportionment of VAT share among the *Länder* according to their revenue raising capacity constitutes the first in the multi-step process of horizontal fiscal equalisation as described in section 3.2.

the corporation tax each. Of the income tax, 42.5 per cent go to the Federation and the Länder each, while the municipalities receive 15 per cent as established by the Municipal Finance Reform Act (*Gemeindefinanzreformgesetz*). Of the VAT, a share from the Federation goes to the European Union, that is recalculated annually. In 2011, the planned VAT revenue shares were as follows: 53 per cent to the Federation, 45 per cent to the Länder, and 2 per cent to the municipalities (Bundesministerium der Finanzen, 2012). In addition, there are special rules regulating the apportionment of motor vehicle tax and federal grants for local mass transit (Art. 106a and 106b BL).

Municipalities also receive their share in the intergovernmental distribution of tax revenues. As to the shared taxes, they receive shares of income tax and VAT. In particular, they are empowered to draw on the property tax and the local business tax (raised on top of corporate tax and mainly based on company profits albeit corrected for a number of items), of which a minor part are still ultimately paid to the Länder and federal governments. To this add local taxes on consumption and expenditure (including taxes on hunting, fishing, drinks, dog ownership, second residences).

Joint taxes provide the largest part of federal revenues. For instance, of the total projected federal gross revenues of 306 billion euro in 2011, about 60 per cent were receipts from joint taxes, while about 30 per cent were federal tax revenues, in addition to other revenues amounting to 10 per cent.

The pillars of social security receive revenues from contributions of contributors – typically by employers and employees in equal shares – that are complemented by grants (see Section 3.2). Social security contribution ceilings (*Beitragsbemessungsgrenzen*) and contribution rates (*Beitragssätze*) are established by concurrent legislation, i.e. in practice by governmental ordinance with the consent of the Bundesrat. The tasks of the statutory accident insurance providers are financed by employers and the Federation, the Länder or the municipalities respectively; contributions are being established ex-post to cover outlays based on employment compensation, occupational risk and the number of inhabitants (in the case of municipal bodies) and insured members respectively.

3.2 Fiscal transfers across and within sectors of general government

To equip each Land with the necessary means to cover their necessary expenditures and ensure equivalent living conditions, Germany operates a powerful system of fiscal equalisation involving the Federation and the Länder. It consists of three schemes: (1) primary horizontal equalisation between the Länder (*gesamtdeutscher Finanzausgleich*) by means of distributing part of the Länder share of VAT according to revenue raising capacities (Art. 107 (1) BL), (2) secondary horizontal equalisation – *Länderfinanzausgleich* in the narrow sense – across the Länder (Art. 107 (2) BL), and (3) secondary vertical equalisation by supplementary federal grants (*Bundesergänzungszuweisungen*)(Art. 107 (2) BL). In the first step, a maximum of 25 per cent of the Länder share of VAT goes to the Länder with below-average revenue from income tax, corporation tax and the Länder taxes (*Umsatzsteuer-Ergänzungsanteile*) as established by Art. 107 (1) BL. Receipts are established according to the volume of the Länder receipts from the joint taxes (without VAT) plus the Länder taxes. The second step further equalises tax revenues at the Länder level (Art. 107 (2) BL), based on a measure of fiscal capability and a measure of theoretical equal revenues. The former consists of the sum of tax revenues at Länder level and 64 per cent of municipal tax revenues

in the respective Land. The latter is calculated in the same way, but using average per capita revenues; adjustments then are made to reflect structural characteristics of the city states (with adjustment coefficients of 1.35) and some Länder of the former GDR with low population densities (with adjustment coefficients of 1.02 to 1.05). Länder with a negative difference between the two indices are entitled to equalisation payments from the Länder with above average capabilities, where contributions and receipts decrease towards the mean respectively. In the third step, supplementary non-earmarked grants are provided by the Federation to Länder with subpar fiscal capacity, levelling the gap between the revenues against 99.5 per cent of the mean by 77.5 per cent (*Bundesergänzungszuweisungen*). Even further to that, Länder with weak revenue raising capability receive transfers to compensate from specific spending needs (Art. 107 (2) BL)(*Sonderbedarfs-Bundesergänzungszuweisungen*). In 2011, such transfers were granted (1) to Berlin and the five eastern Länder to cope with investment backlogs resulting from the separation of Germany within the renewed Solidarity Pact (*Solidarpakt II*); these payments will be discontinued as of 2020;¹⁰⁸ (2) the five eastern Länder (without Berlin) to support fiscal needs from structural unemployment and the combination of unemployment benefits and welfare aid, and (3) grants to fiscally weak small Länder to compensate for above average expenses on political governance. In sum, these equalisation funds provide considerable and projectable statutory transfers to the Länder with below-average fiscal capability.

The variance of per capita revenues across the Länder has been considerably compressed by fiscal equalisation. In 2011, the three mechanisms (without transfers for specific needs) reduced the range of Länder tax revenues relative to the average from 156 and 128 to 51 per cent (Hamburg and Bavaria versus Thuringia) to 105 to 98 per cent (Hesse versus Saxony)(Bundesministerium der Finanzen, 2011). The volumes involved in the first and the second step amounted to about 7.3 billion euro, i.e. around 3.3 per cent of the total amount of Länder revenues without federal grants (but including the VAT Länder share), while the federal grants under the third step made up 2.6 billion euro, 1.2 per cent of the Länder revenues without these grants. The largest part of revenue – 90 per cent of the vertical distribution of VAT (step one), and 81 per cent respectively involved in horizontal redistribution and the non-earmarked federal transfers (steps two and three) – were received by the ex-GDR eastern Länder. The first step reduced the relative fiscal positions of seven countries (Hamburg, Bavaria, Hesse, Baden-Württemberg, North Rhine-Westphalia, Rhineland-Palatinate, and Schleswig-Holstein) while improving positions of the others. In the second and third step were twelve and eleven recipient Länder respectively (Lower Saxony, Saxony, Rhineland-Palatinate, Saxony-Anhalt, Schleswig-Holstein, Thuringia, Brandenburg, Mecklenburg-Vorpommern, Saarland, Berlin, and Bremen, and North Rhine-Westphalia (only step 2). The federal grants for special needs (*Sonderbedarfs-Bundesergänzungszuweisungen*) made up for a total of another 12 billion euro. Non-earmarked grants to the Länder made up about 10 per cent of the projected budget – 28.8 billion euro – in 2011.

Revenues of the social insurance institutions, including unemployment insurance, are complemented by federal grants as established by the Basic Law (Art. 120 (1) BL). In case of the statutory pension insurance scheme, *Deutsche Rentenversicherung*, the Federation provides co-funding by balancing the difference between revenues and expenditure. In the federal budget plan of 2011, grants to the pension scheme amounted to 26 per cent of the federal budget; high subsidies also result from the merger of the social insurance funds of the

¹⁰⁸ The first cycle of the Solidarity Pact was established in 1995. As a result of a challenge by Baden-Württemberg, Bavaria, and Hesse, the solidarity pact was renewed in 2005, limiting the transfers and scheduling their discontinuation after 2019.

former GDR with the German statutory insurance carrier. Bodies of the statutory health insurance system (*Gesetzliche Krankenversicherung*) also receive annual grants to compensate for the execution of tasks that are outside their immediate remit (such as co-insurance of non-contributing family members); these were projected to amount to 5 per cent of the federal budget (amounting to 15.3 billion euro) in 2011.¹⁰⁹

The own revenues of municipalities are augmented by equalisation revenues. With the exception of the three city states, municipalities receive an additional source of revenue where required to minimise differences in financial power among the municipalities. Indeed on average this is the largest spending item in *Länder* budgets. This system of vertical and sometimes horizontal equalisation (where municipalities become net contributors) within each *Land* varies and is laid down in individual *Länder* laws. Some of these vertical transfers are disbursed as matching grants, involving co-financing, occasionally also by the federal government or the EU. Those matching grants would typically be for transport and other infrastructure projects. However the largest part of the equalisation transfers is paid out unconditionally, with spending decisions being fully at the discretion of the recipients. The fiscal transfers are calculated on the basis of two criteria: fiscal capacity and fiscal need. Fiscal capacity is computed based on tax revenue at standardised tax rates, while fiscal need is determined on the basis of a politically chosen acceptable amount of spending per resident.

For 2011, the Federation has allocated 11.2 per cent of its planned budget related to basic benefits to jobseekers, that are administered by municipalities or their associations.

4 Fiscal governance

4.1 Provisions on public borrowing, issuance of bonds, insolvency, and bailout

Applying to the Federation and the *Länder*, before 2011, public borrowing was restricted by constitutional provisions in principle but less so in practice. The “golden rule” was introduced into the Basic Law in 1969 to ban financing non-investment expenditure from credit; similar provisions were enshrined in *Länder* constitutions.¹¹⁰ Exceptions made allowed to prevent disturbances to the economic equilibrium. Arbitrary application of this possibility resulted in the rise in public debt at the *Länder* level. Fiscal imbalances have become particularly pressing in three *Länder*: Berlin, Bremen and Saarland.

With entry into force in 2011, Germany introduced a constitutional structural budget balance rule applicable to the Federation and the *Länder*. Specifically, the amendments agreed in 2009¹¹¹ require that the budgets of the Federation and the *Länder* be balanced

¹⁰⁹ Concerning employment, the federal budget plan 2011 foresees no grant to the Federal Employment Agency (2010, such grants made up 5.2 billion euro or 1.7 per cent of the budget), while loans of comparable magnitude – 5.4 billion euro – are budgeted instead.

¹¹⁰ Before the 1969 reform, the Basic Law allowed public borrowing only to cover extraordinary needs and only for profitable purposes. The reform in 1969 enabled debt-financed public expenditure for economic stabilisation.

¹¹¹ In the deliberation phase, the *Länder* maintained strong reservations against the introduction of the debt brake, based on their right to fiscal autonomy; positions only moved in the course of the financial crisis 2008. Schleswig-Holstein even – unsuccessfully – challenged the debt brake at the federal Constitutional Court in 2010.

without revenues from credit (Art. 109 (3) BL). For the Federation, this principle is established to be satisfied when revenue from borrowing does not exceed 0.35 per cent of nominal GDP, while cyclical effects have to be taken into account symmetrically.¹¹² The Basic Law further establishes a notional control account where deviations from the ceiling are recorded; debits on this account exceeding 1.5 per cent of GDP have to be reduced in accordance with the economic cycle (Art. 115 (2) BL). The established credit limits may be exceeded in the case of natural catastrophes or unusual emergency situations beyond governmental control and with substantial harm to the state's financial capacity. Such deviation requires decision by the majority of Bundestag members as well as the submission of an amortisation plan including repayment of such excess credit within an appropriate time horizon. The deficit ceiling of the budget balance rule is phased in with a transition period to gradually reduce the excess structural deficit by about 0.3 per cent of GDP p.a. to reach the ceiling as from 2016. For the Länder, a transition period is granted to reduce excess structural deficits and comply as of 2020. During the adjustment path, Schleswig-Holstein, Berlin, Bremen, Saarland, and Saxony-Anhalt, Länder with particularly difficult fiscal positions will receive assistance payments provided in equal shares by the Federation and the other Länder (*Konsolidierungshilfen*). These grants are conditional on compliance with an agreed consolidation path.

Seemingly strong at first sight, the debt brake carries implementation risks at the federal level; substantial scope for variation in the transposition to constitutional and secondary law at Länder level adds to the risk of inconsistent and overly permissible application. Specifically, at the federal level, inconsistent accounting provisions, the lack of consideration of financial transactions, and insufficient consideration of fiscal positions of the social security sector and of special funds have been identified as potential obstacles to an effective containment of debt (Sachverständigenrat, 2011). The Länder are free to specify the legal basis and relevant implementation provisions. Four Länder have already enshrined balanced budget rules in their constitution, while in another such an amendment is being drafted. Another six Länder have incorporated budget balance rules in their state budget acts. The latter typically allow for more generous possibilities for non-compliance though, and can besides be modified by ordinary legislative procedures.¹¹³ Further scope for differences in implementation is given by the choice with regard to applying the debt brake to nominal or structural budget balances, the methodology for cyclical adjustment, or whether to use a control account.¹¹⁴ The effectiveness of debt brake provisions at the Länder level might further be hampered by the insufficient coverage of municipal public finances (Sachverständigenrat, 2011).

The institutional framework to monitor compliance with the debt brake has been strengthened in Germany, while enforcement provisions are less strict. Compliance with the constitutional debt brake at both the federal and the Länder level is monitored by the newly established Stability Council that is composed of the federal ministers of finance and economics and the finance ministers of the Länder. Assessments are based on a federation

¹¹² At the level of the Federation, cyclical adjustment is done using the common OECD/Commission methodology. On the *Länder* level, there is a lack of an agreed methodology for cyclical adjustment: this may result in differences in the effective implementation of the rule.

¹¹³ Schleswig-Holstein, Hessen, Rhineland-Palatinate, and Mecklenburg-Vorpommern have enshrined a debt brake in their constitutions, while such amendment is in the process of adoption in Lower Saxony. Baden-Württemberg, Bavaria, Hamburg, Saxony, Saxony-Anhalt and Thuringia have adopted balanced budget rules in their [budget acts](#) (*Landeshaushaltsordnungen*).

¹¹⁴ E.g., to date, only Rhineland-Palatinate has set up a control account similar to the one at the federal level. , based on a federation wide early warning system to indicate fiscal distress.¹¹⁴ The Stability Council

wide early warning system to indicate fiscal distress: in their presence, a consolidation will be established in the concerned Land.¹¹⁵ Concerning enforcement provisions, there is the option of filing an action with the Federal constitutional court (covering the Länder as well as of 2020) or at the Länder constitutional courts in case that respective constitutional amendments have been made at the level of the respective Land. Additional sanctions are available for the recipients of consolidation support (see Section 3) that are suspended in case of non-compliance.

Budget balance rules have also been in place for the local government sector, typically codified in the Länder Local Authority Acts. Local authority budget law generally obliges the municipalities to balance revenues and expenditure in its administrative and capital accounts, but does permit some borrowing, for investment purposes in particular. The monitoring is carried out by the municipal supervisory agencies of the Länder. The local authority supervisory agencies can refuse the authorisation of the municipal budgets in case of non-compliance. They can impose sanctions against the local authority concerned. Municipalities with financial difficulties can be obliged to implement consolidation programmes. In particular cases, the supervisory agencies can also temporarily take over the administration of the municipality. The rule has been respected in more than 50% of cases and contributes to fiscal discipline. Non-compliance is justified mostly by poor financial endowment of the local authorities.

Default of public authorities has not been a credible scenario in Germany in the past, but expectations could be changing at present. Specifically, according to the bankruptcy code (*Insolvenzordnung*), bankruptcy procedures against public bodies are inadmissible. At the same time, the highly indebted Länder recurrently obtained large transfer payments to alleviate their fiscal distress. In 1988, Bremen and Saarland turned to the Constitutional Court to demand transfer payments from the Federation, arguing that their high levels of debts resulted from adverse economic developments outside their control and claiming that they would be unable to fulfil their constitutional mandate otherwise. A ruling of the Constitutional Court of 1992 posited that financial support indeed was to be granted to states in financial hardship. As a result of a Constitutional Court decision of 2005, payments to Bremen and Saarland are to be discontinued until 2019# (Stehn and Fedelino, p. 9).

In the event of municipalities being highly indebted or experiencing payment difficulties, the responsibility rests with the government of the respective Land to restore the financial capability of the municipalities concerned. To that end many Länder have implemented or announced programmes for local authority debt reduction and fiscal consolidation. Regional government support generally is linked to consolidation efforts at the local authority level. Municipalities are not directly involved in the debt brake. However, at present there are concerns that its introduction at state level may imply a shift of the financial burden to municipalities.

4.2 Medium-term planning and other budgetary procedures

¹¹⁵ Potential fiscal distress is monitored using the following indicators: structural budget balance per capita, borrowing-to-expenditure ratio, interest-tax ratio and debt level per capita. When three of these indicators exceed the established thresholds, budgetary distress is identified. Thresholds are defined against the *Länder* average. Therefore, a simultaneous worsening of the fiscal situation of the *Länder* is left undetected.

Although not legally binding, some co-ordination is applied in medium-term budgetary planning of the Federation and the Länder. For the Federation, medium-term planning is anchored in the Basic Law (Art. 110 BL). A medium-term financial plan is adopted with the federal budget each year, it extends over three forthcoming years. The plan includes detailed projections for the main expenditure items by spending areas and revenues broken down on different taxes. The budgetary targets can be revised, but medium-term planning is part of the coalition negotiations, so that new drafts are in line with (maintained or revised) budgetary objectives. Owing to their fiscal autonomy, the Länder operate separate procedures for medium-term budgetary planning that correspond to that of the federal level. Co-ordination of medium-term planning between the Federation and the Länder is provided by the Stability Council. The Stability Council makes recommendations for budgetary discipline and for a common line on expenditure specifically. Furthermore, it biannually discusses budget projections for the federation and the Länder used as inputs to the Stability Programme.

Consistency of budgetary planning across sectors of general government is also by the work of independent fiscal institutions traditionally operating in Germany. Specifically, projections for taxes provided by five economic research institutes, the Bundesbank, the German Council of Economic Experts (*Sachverständigenrat*) and the federal Ministry of Finance are co-ordinated by the Working Party on Tax Revenue Forecasting (*Arbeitskreis Steuerschätzung*). This body acts as advisory council to the federal Ministry of Finance and consists of representatives of the federal ministries of finance and economic affairs, the five research institutes, the federal Statistical Office, the Bundesbank, the German Council of Economic Experts, and the Federal Union of Central Associations of Local Authorities (*Bundesvereinigung der kommunalen Spitzenverbände*). The co-ordinated tax revenue estimates are extrapolated to tax revenue for the federal government, the Länder governments, the local authorities, and the EU; this provides the grounds for the annual budget and medium-term budgetary planning of the Federation. The consistency of budgetary planning across sectors of general government is further enhanced by the scrutiny of independent fiscal institutions. Notably, the Council of Economic Experts (*Sachverständigenrat*), a body of independent economic experts, provides fiscal analyses as well as macroeconomic forecasts and long-term projections for all general government, and assesses the medium-term budgetary framework of the Federation. Yet another institution, the Joint Macroeconomic Forecast initiative of leading research institutes (*Gemeinschaftsprognose*), co-ordinates the data, assumptions and conclusions applied by several leading research institutions in their analyses of general government public finance, and also scrutinises the medium-term planning framework of the Federation. Finally, the Advisory Board to the Federal Ministry of Finance advises the ministry on all issues of fiscal policy, covering all general government and fiscal relations between its sectors as well.

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IRELAND

1. General description

Ireland is a unitary country. The Irish Constitution recognises the role of local government in providing a forum for the democratic representation of local communities, in exercising and performing at local level powers and functions conferred by law and in promoting by its initiatives the interests of such communities. The Local Government Act 2001 is the principal legal code governing local government in terms of structures, operations and functions. In addition to the 2001 Act, the operation of local authorities is affected by a range of other legislation dealing with specific services such as housing, roads, planning and waste.

Ireland has a three-tier government structure – central government and two-tiers of local government. 26 county councils and 5 city councils are the primary units of local government, which cover the entire territory of the state. In the second tier of the local government are 80 town councils with limited functions in smaller urban areas¹¹⁶.

The most recent wide-ranging reform of the local government sector was in 2001. It simplified the fragmented structure that existed since 1898 and introduced the second tier of the local government. Several lower-level reforms are on-going, including merging of some local authorities; efficiency reforms (shared services, common procurement platform, staff number reductions) and improvements in budget control and reporting framework.

Elected members of the local authority form the principal decision-making body in each authority. They adopt an annual budget, pass or revoke local laws (secondary legislation), approve borrowing and lay down the policy framework under which the county managers must operate. The county or city managers are appointed chief executives with delegated powers to manage local authorities on daily basis.

Local government sector in Ireland is one of the smallest in Europe. Total expenditure of the local governments amounted to 6.8% of GDP in 2010 on unconsolidated basis. Level of control of the local authorities is even lower as the central government funds about 60% of local government expenditure.

2. Government spending

Local authorities are responsible for an extensive range of services including housing, roads, water services, community development, environmental services and protection, planning, fire services, libraries, arts and culture, parks, open spaces and leisure facilities, higher education grants to students¹¹⁷, motor tax collection, maintaining the register of electors, and other services. Local authorities are exclusively responsible for certain services, notably water supply, waste water management and fire-protection services, as well as cover large share of other public services in their area of responsibility. However, they are not autonomous in the

¹¹⁶ Administrative areas of town councils are limited and do not cover the whole country. Town councils do not have all functions of the county councils – both institution levels have distinctive responsibilities in the same territory.

¹¹⁷ The Higher Education Grants Scheme is one of four different student grant schemes and it is processed by local authorities, while money comes from the central government (the Department of Education and Skills). Most of the responsibility for education system rests with the central government. Universities in Ireland are classified outside the government sector.

decision making process, as services are largely coordinated and funded by the central government. Higher control of local authorities and lower central government funding are in the areas of housing and urban development, cultural services and fire protection. The range of services provided by the local government sector in Ireland is relatively narrow in an international context, with a number of key services such as health and policing being provided through central government systems. However, local government, and government in general, is highly involved in the housing market as compared to other Member States. Local authorities' housing services account for a quarter of their budget and serve almost 16% households in Ireland. They include local authority-owned housing (7% of all households), rent supplement schemes (6%)¹¹⁸, housing leased by local authorities (2%) and housing owned by approved voluntary and co-operative housing bodies (1%).

Total expenditure of the local government sector amounted to EUR 10.5 billion in 2010 on unconsolidated bases (about 15% of general government expenditure excluding banking support measures), of which EUR 6.7 billion in current expenditure and EUR 3.8 billion in capital expenditure. Current expenditure covers the service provision costs of local authorities, including staff salaries, housing maintenance, pensions, operational costs of water treatment plants, etc. Current expenditure is funded through a combination of commercial rates, charges for goods and services, specific and general grants from central government. Local authorities employ approximately 30.6 thousand people – about 10% of total public service employees. Capital expenditure is spent on road construction, building or purchase of houses, swimming pools, libraries, etc. Capital expenditure is funded through a combination of central government grants, borrowings and income from other sources such as development levy contributions. While local authorities spend some 70% of the general government investment, central government determines large share of investment priorities as specific capital grants from central government account for around one-third of capital spending. Road construction and maintenance is supervised and coordinated, and funded from the National Roads Authority (part of the central government). Other projects are coordinated between local authorities and respective central government departments. For example, water supply and waste water infrastructure is administered and maintained by the local authorities, but it is largely funded by the Department of Environment, Community and Local Government, also being involved in the decision making process.

3. Financial arrangements

Main source of local government revenue is grants from the central government, which accounted for 60% of total revenue in 2010. There are two types of central government grants to local authorities – general and specific. General grants are not constrained by specific spending parameters and include most of the financing allocated from the Local Government Fund. Specific grants are earmarked for specific purposes and cover the delivery of specific state services or projects through local government such as roads or higher education grants. Local Government Fund is made up of a contribution from the central government and motor tax receipts. Motor tax is collected by the local authorities, but rates are set at the national level, as well as revenue is recorded in the central government accounts. General grants account for 90% of the fund and the rest is specific grants for non-national roads. General grants are structured to bring about equalisation of resources among local authorities over time. For the purposes of allocations, a range of factors is taken into account, including each local authority's expenditure and revenue, as well as the overall amount of funding available

¹¹⁸ Provided by central government (Department of Social Protection)

for distribution. A computer-based model assists in determining whether spending level and resources are adequate in each local authority.

High share of specific grants in revenue implies limited control of local authorities over this part of their budgets. Excluding expenditure funded by specific grants, local governments have discretion over some 7% of general government expenditure (about 3% of GDP). The share of the grants in the local government has increased as other revenue sources declined during the financial crises. This has required an appropriate adjustment in expenditure of the local authorities, given borrowing restrictions.

Other major revenue source of local government is commercial rates, charges for goods and services and development contributions. The local authorities have some control over this revenue and its use, although some charges (such as planning application fees) are set centrally.

Commercial rates are property taxes (indirect taxation) levied on commercial property. Revenue from commercial rates amounted to 13% of total local government revenue in 2010 (0.9% of GDP). The level of the rate is determined each year by local authorities as part of their annual budgetary process. The rates are applied on the value of the property determined by the Commissioner of Valuation, which periodically revaluates commercial properties in local authorities.

Charges are levied on services provided by local authorities, for example, commercial water charges, housing rents, waste charges, parking charges, planning application fees, refuse and landfill charges, library fees and fire charges. Development contributions are paid to local governments as a condition of planning permissions and allow recouping some of the public costs for providing public infrastructure and facilities that benefit development in the area. Development contributions and related capital expenditure have substantially declined after the crash in the property market.

In order to place local government on a sound financial footing and reduce reliance on the central government grants, new income streams are being developed. A charge on non-principal private residences of EUR 200 was introduced in 2009 and an additional household charge of EUR 100 in 2012. Both charges yield more than 0.1% of GDP. Further revenue-increasing measures will be introduced in 2013-15, in line with fiscal adjustment plans, yielding additional 0.4% of GDP. In particular, a valuation-based property tax will be introduced replacing the current interim measures.

In the national accounts, different charges and development contributions are recorded as sales, property income and transfers from private sector. Total revenue of this kind amounted to 23% of total local government revenue in 2010 (1.5% of GDP). Social contributions received by local government sector are those paid on wages for own employees.

4. Fiscal rules

A fiscal rule for local government sector was established in 2004 – the sector's fiscal deficit on ESA95 basis should not exceed EUR 200 million in any year. The rule was established as a political agreement and is laid down in administrative circulars. The implementation of the rule is controlled by the Department of the Environment, Community and Local Government.

The overall deficit rule is expressed in the operational limits for local government borrowing taking into account existing loan repayments.

The adherence to the rule is monitored by current and capital account controls, and loan sanctions. Control measures have been tightened since 2009 to strengthen adherence to the rule. Accrual-based fiscal target can be measured from both the non-financial transactions and the financial balance sheets. The former are recorded in current and capital accounts of the local authorities, which are required to have balanced revenue–expenditure positions. However, as these accounts include certain financial transactions, a control of financial balance sheets and borrowing limits are necessary. Borrowings by the local authorities are sanctioned by minister, ensuring that the required borrowing limits are respected. The budgets of local authorities are monitored throughout the year and any expenditure overruns should be compensated for by either a reduction in another expenditure area or increased income.

Local government debt was at 3.4% of GDP in 2010, of which 2.8% to central government and 0.6% to private sector. While default by local government is possible, it is most likely to be bail-out the central government. In 2010, the central government repaid some of the loans of local authorities in financial difficulties. Alternatively, these troubled authorities would have cut their services.

ESTONIA

1. General description

Estonia is a unitary country. It has a two-tier government structure introduced in 1993, which includes the central government and 266 local governments. The municipalities have their own councils elected every four years and their own budget. The size of the local governments varies greatly: the biggest municipality is the capital city Tallinn, while around two thirds of the local governments have less than 3000 inhabitants. The local governments can form districts on their territory in accordance with the law.

The local governments are integrated into 15 counties, which are not a separate governance tier, but state administrative units. Their role is to facilitate coordination between the state and the local level in implementing regional development programmes. The counties' governors are appointed by the government in consultation with the local governments to represent interests of the state in the county.

Basic provisions concerning local governments are established in the Constitution and regulated by laws. The main legal act governing municipalities is the Local Government Organisation Act (1993). Estonia ratified the European Charter of Local Self-Government without reservations in 1994. Since then, the local governance framework remained broadly stable.

According to the OECD data¹¹⁹, in 2010, the total expenditure and revenue of the local governments amounted to EUR 1435.4 m and 1467.9 m, respectively, which is around 25% of general government expenditure (slightly below the historical average) or 10% of GDP. Taxes represent around 46% and grants 42% of the total local government revenue, while the respective shares for the central government are 86% and 0%.

2. Government spending

The main areas of responsibilities of the local governments include education, health care, culture and sports, social welfare services, housing and utilities, waste management, maintenance of infrastructure, and spatial planning:

- Education accounts for roughly 40% of all total expenditure of the local governments and 58% of the total education budget. Local governments' responsibility is to organise maintenance of public pre-schooling (e.g. kindergartens), basic and secondary schools, and to cover their operational expenses (teachers' salaries, etc). The local governments are also responsible for organising student transport. The state is responsible for development of education policies and for establishing the overall standards in the education system (such as qualifications and basic salaries of teachers).
- Healthcare accounts for 16% of the total expenditure of the local governments and for about one third of the total healthcare budget. However, this data does not reflect the fact that the healthcare is funded from the budget of the Estonian Health Insurance Fund (HIF), who with the central government is responsible for policy development and implementation. While formally local governments own local hospitals, their operational expenditures are financed from the HIF. Local governments are partly responsible for the

¹¹⁹ OECD Fiscal Decentralisation Data includes expenditure of both local governments and dependant units (hospitals).

provision of the first level health care services (family physician), though the counties (state) have the overall responsibility.

- Social welfare services account for 8% of the total expenditure of the local governments. Local authorities are responsible for organising maintenance of social welfare institutions owned by them (e.g. shelters, care homes, etc.) and for organising social assistance and welfare for elderly, disabled, and other persons in need of assistance (e.g. homeless). The state is responsible for the development of the social welfare policy, the identification of social needs, and for the organisation of victim support and conciliation service.
- Economic activities (provision of transport), recreation (culture and sports), and housing and utilities (water supply, heat supply, waste management, etc.) are under responsibility of the local governments.

3. Financing

According to the Estonian legislation, the state budget and the local governments' budgets are separated. Local governments may use the following means to finance their expenditures: shared (state) and local taxes; grants and allocations from the state budget; locally generated income fees and proceeds from municipal property. There is a mechanism for equalisation of revenue between the municipalities.

Revenues from taxes

- The biggest portion of income for the local budgets comes from the state personal income tax (46% of total revenues in 2010¹²⁰). This is a shared tax, and the local authorities receive 11.4% of resident's total revenue¹²¹. The tax threshold and tax exemptions are not applied to the local government share, but are settled fully out of the state share. This means that in practice the local share of the tax revenues was as high as 80%.
- Land tax accounted for 4% of the local governments' revenues in 2010. While it is a state tax by law, it is fully paid into the local budgets. The tax base and the limits of the tax rate (0.1–2.5% of the estimated value of land; 0.1–2.0% for agricultural land) are set by law, and the local authorities can determine the tax rate within those limits. In 2013, Estonia abolished the land tax requirement for the most of the residential land provided that the primary residence of a taxpayer is located on that land.
- Local governments can impose and levy local taxes and user charges in accordance with law. The main local taxes include advertisement tax, road and street closure tax, motor vehicle tax, animal tax, entertainment tax, and parking charges. However, the local taxes and fines represented only about 1% of the total local revenues in 2010.

State grants and allocations

The second largest source of income for the local governments are **grants from the state budget** which accounted for 34% of the total revenues in 2010. They are allocated through the equalisation fund and the block grant (together representing some 90% of total grant distribution), and through earmarked grants from ministries and state agencies.

¹²⁰ Data based on local budget execution reports prepared by the Estonian Statistical Office. It excludes expenditure of the dependent units (hospitals).

¹²¹ The personal income tax rate is 21%, to be reduced in 2015 to 20%

- The purpose of the block grants (ca 3.5% of the 2012 state budget expenditure) is to support service delivery in several areas. The most important area (87% all grants) is education, as the local authorities are obliged to maintain their school houses and to pay salaries to teachers. Other areas include the subsistence benefits, some types of social benefits and services, a support for registration of the changes in population (birth and deaths), and a support to small islands.
- The purpose of the equalisation fund (ca 1.1% of 2012 the state budget expenditure) is to balance the excessive differences among the income bases of different local authorities, and to ensure that all municipalities provide adequate public services to their inhabitants. The amount of the equalisation fund in a draft state budget and its distribution among municipalities are determined in the negotiations between the local governments and the state. The equalisation grants are divided between the local governments based on the equalisation mechanism that takes into account the average expenditure need based on population size and age structure, and the weighted lagged accounting revenues. Overall, a large majority of the local governments receives the equalisation grants, with a notable exception of Tallinn area and the oil-shale production region in the north-east of Estonia.
- Other earmarked grants cover mainly local governments' activities to maintain and develop infrastructure and are provided from the annual budgets of ministries.

Other sources of revenue

Local governments receive revenue from their economic activity (sale of goods and services, ca 11% of revenues in 2010), property income (2.4%), and a sale of property (1%). The amounts of fees for the use of natural resources and water, as well as the size of the share paid into the local budgets are determined by a government decree.

4. Fiscal rules

The difference between the revenues and expenditures of the local governments is financed by borrowing. In 2009, local governments' debt burden reached 50.8%¹²². Due to eroding revenue base during the financial crisis, one-off measures were introduced to limit the borrowing by local authorities. Consequently, the debt burden of local governments fell slightly to 50% in 2010, marginally outpassing the 60% threshold only in Harju and Parnu counties (60.7 and 60.5%, respectively).

From 2009 until end-2011, the local government could undertake new financial obligations (i.e. take loans, issue debt securities, sign financial leasing agreements) only under the double condition that the total amount of the outstanding financial obligations by a local government and their servicing would not exceed 60% and 20%, respectively, of the budget revenue planned for a given budget year (excluding the earmarked transfers from the state budget). Moreover, since 2009, the local governments could only borrow to co-finance structural funds and to re-finance their existing liabilities, and only with the consent of the Ministry of Finance.

¹²² Debt divided by net revenue, based on the local governments budget execution reports. Data provided by the Estonian Statistical Office.

As of 2012, a new local government financial management act is in force, which makes provisions for medium- to long-term financing frameworks, modernises and increases transparency of financial governance, and reinforces fiscal discipline of the local governments. It establishes a net debt ceiling (debt minus liquid assets) of 60%-100%¹²³ of the operational revenue in the current fiscal year depending on a self-financing capacity of municipalities. The ceiling is allowed to be exceeded by the amount of a 'bridge financing', essentially in order to ensure sufficient co-financing of the EU structural funds. The bridge loan can be taken in the amount of targeted foreign financing and received co-financing to provide payments until the receipt of the targeted financing and co-financing. The new rule is applicable to all borrowing by the local governments and their dependent units, with no escape clauses.

The responsibility for monitoring and enforcement of the rule lies with the Ministry of Finance. In case of deviations, the Ministry of Finance makes proposals to correct the situation. A local government has to submit to the Ministry of Finance an operational plan for t+3 years indicating measures to ensure financial discipline. In case of a risk of a difficult financial situation, the Ministry of Finance forms a committee independent of the local government at risk, which in cooperation with the local government prepares a recovery plan for t+4 years, which includes be a sound financial plan.

To ensure implementation and timely submission of the corrective plans, the Ministry of Finance can suspend the transfers from the equalisation fund and of the income tax share of the local governments. In practice this means that the financial sanctions are only applied if the local governments ignore or disobey the corrective procedure.

¹²³ Exceptionally, in 2012 local governments cannot take new loans if it results in a debt burden of over 60%. Local governments whose debt is already above 60% cannot borrow at all in 2012.

GREECE

5. General description

The Greek state has been highly centralised since its founding in **1832**. This situation has been gradually changed since the adhesion to the European Union in **1981**. In **1987**, **13 programme-regions** were established by a presidential decree. In 1994, the 51 nomoi (prefectures), which have been acting as state territorial administration units for 160 years, became self-governments with directly elected prefects and councils (law 2218/94 on the establishment of democratically elected government at prefecture level). In **1997**, the law 2539/97 on the "formation of the first level of local government" was an attempt to empower the municipalities by increasing their size. This programme, called **Cappodistrias Plan** reduced the number of primary local authorities from 5825 in 1997 to 1034 in **2005**. In **2001** a constitutional revision reinforced decentralization and explicitly stated that there are two levels of local government in Greece. From **2003**, discussions between the Hellenic Ministry of interior, the Parliament and local authorities were focused on redrawing (under a **Cappodistrias 2 plan**) the administrative boundaries of the local authorities, in order to better profit from EU funding.

Greece is a unitary state with a two-tier government structure. Its constitution was ratified on June 11, 1975. The articles 101 and 102 recall the principles of decentralisation and local autonomy. The 2001 constitutional revision explicitly states that the administration of local affairs shall be exercised by local governments of first and second level and that they enjoy administrative and financial independence. In particular the article 102, paragraph 5 of the constitution states: "The state takes all the legislative, regulatory and fiscal measures needed for guaranteeing the economic and resources autonomy of the local self-Government Organizations (**OTA**), together with assuming the responsibility of securing administration transparency of these resources".

Law 3852/2010 on the "New architecture of self-governance and decentralized administration- Programme Kallikratis" is the most recent modification of the decentralised governance in Greece.

In particular, there are two levels of subnational self-governments:

- At the first level, **325 municipalities** have been established (substituting the 1034 ones from the previous legislation). Each is comprised by the unification of a number of the pre-existing local departments which have been renamed as **local communes** (when population is up to 2000) or **municipal communes** (when population is more than 2000).

The **municipalities (the 1st level of self-governance)** are self-governed autonomous public law legal entities. They are governed by the municipal council (the number of its members varies with the corresponding population), the economic committee, the committee of quality of life (for municipalities of more than 10000 inhabitants), the executive committee and the mayor. Each of the municipal communes and local communes are governed by the council and a council president.

- At the 2nd level, **13 regions** (peripheries; in the previous legislation they were the decentralised state administration units) are established. Those are governed by the Head of the Region (peripheriarchis), the vice-heads of the region (antiperipheriarchis) the Region Council, the economic committee and the executive committee. The number of these offices is determined by the law according to the population features of each region.

At the national level Greece is divided in **7** integrated decentralised state administration units, called **Decentralised Administrations** (*apokendrwmenes diikiseis*), for each of which a Secretary General is appointed by the central government.

After Kallikratis Law implementation, subnational governments have undertaken extended competences in functions such as environment, life quality, social protection, education, culture and sports, agriculture, breeding and fishery development, etc (as set by Law 3852/2010).

Subnational governments' share of responsibility has increased after Kallikratis Law implementation as they have also accepted exclusive duties, in all cases served under central government directives.

They do not have autonomy in legislation but according to Constitution (Syntagma) they have administrative and financial autonomy.

Revenues of the decentralized self-governments

Law 1828/1989 introduced the model of direct state funding to the local self-governments through institutionalisation of the Central Autonomous Resources (Kendrikoï Autoteleis Poroi, KAP) within the national budget.

After 20 years in service the KAPs have been restructured according to the Law 3852/2010 (Kallikratis) aiming to the long term economic sustainability of the local government finances and their protection towards economic risks. The new sources of these funds are as follows:

- The revenues for the municipal KAPs are
 - i. The 21,3% of the total annual receipts of the income tax of the physical persons and legal entities, once revenues earmarked for OGA have been deducted;
 - ii. The 12% of the V.A.T. total annual revenues; and
 - iii. The 50% of the total annual receipts on regular property tax.

Two thirds (2/3) of the category (i) revenues and the total of (ii) and (iii), comprise the account covering operational and other general expenditures of the KAP. The rest one third (1/3) of the (i) category covers investment expenditures.

KAP covers 46%-49% of total Revenues of municipalities (and this share is planned to decrease according the Medium Term Fiscal Strategy 2013-2016).

- The revenues of the regional KAPs are:
 - i. The 2,40% of the total annual receipts of the income tax of the physical persons and legal entities, once revenues earmarked for OGA have been deducted;

- ii. The 4% of the V.A.T. total annual revenues.

Those revenues are distributed to the regional accounts specific for operational and other general costs and, to the regional accounts specific for investment expenditure, according to a common decision taken by the ministry of Internal Affairs, the ministry of Decentralization, the ministry of Economics after consultation of the Union of the Regions. Recently, an annual cap of 5.200 mln Euros has been introduced as part of the Medium Term Fiscal Strategy for the sum of the earmarked revenues for municipal and regional local governments. On a Regular Basis, Regions' Revenues come from KAPs and a part of it comes from Public Investment Programs. Additional Revenues include income from taxes of movable and immovable property, insurance contributions, fines and fees.

Municipal expenditures and revenues (other than the KAPs)

Expenditures of municipalities include: (i) Operational costs such as remuneration and personnel expenses, remuneration of elected and other staff; costs for serving the public trust (i.e. loans for covering operational and investment costs), costs for consumable goods (i.e. school maintenance and building materials); leasing costs and other general operational costs. (ii) Investments such as purchase of buildings, technical works and procurement of fixed assets; works; fixed assets/holdings in enterprises, and (iii) payments, returns and forecasts incurred in previous years.

Revenues may be distinguished as regular and irregular. Regular revenues are (i) revenues from immovable properties (i.e. rents from the use of public areas such as forest rents or fish-farm rents), (ii) revenues from movable properties (i.e. capital interest etc), (iii) revenues from retaliatory fees (e.g. cleaning, lighting, port, water, and sewer fees), (vi) revenues from royalties and services (e.g. revenues from cemeteries and slaughterhouses, fees on gross tradesmen income), (v) revenues from taxes and duties (electricity tax, beer tax, other municipality specific taxes)¹²⁴. Irregular revenues are mainly: revenues from selling immovable and movable property; subsidies for covering operational costs; investment subsidies (state or community funds); donations and inheritance; surcharges fines and fees (e.g. parking fines); loans. Taxes and their range are set by legislation with the only exception being the retaliatory fees for which municipalities can set their own rate.

Fiscal Decentralisation

The article 261 of the Law 3852/2010, explicitly states measures concerning fiscal decentralization of taxation.

1. A percentage of the actual increase of the VAT receipts within the administrative territory of a municipality will be assigned to the municipality concerned and it will exclusively be used for services of social solidarity. This is an attempt of certification, reception and allocation of local public revenues by the local government itself.

2. A percentage of 20 of the property tax revenues may be considered as local municipal revenue depending on the total amount of taxes collected in the administrative area of a

¹²⁴ The main taxes and fees (imposed as taxes) are 6. Electricity tax, beer tax, immovable property charge, gross income fee, sojourn fee and local tax of Dodecanese. Total taxes and fees imposed by municipalities are about 40. Apart from the main 6 the rest of them account for an important part of total revenues from taxes-fees.

municipality and the related ministerial decision. This revenue is allocated to actions concerning urbanization and related services.

3. The municipalities are given the power to ask for information on wealth elements (properties and income) of the physical and legal persons in their administrative territory.

Credit Policy

Regions and municipalities may take loans from financial organisations in the country or abroad only in the context of financial investment and debt financing purposes and, under the constraints: (a) that the annual cost of a debt financing does not exceed the 20% of its annual regular revenues; (b) the total debt of the region/municipality proceeding to borrowing does not exceed a threshold percentage of its total revenues. This threshold is determined by a ministerial decision. The total debt of the region/municipality is defined as the sum of its short and long term obligations. Subnational governments can issue bonds but this has not been applied yet. Local Government debt contributed with a minor percentage to General Government fiscal slippages.

Budgetary (5 years' term same as the mandate of the local governments) and financial control of the local governments is made by the Conference of Auditors (Elegktiko Synedrio). There have been cases of bail-outs of local governments in financial difficulties

SPAIN

1. General description

Spain is a **highly decentralized** country with a significant share of spending powers devolved to the regions denominated Autonomous Communities (CCAA henceforth), mainly on health care, education and social services. Article 2 of the Constitution ratified in 1978¹²⁵ guarantees the right of the CC.AA. and the regions to have their self government and ensures the solidarity amongst them. In turn, Article 137 sets out that CC.AA., provinces and municipalities enjoy autonomy for the management of their respective interests. Article 140 also ensures full autonomy to the municipalities.

As a snapshot, around 35% of total consolidated general government expenditure is made by the CCAA, whereas local governments are responsible for some 13%. Hence, altogether public spending under the responsibility of State (CCAA) and local governments amounts to almost 48% of total general government spending. Likewise, Spain also enjoys a high degree of fiscal autonomy. A sizeable share of tax receipts and fees are transferred to subnational governments, while at the same time they enjoy a high regulatory capacity over both shared and transferred taxes. Thus, shared and transferred taxes to the CCAA and local governments amount to some 29% and 15% of total consolidated government revenues, respectively; the remaining 56% remains in the hands of the Central Government.

The Autonomous Communities are divided into two main groups, namely the Autonomous Communities (CCAA) of **Ordinary Regime** and the Communities with **Foral Regime**. The financing systems differ between the two groups. The Autonomous Communities of **Ordinary Regime** are Andalusia, Galicia, Cantabria, Asturias, Castile-León, Castile-La Mancha, Aragón, La Rioja, Catalonia, Comunidad de Madrid, Comunidad Valenciana, Extremadura, Murcia, Balearic and Canary Islands, and the autonomous enclaves of Ceuta and Melilla. Their financing system of the Autonomous Communities (CCAA) of **Ordinary Regime** in Spain has been revised very recently (Law 22/2009 of 18 December). In turn, the Communities with **Foral Regime** are Navarre and the Basque Country, which enjoy full fiscal autonomy excluding customs tariffs, with the limitation that the overall effective tax burden does not fall below that of the rest of Spain.

Finally, the principles of the Social Security¹²⁶ are enshrined in Article 41 of the Constitution and its main tasks are assigned to different public agencies within the general government.

2. Government spending

The **central government** holds full legislative power only in the areas of international relations, nationality, migration, political asylum rights, defence, justice, customs, currency,

¹²⁵ <http://www.boe.es/aeboe/consultas/enlaces/documentos/ConstitucionCASTELLANO.pdf> or also in its English translation http://www.congreso.es/constitucion/ficheros/c78/cons_ingl.pdf

¹²⁶ These agencies are the National Social Security Institute (INSS in its acronym in Spanish), the National Institute of Healthcare Management (INGES), the National Institute of Social Services (IMSERSO), the Social Institute of the Navy (ISM) and the General Treasury of the Social Security (TGSS). However, this national institutional definition of the Social Security does not coincide with the Social Security subsector as defined in ESA95, which comprises the Social Security System (the main function of which is the functioning of the public pension system), the Public National Employment Service (SPEE in its acronym in Spanish) and the Wage Guarantee Fund (FOGASA).

general finance and Central Government debt, commercial, criminal, labour, civil and intellectual property legislation, general coordination of the public Health Care system and legislation on pharmaceutical products. The central government also has legislative powers on the basic legislation, definition of principles and economic regime of the Social Security including Health Care, although the provision of services is devolved to the CC.AA. and Local Governments. In many areas the central government shares competences with the CC.AA.

By the functional breakdown of public expenditure (COFOG) the assignment of the different competences can be summarized as follows:

- **General public services:** Definition of policy principles and their implementation lie within the remit of the central government except for debt issuance by CC.AA. and Local Governments.
- **Defence:** Full responsibility of the central government.
- **Public order and safety:** The definition of policy principles lie within the remit of the central government except for the areas of police and fire protection services. The effective implementation of public order and safety policies is accomplished by the central government, the CC.AA and the municipalities.
- **Economic affairs:** The definition of policy principles lies within the remit of the central government, while spending powers concerning areas such as agriculture, forestry, mining, fishing, construction, transport and communication have been devolved to the CC.AA. Local Governments have also powers on public transport within their geographical area.
- **Environmental protection:** The definition of policy principles and the implementation of these policies lie within the remit of the central government. The CC.AA. enjoy additional legislative power, while municipalities also enjoy spending powers on waste management and pollution abatement.
- **Housing and community amenities:** These spending competences have been mostly transferred to the municipalities, although the CC.AA can define the basic principles of town and country planning and housing.
- **Health:** The definition of policy principles and general coordination lie within the remit of the central government, whereas the effective spending powers have been devolved to the CC.AA. However, the legislation on pharmaceuticals lies exclusively on the hands of the central government.
- **Recreation culture and religion:** The definition of policy principles and general coordination lie within the remit of the central government, whereas the effective spending powers have been devolved to the CC.AA.
- **Education:** The definition of policy principles and general coordination lie within the remit of the central government; the effective spending powers have been devolved to the CC.AA.
- **Social protection:** The definition of policy principles and general coordination lie within the remit of the social security, as well as effective spending on areas such as unemployment and old age. Effective spending powers on social services have been devolved to the CC.AA and, to a lower extent, to municipalities.

3. Financial arrangements

3.1. Autonomous Communities

There are basically two different financing systems for Autonomous Communities in Spain depending on their regime. The two Communities with **Foral Regime**, notably Navarre and the Basque Country, enjoy full fiscal autonomy excluding customs tariffs, with the limitation that the overall effective tax burden does not fall below that of the rest of Spain. They are responsible for taxes collected in their respective territory and negotiate the amount to be transferred to the central government on account of such taxes for responsibilities remaining centralized, and in proportion to their relative income and population. This transfer is set to evolve in line with the observed growth rate of the Central Government's tax revenues. This agreement is revised every five years. In turn, the Autonomous Communities (CCAA) of **Ordinary Regime** enjoy a different financing system that has been revised very recently (Law 22/2009 of 18 December). This system is described in greater detail in the next subsection.

The financing system of Autonomous Communities of Ordinary Regime

The current financing system introduced some amendments to the previous one in effect until 2008. In essence, the functioning of the financing system can be summarized as follows:

- a. The new system first determines the funding needs (spending needs in the previous system) for all the CCAA in a base year augmented with additional resources contributed by the Central Government.
- b. These funding requirements are distributed among the CCAA according to the agreed criteria concerning the so-called "essential public services"¹²⁷ (Guarantee Fund) and confronted with the 75% of the transferred tax revenues in each Autonomous Community. The difference between them takes the form of a grant from (+) or to (-) the Central Government.
- c. Levelling transfers are set to ensure that each Autonomous Community receives enough resources in the base year for the competences assumed (Global Sufficiency Fund).
- d. Two additional Convergence funds are set, notably the Competitiveness Fund and the Cooperation Fund, whose basic function is to provide certain CCAA. with additional resources.
- e. Finally, standards for the evolution of transfers are set. In practice, there are advanced payments on account of budgetary projections in the Central Government Budget for a given year, with its final settlement normally taking place after two years.

a. Overall financing needs in the base year

For each Autonomous Community the resources in the base year were gauged on the basis of the funds that it would have received under the previous system. Thus, the overall funding needs in the base year were assimilated to the finally settled ones by the previous funding system, augmented with additional resources that amounted to some € 7.4 billions (0.7% of GDP). These additional resources were allotted according to some pre-determined criteria.

b. Tax capacity

¹²⁷ In the previous system funding needs were distributed according to all the powers transferred.

The tax capacity of CCAA to finance the expenditure related to the spending powers assumed is also estimated for the base year. Such tax capacity includes both the collection of taxes assigned and the specific fees linked to the powers assumed.

The new system raised the amount of taxes transferred (personal income tax, VAT and excise duties) and tax powers on the personal income tax and other traditionally transferred taxes such as Property Transfer and Stamp duty, Inheritance and Gift, taxes on gaming, hydrocarbon-oil taxes, taxes on certain means of transport and fees. Specifically, the share of taxes transferred to the CC.AA. are:

- **Personal Income Tax:** 50% of total net tax revenues thereof (33% in the previous system), with normative capacity on the regional rate (progressive) without restrictions on brackets, though subject to approval. CC.AA. also have normative capacity on personal and family allowances (\pm 15% limit for each of the components) and deductions for personal circumstances, business and housing investments. However, the definition of family circumstances covered by such allowances cannot be changed. Restrictions on the number of income brackets and marginal rates were removed on condition that the autonomic rate is progressive. Moreover, regional rates are subject to annual approval.
- **VAT:** 50% of total receipts thereof (35% in the previous system), although with no normative capacity. These are distributed among CCAA according to regional consumption indexes gauged by the National Statistical Office (INE).
- **Excise duties on manufactured production of alcohol, tobacco and hydrocarbons:** 58% of total net tax revenues thereof (40% in the previous system), with no normative capacity. These revenues are distributed among CCAA according to regional consumption indexes gauged by the National Statistical Office (INE), the Ministry of Industry, Energy and Tourism or the Tobacco Market Commissioner.
- **Hydrocarbon-oil retail sales:** 100%, with some normative capacity on the tax rate.
- **Electricity:** 100% of total net tax revenues, with no normative capacity. These revenues are distributed among CCAA according to regional consumption indexes gauged by the National Statistical Office (INE) and the Ministry of Industry, Energy and Tourism.
- **Property Transfer and Stamp Duty:** 100%, with normative capacity on the tax rate (except for corporate transactions) and on deductions and allowances.
- **Registration of motor vehicles:** 100%, with some normative capacity on the tax rate.
- **Taxes on gaming:** 100%, with normative capacity on exemptions, rate, tax base, fixed fees, allowances and accrual.
- **Wealth tax:**¹²⁸ 100%, with full normative capacity on the tax rate, allowances and allowances.
- **Inheritance and gift tax:** 100%, with full normative capacity on the tax rate and some normative capacity regarding reductions in the tax base, deductions, allowances and coefficients of existing wealth.

¹²⁸ This tax was withdrawn in 2009 and has temporarily been re-introduced to assuage the budgetary impact of the crisis. The tax is envisaged to take effect in 2012 and 2013.

c. Guarantee fund for essential public services in the base year

The distributing criteria of resources across CCAA only apply to the so-called "essential public services of the welfare state", namely health care, education and social services.¹²⁹ A Guarantee Fund for Essential Public Services (Guarantee Fund henceforth) aims to ensure uniform access to these basic services to all citizens regardless of their place of residence. All CCAA contribute 75% of the tax revenues and fees assigned to them to this fund,¹³⁰ to which € 8.7 billions contributed by the Central Government were added in the base year. Notwithstanding the way these funds are gauged, most **financial resources assigned to the CC.AA. are not earmarked.**

This fund was theoretically distributed among the CCAA based on the so-called "adjusted population", which is gauged as a weighted average of seven variables: population (30%), area (1.8%), dispersion (0.6%), insularity (0.6%), equivalent protected population (38%), population aged 65 years or above (8.5%) and population up to 16 years of age (20.5%).

Thus, the net transfer from the Guarantee Fund (NT) was gauged as the difference between the amount of the share of each Autonomous Community in the Guarantee Fund in the base year (GF) and amount of its contribution (75% of its respective tax revenues in normative terms (TREV)). Such net transfer takes the form of a grant between the Central Government and the relevant Autonomous Community according to the following formula:

$$NT_i = GF_i - 75\% \text{ TREV}_i$$

d. Global Sufficiency Fund in the base year

In order to ensure enough resources for the competences assumed, a levelling grant called Global Sufficiency Fund (GSF_i) for the base year and for each Autonomous Community was set. Such grant covered the difference between the overall financing needs (NF_i), on the one hand, and the sum of the tax capacity (TREV_i) and the transfer (positive or negative) from the Guarantee Fund, on the other. In practical terms this implies that each Autonomous Community will have the 25% of its tax revenue in normative terms, plus its participation in the Guarantee Fund, plus its share on the Global Sufficiency Fund to cover its financing needs.

$$NF_i = 25\% \text{ TREV}_i + GF_i + GSF_i$$

This Global Sufficiency Fund consists of a transfer from the central government to respective Autonomous Community if overall spending needs exceed the resources provided jointly by the fiscal capacity and the participation in the Guarantee Fund, or a transfer from the Autonomous Community concerned to the Central Government otherwise.

e. Additional resources

The Central Government provides additional resources to the CCAA to strengthen the Welfare State according to some different criteria under the umbrella of the so-called Competitiveness Fund and the Cooperation Fund. Both funds amount to some € 3.7 billions, around 0.4% of GDP. The former aims to strengthen horizontal equity and reduce differences in per capita funding across CCAA; the latter is intended to promote regional income

¹²⁹ In the previous system only the first two were considered as such.

¹³⁰ All the calculations are based on "normative taxes", which basically consist on taxes transferred to the CC.AA. before exerting their normative capacity.

convergence. These funds are primarily assigned to the CCAA with lower revenues, per capita income and population density.

f. Evolution of the system in subsequent years

After the base year the CCAA obtain their corresponding share of the transferred taxes, jointly with the corresponding (positive or negative) grants from the Guarantee and Global Sufficiency Funds. The variables of distribution of the Guarantee Fund are reviewed annually, although final settlements typically take place with a two-year delay due to data availability limitations. The Central Government contribution to the Guarantee Fund and the Global Sufficiency Fund are set to evolve in line with the observed growth rate the Central Government's tax revenues. Finally, the structural variables of the system are revised every five years.

3.2. Local Governments

The Royal Legislative Decree 2/2004, of 5 March 2004,¹³¹ which approves the revised text of the Local Tax Offices Regulatory Law, forms the basis of the local financing system. According to Article 2 therein, the resources of local governments consist of revenues stemming from its property, own taxes, fees and surcharges accrued on taxes of CC.AA., their agreed shares on central government and CC.AA. taxes, subsidies, regulated prices, fines and sanctions within the remit of their powers and resources stemming from credit operations and debt issuance.

In particular, own taxes are divided in two groups: regular-basis taxes and other taxes. The former comprise taxes on immovable property, the local business tax and the tax on motor vehicles; the latter comprise taxes on construction, settlements and works and the tax on the increase in the value of land of urban nature. Town/city councils can raise or lower tax rates and establish discretionary tax benefits but are not allowed to set new taxes.

Municipalities that are capitals of a province or Autonomous Community, or which have over 75,000 inhabitants, are assigned a part of the Personal Income Tax, VAT and special taxes on alcohol, hydrocarbons and tobacco products (approximately between 1% and 2%, depending on the tax and whether it is a municipal or provincial one). The so-called “tourist municipalities”¹³² enjoy somewhat similar special regime.

4. Fiscal rules

Fiscal rule

The current Budgetary Stability Act entered into force in 2008.¹³³ According to it, the general government as a whole, its subsectors and public-owned entities must attach to the principle of budgetary stability. Budgetary stability implies that the Central Government, the Autonomous Communities and the Local Governments have to be in balance or in surplus in

¹³¹

http://www.minhap.gob.es/Documentacion/Publico/NormativaDoctrina/FinanciacionTerritorial/Financiacion%20Local/REAL%20DECRETO%20LEGISLATIVO%202%202004%20-Haciendas%20Locales_.pdf

¹³² These are places that, although they do not comply with the requirements for accessing the tax assignment system, do have a population of over 20,000 inhabitants and a greater number of second homes than first homes.

¹³³ This Act revised the first Budgetary Stability Act due to 2001 and in force between 2002 and 2007.

an ESA95 basis along the economic cycle. This implies that their cyclically adjusted balances have to be in balance or in surplus. In their case, an upper and a lower threshold for GDP growth are defined. Hence, if GDP growth falls short the lower threshold, the general government as a whole could register a deficit no higher than 1% of GDP, of which the central government deficit should not exceed 0.2% of GDP, the deficit of the Autonomous Communities should not exceed 0.75% of GDP and the deficit of the Local Governments should not exceed 0.05% of GDP. If GDP growth stands between both thresholds, these subsectors and the general government as a whole should be in balance at least. Finally, if GDP growth exceeds the upper thresholds these subsectors and the general government as a whole should register surpluses. Moreover, the Social Security subsector is set to be in balance or in surplus, regardless of the cyclical position.

Higher deficits, however, are exceptionally allowed if they are devoted to financing productive investment projects, including Research, Development and Innovation. Higher deficit derived from these programmes cannot exceed 0.2% of GDP in the central government, 0.25% of GDP for the Autonomous Communities as a whole and 0.05% of GDP in the Local Governments subsector.

In the case of the Central Government, a ceiling on total non-financial expenditure is set in the Budget Law each year. No expenditure ceiling though is set for either the Autonomous Communities or the Local Governments.

Budgetary targets

Budgetary targets have to be formulated within a multiannual scenario. In the first semester of the year the government has to set the budgetary targets (as a percentage of GDP) for the general government as a whole, its subsectors and each of the different entities therein for the next three years. Such targets will be set on the basis of a report on the cyclical position of the economy conducted by the Bank of Spain, and taking into account the economic forecast by the European Commission and the European Central Bank.

Accountability and enforcement

Before the 1st of October each year the Ministry of Finance will submit to the Government a report assessing the degree of compliance with the budgetary targets in the previous year. This report will be made public. In case of deviations from the specified targets, the Autonomous Community or the Local Government concerned has to present a 3-year rebalancing plan. In case of non-compliance with the previous provisions the Government will be entitled to impose constraints to credit or debt issuance to the relevant entity.

Sanction mechanism

In case of non-compliance the concerned administration will have to contribute to any financial sanction raised according to the EU Stability and Growth Pact in proportion to its fiscal slippage.

Debt issuance and bailouts

Autonomous Communities and Local governments can issue debt on condition of compliance with their budgetary targets. In case of non-compliance with the budgetary stability target, but with an approved corrective plan, any new long-term indebtedness is subject to approval by the Central Government. In case of not having any approved corrective plan, all indebtedness operation regardless of the term is subject to approval.

In any case, the central government will not bail any autonomous community or local government out in case of default.

Due to the current economic and financial crisis the budgetary targets have been missed since 2008 on. No default by any entity within the general government has taken place.

5. Other relevant institutional features

The government has released a draft law to amend the existing Budgetary Stability Act (Draft Budgetary Stability and Financial Sustainability Act). The basic principles of the reformed law would be:

- The general government deficit cannot exceed 0.4% of GDP in periods of low or negative growth.
- A transition period is envisaged to resume to debt levels below 60% of GDP.
- An expenditure ceiling is set for all entities within the general government.
- The sanction mechanism will be reinforced.

6. Overall assessment

The system is highly decentralized with many spending powers devolved to regional and local governments. Moreover, subnational entities enjoy a considerable degree of autonomy on the revenue side. However, in normal years spending by subnational governments, especially on healthcare, has risen at elevated rates. Buoyant revenues, partly linked to the housing sector, allowed offsetting to a large extent such spending increase. However, the collapse of tax revenues due to the economic and financial crisis has unveiled the main weaknesses of the system as expenditure levels at the onset of the crisis were clearly oversized. On the other hand, the normative capacity of Autonomous Communities on a number of taxes has mainly been used to raise allowances and deductions, thereby increasing tax expenditure, while being largely reluctant to use it to increase taxes.

The system lacks credible enough incentives to prevent fiscal profligacy by regional and local administration. No expenditure ceiling rule applies to subnational levels of government. The new draft Budgetary Stability and Financial Sustainability Act aims to fill this gap, jointly with imposing more stringent deficit criteria. This is a promising step to underpin budgetary discipline.

FRANCE

1. General description

France is a unitary state where the central government is predominant. However, the Constitution adopted on 4 October 1958 recognises the principle of local government autonomy. This principle has been consolidated since the constitutional reform of 28 March 2003.

The country is broken down into three tiers of subnational government the main units of which, defined by the Constitution as *collectivités territoriales*, are the regions, the departments, and the municipalities (and also the overseas territories). There is no subordinated link between the three entities; all three layers are governed by national legislation. There are 22 regions and 96 departments of mainland France, 4 regions and 5 departments overseas, and nearly 37 000 municipalities, which can gather within *établissements publics de coopération intercommunale* (EPCI). A small number of local governments, known as *collectivités territoriales à statut particulier*, have slightly different administrative frameworks; among these are the island of Corsica and the country's largest cities.

The so-called Defferre laws of 1982–83 together with the 2003 constitutional reform are the main institutional reforms that have shaped over time the current system. Prior to these French municipalities and departments enjoyed a limited autonomy, and the chief executive of the department was the government-appointed prefect (*préfet*) who also had strong powers over other local authorities.

The decentralisation process initiated in the early 1980s translated into a number of key changes. The administrative stewardship of the prefect was replaced by a legal check and balance exercised by the administrative courts and the regional courts of auditors. Departmental executive power was transferred from the prefect to the president of the departmental council (*Conseil général*). Regions were given full powers and recognised as *collectivités territoriales*, with directly elected regional councils and the power to elect their executive. The law also devolved to local governments many functions hitherto belonging to the central government, in particular economic development, social welfare, regional planning, secondary schools, cultural matters, etc.

The 2003 constitutional reform introduced the principle of financial autonomy of local governments. The changes also introduced the possibility of holding local referenda and the right to petition. New responsibilities were also transferred to local governments as part of the Decentralisation Act that followed in 2004, particularly to regions and departments (responsibility of non-teaching staff in schools, vocational training, ports, airports, etc.).

In 2010, total spending by local government amounted to 11.8% of GDP¹³⁴. Three quarters were to cover current expenses. Total revenue excluding borrowing stood at 11.7% of GDP.

¹³⁴ To be noted is one of the measures of November 7 (article 108 of LFI 2012) :

'Chaque année, le Gouvernement dépose en annexe au projet de loi de finances un rapport qui comporte une présentation de la structure et de l'évolution des dépenses ainsi que de l'état de la dette des collectivités territoriales. A cette fin, les régions, les départements et les communes ou les établissements publics de coopération intercommunale de plus de 50 000 habitants transmettent au représentant de l'Etat, dans des

55% of total revenue was covered by taxes set and raised locally or by shared taxes. The main direct taxes are the property tax on buildings and land, the residence tax and up until 2009 the local business tax. Central government transfers and grants represented 28% of total revenue. These fall into two categories: grants and subsidies for current spending and compensation for transfer of responsibilities, and grants and subsidies for capital expenditure. Borrowing is yet another source of revenue for local governments in France, and represents around 1% of GDP each year. Local authorities do not need to seek central government authorisation in order to borrow money but all resources from borrowing can only be spent on investment (not current spending)¹³⁵.

2. Government spending

Municipalities benefit from a general responsibilities clause: they can intervene over and above their responsibilities in all fields of local interest. Traditional responsibilities include register office functions, electoral functions, social aid, primary education, sports and art facilities, maintenance of municipal roads, land development and planning, local public order, and local public utilities. Departments are mainly in charge of social assistance and medical prevention, construction and maintenance of secondary roads, construction and maintenance of secondary schools and management of some non-teaching staff (*collèges*), culture and heritage, economic development, and environment. Regions are responsible for economic development, territorial development and planning, transport, vocational training programmes, construction and maintenance of secondary schools and management of some non-teaching staff (*lycées*), as well as special education institutions.

In 2010, total spending by local governments amounted to EUR 228.7 billion or 11.8% of GDP. Based on the COFOG classification, local governments spent 18% of their budget on general public services, 17% on social protection, 16% on education, 15% on housing and community amenities, 13% on economic affairs, 9% on recreation, culture and religion, 8% on environmental protection, and 4% on other functions. The share of social protection in total expenditure has increased substantially since 2000 (+4 pps.) while that of general public policies has registered a significant decrease (–6 pps.).

Among capital expenditure items, housing and community amenities accounted for one third of total spending, general public policies and education represented approximately 15% each, followed by recreation, culture and religion (12%), economic affairs (10%), and environmental protection (9%).

Local government responsibilities mainly concern the implementation of policies, whereas their regulation is generally entrusted to the central government. In the case of education, for instance, overall standards (i.e. requirements of educational institutions, level of qualification of teachers, etc.) are set by the central government, whereas municipalities are responsible for establishing, reorganising and closing education institutions. The same goes for social

conditions fixées par décret en Conseil d'Etat pris après avis du comité des finances locales, un rapport présentant notamment :

- les orientations budgétaires,
- les engagements pluriannuels envisagés,
- la composition et l'évolution de la dette,
- ainsi que la composition et l'évolution des dépenses de personnel, de subvention, de communication et d'immobilier'.

¹³⁵ Funds obtained through borrowing can no longer be used to service outstanding debt (which has to be financed by a surplus of the operating budget).

allowances such as the *revenu de solidarité active*, the *allocation personnalisée pour l'autonomie* and the *prestation de compensation du handicap*: local governments are responsible for paying such allowances¹³⁶, while the amount and eligibility criteria are determined nationally.

3. Financial arrangements

In 2010, **total revenue** of local governments excluding borrowing stood at EUR 227 billion, or 11.7% of GDP.

Tax revenue (own-source local taxes and shared taxes) accounted for 55% of total revenue while operating and investment grants represented approximately 28%¹³⁷. The remainder stemmed from the sale of goods and services to end users, asset management and extraordinary revenue. Municipal and departmental revenue was mainly tax-based, while that of regions was broadly balanced between tax revenue and grants.

Own-source tax revenue, which represents 80 to 100% of total tax revenue for each of the three tiers of *collectivités territoriales*, mainly comes from four direct local taxes, which account for nearly two thirds of total tax revenue. These are levied by local governments and by some inter-municipal cooperation structures. French local taxation works on a system of rate stacking: the overall rate of each tax is calculated by summing up rates imposed by different local government tiers, thus varying across land areas. However, the role of regions and departments in setting tax rates has recently decreased, while they are not empowered to set up new taxes. The central government collects the local taxes annually, and reimburses local governments monthly.

The four main local taxes are:

- The CET (*contribution économique territoriale*) which replaces the local business tax (*taxe professionnelle*). The local business tax was paid by companies and was essentially based on the rental value of fixed assets. It was subject to exemptions decided by the central government. This tax was abolished in 2010 and replaced by a new economic contribution for business, the CET, a flat-rate tax on network businesses, and new tax revenue were transferred to local governments. The CET tax comprises a land tax levied on companies (*cotisation foncière des entreprises* or CFE) and a new levy on the value added by a company (*cotisation sur la valeur ajoutée des entreprises* or CVAE). Local government (municipalities) can only set the rate for the CFE.
- The property tax on buildings, paid by property owners (companies and individuals), is based on the property's theoretical rental value according to the local land registry, and is adjusted in line with inflation. As of 2011, the tax rate is set only by departments and municipalities.
- The residence tax, paid by the residents of housing buildings, is also based on the property's theoretical rental value and adjusted in line with inflation. There are exemptions for over 60s, low-income households and also if the property is incapable of

¹³⁶ Including associated proximity services (monitoring, activation measures etc.).

¹³⁷ Figures reported here come from Dexia Crédit Local's *Note de conjuncture* available at: http://public-dexia-clf.dexwired.net/collectivites-locales/expertise/Documents/ndc_france_2011.pdf

occupation due to it needing extensive renovation. As of 2011, the tax rate is set only at the municipal level.

- The property tax is also paid by owners of non-built land (companies and individual). As of 2011, the tax rate is set only at the municipal level.

Local governments levy other own-source direct or indirect taxes, including transfer taxes on property transactions (municipalities and departments), a transport contribution (municipalities), a household waste disposal tax (municipalities), a vehicle registration tax and a tax on driving licences (regions), an electricity tax (municipalities and departments), and various town planning taxes levied by local governments as a whole.

The central government has increasingly **shared tax revenue** with local governments to compensate for transferred responsibilities and reforms such the local business tax abolition. Regions have been receiving a fraction of the domestic tax on petroleum products (*taxe intérieure sur les produits pétroliers* or TIPP) and a surcharge on the apprenticeship tax (*taxe additionnelle à la taxe d'apprentissage*) since 2005. Departments have also been receiving a fraction of the TIPP tax and a fraction of the special tax on insurance contracts (*taxe spéciale sur les conventions d'assurance* or TSCA) since 2005. Except for an earmarked share of the TIPP tax, where regions have the power to set rates (within a limited range), local governments do not fix the rate of any of these indirect taxes. Some new tax revenue has been transferred to local governments since 2011 as part of the local business tax reform, including the remaining fraction of the TSCA tax.

Grants from the central government consist of operating grants and capital expenditure grants (82% and 18% respectively in 2010). In the past the central government set up various mechanisms (*pacte de stabilité, contrat de croissance et de stabilité, contrat de stabilité*) aiming at better controlling increase in grants. Under the second multi-annual public finance planning act, which covers the period 2011–14, transfers to local governments have been frozen in nominal terms¹³⁸.

The main operating grant is the so-called global operating grant (*dotation globale de fonctionnement* or DGF), which amounted to EUR 41.1 billion in 2010 and represented around 85% of all operating grants. It has increased drastically since the 2004 budget, which simplified operating grant structure by integrating various grants and compensations for tax exemptions into the DGF. This reform also introduced a share for regions, and reviewed financial equalisation mechanisms: each local government receives a fixed grant, where the amount allowed may vary according to local needs, and an equalisation fraction with a view to remedying the adverse effects of the unequal distribution of resources and expenditure requirements.

<u>Equalisation mechanisms across subnational entities in France</u> ¹³⁹

¹³⁸ And a 200 M€ decrease was voted in the 2012 budget law as part of the fiscal consolidation package.

¹³⁹ For more information, please refer to *Péréquation financière entre les collectivités territoriales : les choix de la commission des finances du Sénat*, Rapport d'information n° 731 (2010-2011) de MM. Philippe DALLIER, Charles GUENÉ, Pierre JARLIER et Albéric de MONTGOLFIER, fait au nom de la commission des finances, déposé le 6 juillet 2011, <http://www.senat.fr/rap/r10-731/r10-731.html>.

The basis for *vertical equalisation* is the "financial potential", applicable to all subnational entities and set each year by the Finance Law. This corresponds first to the income which would be generated if the local government concerned were applying to its tax base, and for the four main local taxes presented above, the average rate observed nation-wide at a similar level of sub-government. Since 2005, was added to this "tax potential" the amount perceived the preceding year from the global operating grant (regions and EPCI are also concerned since 2011 only). The financial potential therefore corresponds to the revenue the subnational entity should be able to rely on if it were applying "average" tax policies.

With the dying out of the "professional tax" in 2011, it was also decided to create for a fund for *horizontal equalisation* at the municipal level (*fonds de péréquation nationale des recettes intercommunales et communales* (FPIC)), on the model of a fund created specifically in 2010 for the Ile-de-France region (Paris and surroundings). The FPIC will begin operating in 2012.

In addition, capital expenditure grants include reimbursement of the VAT that local governments pay on investment spending, a rural area equipments grant, a school equipments grant for regions and departments, and also some ministerial subsidies.

4. Fiscal rules

Principles of sincerity and balance cover both the operating and capital formation sections of the budget of all subnational entities, requiring expenditure and revenue to match in each section. The term budget as used under the rule refers to the voted budget. *Ex-post*, the budget can be unbalanced but deficits¹⁴⁰ may not exceed 5% of the year's current revenue (10% for small municipalities). There are no pre-existing escape clauses. Average deficits, observed *ex post*, shrank from close to 5% of the annual revenue in 2007 and 2008 to less than 1% in 2010¹⁴¹.

The golden rule applicable to the *collectivités territoriales* prohibits current expenditure to be financed by debt; borrowing can thus only be used to finance capital expenditure and is today used to cover about one third of investment spending undertaken by subnational entities¹⁴². This also means that debt annuities, in turn, have to be financed by own resources¹⁴³. The rule has been into force since 1983 for municipalities and departments, and since 1988 for regions.

Any decision to borrow is subject to *ex-post* legal control on the decision to borrow. It is also subject to a budgetary control by the central government representative – the prefect – together with the regional chamber of auditors to ensure that debt annuity has been included in the budget as a compulsory expenditure and to check compliance with the rule. In case a significant deficit is recorded (see above mentioned thresholds), the regional chamber of auditors shall propose corrective action within one month.

¹⁴⁰ Of the operating part of the budget.

¹⁴¹ For detailed statistics, see Insee "Dépenses et recettes des collectivités locales (S13131)", available at http://www.insee.fr/fr/themes/comptes-nationaux/tableau.asp?sous_theme=3.2&xml=t_3206

¹⁴² Net borrowing is at 5/10% of investment but gross borrowing is at around 16M€ for 45 M€ of capital expenditures.

¹⁴³ It is in fact even tighter than this, as resources of the investment part of the budget cannot be used to that purpose.

Since 1982 French local governments have been able to borrow freely, without requiring central government's permission. The outstanding amount of subnational government debt, which has substantially decreased since the 1990s, represented 7.7% of GDP in 2011 (mainly driven by regions and municipalities), thus less than one tenth of the outstanding debt of the public sector. Banks have been the biggest source of external funding to local governments, which borrow around EUR 20 billion or 1% of GDP each year in the form of loans, structured loans, revolving loans, and foreign currency loans. Although legally allowed, direct financing via capital markets has been little used to date.

Local governments are obliged to deposit their liquid assets and cash with the French treasury in a non-interest bearing cash account. They are therefore not allowed to invest their daily cash with banks. However, local governments are entitled to use bank lines to cover their day-to-day liquidity shortfalls.

Local governments cannot be declared bankrupt. In the event of default, there is no central government guarantee. For example, when the cities of Angoulême and Briançon defaulted on their debt, in 1991 and 1992 respectively, they had to negotiate a debt rescheduling with their creditors and had to undertake a stringent plan for the consolidation of their public finances. In case of extreme liquidity tensions, the central government may however provide local governments with exceptional transfers in the form of advances on tax payments; for instance, Angoulême was granted 10.7 million francs (about 1.5 EUR mn) over 7 years, in 1991, to support the stabilization of its financial situation and meet mandatory payments. Furthermore, the representative of the central government can put local governments under supervision (*tutelle de l'État*).

ITALY

1. General description

As in many other European countries, fiscal decentralisation in Italy has historically been driven by pressures from regions for more direct participation and control in the political process. Italy is currently composed of 20 regions, including five that have a special status granting them more autonomy¹⁴⁴, 110 provinces and 8092 municipalities. Regions were granted political autonomy by the 1948 Constitution of the Italian Republic, but the actual implementation of regional autonomy was postponed until the first regional elections of 1970. Since then, the Italian public finances have been characterised by a combination of high centralisation of revenue and sizeable decentralisation of expenditure, corresponding to an important devolution of functions to the lower government levels. Subnational powers of taxation increased somewhat in the 1990s, alongside a further decentralisation of administrative functions.

In 2001 a Constitutional reform introduced deep changes in the relationships between State, regions and local authorities, opening the way to fiscal federalism. However, delays in the adoption of the ordinary legislation required to allow the entry into force of the new fiscal configuration has kept alive a system where the funding of subnational government expenditure is highly dependent on transfers from the centre. A crucial step was taken in May 2009, with the approval of a framework law that delegated the government to adopt legislative decrees enacting fiscal federalism, on the basis of identified principles and guidelines.

In 2009, sub-central government expenditure amounted to 31% of general government expenditure (15% of GDP), while local government revenue excluding transfers from the central government is estimated at 17% of general government revenue (8% of GDP). In this context of relatively high subnational government spending but limited revenue decentralisation, fiscal relations between the central government and the local authorities during the past decade have been regulated by a domestic stability pact (DSP), setting annual constraints on expenditure and/or the budget balance of the subnational units, and a health pact, controlling regional governments' spending on health services. Parliament is now about to adopt a bill introducing a balanced budget rule in the Italian Constitution that applies to all government levels.

2. Government spending

A major Constitutional reform of the distribution of powers across levels of government was approved by the Italian Parliament in 2001. The reform increased the regulatory and spending functions falling under the jurisdiction of sub-central governments.

The Italian central government is exclusively, or near-exclusively, responsible for expenditure on social protection transfers (38% of total general government expenditure), defence (3%), and public order and safety (4%). On the other hand, health care (14% of total general government expenditure) is practically completely devolved to the regions. Sub-central authorities also make a large majority of national spending on housing and community amenities (1.5% of total general government expenditure) and on environmental protection

¹⁴⁴ The five regions with special status are Friuli Venezia Giulia, Sardegna, Sicily, Trentino-Alto Adige and Valle D'Aosta.

(1.5%), reflecting the limited scope for economies of scale in centralised provision of such services. Municipalities and regions are also directly responsible for town planning.

The new Title V of the Constitution and subsequent legislation also specified functions of shared competence between the central and sub-central governments. These include general public services (18% of total general government expenditure, more than half of which is accounted for by debt servicing expenditure by the central government), education (10%), economic affairs (8%), and recreation, culture and religion (1.5%). Following conflicts over the actual division of responsibilities in the areas of shared competence, the Constitutional Court stated that responsibilities should be split up as follows: (a) the central government legislates the fundamental principles for the exercise of the power in question; (b) the region undertakes the financing, administrative, and management functions for this exercise; and (c) the local authorities perform “hands on” delivery of services unless there are strong reasons to do so at a higher level.

Table 1 lists the different competencies devolved to the three tiers of sub-central governments in Italy.

Table 1: Subnational government competencies following the 2001 constitutional reform

Municipalities	Provinces	Regions
Social housing	Road network maintenance	Health
Town planning	Transport	Health centres and hospitals
Aid to the disabled and other social services	Secondary schools (construction of buildings)	Vocational training
Local public transport	Environment including protection and improvement of the energy resources	Culture
Road network maintenance	Cultural heritage	Town planning
Local police	Household waste and sewage	Road networks, civil engineering and regional railway transport
Pre-primary (all), primary and vocational schools (building construction and maintenance)	Management of employment services and subsidies	Agriculture
Culture	Vocational teaching	Environment
Sport	Economic development	Country side planning and economic development
Sewage and waste disposal	Management of employment services and subsidies	Social services
Upkeep of pharmacies in rural areas		Education

Source: ISAE.

Expenditure by regional governments accounts for around two-thirds of total sub-central government expenditure in Italy. Reflecting the fact that 80% of regional expenditure goes to health care provision, the purchase of goods and services and wages account for 50% and 25% of regional spending respectively. Provinces account for only 5% of sub-central government expenditure, or less than 2% of total general government spending. Their very limited role in the current fiscal devolution set-up confirms that there is scope for administrative expenditure savings through the integration of their functions in the other two tiers of sub-central governments, as has been stipulated in the December economic and budgetary package. Capital expenditure is a relatively important part of the combined budget

of municipalities and provinces, with investment spending representing around 20-25% of their total expenditure between 2005 and 2010.

3. Financial arrangements

The Constitution (Art.119) establishes that subnational governments have revenue autonomy to perform the new functions attributed to them. Specifically, they can raise revenue from:

- Own taxes;
- Shares in the national tax revenue;
- Equalising transfers for territories having lower per-capita taxable capacity.

A golden rule is, however, envisaged for subnational governments, which are allowed to borrow only for investment financing. Moreover, the central government has the possibility to allocate supplementary resources to subnational governments in order to promote economic development and social cohesion or to perform functions that go beyond their normal remit.

In 2009, the total revenue of sub-central governments in Italy amounted to 33% of (consolidated) general government revenue (15% of GDP). **Transfers from the central government** accounted for 50% of sub-central revenue (8% of GDP).

Sub-central government revenue from indirect taxation (excluding taxation on property) was in 2009 the most important source of own-revenue for sub-central authorities, accounting for more than 25% of their total revenue (4% of GDP). Almost 60% of the sub-central government indirect tax revenue is collected through a **regional tax on productive activity** (IRAP - *Imposta regionale sulle attività produttive*). IRAP is a tax on the value added of firms, with some tax deductions for labour costs gradually introduced since the inception of the tax in 1998 (including in the December 2011 budgetary package). The basic rate of IRAP stands at 3.9%, with regions having the power to increase or reduce the rate by around 1%. Sub-central authorities also receive a share of the national revenue from VAT, which in 2010 was equivalent to 10% of sub-central indirect tax revenue. The distribution of national VAT revenue across regions takes into account health-related indicators designed to measure regional differences in health spending pressures. The five **special-statute regions** are entitled to a higher share of the national taxes due on economic activity carried out in their territories. Other important sources of indirect taxation for sub-central governments include taxation on car insurance and motor vehicle registration (6% of sub-central government indirect tax revenue), taxation on building permits (5%) and a surtax on electricity consumption (3%).

Sub-central taxes on personal income (IRPEF - *Imposta sul reddito delle persone fisiche*) were equivalent to 10% of sub-central revenue (1.5% of GDP). Regional and municipal income surtaxes are levied on top of the national income tax, using the same tax base. The regional income surtax in 2010 stood at 0.9%, but the regions can increase it to 1.4%. Regions running substantial financial deficits on health care provision have been authorised to increase their surtax to 1.7%. The December 2011 package increased the basic rate of regional income tax from 0.9% to 1.23% as from the 2011 tax year. The maximum municipal income surtax rate is 0.8%, although the rate is automatically increased by 0.3% for municipalities in breach of "stability pact" provisions.

Taxation on property (ICI – *Imposta Comunale sugli Immobili*) accounted for less than 5% of sub-central revenue (0.5% of GDP) in 2009, with the intakes accruing to municipalities. The tax base is based on so-called cadastral values of property, which are official reference values that take into account property specificities but which are well below market values. The importance of property taxation for financing the activities of municipalities is expected to increase substantially starting from the current year, especially with the widening of the property tax base to include homes of first residence.

4. Fiscal rules

Fiscal relations between the central and sub-central governments have been regulated over the past decade through a domestic stability pact (DSP) and, for spending on health services, a health pact. The entry into force of fiscal federalism's permanent provisions will make both pacts unnecessary; however, they will remain in place in the current long transition period.

4.1 Domestic Stability Pact

A Domestic Stability Pact (DSP) was introduced for the first time in the budget law for 1999 to improve the governance of fiscal relations between the central and sub-central governments. The DSP rules, which are established each year by the budget law, set annual constraints on expenditure and/or the budget balance of the sub-central governments. The rules changed substantially over time, in part reflecting successive attempts to correct identified weaknesses in rules set in preceding years. Although enforcement mechanisms have been strengthened, the frequent changes in the DSP targets and coverage have reduced the effectiveness of the DSP as a tool for the central government to ensure budgetary discipline at local level and as a mechanism for expenditure planning by sub-central governments. Initially, regions and local governments respected the DSP rules, but the high degree of compliance was primarily the result of the relatively unambitious constraints set by the rules. Regional and other local administrations in breach of the DSP must increase regional/local surtax rates. In case of serious and protracted breach, the central government can replace locally elected administrators with centrally appointed commissioners.

As from 2012, sub-central governments have to provide a significant contribution to the national consolidation effort, by around 0.4% of GDP per year. This will be shared among them also according to a system based on "virtuosity", namely the respect of previous years' DSPs, and pending the identification of essential service levels and their standard cost.

4.2 Health Pact

The Health Pact is a separate fiscal mechanism governing regional government's health-related spending. The Pact, which is updated every three years, sets limits to current and capital expenditure for health care by region. Sanctions apply to regions exceeding their limit: local tax shares are increased, citizens' contributions to costs are raised, and/or administrative sanctions (including the dismissal of administrators) are imposed. Still, over the last decade, annual health expenditure exceeded its funding by around 0.3 pp. of GDP per year on average. The health pact also incorporates specific caps on the share of pharmaceutical

expenditure in total health expenditure, with the purpose of encouraging savings both through tougher price negotiations with suppliers and the wider use of generic drugs.

5. Design of a new institutional set-up

5.1 The 2009 framework law on fiscal federalism

The implementation of the Constitutional provisions granting greater financial responsibilities to sub-central authorities requires enabling legislation. Postponement of the adoption of such legislation sustained a system where the funding of subnational government expenditure remains highly dependent on transfers from the centre. A crucial step was taken in May 2009, with the adoption of a framework law setting down broad guidelines to support the transition towards a more complete federal fiscal structure by 2017. The law, however, still required the central government to adopt, in agreement with the subnational governments, enacting decrees in order to specify the rules governing fiscal federalism. To date, eight decrees have been adopted by government and approved in Parliament, including on the definition of essential financing needs and standard costs for sub-regional authorities (November 2010), the role of municipalities in tax assessments (March 2011), allocation of additional financial resources to less prosperous areas (May 2011), standard costs and financial needs for health care provision (May 2011), and sanctioning and reward mechanisms (September 2011). This Section describes the fiscal federalism set up that is expected to take place over the next few years as a result of the 2009 framework law and subsequent legislation.

The most innovative and important principle established in the 2009 framework law consists in the introduction of the so called “standard cost” criterion in place of the “historical expenditure” criterion used so far to determine the costs necessary to the pursuit of the functions entrusted to the territorial bodies. Standards of quality and efficiency are to be adopted in establishing proper unit costs and service provision methods and procedures. Subnational governments providing essential services at a higher cost, or offering more services than those identified as standard needs of the population have to raise additional sources of financing. Another key principle is the introduction of equalisation transfers redistributing revenue across subnational governments. These transfers will partially compensate for differences in fiscal capacity, as measured assuming identical tax rates, so as to bridge the financing gap in providing essential services.

The main sources of financing for regions will continue to be the regional tax on productive activity (IRAP), part of the revenue from VAT, and the surcharge on the personal income tax. Regions will be able to increase the latter by up to 0.5 pp. in 2013, 1.1 pp. (cumulative) by 2014 and 2.1 pp. as from 2015. An equalizing fund will transfer resources to regions with lower fiscal capacity.

The decree law on municipal fiscal federalism sets up a temporary experimental re-balancing fund ("*Fondo sperimentale di riequilibrio*") to aggregate all the proceeds that are intended to replace permanent and general transfers from other administrations, namely: 30% of the recurrent taxes raised on real estate property part of the resources coming from a new tax on property leasing (21.6% from 2012 onwards), and a share in VAT revenues. The aim of this fund, which will cease to operate after 2013, is to ensure a gradual and geographically-balanced devolution to municipalities of real estate taxation. In a second and final phase, which was originally planned to get underway in 2014, existing taxes are planned to be replaced by two new forms of municipal taxes: (i) a municipal tax on real property (unified municipal tax IMU) that would combine the current ICI tax and the part of personal income

tax (IRPEF) payable on property income; (ii) a secondary municipal tax on the occupancy of state property.

In December 2011, the Italian government brought forward to 2012 the introduction of the unified municipal tax (IMU) and extended it to owner-occupied dwellings (homes of first residence) that had been excluded from taxation in 2008. Part of the receipts from IMU will be initially assigned to the central government. The government also announced plans for a substantial revision to the cadastral property valuation register, which is the tax base of IMU.

Although several enacting decrees specifying the rules governing fiscal federalism have been adopted in 2010 and 2011, crucial details are still to be determined through administrative acts. Chief among them are the revenue sharing mechanism and the definition of essential levels of services and their standard costs. They will have to be defined by 2016, with fiscal federalism expected to enter into full force by the end of 2017.

5.2 Constitutional amendments establishing balanced budgets principle

On 15 December 2011, the Italian parliament approved a bill introducing a balanced budget rule in the Italian Constitution. The amendments approved by parliament as part of this process included changes to Article 119 that establish the financial autonomy of subnational governments. The amending provisions introduce the principle that subnational governments must balance revenue and expenditure in their budgets. The Constitutional amendment also retains the existing possibility for subnational governments to resort to indebtedness to fund investments, but under the condition that the aggregate budget of all sub-central governments within a region must be in balance. The key to the success of this new provision to contribute to the achievement of a balanced budget for the whole general government will hinge on enforcement mechanisms for execution. Effective ordinary legislation will need to be designed, specifying the balance to be considered, modalities of application (e.g. on cyclical conditions) and appropriate correction mechanisms, as required by the fiscal compact.

CYPRUS

General

Cyprus became an independent republic on the 16th August 1960. It is a member of the United Nations, the Council of Europe, the Commonwealth and the Non-Aligned Movement. According to the above treaty, Britain retains two Sovereign Bases (158.5 sq. km) on the island, at Dekeleia and Akrotiri-Episkopi.

Administrative districts

Cyprus is divided into six administrative districts (eparcheies). These are: Nicosia, Limassol, Pafos, Larnaka, (in the government-controlled areas) and Famagusta and Keryneia (in the occupied areas). Each District is headed by a District Officer (eparchos) who is essentially the local representative or extended arm of the government. The District Officer acts as the chief-coordinator of the activities of all Ministries in the District. District Officers are answerable to the Ministry of the Interior, which is headed by a Permanent Secretary as chief administrator.

Local authorities

Municipalities and Communes are the two types of local authorities and are governed by separate laws. In principle, Municipalities constitute the form of local government in urban and tourist centres while communities constitute the local structure in rural areas. 33 **municipalities** (dimarchia) account for about 60 per cent of the population, while 353 **communes** (koinotita) cover the rest of the population. The functions of Municipalities are determined by the Municipalities' Law of 1985. Their finances derive from municipal taxes, fees and duties as well as state subsidies.

In October 1985, a new comprehensive law on local government, the Municipalities' Law 111 of 1985, was passed by the House of Representatives. This Law has since been amended by 25 amending Laws. In addition to the six principal (Nicosia, Limassol, Famagusta, Larnaca, Paphos and Kyrenia) and nine rural communities, the Law provided for the establishment of new municipalities. According to this Law, any commune may become a municipality by local referendum, subject to the approval of the Council of Ministers, provided it has either a population of more than 5,000 or has the economic resources to function as a municipality. Eleven new municipalities were established in 1986, five in 1994 and one more in 1996, increasing the number to thirty-three.

Since the Turkish invasion of 1974 and the subsequent occupation of the northern part of Cyprus by Turkey, nine municipalities (Famagusta, Kyrenia, Morphou, Kythrea, Karavas, Lapithos, Lefkonikon, Akanthou and Lyssi), although still maintaining their legal status, have been temporarily relocated to the free areas.

Mayors are elected directly by the citizens on a separate ballot, for a term of five years and are the executive authority of the municipalities. The Mayor represents the municipality in a court of Law and before any state authority, and presides over all Council meetings, Administrative Committee meetings and any other municipal committee. He executes the Council's decisions and heads all municipal services which he directs and supervises.

Municipal councils, which are the policy-making bodies of the municipalities, are elected directly by the citizens for a term of five years, but separately from the Mayor. The Council appoints the members of the Administrative Committee. The latter's duties include the preparation of the municipality's budgets and annual financial statements, the provision of assistance and advice to the Mayor in the execution of his duties, coordination of the work of other committees appointed by the Council and the carrying out of any other duties entrusted to it by the Council or the Mayor. The Council may also set up ad-hoc or standing committees which have an advisory role.

According to the law, the main responsibilities of municipalities are the construction, maintenance and lighting of streets, the collection, disposal and treatment of waste, the protection and improvement of the environment and the good appearance of the municipal areas, the construction, development and maintenance of municipal gardens and parks and the protection of public health. The Municipal Council has the authority to promote, depending on its finances, a vast range of activities and events including the arts, education, sport and social services. In addition to the Municipalities Law, there are several laws giving municipalities' important powers other than those already mentioned. Such laws are the Streets and Buildings Regulation Law, the Town Planning Law, the Civil Marriages Law and the Sewerage Systems Law.

Local government finances

The main sources of revenue of municipalities are municipal taxes, fees and duties (professional tax, immovable property tax, hotel accommodation tax, fees for issuing permits and licences, fees for refuse collection, fines etc.), as well as state subsidies. Taxes, duties and fees represent the major source of revenue while state grants and subsidies amount to only a small percentage of the income. The central government, however, usually finances major infrastructure projects undertaken by the municipalities, but this is dependent very much on each individual project. The yearly budgets of the municipalities are submitted to the Council of Ministers for approval and their accounts are audited annually by the Auditor General of the Republic. Municipal loans also need to be approved by the Council of Ministers. The following figures concerning municipalities finances are rough estimations and may vary among municipalities:

Municipalities' revenues mainly come from (i) government subsidies estimated to approximately 40% of total revenues; taxes, licence fees and rights estimated to approximately 45% of total revenues and; fines approximately to 5% of total revenues

Municipalities' expenditure is mainly categorised into: (i) salaries and payments to pension schemes estimated to approximately 55%-65% of the total spending; (ii) utility works/maintenance approximately 15% of the total and; (iii) loan repayments to approximately 10%-15% of total spending.

LATVIA

1. General description

Latvia is a unitary country. Local self-government is only indirectly recognised in the Constitution via references in certain articles.

A major territorial administrative reform took effect from July 2009, implementing a two-tier government structure, including the central government and local governments, the latter comprising 9 republican cities and 110 local municipalities. Before the reform, the government structure had three tiers and included over 500 local government units, with districts being the intermediate level. As a result of the reform,

- Most municipalities were amalgamated into larger ones, by forcing rural municipalities which did not have the scale and resources to efficiently provide public services under their competence, to merge with others.
- Districts were abolished.

To facilitate planning and resource management, the municipalities are furthermore integrated into five planning regions since 2003. These do not represent a separate governance tier but nevertheless play an important administrative role as an interface between state administration and local governments in preparing, co-ordinating and implementing regional development programmes, including those co-financed from the EU structural funds. Legally these regions have a status of derived public persons. The governing bodies of planning regions are elected by municipalities, while their operational costs are covered from the state budget.

Main legal acts governing municipalities in Latvia are the Law on Self-governments (in force since 1995), the Law on the Equalisation of Self-government Finances (in force since 1998) and the Law on the Stabilisation of Self-government finances and the Monitoring of the Financial Activities of Self-governments (in force since 1999). The territorial administrative reform was implemented on the basis of the Administrative-Territorial Reform Law (in force since 2005).

2. Government spending

The main autonomous functions of local governments are the provision of utilities (water supply and sewerage, supply of heat, management of municipal waste, water management etc.); provision of education services (including pre-school, primary and general secondary education, extracurricular training etc.); ensuring access to health care and promoting healthy lifestyle; maintaining public facilities (buildings, streets, roads, parks etc.); providing social assistance to poor and socially vulnerable persons; determining procedures for utilisation of public-use forests and waters; maintaining of cultural objects and preservation of traditions; performing civil status document registrations; issuing permits and licences for commercial activity and others.

Total expenditure of local governments amounted to LVL 1,534 m in 2010, which formed 27% of general government expenditure (broadly corresponding to historical average) or 12% of GDP.

Education is by far the largest expenditure category in local governments' budgets, representing ca 37% of their total expenditure in 2010; local governments are responsible for delivering ca 70% of the overall education budget. The role of local governments in the provision of pre-school, primary and secondary education is, however, restricted to the implementing the education policy by establishing, reorganising and closing education institutions, while overall standards (i.e. requirements for educational institutions, level of qualification of teachers and their basic salaries etc.) are set by the central government. Following the implementation of the "money follows a pupil" principle from 2009, local governments receive transfers from the central government in accordance with the number of children enrolled in schools and pre-school establishments on their territory, but they can supplement educational expenditure from own resources.

The provision of healthcare services is organised at the level of the central government and direct involvement of local governments in health services provision is relatively limited. Nevertheless, municipalities can play an important role in ensuring the accessibility of healthcare services (e.g., organising transport for socially vulnerable patients to reach a health establishment), as well as by providing the necessary infrastructure and support services (e.g. rooms for general practitioners). Moreover, as most formal health establishments in Latvia are owned as limited liability companies either by state or by municipalities, the municipalities may be confronted with a need to cover operational losses of municipal hospitals. The healthcare related expenditure accounts for around 9% of municipalities' budgets.

Municipalities have an almost exclusive competence with regard to the provision of housing and community amenities, which accounts for another 10% of their budgets' expenditure side. Moreover, provision of public transport services is another area where the local governments play an important role by organising urban public transport in cities and regional transport at the level of planning regions; this function is partly covered by earmarked transfers from the central government.

With regard to the social sphere, the autonomous role of municipalities relates to the provision of social assistance to socially vulnerable citizens and groups; this function accounts for another 10% of municipal expenditure (while social insurance and categorical social benefits are financed respectively by the Social Insurance Agency and the Ministry of Welfare). While legal minimum requirements governing the provision of social assistance are set in the law, the financing for the social assistance function of local governments is not allocated from the central budget¹⁴⁵ and its financing remains the responsibility of local governments.

Overall, local governments in Latvia play an important role in ensuring that state's basic functions are delivered to citizens according to appropriate standards, from the provision of basic infrastructure and transport services to social assistance and the provision of preschool, primary and secondary education. However, only part of the financing for implementing these functions is provided from the central government budget.

3. Financial arrangements

Local governments in Latvia do not have own-source taxes. The financing mainly comes from shared taxes (56% of total revenue of local governments in 2010) and grants from the central government (36% of total revenue in 2010). Furthermore, within the local governments' sector there is a mechanism for redistributing revenue between richer and poorer municipalities.

Shared taxes include:

- The Personal Income Tax, which is the most important tax revenue source for municipalities (representing close to 50% of overall revenue and over 85% of tax revenue of local governments). The overall tax rate, base and sharing formula of the PIT are however defined by the central government and these parameters have been frequently changed in the recent past. Thus, until 2009 the personal income tax rate was set at a flat rate of 25 %, while the share of local governments in the overall PIT revenue was gradually increasing from 71.6% in 2005 to 83% in 2009. However, the flat rate was lowered to 23% in 2010, increased to 26% 2011 and lowered again to 25% in 2011, while the share of local governments was first lowered to 80% in 2010, then increased to 82% in 2011 and lowered again to 80% in 2012. These frequent changes create an unstable planning environment for local governments; moreover, the tax revenue itself is rather volatile, making local governments' revenue base highly cycle-sensitive. However, the fact that local governments receive their share based on forecasted rather than actual tax collection, adds some predictability for local governments.
- The real estate and land tax (representing 7% of local governments' total revenue and 12% of tax revenue in 2010). Municipalities receive 100% of the receipts from this tax, although currently they have no leeway over the tax rate or base; however, according to current plans local governments will receive considerable flexibility in application of the real estate and land tax rates from 2013.
- Other taxes include ca ¼ of gambling tax and below half of the natural resources tax collected at the level of the general government; these taxes together represented 0.5% of local governments' total revenue and 1% of tax revenue in 2010. In particular the natural resource tax has a potential to become more prominent revenue source in the future.
- Other sources of own non-tax revenue are formed by self-earned revenue (e.g. payments for services), non-tax revenue (e.g. property income) and to a marginal extent donations. These other sources accounted for 9% of total revenue of local governments in 2010.

Grants from the central government formed ca 35% of total revenue of local governments in recent years. All these grants are earmarked; they cover education expenditures (i.e. teachers' salaries and education activities) as the biggest category, road maintenance (via the Road Fund), investment projects and other.

In addition to own revenue and earmarked grants from the central government, there is a mechanism for re-distribution of revenue through the Local Government Finance Equalisation Fund (LGFEF), with the aim to ensure availability of sufficient resources also for regions with

¹⁴⁵ Except in 2009-2012 when the provision of Guaranteed Minimum Income (GMI) was 50% co-financed and the provision of housing benefits 20% co-financed from the state budget under the Emergency Social Safety Net Strategy.

lower tax base. The fund is mainly financed by municipalities with more solid revenue base (in particular the city of Riga) and, to a much lesser extent, by the central government. According to the law, its total envelope is decided annually via negotiations between the central government and the Latvian association of local and regional governments. The redistribution formula is based on expenditure need, i.e. the minimal amount required to carry out municipal tasks, calculated based on demographic and other criteria, and on revenue equalisation, so that municipalities with tax revenue from PIT and real estate tax which exceeds by 10% or more their calculated expenditure needs have to contribute to the Fund. Most municipalities are net receivers from the LGFEF.

Overall, while the local governments are free to attribute non-earmarked revenue sources (which form approximately two-thirds of total revenue) across expenditure categories – including to top up earmarked grants – several minimum requirements for the provision of services are set in legislation, thus limiting notably the discretion of local governments and possibly creating disparities in the standard of provision of various services across the municipalities. Most of the revenue sources of local governments have a marked cyclical nature, while the ability to raise own taxes currently does not exist (although a more flexible approach with regard to the real estate and land tax will be adopted from 2013). During years of fiscal consolidation in 2009-2012, local governments shared the burden of the adjustment, as their revenue sources (notably personal income tax) considerably declined both as a result of both cyclical developments and discretionary policy decisions, while expenditure pressures coming from social assistance needs increased.

4. Fiscal rules

The main fiscal rule applicable to local governments is a debt rule, which targets stabilisation of local governments' debt level in nominal terms and thus acts as a de fact budget balance rule. According to the legislation, annual debt servicing by a municipality should not exceed 20% of its local tax revenue. The borrowing and issuing of guarantees by municipalities is constrained by the central government on an annual basis, with aggregate borrowing and guarantees limits being negotiated between municipalities and the central government and these limits included in the annual budget law. During the budgetary year, the municipalities are allowed to take loans and to provide loan guaranties only within these limits. Furthermore, regarding each individual loan within the limit, the municipalities must consult the Board monitoring and supervising municipal loans and loan guaranties, which involves officials of the ministry of finance. Such permissions are granted only for financing of investment projects – and in more recent years only for investments co-financed from EU structural funds – thus imitating the "golden rule". The rule has been in place since 1994 and generally respected, thus contributing to limiting the expenditure growth and nominal debt levels of local governments. The gross debt of local governments amounted to 6.4% of GDP as of end-2010.

Given the considerable volatility of local governments' revenue and restrictive borrowing regulation, several municipalities use precautionary savings; as of end-2010 accumulated liquid assets of local governments amounted to 2.4% of GDP.

In case of intra-year financial difficulties, short-term borrowing is allowed only to cover a short-term deficit and has to be repaid within a year. The main lender of local governments is

the State Treasury, although few bigger municipalities have loans from financial institutions; loans taken from another institution need to be authorised by the minister of finance. The Treasury can impose sanctions to local governments if they do not comply with repayment obligations. Municipalities in financial difficulties, as stipulated by law, are required to prepare and implement a financial stabilisation plan under a supervisor appointed by the minister of finance. Currently only one municipality is under the financial supervision procedure, although the number was considerably higher before the implementation of the territorial reform.

As a result of the debt rule and other financial requirements applicable to municipalities, their fiscal position has been overall sound in recent years and their debt level is modest. Given the involvement of central government in setting borrowing limits and borrowing procedures for municipalities, it is unlikely that local governments can pose a serious threat to meeting fiscal targets at the general government level, although expenditure of local governments financed from previously accumulated reserves falls outside the control of the central government. Before the 2009-2010 crisis local governments (similarly to the central government) contributed to the loosening of the fiscal position of Latvia by spending large part of the windfall revenue, although some municipalities did accumulate precautionary reserves. While at the level of the central government the envisaged Fiscal Discipline Law is expected to substantially improve the counter-cyclical nature of fiscal policy making, no particular changes are foreseen at the level of municipalities.

LITHUANIA

1. General description

Lithuania is a unitary country. The government structure has three tiers, with 10 counties being the intermediate level. There are 60 local governments whose self-governing right is secured by the Constitution and other laws.

The development and operation of local governments are legally defined in the Constitution of the Republic of Lithuania and in the Law on Local Self-government. The Constitution grants administrative units the right to free and independent governance within the limits of their competence, implemented through local government councils. Members of local government councils are elected for three-year terms in direct elections. Law establishes that local government councils have the right to form executive bodies for the direct implementation of laws and the decisions of the government and local government council.

The Constitution gives local governments the right to draft and approve their own budgets, to establish local duties and to levy taxes and duties. Local governments also must have a reliable financial basis. According to the Law on Methodology for the Establishment of Local Government Budgetary Revenues, part of the personal income tax income is ascribed to the local government budget.

In the Law on Local Government, local authority functions are strictly defined and according to decision making freedom they are divided into: (i) independent, (ii) ascribed (insufficiently independent), (iii) state (relegated by the state to municipalities for execution), and (iv) conventional. The Laws on Budget Structure and on Local Government define their financial resources that could be split into tax and non-tax income and state budget transfers. Local authorities may also use bank credits, take and give loans in the order established by law. All financial resources of local authorities are included in local government budgets which according to the Constitution and the Law on Budget Structure are independent. Independent municipal functions are financed at most by tax and non-tax income of local governments. Execution of state and a part of ascribed functions as well as projects of the Parliament and Government are financed by transfers from the state budget of special purpose.

The local government expenditure and revenue are around 25-30% of total general government expenditure and revenue and these make around 10% of GDP.

2. Government spending

Local governments are charged with providing services in the fields of education, social security, health care, culture and leisure and communal economy.

- In the field of education local governments establish, reorganize and abolish primary and secondary schools, as well as appoint and dismiss, with the approval of the Ministry of Education and the county governor, the heads of these institutions. They also approve the regulations of educational institutions, ensure their functioning and maintenance, administer the registration of children under the age of sixteen and organize transport to school for children in remote areas.
- The functions of local governments concerning social security focus on providing social services and benefits. Local governments may also engage in social care if they have adequate material resources. Generally local governments establish, reorganize and abolish local government institutions in charge of social services and regulate the activities of social service providers. Local governments also collect and analyse data

on persons who are in need of social support, administer their registration and establish the scope and methods of assistance.

- Concerning health care, local governments manage primary health care centres, clinics and ambulance services, centres of psychological health and a number of other public health institutions. Local governments also organize health control.
- In the field of culture and leisure local governments manage libraries, museums, cinemas, theatres and other cultural establishments. Since such institutions may be subordinate to various central, regional and municipal organs, local governments are responsible only for those that they establish. However, they may not reorganize or abolish such institutions without the permission of the Ministry of Culture.
- Concerning economic issues, local government services provide communal services such as water, gas, electricity and heating supply; waste collection and treatment; and administration of engineering networks. These services may be provided by state and local government enterprises, joint-stock companies, private and non-profit companies. Local governments also address public transport, construction and maintenance of local roads and various construction projects.

There are no specific legal restrictions on the privatisation of local services, but local governments manage a number of companies specifically designated for such service provision that would not be able to function without local government support. Local governments have the right to privatise up to 30% of their shares in such companies.

3. Financial arrangements

The National budget is comprised of the state budget and of independent budgets of local authorities. The latter have to be balanced.

The process of designing budgets of local authorities is regulated mainly by the Law of the Budget Structure and the Law of the Methods for Determining Local Authority Budgeted Income and Government decision. Designing their budgets, the local authorities must observe the financial indices for local authorities' budgets approved by the Parliament. The local authorities have to approve their budgets no later than in two months after approval of financial indicators of the state and local authorities' budgets. Thus, rather strict time limits are set for local authorities to adjust and coordinate financial indicators of their budgets with those approved by the Parliament. If a local authority fails to confirm its budget before the end of the budgetary year, then in the following year its activities are limited and it is allowed only to pursue existing obligations (i.e. not allowed to take new obligations) and to serve debt until the budget is approved. Resources allocated to that purpose cannot exceed 1/12 of the last year's budget per month (until the budget is approved). Because a fortnight is likely to be short to adopt the budgets of the local government (following the adoption of the financial indicators by the Parliament, probably there are only two weeks left before the end of the year, see above), execution of the functions of the local authorities might be limited until the budgets are adopted¹⁴⁶. Following the requirements of the law, a local authority has to submit to the Ministry of finance not only approved budgets, but also the estimate of the privatisation fund.

Lithuanian legal acts set the following kinds of budget receipts for local authorities:

¹⁴⁶ Essentially, this implies that the local authorities may not manage to approve their budgets by the end of the year and hence their functions and budgetary means might be limited for a few weeks or months in the following year until their budgets are approved.

- Tax revenue, comprised of taxes assigned to local authorities and part of common taxes set by law.
- Non-tax revenue received from the property of a local authority, local levies, fines, and other non-tax sources.
- Transfers from the state budget, allotted for equalising the differences of income and expenditure among local authorities and for performing the functions relegated by the state.

Tax revenue includes following different taxes: (i) part of personal income tax, after mandatory health insurance deduction, (ii) land tax, (iii) tax on renting state land and use of state water reservoirs for commercial or amateur fishing, (iv) tax on real estate of enterprises and organizations, (v) stamp duties, (vi) tax on the use of marketplaces, (vii) inheritance and donations tax and (viii) other minor taxes established by law.

Non-tax revenues include (i) revenues received from municipal property, (ii) fines and revenues from the sequestration of property, (iii) local duties, (iv) revenue from the services of local government budgetary institutions, (v) interest on funds in current accounts, (vi) revenue from non-agricultural state land leasing or sales in accordance with established procedures, and (vii) other non-tax revenues established by law.

The local government can set the level of the tax on income from economic activities requiring a business certificate and on related charges, the level of the real estate tax, within the limits set by the Law on Immovable property, and rates of the taxes for the state land lease within the limits set by laws or decisions of the Government. In other cases (i.e. for the remaining taxes) the local government can reduce the rate of the tax or grant an exemption from it and cover the financial losses from its budget. The local government has no freedom of imposing taxes on personal income of residents, on pollution of the environment and on natural resources of the state.

Transfers from the state budget are either general or earmarked. The allocation from the state budget are regulated by the Law on the Methodology of Municipal Budget Income Estimation. The general transfers are for creation of reserves for unforeseen expenses during the planned budgetary year, for the equalization of tax-related revenues and for the equalization of structural differences in expenditures caused by objective factors that do not depend on local government activities. The earmarked transfers are allocated to perform state functions prescribed to municipalities and implement programs approved by the Parliament and the Government. Amounts of transfers are approved by the Law on State and Municipality Budget Financial Indices of the corresponding budgetary year, based on rules set by the Government. These transfers are related to very clear functions to be performed by the local government assigned by different ministries and the needs are calculated according to approved methodology. Since 2009, if these funds are not used for purpose of a specific function they have to be returned back to the state budget at the end of the budget year.

According to the Law on Charges municipal councils have the right to determine eleven types of local charges. Income from local charges comprises only 1% of all the municipal budget revenue. In accordance with the Law on Charges, the local council has a right to set local charges in its territory for giving permissions. The council of a local government makes its own decision on local charges and approves the rules. A local government may index the size of charge once a year, in case the annual price index of commodities is larger than 1.1.

As mentioned above, budgets of local authorities have to be formed without deficit, i.e., expenditure should not exceed revenues. Local authority is under an obligation, set by law, to undertake functions committed to them. Appropriations for local authorities can be used only

to carry out the state functions devolved by law to local authorities as well as to pursue the programmes approved of the common councils.

However, local authorities are also permitted to raise short-term and long-term domestic and foreign loans if it fails to balance its budget. According to the decision by the Government Concerning borrowing rules for local governments, borrowing can be permitted only for following purposes:

- Take long-term domestic and foreign loans to finance investment projects, to buy movable and immovable properties, to cover debts;
- Take short-term domestic and foreign loans to cover a temporary income shortfall in a fiscal year, if committed budgetary means are insufficient;
- Provide guarantees for loans to companies controlled by the municipality used to finance investment projects.

Borrowing limits are set annually and approved by the Parliament in the Law on State and Local Government Budgets. 2012 budget law sets borrowing limits for local authorities as following:

- The debt of municipalities, with the exception of Vilnius city municipality, cannot exceed 70% of the approved 2012 municipal budget revenues (excluding state grants of special purposes). For Vilnius city municipality debt cannot exceed 120% of the approved 2012 municipal budget revenues (excluding state grants of special purposes), at least 30% of it can only be related with payments for arrears in services provided until 31 December 2011.
- The municipality's annual net borrowing shall not exceed 20% (the Vilnius city municipality – 35%) of approved 2012 municipal budget revenues (excluding state grants of special purposes);
- Loans to be repaid in 2012 and subsequent years and interest to be paid may not exceed 15% of the approved municipal budget revenues (excluding state grants of special purposes);
- Guarantees provided by the municipal may not exceed 10% of the approved 2012 municipal budget revenues (excluding state grants of special purposes).
- According to 2012 budget law, municipalities (except Vilnius) with a debt of more than 45% of the approved 2012 municipal budget revenues (excluding state grants of special purposes) in 2012 can borrow only for implementation of projects co-financed by the EU and other international financial support. Vilnius city municipality can borrow only to cover the payments for services provided until 31 December 2011 and the implementation of projects funded by the EU and other international donors.

Local authorities have to inform the Ministry of Finance about undertaken borrowing and provided guarantees according to the rules defined by the Ministry.

According the Law on Local Self-government, a controller elected by the local council supervises the use of municipal budgetary funds and the legitimacy, suitability and effectiveness of the municipal property use and state property entrusted to the local authority. The main problem seems to be the lack of independence from the local government council as the council may dismiss the controller by a majority vote on proposal of at least one-third of the councillors.

The State Audit Office, which is subordinated to the Parliament, supervises the legal and effective use of state property, the fulfilment of the state budget and financial discipline of state institutions. While performing its functions concerning local self-governments, the State Audit Office determines if local authorities are using state funds appropriately and efficiently and, if necessary, evaluates municipal budget performance and the economic and financial activities of municipal offices and enterprises.

4. Fiscal rules

Until 2011, the main fiscal rule concerning the local government budget was a balanced budget rule, which requested that the approved local budget has to be balanced as defined by the Law on Budget Structure. However, as the local authorities might receive additional revenue than planned in the budget and also use borrowed funds (for limited purposes as described above), budgetary outturn might result in a deficit. Therefore, the Law was amended in 2010. Currently, the Law states that the approved deficit of the municipal budget must not exceed the planned borrowing (within the approved borrowing limits set by the Law on State and Local Government Budgets) for financing of investment projects. To ensure that local government does not borrow more than set in the limits, the Government representative participates in the council meetings and ensures supervision before the local government makes a decision for additional spending. However, there are no official sanctions set in legislation.

Therefore, the main fiscal rule applicable to local governments is a debt rule, which targets stabilisation of local governments' debt level in nominal terms. Annually the Law on State and Local Government Budgets sets clear limits for additional long-term borrowing, debt servicing (shall not exceed 15% of its budget revenue) and guarantees issued by municipalities. During the budgetary year, the municipalities are allowed to take loans and to provide loan guaranties only within these limits. The gross debt of local governments increased somewhat from 1.3% of GDP in 2008 to 1.8% of GDP in 2011 but remained limited compared to the general government debt of around 40% of GDP. Municipalities can take long-term loans for investment purposes only; short-term loans are only to cover temporary revenue shortfalls.

LUXEMBOURG

1. General description

The Grand Duchy of Luxembourg is a unitary state. Luxembourg's 106 municipalities (communes) are the only tier of subnational government. Their autonomy is anchored in the Constitution¹⁴⁷. Communes have mandatory responsibilities defined by the Constitution or delegated by laws related to spatial planning, enforcement of public order and safety, organization of nursery and primary school education and supply of public utilities and networks (local road network, drinking water distribution, sewerage, waste collection and disposal, cemeteries,...). In addition, communes have optional responsibilities such as providing infrastructure for sports, culture, tourism, health care or public transport. In order to increase efficiency, communes are allowed to form legal associations ('*syndicats de communes*') to fulfil certain services jointly. A territorial reorganisation of the communes is on-going in order to increase quality and efficiency of services.

Municipalities are allowed to impose communal taxes after approval by the central government. Total expenditure of local governments amounted to EUR 2283.9 million in 2011, which represents 12.7 % of general government expenditure and 5.2 % of GDP. In 2011, local government realized a consolidated surplus of EUR 50 mio (0.12% of GDP). Gross debt of local government amounted to around 975 million EUR or 2.3% of GDP.

2. Government spending

The main areas of spending of local government are education, general public services, economic affairs, recreation and culture, and environment protection. The Minister of the Interior supervises municipal acts and can reject municipal budgets. For this administrative surveillance, the communes are grouped into three administrative districts (Luxembourg, Diekirch and Grevenmacher), each managed by a district commissioner appointed by the government. The City of Luxembourg falls outside these districts and reports directly to the Minister of the Interior.

3. Financial arrangements

Luxembourg communes receive an overall grant from the State via the communal financial endowment fund (*Fonds communal de dotation financière* or FCDF). The FCDF is funded by revenues from taxes on alcohol, 10% of VAT revenues, 20% of the motor vehicle taxes and by a budget line from the Ministry of the Interior. The yearly transfer from the fund to the communes is determined as the sum of 18% of personal income tax receipts, 10% of VAT receipts, and 20% of motor vehicle tax receipts, on top of a subsidy which is established on an annual basis. It amounted to EUR 740 million in 2010, representing one third of overall communal revenues. The amount is divided between communes in accordance with the municipality's surface and population.

Beside this general grant from the FCDF, municipalities receive earmarked grants for specific purposes, such as musical education, nurseries and compensation of employees in the municipal administration.

¹⁴⁷ Art. 107 of the Constitution: Communes form autonomous authorities, on a territorial basis, possessing legal personality and administrating through their institutions, their patrimony and own interests under central government control.

Local authorities have also limited availability to raise their own revenues via taxes. All municipal taxes, levies and fees must be approved by the municipal council and the central government. Most taxes are collected by the central government, and then transferred to local authorities. Total local government receipts from own taxes amounted to EUR 742 million in 2011, representing about 32% of their total revenue and around 6.7% of total general government tax revenue.

The municipal business tax (*impôt commercial communal* or ICC) accounts for around one fourth of total revenues. This tax on local business profits is levied by the central administration for the benefit of municipalities. Municipalities are allowed to set the rate freely but the rates must be approved by the government. The municipalities are allowed to collect a property tax (*impôt foncier* or IF), which nowadays only represents a small share of their revenues (around 1.5%).

Furthermore, a variety of other taxes exist (property transfer duty, gaming taxes, tourist tax, dog tax, etc) which constitute however only a minor share of overall municipal revenue. Municipalities have also some own revenues from the provisions of services (*autres recettes propres des communes* or ARP) such as drinking water supply, waste water treatment, waste collection, distribution of electricity and gas. Lastly they also get part of their revenue from own property.

In addition, municipalities receive extra-ordinary revenues. The Ministry of the Interior allocates earmarked grants to municipalities and inter-municipal groupings for basic utilities, constituting capital expenditure arising from the municipalities' mandatory missions. These grants are targeted towards the creation or expansion of schools, town halls, infrastructure for water supply, technical services and cemeteries.

5. Fiscal rules

The Interior Ministry is responsible for the budgetary surveillance of local authorities. According to the Communal Law, municipalities are not allowed to run an operating deficit. Investments can be financed by issuing debt if no other financing is possible or viable and only when a regular reimbursement of the annuities is ensured through the operation budget¹⁴⁸.

¹⁴⁸ Art. 118 of the *Loi communale* of 13 Dec 1988

HUNGARY

1. General description

Fiscal governance in Hungary is characterised by a mixed, hybrid system with a decentralised structure, strong financial dependence on the centre and, until recently, broad local public service obligations.

In 1990, after the change in the political regime, local communities (regardless of their size) were given the right for self-governance, which was also enshrined in the constitution. The intermediate layer of counties was kept but municipals were not subordinated to counties and thus their influence on local affairs was significantly reduced. This resulted in a very fragmented, decentralised structure with nearly 3200 municipalities and with an average population of around 3100.

Municipalities enjoy a wide range of freedoms (independence, legislative power, right to levy taxes, etc.) but, at the same time, the 1990 Act on Local Governments (ALG) also delegated to the local level the delivery of a sizable part of public services. According to the COFOG classification, in 2010, 66% of government expenditure on education was carried out at the local level; this ratio stood at 37% for health, 44% for spending on recreation and culture, and 73.5% for environmental protection. Overall, local authorities are responsible for $\frac{1}{4}$ of total government expenditure.

Thus, there are effectively two layers of public administration in Hungary: the central administration and the local governments of the municipalities. The rather small average size of the latter together with an extensive range of mandatory services makes the Hungarian system distinct from other unitary models, such as the Mediterranean-type system (small units, fewer responsibilities) or the Scandinavian-type system (larger units, wide range of competences). Some features, such as the 'multi-purpose micro-regional associations', were introduced to move towards a more balanced mix of size and competence at the local level. Also, the main role of the additional layer of counties has been to bundle together some of the public services (especially in the education sector) of small municipalities or parishes by taking over both their service obligation and the associated central transfers. Nevertheless, the apparent mismatch between the size of local units and their obligation in delivering public services has been a driving factor in the evolution of subnational fiscal governance in Hungary.

Local governments also got a free-hand in managing their financial affairs. They had acquired the ownership of formerly state-owned local properties, received block grants and shared taxes from central government and were free to issue liabilities. However, the wide range of service obligations relative to the average size (and thus revenue raising capacity) of municipalities created a challenge in financing the activities of the local level. At the same time, the lack of fiscal space of the general government led to decreasing allocation of funds to municipalities, together with the increasing use of earmarking or ex post financing through reimbursement formulas.

Local governments compensated shrinking fiscal transfers by a rundown of their wealth; initially through sales of assets and eventually through growing indebtedness. Ineffective regulations and the practice of central government to cover local deficits created the

perception of a soft budget constraint and diminished incentives to fill the financing gap through raising local taxes.

The Hungarian subnational fiscal governance system has become almost dysfunctional, with entities inadequate in size to deliver the wide range of obligatory services and lacking both the incentives and the institutions to ensure prudent financial management at the local level. However, the ALG being an organic law, little changes to the regulatory environment were possible until recently. The amended the ALG, which has come into force on 1 January 2012, has significantly reduced the range of obligatory services, especially in the education and health sectors. Moreover, a draft law on the establishment of administrative micro-regions ("járás") has been submitted to Parliament in late March 2012. The new regulation foresees that a number of public tasks will be carried out by these new districts (notably, permission for buildings, issuance of various IDs, etc). These efforts should bring the optimal size of local public service provision better aligned with the actual size of municipalities, reducing their reliance on vertical government transfers. However, the implications of the amended ALG on the functioning of intra-government transfers and on public financial management as whole are not yet known.

2. Government spending

The 1990 ALG assigned numerous service obligations to the local level. The compulsory responsibilities of local entities included education (up to secondary level), health (basic medical care, specialised health services and hospitals), social welfare, provision of local public utilities and tourism. The overall expenditure of local governments reached to 12.7% of GDP in 2010, which is in line with the EU average of 12.2%.

Spending in education is mainly covered by normative grants, whereas operational grants primarily contribute to healthcare services and public goods provision (e.g. public lightning, infrastructure). These grants from central government are, in effect, formula-based reimbursements of (part of) the expenditure by local authorities. Thus, unlike block grants, they de facto limit the municipalities' room for manoeuvre when it comes to reshuffling funds between the different expenditure items. Besides these funding constraints, the municipalities enjoy a substantial flexibility with respect to the quality of the service they provide. This has led to a significant dispersion in the quality of obligatory public services, especially in the health sector.

Difficulties in funding and the cash-based accounting and budgeting system (in which the costs of the 'wear and tear' are not shown explicitly) led to an under-spending on fixed capital. Indeed, gross fixed capital formation in the first decade of the 2000s was only sufficient to cover amortisation; the former averaged at 1.8% and the latter at 1.7% of GDP. At the same time, in EU27 fixed capital investments of local governments amounted to 1.5% of GDP but it more than covered the consumption of capital which averaged at 1% of GDP.

The recently amended ALG, in parallel to completely evacuating the county level activities, shifted to the central administration the duties related to secondary education and hospital services. This rearrangement of duties is expected to considerably alleviate the burden of local authorities and to improve the efficiency and effectiveness of public services by leaving those tasks at the municipal level in which they are likely to be more competent than the state.

3. Financial arrangements

Revenues of local governments come from own resources, shared taxes, state transfers and other grants. Own-source revenues and grants from the central budget each cover around one third of total revenues. Shared taxes, investment grants (including EU grants) and grant-like revenues from other government entities (such as the Health Insurance Fund and the Labour Market Fund) make up the remaining one third.

Local governments have the authority to levy local taxes, the most important of which is the business tax levied on gross corporate profits, covering more than 80% of all local taxes. Local authorities can decide on the tax rate (within the ceiling of 2%) but revenues are effectively collected by the central tax authority. The vehicle tax (which was initially shared with the central budget) is collected the same way, but it amounts to only 7% of all own-source revenues. A similar amount is raised through the locally collected property tax (levied on buildings and land).

Revenues from the personal income tax (PIT) are shared between the central and local levels through different channels. First, some of the PIT receipts used to be passed on to municipalities in the form of normative grants. However, starting from January 2012, all normative grants have been delinked from PIT, while maintaining their level; thereby reducing the cyclicity of state transfers. Second, 8% of PIT revenue is allocated to the municipalities based on the residence of the tax payer, representing 4% of total revenues of the local government level. Finally, the PIT is the source for the revenue equalising grant which is used to diminish the gap between municipalities stemming from their different fiscal capacity.

Around $\frac{3}{4}$ of the transfers from the central budget are provided as normative grants. Investment grants, revenue equalising transfers and operational grants make up the remaining part. While only a small part of the normative grants are explicitly earmarked for specific purposes, general normative grants are also allocated to narrowly defined functions, mostly in the fields of education, social protection and culture. These transfers are in general based on expenditure needs rather than on actual output (also with a view to balance the financial disparities among municipalities), a feature that effectively discourages raising the efficiency or the quality of local public services. Moreover, the nearly 100 normative titles and the more than 150 operational grants (prior to the recent reduction in obligatory services) also makes the system administratively very costly, while frequent changes in the formulas increases uncertainty and hinders medium-term planning.

The equalisation system for local governments includes adjustments to the normative grants, a designated equalising transfer and a mandatory deficit grant. The latter was designed to cover the deficits that the municipalities encounter for no fault of their own. While deficit grants are used extensively (roughly one third of local governments received a mandatory deficit grant and even more received a discretionary deficit grant) the amount so distributed has remained limited (less than 0.1% of GDP).

To summarise, local governments enjoy – by design – a great deal of autonomy; however, the mix of local public services is determined to a large extent by their financial ties with central budget. At the same time, the intra-governmental financial system is overly complicated and without a clear relationship between different instruments and their policy purposes (e.g. the equalisation system). Hence, this government structure is not conducive to raising the

efficiency and quality of public goods provision or to improving financial prudence at the subnational level.

4. Fiscal rules

Given the legal independence of local authorities, ensured by the Constitution, little constraints apply to the financing or wealth management of municipalities. In fact, local governments are allowed to borrow from financial institutions or directly from the market (by issuing bonds). Also, until recently, there has been no procedure put in place that would have allowed the central administration to oversee such borrowing. Furthermore, no 'golden rule' exists; hence, even operational deficits were often financed by borrowing or disinvestment (i.e. sale of assets). As a result, assets in the local government sector have been declining while the sector's debt has been increasing in the past decade. This serious problem has been long recognised and the recently amended ALG now forbids operational deficits. However, it is yet unclear how this will be enforced in practice.

In fact, government control (either central or local) over local financial affairs are also hindered by the extensive use of state owned enterprises (SOEs) in the public service provision. Transparency of financial management is further reduced by the possibility for local governments to open an account in commercial banks and by the use of cash-based accounting and reporting systems. Moreover, in case of insolvency of a local authority existing procedures only concern settling liabilities vis-à-vis creditors but no remedial action is triggered to correct structural problems or to prevent the recurrence of such situations.

Finally, there is no 'national stability pact' type agreement between the central and the local levels. On a positive note, fiscal rules governing public finances at subnational level have been strengthened by the 2011 Economic Stability Act. In particular, municipalities engaging in new financial liabilities are in general subject to authorization by the central government (both for new loans and for rolling over existing ones). Loans can be taken out only for investment purposes (operational loans with a longer maturity are forbidden) and only if debt redemption would not exceed 50% of own revenues in any given year during the maturity of the loan contract (a more precise formulation is yet to be established by secondary legislation).

Prior to the new regulation and starting from 1996, the Local Government Act set a ceiling on the debt stock of subnational governments, which was specified at 70% of the "annual own revenue capacity" (calculated as receipts from local taxes and other revenues minus interest payments). However, this provision was not monitored or enforced by any official entity. As a result, from the early 2000s, local governments started to increasingly circumvent the regulation e.g. by accumulating debt in the books of local government-owned public companies instead of their own accounts. Indeed, the consolidated debt of local governments increased from roughly HUF 200 billion in 2000 to more than HUF 1200 billion (4½ % of GDP) in 2011; although this amount has been reduced by HUF 180 billion in 2012, due to the fact that the central government took over both the assets and the liabilities of the counties. In addition, according to the State Audit Office, 80% of the servicing costs of the liabilities (mostly accumulated in 2007-2008) will weigh on local governments' budget starting from 2014.

MALTA

1. General description

As one of the most centralised countries in the EU, Malta has a three-tiered unitary government system, based on central government, regional committees and local councils. There are also administrative committees which fall under their respective Local Council. . Local government (local councils) was established in 1993 through the Local Councils Act, which is the regulatory primary legislation, complemented with subsidiary legislation on financial, tendering, audit, human resources and other matters. The Local Councils Act was modelled on the European Charter of Local Self-government of the Council of Europe and has been amended on several occasions.. The system of local government is also entrenched in the Constitution of Malta through an amendment in 2001¹⁴⁹.

There are currently 5 Regional Committees, 68 Local Councils and 16 Administrative Committees. According to Eurostat's Government Finance Statistics for 2010, local government expenditure represents around 1.5% of total general government expenditure (0.7% of GDP), mainly taking the form of intermediate consumption (64%), followed by investment (21%) and compensation of employees (15%). Local government revenue corresponds to around 1.7% of total general government revenue (0.7% of GDP).

2. Government spending

Local authorities have gradually gained more responsibilities over the years. They have powers in the areas of environment, internal security and infrastructure. In particular, they are responsible for the general upkeep and embellishment of the locality, establishment and maintenance of playgrounds, public gardens, local libraries and sports facilities, local enforcement, refuse collection and carry out general administrative duties for the central government, such as the collection of government rents and funds, and answering government-related public inquiries. Local Councils do not participate directly in national economic planning. Their participation in national spatial planning is limited; they are allowed to make recommendations to any competent authority in relation to any planning or building scheme.

3. Financial arrangements

Local Councils depend mainly on central government for their financing. Their annual financial allocation is determined by a formula in the Local Councils Act. Originally the formula for allocating funds to Councils was based on each locality's population and surface area. However, in 1999, a new funding formula was introduced to better reflect the financial needs of each locality, based on the cost it incurs for the provision of local services and administration. This funding formula was further refined in 2009. The Minister for Finance may approve a supplementary allocation if it is found, after due consultation with the Minister responsible for local government, that the original amount was insufficient, while payments to cover special needs of a locality or localities are possible in exceptional cases. Since 2009

¹⁴⁹ "The State shall adopt a system of local government whereby the territory of Malta shall be divided into such number of localities as may by law be from time to time determined, each locality to be administered by Local Council elected by the residents of the locality and established and operating in terms of such law as may from time to time be in force"

Local Councils have benefitted from a number of financial schemes launched by central government. These schemes have been directed towards all aspects of society and include such diverse areas as: accessibility, cultural activities, alternative energy, sustainable localities and localities with special needs.

Local Councils are empowered to raise funds “by means of any scheme designed to provide additional funds”. They enact bye-laws to charge fees for, for instance, advertisements on (Council) street furniture and notice boards, the administration of (Council) property and use of (Council) facilities, etc. Local Councils may also be empowered to act as agents for public bodies or government departments, for instance when the handling of licences is delegated to the local level, in which case they can be granted a percentage of the collected fees.

Local Councils need written authorisation from both the Minister responsible for local government and the Minister for Finance in order to take a bank loan (there are no statutory criteria for such loan approvals but Councils have to follow a strict procedure in applying for such loan approvals) and the local commercial banks are the main sources of their borrowing. There are no provisions regarding guarantees given by the state or by other bodies.

4. Fiscal rules

There are no fiscal rules guiding the finances of local government. However, a portion of the financial allocation of a local council may be retained if necessary to correct a local deficit or a balance below the benchmark established in its annual budget. A persistent breach of financial responsibilities could constitute a ground for the Prime Minister to advise the President to dissolve the local council concerned.

5. Other relevant institutional features

The local councils’ accounts are audited by local government auditors under the responsibility of the Auditor General. The auditors also verify that proper arrangements are in place for securing economy, efficiency and effectiveness

THE NETHERLANDS

1. General description

The Netherlands is a unitary state, defined in its Constitution (last revised in 2002) as decentralised with a three-tier government structure (provinces and municipalities).

Throughout history the Netherlands was first constituted as a federal republic of sovereign provinces in the 16th century, but a unitary and centralised form of government prevailed since the Napoleonic period. In the past 30 years the country has, still being a strong unitary state, moved somewhat towards a more decentralised model which increased the responsibilities of local governments. Municipalities remain by far the most important level of local government, and since the Second World War a steadfast consolidation trend, driven by efficiency considerations, has seen their number cut from over 1100 to 430 currently. Their expenditure amounts to around 10% of GDP (2009 figures), while the 12 provinces spend around 1% of GDP. In parallel to this tiered system, an additional feature of Dutch public administration rooted in history and the topographic specificities of the country is the separate, autonomous network of water authorities (currently 23 across the country) which raise their own taxes and run specific elections.

While an overwhelming majority of revenue is raised by the central government, sizeable transfers grant significant spending responsibilities to the provincial and, in particular, municipal levels. The main responsibilities of provinces cover environmental and infrastructure issues at regional levels, whereas municipalities are in charge of delivering some major expenditure items such as social protection, health, primary education, and housing.

The recent trend over the past two decades has been to accompany the greater transfer of these tasks to municipalities with an increased focus on resource efficiency, through e.g. greater accountability and financial controls, aligned incentives for spending, and fewer earmarked transfers.

2. Government spending

By and large, government functions in the Netherlands remain largely centralised, whereby policy is determined centrally and implemented subnationally through the provincial and municipal governments' delegated authority. This is for instance the case for education, social and healthcare policy: the financial responsibility and discipline of municipalities is spurred by financial management incentives but leaves little policy discretion. Only for a few areas directly relevant to local/regional-scale management, responsibilities are more equally shared across government tiers e.g. spatial planning, transport and environmental issues. The main areas where spending is devolved to regional and local authorities reflect the increasing transfer of spending competences to the local level.

For instance, the government's major expenditure item, social protection, is split between government layers, with municipalities assuming charges such as social assistance (incl. minimum income), unemployment benefits, support to families and the elderly, special care... whereas provinces focus their action on child/youth action programmes.

3. Financial arrangements

The power of provinces and municipalities to raise tax revenue is very limited. The provinces' only source of own revenue stems from collecting a share of the national car registration tax (in the form of a surcharge, with a capped rate). Municipalities can collect tax and sales revenue on a broader variety of local bases (e.g. real estate, building permits, parking fees, sewage, rubbish collection, pets, tourism...) but this still only constitutes a limited share of their operational income.

Most of the revenue of subnational governments is therefore based on **transfers** from central government. In the case of municipalities (the major tier of subnational government) transfers make up almost 2/3 of their revenue.

General transfers

General transfers to municipalities (respectively provinces) are managed through the operation of a dedicated fund and distributed using a formula based on fairly sophisticated criteria¹⁵⁰. The size of the municipality and provincial funds is indexed on the overall expenditure of central government, which has the drawback of occasionally increasing their allocation with no specific increase in matching responsibilities; however, austerity at central government level also results in a shared effort at subnational scales.

Provinces and municipalities then dispose of a certain leeway in the use of the general funds, while having to fulfil their devolved competences. The recent trend has moved towards more aligned incentive schemes in those areas of responsibility, e.g. social services: "More incentives implied a change in financing Dutch social assistance benefits. In the past, municipalities could claim most of their expenses on social benefits to the central government. However, since 2004, they receive a fixed budget which is insulated from the macro-economic developments through a calculation by the CPB. As a consequence, municipalities now have an incentive to reduce the number of social assistance benefits."

Earmarked transfers

In addition to the general transfers channelled through the municipality / provincial funds, subnational governments still receive a large share of specific transfers allocated by the central government for devolved implementation of specific missions. The breakdown by government ministries illustrates the predominance of social service costs in specific transfers.

4. Fiscal rules

Provincial governments exert a role of financial control over municipalities; however, both tiers of subnational governments may borrow without any prior authorisation and from the establishment of their choice; bond emissions are rarely used (Dexia 2008).

¹⁵⁰ Which "[not only takes into] account the number of inhabitants, but corrects also for differences in tax earning capacity (real estate value of dwellings and business property) and external circumstances, like a regional function or the social and physical structure. Indicators used are the number of households receiving social benefits, number of people from ethnic minority groups, number of young or elderly, density of addresses and the surface area of the historical centre. However, differences in other revenues, like interest, dividend or from the sale of land, are not taken into account. Supplementary to the general distribution formulae, the Frisian Islands and the four major cities receive a fixed amount." (Bos 2010)

In practice however, since the medium-term budgetary framework imposes a "golden rule" for subnational governments' budgets, borrowing is only used to finance investment, which is defined using self-defined accounting standards¹⁵¹. No upper limit to borrowing has been set so subnational governments can borrow as long as they can finance the debt service.

Following decentralisation efforts between the two world wars, the debt of municipalities had increased sharply in the 1920s to over 40% of GDP. It stabilised around 20-30% of GDP in the 1970s where it still constituted the overwhelming majority of Dutch public sector debt. With increased fiscal discipline the trend has been steadily decreasing since then, when at the same time central government debt increased significantly. By 2009, the outstanding debt of the Dutch subnational public sector (mostly municipalities) had been reduced to 8.2% of Dutch GDP (still, the second highest level in the EU) at nearly 47.9 bn€ (2'890€ per inhabitant, the highest amount in the EU).

In the unlikely event of a municipality threatening to declare bankruptcy, the entity in question would lose control over their budget and the national government takes charge. The strictest form is the control under article 12 of the "financieel verhoudingswet". In 2009-2012, 4 municipalities were under this special control scheme of the central government and received in total around 22.4 million euro (2011) in financial support.

References & data sources

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¹⁵¹ This budget balance would therefore technically result in a deficit by ESA standards.

POLAND

General description

The public administration reform of 1999 aimed at the decentralisation of power and fostering self-determination by the local communities. It established a three-tiered system of local public administration. According to the Constitution, local governments assume the public tasks which are not explicitly assigned to the other organs of public administration. The entities of different tiers, although territorially overlapping, are independent of each other in the sense that entities of a higher level do not exercise authority or control over the entities of a lower level.

Tiers of local government and their responsibilities

The basic tier of local government in Poland is a *gmina* (commune/municipality) which is defined as a self-governing community of people inhabiting a defined territory. Currently there are 2479 *gminas*, 1571 of which are classified as rural, 602 as rural-municipal, and 306 as municipal. A *gmina* can be established, dissolved, merged or divided by the national government on the basis of its ability to effectively exercise its public functions. The law guarantees *gminas* autonomy in all matters of local concern which are not regulated by other legislation or assigned to other tiers of local government; grants them legal identities, ownership rights and independent budgets. In broad terms, a *gmina* is responsible for meeting the collective needs of the community. In this context, it assumes two types of tasks: those which are directly assigned to it by laws ('own tasks') and those which are delegated by the central level of government ('delegated tasks'). Own tasks are divided into obligatory, which a *gmina* is obliged to assume due to their elementary character, and facultative which should be assumed to a degree depending on the financial resources and local community's needs. In particular, most important areas of *gmina's* own responsibilities include: public transportation, water supply and sewage treatment, waste collection and disposal, energy and heating systems, local roads and buildings, land use and spatial planning, municipal cemeteries, libraries and cultural services, non-obligatory pre-school education for children from 3 to 5 years of age, obligatory pre-school education for children of 6 years and primary education.

The second level of local administration are *powiats* (county) which, depending on the character of the municipality, can have two different legal forms. Usually *powiats* are composed of several *gminas* and have separate administrative organs (currently there are 314 of them). However, larger cities (65 of them) are categorised as 'cities with *powiat* status' (city county / *miasto na prawach powiatu*), which are, de facto, *gminas* which assume also the tasks and responsibilities of a *powiat* (they have no separate *gmina's* and *powiat's* organs). In several cases, cities have been separated from its rural neighbourhoods to constitute an independent 'city with *powiat* status'. This has administratively separated the population of a significant area from an infrastructure (mainly secondary education) and own financial resources (tax base being concentrated in the cities), contributing to widening economic and social disparities within the same region. A *powiat* as a new entity introduced by 1999 reform has been assigned relatively narrowly defined range of responsibilities, including: managing general healthcare and hospital services (whose financing remains however within the responsibility of the National Health Fund), secondary education, roads, sanitary and health inspection, public safety and social welfare services (in particular running local employment offices responsible for active labour market policies and the payment of unemployment benefits).

A third, highest level of territorial division is a *voivodship* (*województwo*), where two tiers of government co-exist with separate responsibilities. Since the administrative reform, the representatives of the central government (*voivods*) have seen their competences shrinking considerably at the benefit of independent regional bodies (*sejmik*). While the former have maintained some role in maintaining the police, security and criminal justice functions of the national government and monitoring the use of grants by local governments, the latter have become fully responsible for the primary function of a *voivodship* which is regional development planning (as such they are the main players in the process of planning and management of the EU structural funds), and a number of other tasks, such as higher education, culture, health care and transport infrastructure. Currently Poland is divided into 16 *voivodships*.

Local government's finances

The amount of tasks and degree of responsibilities are reflected in the structure of financial resources used by different tiers of local government. Over the past decade local governments have been responsible for providing an increasing amount of public goods and services to their respective populations (a real increase of ca. 70% in total revenues and expenditures). Among them, *gminas'* budgets, given the widest range of tasks, accounted for almost half of total public finances managed by the local governments. Cities with *powiat* status, given the significant size of population covered, but relatively small number, accounted for over 30%, *powiats* for less than 20% and *voivodships*, due to their limited responsibilities, for less than 10%.

Revenues

The law defines three basic categories of revenues of local government entities: own revenues, general subsidy from the state budget and appropriated allocations. In 2010, ca. 48% of revenues of all local government entities came from own revenues, 29% were transferred as subsidies from the state budget, and 23% were earmarked grants.

Own revenues consist of incomes from local taxes (only for *gminas* and large municipalities), user fees, charges and fines, revenues of productive entities owned by the local government, income from the sale or rental of municipal property, and shares of revenues from personal income tax (PIT) and corporate income tax (CIT) paid by individuals and companies who are residents/located on the territory of the entity.

Local taxes levied by *gminas* include: real estate tax (flat per metre charge on land and a percentage of the construction costs of buildings), agricultural and forestry tax (based on the price of per hectare yields of particular types of land), motor vehicle tax, inheritance and donation tax, tax on civil law transactions, and a simplified income tax on small businesses.

The share of income tax revenues transferred to an entity amounts to 39.34% of PIT and 6.71% of CIT revenues collected on the territory of a *gmina*, 10.25% of PIT and 1.40% of CIT revenues collected in a *powiat*, and 1.60% of PIT and 14.75% of CIT revenues collected in a *voivodship*.

Total amount of the **general subsidy** transferred from the state budget to the local government entities is defined annually in the budget law, separately for *gminas*, *powiats* and *voivodships*. The subsidy has a redistributive function: the size of a major ('equalization')

component depends on the sum of tax revenues (local taxes plus share of PIT and CIT) per inhabitant of a *gmina* and, to a minor extent, on its density of population. A minor ('balancing') component is distributed among *gminas* according to the amount of housing subsidies paid by them and overall level of their population's wealth. For *powiats* and *voivodships* a similar mechanism is complemented with slightly different criteria. In case of *powiats*, the size of a subsidy is determined by tax revenues per inhabitant, the level of unemployment, and a combination of factors: total length of local, regional and national roads, size of family transfers, and a trend in a *powiat's* revenues. For *voivodships*, it depends on the tax revenues per inhabitant and the overall number of inhabitants (higher subsidy for small *voivodships*), and a number of other factors: the length of regional roads, unemployment rate, subsidies to regional railway operation and GDP per capita. A separate **education subsidy** is distributed among entities (*gminas*, *powiats* and *voivodships*) by the Minister of Education, taking into account the range of education tasks under their responsibility. The subsidy is the main source of financing for primary and secondary level of education in Poland. The current formula takes into account the number of pupils weighted according to the type of schools they attend and the pupil-per-teacher ratio in the area. Such formula implicitly favours rural areas, where the latter ratio is the lowest.

The third source of local governments' revenue is **earmarked grants**. They are either paid from the state budget, in the framework of the programmes financed from the EU funds, or from other earmarked funds. The former ones are allocated for the execution of the own functions of the local government and the functions delegated or commissioned to them by the national government. They must be co-financed (at least 50%) from own resources of an entity and are mainly granted for investments in education, culture and sports.

Expenditures

Local government entities spend their resources on current expenditures, including mainly wages and salaries, purchase of goods and services, social benefits, grants for subordinate organisational entities, and debt service, and on investment expenditures.

The structure of expenditure of various levels of local government reflects main tasks and responsibilities legally assigned to them. While classification of public expenditure according to COFOG is not available at a regional and local level, a national budget classification can serve as a proxy. *Gminas'* main items of expenditure are: education (33.3%) and social protection (16.5%), *powiats* and large municipalities finance mostly education (respectively 28.5% and 27.8%) and transport and communication (respectively 21.7% and 20.3%), while *voivodships* are predominantly responsible for financing transport and communication (39.1%).

Fiscal framework

Apart from the legal obligation to exercise the functions assigned to them by law, freedom of the local government entities to pursue their autonomous fiscal policy is constrained by the fiscal framework composed of medium-term programming and fiscal rules.

Medium-term programming involves both central government (in a form of Multiannual Financial Plan of the State) and all levels of local government. Multiannual Financial Projections are prepared for the current and at least three subsequent budget years, but the coverage may be extended if investment projects are implemented over a longer time span. The Projection is established together with the annual budget resolution and submitted to a

local accounting council for agreement. The document indicates the level of revenues and expenditures for the entire programming period, serves as a numerical guidance for the fiscal policy adopted in the annual budgets and provides a limit for the budget deficit and debt for a given year, although is not binding in more specific details.

Local governments are also subject to a series of fiscal rules. The general rule can be considered as a type of golden rule: it states that current expenditures planned for a given budget year cannot be higher than the sum of current revenues, budget surplus from the previous year and unassigned resources. An additional rule applying to debt and interest paid on it is expected to change soon. The current rule, in force until end 2013, requires that the overall debt level of each entity do not exceed 60% of its revenues at the end of each year and each quarter (although bonds issued and loans incurred in order to co-finance the EU-financed projects are not accounted for). At the same time, the interest paid on the debt cannot exceed 15%¹⁵² of the planned revenues. From 2014, a new, more flexible rule established by the Public Finance Law of 27 August 2009¹⁵³, will enter into force. It introduces an individual coefficient of debt, which defines the specific maximum expenditure on debt service for each local government entity. It is calculated as a three-year average ratio of the sum of current surplus (current revenues minus current expenditure) and sales to total revenues. The new rule, contrary to the existing one, will allow the entities to devise their individual fiscal strategy in a more flexible manner, depending on their ability to raise additional debt in order to finance sustainable investment projects.

¹⁵² If the state budget debt exceeds 55% of GDP, the limit will be lowered automatically to 12%.

¹⁵³ A 4-year *vacatio legis* has been decided in order to allow the local governments to adopt their budgetary policy to the new rules.

PORTUGAL

1. General description

Portugal is a relatively centralized country, but subnational governments enjoy a very large degree of autonomy including at the financial level. Subnational governments in Portugal are composed of 308 municipalities and two autonomous regions, each subnational structure being governed by a separate law.¹⁵⁴ Portugal has no formal regional level, except for two autonomous regions that cover the islands of Azores and Madeira. The two regions enjoy broader autonomy than municipalities. They have their own regional legislative assembly, their own regional government presidents (Presidente do Governo Regional) and their own regional secretaries (Secretários Regionais). The two regions also include municipalities and parishes governed by regional regulations and inspection bodies.

Municipalities are politically and administratively independent from central government. They have a municipal assembly, a mayor (presidente da Câmara municipal) and an executive council (Câmara municipal) elected for a four-year term. Municipalities are subdivided into parishes (freguesias), which also have an independent status, being in charge of some local administrative tasks (there are currently, 4,259 parishes). The majority of municipalities are small in size (less than 50,000 inhabitants).

There has been growing devolution of tasks to subnational government levels. According to the Constitution, the allocation of responsibilities among levels of government is based on the subsidiarity principle. The subsidiarity principle also applies to Azores and Madeira, but their own regulations prevail over national ones. The devolution of tasks at local level is revised annually through a Protocol signed between the central government and the Association of Municipalities. The Association of Municipalities and the Association of Parishes take part in the formal consultation procedures established by the constitution or by law. They are also consulted by the government on an ad hoc basis, in some cases informally before the formal consultation procedures, and are informed on developments of central government policy such as the preparation of the state budget and the Stability and Growth Program.

2. Government spending

Spending at subnational government level has been increasing steadily over the last decade, with budget deficits widening over the last five years. The increase in spending is mostly due to an increase in current expenditure, mainly compensation of employees and intermediate consumption, which has markedly contributed to general government current expenditure. Expenditure competences do not seem to be defined clearly and are revised on an annual basis through the signature of annual protocols between the central and subnational governments. Subnational governments are responsible for a significant part of general government investment, which however has fallen sharply in the last years. A review of the adequate levels of investment at local level is needed to help eliminate inefficiencies and redundancies.

¹⁵⁴ Local Finance Law 2/2007 of 15 January, and subsequent amendments and Regional Finance Law, Organic Law 1/2007 as amended by Organic Laws 1/2010 and 2/2010.

The structure of subnational governments' expenditure in Portugal is similar to other EU countries, with a high percentage of total expenditures on general public services. Data indicates important responsibilities in providing housing and community amenities, environmental protection, and recreation, culture and religion and general public services, while responsibilities in health, education and social protection are shared with central government. An increase in the education services attribution can be observed since 2006. Municipalities play an important role in licensing, as well as in supervising and enforcing national regulations, in areas such as water supply, drainage network, urban waste disposal, parks and gardens, street repairs, social and cultural facilities, primary schools and the municipal road network. The shared competencies between local governments and central government are being revised annually through a Protocol, and are not considered and/or reviewed in a multi-annual framework.

3. Financial arrangements

About 40 per cent of regional governments' revenues and about 50 per cent of local municipalities' revenues derive from transfers. According to the Regional Finance Law, the transfers are updated annually according to the rate of change of the current expenditure¹⁵⁵ of the State in the year previous to the State budget authorising the transfers. The allocation between regions is determined by their population, their relative periphery distances, the number of islands and a tax ratio. The regions also benefit from a Cohesion Fund for investment projects. Each year funds are transferred from the State budget to this Fund according to the ratio between regional and national GDP per capita.

Own revenues are collected by the central government's tax administration (Autoridade Tributária) for all local and regional entities besides Madeira, which has its own tax administration. The information on taxes paid is sent monthly to them by the central tax administration as requested by law. Municipalities in the regions benefit from the same revenue and transfers system as all other municipalities on the mainland. Own revenues represent about 30 per cent of local governments' revenues and 56 per cent of regions' revenues. In addition, regions retain all taxes levied on their territory.

Municipalities' own revenues include according to the Local Finance Law: i) a 5 per cent share in state personal income tax collected from residents; ii) own taxes (property taxes, surcharges on state corporate income tax, tax on vehicles, fees and fines), iii) a block grant defined as a share of central government revenues (currently set at 25.3 per cent) from personal and corporate income tax and value added tax as accrued in the year before the last in which the state budget authorising the transfers refers; and iv) an earmarked grant to finance tasks and responsibilities transferred from the central government. The revenue-sharing between central government and local governments is carried out according to detailed formulas set out in the Local Finance Law, through the following funds:

- the Financial Balance Fund (FEF), composed of: i) the General Municipal Fund (FGM), adjusts the resources of each administrative level to its respective attributes and competences; and ii) the Municipal Cohesion Fund (FCM), designed to correct

¹⁵⁵ It excludes the transfer for social security and contribution to the civil servant pension system.

asymmetries among local authorities resulting from different capacities to collect revenue or different expenditure needs. The two sub-funds are equal in size and are financed through the block grant of 23.5 per cent.

- The Municipal Social Fund (FSM), an earmarked grant to finance responsibilities transferred from the central government in education, health and social services. If the municipality does exhaust the allocated amount, the savings are deducted from the amount to be received the following year.
- The Parishes Financing Fund (FFF), financed through a share of 2.5 per cent of central government average tax revenues obtained from personal and corporate income tax and value added tax.

Municipalities can legally exercise tax powers only to the extent defined in the Local Finance Law. They can adjust the tax rate or base for the taxes under their powers according to the law. Although the overall amount of transfers from State's tax revenues is determined in the Local Finance Law, the central government can modify the attribution by a discretionary decision. Moreover, the overall growth in transfers is capped at 5 per cent.

There is no budget calendar for subnational governments. They finalise their draft budgets following the submission of the State budget to Parliament. The State budget conveys the information on transfers as well as on central government's tax revenue, which serves as a basis for projecting local and regional taxes. Before the State budget submission there is very little exchange of information between the central government and subnational levels. As a consequence, regional and local governments' budgets have consistently overestimated their projected revenue. During the last five years, average collected revenues were equivalent to only 65 per cent of the amounts projected by local governments. Revenue overestimation together with a weak public financial management is the main cause for the weak budgetary execution.

4. Fiscal rules

Portugal imposes debt rules and borrowing constraints to subnational governments. The Local and Regional Finance Laws define: (i) net debt ceilings, and borrowing constraints for local governments, (ii) and a debt service rule for regions. In addition, the 2012 budget law prohibits any increase in the net debt of regions and municipalities in 2012. This target temporarily supersedes other borrowing constraints.

Net indebtedness of municipalities cannot exceed 125 per cent of the sum of own taxes, shared tax, intergovernmental transfers and dividends from municipal enterprises recorded in the previous year.¹⁵⁶ Within the this limit: i) medium- and long-term financial liabilities, which are earmarked for investment purposes, cannot exceed 100 p.p.; and ii) short-term financial liabilities, which are to be used for cash management purposes only, cannot exceed

¹⁵⁶ Net indebtedness is defined as the difference between the sum of liabilities (financial and non-financial) and the sum of financial assets, including those pertaining to associations of municipalities and enterprises owned by local governments. Loans for financing urban rehabilitation programs, those related to EU co-financed projects and those for areas affected by public disaster are excluded from the computation of net indebtedness by authorization of the Ministry of Finance.

10 p.p. If a municipality exceeds the limit for net indebtedness, and/or for medium- and long-term financial liabilities, it must reduce it by at least 10 per cent per year until it falls back within the limit. In addition, if a municipality exceeds the limit for net indebtedness, the transfers it receives from central government are reduced by a corresponding amount. The money is then allocated to a regularisation fund (Fundo de Regularização Municipal) to deal with situations of structural financial imbalances of municipalities.

A situation of financial imbalance becomes “structural” if at least three of the following conditions occur: a) medium- and long-term financial liabilities exceed the 100 per cent limit; b) net indebtedness is higher than 175 per cent of previous year revenues; c) arrears exceed 50 per cent of revenues of previous year; d) total financial liabilities (including those not included in the computation of the net indebtedness limit) in excess of 300 per cent of last year revenues; e) average length of arrears above 6 months; f) failure to reduce liabilities by at least 10 per cent per year if the limits for net indebtedness and medium- and long-term financial debt are exceeded. The municipality is required to prepare an adjustment plan which, in this case, needs the approval of the Ministry of Finance. Approval of the plan gives access to the regularisation fund. The municipality must report quarterly on the implementation of the plan. Failure to report or to implement the plan results in the retention of 20 per cent of transfers from the central government.¹⁵⁷

The institutional framework that sets out indebtedness limits for local governments in relation to past revenues weakens the budgetary constraints in a pro-cyclical pattern. Growing revenues in good times raise the nominal amount of permitted borrowing under the debt ceiling, while servicing the liabilities incurred becomes more difficult during downturns when revenue transfers are declining. As a consequence, regional and local governments have built up significant amounts of debt over the last decade. Financial debt reached 5½ per cent of GDP at end-2010¹⁵⁸, while debt to suppliers above 90 days stood at EUR 2.7 billion (about 1.6 per cent of GDP) at end-2011 according to the survey on arrears.

Moreover, a significant number of local state-owned enterprises and other quasi-fiscal entities have been created by municipalities. Although, municipalities are not allowed by law to guarantee debt of these entities, the creation of such entities allows further accumulation of debt outside the local governments’ balance sheet and weakens their current indebtedness ceilings. New legislation enacted end- 2011 establishes mandatory rules on transparency and information on the operation of the local business sector and suspends the creation of new businesses by municipalities, inter- municipalities and metropolitan areas, as well as the acquisition of shares by them.

¹⁵⁷ On a voluntary basis, a municipality may declare to be in a situation of “temporary imbalance” and trigger a rebalancing procedure which foresees the preparation of a debt restructuring plan and of measures to reduce expenditure and increase revenues. Any of the following triggering criteria can be used: a) breaching the net indebtedness limit; b) arrears in excess of 40 per cent of previous year revenues; c) total financial liabilities (including those not considered to compute the net indebtedness limit) in excess of 200 per cent of revenues; d) average length of arrears above 6 months.

¹⁵⁸ Municipalities’ debt represented 3½ percent of GDP at the end of 2010, and Madeira’s amounted to 1.8 percent of GDP.

The government has tried to address growing financial imbalances in subnational governments through a number of measures: i) triggering of corrective actions as stipulated by the Local Finance Law through the adoption by municipalities of “financial rebalancing programmes”; ii) ad hoc measures included in the annual budget law, such as a limit of zero net indebtedness on aggregate local governments; and iii) several measures under the Economic Adjustment Programme for Portugal (See Box 1). Currently, there are 50 municipalities who should fall under the structural financial rebalancing programme according to the criteria set by the law.

In addition, a financial assistance programme between the central government and the Autonomous Region of Madeira was concluded in January 2012 to limit the fiscal risks that the region is causing on the Portuguese public finances. The arrangement includes fiscal consolidation measures, but also measure for structural performance such as introducing an effective commitment control system, an integrated financial management information system, accounting, fiscal monitoring and reporting in line with central administration, a restructuring plan for regional publicly-owned enterprises, and cost benefit analysis for investment projects and PPPs.

Box 1. Subnational governments' institutional reform under the Economic Adjustment Programme

1/ The Local and Regional Finance Laws will be revised to adapt subnational budgetary frameworks to the principles and rules of the revised Budgetary Framework Law, namely (i) the inclusion of all relevant public entities in the perimeter of local and regional government; (ii) the multi-annual framework with expenditure, budget balance and indebtedness rules; and (iii) the interaction with the Fiscal Council.

2/ Public financial management measures for fiscal reporting and monitoring and accounting in line with central administration will be implemented, and an effective commitment control system will be introduced. The number of public employees will be reduced by 2 per cent per year over the duration of the program.

3/ The fiscal rules for subnational governments will be reviewed and early triggers for corrective action will be introduced. At municipality level, fiscal rules will not be defined in structural terms as at the national level, other solutions to correct for possible pro-cyclical bias will be determined. By contrast, at regional level, the fiscal rules at the national level may be replicated conditional on appropriate development of statistical methods for regional GDP figures. These have the advantage of being simple and easy to understand.

4/ A procedure for an orderly debt resolution for regional and local governments will be designed and implemented.

5/ The revenue sharing mechanisms are to be revised and a fully-fledged medium-term fiscal framework in line with the central government will be introduced. The revisions also need to be designed in the light of the new EU fiscal framework.

FINLAND

1. General description

Finland is unitary country with two-tier government structure. Municipalities are self-governing units where the highest decision-making authority is vested in local councils elected by residents. Autonomy of the local authorities is protected by the constitution. The law on local self-governance (*Kuntalaki*) states that the local authorities have to perform the functions delegated to them in the laws and can decide to take other functions by virtue of their autonomy. Local authorities may not be allotted new functions or duties, nor shall they be deprived of functions or rights, other than by passing legislation to this effect.

Municipalities have very important role in Finnish public finances. They are responsible for wide variety of public services, they have right to levy taxes on their inhabitants. The budgets of local and joint municipal authorities were approximately 42 billion euros in 2011 or 22% of GDP. Some 430 000 employees, or close to 20% of the Finnish workforce, are working for the municipalities.

The tax ratio, i.e. the ratio of taxes and compulsory social security contributions to gross domestic product was 42.9 per cent in 2011 in Finland. Local governments collected 19.2 billion euros or 10% of the GDP in local taxes. In addition, the local governments receive revenues from state transfers and for the provision of their services. The stock of loans of local municipalities is ca 12.2 bln euros at the end of 2011.

The Ministry of the Finance is monitoring the operations and finances of local authorities in general and ensures that municipal autonomy is taken into account in the preparation of legislation concerning local authorities. Central Government's Regional Administrative Agencies (*Aluehallintovirasto*) supervise the activities of the municipalities, verifying that these are in line with the laws in force. They also investigate any complaints in this regard. However, this does not give rise to three-tier structure.

At the beginning of year 2012, Finland had 336 municipalities. The municipalities are relatively small – there are less than 6000 inhabitants in more than half of the municipalities. Seven urban municipalities have more than 100,000 inhabitants. Municipalities are encouraged to form joint municipal authorities to provide services to their inhabitants. There are ca. 180 joint authorities in Finland. These are set up by two or more local authorities to carry out specific tasks on a permanent basis. The most important joint authorities are hospital districts, districts for care of the disabled and joint authorities for the performance of functions related to public health and education. Three-quarters of all joint authority expenditure is incurred from organising health services.

There is also special joint authority called regional council or “*Maakuntaliito*” which consists of the municipalities in given geographical region corresponding to the NUTS region. There are 19 regions in Finland and it is obligatory for the municipalities of the given region to be associated with a regional council. However, this must also not be confused with three-tier governance system. The councils are responsible for regional development, including the EU structural funds programmes and regional spatial planning. These represent and promote the regions but their economic importance is limited – the total number of staff of all offices is about 650 persons, the budgets about 50 million euros or around 1% of local government sector expenditure.

The number of municipalities has been declining (there were 452 municipalities in the beginning of year 2000) but is generally still considered to be too large in Finland, arising concerns that the municipalities are not efficient in delivering the services. Fusions of municipalities have been encouraged by the government. There is an on-going debate regarding the reorganization of local authorities, dramatically lowering the number of the municipalities, mainly in order to improve the cost-effectiveness of their services. The reform would also concern legislation governing the activities of the municipalities.

Municipal finances are based on annual budgeting. This consists of the budget for the next financial year and budget framework for minimum three years, including the budget year. The law requires that the budget must be in balance over the four-year period. Ministry of Finance supervises the compliance regarding the budget balance rule. The primary responsibility rests within the municipality itself – committee appointed by the council monitors and reviews the execution of the budget, including the achievement of the objectives set in the budget. Activities and accounts of municipalities are subject to annual audits by professional audit companies. Auditors report to the municipal council.

2. Government spending

Local governments' budgetary expenditure in 2011 was 40.4 bln euros while the general government sector spent 103.5 bln euros. Largest share of expenditure goes towards the production of basic services, the most important of which relate to social welfare and health care, education and culture, the environment and local infrastructure. In each area there is an elaborate division of labour between the central and local government, clearly defined in the legislation. Generally, central government agencies are responsible for making the transfer payments to the citizens while local authorities provide the services. Nature and quality of the services (for example, the content of the curricula at schools or the required medical services) is mostly pre-defined in legislation. Often the legislation defines the objective the municipality has to reach but leaves its hands free in choosing the means. Municipal council has to decide on the allocation of resources to achieve targets set by the laws. In most cases the council is free to select the level of resources but can be made responsible when standards are not met. This includes the possibility to levy fines on the municipality.

As an example of the division of labour, central government agency KELA is responsible for the payment of pensions, including disability pensions, and compensation for the medication. Similarly, they pay compensation for income lost due to sickness and compensate some form of treatment received in the private medical services sector. At the same time, the local authorities are responsible for the organization of the provision of medical services in medical centres and hospitals. They organize children's day-care, services for the elderly, including long-term care etc. In principle, the inhabitants are expected to use the services offered by their municipality.

Important challenge in this system is that the services are fragmented and citizens have unequal access to the services depending on the municipality where they live. Fragmentation increases costs per se, but apparent lack of competition in service provision has enabled steady decrease in the productivity in delivering these services.

49% of municipal expenditure was directed towards social welfare and healthcare services in 2011. Education and culture accounted for 22% of expenditure, municipal investments 11%. Debt servicing expenditure was 4% of the total expenditure.

In the provision of education, the municipalities are responsible for all levels of primary and secondary schools. They are also responsible for life-long learning activities and youth activities. Universities are independent institutions, with autonomy granted in the constitution and governance regulated by special legislative acts.

In addition, the municipalities are responsible for spatial planning and supervising the construction activities. Municipalities arrange the provision of water, energy and waste services, take care of the streets and environmental protection. Often these services are provided by companies owned by the municipalities or groups of municipalities.

3. Financial arrangements

Taking the example of year 2010, the tax revenue of the local authorities accounted for 46% of their total revenue. It consists of municipal tax on earned income, real estate tax and part of company tax. Average municipal tax rate is 18.3%. The tax rate of the municipal income tax can be set to any level decided by the council, but according to the law the tax rate is flat and the tax base is earned income, capital income is not taxed by the local authorities.

Land and buildings are subject to real estate tax, except land used for agriculture or forestry. Tax is paid by the owner of the real estate, taxable value is defined in the act on the valuation of assets in taxation. Municipal councils can determine the rates in the limits set by law. These limits are rather low for primary residences and higher for real estate related to business and industry. Interesting aspect is punitive rate towards empty lots allocated for construction.

Corporation tax is tax collected from companies, the rate of which is 26% of the taxable income of a corporation. This tax is paid to the state, municipalities and parishes of the Finnish Evangelical Lutheran and Finnish Orthodox Churches. The share of municipalities is ca 1/5 of the tax collected. However, this tax is national tax and municipalities do not have right to decide on the level or base of the tax.

Operating revenue accounted for 27% of the revenues, its sources are revenues from companies owned by the municipalities in water, energy, and waste and public transport sectors. Some revenue is also earned by the provision of social and health services. Education is always provided free of charge.

Further 18% of local government revenues stemmed from the central government transfers (7.7 billion). Central government finances certain state functions delegated to the municipalities. These include obligations of the municipalities to provide services in education, day-care for children, healthcare, social security, protection of minors, assistance to disabled, prevention of health hazards, environmental services, consumer protection and culture, including the provision of library services.

The government transfers are also aimed at streamlining the economic differences between the municipalities in order to achieve uniform level of services across the country. Municipalities can also apply for additional discretionary governmental support in case of lasting economic difficulties. However, the discretionary support is used on very limited cases

and the amounts granted are small. In 2011, 63 municipalities applied for the exceptional support (for the amount of €70 mln) and it was granted to 31 in the amount of €20 mln.. Largest amount granted was €1.2 mln euros. As such, the possibility to receive discretionary support does not lower the fiscal discipline of municipalities. Any request for discretionary support must include a programme to balance the budget. Special conditions could be set by the government and the municipality cannot count that the support would be awarded also in the following years. The complicated formulas for determining the central government transfers take into account the presumed costs of providing the services, population structure and density, existence of island conditions, remoteness from larger centres, unemployment level, number of disabled and elderly needing care etc. If the estimated tax income per capita is lower than 91.86% of national average, government transfer is increased. The transfers are based on the central government estimations of the cost of required services' provision but the funds are not earmarked to specific activities. This means that there is incentive to be economical in service provision – cost-efficiency enables additional expenditure in other areas whereas the municipality does not have possibility to receive additional transfers when actual cost for some service proves to be higher than central government calculation foresees.

4. Fiscal rules

Local governments are obliged by law to keep their budgets balanced over a four-year period and municipalities generally abide by the law. The Ministry of Finance monitors the ability of the municipalities to meet their funding needs and forecasts short-term trends in local government finances, both in individual municipalities and at regional level. The government has specific powers to enforce a review of a municipality's finances and to work toward a recovery plan if the local government has fallen below target financial ratios. In case the ratios are breached in two consecutive years, a special committee is formed. This includes representative from the Ministry of Finance, representative from the municipality under question and an independent chairperson. The committee forms a proposal on the necessary measures to guarantee the continued delivery of services to the citizens. Based on the review, Ministry of Finance can decide to start the procedures to merge the municipality with another. Municipalities are not subject to the bankruptcy law.

So far, on the aggregate level, local government deficits and debt have remained modest (local debt amounts only to about 6% of GDP).

The municipal council has very wide authority: it sets the tax rates, decides on the general principles for the charges to be collected for services and other performances, sets operational and financial targets for a municipal enterprise, decides whether to provide a guarantee or other security for another party's debt, decide on the principles for the financial remunerations of elected officials, chooses the auditor and approves the financial statements.

When approving the budget, the council must also approve a financial plan for three or more years. The financial plan must be in balance or show a surplus during the planning period of maximum four years.

Municipalities are also subject to strict reporting rules. Financial statements on each financial year have to be drawn up by the end of March of the following year and submitted to the auditors for inspection. The documents include a report on operations, providing an account of how far the operational and financial targets set by the council have been achieved.

Auditors (professional audit organisations) verify that the local authority has been administered in accordance with the law and council decisions, financial statements give correct and adequate information on finances and that the information given on the bases for and use of government grants is correct.

5. Other relevant institutional features

Local government lending is dominated by Municipality Finance Corporation (*Kuntarahoitus OY*). Owned by municipalities and the Finnish state, Municipality Finance is a credit institution in the service of its members. The credit ratings for Municipality Finance's long-term funding are the highest possible: Aaa from Moody's, and AAA from Standard & Poor's and thus the institution has access to low-cost funding.

Municipality Finance offers financial services on market terms for municipalities, municipal federations, municipally controlled organisations and non-profit housing organisations. The company's funding is obtained from both international capital markets and domestic investors.

All the borrowing is guaranteed by the Municipal Guarantee Board. Almost all Finnish municipalities are members of the MGB and are consequently liable for its liabilities. If a municipal member failed to pay on its obligation, other members would be jointly liable for the shortfall according to their share of participation to the MGB.

Municipality Finance has not suffered any loan defaults. It is not obliged to extend a loan and may decline a loan application, although the strengths of the Finnish local government and government-related sectors make a refusal unlikely.

SLOVENIA

1. General description

The Constitution of the Republic of Slovenia provides for a decentralised, two-tier¹⁵⁹ government structure, composed of central government and local governments (municipalities). This structure was shaped in the second half of the 1990s when the number of municipalities gradually increased from 60 to almost 200; it now stands at 211.

Municipalities are responsible for local functions they can provide independently for their inhabitants (*original functions*) and for functions transferred by the central government, with their consent and if sufficient financing is provided (*transferred functions*). More than half of their revenue comes from the redistribution of personal income tax.

According to the OECD Fiscal Decentralisation database, the share of municipalities' expenditure in total consolidated general government expenditure was 25.5% in 2010, corresponding to about 10% of GDP. Their share in total consolidated general government revenue was 15.4% (5.9% of GDP). Municipalities usually record a marginal deficit position of around 0.1% of GDP (over the period 2001-2011, the deficit was higher at around ½% of GDP on average in the years 2008-2010)¹⁶⁰.

There are also two social security funds: the pension and disability insurance fund (PDIF) and the health insurance fund (HIF). Any PDIF deficit is covered by financing from the central budget, while the HIF has been in deficit in recent years, following several years of surpluses.

2. Government spending

According to the COFOG classification of government expenditure, municipalities' main functions are: (i) economic affairs, especially road transport (24% of their total spending in 2010); (ii) education, especially pre-primary and primary education (20%); (iii) general public services (17%); and (iv) recreation, culture and religion (16%). Other non-negligible functions in terms of spending are environmental protection (waste and waste water management) and housing.

Policies for pre-primary and primary education are designed, and standards formulated, at the central level, whereas municipalities ensure their implementation, with some autonomy in particular over capital expenditure for the supporting infrastructure. Municipalities have some more autonomy in policy and decision making for the other main functions highlighted above.

The PDIF administers various old-age and disability pension schemes. The HIF pays for the provision of medical services and related compensations of policyholders.

3. Financial arrangements

¹⁵⁹ The Constitution foresees the possible formation of regions, which is the autonomous local government level to administer local functions of a broader importance than those of municipalities as well as other functions as defined by law. However, this provision has to date not been implemented.

¹⁶⁰ The municipalities' revenue and expenditure shares as percent of GDP do not add up to the deficit ratios because in the database consolidated total general government expenditure is defined as global total expenditure at general government level plus the total inter-governmental property expenditure and consolidated total general government revenue is global total revenue at general government level plus the total inter-governmental property income.

Municipalities' financial arrangements are based on the concepts of "adequate spending" and "adequate funding" and the principle of proportionality between responsibilities and resources¹⁶¹. *Adequate spending* is the amount a municipality is assumed to spend on its responsibilities. It is based on a formula including a lump sum per inhabitant¹⁶² and the number of inhabitants adjusted for the situation of the municipality on some specific parameters (such as its relative area surface, length of local roads and proportion of inhabitants under 15 and over 65). It is financed through the redistribution of personal income tax (PIT) revenue, which is based on the concept of *adequate funding* and represents around 58% of municipalities' total revenue, and, where needed, additional government transfers¹⁶³.

Municipalities' revenues also consist of other own resources and municipal fees. Examples of the former are taxes on vessels, on inheritance and gifts and on winnings from conventional games of chance as well as real estate turnover tax; municipalities have no autonomy for setting underlying tax rates or bases. They do have this autonomy (to some extent) for municipal fees, including concessions, fines, environmental charges¹⁶⁴ and payments for local public services. Finally, municipalities receive property income as well as donations and transfers from the EU and central government for specific purposes (e.g. investment).

The PDIF is funded with mandatory contributions for pension and disability insurance as well as with transfers from the central government budget, which must fully cover any gap between PDIF expenditure and revenue. These transfers are on an increasing trend and stood at around 4% of GDP in 2011. The PDIF is not permitted to accumulate debt.

The HIF is funded with mandatory contributions for health insurance. It was in surplus until 2008; its deficits since then have been covered by reserves.

4. Fiscal rules

Municipalities are only allowed to borrow domestically, and for investment purposes, up to a certain ceiling. A municipality can also borrow for liquidity purposes up to 5% of the last adopted budget. Debt assumptions are prohibited and municipalities cannot issue bonds but they can issue debt guarantees for indirect budgetary users¹⁶⁵ and local public enterprises. The Minister of Finance has to authorise any borrowing when the repayment is not foreseen to occur within the same budgetary year.

¹⁶¹ Financial arrangements are presented in detail in the Municipalities' Financing Act and the Public Finance Act.

¹⁶² Set at €554.50 in 2012 at the state level.

¹⁶³ Adequate funding is based on a similar formula as adequate spending but with the adjustment reflecting each municipality's specific situation assuming a lower weight. In year *t*, the central government redistributes 54% of PIT revenue paid in year *t*-2 indexed for inflation in years *t*-1 and *t*, in three steps. First, 70% of this amount is redistributed, based on the proportion of total PIT collected in each municipality (and limited to its adequate funding). Second, additional PIT revenue, eventually increased by part of redistributed PIT revenue from the first step which already exceeded adequate funding for individual municipalities, is allocated up to the total adequate funding for all other municipalities (*solidarity compensation*). Third, in case the total available amount of PIT revenue exceeds total adequate funding, the remainder is further redistributed to proportionally cover as much as possible the gap with municipalities' adequate spending (*additional solidarity compensation*). If a municipality's total PIT revenue still falls short of its adequate spending (expected to apply to 150 municipalities in 2012), it receives an additional equalising transfer from the central government (*financial compensation*) to fill the gap. Municipalities with a higher proportion of high-income earners end up with redistributed PIT revenue exceeding the amount they are assumed to spend on their responsibilities (adequate spending).

¹⁶⁴ Environmental charges are earmarked for infrastructure and implementation of environmental measures and standards.

¹⁶⁵ These are institutes and foundations, i.e. legal entities for the provision of specific public services, such as schools, libraries, medical centres, sports and cultural centres, etc.... There are some 1500 indirect budgetary users in Slovenia.

The Municipalities' Financing Act specifies a debt rule for municipalities. The annual ceiling for their payment of loans principal and interest, financial leasing, trade credits and contingent liabilities is set at 8% of their revenue in the previous year (excluding donations, investment transfers from the central government, EU funds and revenue from business activities). The rule is based on cash accounting and there are no predefined escape clauses. It was introduced in 1995 and the most recent revisions have made the rule more coherent by abolishing special treatment of certain investments (e.g. in education, housing, water supply). It is monitored and enforced by the Ministry of Finance. Over-indebted municipalities are not authorised to borrow by the Ministry of Finance and first have to reduce their debts. The available information does not suggest that any municipality has ever defaulted or been bailed out, although there are few municipalities with blocked transaction accounts due to over-indebtedness.

The local debt rule generally appears to have ensured that municipalities curb their expenditure rather than break the debt ceiling. Municipalities are estimated to spend on average around 5.4% of their revenue on the annual payment of liabilities, which suggests that they are generally below the 8% threshold by a relatively wide margin. Still, local government debt in ESA95 terms increased from 0.7% to 1.7% of GDP between 2007 and 2010 and the number of municipalities without debt has shrunk. To improve public finance surveillance at the local level, the government intends to launch an online tool for an up-to-date and comprehensive calculation of individual municipalities' indebtedness levels in the near future.

5. Other relevant institutional features

Several legal provisions seek to limit deviations from the fiscal targets adopted by the municipality council. During the budget execution phase, the mayor can, on a proposal from the municipal department responsible for finance, impose a temporary moratorium (of up to 45-days) on new expenditure by (i) blocking new contracts from being signed; (ii) prolonging payment periods; and (iii) ending the redistribution of budgetary funds among users. If such a moratorium is not sufficient, the mayor must propose a supplementary budget and can prolong the moratorium until this supplementary budget is approved. These arrangements are similar those for the central government budget.

SLOVAK REPUBLIC

Introduction:

Slovak Republic is a unitary state with two tiers of sub national entities: 8 regions (VUC) and 2887 municipalities (obce). The existence of municipality and region (higher territorial unit) is embodied in the Constitution which states that the basic unit of territorial self-administration is the municipality. The territorial self-administration is then composed of a municipality and a higher territorial unit. Both levels of subnational government are independent territorially and administratively and they are also independent of each other.

Significant changes to the system took place between 2001 and 2003. In 2001 the regional governments were established as units of self-administration and in 2002 the transfer of competences to regions and municipalities began. Between 2002 and 2003 over 90 competencies were transferred to regions and over 60 to municipalities.¹⁶⁶ In 2004, administrative districts (okres) were abolished.

Government spending:

Main responsibilities of municipalities lie in the fields of education, social welfare for elderly, social housing (construction and maintenance), local utilities, health (outpatients departments, hospitals and medical centres of first type), tourism and public order. In terms of spending, over 30% of overall expenditures in 2011 were devoted to education where municipalities are responsible for preschool education (kindergartens, nursery), primary education and activities which are not directly related to primary education such as art schools, school kitchens and canteens etc.

Main responsibilities of regions are in the fields of secondary education, social welfare and social policy, regional roads, transport, railways, health (hospitals and medical centres of second type, non-state health care) and regional development. Education is again the most significant area of spending with almost 40% of overall expenditures devoted to it in 2011.

Financial arrangements

Municipalities and regions provide services in two different ways - through autonomous and delegated competences. These two ways differ in degrees of competences and ways of financing.

When exercising autonomous responsibilities the subnational government is bounded by the Constitution and laws but the actual exercise powers are under the discretion of a municipality or a region. Subnational governments decide independently and carry out all autonomous responsibilities as defined by law and the state only monitors whether subnational governments comply with the law. Autonomous competences of subnational governments are funded from own revenues.

For example, in case of education, financing of art schools, kindergartens, language schools, clubs, children's educational centres for leisure activities and other facilities within the scope of autonomous responsibilities of subnational governments is secured in this way (i.e. from own revenues).

In terms of delegated responsibilities, subnational governments have a role of executive bodies that apply state administration under the control of the state. Subnational authority is bound not only by the Constitution and law, but also by lower levels of legislation such as government regulations, decrees, ministerial actions etc. Although subnational governments finance these services from their budget, the funds in fact come from the state budget and individual ministries in the form of transfers. In this case, the state controls extensively the use of the funds provided to

¹⁶⁶ <http://www.infostat.sk/vdc/pdf/slavikdoc.pdf>

subnational governments. For example, current expenditures on education in primary and secondary schools are funded in this way.

Revenues

Revenues of both levels of subnational governments come from shared taxes, own revenues and grants. Shared taxes include personal income tax which is collected by the state and shared among regions (23.5%), municipalities (70.3%) and the central government (6.2%). The sharing key is a function of demographic criteria. From January 2012 a new rule for sharing tax income revenue entered into force setting new shares for government layers - regions (21.9%), municipalities (65.4%) and the central government (12.7%).

For municipalities, tax revenues account for over 50% of overall revenues. These include own-source revenues such as the real estate tax and other taxes on goods and services on which municipalities can freely decide the rate (except for a capping). However, the personal income tax revenues is the most important revenue source accounting for almost 70% of all tax revenues in 2010. This can in a way problematic because revenues from the personal income tax are rather cyclical.

Grants represented almost 35% of total revenues and they were all earmarked to cover all delegated responsibilities or to finance specific projects.

For regions, tax revenues represented about 47% of total revenues in 2010 of which over one quarter is own-source revenue from the vehicle tax. The rest comes again from the personal income tax. Grants accounted for over 45% of total revenues in 2010 and were again all earmarked to cover all delegated responsibilities (or to finance specific projects).

Fiscal rules

Fiscal rules aimed at local governments include a debt rule, a budget balance rule and recently certain new measures embodied in the constitution.

Debt rule states that subnational governments are allowed to take out credit/loan/issue bonds only if: a) the total sum of the debt of the municipality or self-governing region does not exceed 60 % of final current revenues of the preceding budget year and b) the sum of the annual instalments of the loans does not exceed 25% of final current revenues of the preceding budget year.

Budget balance rule says that the current budget (one part of the overall budgets of local governments) has to be adopted either as balanced or in surplus. The Act on budgetary rules of subnational governments lists possible exceptions, for example in cases when a subsidy from the state budget is envisaged or when EU financing is budgeted for the fiscal year in question. Capital budget may be set up with a deficit if this deficit can be covered from previous years, and reimbursable sources of financing (loans), or if this deficit is covered by the current budget surplus in the budget year.

Generally, it can be said that the budget balance rule has been respected. If a subnational entity breaks rules the Ministry of Finance may impose a fine of up to €16 597. However, this kind of punishment is not automatic and has been used only in exceptional cases when certain municipalities did not provide their financial statements..

Finally, Constitutional law no 493/2011 article 6 paragraph (3) states that if the total debt of the municipality or higher territorial unit reaches 60% of actual current income of previous financial year or more, municipality or higher regional units are obliged to pay a fine imposed by the Ministry of Finance amounting to 5% of the difference between the total debt and 60% of actual current income of the previous financial year. The paragraph will be effective from 1.1.2015.

In terms of bankruptcy, subnational governments cannot declare bankruptcy. Constitutional law no 493/2011 article 6 paragraph (1) states that the Government does not guarantee funding for provision the solvency and is not responsible for the solvency of the village or higher territorial

unit. A procedure for dealing with insolvency of a municipality or higher territorial unit is provided in a secondary legislation. In case of serious financial difficulties municipalities are obliged to introduce "recovery regime" (1st mode) which gives municipalities 120 days to demonstrate an improvement in their financial condition. If they fail to meet this deadline the Ministry of Finance is entitled to decide about the introduction of forced administration (2nd mode) in which case the Ministry has the authority to approve all financial transactions and to request adoption of revenue raising measures. The Ministry does not provide additional funds to a municipality. Out of 2900 municipalities, 12 municipalities introduced a recovery regime in 2011. Forced administration was used in 6 municipalities since 2005.

SWEDEN

1. General description

Sweden is a decentralised country with a high degree of local self-governance. Local government has a long tradition in Sweden. The country's 290 municipalities and 20 county councils and regions are responsible for providing a significant proportion of all public services. They have a considerable degree of autonomy and have independent powers of taxation. Local self-government and the right to levy taxes are stipulated in the Instrument of Government, one of the four pillars of the Swedish Constitution.

There is no hierarchical relation between municipalities, county councils and regions, since all have their own self-governing local authorities with responsibility for different activities. The only exception is Gotland, an island in the Baltic Sea, where the municipality also has the responsibilities and tasks normally associated with a county council. A region is a county council with extended responsibilities.

About half of all public revenues and expenditures relate to subnational governments, corresponding to about 24% of GDP. Tax revenues, most of which consist of taxes on earned income, make up about two thirds of overall revenues, with general state transfers providing another 15% and targeted state transfers, user fees, rents and other revenues making up the rest.

2. Government spending

The municipalities are legally or contractually responsible for providing the following services: social services, childcare and preschools, elderly care, support for the physically and intellectually disabled, primary and secondary education¹⁶⁷, planning and building issues, health and environmental protection, refuse collection and waste management, emergency services and emergency preparedness and water and sewerage. Other activities are provided on a voluntary basis, such as leisure activities, cultural activities (apart from libraries, which are a statutory responsibility), housing, energy as well as industrial and commercial services. The county councils are legally obliged to provide health care (managing and financing hospitals), dental care for people up to the age of 20 and public transport (in some cases, public transport is managed in cooperation with municipalities). Other activities are provided on a voluntary basis, such as cultural activities, education, tourism services and regional development.

Generally, subnational governments enjoy a relatively high degree of freedom to organise their activities, which can be adapted to local circumstances. The Local Government Act governs the responsibilities, obligations and mandate of local governments. There are some restrictions on what local government can do, notably in the commercial sector in cases where they enter into competition with private firms¹⁶⁸.

¹⁶⁷ All compulsory education is the responsibility of municipalities.

¹⁶⁸ The Competition Act was modified in this sense in 2010 giving the Competition Authority to take action against local, regional and central government that are deemed to harm competition.

The distribution of municipalities' expenditures is as follows: kindergartens and after-school care 14%, education 28%, elderly care 19%, support for handicapped people 11%, economic support 3%, other individual and family support 4%, business activities 5%, and others 16%. For the counties, the largest items are various forms of health care 79%, support for medicine expenditure 8%, transport and infrastructure 6%, dental care 4% and regional development 2%.

3. Financial arrangements

Municipalities, county councils and regions are entitled to levy taxes in order to finance their activities. Taxes are levied as a percentage of the inhabitants' income. Municipalities, county councils and regions decide on their own tax rates. The average, overall local tax rate is 30 per cent. Approximately 20 per cent goes to the municipalities and 10 per cent to the county councils and regions. Tax revenues are the largest source of income for Sweden's municipalities, county councils and regions and account for approximately two-thirds of their total income. Technically, it is collected by the state, but the revenues are redistributed to the various subnational levels according to their tax base and applicable tax rates.

Grants from the State are either general or targeted. General state grants represent 15% and 9% of total revenues for municipalities and counties, respectively. These are paid per inhabitant. Each municipality, county council or region can use this money on the basis of local conditions¹⁶⁹. Targeted grants, which make up 3-4% of total revenues, must be used to finance specific activities¹⁷⁰, sometimes over a specific period of time.

There are major variations in the average income of the inhabitants of Sweden's municipalities, county councils and regions. The cost per inhabitant, for providing the services to which they are entitled, also varies. In order to ensure fairness, a system has been introduced with the aim of providing equitable conditions in all municipalities, county councils and regions. This is the local government equalisation system, which entails redistributing the revenues of the municipalities, county councils and regions on the basis of their tax base and level of expenditure¹⁷¹. The equalisation system is managed by the State.

Municipalities, county councils and regions may charge users for their services. A non-profit principle applies, however, which means that fees may not be higher than the costs relating to the service concerned. Fees account for about 6% and 3% of revenues for municipalities and counties, respectively. If the municipalities, county councils and regions are obliged to provide a service, they may only charge for the service if specifically permitted to do so by law.

4. Fiscal rules

Municipalities and counties are subject to a balanced-budget requirement, meaning that they cannot plan a budget with a deficit. The law requires them to conduct their financial planning

¹⁶⁹ General grants come with no strings attached, but as local gov't spending to a large degree is made up of the wage bill, increasing central government grants to local gov't is a rather efficient way of counteracting cyclical downturns, as it may prevent local gov't from reducing staff in cyclical downturns (which they otherwise may deem necessary to comply with the local gov't balanced budget requirement).

¹⁷⁰ Specific grants can be given for any purpose and depends on the priorities of the central gov't at any given moment in time.

¹⁷¹ Measured by structural factors, such as age structure etc.

in a prudent way, which has come to mean in practice that they should aim for a surplus of about 2% of total revenues from taxes and general state grants. Since 2005, the average has been 3%. If, ex post, there is a deficit, it has to be compensated within three years, unless special circumstances apply, for which exceptions can be granted¹⁷². The experience so far is that municipalities and counties take this requirement seriously and the rule has thus contributed to the overall positive performance of Swedish public finances. There are no formal sanctions for breaches of the rules, but the system has so far worked on the basis of self-discipline, relying on voters to punish bad financial management.

¹⁷² Exceptions could be related to unrealized capital losses on financial assets (to avoid the ups and downs of the stock market to lead to yearly fluctuations in the operations of local gov't) or other (unspecified) special circumstances.

ROMANIA

1. General description

Romania is a unitary national state with a predominant central government and a two-tier structure of local government¹⁷³. The territorial administrative framework¹⁷⁴ consists of 41 counties (*judete*)¹⁷⁵ and the capital city of Bucharest, which are defined by limited autonomy, both in terms of decisional power, and financial and fiscal areas. A second-tier local administration is made out of localities (*localitati*). In 2011, there were 3,181 such jurisdictions, consisting of 2,861 communes (*comune*)¹⁷⁶, 217 towns (*orase*), 103 cities (*municipii*). The city of Bucharest has a dual status of municipality and county.

During the last two decades, Romania has made important steps in adjusting its system for financing the administrative-territorial units, which could be broadly divided into 3 separate reform cycles: (i) covering the period 1991-1994, in which important steps were made with regard to the administrative structure and financing of public local authorities (including the local tax system); (ii) concerning the period 1998-2000, which saw a further increase of the revenues transferred to the local budgets (from 3.6% to 6.5% of GDP between 1998-2001); and (iii) covering the period 2001 onwards, with the adoption of the 215/2001 Local Public Administration Act that set out the general conditions for self-government, autonomy and organisation at public level and the 273/2006 Local Public Finances Act that set out the framework and the rules for revenues and spending at local level. These changes were mainly driven by the need to increase the performance of local public administration, as well as to assure a high level of transparency and stability of the inter-governmental fiscal relationship. Several other acts (e.g. the 195/2006 Framework Law on Decentralisation, the 286/2006 Local Public Administration Act, and the 51/2006 Community Services of Public Interest Act) reinforced the reforming process of local public administration.

In 2010, total spending by local government amounted to 9.6% of GDP (excluding the interest), of which over 70% are used to cover current expenses. Total revenue accounted for 9.7% of GDP. Central government transfers and grants¹⁷⁷ represented almost 7.6% of GDP, around 19% of total public expenditure. Local authorities also have the possibility of borrowing money within a total annual ceiling approved by the central government.

2. Government spending

The responsibilities of local government mainly concern the implementation of certain public policies, with some autonomy in particular over capital expenditure for the supporting local infrastructure, while their regulation is conducted by the central government. Nevertheless, municipalities exert some management control on specific public utilities (e.g. water supply, sewerage, waste, district heating, and in larger cities public transportation). The majority of

¹⁷³ This is according to the Constitution of Romania (articles 119-120), adopted in 1991, amended in 2003 and 2011, as well as in the Law on Public Administration (as amended in 1996).

¹⁷⁴ Historically, the public administration in Romania was subject to multiple reforms (i.e. approximately 30 reforms during the last two centuries). The current structure is the result of this step-by-step approach in institutionalising the local and regional administrative structures.

¹⁷⁵ The counties are formally grouped into 8 development regions, according to the NUTS-2 criteria. The regions are not territorial-administrative units, but rather created as a group of counties, aiming to facilitate the implementation of the European regional development policy.

¹⁷⁶ The communes together comprise more than 13,000 villages, with populations of up to 5,000 inhabitants each.

¹⁷⁷ They fall into two categories: grants and subsidies for current spending and compensation for transfer of responsibilities, and grants and subsidies for capital expenditure.

sub-national discretionary spending is devoted to community infrastructure, street maintenance, cultural programs, school operating and maintenance, and social assistance programs.

In 2010, total spending by local governments amounted to EUR 11.9 billion or 9.8% of GDP. Based on the functional breakdown of public expenditure (i.e. COFOG classification), the budgets of local governments are dominated by spending on education. Education accounted for more than 20% of local government expenditure, closely followed by economic affairs with 19%. However, with regard to the education, their role is rather limited, mainly acting as paymasters, as well as for operating and maintaining school buildings (financed from discretionary revenues). Similarly, they act as agents of centrally-financed social assistance programs (e.g. guaranteed minimum income).

An analysis by type of expenditure shows that current expenditure accounted for EUR 8,578.6 million and represented more than 71.4% of sub-national public expenditure, while the remaining part is related to the reimbursement of capital and the payment of interest costs. In the last years, local investment has been on the rise, mainly as a result of the greater decentralisation. In particular, the ratio of capital expenditure in total expenditure for counties stood at 26.5%, due to their increased responsibilities in the management of public services, as well as maintaining the road network and public transportation.

3. Financial arrangements

Local budgets are highly dependent on the transfers received from the central budget. A small number of local communities generate sufficient revenues by their own. The source of revenues for local administration is divided into several categories: (i) current fiscal revenues (e.g. taxes on properties, land and transportation vehicles); (ii) current non-fiscal revenues (e.g. transfers and grants from the state budget); (iii) capital revenues (e.g. through the privatization process); and (iv) revenues from special sources (e.g. taxes and unused expense allocations for year t , which are carried forward to year $t+1$).

In 2009, the largest single source of local government revenue (i.e. 28% of the total sub-national revenues) consisted of earmarked grants for decentralized functions, followed by the personal income tax (i.e. 25%) and local taxes and fees (14%). Subventions, which consist of earmarked subsidies from sectoral ministries, comprised another 10% of total revenues.

Following an ever increasing budgetary autonomy of local governments, the equalization plays an important role and implies a greater responsibility with regard to efficiency and rationality of utilizing local resources. That is why budgetary correcting mechanisms and equalising transfers are set in place. Their aim is to correct imbalances that occur locally both vertically (e.g. local taxes do not cover the public expenditures), and horizontally, because not all local communities are financially sound.

4. Fiscal rules

There are two fiscal rules currently applying in Romania (i.e. budget balance rule, and debt rule), both having a statutory basis in the Local Finance Public Law. 'The budget balance rule' is applicable to local governments, being in force since 1990. Loans used to finance investment and debt refinancing are excluded from the scope of this rule. 'Debt rule' is defined as a ceiling (i.e. percentage) of current revenue and is in force since 1999. Local government cannot contract or guarantee loans if their annual public debt service (e.g. principal payment, interest, commissions) including the loan they want to contract, is greater than 30% of their own revenue. From this rule, the loans for co-financing EU projects are excluded. Local

lending is subject to authorisation by a central commission organised at the level of the Ministry of Public Finance.

5. Overall assessment

Despite many past efforts to increase the degree of autonomy at local level, Romania still remains a highly centralized country, with a relatively low degree of fiscal autonomy for both revenue and expenditure side. In this respect, there is considerable room for improving the legal framework and removing the inconsistencies in its design. The actual implementation could also be reinforced, by making use of monitoring oversight, as well as increasing the managerial capacity.

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UNITED KINGDOM

1. General description

The United Kingdom is constitutionally a unitary state: ultimate sovereignty resides with the UK Parliament, and it is up to Parliament to decide what powers and responsibilities (if any) it devolves to local or regional bodies, and how such bodies are organised and financed. This contrasts with federations such as Germany and the United States of America, where the autonomy of subnational authorities (länder in Germany or states of the USA) and the division of powers between federal and subnational governments are constitutionally entrenched. Historically, the UK has been relatively centralised even compared with other unitary states.

Devolved country governments

The United Kingdom consists of four countries: England, Northern Ireland, Scotland and Wales. The territorial organisation of the UK is highly complex and differs widely across the four countries, not least because devolution was designed differently for each of Scotland, Wales and Northern Ireland

There are three devolved national administrations. Each was set up in 1997 or later and they have varying power and are situated in Belfast, Cardiff and Edinburgh; the capitals of Northern Ireland, Wales and Scotland respectively. The 3 nations have their own institutions, legislative (Wales – only secondary ones) and administrative powers, i.e. they can modify all laws in their sphere. Scotland and Northern Ireland particularise the central powers, while Wales specifies the assigned ones.

Unlike the other countries of the UK England (which has over 80% of the UK population) has no devolved assembly or government of its own but is represented solely by the UK parliament and government. English regions (9) have only administrative competences (and the Regional Development agencies (RDAs) have been abolished).

Local government

Systems of subnational authorities differ across the UK:

- In England there are 34 shire counties (divided into 238 districts), 47 shire unitary authorities, 33 London boroughs (overseen by the Greater London Authority - GLA) and 36 metropolitan (urban) unitary authorities¹⁷⁸. England therefore has a total of 389 territorial governments, 354 at local level and 35 at intermediate level (county councils and the GLA)
- in Wales – 22 unitary authorities
- in Scotland – 32 unitary authorities,
- Northern Ireland has 26 district councils.

¹⁷⁸ See Dexia (2008). Only the shire counties and GLA are 'intermediate' – all the other entities are 'local'. The London boroughs, other urban metropolitan authorities and shire unitary authorities are all basically at the same level and similar size (usually around 100,000 – 300,000 inhabitants) with similar powers except that in London some powers are with the higher level GLA. The shire districts are often a bit smaller and more 'local'. A lot of UK 'local' governments have much larger populations than the lowest tier of government would have in most other countries (a few of the biggest unitary authorities have over 500,000 people).

All local authorities of all types have only administrative competences. There are also some smaller-scale community, parish and town councils which deliver some services for local authorities at a very local level¹⁷⁹.

2. Government spending

The UK government remains responsible for national policy on all matters that have not been devolved, including foreign affairs, defence, social security, macro-economic management and trade.

It is also responsible for government policy in England on all the matters that have been devolved to Scotland, Wales or Northern Ireland. The UK Parliament is still able to pass legislation for any part of the UK, though in practice it only deals with devolved matters with the agreement of the devolved governments.

Local government spending is about a quarter of all public spending in the UK. Local authorities are funded by a combination of grants from central government, Council Tax and business rates. In Northern Ireland, district councils still raise money through a domestic rate and a business rate.

The main responsibilities of Scottish, Wales and Northern Ireland central authorities are local and regional planning, economic development, transport, agriculture, forestry and fishery, environment, housing, health, education¹⁸⁰, culture and leisure. Scotland and Northern Ireland has additional competences of local government organisation, civil law (only Scotland), and police and public order. Scotland's unitary authorities and Northern Ireland's councils are assigned areas of local planning, registration, primary and secondary education, traffic, public transport, highways, personal social services¹⁸¹, housing, consumer protection, culture and recreation, fire and police services, refuse disposal.

The capital city London has a special statute, with the **Greater London Authority** (GLA) holding some powers allocated to local authorities and counties elsewhere (the GLA covers the 33 local authorities that are part of London). The GLA is responsible for strategic planning, economic development, transport, environment, public health, fire services, police, and culture. Counties have powers in areas of local planning, transport, primary and secondary education, culture and leisure, personal social services, consumer protection, refuse disposal, fire services and police. Districts have competences of local planning (shared with county), registration, housing, environment, culture and recreation¹⁸².

Local government in England

Functions and powers

¹⁷⁹ For more details, see http://www.hm-treasury.gov.uk/d/pesa_2011_chapter7.pdf.

¹⁸⁰ The Scottish and Welsh governments do have some autonomy in running services. On education, local authorities have traditionally run schools (not higher education) although there is now a mix with 'academies' and 'free schools' which are funded centrally and not under local authority control, while other schools remain under local authority control.

¹⁸¹ 'personal social services' is usually referred to in the UK as meaning social care for the elderly and disabled (washing, cleaning, providing meals, etc.) and services to provide support to other vulnerable people (e.g. social workers whose job it is to work with problem families and protect children).

¹⁸² Some local authorities are trying to move to having more shared services where a number of local authorities provide a single service.

Arrangement	Upper tier authority	Lower tier authority
Shire counties	waste management, education, libraries, social services, transport, strategic planning, consumer protection, police, fire	housing, waste collection, council tax collection, local planning, licensing, cemeteries and crematoria
Unitary authorities	housing, waste management, waste collection, council tax collection, education, libraries, social services, transport, planning, consumer protection, licensing, cemeteries and crematoria †, police and fire come under Shire councils	
Metropolitan counties	housing, waste collection, council tax collection, education, libraries, social services, transport, planning, consumer protection, licensing, police, fire, cemeteries and crematoria †	
Greater London	transport, strategic planning, regional development, police, fire	housing, waste collection, council tax collection, education, libraries, social services, local planning, consumer protection, licensing, cemeteries and crematoria †

† = in practice, some functions take place at a strategic level through joint boards and arrangements

However even in many of the policy areas administered by local government, implementation is still largely on the basis of national policy rules and guidelines. This limits the ability of local government to vary the way in which it operates policy much from a nationally set template (for example education, planning)¹⁸³.

3. Financial arrangements

Tax

All taxes are set and collected by the British government, aside from Council tax (for local government), **and in Scotland the power to vary income tax by 3%** (so far unused).

Tax (and social security) policy remains almost entirely the preserve of the UK central government, meaning that, **crucially, devolved and local authorities have little control over their overall budgets**. By international standards, UK government finances are highly centralised. The UK has 95% of tax revenue going to central government.

About 85% of taxation revenue is collected by national government. Local authorities impose a council tax on property. Scotland, Wales and Northern Ireland set rates for business property taxes, in England they are set by the central authorities. The revenue is allocated to local authorities on a per capita basis. Scotland has control over local government taxation and can vary the rate of income tax, but it has no borrowing powers. The revenue is mainly in form of transfers. Wales and Northern Ireland have no taxation autonomy and receive block

¹⁸³ The current UK government has a policy of 'localism' see <http://www.communities.gov.uk/localgovernment/decentralisation/>) whereby local bodies are meant to be given increasing autonomy.

grants. The Greater London gets a share of council taxes in addition to intergovernmental grants.

A large proportion of local authority spending is financed from central government grants. However, they are also entitled to levy one tax, i.e. the **Council Tax**. This is a domestic property tax the rate of which subnational governments can change to raise revenue to finance spending, whereas they cannot change the tax base¹⁸⁴. It provides about a quarter of local funding. Local authorities set the total Council Tax based on their overall budget for the year. Each household pays an amount depending on the value of their home.

The government has powers to ensure that increases in local authority budgets and Council Tax are not excessive. The current Government has decided in April 2012 that any council that budgets for an increase in council tax of 3.5% or more will be capped unless they have their budget passed by a local referendum¹⁸⁵. Central government has also offered additional grant to councils who budget for increases of less than 2.5%.

Business rates are a property tax on businesses and other non-domestic properties. Their formal name is national non-domestic rates. The national rates are set by central government. The revenue is collected by local authorities, pooled by central government, and then redistributed to local authorities¹⁸⁶. As such local authorities don't benefit directly from increased business activity but they are often responsible for providing infrastructure for new commercial development. To remedy the disincentive to development this creates (especially given up-front costs that may not be compensated at the time), the government is introducing a system whereby local authorities will be allowed to retain additional revenue from new commercial developments for a number of years.

Local authorities may also impose **charges** for services as an additional revenue source and to recoup the cost of service provision where appropriate (for example parking charges and charges for recreational and personal care services). Due to the ongoing squeeze on their budgets as a result of fiscal consolidation, many local authorities are currently increasing both the scope of charges and their level.

Overall the key point to note about the UK system is that although some taxes are collected at local level and a lot of spending is administered at local level, subnational governments have very limited scope to borrow or to affect the overall level of tax and government spending. **Fiscal policy in the UK is therefore effectively set and controlled almost exclusively by national government – if the UK misses deficit targets it will not be due to the actions of subnational governments.**

Provision of Funds and equalisation

Central government (or the devolved government in Scotland, Wales and Northern Ireland) provides specific and general grants to enable local authorities to deliver all the necessary services. To divide up the funding, the government uses a system that takes into account the

¹⁸⁴ An adjustment is made so that local authorities with low value property and so low council tax revenues get a more generous block grant from central government

¹⁸⁵ Some councils have predictably responded by budgeting for an increase of 3.49%.

¹⁸⁶ Redistribution is broadly on a per capita basis but there are some adjustments based on the cost of providing services – for instance Westminster in central London gets extra money for the cost of providing services to the unusually large number of people that pass through the borough and travel around its streets.

number and value of properties in each area, and how much it costs to provide services there. Given this, and that locally raised taxation provides only a minority of local government budgets while central government grants provide the majority, UK local government financing is strongly characterised by equalising transfers.

Local authority spending is the sum of central government support for local authorities within Departmental Expenditure Limits (DEL) and Departmental Annually Managed Expenditure (AME), plus locally financed expenditure in AME (council tax and other local revenue). Central government support for local authorities consists of current and capital grants, and supported capital expenditure (permissions to borrow).

The largest grants are the revenue support grant¹⁸⁷ and the redistribution of pooled national non-domestic rates (NNDR). These count within the Communities and Local Government (CLG) departmental expenditure limit. Other departments provide grants for specific purposes (for example education) and these also count in the department's DEL, as does supported capital expenditure.

Departmental annually managed expenditure (AME) includes grants that reimburse local authority payments of social benefits - mainly rent rebates and rent allowances¹⁸⁸ - and capital grants from the lottery distribution funds.

Local authority spending can also be analysed in terms of what the expenditure is for - such as education or social services. Or it can be broken down by economic category such as pay, procurement, subsidies, other grants and capital expenditure. Economic categories are used by the Office for National Statistics in the compilation of national accounts.

Local Authority own expenditure is defined as the contribution of local authorities to Total Managed Expenditure (TME) as measured in national accounts. TME is a consolidated measure in the sense that transactions between parts of the public sector do not add to TME. So, for example, total local authority expenditure defined here excludes capital grants paid to public corporations and interest paid to central government.

Devolved country governments

The devolved bodies are largely unable to use fiscal policy to influence economic performance or to deliver other distributive or redistributive goals. For instance, the current administrations in Scotland and Northern Ireland have both called for the ability to reduce the rate of corporation tax imposed in their territory in order to attract more inward investment. Both have been rebuffed. As noted above the Scottish government does have the power to vary income tax by up to 3p in the pound, but this has not been used to date.

The subnational governments' lack of fiscal powers means they have no direct ability to influence the size of their own budgets. The UK government allocates to each of the three devolved territories a “**block grant**” out of its general tax revenues, which the devolved bodies then use to fund the public services for which they are responsible. The size of these grants is calculated principally via the **Barnett Formula**, based on the respective population

¹⁸⁷ The block grants that central government give to local authorities are funded by a wide range of taxes.

¹⁸⁸ As most social transfers are paid by central government agencies. Support for rents paid by local authorities (but ultimately funded by central government) is an exception.

shares of the four parts of the UK¹⁸⁹. The advantage for the **subnational governments** is that they **have complete autonomy over how to spend the grant**.

Weaknesses of Barnett formula: Lack of accountability; there is no clear relationship between taxes paid and services received. A devolved administration has little influence over the size of the block grant and revenues are not related to management or performance of the devolved administration's economy. Overall budget is not needs-based (the Barnett formula is generous to the devolved governments and spending per head in Scotland, Wales and Northern Ireland is significantly higher than it is in England). The UK Government remains responsible for borrowing to meet any shortfall in tax revenues.

Local authorities (applies to England, and in most policy areas to the rest of the UK)

Local governments are mainly funded by grants from central government but they also levy the Council tax.

Local Authorities are also prevented from issuing their own debt, but they are permitted to borrow to finance capital investment. Prudential borrowing regimes for local authorities in England, Scotland and Wales (and for the Northern Ireland Executive in the case of Northern Ireland) were introduced in 2004-05. HM Treasury is responsible for determining the overall affordability of the UK's public sector debt levels against the general economic and fiscal environment, and for advising the UK Government if borrowing within the public sector needs to be constrained.

The UK does not have local income taxes.

4. Fiscal rules

The UK government introduced a new fiscal framework after taking office in May 2010. The three key pillars are the setting of a new "fiscal mandate" targeting the cyclically-adjusted current balance, the setting of a net debt target and the establishment of the Office for Budget Responsibility (OBR), an independent body tasked with producing the official forecast. The fiscal mandate requires that the cyclically-adjusted current budget be on track to be in balance by the end of a rolling 5-year forecast period, currently ending in 2016-17. This is supplemented by a debt sustainability target which requires the public sector net debt as a percentage of GDP to be falling by 2015-16. The OBR must judge whether the chances of the government meeting the fiscal mandate and debt sustainability rule are greater than 50%.

Government spending is set out in the Spending Review which is published every three or four years. This sets out multi-annual limits for predictable spending in every department through "departmental expenditure limits" (DELs). The remainder of spending, mainly social security, debt interest payments, public sector pensions and EU contributions, is classified as "annually managed expenditure" (AME) and is not capped in advance. The devolved administrations are financed through grants from central governments and cannot issue their own debt.

Due to the limited control over their overall budgets that the devolved country governments and local authorities have, and their very limited powers to borrow, **the UK's overall fiscal**

¹⁸⁹ See <http://www.parliament.uk/documents/commons/lib/research/rp98/rp98-008.pdf>.

strategy and its performance against fiscal rules are determined almost wholly by the central UK government. In the context of the size of overall UK tax and government spending any fiscal decisions made by subnational authorities have very limited impact.

5. Other relevant institutional features

There are a couple of recent and current reforms to subnational government with implications for subnational policy:

- **Abolition of RDAs:** Following the 2010 election the UK government decided to abolish the Regional Development Agencies (RDAs) in England. There were nine RDAs which sat above local authorities and below national government. The RDAs did not have any tax raising powers and had limited policy responsibilities and budgets but one of their main roles was in making use of EU funding streams. The RDAs did however have a significant impact on the implementation of the English European Regional Development Fund (ERDF) (2007-2013) programmes both in terms of management - the RDAs were intermediate implementing bodies- and match funding - the RDA budgets were an important source of match funding in the English programmes.
- **Localism:** The current UK government is pursuing a 'localism' agenda, which seeks to give greater power and flexibility to local communities. This means giving local authorities (and other local groups, inside and outside government) more control over how they allocate their budgets, implement national policy and run services. Historically UK local authorities have been quite constrained by compartmentalised financial allocations from central government and detailed rules on how national policy should be implemented across the country. It is not yet clear how much of a difference the localism agenda will make in practice. However the (national) government's current plans for localism are more about the allocation of spending than its overall level and do not envisage major new borrowing powers for subnational government. Therefore they should not have a significant fiscal impact in aggregate.

Annex 2: results of regressions with expenditures and revenues as dependent variables

Table A1: results of regressions with primary expenditure of general government as dependent variable (LSDVC estimator, EU27, 1995–2010)

	1	2	3	4	5	6	7	8	9
VARIABLES	primexp	primexp	primexp	primexp	primexp	primexp	primexp	primexp	primexp
L.D	-0.0204*	-0.0173	-0.0144	-0.0192	-0.0125	-0.00912	-0.0118	-0.00653	-0.0168
L.log	0.190***	0.166***	0.159***	0.166***	0.173***	0.219***	0.220***	0.223***	0.188***
expdec	-0.784***	-0.0405	-0.185***	-0.222***	-0.216***	-0.699***	-0.723***	-0.782***	-0.715***
revdec	0.800***	0.346***	0.437***	0.803***	0.212***	0.863***	0.865***	0.864***	0.957***
Expdec* trsf	0.792***					0.577***	0.607***	0.691***	0.662***
Ele	0.123	0.116	0.0258	0.0311	0.0607	0.114	0.118	0.137	0.0590
L.infl	0.0290**	0.0259*	0.0355***	0.0323***	0.0264**	0.113***	0.112**	0.117***	0.0344***
TO	-0.736*	-0.736	-0.850**	-0.871**	-0.965***	-1.056***	-1.027***	-1.084***	-0.672*
Expdec*tax		-0.298**							
Expcov			-0.109***	-0.0953***	-0.0683***	-0.0833***	-0.0805***	-0.0685***	-0.0848***
Expdec* decSoc						0.138			
Expdec* decHealth							0.0405		
Expdec* decGS								0.213**	
revdec* %tax				-0.524***					
revdec* trsf					0.744***				
Expdec* decWag									-0.145
Observations	401	401	401	401	401	380	380	381	401
Number of panel	27	27	27	27	27	27	27	27	27

Source: own calculations from Eurostat.

List of variables: see Table IV.3.4 above. New variables added: Primexp = general government primary expenditures (% of GDP), L.infl = lagged inflation rate, TO = Trade Openness (% of exports plus imports in GDP).

***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.

Table A2: results of regressions with total revenues and tax burden of general government as dependent variable (LSDVC estimator, EU27, 1995–2010)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
VARIABLES	totalrev	totalrev	totalrev	totalrev	taxburden	taxburden	totalrev	taxburden
L.D	0.0235***	0.0191**	0.0185**	0.0117	0.0114	0.00967	0.0194**	0.0154*
Rgrowth		-3.697***	-3.612***		-2.333**	-2.235**	-3.643***	-2.350**
Expdec	-0.000552	0.166	0.0297	0.0116	0.142	0.0402	0.0141	0.0292
Revdec	-0.0863	-0.239**	-0.218**	-0.192**	-0.253**	-0.265***	-0.227***	-0.283***
Expdec * trsf		-0.168			-0.131			
Expcov	0.0308**	0.0372***	0.0406***	0.0359***	0.0411***	0.0397***	0.0402***	0.0465***
Ele	-0.201*	-0.0795	-0.0658	-0.0723	-0.107	-0.0960	-0.0816	-0.103
L.infl	0.00340	-0.00538	-0.00458		0.00259	0.00312	-0.00428	0.00353
TO	-0.108	-0.327	-0.299	0.111	-0.0995	-0.0683	-0.316	-0.142
L.log	0.00922							
Revdec * tax			0.149	0.115		0.184*		
L.rgrowth				0.536				
Expdec * tax							0.146*	0.128*
Constant								

Observations	405	375	375	348	373	373	375	373
Number of panel	27	27	27	27	27	27	27	27

Source: own calculations from Eurostat

List of variables: see Tables IV.3.4 and IV.3.6 above. New variables added: totalrev = general government total revenues (% of GDP), taxburden = tax revenues of general government (% of GDP), Rgrowth = real growth rate of GDP, L.rgrowth = lagged real growth rate of GDP.

***, **, *: coefficients estimates statistically significant at the 1, 5 and 10% level, respectively.