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## *International experience concerning the development of local finance*

**I**n Europe, the decentralization of the exercise of public functions has been a marked tendency since the early 1980's. A related phenomenon was the wide acceptance of the European Charter, adopted within the framework of the Council of Europe. The Charter is a fine example of the process now called “open method of coordination”, whose objective was to define the framework of this decentralization process without intervening in the internal affairs of individual states. The political structure, the constitutional model and the historic traditions of the countries produced highly variegated subnational governmental systems. In the European Union, there is no specific model of local government; however, it is indisputable that a Europe undergoing the process of unification can offer several models to be followed in the field of subnational government. The present essay sheds light on the activity of some forums which serve as a basis for the above-mentioned “method of open coordination”, and which, nonetheless, deserve attention. We find it regrettable that Hungarian decision-makers do not investigate good international practices carefully enough; what is more, they do not even share those experiences be gained within the framework of international relations. We are glad to have the opportunity to present our experience to the professional public in this

journal. In the section below, we provide information about those events in the Council of Europe, the OECD and the French Presidency of the EU, which dealt with the issue of modernizing the financing of local authorities. Most probably, this is not accidental.

As for Hungarian experts, they display an enthusiastic attitude towards reforms; there are numerous ideas concerning the development of the local governmental system. However, proper reforms take place and long-term solutions are reached not as a result of short periods of enthusiasm but when reforms involve those “details” in which, the proverbial devil is. A standpoint frequently adopted in debates in Hungary is that financial matters of local authorities are just “servants” while substantial changes can be brought about exclusively by systemic transformation (of tasks, competences and organizations). As for us, we do not agree with this approach. The financial system plays a key role in the economy – in the context of local authorities, too. To put this in another way, the financial system can be regarded as the blood circulation of the economy that carries not only energies required for functioning but in certain cases the effective agents of medicines, too. That is, the financial system plays a role far more important than generally assumed. The functioning of the local governmental system of

Hungary illustrates this fact, as in the last 25 years the internal imbalances of the system have been corrected by the financial system, especially by the regulation of funding. This is why financial risks<sup>1</sup> are regarded as an important sign. Furthermore, major structural reforms can rarely be realized; in addition, their planning requires extreme accuracy. A financial system equipped with adequate instruments can contribute to the correction of the system or to the successful adaptation to external conditions. This is why we are convinced that sharing the experiences obtained in the above-mentioned forums is useful for all. A report cannot substitute for a thorough examination of related material. The collection certainly contains some subjective elements yet they may work as “appetizers”.

## WORK WITHIN THE COUNCIL OF EUROPE

In *Strasbourg*, under the guidance of the *European Committee on Local and Regional Democracy* (CDLR) of the Council of Europe, a dedicated *committee of experts* (Committee of Experts on Governance and Resources – LR-GR) deals with, among others, issues related to and challenges resulting from the modernization of the financial systems of local government. The committee, as a rule, defines the challenges, explores their background and draws evaluative conclusions; as for the latter, a report is prepared for the Committee for adoption.

The study and report by *Jorgen Lotz* has been last year's most interesting topic and has generated heated professional debates.<sup>2</sup> The document, prepared on the basis of a questionnaire survey completed by member states beforehand on a voluntary basis, gave a quite clear and comprehensive picture as to what extent the policies and practices of certain member states (including Hungary) in the context of the financing systems of local authorities are in harmony with the relevant directives

of the Council of Europe. As for the directives, the most significant ones are dealt with; namely, the following regulations on financial resources in Article 9 of the European Charter of Local Self-Government (ECLSG)<sup>3</sup>:

“3. Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.”

“7. As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.”

The analyses published in the report offered defined and standardized viewpoints, which, on the one hand, made it possible to compare elements of the financing local authorities in various countries and the degree of resource decentralization, and, on the other hand, gave a process-like presentation of member states through an examination of the period from 1994 to 2004.

As there was a demand for interpreting the financial data under review in a way that is unambiguous for everyone, and as points representing delicate issues for some member states were raised, the debates and opinions – on the basis of the principle of “the devil is in the details” – centred around the following major topics.

① The “degree” of the freedom of decision of local authorities in terms of producing the sources of revenues required for the functioning and for the maintenance of public services, as well as in terms of defining the scale of these resources and their utilisation.

According to the interpretation of the Netherlands, the Charta does not have the sole purpose of providing local authorities “only” with adequate freedom of decision and autonomy. When formulating the Charter, the principal objective was to offer the possibility to

impose taxes that are needed for producing adequate resources for the performance of the tasks of local authorities and thus, in turn, to create a “healthy” balance of non-earmarked and earmarked grants. As Lotz says, nowadays it is not enough to lay emphasis on the freedom of decision of local authorities for the sake of their ability to raise and increase resources, but it is of even greater importance that this freedom should be relied on when spending funds.

② *Taxes* defined and imposed by local authorities, as well as *charges, fines* and *levies* imposed and collected in the territory of the local authority, need definition and clarification in terms of meaning and concept in order to avoid divergent interpretations by member states that exist regardless of the fact that international statistics employ a uniform terminology.

③ In the financial system of local authorities, two main categories of grants are differentiated: non-earmarked and earmarked grants (that is, grants that can be spent only for a specific purpose).

As the report points out, the definition “*the provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction*” (in Article 9 of the Charter, cited above) unambiguously declares the requirement of non-earmarked grants. Earmarked grants exercise a negative influence: they motivate local authorities to increase spending and lead to weakened budget positions. Without disputing these arguments, we – together with some other member states – pointed out other aspects and conditions that, in our opinion, are necessary to be taken into consideration. They are as follows:

- in our judgement, other provisions of the Charter (“*Local authorities shall be entitled, within the national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers*”<sup>4</sup> or “*As far as pos-*

*sible, grants to local authorities shall not be earmarked for the financing of specific projects*”<sup>5</sup> suggest additional aspects to consider in the issue of the exclusive legitimacy of non-earmarked grants;

- earmarked grants are justified not exclusively in relation to development grants.

The latter idea was supported by the individual Hungarian position which emphasized that

- as a result of compensation costs resulting from the centralization of tasks and resources,
- in the case of grants oriented towards cooperation and task performance at micro-regional level,
- for the safety of public service offered for the population by local authorities as stipulated by law,

the application of a general, non-earmarked budgetary grant is not yet adequately efficient.

The author of the report accepted Hungarian remarks and incorporated them into the study. As a consequence, in the case of Hungary it was positively established that, in the ten-year period under survey, the degree of decentralization increased while local authorities were successfully “put on the right track” towards a wider-range local taxation. At the same time, the ratio of local taxes as compared to the volume of revenues of local authorities is regarded as low. Furthermore, the report classifies Hungary as a country where the ratio of earmarked grants in the financing system of local authorities is exceedingly high.

## FISCAL RELATIONS ACROSS GOVERNMENTAL LEVELS – THE OECD NETWORK OF EXPERTISE

Around 2000, the Secretariat of the OECD realized that decentralization processes of the previous decades posed a challenge. Therefore, in 2003 the OECD established a working party

dealing with the operation of fiscal relations across governmental levels; the working party was established with the participation of three Directorates and functions as a network.<sup>6</sup> A glance at the participating Directorates makes it evident that the joint expertise and efforts of the divisions specialized in taxation, economic research as well as governmental and local development may result in a strong synergy effect. Seventeen member states participate officially in this work; eight others (including Hungary) contribute to the successful activity of the network by reporting data. Beside the General Secretariat of the OECD, the European Commission, the IMF and the World Bank take an active part in the network.

The activity of the network of expertise is characterised by a bottom-up construction. With the clarification and unification of statistics concerning local authorities, an opportunity was created to have an insight into the issues we are dealing with. Thus, as a result of expert work, the information environment of reforms of local governance improved significantly. The second stage of the activity of the working party was to analyze issues related to performance-oriented functioning. This step could rely logically on the first phase and, in our opinion, it constitutes another pillar of rational reforms.

*In May 2008 in Vienna*, the working party opened up another dimension of the issue: within the framework of a two-day workshop discussion, the participants discussed the central issues of *sub-central government* financing at the level of the governmental sector. Adopting a remarkable (yet, in the context of the expert work of the OECD, by no means unique) working practice, they discussed the ratio of local taxes and central grants, the level of taxation independence of local authorities and the efficient financing of obligatory tasks (whether ear-marked or non-earmarked grants are adequate to be used; whether task-financing

or grants allocated for task-financing offer a better solution). The working practice involved presentations on national practices in terms of all the three main subjects, comments made by an opponent invited beforehand, and finally questions, remarks or, sometimes, heated debates. In the Vienna workshop, Japanese, South Korean and US experts also participated. The limited coverage of this study does not allow for a summary of the results; nevertheless, it is quite possible to draw some important conclusions for Hungarian experts. First, it can be deduced from the debate that the grass is not necessarily greener on the other side of the fence. More than once, it became apparent that other countries are facing exactly the same problems as we are. The debate that evolved on the issue of fiscal equalization, more specifically, on its objectives and instruments, (albeit by that time the first signs of the crisis were not perceptible at the level of local authorities) was very illuminating. This, among other reasons, leads to the statement that it is highly recommended to examine international experience on the basis of the principle “the wise can learn from the experience of others”. Another remarkable experience was the tolerance between experts; despite the heated debates, nobody put forth a standpoint saying that *a certain solution is the best one*. Another positive effect of the working party's activity was that those participating spoke the same language – and not only because the working language was English but also because the efforts of recent years have contributed to the gradual evolution of an international terminology.

It was interesting to see that several countries (e.g. Japan and Turkey) encourage local authorities to borrow as a reaction to inadequate resources. In relation to the Japanese presentation, a stormy debate took place between the Japanese ministry of finance and the ministry of internal affairs on the proper degree of fiscal independence to be given to

local authorities. Federal states (especially Switzerland) and recently regionalized states (Spain, Italy) attribute a more significant role to local taxation and regard central grants as a hindrance to local independence. For the latter countries, strong low-level governmental fiscal autonomy and meeting the criteria of the Stability Pact pose a considerable challenge. Spain meets the challenge with adequately developed mechanisms, while in Italy the problem has not yet been fully solved.

## LOCAL FINANCING AND FISCAL AUTONOMY IN THE EUROPEAN UNION

The issue of financing local authorities, and of local fiscal autonomy, was dealt with by experts from the EU member states within the framework of the *Paris seminar* in December 2008. The conference was a unique event, partly because it was the last official event of the French Presidency, but also because participants had an insight into the influence of the crisis on systems of self-government. It became evident that even the strong French system of self-government could not stay intact against the fiscal shocks caused by the crisis. The presentation given by the representative of the European Court of Auditors was remarkable; it shed light on new approaches to the controlling of EU resources.

The working group *Financing of local governments in the European Union* made three essential summary statements.

① In the majority of member states, decentralization resulted in a modification of the financing systems of local authorities.

② The EU is characterized by a “uniformity” and a diversity at the same time: there is no one-size-fits-all financing model that offers a solution for every problem, yet

③ The questions to be raised in terms of financing are the same everywhere:

▶ What should be the local tax revenues of local authorities?

▶ How to guarantee the fiscal autonomy of local authorities?

▶ How to operate more efficient equalizing mechanisms?

In the member states of the European Union, 47 per cent of revenues of local authorities come from taxes. Out of this ratio, 27 per cent derive from local taxes and 20 per cent from shared taxes.<sup>7</sup> Now it seems to be a general stand-point that a most reasonable way of modifying the financing systems of local and regional authorities is to increase the ratio of local taxes as much as possible. Among others, this is a factor that can contribute to the strengthening of the fiscal autonomy of local authorities. Thus the working party defined revenues from local taxes as the primary resources of local authorities. In the individual member states, the importance and scale of revenues from local taxes are highly variegated. In the majority of the states, characteristic tax types are real estate taxes, asset-based taxes and taxes imposed on certain economic activities<sup>8</sup>. As for the latter, in certain member states there are debates about its possible negative effects on the competitiveness of taxpayers and, thus, about the reason for its existence. In Spain, the burden is regarded as disproportionate; in France, the objective of reforming local business tax was defined. Besides the tax types mentioned, there are other kinds of local taxes that vary from country to country, such as the environment tax imposed on car owners in Spain, or the tax imposed on real estate activities in Portugal.

Basically, the powers of the local authorities to impose taxes and the definition of the scale of taxes is stipulated by law; the autonomous communities of Italy and Spain are exceptions as they have the powers to create new tax types independently yet they do not exercise these powers often.

Out of the 27 member states of the EU, 20<sup>9</sup> have shared taxes of different levels of importance. They play a highly significant role in Germany, Austria, Poland and Romania, while they are less emphasized in Finland and Cyprus.

In terms of shared taxes, the member states fall into three categories.

① Federal states, where the system of shared taxes is quite developed. Shared taxes make up a significant part of taxes in general yet the distribution between local authorities takes place in a differentiated way.

② New member states of EU, where shared taxes are very widespread yet, as a rule, are calculated on the basis of a defined part of the income tax of individuals.

③ Countries where there are shared taxes yet they are of less significance or the emphasis is on other tax types.

In the budget of local authorities, besides resources from tax revenues state grants are also crucial. The decentralization of the scope of duties and powers in self-governmental systems of the Union calls for a reconsideration of the nature and structure of state grants. In relation to this, obviously, the issue of the scope and application range of non-earmarked and earmarked grants has arisen once more. Opinions were similar to those formulated by the expert committee of the Council of Europe.

*In the EU, there are various ways of interpreting the relation between state support (or the lack of it) and the fiscal autonomy of local authorities.* In the opinion of certain countries (including, for instance, the Netherlands) the calculable and adequate resources given by the state to local authorities is of great importance while according to the judgement of others (for example, France), the fiscal autonomy of local authorities should basically derive from the strength of local democracy. All agree, however, that in terms of expenditure (i.e. using the

resources) local authorities should enjoy a certain degree of autonomous freedom. Obviously, it is to be taken into consideration whether a given public service is an optional or compulsory task of the local authorities; nevertheless, the general opinion is that in the context of spending on healthcare or social welfare, local authorities should be given a certain scope for action. In addition, the fact that the “degree” of autonomy is measurable at national, regional and local level, is not to be ignored.

It is not only the degree of autonomy that can be different at the various levels; also, demographic, geographic and economic potentials may vary within each level. As a consequence of territorial unevenness, local authorities cannot offer public services of the required standard; therefore, it is indispensable to operate an equalizing mechanism or mechanisms in the financing systems of local authorities so that the population may have access to public services of the same quality everywhere.

*In the EU, there are two models for the reduction of differences of revenues of local authorities: a vertical and a horizontal model.* In the vertical model (which is the most widespread one in Europe) the state uses the instrument of grants or other financial transfers to decrease the (negative) difference between the resources at the disposal of a local authority and the resources required for the performance of its functions. In the horizontal model, an equalization mechanism operates between the local authorities: from “richer” local authorities resources are channelled to “poorer” ones, either in proportion to the population or in a way defined on the basis of expenditure needs. Germany, Austria, Denmark, Poland and Lithuania are examples of this model, while Latvia, the Nordic states and Hungary combine the two models.

A remarkable event of the conference was *the evaluation of the instruments of the performance-oriented functioning of local authorities.*

The issue was in the focus of attention within the framework of a plenary presentation (given by a leading expert from the United Kingdom) as well as of a separate dedicated section. It was beyond dispute that an adequate method to solve the problem of a generally increasing amount of local tasks and relatively limited resources, is performance-oriented functioning – especially in the present critical situation. However, there was no agreement as to whether the British practice (which, in several respects, resembles the planned economic system combining the breakdown of plans and financial incentives) is the most efficient method. Several participants voiced their doubts about the functioning and the long-term effects of the system. *The debate made it evident that looking for a “universal” solution would lead to a deadlock.* The realization of a performance-oriented system depends on the nature of the tasks of local authorities (i.e. from the features of the given field) as well as on the general conditions of financing and incentives. As debates in the section made it evident, there are such reserves in the self-governmental systems of the EU member states.

Another remarkable question debated in the Paris seminar was *how to guarantee the regular and transparent accounting of local authorities and the high quality of accounting reports* in a way that would, at the same time, make it possible to compare EU member states. The complex issue indicated and postulated different practices on the part of the member states, which differences exist regardless of the adoption of the International Financial Reporting

Standards of the budgetary sector. To facilitate high-quality reports from local authorities, the seminar pointed out three of the instruments currently in use in the EU:

- ① *Legal norms and regulation of accounting*, generally prescribed by the state.
- ② *Internal control*, functioning as specified in the international recommendations and proposals of the COSO<sup>10</sup>.
- ③ *External control*, normally by public supervisory bodies or auditors.

In 2006, in 25 member states of the EU, expenditures of local authorities amounted to EUR 1,374 billion, that is, 12.7 per cent of the EU's GDP. These figures may *support efforts made towards an EU-level harmonization of the regulation of bookkeeping of local authorities.* The standardization of the International Public Sector Accounting Standards (IPSAS) was marked as a possible method. As for the feasibility and necessity of the proposals, opinions varied. Yet everyone agreed that reliable and valid reports of local authorities should also serve as an instrument for making decisions which, in turn, will lead to an efficient economy.

The work in international expert workshops and the experience gained thereby point to the fact that we, Hungarian experts, must define those questions that are most relevant for us and then we must look for and find the answers. Neither the Council of Europe nor the European Union offer a “tested and tried recipe” in the possession of which we can get what we want from an international organization; nevertheless, demands and recommendations remain there...

## NOTES

- <sup>1</sup> Állami Számvevőszék Fejlesztési és Módszertani Intézet (2008): Értékelő tanulmány a 2009. évi költségvetési törvényjavaslat makrogazdasági megalapozottságának néhány kérdéséről (The Court of Auditors' Institute for Development and Methodology (2008): Evaluation study on certain matters related to the macroeconomic foundations of the 2009 budget bill. October, www.asz.hu
- <sup>2</sup> Final draft report on the pilot study concerning the degree of conformity of member states policy and practice with council of Europe Standards for local finances, Strasbourg, 14 November 2008. An essay by the author of the report is published in the present journal. [http://www.coe.int/t/e/legal\\_affairs/local\\_and\\_regional\\_democracy/main\\_bodies/steering\\_committee/CDLR\(2008\)\\_EN.pdf](http://www.coe.int/t/e/legal_affairs/local_and_regional_democracy/main_bodies/steering_committee/CDLR(2008)_EN.pdf)
- <sup>3</sup> Act XV of 1997 on the declaration of the European Charter of Local Self-Government adopted on 15 October 1985 in Strasbourg
- <sup>4</sup> Act XV of 1997 on The European Charter of Local Self-Government, Article 9, Section 1
- <sup>5</sup> Act XV of 1997 on The European Charter of Local Self-Government, Article 9, Section 7
- <sup>6</sup> OECD Network on Fiscal Relations Across Levels of Government – unfortunately, Hungary has not joined the network officially.
- <sup>7</sup> Les collectivités territoriales dans l'union Européenne – Organisation, compétences et finances (Collection Europe, DEXIA, November 2008, p. 94)
- <sup>8</sup> In Hungary: local business tax
- <sup>9</sup> DEXIA (p. 115)
- <sup>10</sup> Committee of Sponsoring Organizations of the Treadway Commission – it was established in 1985 by five big American private organizations and worked out a complex framework of internal control to be used in the private sector in the United States of America.