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Is there conformity with the Council of Europe Guidelines for local finances?

T*This paper describes some recent work by the Council of Europe¹ on local government finances in European countries.*

The work of the Council of Europe on local finances in Europe is grounded in the text of the European Charter of Local Self-Government resulting in a difference in emphasis than similar analytical work by the OECD and other international organisations. The Council of Europe basically seeks to register and overlook conformity with the guidelines of the Charter.

On the observed use of “own” local taxes – i.e. taxes where the local authorities set their own rates – it is found that they are a significant part of local finances thus being in conformity with the Charter. But the data suggest an increase in the use of earmarked grants to local authorities – i.e. grants that cannot be used in accordance with local priorities. This is not in conformity with the Charter. Exploring the reasons for this, it is found that European governments as a rule follow a policy of funding new competences for local authorities, and that many governments prefer to use earmarked rather than general grants for such funding.

In spite of this the studies conclude that member countries are in acceptable conformity with the Charter, and that governments follow responsible and sound decentralisation policies of funding new local competences.

INTRODUCTION, THE EUROPEAN CHARTER

The European Charter of Local Self-Government

In 1985 the European Ministers agreed on the text of the “European Charter of Local Self-Government” (hereafter referred to as “the Charter”). This Charter has since then been ratified by the national parliaments.

The Charter describes a set of guidelines for the relations between central governments and their local authorities. The conformity of two of these guidelines has recently been tested in a pilot study by the Council of Europe².

One is article 9, paragraph 3 of the Charter: “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”. The wording of this paragraph does not reject the use of grants and tax sharing but only requires that own tax resources should be a not specified part of local financing.

The other is article 9, paragraph 7 of the Charter: “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". This strong wording signals that earmarked grants should in general be avoided.

Why does the Charter promote own local taxation and discourage earmarking of grants?

The arguments in favour of the Charter recommendations relate to the issue of local "accountability". The local councils should, when they decide on public expenditure, also be held responsible for financing their expenditure decisions.

"Own" local taxes are assumed to promote local accountability. If local authorities want to improve the level of local services they are obliged to increase their own tax rates, and if they manage to find budgetary savings they can translate these into local tax reductions. This way the electorate, if they find the local taxation is too burdensome considering the benefits from the local services, gets clear signals for reactions at the next election or for deciding to prefer to have residence in another local authority ("voice" or "exit"). As said, not all local taxes need to be "own" in order to ensure accountability. Accountability depends on a one-to-one relationship between new local spending decisions and local taxation *on the margin*. This explains why the Charter advocates only that "part at least" of the financial resources of local authorities shall be own taxation.

The reasons for objections to the use of earmarking of grants are their assumed effects of distorting local priorities and – when they are conditional (matching) – of giving incentives for increased local spending. The use of matching grants (conditioned by local spending) is seen as weakening accountability and softening local authorities' budgetary constraint.

DEGREE OF CONFORMITY WITH COUNCIL OF EUROPE STANDARDS FOR LOCAL FINANCES

The test

The test of conformity with the guidelines of the Council of Europe was in a pilot study that included 14 countries including Hungary who volunteered to participate (for the full list of countries *see table 1*).

What is meant by local freedom?

The testing gave rise to discussions in the committee of some basic issues.

One was how to interpret the concern of the Charter relating to "freedom" for local authorities. There was agreement that local authorities must have sufficient freedom and autonomy but some argued that more emphasis is today on the freedom to spend compared to the freedom to finance. The committee concluded that the freedom on the financing side is still vital for local democracy.

Another issue discussed was whether tax sharing revenues, when the local share is annually negotiated with the local authorities, could be considered to have similar effects for accountability as an "own tax"? The conclusion of this discussion was that tax sharing under no circumstances promotes local government accountability the way intended by article 9, paragraph 3 of the Charter.

When are "charges" similar to own taxes?

Article 9.3 speaks of "local taxes *and charges* of which, within the limits of statute, have the power to determine the rate". There was some discussion of the interpretation of what is meant

by the word “charges”. The decision on this was based on international statistical definitions.

The distinction between local taxes and charges according to international definitions

According to international definitions some revenue-items, that are in the local budgets described as charges, are actually local tax revenues. This is the case when³:

- the charge exceeds the costs of providing the services;
- the payer is not the receiver of the benefit (e.g. a slaughterhouse fee for the benefit for farmers);
- there is no specific service in return for the levy (e.g. fees for a license for hunting or fishing);
- the benefits received are not in proportion to his payments.

It was decided to interpret the Charter text in art. 9.3 to include as local tax revenues such local charges that are in the international definitions counted as local taxes.

Some member countries argued that charges could also be counted as own local revenues when local authorities were free to charge less than the cost price. In such cases, it was argued, the public sees the price tag and is free to submit complaints to the municipal council, and such charges should therefore in the sense of the Charter equal to own taxes. The consequences of this argument would be that, for example, the existence of local cost-related charges for garbage removal could become a valid excuse for a government to deny its local authorities the right to collect any other own taxes as part of their financial resources. This argument was not accepted.

Categories of grants

The statistical categories of grants are based on the international classification⁴ originally

designed by the Council of Europe⁵ and adopted by the OECD⁵.

The classification distinguishes between earmarked and non-earmarked grants.

The OECD definitions of grants to local authorities:

- A. Non-earmarked grants
 - A1. Mandatory
 - (A1a) general purpose or
 - (A1b) block grants
 - A2. Discretionary grants
- B. Earmarked grants
 - B1. Mandatory
 - (B1a) non-matching or
 - (B1b) matching grants
 - B2. Discretionary
 - (B2a) capital grants or
 - (B2b) current grants

Earmarked grants are such that can be used only for a specific purpose, that is: to cover the costs of specific services. Non-earmarked (general) grants can be spent freely like own (non-earmarked) tax revenue of local authorities.

The Charter text gives quite clear directions on the use of these statistics saying that “as far as possible, grants to local authorities shall not be earmarked” meaning that group B grants should be avoided and group A grants are acceptable.

During the discussions it was argued that the Charter fails to distinguish between different kinds of group B grants. Some earmarking schemes are more broadly based than others and permit the local authorities more freedom. It was argued that such differences should be taken into account when deciding the degree of conformity with art. 9.7. However, international statistics fail to distinguish between narrowly defined earmarking and more broad-

Table 1

COMPARISON ACROSS COUNTRIES OF TAXES, GRANTS, AND DEGREE OF DECENTRALISATION, 2004

	1. Own taxes pct of GDP	2. Own taxes pct of local taxes	3. Total local tax revenue pct of GDP	4. Ear-marked grants pct of GDP	5. Ear-marked grants pct of grants	6. Total grants pct of GDP	7. (3+6) Sum tax and grants in pct of GDP	8. Ear-marked grants (4) in pct of (7)	9. Own taxes (1) in pct of (7)
Albania**	1.5	100	1.5	4.5	84	5.4	6.9	65	22
Belgium (Walloon) ¹	3.1	100	3.1	2.1	59	3.6	6.7	31	46
Belgium (Flemish) ²	2.4	100	2.4	0.8	43	1.8	4.2	19	57
Czech Republic	0.4	10	3.5	3.5	100	3.5	7.0	50	6
Croatia	0.6	16	3	0.6	100	0.6	4.8	17	14
Denmark**	10.6	96	11	2.3	46	5	16	14	69
Estonia	0.4	9	4.1	0.5	20	2.8	6.9	7	6
Finland*	10.0	95	10.5	0.5	10	5.2	15.7	2	64
Hungary	1.9	77	2.2	3.5	57	6.2	8.4	41	23
Iceland**	9.3	100	9.3	0.5	44	1.2	10.5	5	89
Netherlands	1.4	100	1.4	3.7	59	6.3	7.7	48	18
Norway*	0.3	5	5.6	2.2	47	4.7	10.3	21	3
Slovenia**	0.9	30	2.9	1.1	36	1.0	3.9	28	23
Sweden*	10.5	100	10.5	2.2	43	5	15.5	14	69
Unweighted average	3.8			2.0				26	36

* 2006

**2005

1 Note that data for local government finances do not follow international definitions.

2 Data based on the 53 largest cities have been scaled up by increasing them with 33 per cent.

Source: Council of Europe 2009a

based earmarked grants. The committee agreed that this is a point worth developing further.

Another argument put forward in favour of earmarked grants by a number of countries was that earmarked grants are needed to compensate local authorities for the cost of new competences. This line of argument appears to take issue with the Charter, and it was made subject to a separate exploratory examination of the extent and necessity of this use of earmarked grants. This study⁶ is described in the next chapter of this paper.

Finally, it was argued that earmarked matching grants are necessary for development grants. This use of earmarking is generally accepted by the Council of Europe in the explanatory report on the Charter.

Comparison of levels in 2004

The pilot study found looking at European countries an average share for own taxes of 36 per cent. (See Table 1, column 9). The recent OECD study (OECD 2006) found a similar pattern, own taxes amounted to 40 per cent of local financing.

The highest proportion of earmarked grants (column 8) was found for *Albania, the Czech Republic*, and the *Netherlands*. The lowest proportion of own taxation (column 9) is found for the *Czech Republic, Estonia* and in *Norway*. By approving the report the committee accepted that these borderline performances are still in conformity with the Charter.

Comparison of developments over time

The development in the sum of grants to local authorities and their tax revenues (Table 2, column 7) suggests a general trend toward more decentralisation.

On the use of own local taxes (column 9) the situation has not deteriorated, but none of the countries ranking with the lowest proportion of own taxes in 2004 have reported improvements.

During the discussion of this some countries reported that they have given freedom for local authorities to impose their own taxes but that local authorities hesitate to make use of it. The OECD (2006) notes on this issue that such “unused taxing power” invites a deeper look into fiscal institutions and the incentives they generate for tax competition.

The use of earmarked grants seems to have increased. Four out of these best performers in 2004 (Table 1 column 8) had seen an increase in the importance of earmarked grants. Did these countries feel that it had been necessary to increase the use of earmarked grants in order to fund new local competences, that it so to speak is only the other side of the coin of more decentralisation of competences? This is the question to be taken up in the next section.

FUNDING OF NEW COMPETENCES OF LOCAL AUTHORITIES, A EUROPEAN MODEL⁷

The hypothesis

Recent years have seen a trend towards an increase in the relative importance of the sum of local tax revenues and grants (Table 2, column 7) suggesting a general trend toward more decentralisation. Over the same period there has been an increase in the relative importance of grants to local governments, and in particular the use of earmarked grants. Both these trends were confirmed by recent OECD data (OECD 2006).

Several participants in the Council of Europe pilot study (2009a) the combination of these developments saw this as an indication that the

Table 2

TAXES, GRANTS, AND DEGREE OF DECENTRALISATION. CHANGES IN PER CENT POINTS IN MOST CASES FROM 1994 TO 2004

	1. Own taxes pct of GDP	2. Own taxes pct of local taxes	3. Total local tax revenue pct of GDP	4. Ear-marked grants pct of GDP	5. Ear-marked grants pct of grants	6. Total grants pct of GDP	7. (3+6) Sum tax and grants in pct of GDP	8. Ear-marked grants (4) in pct of (7)	9. Own taxes (1) in pct of (7)
Albania	1.5	100	1.2	-1.5	-16	-0.3	0.9	-34	22
Belgium (Walloon)	-	-	-	-	2	-	-	-	-
Belgium (Flemish)	0.2	-	0.2	-0.1	-7	-	0.2	-3	2
Czech Republic (n. a.)	-	-	-	-	-	-	-	-	-
Croatia	-	-5	0.7	0.5	-	0.5	1.6	13	-7
Denmark	-	1	-	0.5	-	1	1	2	-5
Estonia	-0.1	-0.5	-0.6	0.1	-4.2	1.2	0.6	0.9	-2.1
Finland	0.7	6	0.1	0.3	7	-1.0	-0.9	-1	8
Hungary	1.1	-	1.3	1.5	14	1.5	2.7	6	9
Iceland	2.8	-	2.8	0.4	16	0.8	3.6	4	-5
Netherlands	0.1	-	0.1	-1.6	-7	-1.7	-1.6	-9	5
Norway	-	-1	1	-	10	-1.3	-0.7	1	-
Slovenia	0.2	4	0.3	0.7	-64	-0.1	0.2	17	4
Sweden	1.5	-	1.8	-0.3	-20	1	2.8	-6	0

Source: Council of Europe, 2009a

trend toward more competences delegated to local authorities necessitated funding by centre in the form of increases in grants and in particular in earmarked grants.

The Council of Europe decided to examine this hypothesis in a survey of the practice of funding new local competences in 23 voluntary countries (document 2009b, *op.cit.*).

Are local authorities compensated for new competences?

Local governments often complain that central governments tend to burden them with new functions but without making the financing available. This picture was not confirmed by the study. Fifteen out of 23 countries answered that they nearly always funded new local competences and 6 did it “most often”, only 2 countries answered that they did “most often not” make funding available.

In a recent survey the Council of European Municipalities and Regions looked more closely at the local claims. Their report⁸ – based on information supplied by European local government associations – recognised the policies to fund new local competences. But also some dissatisfaction was expressed with the compensations and with the consultation procedures as being too late and too summary.

How are local authorities compensated for new competences?

What is meant by “funding” or “compensation”? Compensation, it appears from the survey by the Council, may take other forms than just increasing a grant.

For example, the Walloon region of Belgium has in some cases compensated for transfers of competences to local authorities with transfers of the staff that used to work on the functions

concerned. In another case they have compensated by employing an advisor to assist local authorities (on environmental questions).

In other cases central governments seem to consider it to be “compensation” that they permit local authorities to raise *new taxes*. The Committee saw this as a questionable method of compensation. Permission to raise new local taxes to finance centrally mandated new functions places the political responsibility for the financing at local level. This goes against the objective of accountability, and local politicians may not accept this as compensation (unless the new taxes like in Norway are tax sharing revenues and not own taxes).

The evaluation may not be much different in respect of the method reported by one country to compensate with permission for local authorities to collect new local *user fees* (Sweden is an example).

Why does the centre compensate for the costs of new local competences?

A very essential question is why it is preferred, when new local competences are decided upon, to finance it by grants from central government instead of relying on local tax increases?

One argument brought up was the desire for *accountability*. If new functions are created by the centre, and they are mandatory for local authorities, it is desirable that the centre is politically responsible also for the financing in order to insure accountability at the central level. There are even possibilities for better internal central government accountability if the burden of the compensation is borne by the ministries responsible for the new legislation as is the case in *Denmark, France, Latvia, Sweden* and in the *Flemish Region* of Belgium.

It was also asked if one reason for the widespread use of compensation could perhaps be

that it *makes decentralisation of new functions easier*. Without financial compensation local authorities may oppose acceptance of new mandates. Such resistance against more decentralisation might be seen as preventing decentralisation of functions even where, according to the principle of subsidiarity, they ought to be administered at the local level. However, the a great majority in the committee reported that local governments in general are eager and ready to accept new competences – though the view was also heard that this willingness is not so much because local authorities thought that they were better in delivering the new service as it is based on the lust for getting their hands on the compensation.

The difficulties of using general grants for compensation

General grants are grants that local authorities to may use freely the way they prefer. They are most often distributed to local authorities according to objective indicators like size and composition of the population, in many cases – depending on which functions are decentralised to local delivery – supplemented by some socio-economic indicators. A problem using such grants for compensation for new local competences is that it may be difficult to find objective indicators that result in a distribution of the compensation exactly corresponding to the distribution of the costs of a fulfilling a new competence. Compensation by general grants will often leave some local authorities overcompensated and other without full compensation.

Does earmarking help to a better distribution of the compensation?

Earmarking grants does not help much in this respect. To earmark (ring fence) compensation

for a new mandate may still result in the same imprecise distribution as using general grants, there is the same difficulty of finding objective indicators. But earmarking may have the attraction for the central government as it is an instrument of control.

However, the *conditional (matching)* type of earmarked grants works much better from the point of view of distribution of the compensation. Conditional grants, i.e. grants where the central government (co-)finances the local spending, by definition distribute the funds to where the costs are. They may also be seen as an instrument of control as they offer incentives for the local authorities to supply the functions in accordance with the central expectations. The other side of the coin is that, when local spending is subject to refund from the centre, there is a risk that the local authorities spend more than needed.

The conclusion is that the most effective distribution of compensation for new competences may be achieved through matching grants. But such arrangements may involve a risk of distorting local priorities and to encourage excessive local spending.

Further examination of the policies revealed that the earmarked grants used for compensation are often conditional (matching). In other cases they were for investment purposes. Both of these types of grants give a good correspondence between the distribution of grants and costs.

The organisation of funding new competences, a European model

The findings of the study give new knowledge on the way most European countries, sometimes by legally binding rules, require compensations to be paid for new competences.

France has a constitutional requirement of

compensations. Several other countries refer to commonly accepted procedures. The size and the design of the compensation is most often subject to negotiations with local government associations.

Only three countries reported that normally no such negotiations take place. And in the 20 countries where negotiations are always or usu-

ally the rule, negotiations typically result in some agreement.

In nearly all cases a permanent body is created for discussions between the government and local government associations. All this described some common features that may be called a European model for negotiated compensations.

NOTES

¹ The European Committee on Local and Regional Democracy (CDLR)

² Based on Council of Europe (2009a) and (2009b)

³ See OECD Revenue Statistics, recent years

⁴ Council of Europe (1986)

⁵ OECD (2006)

⁶ See Council of Europe (2009b)

⁷ This section is based on Council of Europe (2009b)

⁸ Council of European Municipalities and Regions (undated)

LITERATURE

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