

FISCAL DECENTRALISATION

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Introduction

Fiscal decentralisation comprises the financial aspects of devolution to regional and local government. It is the currently fashionable term; the alternative descriptions "central-local (or intergovernmental) financial relations" and "fiscal federalism" are often used by European and American writers respectively.

Fiscal decentralisation covers two interrelated issues. The first is the division of spending responsibilities and revenue sources between levels of government (national, regional, local etc). The second is the amount of discretion given to regional and local governments to determine their expenditures and revenues (both in aggregate and detail).

These combined dimensions have a significant impact on the reality of decentralisation in its broader political and administrative sense. How much power and responsibility regional and local governments actually exercise depend substantially on

- (1) what range of public services they finance;
- (2) whether their revenues are commensurate with these responsibilities;
- (3) how much real choice they have in allocating their budget to individual services;
- (4) whether they can determine the rates of their taxes and charges (both allowing them to vary their level of spending and making them answerable to the payers).

The term "local government" will be used to describe both upper (regional, county, district) and lower (city, municipal, settlement) tiers of self-government.

Spending Responsibilities

There is wide diversity between individual states in the scale of the tasks devolved to local government. In most countries local government is responsible for what are often called "communal services": local roads and lighting, water supply and sanitation, waste management, parks and sports facilities, cemeteries, social housing. What varies greatly is the extent of local responsibility for the social sector, chiefly comprising education, health and social assistance. In some cases the whole service is funded by the State Budget, in some costs are split between levels of government, in some local budgets meet all costs except central supervision. Cost splitting may be by function (e.g. the State paying for secondary education, hospitals, social benefits and local government for basic education, primary health care and social services) or by cost factor (e.g. the State providing professional salaries while local government pays all other operating costs).

This varying degree of local budget responsibility for the social sector makes a major difference to the nature and scale of decentralisation. Without such responsibility local government expenditure is unlikely to exceed 5-6% of GDP. Responsibilities for education, health care or social assistance are likely to double or treble this proportion. This in turn has a major impact on financial self sufficiency. Major social sector responsibilities are usually combined with a

substantial dependence on State grants or tax shares, both because of the limited capacity of revenues which can be assigned to local levy and because of the degree of geographical equality expected in access to these services and, in consequence, the need to equalise financial resources.

It is normal to distinguish between current and capital expenditure. Current expenditure covers such operating costs as salaries, repairs, energy and other utilities, travel, materials and debt service. Capital expenditure covers investment in new construction, major renovations, and purchase of land and substantial and durable equipment. It is also normal to distinguish between the financial sources for these two types of expenditure.

Operating costs are normally covered by a combination of local taxes, user fees, intergovernmental transfers comprising either grants/subventions or shares of State taxes. These will be described in turn.

Local Taxation

There are varying definitions of "local taxation". For the purposes of this Paper it will be taken to describe taxes which

- (1) accrue to the budgets of the local government in whose area they are collected, and
- (2) are subject to some degree of variation by the recipient local government; i.e. the local government has some discretion in deciding how much each person pays, by setting the rate, determining the basis of assessment, granting exemptions etc.

Local taxes may be shared between levels of local government. In Britain both counties and districts, in Sweden both counties and municipalities and in France regions, *departements* and *communes* levy separate rates on the same tax bases. Responsibility for assessing and collecting local taxes may be undertaken by the State Tax Administration or the local governments or divided between them; there is no uniform pattern.

Local taxes can be divided into three categories: taxes on property (normally confined to real estate), income (personal and corporate), sale of goods and services.

Taxes on *property* are the most common local taxes, though not necessarily the most important. They have two major advantages for local government. Firstly, their base is obviously localised; there is no room for argument where the revenue should accrue; there are clear connections between the value of real estate and the municipal expenditure on local infrastructure. Secondly, real estate is the one tax base which cannot be hidden by a "black economy".

There are also significant weaknesses which, in practice, keep the yields of property taxes far below those of major taxes on income and sales. Assessing the base of the tax is complex and slow; as a result it is hard to keep valuations up to date so that the tax base responds very slowly to changes in prices or economic growth which increase demands on municipal expenditure. The tax has to be collected directly from the taxpayer, making it more politically sensitive than other levies paid indirectly or deducted from salaries.

Local property taxes exist throughout central and eastern Europe but are largely assessed on the size rather than the value of land and/or buildings. As a result they do not accurately capture

differences in ability to pay and rates and yields are low. It is widely agreed that a change to market valuation is needed to improve their contribution to local revenue, but few practical steps have been taken.

Shares of *personal income tax* are the largest tax revenue for local government in most CEE countries, but only in Croatia do local governments have any control over their rates. In some western European states (notably Switzerland and the Scandinavian countries) local governments add their own rates as surcharges on the national rates of personal income tax; the national rates are kept low enough to allow room for the local levies. It is no coincidence that these are the countries where local government has the highest measure of fiscal independence. This is because personal income tax has far greater potential capacity than any other tax capable of levy at local level. It also has clear linkages to expenditure on personal services such as health and education.

Under the Communist system local budgets also retained some shares of tax on *corporate profits*. These are generally in decline as a local government revenue throughout Europe. There are severe technical difficulties in assigning such receipts to the local government from which the profits truly derive. Corporate profits are highly volatile and the base lacks the stability to support services with such a large component of regular committed expenses as those of local government. National governments are anxious to restrict taxes on this base to attract inward investment.

Taxation of *sales of goods and services* is dominated in most countries by national value added taxes. There are some local levies in this field such as taxes on the sale of alcoholic beverages or the local turnover tax in Hungary. EU accession poses some long term challenge to these local taxes, both because of their competition with VAT and through increasing pressure from commercial enterprises to be free of tax burdens which increase their cost in a single market.

Local taxation has the advantage of enhancing local discretion over levels of expenditure and of making local officials more openly accountable to their taxpayers. Its development in CEE countries since 1990 has been generally slow and disappointing. Local government representatives have rarely pressed for extra taxing power, being generally content with a tax sharing system which frees them from responsibility for tax setting, and ministries of finance have been in no hurry to surrender their monopoly of fiscal decisions.

At municipal level reform of property taxation coupled with increasing discretion over user charging (discussed below) may provide sufficient enhancement of local accountability. By far the greatest scope for increasing fiscal independence lies, however, with the substitution of surcharges for shares of personal income tax. This might be particularly suitable for upper tiers of local government which generally lack taxing power at present. It would be administratively simpler to have variable rates of income tax at this level, and this would be an appropriate tax base to support the major social services like secondary education and hospitals which are frequently devolved to the regional or district tier.

User Charging

At municipal level user charging is generally more significant than local taxation in its yields and impact on household incomes. It is less discussed, partly because it has been tightly controlled by the State in most CEE countries and because it tends to be undertaken by subsidiary enterprises rather than the parent municipality. However, deregulation of prices and

withdrawal of state subsidies are generally increasing both the burden of charges such as housing rents, water and heating charges and public transport fares, and the responsibility of municipal governments for determining tariffs.

Local governments are under increasing pressure to increase tariffs to meet the full cost of the services for which they are charged. This poses both technical and political challenges. A town hall may lack the professional capacity to scrutinise the accounts and operations of subsidiary companies which may well be partly or wholly owned by private interests. Full costs may be difficult to identify if a company operates in different localities or covers a range of services with a common management and support structure. Withdrawal of subsidies usually forces price rises which may well lead to significant increases in non-payment and the need to provide for those genuinely unable to pay; this usually involves closer coordination between service providers and housing benefit agencies.

The most difficult issue in many CEE countries is the relationship between user charges and investment costs. Under the Communist system it was common for construction, purchase and renewal of assets to be charged to revenue budgets, leaving fees to support operating costs only. The capacity of revenue budget surplus to meet such investment costs is diminishing, particularly given the scale of cost involved in improving environmental standards. It is general practice in western Europe to meet investment costs of private good services through credit and to service the consequent debt through user charges. Public subsidy is confined to the assistance of poorer households for whom the ensuing costs are insupportable.

Intergovernmental Transfers

Intergovernmental transfers take a number of forms:

- 1) shares of national taxes distributed *either*
 - a) by formula (e.g. *per capita*), *or*
 - b) by origin (i.e. to the local government where they are collected).

- 2) grants/subventions which are *either*
 - a) targeted to support specific expenditures (e.g. social benefits, education), *or*
 - b) untargeted and used at the discretion of local government (often known as block grants).

Targeted grants are usually intended to stimulate a specific type of expenditure which is favoured or mandated by national government.

Tax sharing and block grants usually have two main purposes, vertical and horizontal equalisation. *Vertical* equalisation means closing the gap between the cost of the services devolved on local governments and the yield of their direct revenue sources. *Horizontal* equalisation adjusts differences between individual local governments in their *per capita* revenues or spending needs. In some cases such as Poland horizontal equalisation is partially financed through redistribution, i.e. by reducing transfers to local governments with above average revenue bases.

Although the principles of equalisation are well understood in CEE countries, their application has been slow to develop. Much depends on local government responsibilities. Horizontal

equalisation is usually given greater importance where local budgets finance major social services such as schools and hospitals, since national constitutions or policies usually require at least minimum standards of provision. Equalisation is not so important in respect of expenditure on physical infrastructure. Indeed above average local revenues may reflect levels of local economic activity which impose extra costs on local budgets (e.g. on road maintenance and traffic management).

Equalisation formulae should be based on objective measurements of local spending need and revenue capacity. They should not be open to influence by the decisions and performance of the recipient local government. For example, calculations of revenue capacity should assume that all local governments levy the same rate of tax, and should not change because a particular authority chooses to increase or reduce it.

The Soviet system of local finance involved redistribution, but it had no formulaic base and was not systematic, consistent or transparent. It purported to balance local revenues and expenditures, basically by varying the shares of locally collected national taxes which each locality was allowed to retain, but the system of calculation included two major perverse incentives. The calculation of local revenues was based on the previous year's actual performance and actively discouraged local tax effort; if you collected more you would be expected to surrender a bigger share. Secondly, expenditure was largely assessed according to the normative costs of a given historic network of institutions and facilities. This disregarded the objective need for the network or the equity of its geographical distribution.

The challenge to CEE countries has been to develop equalisation formulae which are based on revenue potential rather than performance and the comparative need for services as opposed to their historic provision.

A major weakness of intergovernmental transfers in most CEE countries is their dependence on arbitrary decisions in annual State Budgets. These may reduce their level or vary their distribution to serve the fiscal or political interests of the State with very little parliamentary debate or opportunity for consultation.

Local government would be better protected from such arbitrary decisions if the level and distribution of transfers were determined by legislation other than the annual State Budget Law. This would mean that changes could only be made after full parliamentary debate and opportunity for consultation with local government associations. There are examples of such protection in Dutch and French legislation, and the Polish law on intergovernmental finance stipulates that the education elements of the grants should not fall below 12% of State Budget revenues.

Capital Finance

Capital expenditure is normally financed from one or more of the following sources:

- 1) Grants from the State Budget or national funds
- 2) Operating surplus
- 3) Sale of assets
- 4) Credit (loans or bonds).

Grants are still quite common despite State Budget constraints, sometimes backed by donor funds or environmental penalties. In a number of CEE countries there are concerns that such grants lack a normative base of distribution. Whilst transparent formulae have been developed for grants or tax shares in support of current expenditure, these do not apply to investment funds which are still regarded as an instrument of political patronage.

One partial safeguard would be a requirement that the availability of investment grants and the criteria for their award should be advertised so that all eligible authorities have the opportunity to submit bids.

Operating surplus represents the excess of current revenue over current expenditure. This may be planned in the annual budget, or simply emerge from its realisation, creating reserves which can be invested in capital development in the following year.

Asset sales: in most CEE countries large holdings of State property were transferred to newly formed local governments after the end of Communist regimes, usually in the form of real estate or public enterprises. Much has been sold and the receipts devoted to local budget expenditure. This is in accordance with "good practice" where the receipts are reinvested in construction or purchase of new assets, i.e. in capital expenditure. Conversely it is inadvisable to use such irregular sources of revenue to finance recurrent costs such as salaries. The problem is that the lack of separation of current and capital budgets in most CEE countries obscures the use to which funds from sales of assets are actually put.

Loans are frequently taken to finance large capital investments which cannot be funded from annual revenues. They are a particularly appropriate source for long term investments which will produce additional revenue. However, ability to repay capital and interest clearly needs careful calculation. Both lender and borrower should be sure that debt service can be covered either by an increase in the income from relevant user charges or by reliable operating surplus. Most western European countries have legal limits on borrowing designed to avoid excessive repayment burdens or preserve some national, macroeconomic ceiling on public sector debt; such limits have not been imposed in most CEE countries and there have been growing concerns over the indebtedness of some local governments.

The danger of excessive borrowing has been increased in some CEE countries by the promotion of municipal bond issues as a channel of credit. Although common in the past, such issues have become rare in most western European countries where most local government borrowing is from banks specialising in public sector credit requirements. These normally require repayment of capital by annual instalment, so that regular provision for debt reduction has to be made in annual budgets. Bonds, on the other hand, require lump sum redemption at the end of their term; the risk is that borrowers make no advance provision for this.

Local Discretion

Clearly, the structure of local government responsibilities and resources makes a substantial difference to its discretion - its ability to make decisions over the nature and levels of local services. For example, a local government should have more ability to determine its level of expenditure if it obtains a significant proportion of its revenue from local taxes and charges which it can vary. Revenue shares and block grants should provide more freedom of allocation than targeted grants.

In practice local discretion depends on a more complex set of factors. Shares of a buoyant national tax may support more budgetary choice than dependence on a politically sensitive and administratively burdensome local tax. Targeted grants may simply release local government funds for other expenditures. Expenditure decisions may be largely determined by national regulations over service requirements.

The classic argument for maximising local discretion has been made in the fiscal federalism literature most associated with Wallace Oates, (Oates, 1977). This argues that the greatest efficiency is achieved when budgetary choices are made by local officials elected by local people who have to meet the full cost of their decisions through local taxes. This view has been challenged by European writers (Prudhomme, 1989, Davey 1996) who consider the link between local government budget choices and popular preference somewhat tenuous. They argue that the efficiencies of local expenditure choice outweigh those of local taxation; many important fields of local expenditure such as education or environmental services combine legitimate national and local interests. Moreover, in recent years national macroeconomic policy has sought to restrict fiscal burdens; it has been common for governments in both eastern and western Europe to restrict local taxation, particularly on business, to stimulate investment and growth.

The extent of local discretion is, therefore, a matter of balance between national and local interests. Neither central control nor local autonomy have unchallenged priority.

Conclusion

Fiscal decentralisation sets the framework of expenditures, revenues and legal discretion within which regional and local governments operate. It does not deal with issues of *financial management*, the processes of budgeting, accounting, delegation, procurement, auditing etc by which individual local governments manage their financial affairs. These are equally important, but the subject of a separate body of law and practice.

Fiscal decentralisation is inevitably a dynamic process. Although local governments' responsibilities and resources may be fixed in law, demands on their services and the value of their revenues respond to social and economic changes over which lower levels of government have little control. It is essential to maintain channels of consultation between national government and local government associations so that adjustments can be made in a timely and equitable way, usually through the equalisation formulae.

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GLOSSARY

Fiscal decentralisation: the division of public expenditure and revenue between levels of government, and the discretion given to regional and local government to determine their budgets by levying taxes and fees and allocating resources.

Local taxation: taxes which are retained by the local government in whose area they are collected and which are subject to some degree of variation by local government.

Vertical equalisation: correction of disparities between the cost of services devolved to local government and the potential yield of its direct revenue.

Horizontal equalisation: correction of disparities between the per capita revenue bases and spending needs of individual local governments.

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