Local Finance and Recurrent Local Revenue: Options and Conditions for Implementation

Local governments can help attenuate global problems such as rapid urbanisation, lack of infrastructure, and the various global crises – financial, environmental, energy, food security, etc. – which also represent major challenges in themselves. To tackle these effectively, more resources will need to be mobilised, be these funding, technical assessments, or negotiating capacities in complex matters involving numerous stakeholders.

Local authorities can only rise to development challenges if they are well equipped and have the necessary support. In this respect, certain States fail to see the benefits they could gain from strengthening the capacities and effectiveness of local governments. While movement towards localisation is inevitable, the tendency of certain countries to lean towards recentralisation[1] seems to have been exacerbated by the fallout from the global economic and financial crises.

The generalised movement towards decentralisation throughout the world is unfolding through a **great diversity in the organisation and variety of local finance models**. The administrative systems and role of local authorities are the result of each country's history, its traditions of governance and of political and economic systems, past and present. The influence of these concepts persists, albeit subtly, and to advance reforms we must consider beforehand the nature and strength of this heritage. This will be crucial in order to understand how it determines the viability and durability of transformations in local public finance.

One of the main conclusions to be drawn from the GOLD II report[2] as regards the diversity of these systems is that approaches tailored to local contexts are needed each time to tackle funding problems – even the most commonplace. Local governments' financing is actually a set of complex systems comprising a large number of interdependent components, some of which are politically easier to implement or are more achievable than others. Consequently, the architecture of certain local finance systems may be incomplete (in relation to principles and best practices) or only partially implemented, falling short of the current legal framework. The partial or incomplete realisation of these systems often compromises the capacity of the entire system. For example, opacity in the allocation of local government responsibilities translates inevitably into uncertainties regarding local authorities' actual financial needs.

Incomple decentralisation unfortunately most often results in **insufficient funds being allocated to local authorities to finance their responsibilities**. On a global scale, very few countries have managed to restrict the gaps between the responsibilities devolved upon them

[1] In several countries in Africa, Latin America and the Eurasian region, States have unilaterally decided to suspend the payment of certain shared taxes and other tranfers. In other cases, they have increased their control over the funds and budgetary decisions of local authorities.

[2] Second Global Report on Local Democracy and Decentralisation: Local Government Finance: The Challenges of the 21st Century. UCLG 2010

and the local resources made available. These shortfalls may result from a system design flaw, but insufficient funding is more often explained by political reasons or by a lack of resources, even in countries where transferring responsibilities to local authorities without also providing funding is forbidden by law. This is a bigger concern in certain regions: in Africa, for example, revenues are generally less decentralised than responsibilities, leading to particularly large shortfalls between resources and expenditure.

The Financial Weight of Local Government in Public Finance, by Geographical Area[3]:

Region	Local Revenue in % of Total Public Revenue	Local Expenditure in % of Total Public Expenditure	Share of Local Expenditure/Share of Local Revenue
Africa	3.2 (3.6)	7.9 (6.8)	2.47
North America	17.8 (0.6)	26.6	1.49
Latin America	4 (4.5)	11.1 (7.3)	2.78
South Asia	1.5 (0.9)	16 (0.9)	10.67
South-East Asia	5.3 (0.8)	15.5 (0.6)	2.92
East Asia	20 (0.3)	40 (0.3)	2.00
Eurasia	N/A	26.5 (15.1)	N/A
Europe (2008)	13 (0.7)	23.9 (0.5)	1.84
Middle East and Western Asia	N/A	4.6 (1.7)	N/A

Note: Coefficient of variation in parentheses.

The ratio of local expenditure to local revenue enables us to appreciate the degree of local government autonomy. No formula, however, can guarantee that local finance systems will function effectively. To succeed, a certain number of elementary principles of local public finance must be applied in a consistent and ordered fashion: principles which will be set out below and the implementation of which in various countries will be analysed based on the thoroughly comprehensive documentation gathered in GOLD II. These principles are few in number and sufficiently flexible to enable each country to structure its system for distributing resources among the various levels of government according to its history and national objectives (Part I).

On this basis, this report will examine (Part II) the **conditions for mobilising local resources, especially the recurrent revenue of local authorities**, which notably underpins their ability to access external funding sources such as loans or PPPs, that are becoming essential for covering their broad investment needs (these external resources are covered in a separate report corresponding to the second component of the global study conducted by UCLG/Committee on Local Finance for Development).

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[3] Source: GOLD II page 313

Likewise, the recurrent revenue of local authorities has a direct impact on their capacity to create a long-term budget strategy based on investment planning and programming and taking into account property development potential in particular (this problem is also covered in a separate report, corresponding to the third component of the aforementioned global study).

1. The Structure and Characteristics of Local Finance Systems[4]

For local authorities to be able to assume their responsibilities and contribute effectively towards meeting and overcoming current and future challenges and crises, they must be given a legal and institutional framework plus appropriate procedures. Such procedures have a financial aspect, but also political and institutional dimensions.

1 .1. Institutional context

The importance of the political and institutional aspects of local governments with regard to local finance cannot be underestimated. Without adequate mechanisms for participation and operation or sufficient local powers, local financial autonomy can cause conflict rather than productive results.

1.1.1. Citizen control and participation are at the heart of the decentralisation process

Decentralisation is an eminently political process, as it consists in the State transferring powers and recognising the autonomy of local government. While political forces often pave the way for decentralisation, they can also hinder its effective implementation on the ground[5]. At local level, political leaders can also compromise decentralisation if they do not involve their electors in the process. We must understand these political realities and react to them to give decentralisation a strong dynamic.

The golden rule of participation is to hold democratic elections at regular intervals. But not all countries can – or want to – call free and democratic local elections. Yet local elections are but one form of participation: other, non-electoral mechanisms can play an important role in strengthening local participation, even when elections are held regularly. These mechanisms encourage citizens to participate in local affairs and can improve the transparency thereof: access to information, public minutes, participatory budgeting mechanisms, raised awareness of tax collection, etc. They can reanimate citizenship and the idea of a social contract.

1.1.2. How local governments are organised must be appropriately defined

Systems and procedures for managing local public resources, and frameworks and mechanisms for working together with other levels of government, with economic stakeholders and with non-governmental operators are essential for local authorities to be able to perform the missions that have been transferred to them. Furthermore, local authorities must possess – or

[4] This section is based entirely on the aforementioned GOLD II report.

[5] For example: resistance by national political leaders to transferring powers to local authorities through fear of losing control thereof; opposition from central government bureaucrats whose institutional and personal objectives are contrary to decentralisation; or opposition to the reforms from elites and from deconcentrated State services…

be able to develop – the necessary in-house capacity to function correctly within this institutional framework.

However, in many countries, notably in developing countries, numerous components of these mechanisms are non-existent or incomplete or have been implemented without accounting for the institutional context. More broadly speaking, local authorities' constitutional and legal frameworks (legal status, political mechanisms, powers, administrative and staff structures, etc.) are sometimes well developed, but sometimes barely outlined.

1.1.3. One of the commonly encountered problems is a lack of clarity in the allocation of local responsibilities, which means these responsibilities cannot be translated into concrete financial needs. In numerous regions, particularly in developing countries in Africa, Asia, Eurasia and Latin America, shortcomings in this area weaken local authorities and harm their system of financing. Laws are left hanging and contradictions remain between the laws on decentralisation and the sector-specific legislation regarding particular public services. Besides, State or regional governments witness, control – sometimes even approve – the budgets voted by elected local officials. This practice of control *ex ante* (control of opportunity) is contrary to the budgetary autonomy of local authorities.

Ministries may continue to assume sector-specific responsibilities (water, education, health, etc.) without coordination or in competition with local authorities. The situation may be even graver when one level of regional government exercises inappropriate control over another, as is the case in China and in certain federal countries like India. From this point of view it is necessary to differentiate between federal States and unitary States. In the former, local authorities are the legal subjects of each federated entity, which is all powerful in matters of internal administrative organisation. This is not the case in unitary countries, where the central government has sole responsibility for internal administrative organisation. In this regard, in numerous regions from Australia to Argentina, numerous debates arise over whether local authorities should have a specific status independent from intermediary administrations, provinces or states.

Furthermore, the question of how responsibilities are allocated also has major repercussions on the question of territorial coherence, particularly in the governance of large cities whose responsibilities are often parcelled out across the region among several authorities. Services that benefit the inhabitants of several local authorities (with major externalities) are not always provided in a coordinated fashion and/or financed in an equitable way.

1.1.4. The Development of Local Powers is a Major Challenge that must be Raised

In developing countries, local authority powers are often poorly managed. This lack of abilities at local level can turn out to be a major constraint in implementing local public policies and for the financial management of these policies by local chiefs financial officers. For decentralisation to deliver on its promises, these various constraints must be identified, and efforts made to overcome them.

1.2. Financing Responsibilities

Problems with mobilising local resources are particularly recurrent. Even in the most advanced systems in which responsibilities are rather well defined, problems arise when the State transfers or deconcentrates functions without the financial means and corresponding skills on the ground.

1.2.1. Local autonomy and the mobilisation of local resources are two conditioning factors that enable local authorities to effectively assume their responsibilities

Yet, rare are the countries these days that have provided their local authorities with the means and the autonomy required to ensure sufficient revenue. This problem manifests itself in various ways depending on the design and operation of the local finance systems.

There is, in general, a wider consensus on the need to grant greater autonomy in the management of expenditure than in that of revenue. Autonomy in managing local revenues is particularly limited in most of Africa, Asia and the Middle East – Western Asia region. Yet a certain liberty in managing revenue is essential for strengthening local responsibilities and, furthermore, "Whenever national governments have made local governments stronger, investment has improved and national GDP has risen[6]".

The big picture looks better – but still not uniform – in Eurasia and Latin America. Local authorities generally have no decision-making power over new taxes and very little for setting tax rates and user fees for local services. Even in countries where decentralisation is advanced, such as Australia, the federated States restrict local autonomy in resource management. Attempts to strengthen budgetary autonomy and reduce dependence on transfers, such as Japan's trinity reform, have met with only partial success. In Western Europe or North America, the management of resources is more autonomous but problems still remain.

Property tax[7] is the tax most recommended and most used by local authorities throughout the world. However, its revenue potential is rarely realised. On average, it brings in 0.5% of GNP in developing countries, versus 2% in developed countries. It is also unpopular: even in developed countries where it plays an important role (USA, Canada, UK), it is badly accepted by the inhabitants. Collection costs are high and difficult to manage, particularly in many developing countries who are not equipped with suitable property records and who are characterised by widespread informal constructions and little ability at local level to assess property values, implement the tax, and collect it.

Diversification of the local tax base is necessary to strengthen the fiscal potential of local governments. In effect, local tax bases are often narrow, particularly given the problems of major dependence on property tax. Several countries in Europe and North America resort to a local income tax. Scandinavian countries and certain transition economies in Central and Eastern Europe deduct a fixed-rate surtax on personal income through their national income tax. In Latin America, countries including Brazil, Chile and Colombia have adopted various types of local taxes based on economic activities. Taxes on local sales are used notably in Canada, where there is national VAT, and in the USA, where there is not.

Scant diversification of the local tax base is often aggravated by a lack of flexibility when it comes to adapting to structural transformations in the economy (for example the growth of the service sector). The inflexibility of numerous local levies and taxes is problematic in that the demand for services rises faster than revenue – as does their cost. In a certain number of African countries (Tanzania, Uganda and Zambia), viable local taxes have recently been eliminated and partially replaced by transfers. Other countries, including Korea, suffer a proliferation of small indirect taxes on sales, which raise little in comparison with the cost of their collection.

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[6] UCLG Support Paper on Local Finance – 2007 – based on the example of the United States, RSA and the state of Tamil Nadu, India. Page 45.

[7] Cf. findings of the 3rd component of the study on valuing real estate, especially Section 3.2.3.

Where circumstances permit, local authorities apply user charges for the use of services, to ensure the recovery of costs. In Canada and the United States, these make up a quarter of the revenue generated by the local authorities, which is a substantial sum, bearing in mind the generally high level of their revenue. The situation is very different in numerous developing countries: in African countries such as Algeria, Benin, Egypt and Tunisia, local governments are not entitled to set the amount users are charged for local services.

Various political obstacles also hinder the growth of local revenues. These include, among others: the reluctance of local authorities to increase taxes (for example in certain EU countries); restrictions on local tax policy imposed by national legislation; and opposition from the inhabitants expressed via referendums (in numerous states of the USA). These phenomena are largely due to a lack of understanding by the taxpayer, who wants more services, and of better quality, without paying more – indeed, while paying less.

In short, the role of local government in the collection of resources is underdeveloped. All countries strive to maximise revenues while minimising management and control costs (which favours the role of higher levels in management and implementation). While centralised management can sometimes be better suited to certain taxes, the central agencies in numerous regions – including the Middle East-Western Asia and West Africa – do not transfer the resources they collect on behalf of local government within the desired timeframe. The lack of incentive for State tax authorities to ensure the collection of local revenue is often a major stumbling block to local tax policies: Experiences in various countries (Costa Rica, Jordan, several Eurasian countries) show a major increase in local revenues when tax administration responsibilities are transferred to local authorities.

1.2.2. National Revenues are often shared unequally among the various levels of government

In most countries, part of the national taxes is transferred to local authorities; a simple mechanism that provides high revenue potential. This mechanism can also provide a partial solution to vertical imbalances, but is subject to various constraints. According to where the resources were collected, the sharing of revenue can trigger local economic activity, but it can also reinforce horizontal disparities and increase the volatility of local budgets.

In developing countries in particular, the amounts allocated to local levels are largely inequitable with regard to the powers devolved. In this respect, the lack of suitable methods and practices for measuring the cost of the responsibilities transferred does not favour the implementation of a balanced funding system. Furthermore, these transfers can also be unclear or lack transparency, which complicates long-term planning for local authorities. This is notably the case in certain West African countries, where States retain local government resources for their own use or delay the payment thereof. The most important point, perhaps, is that an inequitable or ineffective sharing of revenue can have negative effects on the generation of local resources. This can damage local autonomy and local authorities' responsibilities towards their electors, and can weaken local capacities to provide services, mobilise resources and access to borrowing.

A well structured transfer equalisation system is a crucial element of local funding, which notably enables combat against horizontal budgetary imbalances. The implementation of these mechanisms is necessary to mitigate various factors, such as poverty or population growth in certain municipalities. However, despite the increase in inequalities of revenue among local

authorities around the world, few countries use effective equalisation grants to enable more egalitarian access to resources.

In Africa, only a couple of countries (Morocco and South Africa) have introduced these equalisation grants, while in the Middle East-Western Asia region they do not exist at all. The situation is a little better in Latin America, where certain States (for example Brazil and Chile) use equalisation, but most have only retained a handful of elements, which they have incorporated into their revenue sharing programmes. Several Asian countries use equalisation transfers (Australia, Indonesia, Japan), while others ignore budgetary disparities (China, India, the Philippines, New Zealand). Equalisation subsidies are used in Eurasia, Europe and North America (but not at federal level in the United States), with varying degrees of success.

Where they do exist, equalisation mechanisms will almost always have their faults. Allocation criteria, for example, may only account for differences in budget capacity, or in costs, but not both. They are sometimes based on actual revenue rather than fiscal capacity, which hinders the mobilisation of local resources. The shared pool of funding that feeds the transfers may likewise be unstable or ill defined or use of the funds may be subject to rigid conditions which in practice make them conditional transfers. In federal countries like Australia, the way intermediary administrations interpret federal equalisation policies is a source of conflict.

Conditional transfers granted by the State or intermediary authorities also make up part of local budgets. They serve to promote national standards and objectives for the provision of decentralised services such as, for example, certain aspects of education and health. They also help manage inter-administrative externalities regarding, for example, environmental or local investment issues.

Conditional transfers exist in many countries, particularly for infrastructure investments. Nevertheless, in certain regions such as Eurasia, conditional transfers are still at the embryonic stage. Other countries, like Egypt, Nigeria, Tanzania and Uganda rely almost exclusively on conditional transfers. This type of grant frequently entails several difficulties: their number and complexity, meaning high implementation costs for local authorities; their lack of transparency and stability, including timescales, and the risk of political manipulation. Furthermore, over-reliance on conditional transfers can mean hefty constraints on the autonomy of local authorities and drive them to neglect local priorities in favour of national priorities, thereby destroying everything that gives them their strength.

Grants based on performance and innovation are relative newcomers in the field of transfers. They have generally been introduced in certain African and Asian countries under the influence of international organisations. The local governments generally remain free to decide the best way to use the funds. This type of transfer brings together the flexibility of unconditional grants with an atypical form of conditionality. They can, however, end up favouring the municipalities with the greatest administrative prospects, and risk reproducing the defects of traditional aid programmes. To date, they have served above all to promote respect for financial and administrative management procedures, not to improve the provision of services. It is too early to pronounce definitive judgement on the effectiveness of this type of grant.

It should be noted in conclusion that the weakness of local government funding approaches cannot be put down solely to financial engineering, but also to the institutional, political and social environment. Perceptible progress has been made, and shows that certain national systems can evolve by resorting more to the mobilisation of local resources to finance national and local development.

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2. Analysis of the Financial Disequilibrium of Local Budgets

Decentralised governments' contribution to local economic development lies mainly in the effective and efficient provision of services and facilities tailored to the local context and citizens' preferences. The recurrent running costs incurred by these services and facilities should ideally be covered by resources (taxation, user fees) that are also recurrent – a situation that arises more readily in contexts of high levels of economic and residential development.

This, however, is not generally the case, as we have seen from the assessment made by the authors of the Gold II report, summarised in Section 1 of this paper. Imbalanced local finance is practically endemic in most developing countries. There are numerous causes to this imbalance, which we shall seek to highlight for each side of the equation – expenditure (2.2) and income (2.3) – once we have proposed a framework for analysing local budgets (2.1) that will enable us to move forward with regard to the conditions for mobilising the principal recurrent sources of local funding.

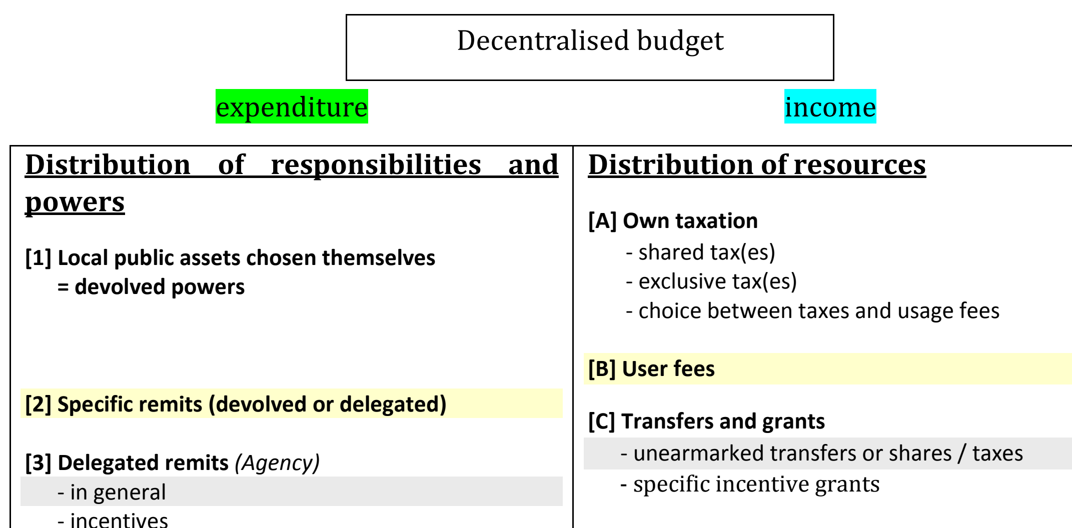
2.1. Proposed analytical framework for the financial balance of local budgets

Nothing requires that local authorities must cover their expenditure entirely with their own resources. There is no reason this should be the case, even in a context of decentralisation (in the sense of delegation). More specifically, it is logical that:

- the responsibilities "chosen" by the local authorities themselves be funded entirely through their own resources; this is the corollary of the very principle of decentralisation
- other specific remits should, for their part, be financed through usage fees charged to users
- in short, expenditure that falls to local authorities but which is incurred through powers that are delegated to them by the central government should be financed either by tax revenue transfers and/or financial transfers from the central government.

The diagram below recaps these basic principles.

The Principles of Local Budget Funding



Source: Dafflon and Gilbert

In practice, however, numerous imbalances may arise that justify making adjustments between the budget subcategories. Based on the principle that usage fees should cover the costs of providing specific services:

- It could be that the fiscal resources allocated to the local authorities exceed the costs of providing the services that the local authorities have chosen to provide themselves. A surplus then arises, reducing the need for financial transfers while maintaining a balanced budget. The inverse would be problematic, as it would mean that own taxation did not stretch to covering local responsibilities, and the latter would need to be adjusted downwards to keep within budget.
- It could also be that the transferred allocations and tax shares are insufficient against (or exceed) the cost of the transferred responsibilities. The deficit (or surplus) should therefore be compensated by an increase (or decrease) in local taxation.
- In short, it could be that usage fees do not fully cover the costs of providing specific local public services. In this case, there must be access to reserves, if these exist and if they have previously been created by surplus revenue from usage fees. Without reserves, the shortfall must be financed either by taxation or by the transfers received, thus reducing the sums available for providing other services.

The origin of these imbalances varies in itself, and may come either from a structural maladjustment common to all the local authorities, between the financial means devolved to the local authorities and the cost of service provision, or from a local maladjustment related to the specific situation of a particular local authority:

- The structural maladjustment originates either in insufficient fiscal resources transferred to the local authorities (if tax bases are too narrow, rates too low, or if the central government imposes a uniform rate), or in inadequate financial transfers.
- Imbalances can likewise be local in the sense that they result from the local authority's individual situation. These imbalances can have various origins, which are worth outlining in order to better pinpoint the effective type of transfer:
    - The geographical perimeter of local service provision exceeds the administrative boundaries of the local authority, giving rise to spillover or overload effects.
    - Local factors make the provision of services more costly (for example difficult terrain, very low population density, a demographic structure with lots of children or elderly people, etc.), all things being otherwise equal, thus exceeding the financial means of the local authority.
    - Or perhaps the local government suffers from insufficient "fiscal potential". Resource transfers – equalising or otherwise – should therefore compensate for these imbalances.

Among the reasons for these imbalances is first of all the fact that *there is no reason why the division of national territories into local authorities should have to coincide with the local economic and residential development map*. The "local recurrent expenditure" and "local recurrent resources" maps are commonly mismatched. There are therefore multiple crossover "spillover effects" among local authorities. Thus some local authorities "piggyback" off local facilities and services designed and financed elsewhere, while others face the reverse situation. This is particularly the case in countries where the territorial network is very fine and/or the

number of government levels is high. This observation is especially important in cities and regions where economic and residential development is extremely concentrated in some territories (coastal areas in Africa or in Asia, for example).

A second reason regards *the difficulty in finding effective local tax sources in an increasingly mobile economic and residential context*. Mobility within and between nations is a particularly formidable obstacle when territories are small. Developing decentralisation, in other words granting local levels the power to make decisions on devolved responsibilities and on finance, is squaring the circle in a context of increasing capital and workforce mobility.

Other causes have already been mentioned in Part 1 of the report, and may be filed under either side of the equation, recurrent expenses or recurrent revenue.

2.2. The origin of financial imbalances linked to the "recurrent local expenses" side

Upstream of the question of local resources, *the spatial distribution of local authorities' fiscal needs is far from how it ought to be*, given the situation of local authorities and the distribution of responsibilities. It is distorted by a certain number of recurrent problems:

- The first, and undoubtedly the most fundamental, arises from the fact that the distribution of powers between central or federal States and local governments is blurred or unstable. This is very generally the case in African or Latin American countries. Texts are often very badly drawn up, imprecise or inapplicable. The resulting "fiscal need" thus cannot be assessed accurately.
- The second problem arises from the fact that the powers devolved to local authorities are either exercised incompletely – indeed not at all – or are exercised at least partially by the services of the deconcentrated State, sometimes in contradiction to the laws of decentralisation. In fact, there is widespread confusion between deconcentration and decentralisation. Coordination is poor between the actions performed by local authorities on devolved responsibilities and the actions of the State, often causing wastage and ineffectiveness. The services provided by the deconcentrated State services may not suit the preferences or situation of the local authority. More seriously, the sustainability of local facilities policies is often problematic. It is very often the case that the State funds facilities that the local authority cannot operate in the long term due to a lack of staffing, material or financial means. Not all local facilities programmes financed by international sponsors avoid this issue.

This systematic failure to account for the recurrent costs linked to local public facilities, which are often installed with external assistance (the State, international development partners), has profound and long-term consequences on the dynamic of decentralisation and on territories' economic development. Investments that are not maintained or used properly, as well as ineffective services, both place local authorities in a permanently fragile situation. How do you collect local taxes if citizens do not receive effective outcomes in return, if the streets are not maintained, rubbish not collected, street lighting deficient, marketplaces badly managed, parking chaotic…?

As a result of all the above, *the "fiscal needs" of local authorities are badly identified and, in fact, not funded*. Responsibility does not lie solely with local authorities: with insufficient – or even contradictory – regulatory frameworks, many States transfer powers to local levels without

ensuring the long-term funding thereof via the appropriate financial transfers (cost shifting or unfunded mandates). Nor is it rare for this fundamental financial imbalance to provide the opportunity for central States to impose obligations and standards of provision of services that restrict local authorities' decision-making powers even within the areas of responsibility devolved to them.

The inadequate framing of local authorities' budgets and accounts, and the control exercised by higher levels of government, are also highly widespread sources of dysfunction within the management of local finance. In most cases, nothing forces a local authority to write off its facilities. It is certainly easy to understand the reasons for this, given the difficulties of local finance. But the aforementioned consequences on the management of local facilities are negative. Most generally, local authority actions (notably regarding budgets and finance) are subject either to *a priori* controls, which goes against the very idea of devolution, or to distorted balancing rules. The redevability of local authorities is only limited to checking the balance between budgets and the books balance (a legitimate concern of the central State), putting aside information on how much it costs to provide local public services.

Yet this is undoubtedly another essential issue in a context of decentralisation: *without knowledge of the costs, there can be no informed local decision-making between policies*, and therefore no effective provision of services. And without effective provision of services, there can be no consent to taxation. Furthermore, without the knowledge of costs, there can be no proper assessment of local "fiscal needs" either, and thus no effective intergovernmental financial transfers, either compensatory transfers or equalising transfers.

2.3. Analysis of the imbalance linked to the "recurrent local resources" side

In reality, there are very few countries in which the local authorities have sufficient own local resources to cover their spending needs. In most cases there is an imbalance between own local resources and recurrent expenses. *The transfer of central government responsibilities to local authorities is rarely accompanied by the corresponding resources*. The majority of constitutions guarantee a balanced transfer of resources *ex ante* but rarely *ex post*. And this transfer generally takes the form of budgetary grants, and is thus subject to the vagaries of the annual nature of budgets. Only very rarely does it come as the transfer of fiscal resources that match up to substantial local decision-making power. The fiscal resources over which local authorities have decision-making power are practically never the majority of the total resources of the authorities. They can even be very much the minority.

To remedy these imbalances, one could tackle the distribution of responsibilities among the levels of government. Taxation powers could be progressively redefined, in parallel with transforming the institutional and political contexts and with strengthening the capacity of local players (new tax distribution, new room for manoeuvre, etc.), or they could, as it is more often the case, resort to financial transfers.

2.3.1. Viewed from a decentralisation perspective, the central question is that of fiscal autonomy (*lato sensu*, including user fees), i.e. local authority's capacity to generate recurrent resources by either "inventing" new taxes, modifying existing regulations on local tax base or rates, or setting a tax ratio on national tax resources (shared taxation). These "autonomous" local taxes are thus clearly distinguishable from State transfers on the one hand (be they financed by national tax revenue) and, on the other, from the "shared (tax) income" based on distribution rules which the local authorities have no power to change. From this point of view, the majority of local authorities' recurrent resources in most countries – developed or developing – fall into the latter category (Ambrosiano and Bordignon…Bloechliger).

Fiscal autonomy appears to be, at first glance, the perfect mirror of the autonomy as for expenditures enjoyed by decentralised authorities, with regard to the powers devolved to them. Supposing that perfect fiscal autonomy is attainable, and that adequate tax bases can be mobilised to this effect, this autonomy is not, however, without downsides. It can lead to tax exporting behaviours (making non-residents bear the weight of local taxes, thereby lightening the tax burden of the residents… who are those who vote) or to predatory behaviours, a kind of fiscal "race to the bottom", leading to the desertification of less fiscally attractive territories.

The dynamic of recurrent local resources rests on two complementary elements; the "rate effect" and the "base effect":

- The rate effect enables the local authorities who have control thereof to adjust tax yield by modifying the rates. These rate effects, when they exist, are rarely wholesale. Local power to set rates is often circumscribed by minimum and maximum rates, by ceilings on annual variation, and by co-variation rules regarding the tax rates on residents and on economic activities. Rarely in less developed countries are local authorities entitled to adjust rates of taxation to a significant degree. Though it should be noted, however, that in certain cases local discretionary margins depend on the range of services offered.
- The base effect enables local authorities who benefit therefrom to record growth in their tax receipts without touching taxation rates. This base effect can only be applied to local authorities in the case of strictly local taxes; it can also be common to a subset of local authorities or even to the whole country in the case of shared taxes or the sharing of national tax income.
- The "feedback" effect of local public services and facilities on local tax bases (or endogenous generation effect) is often mentioned as having to help loop back the accounting dynamic. It rests on the hypothesis that the positive externalities generated by local public facilities and services provide to residents or local economic activities are "capitalised" in land and property values, and therefore create sufficient "base effect" to help finance said facilities. This is not the case, however, either in theory (there are many reasons why capitalisation need not be complete) or in practice. Local land and property taxation makes up only a minor share of local revenue even in developed countries, including the United States and Canada (cf. the analysis of Property Taxation yields in the Study). With regard to other local taxes (on sales, on economic activity, on income), the "feedback effects" of local policies on tax bases are at best diffuse (they more often benefit or affect not only the local authority itself but also neighbouring local authorities). They are also often delayed and partial.

The difficulty in generating financial resources for local authorities on a recurring basis is rooted in numerous factors: technical, economic and political.

An initial technical difficulty stems from the poor administrative capacity of local authorities (particularly in less developed countries) in fiscal matters. Only very rarely are local governments themselves invested with the power to create tax bases. In most cases this task is devolved to the (deconcentrated) services of the State. At most, some local authorities will complete the action of the State services, updating land registers, or scouting for new plots and new taxpayers. This state of affairs is not necessarily without its logic: setting bases and collecting taxes are administrative activities with major efficiencies of scale… On the condition, however, that (i) the deconcentrated tax services are sufficiently motivated, and (ii) the tax incomes collected are reasonably redistributed to the source authorities (subject to a fiscal

sharing or equalisation mechanism) in terms of both amount and timescales. These two conditions are not always met, as recorded by lots of fieldwork in Africa, Asia and Latin America. On the contrary, numerous cases of growth in local tax yields have been observed in countries where more responsibilities have been granted to the local authorities.

A second technical difficulty stems from the fiscal architecture, i.e. the stacking of local, regional and national taxation. It is not rare for taxes or tax products to be shared among local authorities on the same level or among local authorities on different levels (regions and municipalities, for example). This stacking certainly has negative effects: each level behaves as if it were "alone" in imposing taxes, without taking into account in its decision the fact that other levels are simultaneously taxing the same tax base, and as a result the cumulated rate of taxation is "too" high (M. Keen). Again, this device is not without its logic. From the "tax generation" viewpoint first of all: if the decisions made by a local authority are at the root of attracting new residents or new economic activities, the externalities due to the residential and economic development will extend beyond the territory of the local authority itself, thus implicitly creating an "entitlement" for the authority to benefit from the increase in tax revenue. Secondly, from the point of view of power distribution, when responsibilities are shared among several levels of local government (for example in issues of economic development), it is not illogical for a common tax resource to be shared among the levels of local government, with each setting a specific rate.

On the other hand, an economic difficulty stems from the increasing scarcity of potential local tax bases in a context of increasingly mobile and internationalised economies. Leaving aside land and property bases, and bases derived from sites of tourist, geographical or architectural nature (all of which are immoveable by nature), all other potential local tax bases are mobile. Yet the threat of residents and businesses relocating is a "sword of Damocles" infinitely more dangerous for small local authorities than for large countries. Likewise, the development of intangible economic activities, which are in essence non-localised, poses the same threat.

Political difficulties are also just as evident. The very principle of decentralisation consists of bringing together the circle of beneficiaries/users of local public services and the circle of contributors (taxpayers and service consumers). The assumed proximity between usage and the demanded contribution reinforces the political pressure on local decision makers, as illustrated by the multiplication of tax disputes and the resistance to tax increases, notably in European countries and North America.

For all of these reasons, the potential breeding ground for "good" local taxes is reduced, and even shrinking. And this is confirmed in today's world by observing the funding systems of local authorities:

- The use of benefit taxes, which requires the beneficiaries of local public services to contribute, is not as widespread as those who promote them would wish, particularly in most decentralised developed countries. This lies on the grounds that the beneficiaries of local public services provided by local authorities (a necessary condition for the employment of benefit taxes) are increasingly difficult to identify, taking into account the nature of the services provided (education, health, social services, housing, employment, economic development, and so forth).
- The local use of personal income tax makes sense in countries where the responsibilities exercised by the local authorities lead to individual consumption according to revenue. Such taxation can only be designed in the form of tax revenue sharing or, at a push, of shared/stacked taxes (surtax on personal income tax according to residence in countries of Northern Europe, Switzerland, in Eastern European transition countries). Yet, on the one

hand, the stacking of income taxes has its negative effects: overtaxation (vertical fiscal externalities), relocations or optimisations. On the other hand, the spatial distribution of income tax bases is generally highly concentrated, which leads to very broad equalisation mechanisms (see below).

- The somewhat generalised use of local business taxes rests largely on taxes or charges based on the exercise and/or turnover of specific professions, rather like levies, which are very widespread in Africa, Asia and Latin America. Local retail sales taxes persist in the (rare) countries in which no VAT has been introduced at national level (United States) or coexist with federal VAT (Canada). In the latter case, national VAT revenue is often shared among the levels of government, with local authorities unable to adjust the rate at their level. Interesting proposals are currently emerging with a view to implementing "dual" VAT systems: one at national rate applicable to transactions between professionals, and the other opening up the possibility of local adjustments for sales to the general public. In the same vein, recent proposals re-examine the possibility of taxing added value at local level (therefore at differentiated rates) combining the taxation of employment revenues and that of capital revenues (added value then being taxed as the sum of employment and capital remunerations, just like the French professional tax phased out in 2010).

The "invention" of new local taxes with sufficient yield to finance the expenditure relating to the increasing responsibilities or to the increasingly large stock of facilities seems so complex that in the majority of cases the solution lies in resorting to tax resource sharing or, more simply, to financial transfers from the State. Thus to the detriment of local fiscal autonomy.

There remains the case of user payments and charges. These are in theory the second pillar of local government finance, together with benefit taxation. As with benefit taxation, the effective use of charges, tariffs and other user payments presupposes the ability to identify the beneficiaries of the public services. This is not always the case. Then it must be possible to measure the costs of providing the service and to quantify the provision. Furthermore, this remains conditioned by the legislative and regulatory framework (for example, some North African countries do not authorise their local governments to set pricing). All of these reasons explain why the share of user payments in the recurrent resources of local governments generally remains below 10% of total local revenues (though in very rare cases, such as in Canada and the United States, it can be higher).

Beyond the definition of adequate bases for local taxes, there are still the recurrent problems of fiscal flexibility for the taxes in place (updating). This is the case for land and property taxes, with the dynamic of their bases requiring costly information mechanisms regarding house prices and land values. It is also the case for local taxes on individual economic activities and for user payments and charges.

2.3.2. Financial transfers between government levels are in fact the central pillar of local government finance

There must however be guards against any abusive globalisation. Intergovernmental transfers are aimed at very different objectives. They take very different forms. And their effectiveness must be measured against the objectives they target.

The Objectives of Financial Transfers between Government Levels

There are many grounds for financial transfers between tiers of government and between local governments.

1) Financial transfers for funding purposes serve to finance the responsibilities devolved upon the local authorities. They are aimed at indemnifying the local authority when it is obliged to fulfil a function on behalf of the higher level, such as providing a basic service across the entire territory in compliance with the demands of the central government. These transfers are also aimed at correcting vertical imbalances. This is particularly the case when the decentralised public authorities' own resources are insufficient to enable them to finance the expenditure that falls to them.

2) Incentivising transfers are aimed at modifying the budgetary choices of the entities that benefit from them, to guide them towards the services desired by the level of government that is paying them. These transfers are generally linked to specific services, which the beneficiary should provide at the qualitative and quantitative levels established by the payer.

3) Transfers can have the objective of correcting and compensating for external effects (of a spillover effects type) relating to the decentralised provision of certain public services. This is particularly the case when the area in which the public services are being used or the recipient territory extends beyond the borders of the institutional space that is providing the service, or when non-resident economic agents can benefit from the services provided by a local authority without bearing the cost thereof. The education services provided and financed by a given region, for example, have positive external effects on other regions (particularly if individuals are mobile).

4) Financial transfers are also designed to correct horizontal imbalances between decentralised public authorities. Transfers then play a role to equalise resources – and also needs. They are generally aimed at "equalising" (bringing closer to the average) the means at the local governments' disposal, so that these can offer public services of comparable quality (and within the same cost bracket) across a given territory. Supplementary resources are then transferred to the local authorities whose potential tax base is below the national average or whose "needs" are higher than the national average (for example communities in mountainous areas).

(5) The fifth type of financial transfers have a macro-economic dimension to them. It is not longer a question here of the general financing of decentralised budgets, nor of compensation, incentives or correction with a view to a better allocation of resources. In the first instance – at least in theory – the goal is to encourage a global demand that would be insufficient in the event of poor economic conditions. In the second instance, the objective is to steer regional development projects.

(6) The sixth category concerns redistribution policies aimed at individuals. These include, for example, individual welfare benefits, study grants and child allowance payments. They are not taken into account within the framework of this report as they are not aimed at local authorities in their capacity as such.

The types of financial transfers are varied. **The customary typology of allocations and grants between levels** suggests multiple criteria for judging their qualities. The three most standardly used criteria look at *utilisation*, *calculation method* and *availability of funds*:

- With the utilisation criterion, a distinction is made between general grants and specific grants:
  - *general* (block/unconditional) grants are at the beneficiary authority's disposal to use as they see fit. Tax sharing generally comes under this category.
  - *specific* (selective/conditional/restricted/categorical) grants carry selection criteria that restrict the use of the amount by allocating it to a remit or expenditure specified by the issuing authority. The scope of the allocation may be narrow or wide: for example, a

grant for secondary school teaching is obviously less restrictive than a grant to develop the use of IT in secondary schools.

- With the calculation method criterion, a distinction is made between matching and lump-sum transfers:
  - *Matching* (or conditional) grants are tied to a specific expense, with the amount received varying according to either the amount of the grant-aided expenditure or the share of own finance that the beneficiary authority is willing to devote to the grant-aided remit.
  - *Lump-sum* (or non-matching) grants are when the beneficiary authority receives a fixed amount to spend (for the designated remit if it is a specific grant, but not necessarily), regardless of their own contribution, and in the case of tax sharing, if the amount is preset and guaranteed in proportion to tax revenue.
- With the availability of funds criterion, a distinction is made between closed-ended and open-ended grants:
  - *Closed-ended* grants are where the total budgetary means made available by the donating authority for a grant-aided remit are limited. But then selection criteria must also be set for when the sum of the individual demands exceeds the means made available.
  - *Open-ended* grants generally mean that an authority can receive a grant when certain conditions or criteria are met – the authority is entitled to the grant regardless of the financial situation of the authority that is paying the grant, with the paying authority unable to cite its budgetary situation or current circumstances as a pretext for refusing or reducing the grant.

If one takes into account the objectives of the financial transfers described at the start of this section with the three pairs of criteria mentioned (utilisation, calculation method, availability of funds), one ends up with **five typical situations**, which match the expected results:

1/ Incentives to increase the quantity and quality of the decentralised public services can be obtained through specific and lump-sum grants:

- specific, to tie the utilisation of the amounts received to the task being encouraged;
- lump-sum (unconditional), because the amount of the transfer must not depend upon the expenditure that the beneficiary authority would be spontaneously prepared to approve for this task, as precisely this expenditure is insufficient.

2/ Compensation for the requirements and costs of decentralised public services that must meet standards for tutelary goods imposed by central government could be made through specific, matching, and closed-ended grants:

- specific, to ensure that local expenditure is earmarked towards the tutelary domains;
- matching, because calculation of the amount depends on the gap between needs or costs and the standard set for the grant-aided remit;
- close-ended, because closed-ended grants have a greater stimulative effect on local expenditure than open-ended grants.

3/ If the intervention is of a correctional nature, for example regarding the spillover effects of the benefits gained from decentralised public services, grants should be specific, matching and open-ended:

- specific: i.e. tied to the task at the root of the spillover effect ;
- matching: i.e. proportional to the expenditure that causes said effect;
- open-ended: so that the production of services with a positive spillover effect is not restricted by budgetary limitations – the extent of the externality is the determining factor.

4/ The sharing of resources, serving either to distribute financial means within a fairly uniform system or to resolve a budgetary impasse, can be achieved through general and lump-sum grants:

- general: the beneficiary authority is free to dispose of the amount as it sees fit;
- lump-sum: the objective of sharing resources is not to direct the supply of decentralised public services towards a particular usage, and the amount to be allocated should be predetermined and guaranteed.

5/ Equalisation also justifies a general and lump-sum grant. In this case, the difference when compared to grants aimed at revenue sharing is solely linked to distribution criteria: the resources are shared according to the origin of the funds, while equalisation in the strict sense brings the financial capacity of the beneficiary authority into the equation. In the case of equalisation, access to transfers is sometimes subject to additional conditions, such as a minimal fiscal effort or the prior reorganisation of local financial management (for example the application of the polluter pays principle for environmental remits). Equalisation grants may be:

- general: the beneficiary authority must be free to dispose of the amount as it sees fit;
- lump-sum: the amount is predetermined and guaranteed.

In short, there are good reasons for not restricting local authorities' revenue to solely their own resources. Financial transfers coming from higher government levels can be legitimate from the moment their objectives are legitimate.

But not all types of transfers are equally efficient with regard to the objectives. No types of transfers are "good" in themselves, but there are good and bad matches between transfer types and desired objectives.

At most it can be asserted that, in general, transfers that leave local authorities the greatest room for manoeuvre (in terms of amounts and the choice of how to use them) are favourable towards the exercise by local authorities of decentralised prerogatives. Such is the case of general, lump-sum and open-ended transfers. Yet other conditions necessary for the effective performance of devolved responsibilities must also still be met: thus, for example, there is little sense in distributing general transfers to authorities that lack the staffing, material, legal framework or accounting means to exercise their responsibilities.

3. Causal factors of the processes behind the current trend for local resources mobilization

With reference to the analysis above, **intergovernmental transfers as they are implemented today, and their associated reforms, fall within four major trends**:

1. All countries have set up mechanisms for sharing tax revenue**.** With the usual advantages and undesirable effects:

- These mechanisms enable problems of vertical fiscal imbalance to be resolved. If they are

distributed according to the principle of derivation (whereby the central State pays each authority a fraction of the tax revenues collected in their territory), this can be expected to have an incentivising effect on local economic development as a fraction of the tax receipts returns to the local authority.

- However, undesirable effects include the spatial concentration of resources, mirroring the spatial concentration of activities, and the disincentive for the local authority to raise its own tax revenues. Yet these effects must be put into perspective in a good number of developing countries (notably in West Africa) where the annual amount of tax revenue transfers established by law gives rise to unexpected adjustments (cuts in the amounts, delays, and so forth) that render any medium-term budget projections uncertain.

2. A certain number of countries have created transfer mechanisms aimed at reducing financial inequalities between local authorities. This is always the case in developed countries (with sometimes major differences, particularly between unitary and federal countries), often the case in Latin America, occasionally the case in Asia, but rarely the case in Africa.

The formulas employed are usually explicit, sometimes less transparent (in various Asian countries). They are generally based on levelling potential tax revenues (the fiscal potential per inhabitant) (or more often on reducing inequalities). But how this fiscal potential is defined and measured is often incorrect or incomplete: incorrect in that actual tax resources are used to indicate potential tax resources (which neglects the fact that, with identical fiscal potential, some authorities may collect more than others, because they set a higher rate of taxation or they make more effort to keep count of taxpayers or to collect the taxes); and incomplete in that certain equalisation systems take just a part of the potential tax revenues into account (leading to frequent debates, particularly in federal countries, over the perimeter of the representative tax system).

Equalisation mechanisms that are properly founded should also take “spending needs” into account, i.e. the expenditure which the local authority should, all other things being equal, make within the devolved areas of authority, bearing in mind their specific “situation”, which is often understood by reference to the average expenditures calculated across all the local authorities and believed to be representative of an “average situation”. The complex implementation of this concept, with its common difficulties and manipulation risks, has meant that many countries – particularly developed countries – no longer resort to this criterion for distributing equalisation grants. Other countries, meanwhile, have made it their sole criterion for equalisation grant distribution.

3. Aid granted to local authorities for capital expenditures often takes the form of conditional grants. Financial aid from the State is generally subject to the beneficiary authority’s compliance with the typical standards for the envisaged facility. Use of this type of grant is very unevenly distributed. In certain regions around the world (Eurasia, for example) conditional grants are almost non-existent, while in other regions they are the principal form of aid for local authorities. Their usage gives rise to a certain number of recurring problems:

- They are still often erratic and highly complex these days (in France, for example, there were over 1500 sections on the Caisse des Dépôts et Consignations’ list of the characteristics required for local investments eligible for State grants in the 1970s – an

"example" still followed in various African countries).

- But they also have two negative effects with even longer-lasting effects. First of all, they encourage local authorities to equip themselves in areas, with facilities, and to timescales that do not necessarily coincide with their own priorities, but rather with the concerns of the central State. Secondly, and most importantly, coordination between the financial aid for investment and the release of recurrent financial resources is far from assured. The mechanisms for investment aid and those for standard transfers are rarely coordinated. The budgetary and accounting constraints imposed on local authorities do not induce them to include the recurrent costs of the facilities funded thus in their forecasts. This also goes for certain aid programmes, for facilities in disadvantaged areas that are run by international sponsors, which do not concurrently and credibly include the reinforcement of recurrent financial capacities.

4. The final increasingly utilised mode of intergovernmental transfer concerns performance-based grants, notably imposed by certain international donors**.** The big picture is similar to the conditional grants mentioned above. They simply differ in two aspects: in the area to which their conditions apply – these are generally criteria of "good local (financial) governance" – and in the fact that they are not tied to a specific expense and can instead be used freely. However it is too soon to measure their effects here.

Annexe 1: Bibliography

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