



# Local Public Finance in Europe

## Country Reports

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## Preface

There is widespread consensus amongst academics and practitioners: local governments do matter. They deliver a variety of essential public services for their inhabitants. Their political systems are closest to citizens. At no other level of the political-administrative system, political processes are so approachable and ostensive, the barriers of an immediate participation of citizens so low. No other political level does offer comparable options of getting directly involved with politics and thereby influencing and shaping someone's own real life-world context straightforwardly and effectively according to own preferences. Moreover, municipalities function as schools of democracy and build a framework for identity and social cohesion. Those functions are valuable for the state itself. Consequently, there is no lack of commitments by state officials in strengthening local government. At the core of local governments' ability to fulfil the abovementioned functions is local public finance. It is the cornerstone of any workable local government. Without a sound financial footing, municipal governments are not able to meet the requirements requested by their citizens and the state in general.

In contrast to the widespread conviction about local governments' relevance in public service provision, there is little research about local finance from an international comparative perspective. This holds true in particular for two foci: the impact of the great financial crisis of 2008/2009 on the state of local public finances and the regulation of municipal budgets by higher-level governments.

The regulation of local government finance is a multi-level governance task that any country needs to address. Typically, local governments deliver essential public services, but are not financially self-sufficient. Therefore, higher levels of government do not only provide local governments with financial means via intergovernmental fiscal grants, but also need to supervise local fiscal behaviour in order to prevent budgetary crisis as well as to ensure a sustained service provision. Higher levels of government hence established regimes of fiscal governance, intended to monitor local budgets and keep local finances under control. By this, those regulatory regimes create remarkable budget constraints and foster fiscal adaptation and consolidation pressures, especially in case of emerging budget deficits and rising debt levels. Nonetheless, those regimes have hardly been analysed, yet. One can easily call this a blind spot of local government research.

Therefore, the country reports, which this book presents, outline the basic features of local fiscal regulations, like fiscal rules, organization and procedures of monitoring compliance with this regulatory framework as well as enforcement mechanisms in case of rule violations.

The recent financial crisis of 2008/2009 has been a severe external shock for public finances. It did show dramatic and ongoing consequences in many countries around the world. Although plenty of research points to the effects of the crisis on the national level, comparably little do we know about its impact on local governments and their fiscal stance (noticeable exceptions are Bailey & Chapain 2011; Steccolini, Jones & Saliterer 2017).<sup>1</sup> The following country reports show that some states have effectively cushioned their local levels against the negative consequences of the economic downturn; in other states the crisis displayed direct or indirect effects on budgets, regulatory regimes, but also in unexpected fields. The financial crisis did change the central-local-relationships in different ways.

We deepen those matters in the way of single country reports. In all, we cover 22 countries, 19 of them being members of European Union. This selection refers to the idea of showing a wide variety of settings rather than to give an exhaustive picture of EU-members.

Each country report follows the same outline and gives answers to the following questions: (1) What is the administrative structure of the country at whole and of the local level in particular? (2) By which sources local governments are funded? (3) For which functions do they spend their financial means? (4) How is the current fiscal status of the local government level in the respective country? (5) Which repercussions did the financial crisis unfold on local public finance? (6) How do states supervise and regulate local budgets? The first three questions are rather common themes of research. Nonetheless, they are not only alone relevant by themselves and worth being repeated periodically, but they are also necessary framework conditions to light the picture of financial crisis impacts on and state regulation of local public finance.

<sup>1</sup> Bailey, David; Chapain, Caroline (2011) (eds.): *The Recession and Beyond. Local and Regional Responses to the downturn*. London & New York: Routledge. Steccolini, Ileana; Jones, Martin; Saliterer, Iris (2017) (eds.): *Governmental financial resilience. International perspectives on how local governments face austerity*. Bingley: Emerald Publishing Limited.

## List of Authors

In general, all country reports built on literature, be it academic, practice or public reports, listed at the end. Another common pillar is the use of EUROSTAT Government Finance Statistics data, supplemented by data from the OECD fiscal decentralization database, feeding in a comprehensive set of figures on financial indicators<sup>2</sup>. These information were complemented by expertise from national experts, either practitioners or academics in the field of (local) public finance or local government to validate and enrich those findings.

This book is written for academics and practitioners. It seeks to provide a general overview on each national system of local public finance, showing structural lines, rather than to perform an in-depth-look in every country. The latter approach would easily have overstressed the capacities of any research endeavour. We follow an explorative design focusing on basic features, presenting a fundament for comparative analysis, and a reference book on local public finance benefitting all those, who wish to gain a fresh and basic understanding. As this sample of countries will show, there is huge variance on all features of local public finance. Kind of basic description and exploration is the starting point for any further deepening research. Not at least we want to foster international discussion and mutual understanding.

This book is a joint endeavour by Bertelsmann Stiftung and Hertie School of Governance. Both institutions share a common belief of the relevance of local governments in general and of sound public finances in particular. Both institutions built a group of researchers supplemented by a large number of national experts. We want to thank all the ones involved.

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<sup>2</sup> As for the Non-EU member countries Canada and Switzerland, no EUROSTAT data was available, we had to use alternative data sources. In these two cases, we rely on data from the OECD and national statistical offices, whereby we tried as hard as possible to find financial data comparable to the EUROSTAT data.

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## Indicators and Data

Next to extended desk research and expert interviews, a further pillar of the presented country reports consists of aggregate fiscal indicators which give an overall impression of the local fiscal situation in a country. Since aggregate data is provided, no information of the within-country distribution of variables like local government debt or expenditure is given. Data sources of the displayed indicators are the Eurostat Annual Summary Government Finance Statistics<sup>1</sup> consistent with the ESA2010 system as well as the OECD Fiscal Decentralization Database<sup>2</sup>. We present yearly data for the period from 2000 to 2016 (exception: Tax- and Transfer Shares, which end in 2015). Additional to the specific country data, most indicators also display the EU28 average.

Speaking of the local level, we follow the Eurostat distinction of unitary and federal countries. Whereas in unitary countries without any intermediate regional level the local level comprises all governments below the central government level, the local level in federal countries consists of all governments below the regional level. Since the presented data covers the government sector only, public enterprises are not considered. For most indicators, general government data is used for indicator calculation. General government (S13) comprises the consolidated sum of the central government level (S1311), the regional government level (S1312), the local government level (S1313) and social security funds (S1314).

### The following indicators are part of the reports:

- 1. Local Government Aggregate Revenue as Share of General Government Revenue:** Total general and local government revenue exhibit the sum of tax revenue (ESA codes D.2r+D.5r+D.91r), social contributions (D.61r), sales (incl. own account capital formation, P.11+P12+P.131), other current revenue (D.39r+D.4r+D.7r), and capital revenue (D.92r+D.99r). For the indicator the ratio of the local government level over the general government level of a certain country is presented for any given year. The indicator depicts how much of all public revenue can be attributed to the local level.

<sup>1</sup> <https://ec.europa.eu/eurostat/web/government-finance-statistics/data>

<sup>2</sup> <https://www.oecd.org/tax/fiscal-decentralisation-database.htm>

2. **Local Government Aggregate Transfers and Taxes as Share of Total Local Government Revenue:** The two indicators show the local government aggregate transfer and tax revenue as share of total local government revenue in a certain country for any given year. Whereas transfer dependency is a common measure for the so called Vertical Fiscal Imbalance (difference of own expenditures and own-sourced revenues), the tax share proxies the local governments' use of own-sourced revenue stemming from local taxation. Whereas the tax share is directly calculated with Eurostat government finance statistics, the transfer share was retrieved from the OECD Fiscal Decentralization Database (indicator 10).
3. **Local Government Aggregate Expenditure as Share of General Government Expenditure:** Total expenditure of the local level is the sum of intermediate consumption expenditure (P.2), compensation for employees (D.1p), interest payments (D.41p), subsidies (D.3p), social benefits (D.62p+D.632p), other current expenditure (D.29p+D.5p+D.42p+D.43p+D.44p+D.45p+D.7p+D.8), capital transfers (D.9p), and capital investment (P.5+NP) (including gross fixed capital formation, P.51g). The indicator exhibits how much spending responsibilities are delegated to the local government level from higher levels of government and therefore proxies the level of fiscal decentralization in a certain country in each given year.
4. **Local Government Expenditure by Function as Share of Total Aggregate Local Government Expenditure:** The indicator shows local government expenditures disentangled by the conventional COFOG classification of functions of government (general services; defense; public safety; economic affairs; environmental protection; housing and community amenities; health; recreation, culture, religion; education; social protection) as share of total aggregate local government expenditure. Shares for the years 2006 and 2015 are provided. They allow for assessing the expenditure intensity of local level governments in certain expenditure fields and provides an indication of changing public service provision over time.
5. **Nominal Gross Domestic Product:** In order to proxy economic development in a certain country, we follow the Eurostat convention in the Annual Summary Government Finance Statistics Database and display nominal "Total Gross Value Added" (B.1g).
6. **Local Government Aggregate Budget Balance as Share of National GDP:** Local government aggregate budget balances (surpluses/deficits) of a certain country in any given year are the differences of revenue and expenditure and are displayed as ratio over nominal national GDP. It indicates whether the local level spends more money than it receives.
7. **Local Government Aggregate Debt as Share of General Government Debt:** Nominal local government level debt of a certain country in any given year consists of losses created by exchange rate risks due to holdings of foreign currencies (of minor importance, AF.2), of short- and long-term debt securities (AF.3) such as bonds and of short and long-term loans (AF.4) recorded at nominal value. The sum is depicted as share of general government debts (equally structured) and indicates the relative importance of the local level in terms of national public debts.
8. **Post-Crisis Developments:** Local government debt, revenue, and expenditure (in millions in national currency) are displayed in percentages of the base years' value (2007=100). The three indexed time series indicate how central fiscal aggregates of the local level reacted to the financial/sovereign debt crisis.



# 1 | Austria

René Geißler, Falk Ebinger

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### Summary

Austria is a federal country consisting of nine states (including the City of Vienna). These states include a one-tier local level composed of 2,100 small municipalities. Approximately two thirds of local revenue builds on shared taxes and grants. Expenditures such as welfare, education and health make up about 50% of local spending. The overall fiscal situation is challenging. The financial crisis hit Austria in 2009, which resulted in a temporary decline of the GDP. Local governments showed significant deficits in 2009 and 2010. Nonetheless, returning to rising transfers from federal and state level, local government budgets recovered without reaching positive balances.

Austrian municipalities are obliged to adhere to the balanced budget rule. Debts are generally restricted to fund capital spending. Regulation on short-term credits is strict. There are definite ceilings, and they usually have to be paid back within the respective fiscal year. Fiscal rules and financial supervision are state law, in general. The federal constitution regulates some fundamentals of supervision. However, the states execute local level fiscal supervision, be it at the ministerial or the district level. The respective office mainly depends on the actual subject of supervision. If a municipality is not capable

of following fiscal rules, a range of instruments is at the supervisory body's disposal. Supervision can demand special measures, or municipalities might apply for conditional grants by the federal state. Supervisory bodies implemented auditing, as well. By this, they gain a deeper understanding of fiscal status and can back up their supervisory decisions. Austria is a country with a very centralised fiscal policy. The introduction of the Austrian stability pact in 2012 was another step in this direction.

## 1 Administrative Structure

Austria is a federal country consisting of nine states (including the City of Vienna) and approximately 2,100 municipalities (Figure 1.1). Local governments are part of and subject to the states (Article 116 of the Federal Constitution). They have (fiscal) autonomy, granted by the federal and state constitution.

Among these municipalities are 14 so-called statutory cities ("Statutarstädte", without Vienna) in charge of a broader set of services/responsibilities. The remaining municipalities are part of the 79 state districts ("Bezirkshauptmannschaften"). Those are state bodies, organisationally integrated into the state administration. Statutory cities exercise local and district services at the same time. There is a huge variation in population size among local governments (see Table 1). There are only five cities having more than 100,000 inhabitants (Vienna, Graz, Linz, Salzburg and Innsbruck). As the number of inhabitants per municipality is rather low, many municipalities have merged over the years or engage in forms of cooperation. Major functions of municipalities are welfare, health, education (kindergarten, school infrastructure) and utilities. The states have devolved most of these functions to the local level.

FIGURE 1.1 Austria – Administrative Structure, 2017

Central Level	Federal Level	
State Level	8 territorial states	1 city state
	79 state districts	
Local Level	2,100 municipalities	14 statutory cities

Source: own representation

TABLE 1.1 Austria – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Statutory City (without Vienna)	Rust (1,900)	Graz (284,000)	85,000
Municipality (without Vienna)	Gramais (47)	Dornhirn (48,779)	3,300

Source: Statistics Austria

## 2 Revenue

In general, the share of total public revenue and spending of local governments is small and far below the EU average (Figures 3 and 4). There is a slight long-term trend in growing local revenue shares, which is, amongst other things, caused by rising welfare spending (see Figure 3). The vast majority of Austrian local revenues builds on transfers, although this number includes shares of combined taxes (Figure 1.2).

Local taxes are the municipality tax and property tax. Historically, the share of own-sourced tax revenues significantly has decreased over time due to the repeal of the beverage tax in 2001. Generally, the total amount and the structure of local revenues depends heavily on the federal equalisation system. Local tax autonomy is rather low (Korac 2017: 19). The individual revenue composition of each municipality is a result of different factors, among them its economic strength, size and the state in which it is located.

The most relevant local tax is the municipality tax (Kommunalsteuer), which is a type of business tax calculated on the sum of a company's salaries. The tax rate is 3% and set at the federal level. The second most relevant local tax, but by far smaller, is the property tax. Each municipality is responsible for setting its own property tax. As the assessment base has not been adjusted since 1973, this tax is currently under reform. In general, own source tax revenues per capita increase with municipal growth. On national average, municipality tax revenue comprises about two thirds of total local taxes and is four times higher than property tax revenue (Kommunalkredit 2017: 39). About one fifth of current revenue is comprised of those local taxes.

There is a federal financial equalisation law in Austria, which regulates the allocation of revenues between the federal, state and local levels. The shares of combined taxes are the most important source of revenues. The most relevant combined taxes are value added tax, personal income tax, corporate income tax and petroleum tax. Approximately 12% of those taxes are distributed among municipalities according to population (Kommunalkredit 2017). However, since the allocation formula includes caps based on population size, municipalities with more than 10,000 inhabitants receive significantly higher shares per capita.

There is a discrepancy between the western and the eastern parts of Austria regarding the amount of own-sourced taxes and the shares of combined taxes, with the western part economically/financially stronger and benefitting, in addition,

FIGURE 1.2 Austria – Local Government Aggregate Revenue  
As Share of General Government Revenue – From 2000 to 2016

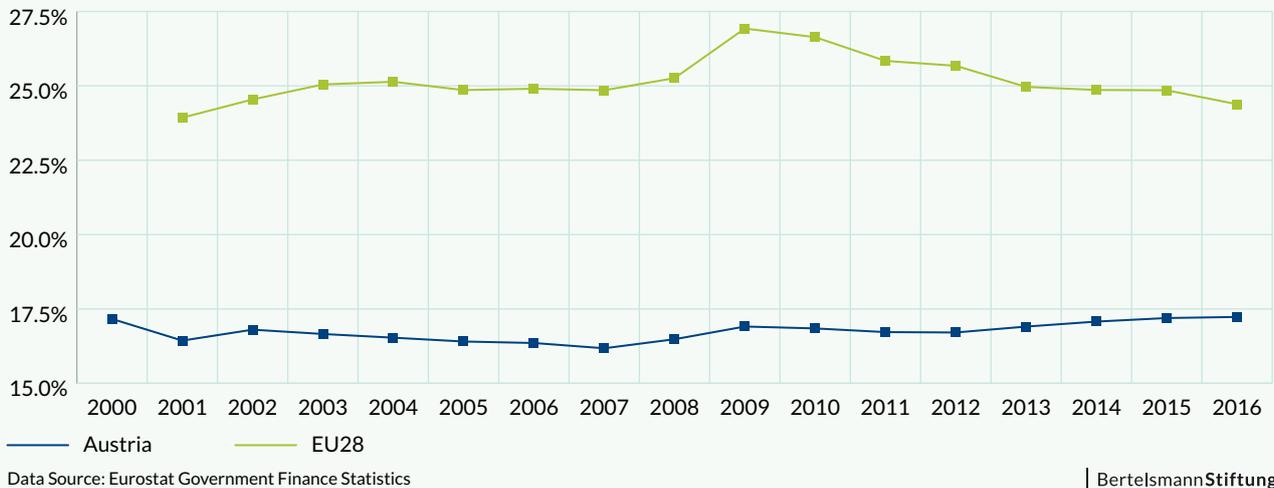
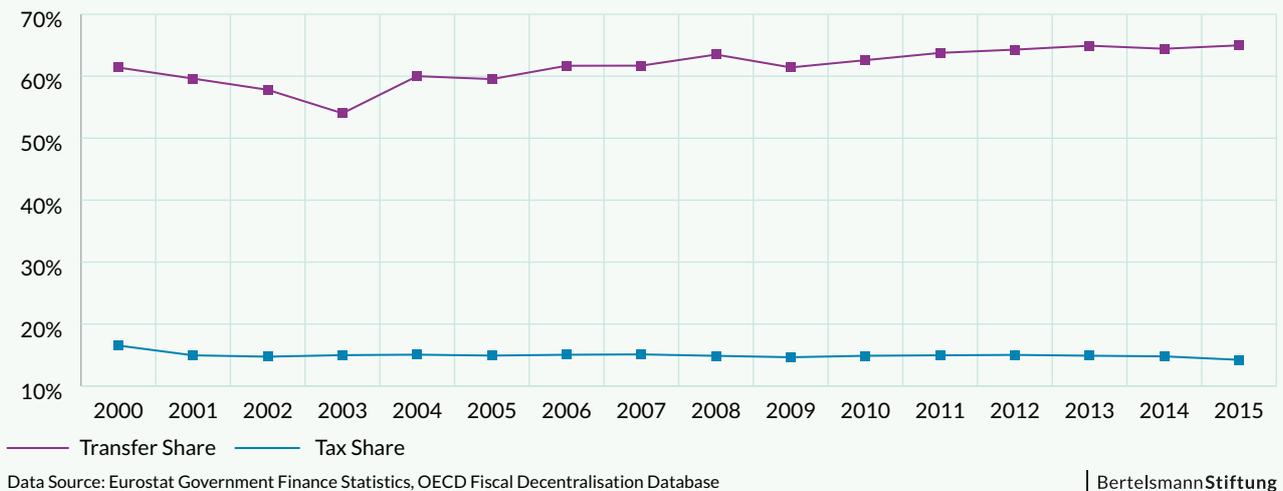


FIGURE 1.3 Austria – Local Government Aggregate Transfers and Taxes  
As Share of Total Local Government Revenue – From 2000 to 2015



from higher compensation payments by the (federal) level for repealing the beverage tax.

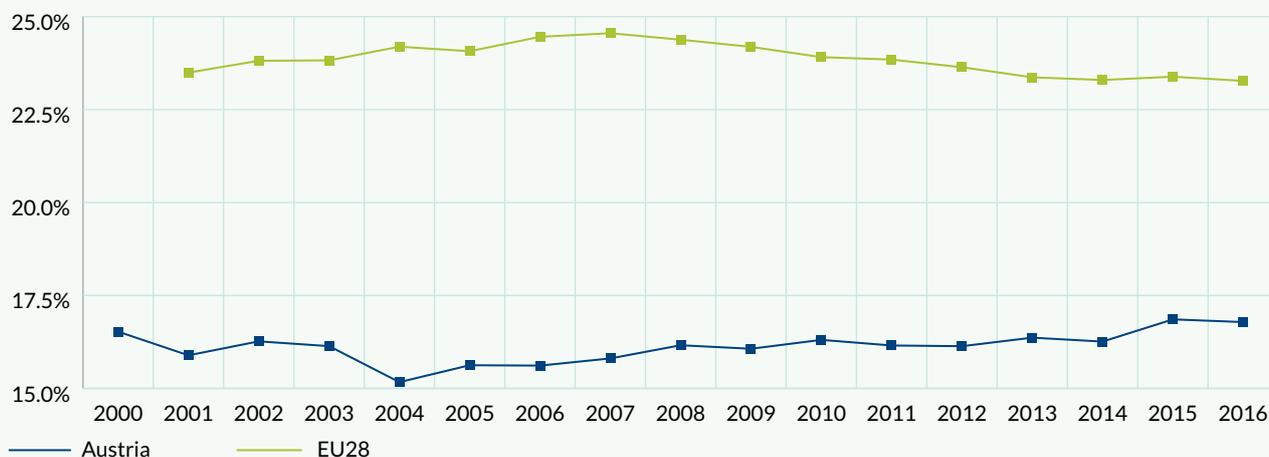
Therefore, the equalisation system builds on shared tax revenue; there is a minor share of local revenue generated by real grants from state and (marginally) federal budgets. In fact, from the municipal perspective, the aggregates of transfers from/to the state level is even negative. This constellation refers to the fact that particular transfer municipalities must pay for state-level welfare spending (Kommunalkredit Austria 2017: 17).

### 3 Expenditure

Austrian municipalities must fulfil both of their own tasks as well as tasks devolved by the state and federal levels. Important functions are the construction of streets and bridges, kindergartens, compulsory schools (“Pflichtschulen”), hospitals, fire stations, theatres, sports grounds, cemeteries, local public transport, water supply, sewage and waste disposal, energy supply, work with the elderly and social welfare (Figure 1.5). When it comes to expenditures, welfare, education and health account for the majority of spending.

FIGURE 1.4 Austria – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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Those are also functions with strong increases over time, which explains the growth in local spending (see Figure 1.4). Another perspective finds that staff salaries cover about a quarter of expenditure. With regard to capital spending, education, traffic infrastructure and services account for approximately 80%.

## 4 General Fiscal Status

The overall fiscal situation of Austrian municipalities is challenging. Long-term budget deficits have been shrinking for the past several years, but have not yet reached positive numbers (see Figure 1.7). Local debt has doubled since the financial crisis (Figure 1.9), with a growing share carried by the small municipalities (Kommunalkredit 2017: 105)

Nonetheless, relevant indicators show positive trends, e.g. rising deposits (Kommunalkredit 2017: 14). Capital spending has grown for several years and remains high, which is one explanation for rising debt levels (Kommunalkredit 2017: 27). Total local revenue grew by 16% in the period 2012 to 2016 (Figure 1.9).

In 2016, the federal government decided to adopt the financial equalisation system. The period of 2017 to 2021 will see some changes with, positive consequences for the local level, which includes a structural increase in local revenues (Kommunalkredit 2017: 12 ff.).

The national government has repeatedly devolved further tasks without adequate compensation (Kovac 2017: 31). There are complaints about rising welfare expenditures but also about healthcare. Welfare spending in particular doubled in the decade from 2001 to 2011 (Kommunalkredit 2017: 25). In 2012, a new funding system (Pflegefonds) was implemented, which led to a decrease in expenditures. The federal level finances the largest share of this fund. Nonetheless, health and education expenditures continue to rise.

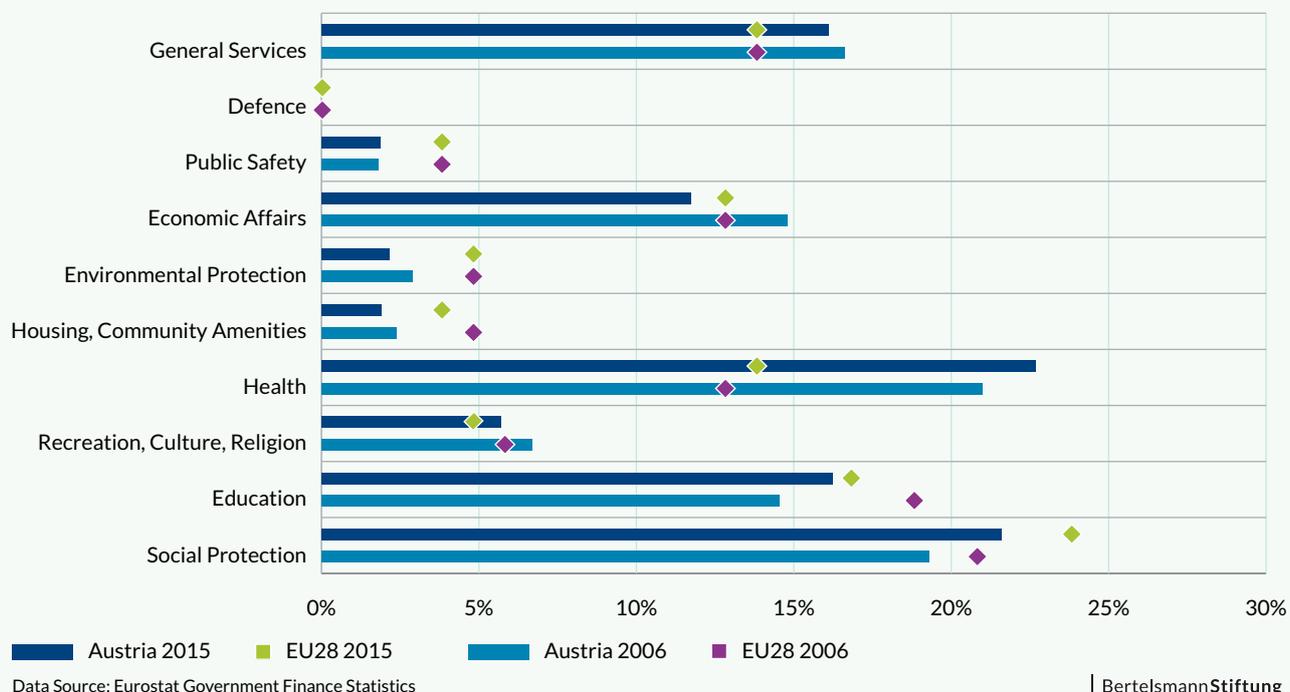
Moreover, the fiscal situation is difficult especially for economically weak municipalities, which are also small, located in rural areas and depopulating. These municipalities face not only higher fixed costs related to their investments/service provision, but also restraints to increases in their levies and fees. In contrast, some larger municipalities face financial difficulties due to urbanisation trends and subsequent needs for higher investments. Although there are some complaints regarding inadequate funding at the local level via transfers and grants, the equalisation system seems to function well.

## 5 Effects of the Financial Crisis

The financial crisis hit Austria in 2009 and resulted in a decline in GDP, which quickly recovered in 2010 (Figure 1.6). Consequently, revenues from shared taxes declined, with local governments recording substantial deficits in 2009 and 2010 (Figure 1.7). There was no real drop in own-sourced municipal tax. In total, local revenue was almost stable from 2008 to 2009 but remained in line with expenditures from

FIGURE 1.5 Austria – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



2010 on. Nonetheless, stagnating revenues compared to rising expenditure needs in some functions created budgetary challenges. Local debt doubled in the period 2007 to 2016 (Figure 1.9). The ambition to overcome the deficit trend was followed by a new system of welfare funding, which was implemented in 2012. This has placed the lion's share of financial responsibility for local welfare expenditures at the federal level and disburdened local budgets. Generally, the financial crisis is considered as a turning point for local governments and fiscal federalism, and is leading to further steps of fiscal centralisation (Kovac 2017: 18).

With regard to EU law, the federal level, states and local governments agreed on an Austrian Stability Pact in 2012, which regulates budgetary coordination, debt brakes and European commitments (Matziner 2015: 150f; Korac 2017: 20f). Amongst other things, local governments are obliged to reduce their debts continuously until Austria complies with the Maastricht criteria (Kommunalkredit 2017: 11).

## 6 Fiscal Rules and Fiscal Oversight

Federal and state constitutions guarantee the right to local autonomy. However, states are still responsible for local

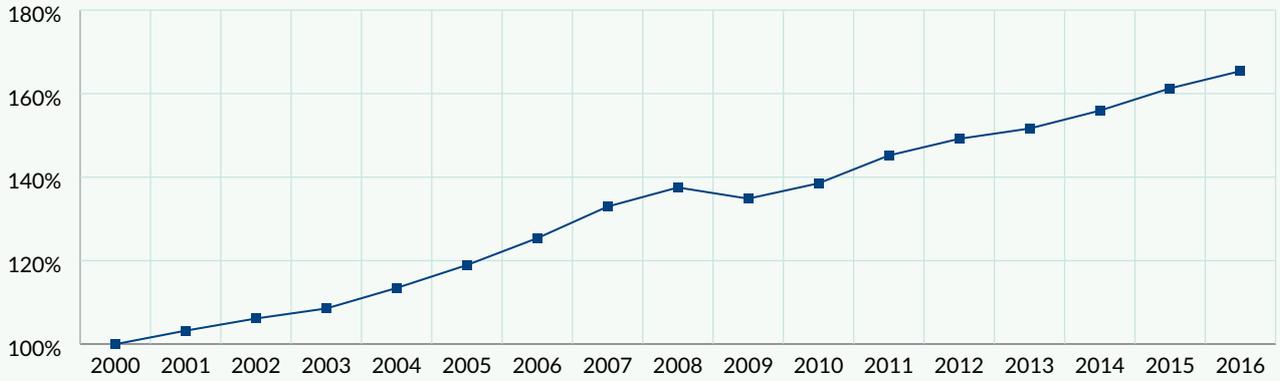
governments and have established their own regulations, which causes regulatory differences between them (Bröthaler et al 2015: 527). Despite this federal structure, the federal constitution contains declarations on financial overseeing, which also reflects a rather high fiscal centralisation (119a Federal Constitution).

Austrian municipalities are obliged to adhere to the balanced budget rule. Nonetheless, not every respective state law contains this rule explicitly (e.g. Carinthia). Debts are generally restricted to fund capital spending and are subject to state approval.

In return for local autonomy, states intensively oversee municipal budgets in order to ensure they comply with regulations (Niemann and Ebinger 2017). Supervision is carried out at the state ministerial or district level. The state government always oversees statutory cities, as they do not belong to a district. In overseeing normal municipalities, the body in charge mainly acts on the actual issue rather than the size of the municipality. By way of an example, districts as the lower level of state administration and supervision approve loans, and the state government itself approves the use of derivatives.

FIGURE 1.6 Austria - Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 1.7 Austria - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2000 to 2016

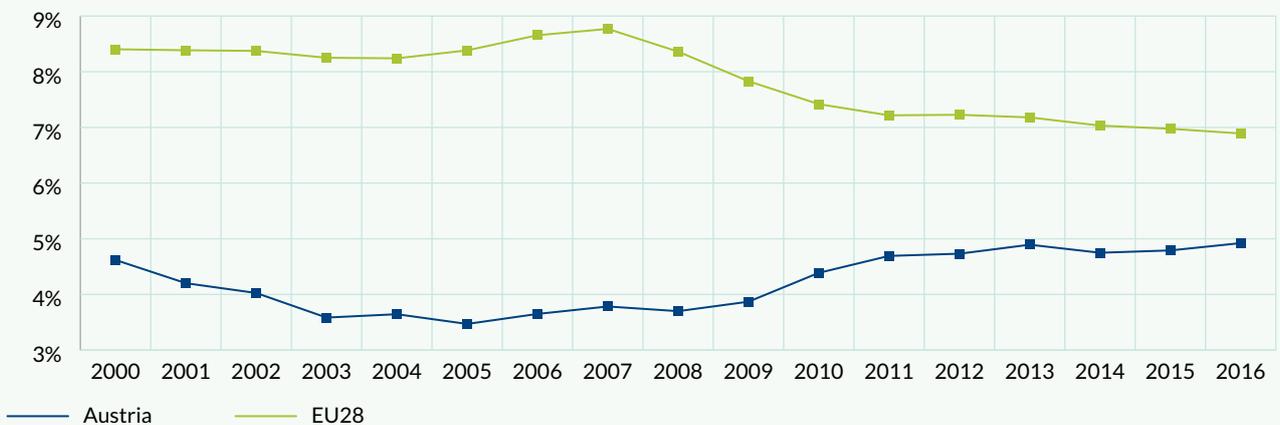


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 1.8 Austria - Local Government Aggregate Debt

As Share of General Government Debt - From 2000 to 2016

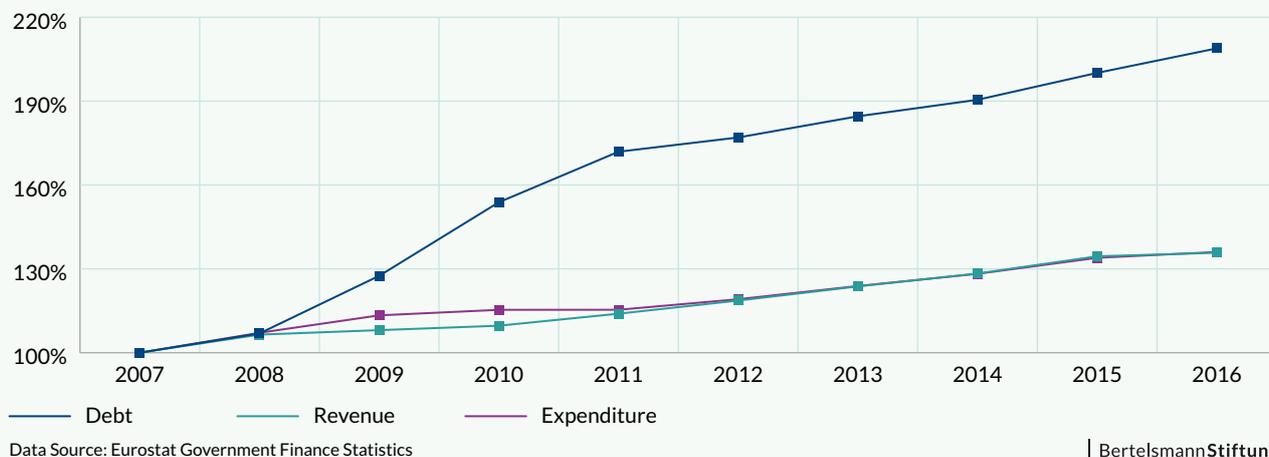


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 1.9 Austria – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



Before the fiscal year starts, municipalities must set up a budget (“Voranschlag”) containing all planned revenue, spending, capital spending and borrowing, which has to be sent to the respective supervisory body. There is no formal approval of the budget as a whole, but supervisory bodies have to notify it. The supervision authority focuses on specific transactions, which are subject to approval. In some Austrian states (such as Burgenland or Carinthia), loans for capital spending generally must be approved. In other states, they only have to be approved if they exceed specific thresholds.

Regulation for short-term credits is strict. In most states, there are definite ceilings for cash credits, which are in relation to current spending (e.g. one sixth of the total revenue of this year’s budget in Styria). Furthermore, cash credits usually must be repaid within the respective fiscal year. If a municipality is not able to do so, the supervisory body has various options. It can either demand that the deficits are returned within the next fiscal year (via additional savings or revenues) or the municipality receives special grants (for municipalities “in need”) from the federal state in order to balance its budget. There are consolidation requirements, which makes this a conditional bailout.

A range of instruments exists to enforce this fiscal regulation. Some are preventive (information, approval), some are restrictive (execution by substitution, dissolution of city council). Although local governments are a state matter, the federal constitution lists a range of instruments reflecting fiscal centralisation. Conditional bailouts as a way of auditing are also further instruments, but this is up to

state law. There is no information available on the general failing of supervision in Austria.

In addition to the right and duty to ensure that municipalities adhere to fiscal regulations, state supervisory bodies also audit local governments (“Gebarungskontrolle”). The object of the auditing process is the economy, the efficiency and the appropriateness of the municipal budgeting. Auditing is executed based on data, sent by the municipality as in-house investigations. Therefore, Austrian supervisory authorities have a further instrument to oversee municipalities. By this, they may obtain a deeper insight into the financial situation. Furthermore, they can also use this information to support their decision to approve (or not) municipal loans for capital spending. Municipal auditing usually takes place every four to five years. In addition to external auditing, there is an internal body (“Prüfungsausschuss”) which audits all revenue and spending affairs. Committee members are selected from city council members.

Some states have recently decided on an additional external audit of smaller municipalities by the Regional Courts of Audit. In contrast, the Federal Court of Audit is responsible for municipalities with more than 10,000 inhabitants. This could lead to an especially thorough auditing process, but could also end up in tricky “double structures”.

The states are not formally required to assist their municipalities in the case of fiscal trouble (e.g. in terms of a bailout). Legally, municipal bankruptcies are possible; nonetheless, its practical use as a market-based control mechanism is very doubtful. The latest bankruptcy took place in the 1930s. As in many

federal countries, there is an inherent bailout expectation at the expense of the states. Beyond this, in case of a bankruptcy, liquidation is limited to assets, which are not necessary for the fulfilment of local public services. If needed, states support their municipalities to prevent any larger financial problems.

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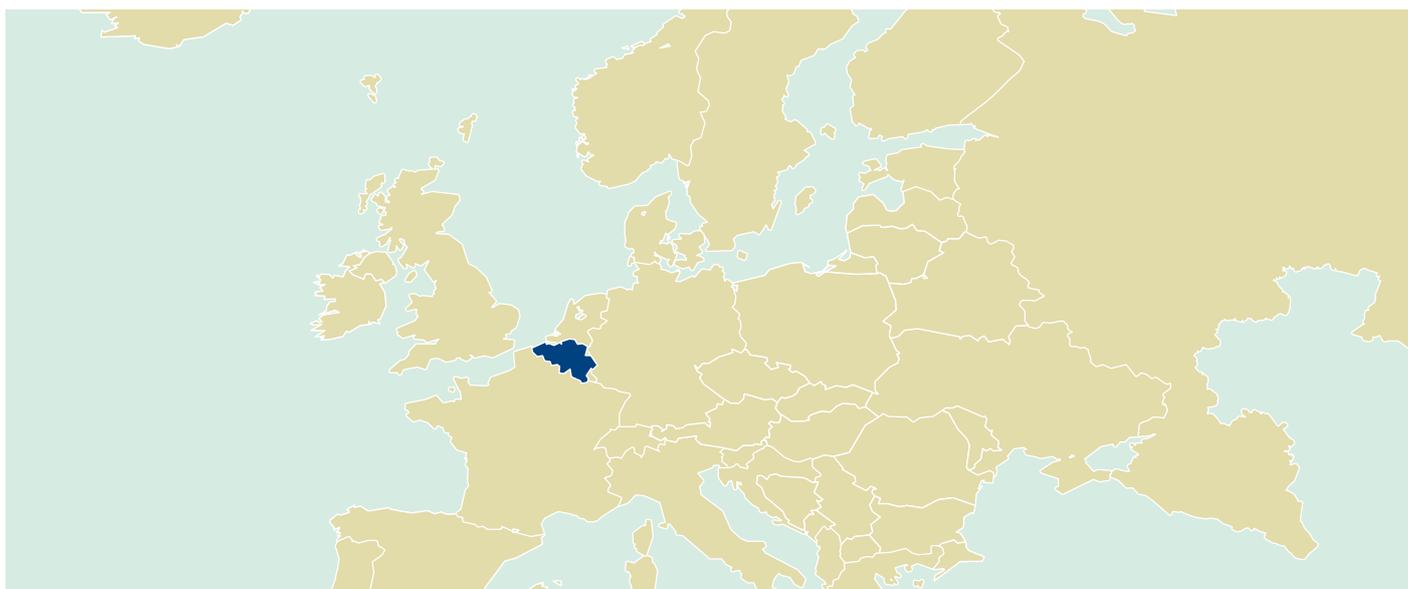
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# 2 | Belgium

Christian Raffer

### Summary

The Belgian administrative structure consists of three government tiers. The intermediate state level of regions and communities enjoys far-reaching political powers, which include the regulation of local functions and finance. The local level currently consists of ten provinces and 589 municipalities, which are relatively insignificant compared to the average EU28 member country in terms of budget size. The main expenditure areas are social protection, education and public safety. Since the regions (and communities) have a major influence upon municipal functions, regional differences among them are common. Like local share in expenditure, local share in general government revenue is small, too. Grants are the main source of income. Each of the three regions administers a municipal fund to finance the municipalities within its territory. Belgium has a relatively open tax system, which allows local governments to create their own taxes. In addition, a larger share of tax revenue comes from surtaxes on regional taxes (property tax) and a federal tax (personal income tax).

Local governments sustain a low and rather constant level of public debt. The financial crisis strained budgets, which were able to show the first post-crisis aggregate surplus only in 2015.

Whereas the Flemish municipalities are currently in good fiscal condition, the Walloon municipalities are suffering. Currently, approximately 20% are in the process of restructuring.

In terms of fiscal supervision, each municipality is subject to its region. Since Flanders, Wallonia and the Brussels-Capital Region have their own say in determining fiscal rules, there is a certain heterogeneity in regard to rules, oversight and enforcement. Whereas all municipalities are subject to a balanced budget rule, there are hardly any limitations on local government debt in Flanders, but strict limits in Wallonia. Flanders maintains no official bankruptcy or bailout mechanism for municipalities. The Region of Wallonia could step in and prevent a bankruptcy by providing additional funds, in the case of major risk. This, however, has not yet happened. In Wallonia, a budget draft and annual report must be approved by the Walloon government. In Flanders, approval for budget plans is not necessary, but is required for annual reports. Walloon municipalities breaking fiscal rules must implement a “management plan” controlled by the regional centre of assistance, which means restrictions in fiscal autonomy. In Flanders, regional governments can annul municipal budget plans.

## 1 Administrative Structure

The Belgian administrative structure consists of three government tiers. The federal structure was established by the constitutional reform of 1993 (Husson et al. 2017: 48). This reform also split up the former Province of Brabant into Wallonia and Flanders, while the area of the Brussels-Capital Region was no longer declared as part of a province. Today, the intermediate state level of regions and communities enjoys far-reaching political powers. From 2000 to 2016, Belgium imposed two major state reforms: the fifth reform in 2001 and the sixth reform in 2011 (in effect since 2014). These led to fundamental changes in the distribution of responsibilities among the different tiers of the government. Whereas the fifth state reform provided more financial autonomy and power over local governments to the regions and communities, the sixth state reform included further and greater transfers of competences and revised public financing schemes (Husson et al. 2017: 49).

The federal government (Federale Regering), as the highest level of government in Belgium, exerts its power over the entire country. It retains central competences (defence, justice, foreign affairs, and finance) as well as social security and important competences in the areas of public health and internal affairs (Husson et al. 2017). The federal state and the lower-level regions and communities are on equal standing (Christiaens and Neyt 2016: 27). The federal (and regional) level has the power to oversee lower-level policies (OECD 2010: 170). Since there is no hierarchy between the federal and the regional level, the Constitutional Court must decide any questions regarding the competences of the two. Federal legislative power lies with the government and the two chambers of parliament: the Senate (which has only very limited competences since the enactment of the sixth state reform) and the Chamber of Representatives (Woyke 2009: 455). Since Belgium is a constitutional monarchy, the King of the Belgians is the head of state.

The federal state consists of six “states” or “federated entities” comprised of the Flemish Region (Vlaams Gewest), the Walloon Region (Région wallonne or Wallonie) and the Brussels-Capital Region (Région de Bruxelles-Capitale – Brussels Hoofdstedelijk Gewest). In principle, the Flemish, the French and the German communities (Vlaamse Gemeenschap, Communauté française, Deutschsprachige Gemeinschaft) comprise the members of the respective language group, no matter where they live (Woyke 2009: 485). Since the Dutch-language speakers live in the northern part of the country, the Flemish Region and Community have equivalent territory. They

merged in 1980 and share the same institutions. The Walloon Region and the French and German-speaking communities did not merge but also have equivalent territory. Although surrounded by the Flemish Region, the Brussels-Capital Region has its own institutions and a bilingual French and Dutch population (Husson et al. 2017). Whereas the Flemish Region and Community have one parliament and government, each of the remaining “federated entities” has its own legislative body and government (Husson et al. 2017: 52). In order to ensure their own budgetary discipline, the federated entities adhere to institutionalised coordination; important coordinating institutions are the High Council of Finance (Conseil supérieur des Finances), the Coordination Committee (Comité de concertation) and the Interministerial Conference on Finance and Budget (Conférence Interministérielle des Finances et du Budget). In its annual report, the High Council of Finance also analyses the local governments’ impact on the country’s overall budget performance.

The three regions (Gewesten) are responsible for areas such as the environment and agriculture. They are also responsible for territorial matters, such as infrastructure and industrial policy, but also for employment and tax matters (OECD 2016). Only residual competences have remained at the federal level. The regions are responsible for the conventional oversight of provinces and municipalities – a duty provided by the fifth state reform in 2001 (Lambermont Agreement) (Woyke 2009). In terms of population, the Flemish Region is the largest with 6,552,967 inhabitants in 2018, followed by the Walloon Region (3,624,377) and the Brussels-Capital Region (1,198,726) (Statbel 2018). Flanders especially strives for more autonomy (Husson et al. 2017: 49).

The three Belgian communities (Gemeenschappen) are political entities based on language. The Flemish and the French communities exercise authority in the bilingual Brussels-Capital area. They are responsible for social issues (e.g. culture, education, welfare, health, sport) (OECD 2016). The 2011 state reform provided them with new competences, such as family allowances, elderly care and health care.

The local level consists of provinces and municipalities.

The ten provinces are located at the intermediate level, which includes the constitutional right of local self-government (Hammar and Wüthrich-Pelloli 2014: 117). They may act within “fields of provincial interest”; this rather vague formulation is consistent with the absence of clear competences established by law (Husson et al. 2017: 55). Hence, the responsibility profile of each province differs quite substantially. In general, their responsibilities are in the fields of education (especially

FIGURE 2.1 Belgium – Administrative Structure

Central Level	Federal Level		
State Level	Flemish Region	Walloon Region	Brussels Capital Region
	Dutch Community	French Community	Bilingual (Dutch/French)
		German Community	
Local Level	5 provinces	5 provinces	
	308 municipalities	262 municipalities	19 municipalities

Source: own representation

in the Walloon Region), social and cultural infrastructure, environment, roads and waterways, transport, etc. (OECD 2016), but they also have a certain degree of freedom to carry out their own initiatives (Hammar and Wüthrich-Pelloli 2014). In some fields, they have tutelage over municipalities (OECD 2010: 170). Brussels does not contain any provinces (Woyke 2009: 478). Councils are directly elected in the provinces, and are headed by an appointed governor who is both a commissioner of the federal state and of the region (Husson et al. 2017: 56). The governor exerts supervisory authority over the province, municipalities, municipal centres for social welfare, policy zones, and charge councils. According to national experts, there is an important and recurrent debate in Wallonia concerning the existence of provinces; a significant share of the population and many politicians are in favor of abolishing them. The current Walloon government has already passed resolutions to reduce their power and competences. Thus, in a few years the Walloon provinces may cease to exist.

In the 1970s, Belgium's 2,675 municipalities merged into the country's current 589 municipalities (Woyke 2009: 479). They form the lowest administrative level; 308 of them are located in the Flemish Region and 262 in the Walloon Region (whereas nine municipalities are part of the German Community) (Wayenberg and De Rynck 2008: 4). The Brussels-Capital Region consists of 19 municipalities. From 2019 onwards, the total number of municipalities will decrease to 581 by merging 15 Flemish municipalities into seven new municipalities. There will then be 300 municipalities in Flanders. Currently, the average municipality size is 19,314 inhabitants, whereas one third of municipalities have less than 10,000 inhabitants and eight have more than 100,000. Municipalities are governed by the local council, an elected mayor and aldermen (Vanneste 2002: 82). They are under the tutelage of higher administrative levels,

TABLE 2.1 Belgium – Population of Local Government Areas, 2018

	Smallest	Largest	Average
Provinces	Luxembourg (283,227)	Antwerp (1,847,486)	1,017,734
Municipalities	Herstappe (88)	Antwerp (523,248)	19,314

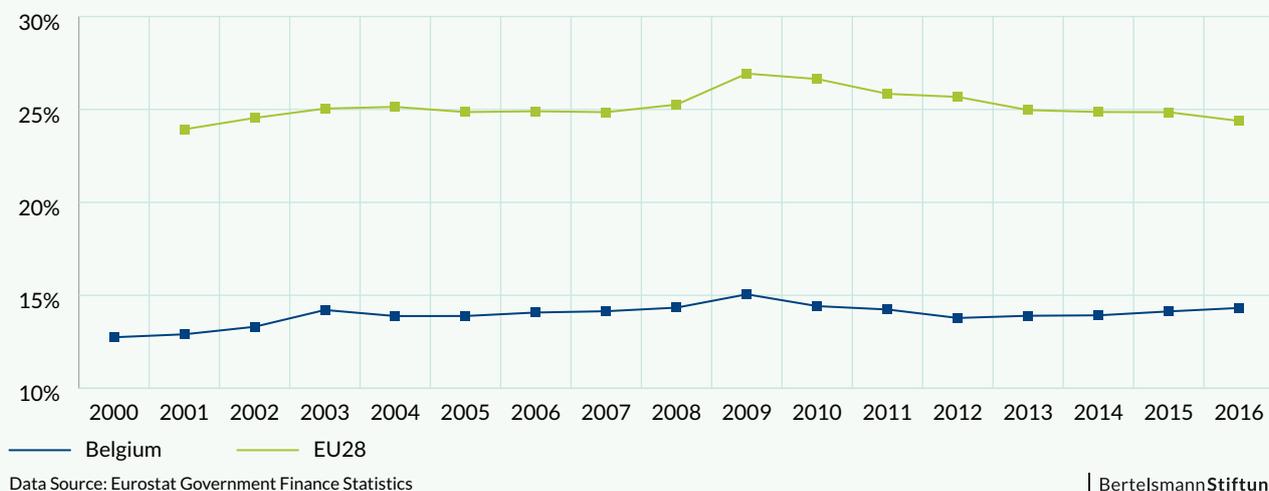
Data source: statbel (2018)

mainly the regions. Although they have the constitutional right to local self-government, municipalities have the mandate to maintain public law and order, and manage civil administrative functions and birth and death registries (OECD 2010: 170; Husson et al. 2017: 56; Wayenberg and De Rynck 2008: 6 ff.; Hammar and Wüthrich-Pelloli 2014). In addition, they are free to take over responsibilities of "municipal interest", such as town planning and roads, as well as education (mostly pre-school and primary schools), culture (libraries and museums) and sports facilities. They are also responsible for waste and water management, tourism, health and social welfare, the latter by maintaining the public centres for social welfare. These centres play a fundamental role in the municipal service provision; Christiaens and Ney (2016: 35) even list them as distinct parts of the local government level in Belgium.

Local governments can provide joint public services (Husson et al. 2017: 57). One form is the so-called inter-municipal structure, or company, in which municipalities and/or provinces pool their resources to maintain utilities (power, water, waste management), health care and economic development. The number of these public law entities is, however, declining due to rationalisation and mergers, especially in Wallonia. In 2015, there were still approximately 195. Other forms of cooperation take place in so-called policy zones (joint provision of public law and order) and fire departments.

FIGURE 2.2 Belgium – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



## 2 Revenue

Local (municipal and provincial) government revenues amounted to an average of 14% of the general government revenue between 2000 and 2016 (Figure 2.2). Over time, this share increased from (on average) 13.4% in the first five-year period (2000 to 2004) to 14% in the last five-year period (2012 to 2016), and peaked in 2009 at 15.1%. Measured as a share of the nominal national GDP, the aggregate revenue for local governments was 6.9% between 2000 and 2016. Over time, revenues increased from (on average) 6.6% between 2000 and 2004 to 7.2% (on average) between 2012 and 2016. From both perspectives, local revenues are significantly below the EU28 average. Thus, compared to other countries, the local level plays a rather limited but slightly increasing role in terms of general government revenues.

Belgium differs from other countries, based on its open system of local taxes (OECD 2016). Article 170 of the Federal Constitution allows local governments to create new local taxes. In principle, the municipal council is free to set the tax base and determine the rate of tax to levy (Council of Europe 2006: 39 ff.) on building permits, the issuance of administrative documents, the construction of sewage and water supply systems, etc. Although municipalities enjoy this unique freedom, it should be added that the law can also impose maximum rates on local authorities and that the regions – with their far-reaching control mechanisms – have the right to intervene. However, the repeated attempt by regions to set guidelines for this area of local taxation has had only limited

success (Husson 2017: 66). In addition to these taxes – which make up less than 10% of all tax revenues<sup>1</sup> (CoR 2018) – the larger share of municipal tax revenue comes from surtaxes (additional centimes) stemming from the regional property and vehicle taxes, as well as the personal income tax (PIT). This was a full federal tax until the 2011 state reform, which then made it a dual tax (75% federal and 25% regional) with surtaxes from the municipalities (OECD 2016). The surcharge on the regional property tax is the most important source for tax revenues, and is higher in Brussels than in Wallonia (Husson et al. 2017: 66). This is the only surcharge provinces may levy. Local governments can adapt these surcharges (Hammar and Wüthrich-Pelloli 2014: 195, 286).

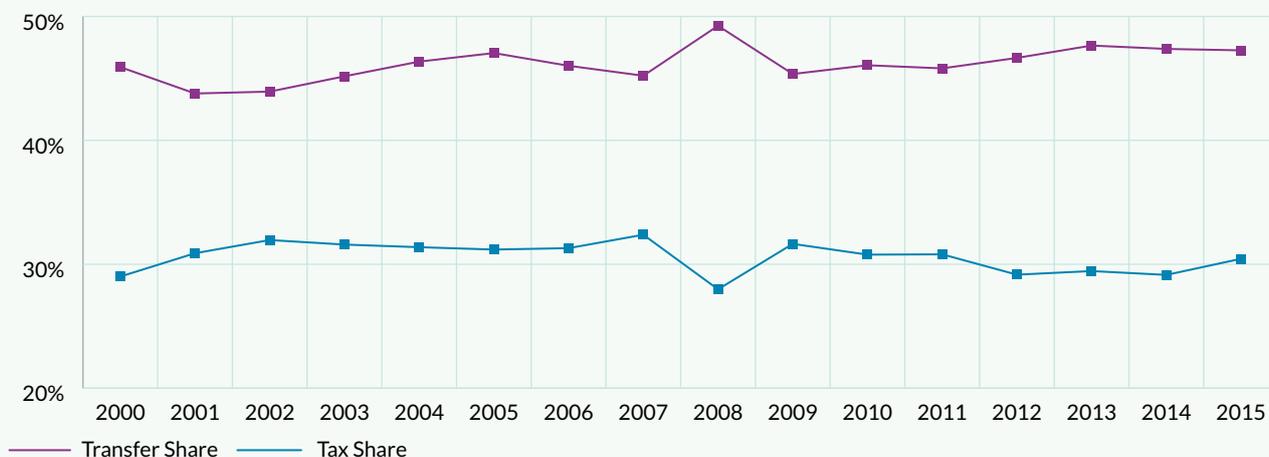
In general, the major source of income for local governments is transfers made at higher government levels and then handed through to municipalities, either in the form of earmarked subsidies or non-earmarked transfers; the latter comes from the regions' central municipal fund (Wayenberg and De Rynk 2008: 9; Council of Europe 2006: 42).<sup>2</sup> Each of the three regions administers such a "Gemeentefonds" to support the municipalities within their territory (Brand 2016: 37). There are also provincial funds; however, Flanders liquidated its fund in 2015. The regions and the German-speaking Community decide upon the repartition criteria regarding grants allocation

1 According to experts in Flanders, the share of self-imposed local taxes was 15% of all tax revenue, which currently accounts for approximately 50% of total municipal revenue. The share in Figure 2.3 is smaller, supposedly because the local level shown also comprises provincial revenues.

2 This is not true for Flemish municipalities, where tax income is the most important municipal income source.

FIGURE 2.3 Belgium – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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(Husson et al. 2017: 66). Flanders, for example, has merged the schemes for general and investment grants (the other two regions have not). Although there are differences in the details, all allocation schemes incorporate local governments' fiscal revenues, spending needs and further external indicators. Non-earmarked transfers make up the bulk of central government transfers to local governments and include a financial equalisation mechanism (OECD 2016). Earmarked grants, on the other hand, are an important source for financing education, culture, police and employment expenditures (Husson et al. 2016: 66).

From 2000 to 2015, the transfer share of total revenues at the local level (municipalities and provinces) was 46.2%, on average (Figure 2.3). Over time, it increased slightly from 45% (average value for 2000 to 2004) to 46.9% (average value for 2011 to 2015). It peaked in 2008, the year of the crisis, which quite obviously reflects the temporary post-crisis drop in tax revenues.

In addition to these traditional financial sources, municipalities can levy admission charges for public institutions or parents' contributions to education costs, for example (Council of Europe 2006: 43). Financial incomes are dividends from inter-municipal companies (Husson et al. 2017: 67).

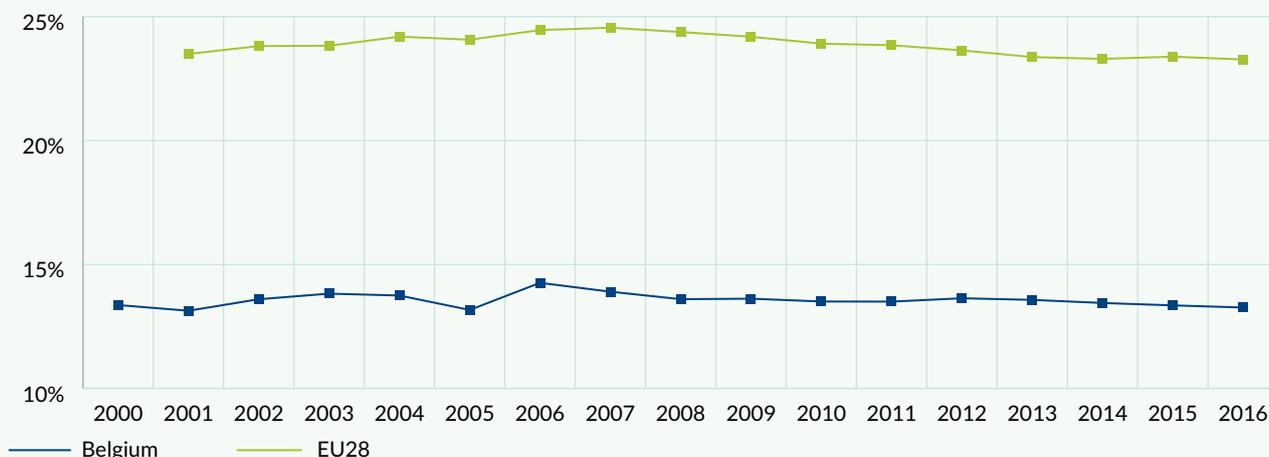
### 3 Expenditure

Local expenditures (combined expenditures of the provinces and municipalities) made up on average 13.3% of the general government expenditure between 2000 and 2016 (Figure 2.4). This level shows certain variations over time – especially in the years 2005 and 2006 – but is broadly constant over the whole 17-year period. Local government expenditures are significantly below the EU28 average value of 23.9%. This shows that local governments play a far smaller role in public expenditures than they do in many other EU28 countries. This is also depicted by expenditures as a share of the nominal national GDP. Whereas the general government expenditure was at 51.9% on average between 2000 and 2016, local government expenditure made up only 7%. Considerable shares of local-level expenditures are spent in inter-municipal cooperation.

A closer look into expenditures by function reveals that local governments spend most on social protection, education, public safety and general services (Figure 2.5). This fits rather well with the municipal responsibilities of maintaining law and order in the form of multi-municipal police zones and public centres for social welfare (OECD: 2016). While social protection and education expenditures increased from 2006 to 2015, expenditures for public safety and general services decreased. Compared to the EU28 average, it is obvious that public safety is a local issue in Belgium, whereas it generally is not in other EU28 countries. The opposite is true for health. From the micro-perspective, functions may vary between the

FIGURE 2.4 Belgium – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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municipalities of different regions and even within regions from one municipality to another, due to idiosyncratic political preferences or geographical characteristics (Husson et al. 2017: 68). Concerning the province/municipality distinction, Walloon provinces are more important than Flemish provinces in terms of expenditure shares.

Since the regions (and communities) have a major impact upon municipal responsibilities, it is not surprising that regional differences are quite common (Wayenberg and De Rynck 2008: 9). Local expenditure in the Brussels-Capital Region, for example, is generally much higher than in the two other regions, which is – at least in part – due to education being more a local responsibility in and around Brussels than it is in the Flemish or Walloon regions.

## 4 General Fiscal Status

Local government nominal debt in Belgium amounted to an average of 5.6% of the national nominal GDP between 2000 and 2016. This level, equivalent to the EU28 average, has been quite constant over time (that is, local debts have increased proportionately to the GDP), with moderate decreases until 2009 and (also moderate) increases thereafter. Local nominal debts are also small compared to general government debt, which amounts to an average of 100.8% of the nominal GDP over the 17-year period. General government nominal debt began decreasing in 2000 – until it reached 87% of the GDP in 2007. It then started to increase with the financial crisis, and peaked at 106.8% in 2014. This quite accurately explains the

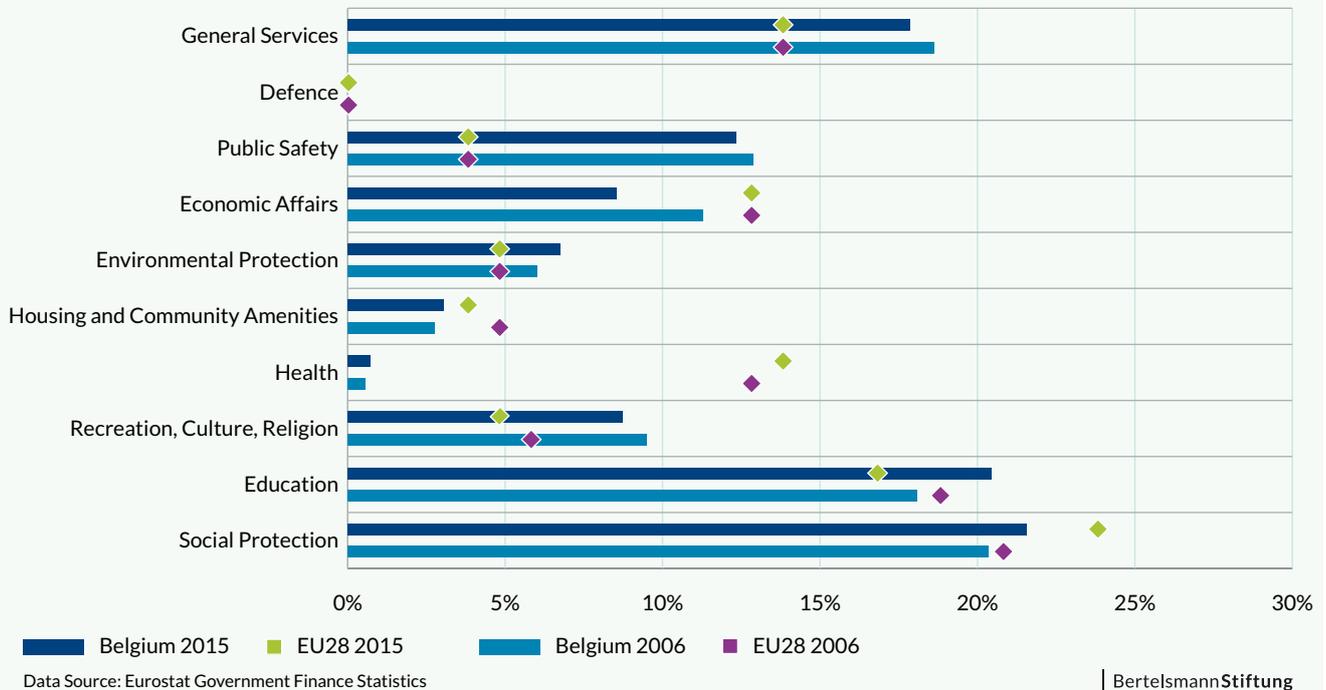
development of local government debt as a share of general government debt (Figure 2.8). In contrast to the general government, the local governments' financial situation appears relatively healthy, with an average share of 5.4% of general government debt between 2000 and 2016.

Municipalities can either arrange public loans (securities) or borrow from banks – which they do almost exclusively (Ashworth et al. 2005: 400). Bank loans made up 97.9% of local debts in 2006 and were at 93.1% in 2016. Commensurately, the role of securities increased from 2.1% to 6.9%. Both are consistent with the EU28 average.

The local government budget balance amounted to an average deficit of –0.03% of the national nominal GDP between 2000 and 2016 (Figure 2.7). Whereas the annual budget balance improved from 2000 onwards until it peaked in 2008 with a surplus of 0.21% of the nominal GDP, it dropped significantly with the onset of the financial crisis (minimum in 2012: –0.5% of nominal GDP). However, it had fully recovered by 2016 (0.21% of nominal GDP). This trajectory of budget balances is consistent with the decreasing level of local nominal debt until 2009 and the (moderate) increase thereafter.

The general fiscal situation of the municipalities differs among the regions. According to national experts, Flemish municipalities currently seem to be in better fiscal condition – based on their returns from taxes and grants – than municipalities in the Walloon Region, where resources are reduced every year. The current situation is already tense. Although able to fulfill their duties, more and more Walloon

FIGURE 2.5 **Belgium – Local Government Expenditures by Function**  
As Share of Total Local Government Expenditures



municipalities need to exhaust their reserves to do so. In 2015, more than 20% of Walloon municipalities were under a so-called management plan due to fiscal distress.

## 5 Effects of the Financial Crisis

Belgian GDP has seen a rather small decline in 2009, but was recovering fast thereafter and continued its earlier growth path (Figure 2.6). Since the financial crisis, major fiscal aggregates have significantly increased at the local level. As Figure 2.9 shows, absolute values of local revenues and expenditures increased by close to 30%, compared to their 2007 level. Whereas revenues show a constant growth trajectory, expenditures exhibited stronger growth until 2012 and stagnated thereafter. Local (municipal and provincial) nominal debt decreased in absolute terms from 2007 to 2008 and increased thereafter until 2014, peaking at 132.6% of its 2007 value. Since 2014, debts have decreased again. This might indicate a lagged response of local public debts to the financial crisis. Analysing the longer-term development indicates that the year 2009 indeed has changed the trajectory of the local debt development. The same is true for the year 2008 when it comes to revenues and expenditures.

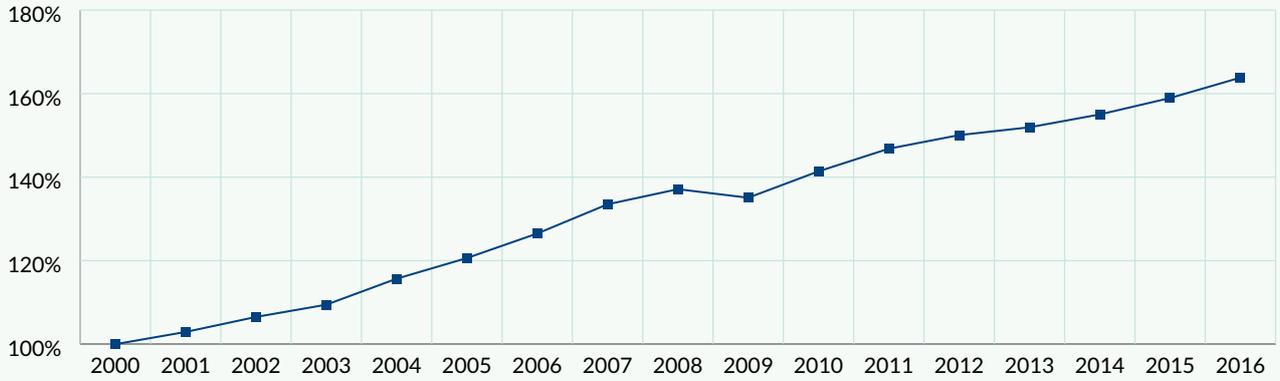
Since the Cooperation Agreement of December 2013 to implement the Fiscal Compact, Belgium has pursued an internal stability pact for the period 2015 to 2018 (OECD 2016). For the first time, it concerns all government tiers, including the local level. Local authorities are formally integrated in accordance with the coordination mechanisms established by the agreement. The Walloon government, for example, implemented a balanced budget rule for municipalities in the wake of the European Stability and Growth Pact.

## 6 Fiscal Rules and Fiscal Oversight

Far-reaching top-down supervision and steering is a main feature of Belgian central-local relations (Wayenberg and De Rynck 2008: 6). Provinces and municipalities are supervised by the federal state, the community or the region, depending on the powers or tasks they exercise (Christiaens and Neyt 2016: 27). Due to their extensive financial links, regional governments have a close constitutional relationship with the municipalities within their territories (Brand 2016: 37). The regions have the right to suspend or even nullify a local decision if it is not in line with the law or the public interest (Wayenberg and De Rynck 2008: 7). Quite obviously, the latter reason exposes local governments' decisions to higher level

FIGURE 2.6 Belgium – Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

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FIGURE 2.7 Belgium – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 2.8 Belgium – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016

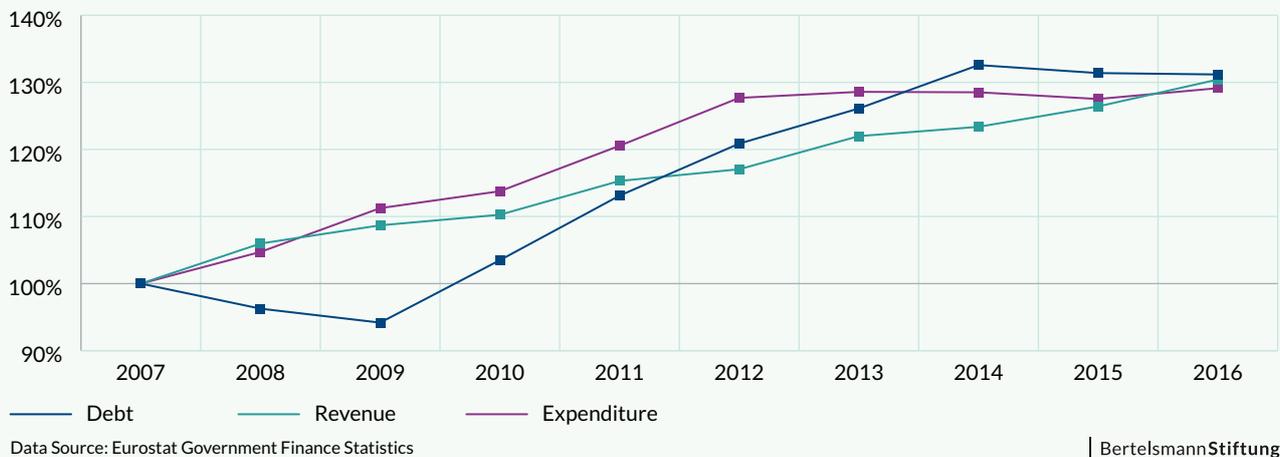


Data Source: Eurostat Government Finance Statistics

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FIGURE 2.9 Belgium – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



political interests. However, suspension or nullification are also an option for the controlling authority, when local decisions do not serve the interest of the local community itself – if, for example, a local government should opt for a very costly infrastructure that would impact the local budget for the next several generations.

In Wallonia, the regional government is the supervisory authority in terms of the budget and imposes new fiscal regulation on local-level governments (Hammar and Wüthrich-Pelloli 2014: 174). If a municipality breaks existing rules, its budget can be rejected. If a municipality finds itself in financial difficulties, it can also be placed under a “management plan” overseen by the Regional Centre of Assistance to Municipalities (CRAC). The objective of this institution is to help municipalities set up their budgets; it also lends funds to ensure financial obligations are fulfilled. In return, CRAC has the right to inspect the financial management by the municipality, whose debt capacity is also restricted during the time frame needed to improve its financial health and restore a balanced budget. In 2016, 54 out of the 262 Walloon municipalities were under such a “management plan” imposed by CRAC. The supervision of provincial budgets and accounts is also carried out by the Walloon Region (Hammar and Wüthrich-Pelloli 2014: 290). Budgets need to be approved before taking effect.

In Flanders, local fiscal supervision and rule-setting is also located at the regional level (Hammar and Wüthrich-Pelloli 2014: 174). Local governments must submit their budget plan to the region but it does not have to be approved to be implemented. However, the region has the right to annul it if it is not financially balanced or does not comply with fiscal rules.

In this case, a municipality can no longer operate autonomously, and no new investments can be made; the region can impose management plans to re-establish sound public finances. In contrast, the budget report must be approved by the Flemish government.

Local-level fiscal regulation should be regarded in the light of Article 252 of the national municipal law – adopted in 1982 – which imposed a balanced budget rule to municipalities (Belfius Bank 2018). This rule, however, takes into account the electoral investment cycle (OECD 2015: 66). Local-level finances have been more or less balanced during the past two decades (variation occurs across individual municipalities and with the electoral cycle). Since pension costs are rising and social assistance expenditure has increased since the economic crisis, as well as due to an ageing society, the balanced budget rule appears to be increasingly challenging for local authorities. It is in effect for the Brussels-Capital Region, the Walloon Region implements it in its own municipal law and the Flemish Region also applies it. In Wallonia, municipalities have been obligated to present a balanced annual budget since 2012. In 2018, not a single Walloon municipality was in deficit. Also in Flanders, expenditures must be balanced with income on an annual basis, taking into account the surplus of the previous year. Flemish municipalities are also required to balance multi-year budget plans: Each municipality has to prove that in the last year of the current multi-year plan (the current period ends in 2019), there is a structural balance – i.e. the primary surplus must be high enough to cover interest and loan payments. According to a report by the Belfius Bank in 2014, approximately 18% of municipalities were struggling to meet this long-term requirement (Flanders Today 2014).

The Flemish government imposed stricter supervision. Hence, all over Belgium, municipalities which present a budget deficit can be forced by the regional supervisors to implement recovery reforms and measures to downsize expenditures and increase revenues in other words, to correct the slip (European Commission 2012: 85).

In all three regions, municipalities can take out loans, which are used for capital expenditure (Council of Europe 2006: 43–44). This “golden rule” restricts borrowing to investment purposes (OECD 2016). Moreover, there are region-specific regulations. In Wallonia, there are quite specific regulations to investment-related debt (“investment markers”). The municipality cannot make lending investments of more than €1,200 per capita for the duration of a municipal mandate (six years), which means €200 per capita each year.<sup>3</sup> Exceptions for certain fields (such as security) are possible. In Flanders, there are no direct limits on a municipality’s outstanding debts.

In Flanders, neither official bankruptcy nor bailout mechanisms exist for municipalities. In theory, municipalities in the Walloon Region also may not file for bankruptcy. If the survival of a municipality is at risk, the Walloon Region would most probably step in and prevent bankruptcy by providing additional funds. This, however, has not yet happened. Although there is no official bailout mechanism, CRAC provides municipalities under financial distress with funds to meet their obligations; in return the municipalities must pursue a recovery plan. This may be seen as a conditional bailout. In the Brussels-Capital Region, the Regional Fund for the Refinancing of Municipal Treasuries (FRBRTC) can either lend funds to relieve local financial difficulty (which also might be understood as a bailout mechanism) or act as an intermediary to the capital market.

At the local level, governments apply accrual accounting (IMF 2008: 36). Local governments were the innovation leaders in terms of the transition from cash accounting (Christiaens and Neyt 2016: 28). In Wallonia and the Brussels-Capital Region, municipalities have a two-part budget, one covering running costs and the other one for investments (Husson et al. 2017: 64 ff.). This also applies to the Walloon provinces.

The budgeting process is different for Walloon municipalities. First, each municipality receives a “guideline letter” (circulaire budgétaire) from the minister of local governance, which advises the municipalities on how to create their budgets. The budget draft must be approved by the local council and then sent to the Walloon government. If it is approved, it becomes actionable. Changes can be made within one year but are

subject to the council’s and supervisor’s approval. In addition, the ex-post budget report must be submitted to the Walloon government.

The Flanders Region follows another budget and accounting format, the so called *Beleidsen beheerscyclus* (BBC), which is seen as major step towards linking strategy, planning, budgeting and control on an accrual basis (Christiaens and Neyt 2016: 35). Currently, Flemish municipalities pursue a multi-year plan, which covers the years 2013–2019, and also prepare an additional yearly budget plan. This will change from 2020 onwards. In 2019, municipalities have to prepare an extended multi-year plan for the period 2020–2025, which integrates the current budget plan. This multi-year plan will comprise political goals as well as financial plans, and must be approved by the local council. For the first year of the plan – 2020 – it must state the maximum amount a municipality can spend. In the following years, this will be updated annually. Neither the current multi-year plan or budget plan nor the future extended budget plan must be approved by the Flemish government to be implemented; they must, however, be submitted to the region (Hammar and Wüthrich-Pelloli 2014: 174). In addition, the yearly accounts are closed by a budget report. As already mentioned, this report must be approved by the Flemish government.

In Flanders, there is an autonomous entity called AudiO, which was created on the initiative of local governments and deals with internal audits (Christiaens and Neyt 2016: 36). In terms of an external audit, the Flemish agency Audit Flanders covers periodical audits of the main processes, thematic audits or fraud investigation. However, an annual, independent financial audit of the Flemish local governments’ financial reporting is lacking. In Wallonia, a project called *Plan Stragégique Transversal* is in its trial stage and would incorporate intensified audit procedures. According to local experts, however, there is currently no structured internal or external audit process. Contrary to the municipalities, provincial accounts are subjected to the scrutiny of the (federal) Court of Auditors (Hammar and Wüthrich-Pelloli 2014: 291).

<sup>3</sup> But it can still invest more if there are financial reserves.

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# 3 | Bulgaria

Christian Raffer

## Summary

Since the collapse of the Soviet Union, Bulgaria has and continues to undergo fundamental administrative reforms to increase decentralisation. The Bulgarian administrative structure consists of a two-tier system of state and local government. Currently, there are 265 municipalities in Bulgaria, sub-divided into smaller towns and villages. Responsibilities are divided among state-delegated ones (e.g. education, social protection and health care) and a municipality's own responsibilities, which include housing and utilities.

Municipalities control local taxes. Councils are free to set local rates within legally predetermined limits. In addition, municipalities receive various state grants. The most relevant are the general grant, which finances activities delegated by the state, equalisation grants and targeted capital expenditure grants. The financial crisis stipulated a nominal stagnation in revenue, taxes, state grants, expenditures from 2009 to 2012. In general, the current financial situation is sound; nevertheless, there is an uneven distribution of debt and, at the end of 2017, approximately 5% of municipalities showed some indication of fiscal stress.

The Public Finance Act of 2014 adopted the EU Fiscal Compact, which brought about new fiscal regulation for municipalities. It consists of a local government recovery procedure, should a municipality experience financial distress. The new mechanism consists of six criteria. If a municipality meets at least three of these criteria, the mayor is obliged to begin a procedure aimed at financial recovery. This opens access to temporary and conditional financial support from the central government. The six criteria cover fiscal rules such as a revenue-based debt limit, a multi-annual balanced budget rule and expenditure ceilings. In addition, the mayor of the municipality presents monthly and quarterly reports on budget implementation as well as other additional information to the Ministry of Finance. In general, municipal budgets are autonomous entities within the consolidated state budget.

## 1 Administrative Structure

The administrative structure consists of a two-tier system (OECD 2016: 111), in which the municipalities (obchtina) are the main local self-government units underlying the central government level. The Constitution of 1991 (Constitution of the Republic of Bulgaria; Official Gazette No 56/1991, in effect since 13 July 1991) stipulates the legal basis of local self-government. For administrative reasons, the state divides into 28 districts (oblasts). Districts are responsible for the development of regional policy, the implementation of state legislation at the local level, and the harmonisation of national and local interests (Vodenicharov 2012: 71). They are, however, not an intermediate administrative level. They have no financial independence and can be seen as local representatives of the central government (Nenkova 2014: 342). Regional governors are appointed by the Council of Ministers. They have supervisory power in terms of legal compliance with municipal decisions (Vodenicharov 2012: 85), but no distinct oversight when it comes to municipal finances.

A municipality is the only administrative territorial unit which is self-governing. Citizens participate in local government through their elected municipal council and, directly, through referendums or general meetings. The population elects the municipal council for a term of four years during local elections held nationwide. Citizens also directly elect the mayor as the body of executive power, also for a term of four years.

Municipalities usually comprise many small and widespread settlements, named after their administrative centre. The average municipality consists of 26,603 inhabitants (OECD 2016; Bulgarian National Statistical Institute 2018).

FIGURE 3.1 Bulgaria – Administrative Structure

Central Level	Central Government (Local Representation: 28 districts)	
State Level		
Local Level	265 municipalities	
	257 cities The three biggest (Sofia, Plovdiv and Varna) comprise 35 raions (districts)	5,010 villages
	2,500 mayoralties formed by one or more city or village	

Source: own representation

TABLE 3.1 Bulgaria – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Municipalities	Treklyano (798)	Sofia (1,325,429)	26,603
Towns	Melnik (189)	Sofia (1,238,438)	20,163
Villages/ Settlements			approx. 373

Source: Bulgarian National Statistical Institute 2018, own calculations

Municipalities sub-divide into towns and villages, which totaled 5,267 in 2015 (OECD 2016). There are also so-called mayoralties, formed by one or more villages or towns, which are administrative units and partly self-governed entities within a municipality. There are approximately 2,500 mayoralties with at least 350 inhabitants. They are established by the municipal council, governed by elected mayors and can execute some local functions. Currently, there are 265 municipalities in Bulgaria, of which 9 had more than 100,000 inhabitants in 2017 and only 10 had less than 2,000. As depicted in Figure 3.1, the local level is organised in three tiers.

Large cities sub-divide into districts or raions. The capital, Sofia, for example, consists of 24 raions. Further cities with raions are Varna (five raions) and Plovdiv (six raions) (Vodenicharov 2012: 71). A raion itself must have a population of more than 20,000 inhabitants and can be established in cities with a population of more than 300,000 inhabitants. In 2017, 63.5% of the Bulgarian population lived in urban areas (Bulgarian National Statistical Office 2018).

Reforms to Bulgaria's administrative structure took place between 1990 and 2016, and can be divided into three stages (Bileišis et al. 2017). The first stage took place in the early 1990's and was completed around 1993–1994. This reform followed an agenda of political transition. The second stage, lasting until 2000, transferred practices and introduced concepts of reform for the traditional model of administration and New Public Management (NPM). The third stage, which is ongoing, is directed primarily at achieving European conditionality (Tomova and Petrov 2017). The decentralisation process began in 2002 with a decentralisation strategy for the years 2005 to 2016 (Patonov 2012). This strategy foresaw the decentralisation of service provision accompanied by adequate power and resources. The new decentralisation strategy for 2016–2025 has succeeded this process and intends to enhance

the influence of regional administrative institutions for the implementation of coordinated regional development policies.

## 2 Revenue

Municipalities have experienced a steady increase in fiscal decentralisation during the past 25 years (Stoilova 2013: 125). After first attempts to assign expenditures and revenues among government levels at the beginning of the 1990s, lower-tier financial self-governance began to strengthen in 2003 with a tax reform which abrogated sharing arrangements and allowed municipal councils to exercise some discretion over certain taxes (Nenkova 2014: 342; OECD 2016). During this period, tax revenue reduced to own-sourced taxes. In addition, the reform aimed to introduce a sound, rule-based system of intergovernmental transfers and the definition of local responsibilities and their financing. Although this (and following reforms) led to increasing shares of own-sourced revenue, Bulgaria is still a rather centralised country in fiscal terms. From 2000 to 2016, local government revenue as a share of general government revenue increased only moderately (Figure 3.2). Whereas the average was 17.36% from 2000 to 2004, it rose to an annual average of 22.16% from 2012 to 2016. The Bulgarian level of fiscal decentralisation is below the EU28 average.

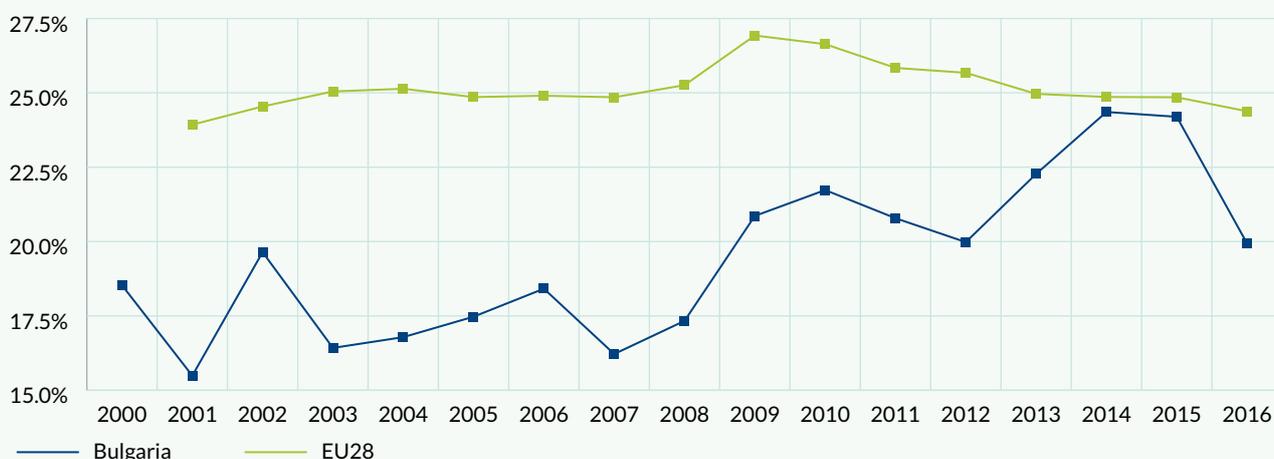
Among the most significant changes implemented by the 2003 reform was the division of local-level services into local and delegated services (Nenkova 2014: 344). This aimed at a clear distinction in terms of financing. Whereas local services (such

as municipal housing or utility services) are financed as far as possible by local own-source revenue, the range of delegated activities (e.g. education and health care) and their valuation is determined annually by the council of ministers and financed by separate conditional grants. In reality, however, a clear task attribution is still lacking and municipalities are often dissatisfied with the amount of these grants; consequently, they assign additional funding from their own revenue to the provision of delegated tasks. Delegated tasks used up approximately half of the municipal budgets in 2012. The legal basis for municipal revenues is the Public Finance Act and the Law on Local Taxes and Fees (Vodenicharov 2012: 82). Major sources of own-sourced revenues are local taxes, local fees and other local revenues, such as rents, sales, etc. (Ladner et al. 2015: 118)

Municipalities did not enjoy tax autonomy at the beginning of the new millennium. The 2003 action plan on fiscal decentralisation (Nenkova 2014: 342) endowed them with a purely local tax basket, which is currently comprised of the property tax, property transaction tax, donation tax, vehicle tax, inheritance tax, patent tax (since 2008), tourism tax (since 2011) and taxi transportation tax (since 2018) (Law on Local Taxes and Fees, art. 1; OECD 2016). This has made Bulgaria one of the few countries within the EU28 which generates municipal tax revenue from own-sourced taxes only. Whereas the property tax, tax on property transactions and vehicle tax account for 95% of total local tax revenue, the remaining taxes are negligible. In 2006, municipalities were given the power to collect taxes and, since 2008, local councils can set tax rates within legally predetermined brackets. However, they are still

FIGURE 3.2 Bulgaria – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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not allowed to define the local tax base and decide on legal reductions for certain taxpayers (Stoilova 2013: 129).

Especially the property tax on land and buildings is of importance for municipal budgets and led to increasing revenues after the statutory values of property were updated in 2006 and upper limits for rates almost doubled in 2011 (Nenkova 2014: 347f.). Property tax rates are quite low and vary between 0.01% and 0.45%. Until 2005, a road tax contributed significantly to local tax revenue, but was abolished following the introduction of road vignettes. The patent tax is a net annual income tax imposed on small business owners and craftsmen (Stoilova 2013: 129). Most local authorities use their right to raise taxes within the predetermined limits (Nenkova 2014: 348). However, they rarely drive rates up to the maximum limit allowed. Since increasing tax rates are rather unpopular, some municipalities have barely raised tax rates since 2008. Although municipalities are gaining more tax autonomy, the share of tax revenues among all local-level revenues is low compared to the EU28 average. It increased moderately from 2006 to 2016 but never exceeded the maximum of 13.4% in 2008. Compared to the overall Bulgarian tax system, local-level taxes are of minor importance (Ladner et al. 2015: 117). The local share in consolidated Bulgarian tax revenues did not exceed 3.0% between 1990 and 2014.

The Public Finance Act, which adopted the EU Fiscal Compact in 2014, stipulates different types of intergovernmental grants already introduced in the 2003 reform. The first one is the general grant for delegated activities, which provides funds which cover expenditures related to state-delegated activities (Nenkova 2014: 349). The corresponding financing standards are adopted annually by the Council of Ministers and therefore subject to central government budget constraints. The second one is the general equalising grant, which aims to ensure that each municipality achieves a minimum level of local service provision; it is fully unconditional. The rule-based equalisation mechanism, which was also introduced in 2003, takes into account several elements which determine municipal spending needs. The local government equalisation mechanism is of minor importance in the Bulgarian transfer system, since it provides only up to 11% of total government transfers to municipalities; it is not considered a demotivation for municipalities to levy taxes (within their very limited bounds). The third one, the targeted capital expenditure grant, can be disbursed for both local and delegated activities; since 2007, a portion of this grant has been used to fund the construction of municipal roads (Nenkova 2014: 349). In addition to these three major grants, the Public Finance Act also allows for other earmarked expenditures and financial compensation by the state. The general grant for state-delegated responsibilities is

– despite its name – a specific-purpose grant, and accounts for about 75% of all transfers in 2013 (OECD 2016). The general equalising grant covered 10% and earmarked grants for capital expenditure covered 6% of local-level transfer revenue. The National Association of Municipalities plays an important role in negotiating standards, allocation mechanisms, and annual levels with the Local Government Financing Directorate at the Ministry of Finance (Hawkesworth 2009: 153f.). The total amount of intergovernmental grants received by local governments makes up roughly four fifths of local-level revenues. This clearly shows that despite ongoing fiscal decentralisation, municipal governments do not enjoy true fiscal autonomy and the fiscal system is still highly centralised.

Although municipalities have been granted vast freedom in levying charges and fees since 2003, they are still a minor source of revenue (OECD 2016). These include fees for waste collection and treatment, kindergartens, social-care homes, municipal social services, etc. According to experts, the fee in many cases does not cover the actual cost of the service provided. In addition to fees, municipalities generate revenues also by the sale and management of municipal property, fines and penalty charges. Over the years, local governments have sold property largely in order to balance their cash flows (Nenkova 2014: 346).

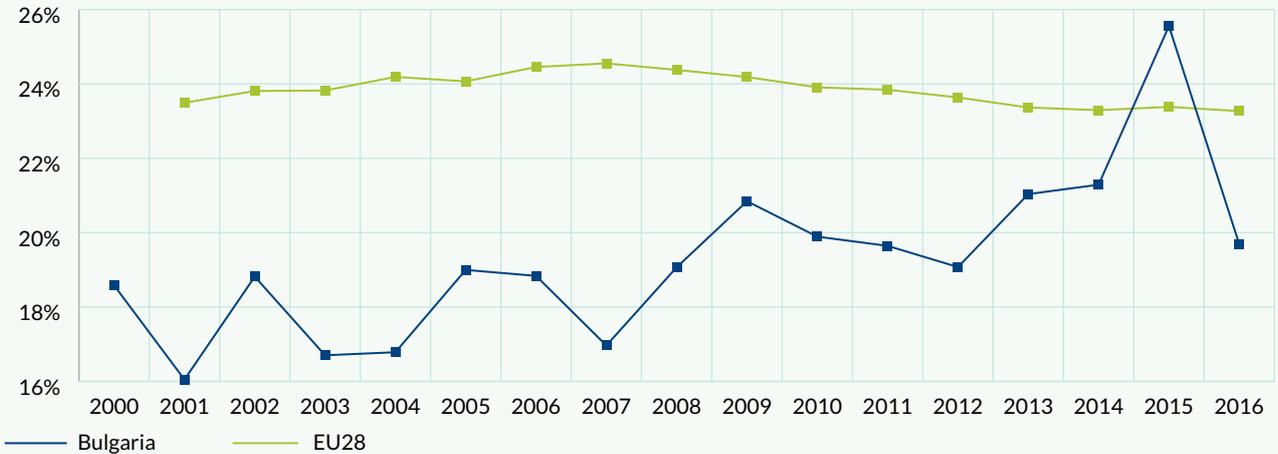
### 3 Expenditure

Municipal responsibilities are divided into two categories (OECD 2016: 111): (1) state-delegated competencies, which include education (primary and secondary), social protection and health care, and (2) municipal-own responsibilities, including housing and community amenities, economic affairs, environmental protection, water supply and sewerage, waste, urban public transport, roads, culture, tourism and leisure. In recent years, approximately 50% of local funds were spent on delegated tasks (OECD 2016). Although municipalities are exposed to an ongoing process of fiscal decentralisation, growth of local-level expenditure as a share of total general government expenditure has remained rather moderate, with an average value of 17.4% between 2000 and 2005 and 21.3% between 2012 and 2016 (Figure 3.3). Despite clear decentralisation reforms, the increase remained moderate. According to local experts, municipalities have sufficient funding to provide public services.

In terms of expenditure functions, the largest portion of local public spending went into education, at 32% in 2006 and 24.8% in 2015. As Figure 3.4 shows, both values are well above the EU28 average for the respective years. This leading

FIGURE 3.3 Bulgaria – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016

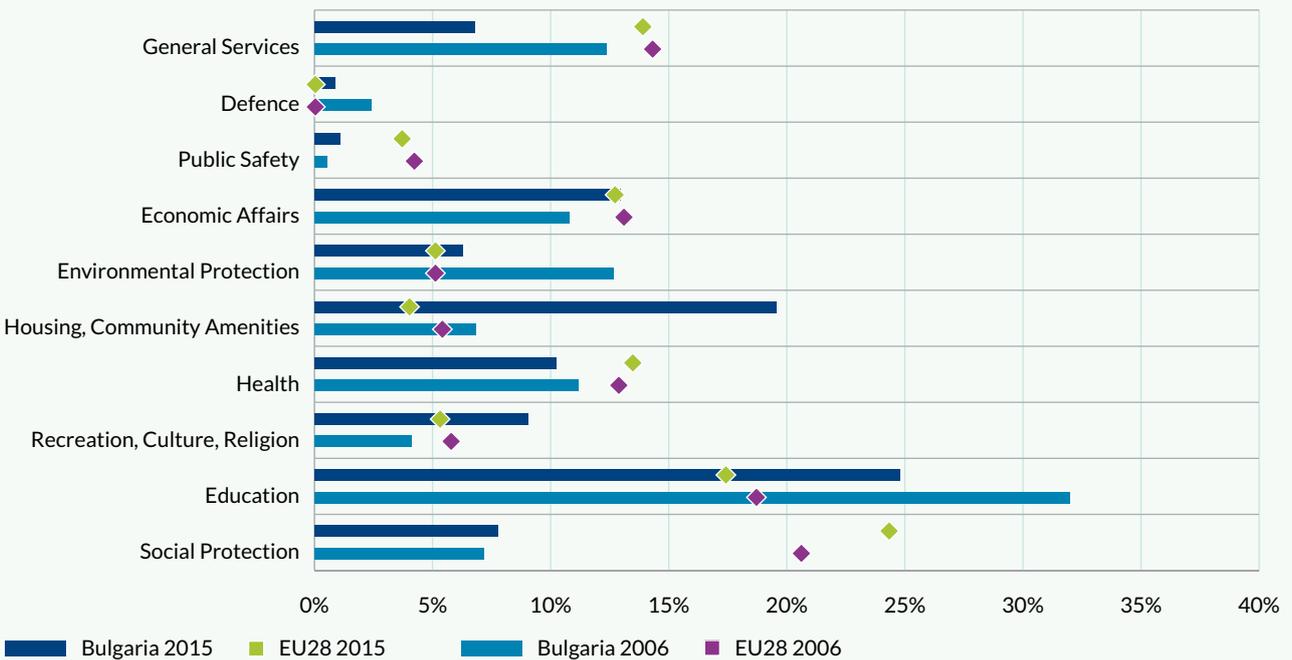


Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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FIGURE 3.4 Bulgaria – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



Data Source: Eurostat Government Finance Statistics

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position is based upon the fact that all activities in the area of pre-school, early, primary and secondary education are funded from the municipal budgets (Nenkova 2014: 345). Since the corresponding services are mainly delegated tasks, the major part of the labor-intensive public function is covered by the central government. Provided funds include salaries and social insurance contributions, as well as school supplies. Construction and maintenance of school buildings, cafeterias and extra-curricular activities are financed with own-sourced revenues. Further relevant expenditure functions are housing and community amenities (e.g. urban heating and lighting, drinking water, etc.), which increased considerably from 2006 to 2015, and economic affairs. Expenditures in the field of social protection range significantly below the EU28 average values.

## 4 General Fiscal Status

The budgetary situation of municipalities is sound, in general, with no lasting effects by the fiscal crisis. However, according to national experts, approximately one fifth of all municipalities reported arrears exceeding 5% of the municipal expenditures in 2017 (Ministry of Finance 2017a). In addition, measured by official indicators,<sup>1</sup> approximately 14% of municipalities showed indications of fiscal stress by the end of 2015; this percentage dropped to 5% by the end of 2017. In 2016, local government debt in Bulgaria made up approximately 4.2% of the general government debt, which was below the EU28 average (Figure 3.7). Since 2011, this share has decreased from a maximum of 7.7%, which was above the EU28 average. This relative decrease, however, was mainly due to a disproportional increase of central government debt (2011: 14.7% of nominal national GDP, 2016: 28.6%). On the other hand, general government debt as a share of the Bulgarian GDP dropped significantly from 71.2% in 2000 to a minimum of 13% in 2008. Since then, it has once again been increasing. Compared to the EU28, Bulgarian local-level debt is below average; the general government debt is also rather moderate. Although local governments have not experienced severe fiscal deficits in recent years (Stoilova 2013: 125 ff.), debt at the local level has moderately increased (as share of the nominal GDP) since the financial crisis.

One reason for this relatively stable debt situation is the adapted equalisation scheme introduced in the 2000s (Stoilova 2013: 125 ff.). Research shows that smaller municipalities received higher subsidies per capita in the past, which

compensated for the shortage of funds caused by low fiscal capacity. Consequently, they tended to decrease their debt levels. In addition, local deficits do not represent a significant burden on local budgets. After the financial crisis of 2008 and 2009, it remained close to or even below EU28 average values. The local-level budget showed a maximum drop of 0.9 percentage points in the Bulgarian nominal GDP only in 2015, which interestingly enough marked the first year of the Public Finance Act (with its local-level balanced budget rule).

Before the Public Finance Act regulated local-level debt, the legal basis was the Law on Municipal Debt, implemented in June 2005. However, the Public Finance Act has not fully abrogated the Law on Municipal Debt. The sound aggregate fiscal situation of local government finances should not hide the uneven distribution of debt (Tomova and Petrov 2017: 464). In 2013, debt as a share of own-sourced revenue ranged between 0% and 243% among Bulgarian municipalities.

## 5 Effects of the Financial Crisis

The financial crisis did not result in a recession in Bulgaria (Figure 3.5), but the long-term growth path stagnated. The extraordinary deficit in 2009 returns to this effect (Figure 3.6).

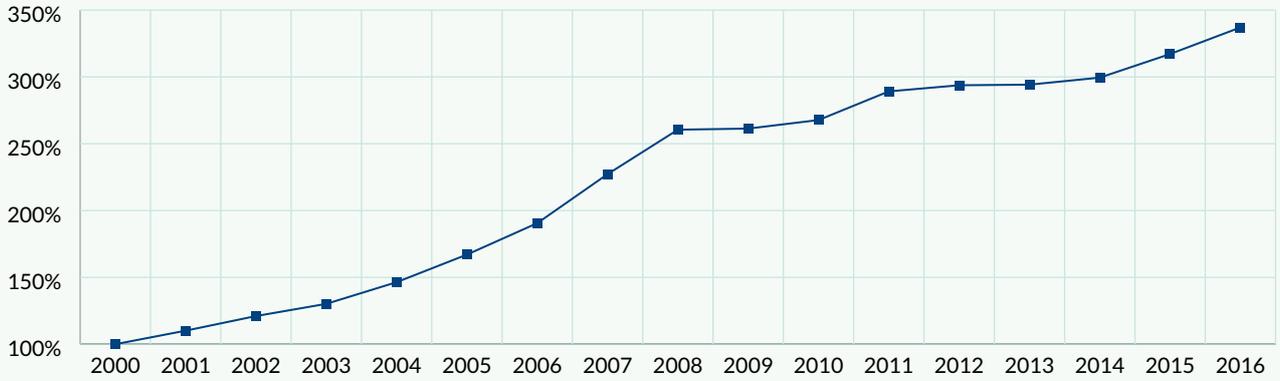
Municipal debt in Bulgaria has steadily increased since the global financial crisis (OECD 2016). Absolute local debt more than tripled by 2016 (Figure 3.8). Although this may first sound alarming, municipalities are – on average – in sound fiscal condition. The total amount of municipal debt is rather insignificant (Hawkesworth 2009: 173). This does not mean that there are no municipalities under financial distress. In 2016, 32 municipalities were forced to begin a financial recovery program. Nevertheless, due to the financial discipline of the Currency Board, financial stability was preserved and the consequences of the financial crisis were less severe in Bulgaria than in other European countries (Stoilova 2013: 130 ff.). However, during the course of the crisis, local government arrears reached their highest level since the start of fiscal decentralisation reform.

Between 2009 and 2011/12, municipalities' expenditures showed a stagnating trend – accompanied by stagnating revenues (Figure 3.8). Both are a result of the weakened post-2008 economy (Nenkova 2014: 343 ff.). Own-sourced revenues decreased, due to drops in the property transactions tax and in municipal property sales after the collapse of the real estate market (Stoilova 2013: 130 ff.). Stagnation occurred even though local governments received full legal rights as public executives, meaning they could levy distraint

<sup>1</sup> Municipalities are considered as being in financial distress when they do not meet three or more of the six conditions formulated in the Law on Public Finance (Article 130a).

FIGURE 3.5 Bulgaria – Nominal Gross Domestic Product

Index: 2000 = 100

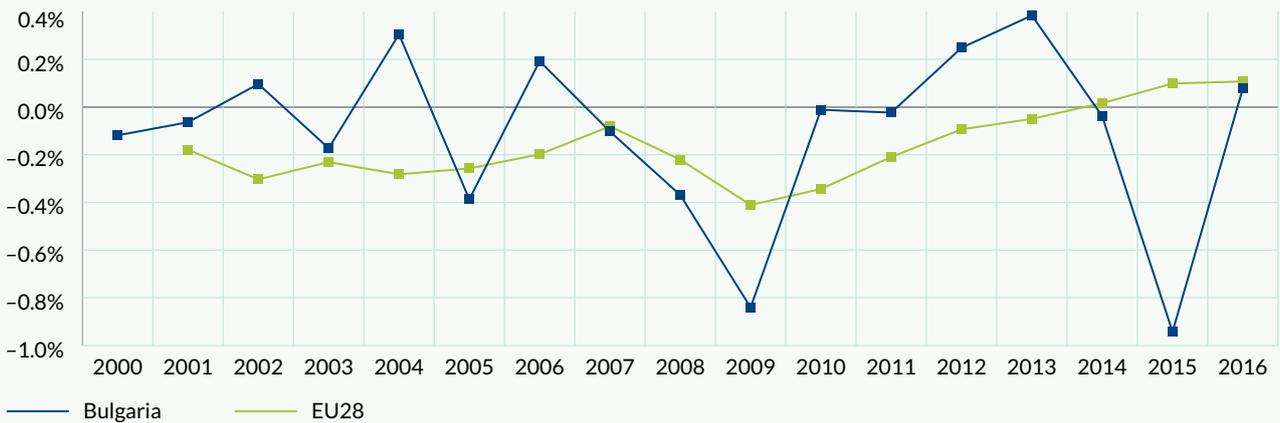


Data Source: Eurostat Government Finance Statistics

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FIGURE 3.6 Bulgaria – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016

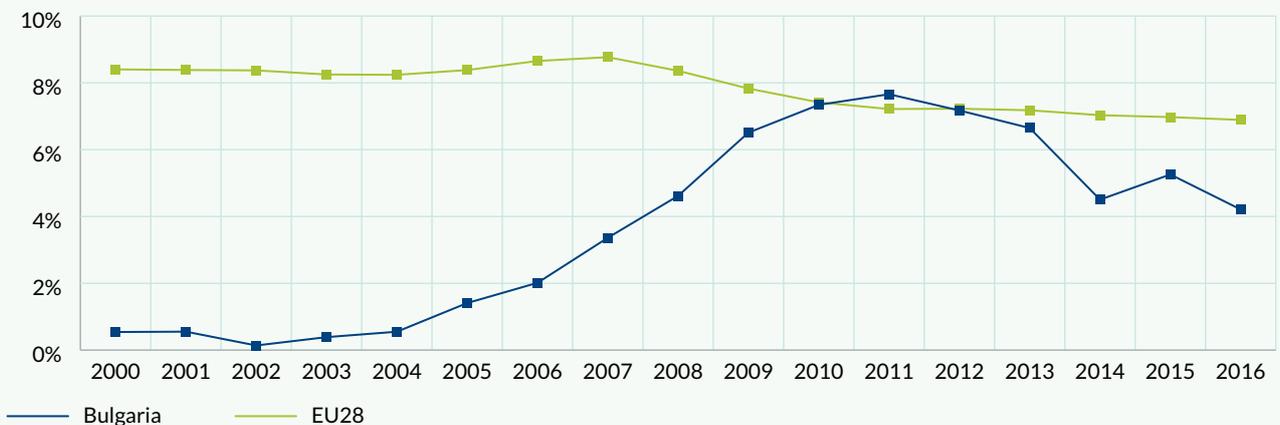


Data Source: Eurostat Government Finance Statistics

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FIGURE 3.7 Bulgaria – Local Government Aggregate Debt

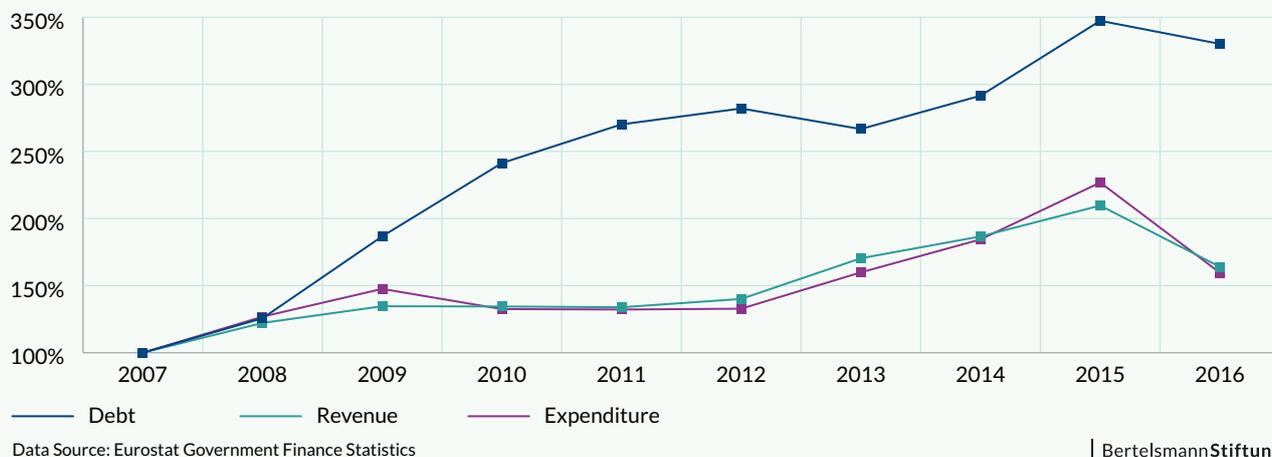
As Share of General Government Debt – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 3.8 **Bulgaria – Post-Crisis Developments**  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



against the bank accounts, salaries, and properties of negligent taxpayers. Moreover, maximum tax brackets were increased after the onset of the crisis (property tax 0.2–0.45%; property transactions tax 2.6–3%). At the same time, the central government cut back transfers after 2009. European funds as an important source of financing capital investment projects were the only counterweight to spending cuts (Nenkova 2014: 343).

In terms of new, post-crisis fiscal regulation, the Public Finance Act of 2014 is the Bulgarian approach to adopting the EU Fiscal Compact as national law (Kovacheva 2012). Therefore, the financial crisis has brought about new rules and procedures, such as the multi-annual balanced budget rule or the fiscal recovery process, in order to ensure local financial soundness. Other than the fiscal regulation stipulated by the Public Finance Act, there were no further legal amendments to implement EU fiscal regulation at the local level. As one further attempt to increase the efficiency of public spending at the local level, the Parliamentary Commission of Regional Policy and Local Self-Government discussed municipal mergers – which did not materialise due to the extensive legal hurdles involved.

## 6 Fiscal Rules and Fiscal Oversight

The central government exercised almost complete control over municipal budgets until the local government fiscal reform of 2003 (Stoilova 2013: 128). This changed with fiscal decentralisation. During the 2000s, several acts were adopted in order to regulate the municipal fiscal framework. Although regional (district) governors who represent the

central government at the local level have far-reaching rights to intervene in order to guarantee the consistency of local and central government interests, they do not have the right to oversee municipal budgets. Municipal budgets are autonomous within the framework of the consolidated state budget. The mayor of the municipality is defined as a “paramount budget spender” (Law on Public Finance, art.11 (3)). He presents monthly and quarterly reports on the implementation of budgets, including EU funds, as well as additional information to the Ministry of Finance. Hence, it is the Ministry of Finance which is the oversight body for municipal budgets. A central feature of current local government fiscal regulation is the six distinct criteria of fiscal distress laid down in the Public Finance Act. The following fiscal rules are represented by these criteria to some extent.

Newly incurred debt does not require approval by the central government. According to the Municipal Debt Act, a central municipal debt register is maintained by the Local Government Financing Directorate at the Ministry of Finance which shows individual records for each local government (Nalas 2010; Ministry of Finance 2019). The register is submitted to the Ministry of Finance every month. The Public Finance Act adopted a debt ceiling, which came into force in 2005 through the Law on Municipal Debt. In terms of debt, it requires that a municipality’s annual debt payment must be lower than 15% of the annual average sum of own revenues and of the block equalising grant for at least three years. In addition, the nominal value of municipal guarantees may not exceed 5% of the same amount (Ladner et al. 2015: 120). Additional to the relatively new Law on Public Finance, the Law on Municipal Debt (Official Gazette No 34/2005) is also still in

effect. It regulates terms and procedures for the assumption of municipal debt and the issuance of municipal guarantees, as well as the types of municipal debt (long-term, short-term debt) and the Ministry of Finance's debt register, which was already mentioned. The quantitative municipal debt limitations (Chapter 3, art. 11 and 12) were abrogated in the Law on Municipal Debt and transferred to the Law on Public Finance.

Municipal debt is decided by the municipal council and consists of issued securities (bonds), loans and the required guarantees, temporary interest-free loans provided by the central government, financial leases and trade credits, among others. The majority of local government debt consists of loans. Whereas the loan share was 82% in 2006, it increased to 89% in 2016. Both values are slightly below the EU28 average for these years. Correspondingly, the share of debt issued in the form of securities decreased. Municipal bonds are usually bought by private banks and investors. According to data provided by the Ministry of Finance, close to 100% of bank loans are long-term and used for co-financing European projects as well as the realisation of other significant investments. There is no major public bank which provides loans to the local sector. However, there is a special fund for local authorities and governments (FLAG) which guarantees loans for co-financing EU-funded investment projects.

The Public Finance Act imposes a balanced budget rule on municipalities and is monitored by the Ministry of Finance in a medium-term perspective (EC 2017). An unbalanced budget three years in a row breaks the rule and counts as one of the six criteria which indicate fiscal difficulties. However, this does not result in any consequences as long as a municipality does not hit more than three criteria indicating fiscal problems. Close to 60% of municipalities showed a deficit for the fiscal year 2015 (Cheresheva 2016).

Recent research shows that in 2015, one year prior to implementation of the Public Finance Act, only 28% of municipalities and cities would not have met any of the six criteria (Ivanova and Kusheva 2017: 62). 42% of municipalities met one criterion, 16% met two and 14% met three or more. Ivanova and Kusheva mention the below-average tax collection rate as a reason for this. In 2016, the year in which the new regulation took effect, 32 municipalities required financial recovery; in 2017, this number dropped to 13 (BTA 2018).

Again, the legal basis is laid down in the Public Finance Act, which revoked the State Budget Act and the Municipal Budgets Act from 1998 at the municipal level (Novinite 2012). It stipulates that municipalities must draft a budget forecast every year for the upcoming three years, have it approved by

the local council and submit it to the Ministry of Finance. The municipal budget draft must be developed on the basis of this forecast and forwarded to the local council. If the municipality is in a recovery plan, the draft must also be sent to the Ministry of Finance. The Council of Ministers must approve key figures of the municipal budget, such as the maximum amount of new expenditure commitments, the municipal debt expected to be incurred, etc. Reserves for contingency and/or urgency costs can only be built up to a ceiling of 10% of the total budget expenditure. Changes to the budget during its implementation are possible and must be approved by the council.

The Public Finance Act includes a local government recovery procedure for financial distress indicated by not meeting at least three of the six criteria (Ivanova and Kusheva 2017: 56). Since this procedure opens access to interest-free loans and additional subsidies by the central government, it may be interpreted as a conditional bailout (Cheresheva 2016). The whole procedure can take up to three years. Before the Public Finance Act came into effect, bailouts were based on ordinances. Corresponding conditions, procedures and criteria for providing funds to municipalities in difficult financial situations were adopted annually by the Council of Ministers.

The recovery procedure works as follows: The mayor of a municipality is responsible for monitoring compliance with fiscal rules. He annually assesses (by March 10) the fiscal status of the municipality based on current data. If the municipality is defined as a "municipality with financial difficulties", the mayor must inform the municipal council within seven days and propose a financial recovery procedure. If the council agrees to a recovery procedure, it must determine the terms within 20 days. This plan must be agreed upon by the Minister of Finance. The municipality may request financial support from the minister in the form of a temporary interest-free loan to support the recovery plan. It reports quarterly on implementation. The municipality can request additional subsidies to repay the interest-free loan at the earliest 12 months following adoption of the recovery plan only if the municipality can provide evidence of its fiscal recovery.

Nominal local government expenditure is subject to a growth ceiling stipulated in the Public Finance Act. The average growth rate of expenditure for the forecasted medium-term period is limited to the average growth rate of the reported expenditure for local activities for the last four years. An exemption is possible only when there is an equivalent and steady increase in revenues. When revenues permanently decrease, however, the law requires that expenditures also decrease. The Ministry of Finance monitors the ceiling.

One of the six criteria of fiscal stress mentioned provides more extensive information on debt among municipalities. It comprises two so-called debt indicators: (1) a municipality's annual debt payment must be lower than 15% of the annual average sum of own-source revenues and the block equalising grant for the last three years, calculated on the basis of the annual reports on implementation of the municipal budget; (2) the nominal value of municipal guarantees issued during the current year may not exceed 5% of the same amount calculated, based on the last annual report (Law on Public Finance, art. 32). At the end of 2017, only 12 municipalities had not complied with these fiscal rules (Ministry of Finance 2017b). Although three of these 12 municipalities are in the Blagevgrad region, over-indebtedness does not seem to be concentrated by region. Municipalities cannot officially declare bankruptcy.

The National Audit Office (NAO) (Smetna palata) exercises control over implementation of the budget and other public resources. In keeping with the National Audit Office Act of 2015, it annually audits the financial statements of municipalities whose budgets exceed BGN 10 million (National Audit Office Act, art. 54 (1)). Smaller municipalities with budgets less than BGN 10 million do not have to be audited annually; audit dates are specified by the NAO or on the basis of a risk assessment (National Audit Office Act, art. 54 (2)). In addition, the State Financial Inspection Agency and the Agency for Public Procurements perform regular audits and surveys. Private auditors can be hired by small municipalities which do not have their own unit for internal auditing. According to the Bulgarian Law on Internal Audit in the Public Sector, each municipality whose budget exceeds BGN 10 million must establish a unit for internal audits; neighbouring municipalities with smaller budgets may establish a mutual unit.

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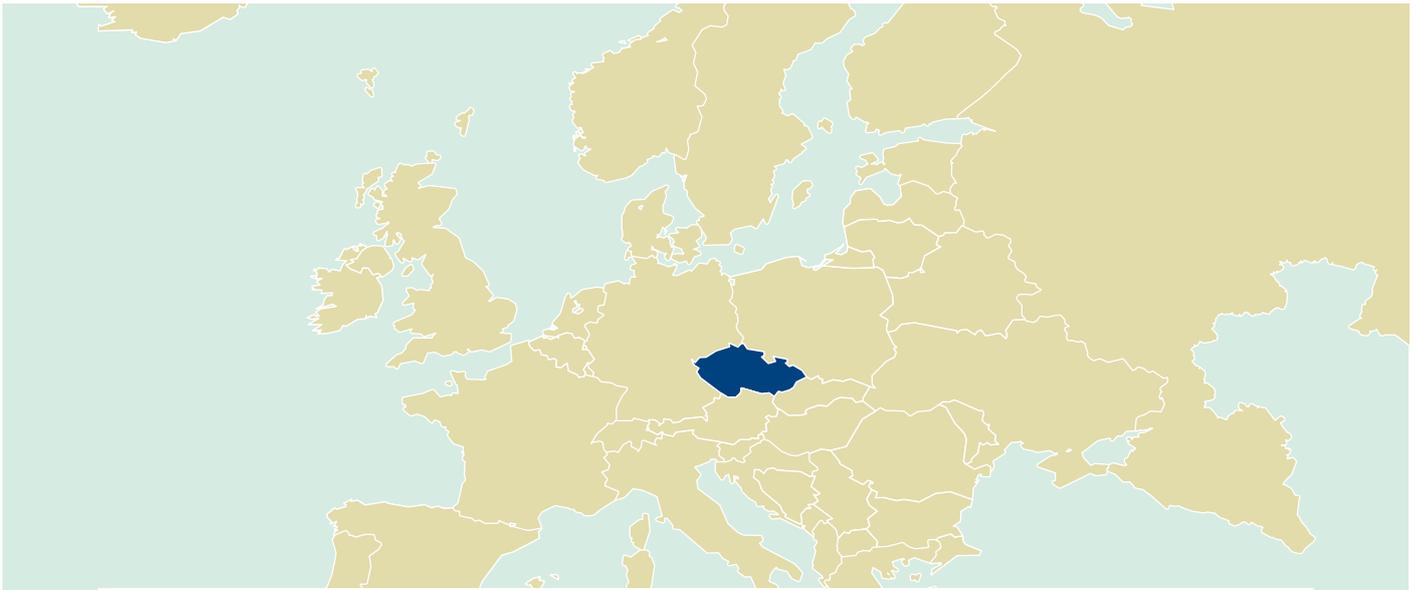
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# 4 | Czech Republic

Andrés Ponce

### Summary

The Czech Republic is a unitary country with two tiers of government. Below the central level, there is a local level, which consists of 14 regions (Kraj) and 6,258 municipalities (Obec). Both address genuinely local but also state-delegated tasks. Depending on the scope of delegated tasks, there are three different types of municipalities: basic municipalities, municipalities with delegated tasks and municipalities with extended powers. When it comes to fiscal supervision, municipalities are supervised by the regions and the Ministry of Finance. Regions themselves are supervised by the central government.

Compared to other European countries, the Czech administrative system shows a relatively high level of fiscal decentralisation. In 2016, local governments spent close to 26% of all public expenditures, which indicates a far-reaching relevance in terms of public service provision. The most important revenue sources for local governments are transfers (of which the vast majority are earmarked and linked to delegated tasks) and taxes. Since most tax-revenue stems from shared taxes on which they have no impact, local governments suffer from a low tax autonomy. Only the local property tax (municipalities) allows them to adjust the tax rate and therefore gives some limited room to counteract revenue fluctuations.

Although the Czech Republic had suffered from the consequences of the global fiscal crisis of 2008/2009 for several years and local government revenues and expenditures dropped thereafter, the general fiscal situation did not deteriorate. This is mainly due to the central government's coverage of most expenditures for economic stimuli. The aggregate local public debt level is remarkably low and highly concentrated among a few big cities. Consequently, only a very small number of local governments have got into fiscal trouble so far, which makes the lack of recovery regulation a minor issue.

When it comes to fiscal supervision, municipalities are supervised by the Ministry of Finance, or the regional offices when such tasks are delegated to them from the central level. Regions themselves are supervised by the central government. Local governments have to meet a rarely enforced balanced budget requirement and, as a consequence of the national implementation of EU post-crisis fiscal regulation, a 60% debt-to-revenue ratio. In 2016 (one year before implementation), only 8% of municipalities were above this level. If, however, the debt level exceeds this threshold, the municipality is forced to lower its debt. If it does not do so, the central government has the right to withhold a certain amount of the shared tax revenue.

## 1 Administrative Structure

According to its constitution, which entered into force in 1993, the Czech Republic is a unitary country organised as a two-tier system with a central and a local level, the latter consisting of regions and municipalities. The public administration reforms which took place after the Velvet Revolution of 1989 until the mid-2000s played an important role in increasing the provision of public goods and services and a social safety net (Lewis and Fall 2017: 5). The administrative structure has shifted closer to the local population by establishing a system of self-governing regions and municipalities. This concept implies an expression of the rights and competencies of subnational authorities to manage public affairs within the limits of the law, under their own responsibility and in the interests of the local population (Pospíšil and Lebieczik 2017: 33).

According to the constitution, the president of the republic is the head of state. He/she is directly elected by a national popular vote, appoints the prime minister and, on the basis of the prime minister's proposal, selects the other members of the government. The parliament is the Czech legislative power consisting of the Chamber of Deputies and the Senate. The judicial power lies with the Constitutional Court, the Supreme Court, the Supreme Administrative Court, and the ordinary court system. In addition, the Supreme Audit Office is an independent body mandated to perform audits on the management of state property and the implementation of the state budget. However, according to the Supreme Audit Office Act No. 166/1993, such control does not extend to the finances of municipalities.

The Czech local administration builds upon a legal framework which ensures self-governance of municipalities and regions.<sup>1</sup> Local and regional autonomy is a result of the reform process conducted between 1997 and 2002 (Kadečka 2012: 113). The introduction of new legislation implied the formal establishment of regions. Regional councils were first elected in November of 2000. Prior to that, from 1990 until the implementation of regions, the higher-level administrative entity consisted of 76 districts. However, this district level cannot be considered a genuine self-governing entity but more a provisional institutional framework (Charvat and Just 2014: 4 f.). In 2003, the responsibilities of the districts were largely passed to 205 so-called "municipalities with extended powers" (Lewis and Fall 2017: 24).

<sup>1</sup> The main legal framework for the structure of Czech public administration at the local level consists of 1) the Constitution of the Czech Republic, 2) Act No. 129/2000 Coll. on Regions (Establishment of Regions), 3) Act No. 128/2000 Coll. on Municipalities (the Municipal Order), 4) Act No. 250/2000 Coll. on Municipal Budgetary Rules, and 5) 320/2001 Coll. on Financial Control in Public Administration.

TABLE 4.1 Czech Republic – Population of Local Government Areas, 2018

	Smallest	Largest	Average
Regions	Central Bohemian Region (1,360,809)	Karlovy Vary (295,231)	758,961
Municipalities	Prague (1,280,508)	Vysoká Lhota (15)	1,690

Source: The Czech Republic Statistical Office 2018

The size of local-level institutions in the Czech Republic with respect to its population is among the smallest of all OECD countries. There are 6,258 municipalities (Obec) and 14 regions (Kraj, including the city of Prague) (OECD 2018: 2 ff.). Thus, with a total population of 10,565,000 inhabitants (2016), the average municipal size is around 1,690 inhabitants and, for regions, 759,000. The city of Prague has a special position being a region and a municipality.

According to Act. No. 129/2000 Coll. (Law on Regions), a region is a legal corporation under public law; it owns assets, has its own income and manages resources according to its own budget. It administers its matters independently, but special laws can delegate state functions to a region. Regional responsibilities include upper secondary education, regional roads, public transport, health care / general hospitals, and economic development and planning, as well as social assistance for disadvantaged groups (OECD, 2016).

The governance structure of regions comprises the elected regional assembly as the deliberative body and the regional council as an executive body, composed of the elected governor, vice-governors and ordinary members of the councils (Charvat and Just 2014: 10). The governor is the head of the region, chairperson of the regional council and external representative. Municipalities are autonomously governed by the municipal council. However, the executive municipal body is the municipal board, the mayor and the municipal office, all of which are directly accountable to the council (Kadečka 2012: 120 f.).

Municipalities perform independent and delegated tasks according to Act No. 128/2000 Coll. The independent tasks of municipalities include matters that lie in the interest of the local community as well as matters stipulated by state law. The scope of delegated tasks differs according to the type of municipality. There are 205 municipalities with extended powers (ORP); 1,036 municipalities with some

delegated powers (e.g. registry office, building authority), including 183 municipalities with an authorised municipal authority; and the remaining, which are “basic” municipalities (OECD 2016). Delegated tasks are carried out through an authorised municipal office not only for its own citizens, but also for citizens of other, neighbouring municipalities. Municipalities with extended powers perform their delegated tasks for the whole region. Delegated tasks are imposed on local authorities by specific, sectoral legislation (Kadečka 2012: 118 f.). Examples include register of inhabitants, social security, social and legal protection of children, education, monument preservation, nature conservation and landscape protection, agriculture, transportation, crisis and emergency management, spatial planning and building code.

The complex administrative structure of local governments in the Czech Republic is mirrored by the extent of delegated tasks (Veselý et al. 2016). This system allows smaller municipalities to rely on others for service provision, which is assumed to be prone to corruption and implies difficulties in public service access because citizens must rely on a variety of offices to complete processes (Lewis and Fall 2017: 24).

## 2 Revenue

In the Czech Republic, the legal base for the municipal budget is Act No. 250/2000 Coll. on budgetary rules of territorial budgets, and Act No. 563/1990 Coll. on accounting. One of the most important revenue sources is the mix of shared taxes, which are centrally collected and distributed. This mix comprises the personal income tax (PIT), corporate income tax (CIT), value added tax (VAT) and income tax on the self-employed (Lewis and Fall 2017: 30–31; OECD 2016). The distribution scheme is determined by technical criteria such as the number of residents and municipality size (Kadečka 2012: 125). The local level has, in general, only a minor role in deciding the composition of the tax structure. The tax revenue of the Czech local level as share of total local revenues for the year 2015 was 41% with a yearly average of 39% from 2000 to 2015 (Figure 4.3). In 2016, 7% of total revenue for municipalities came from own-sourced taxes; it was zero for regions (Lewis and Fall 2017: 30f; OECD 2016). Other sources of income include state grants, which are used to finance delegated tasks, local fees, and capital income (Veselý et al. 2016). Almost one third of municipal income and roughly two thirds of regional revenue are based on transfers, coming especially from the state budget and funds (Kadečka 2012: 126). Regions share about 9% of the state revenue derived from the VAT, PIT and CIT (S. Kadečka 2012: 125). They also receive revenues coming from the tax on personal business

income. The amount of shared taxes a region receives also depends on the number of delegated tasks it has to fulfil.

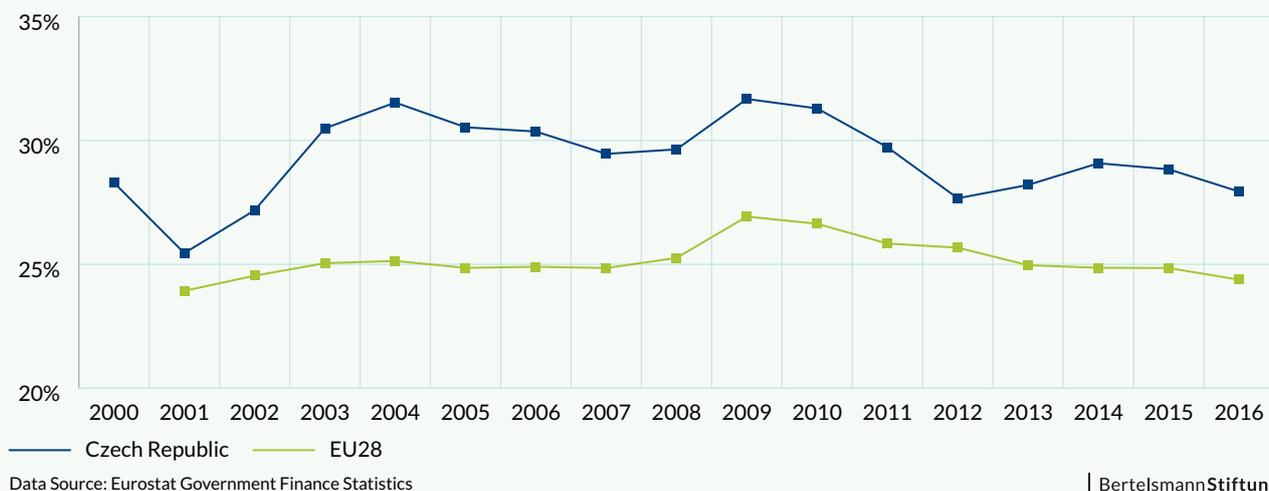
Between 2000 and 2016, Czech local government revenue as share of general government revenue showed a trend similar to the EU28 average, although its proportion is significantly higher (Figure 4.2). This indicates the relative importance of the Czech local level in the administrative system. Following the financial crisis of 2008 and until 2016, on average 29% of general government revenues derived from the local level. This is virtually identical to the years before the crisis. Nevertheless, the post-crisis drop of revenues is significant, permanent and corresponds to an equivalent drop in expenditures in this period (see below). According to the national expert, this is due to a municipal allowance given to low-income citizens which was then passed to the central-level administration in the years 2011 and 2012. General government revenues as a share of national nominal GDP increased from 37% in 2000 to 40% in 2016. Local aggregate revenues grew by roughly 1 percentage point in the same period and stayed above 10% in all years. Czech local government revenues over GDP are well above the EU28 average.

The property tax, which has remained invariable since 1993, contributes entirely to municipalities' budgets. In addition, since the changes in public regulation in the early 2000s, the proceeds from income tax that originated from municipal office duties have fully contributed to municipal revenues (Vybíhal 2018: 84; OECD 2016; national expert). Additionally, the taxing autonomy of municipalities is rather marginal in the Czech Republic (Kadečka 2012: 126). It only exists in the field of the property tax since municipalities have the freedom to establish a local tax rate for the realty assets within their territory. With 0.7% of general government tax revenue, the aforementioned municipal property tax is relatively low compared to an average of 3% in OECD countries (Lewis and Fall 2017: 31).

The average local-level transfer share of the Czech Republic for the period 2000 to 2015 was 36% of total local government revenues (Figure 4.3). Grants and subsidies are the most important source of regional income and second most relevant source for the municipal level (Lewis and Fall 2017: 31 f.). The majority of grants and transfers to local governments are earmarked (up to 91% in 2010), the rest are non-earmarked but require matched funding. Transfers cover a wide range of delegated tasks, along with inherent self-governmental responsibilities. Moreover, municipalities with extended powers receive an additional transfer that is a function of their size relative to the rest of their administrative area. In general, earmarked transfers to local governments become part of the disposable budget through amendments implemented during

FIGURE 4.2 Czech Republic – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



the yearly budgetary execution and mostly financed by the national budget, regional budget or off-budget funds, such as the State Fund for Transport Infrastructure or the State Fund for the Environment (Špaček and Dvořáková 2011: 36). This implies that the approved municipal budget might be different from the one finally executed.

In the Czech Republic, fiscal equalisation prevents potential imbalances, which result from differences in the net fiscal returns (Vybíhal 2018: 96 f.). The transfer system, which has an equalising function, aims at enforcing national standards for expenses at the local government level. It builds on a gross equalisation scheme, where national taxes imposed by the central level are used to provide subsidies to local self-government units relative to their fiscal capacity. The scheme is self-financing in the sense that local governments with low fiscal capacity benefit from subsidies funded by local governments with a higher fiscal capacity.

Local fees are regulated in the Act on Local Fees (Act No. 565/1990 Coll.), which was modified in 2003, with the intention to provide financial advantages to municipalities, in contrast to regions (Bryson 2008: 12). However, this source of revenue represents only a small fraction of municipal income and is negligible for regional revenue (Lewis and Fall 2017: 31). The law contains a catalogue of local charges exclusively for municipalities, which they can levy. These local charges are the charge for dogs; the charge for a spa or recreational stay; the charge for the permission to drive a motor vehicle in selected areas and urban parts; the charge for the operation of the system for collection, transportation, sorting, use and

disposal of municipal waste; and fees on admissions to ticketed entertainment. Other non-tax revenues of the subnational level consist of income from rentals; administrative fees; and capital own income consisting of revenues from the sale of public property, income from local business, and financial operations, among others (Vybíhal 2018: 86).

### 3 Expenditure

Local expenditure as share of general government expenditure (Figure 4.4) shows a significant increase following the public sector / administration reform introduced in 2001, from nearly 23% to almost 30% in 2004. From 2004 to 2009, it was 29% on average. Thereafter, it dropped to approximately 26% in 2016. Despite these fluctuations, the local government share of Czech public expenditures was above the EU28 average in all years except 2001. The activities carried out by the subnational level in the Czech Republic imply a large share of general government resources spent on the local level. This indicates a high level of fiscal and administrative decentralisation in the Czech Republic, at least on the expenditure side. However, according to the national expert, the large share of earmarked transfers could also be seen as a centralisation mechanism because it leaves no room for local government discretion in regards to the nature of these expenditures. Moreover, municipalities have greater spending responsibilities than regions. Among other services, they are responsible for education up to lower secondary school, social services including housing, energy, water infrastructure and waste services (Lewis and Fall 2017: 20).

FIGURE 4.3 Czech Republic – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015

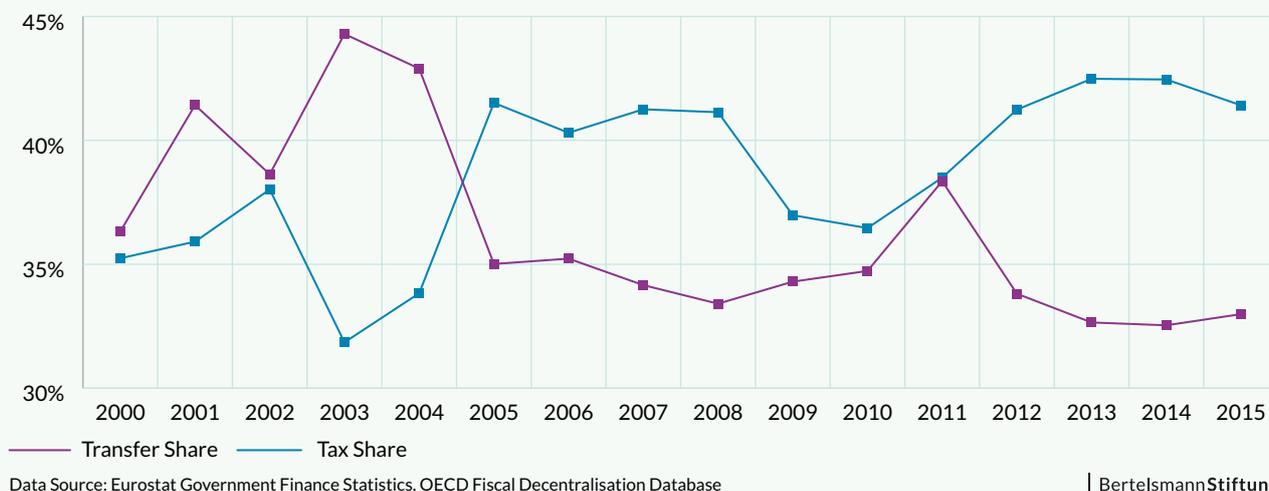
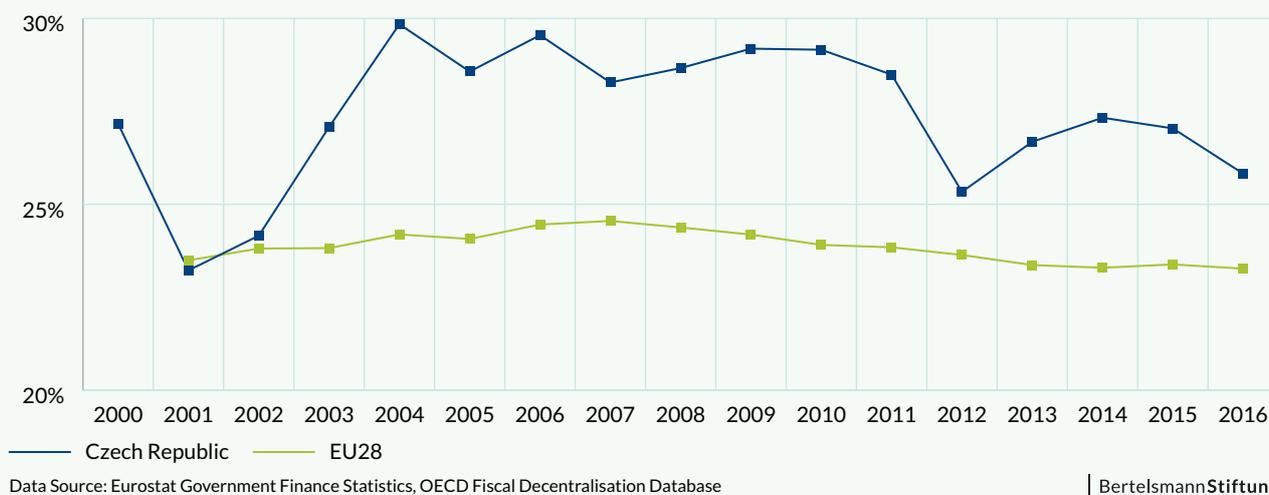


FIGURE 4.4 Czech Republic – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



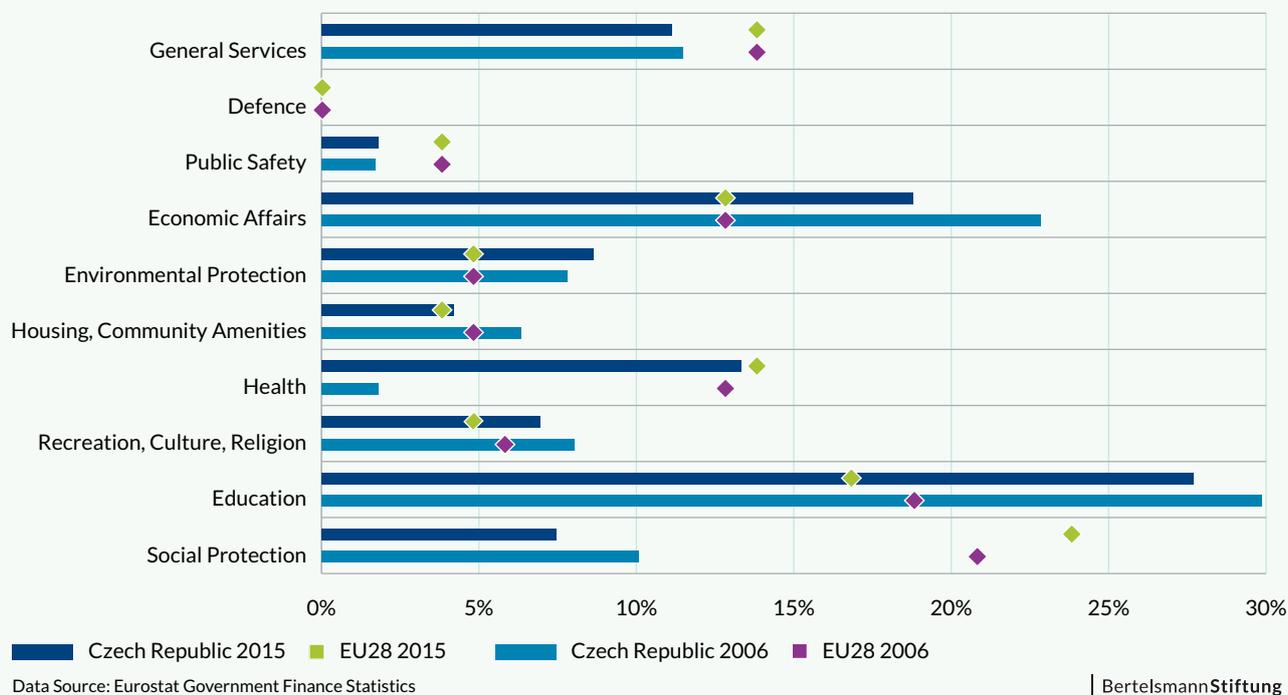
According to expenditures by function (Figure 4.5), the Czech Republic spends the biggest share of resources on education, which decreased slightly from 2006 to 2015. Other noticeable expenditure functions are economic affairs, related to spending on local roads and public transportation, health, which principally relates to primary health care, and general services, such as water and waste management (Lewis and Fall 2017: 22).

## 4 General Fiscal Status

Public debt of the Czech local level (Figure 4.6) makes up for only a marginal share of general government debt. Whereas it was 9% in 2000, this share dropped to 5% by 2016. Following the year of the crisis (2008), the nominal local government debt share in general government debt has, on average, decreased at a rate of 0.4% annually, staying constantly below the EU28. This quite favourable development was at least partially induced by a parallel increase in general government debt after 2008, reaching a ceiling of 45% of GDP in 2013, declining

FIGURE 4.5 Czech Republic – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



to 37% by 2016. Since the Czech Republic is a two-tier system, this means that the central government debt share of general government public debt increased while local government debt decreased after the crisis. One explanation is that the central government bore most of the burden of post-crisis fiscal stimulus (Ministry of Finance of the Czech Republic 2016: 12). Still, Czech debt levels seem to be at a rather sustainable level.

In general terms, financial management of the local level has been sound, with the majority of municipal debt concentrated in the four largest cities (Lewis and Fall 2017: 33). Indebtedness is not a risk to the municipal economic environment, although some small municipalities are heavily indebted, and in the year 2015, three municipalities were considered to be at risk of insolvency. Moreover, despite the introduction of a numerical debt rule (debt ceiling of 60% for the local level) and medium-term budgetary planning in the fiscal reform process from 2015 to 2017, fiscal rules in the Czech Republic remain particularly relaxed on monitoring and enforcement (European Commission 2015: 15).

The improving local government aggregate debt situation as depicted in Figures 4.6 and 4.9 is mirrored by aggregate local-level budget balances (Figure 4.7). Although showing an average deficit of -0.1% of GDP from 2000 to 2016, it

follows a rather constant trend of improvement, which is only interrupted by the effects of the global financial crisis in the years 2008/09. Since 2013, the budget balance has been constantly positive, with a surplus of 1% of nominal GDP in 2016. These surpluses may explain the low and even decreasing debt level of local governments.

In terms of debt types, Czech local level depends predominantly on loans. In 2006, the share of loans among all debts was 71%; by 2016, it increased to 85%. Securities show the opposite development, with a share of only 15% in 2016. Compared to the EU28 average, securities play a bigger role in the Czech local government sector than elsewhere in the European Union.

## 5 Effects of the Financial Crisis

The financial crisis of 2007 changed the economic environment in the Czech Republic. As shown in Figure 4.6, after several years of strong growth, in 2008 the economy slowed down. Nominal GDP decreased in the first post-crisis year and recovered only moderately. This period of modest economic development on the edge of stagnation ended in 2014 with increasing growth rates. The severity of the economic slump

reflected the collapse of world trade that followed the onset of the global financial crisis (OECD 2010: 20, 49 f.). In 2007 and 2008, revenues were buoyant and a number of municipalities profited from substantial asset sales. However, as shown in Figure 4.7, regions and municipalities suffered a temporary aggregate budget deficit from 2008 to 2012.

In this context, municipalities were exposed to economic turmoil for the first time since the reform in 2000. The economic cooling started in 2008, hitting the country in 2009 (Špaček and Dvořáková 2011: 34). The economic slump affected the economic performance of the local level in 2009 but was not as serious as was generally expected. The economic recession caused a slump in tax revenues for municipalities of 12% in 2009. The most affected part of tax revenues were those from the corporate income tax, which decreased by 26% in comparison to the previous year. However, the situation of Czech municipalities was, in fact, better than anticipated. An increase of CZK 9.2 billion in transfers obtained from the central government budget, and the use of own reserves, minimised the impact of the financial crisis. Furthermore, the post-crisis developments at the local level (Figure 4.9) show an increase in debt until 2014 (but still, local government debt never exceeded the very moderate level of 2.8% of national nominal GDP), along with a substantial decline in revenues and expenditures until the year 2012. After 2014, local debt dropped and nearly reached its pre-crisis level in 2016. This trend reflects the development of investments in the entire economy fostered by a higher absorption of EU funds, the revision of measurements – electronic VAT reporting and the fiscalisation of cash payments – to increase tax collection, and the fact that the majority of the fiscal stimulus burden fell on the central government budget (Ministry of Finance of the Czech Republic 2016: 12; European Commission 2016: 7). This is consistent with Figure 4.7, which shows that after the crisis local government experienced a surplus for the first time starting in 2013.

Financial independence and stability of the local government sector has gained new importance following the global financial turmoil. Local and regional finance is assumed to be an important buffer in times of crisis (Guziejewska 2018: 109). This is because the financial conditions of local governments influence the entire public finance sphere, and countries with higher degrees of fiscal decentralisation are supposed to be less exposed to the consequences of income shocks. Consequently, a reform addressing the main weaknesses of the current fiscal framework in the Czech Republic was approved by the government in February 2015, and amended as an ordinary law in 2017 (European Commission 2015: 15). The package consisted of a comprehensive EU budgetary framework

implemented at the general government level. The measures involved strengthening central-level expenditure limits by linking them to the medium-term budgetary objective of a structural deficit of 1% of GDP (European Commission 2016: 15). In addition, it obligated the government to consider long-term sustainable public finances in its budget. Furthermore, it introduced a debt rule for general government, which becomes active once public debt exceeds the threshold of 55% of GDP. In terms of local governments, the package included a new rule for each municipality's level of indebtedness, limiting it to 60% of average municipal revenues.

## 6 Fiscal Rules and Fiscal Oversight

The regulation of budgetary responsibility and state supervision of the performance of municipalities and regions is included in different laws.<sup>2</sup> Whereas regions (as part of local government) supervise municipalities by means of a delegated power granted by the central level, the central government has the task to supervise the local level in its entirety (Kadecka 2012: 129; Act No. 129/2000 Coll.). This implies that regions examine municipal finances in the scope of a delegated competence only. Additionally, the Ministry of Finance oversees the debt levels of all local governments. With regard to separate and delegated tasks, the regional level is subject to state supervision by relevant ministries and other central administrative authorities. The supervision consists exclusively of ex post evaluation of compliance with the laws. Regions have to prepare annual reports on the results of financial controls of municipalities in their territory.

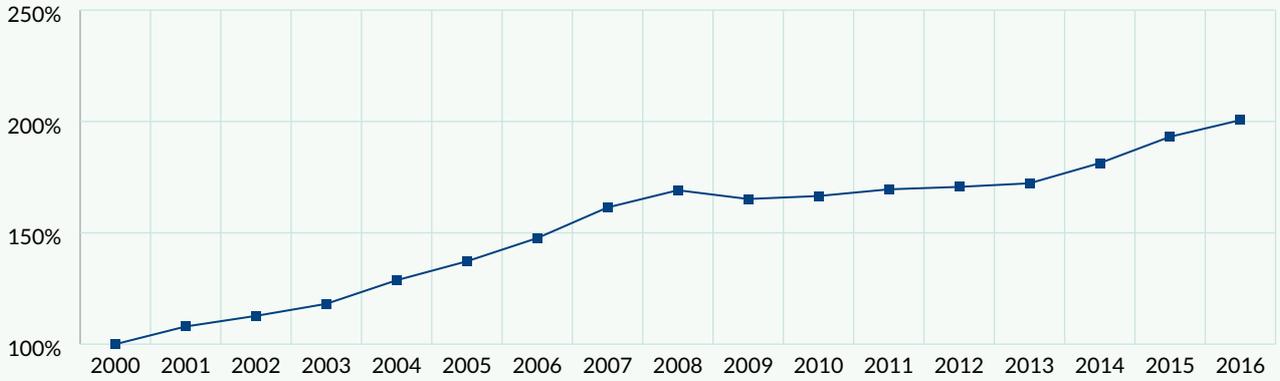
The most significant legislative change in recent years occurred in February 2017 when Act No. 23/2017 Coll. on fiscal responsibility entered into force (Ministry of Finance of the Czech Republic 2017: 37). The new legislation introduced several measures for fiscal responsibility at the national and local level. In general terms, it introduced the forecast and medium-term budgetary framework, the creation of an independent body (National Budgetary Council) for the evaluation and control of the various fiscal rules, and the implementation of these rules.

The budgetary process at the subnational level is regulated in the Budgetary Rules for Territorial Entities Act No. 250/2000 Coll. comprising the municipal as well as the regional level.

<sup>2</sup> The main legal framework for Czech subnational control and oversight consists of 1) Act No. 129/2000 Coll. on Regions, 2) Act No. 128/2000 Coll. on Municipalities, 3) Act No. 320/2001 Coll. on Financial Control, 4) Act No. 166/1993 Coll. on Supreme Audit Office, 5) Act No. 522/1991 Coll. on State Control and 6) Act No. 320/2001 Coll. on Financial Control.

FIGURE 4.6 Czech Republic – Nominal Gross Domestic Product

Index: 2000 = 100

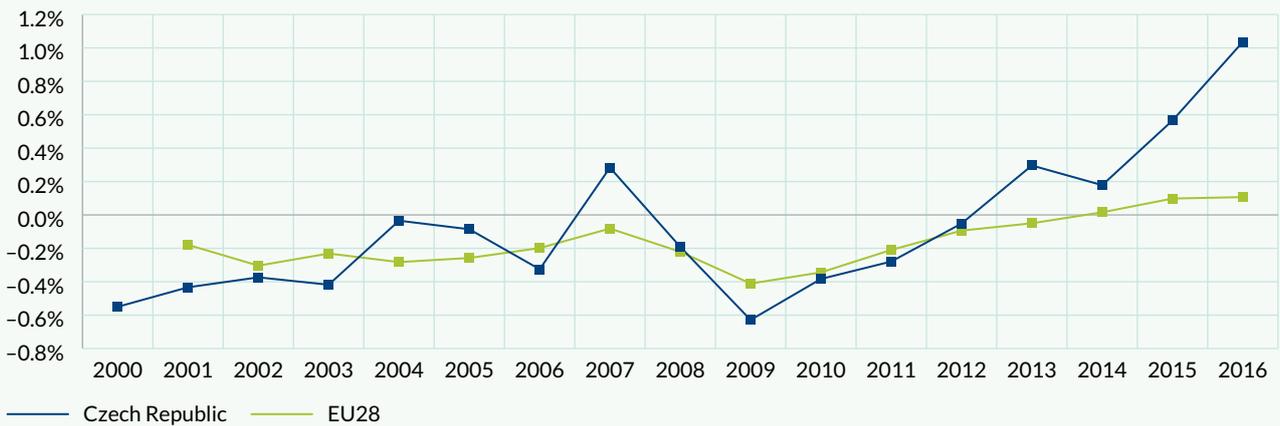


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 4.7 Czech Republic – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 4.8 Czech Republic – Local Government Aggregate Debt

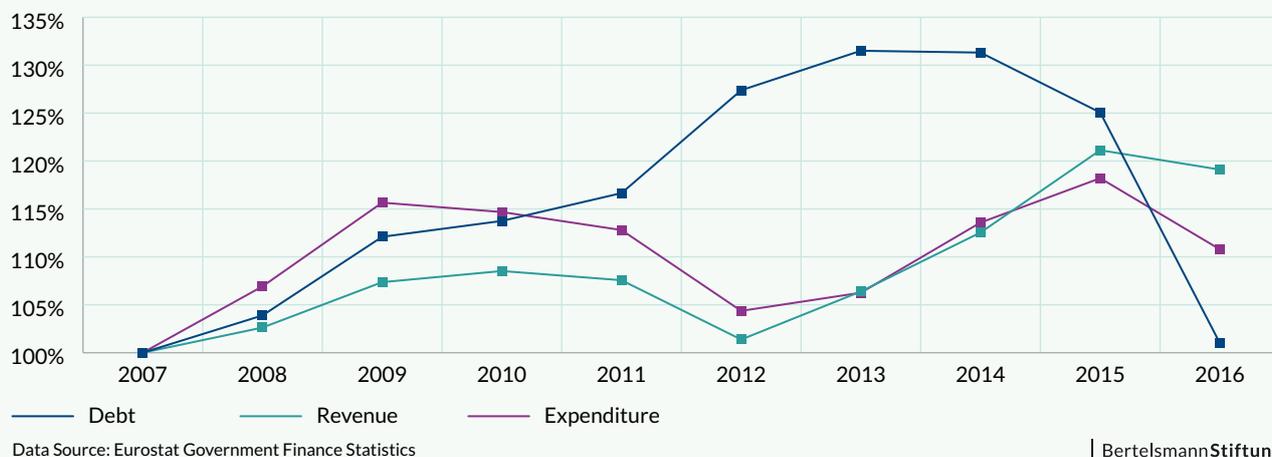
As Share of General Government Debt – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 4.9 **Czech Republic – Post-Crisis Developments**  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



The fiscal year is equal to the calendar year for all public budgets. The regional level draws up its annual budget in relation to its budget outlook and based on data from the valid state budget (Markova et al. 2016: 127). The state budget defines its fiscal outlook considering the budgets of regions and individual municipalities. The preparation of the draft budget starts in September/October (Sedmíhradská 2009: 9 f.). Since municipal budgets depend on state and regional budgets, some municipalities begin their budget preparation after the approval of regional and state budgets. This means that for the first months of the year, they operate on the basis of a provisional budget. Other municipalities have to amend and approve their budgets as soon as the higher-level public budgets are approved.

In municipalities, the budget officer is responsible for the preparation of the draft budget (Sedmíhradská 2009: 9 f.). He/she prepares the revenue estimates; the municipal departments submit their requests and prepare the capital budget. Next, the budget officer discusses the requests with the department heads, adjusts the requests, prepares a draft budget and compiles the necessary information. Various municipal authorities discuss this draft, such as the mayor, financial committee and council. After this internal discussion, the draft budget is published. The law states that the draft budget must be available to the public at least 14 days before the budget debate in the council. The council decides on approving the budget. Compliance with fiscal rules is monitored by the relevant regional authority in the case of municipalities, and the Ministry of Finance in the case of regions (Markova et al. 2016: 128).

In the context of the new law on fiscal responsibility, a rule regulating the level of external debt was set at 60% of the average total revenues for each local government unit over the last four years (Ministry of Finance of the Czech Republic 2017: 37 f.). If this rule is broken, municipalities have a certain amount of time defined by law to reduce their debts. Furthermore, if the local unit still does not comply with this standard, a part of the shared taxes is withheld from the local government based on the reduction that was not carried out. In 2016, approximately 500 municipalities (8% of all municipalities) had a debt higher than 60% of their revenues (Baxa and Paulus 2016: 18), including 29 towns and three statutory cities. The regional governments' debts had not exceeded the threshold until 2016. The two cities with the largest debt-to-revenue ratio were Liberec and Olomouc with approx. 100%.

Before 2017, there was no direct central government limitation on the volume of credit or borrowing that a local unit could accept (Sedmíhradská and Šimíková 2007: 7; Pospisil 2017: 733). However, the legal regulation of the issuance of municipal bonds – the Ministry of Finance has to approve it – is an indirect legislative measure influencing the indebtedness of the municipalities. Furthermore, between 2004 and the introduction of the 60% rule in 2017, there was a debt service ratio regulation for bank credits, municipal bonds and returnable financial aid. This rule foresaw that the minister of finance would require any municipality with a case ratio overrun of 30% to explain the reasons and suggest measures for improvement within three months. The municipality had to submit the audit report and the multi-annual budget outlook. If the debt service ratio was overrun in the next year, the ministry put the municipality on a list. This list was

passed on to the grant providers, such as other ministries and state departments, which were supposed to consider this information when providing new grants.

Furthermore, in 2008 the Ministry of Finance instituted the Municipal Financial Management Monitoring, also called the System of Informative and Monitoring Indicators. This system is used to evaluate the municipal management annually (Linhartová and Němeček 2015: 61). This process concerns the review of different data sources, such as the annual management of the municipality (final account); the disposal and handling of municipal property; and the awarding and execution of public procurements.

Local governments' annual budget must be conceived as a balanced budget (Sedmíhradská and Šimíková 2007: 7; OECD 2016). This rule is enshrined in Act No. 250/2000 Coll. In the case of a deficit, the budget can still be approved, if it is expected to be paid using financial means from past years' yield from municipal sales or other financial assets such as a contractually secured loan, credit, returnable financial aid, or by the yield from sales of the municipality's own bonds. The level of the budget deficit is determined and approved solely by the municipal council, neither the Ministry of Finance nor the region have a right to step into this decision-making process.

According to Act 320/2001 Coll. on Financial Control in the Czech Public Administration, the public authority is obliged to maintain internal control systems aiming for the efficient, effective and functional use of public resources. The principle of internal financial management consists of three subsystems: a) the system of financial control performed by supervisory authorities, referred as the public administration control; b) a financial control system carried by international agreements; and c) the internal control system in public administrations (Kranecová 2015: 124). The internal auditor is an independent unit or employee authorised for that purpose and organisationally separated from the managing executive structures. The primary aim is to perform an objective review and evaluation of operations and of the internal control system of the correspondent public repartition. The council of the region appoints the head of internal regional audit units on the proposal of the director of the regional authority. Additionally, the municipal council performs the same task, if this concerns an internal audit unit of a municipality.

Moreover, the Ministry of the Interior controls the independent competencies of a municipality; for delegated competencies this is done by the regions (Kadečka 2012: 128). Moreover, according to Act No. 166/1993 Coll., the Supreme Audit Office of the Czech Republic is not authorised to audit finances of

municipalities, towns or regions or to audit companies co-financed by the state or by a self-government. According to Act No. 128/2000 Coll. of Municipal Order, a municipality with at least 5,000 inhabitants should have its finances for the previous year audited by an external consultant. In addition, a municipality with fewer than 5,000 inhabitants should have its finances for the previous year audited by the regional office or a private auditor.

In the Czech Republic, there is no law or official procedure for municipal insolvency (Hruza and Novotná 2016: 63–64). Therefore, the discussion has focused on the attributes and identification of municipalities which suffer such insolvent states (without being able to declare bankruptcy). The Ministry of Finance oversees the debt level of all local governments and warns municipalities at risk of insolvency (Lewis and Fall 2017: 33). In 2016, the municipalities of Prameny, Bublava, Turovice, Pohled and Měňany, were considered to have a higher financial management risk by the Ministry of Finance's Financial Municipality Management Monitoring (Linhartová and Němeček 2015: 61). Since the end of the Soviet Union, some Czech municipalities have slipped into a condition that is similar or close to the state of bankruptcy (Hruza 2015: 879). Still, municipalities in a state of quasi-insolvency are rather rare (Hruza and Novotná 2016: 72). There is an ongoing discussion about how to resolve the financial issues of these municipalities, but so far, no systematic solution has been found.

When Czech municipalities suffer financial troubles, the most common way to cope with it is the involuntary sale of municipal property (Hruza and Novotná 2017: 66). Municipal bailout, meaning a takeover or guarantee of debts by higher territorial administrative units, is rather rare. However, the case of the town of Rokytnice nad Jizerou stands out as a special case in which the Czech government intervened in order to solve the municipal debt problem (Jahoda 2007: 65). In this case, the Ministry of Finance acted through the consolidation agency by overseeing the debt. The agency ordered the auction of municipal property to meet obligations, made a partial payoff of a loan for CZK 25 m, and waived other loan obligations.

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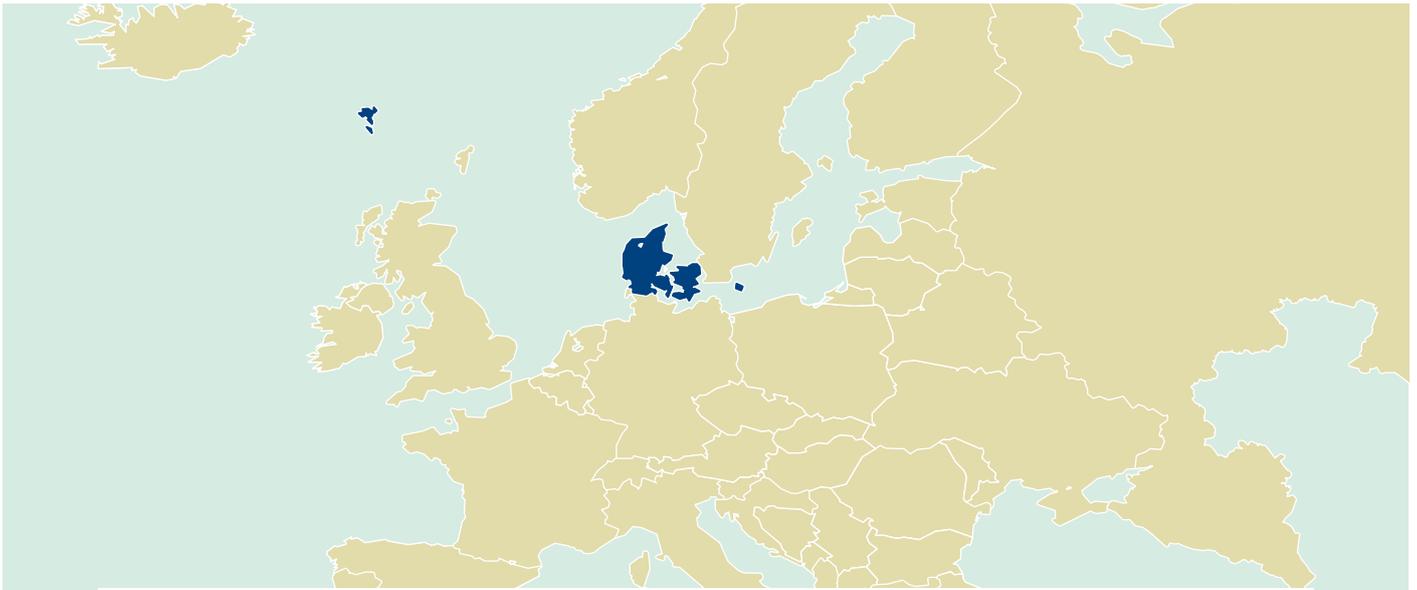
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# 5 | Denmark

Friederike-Sophie Niemann

## Summary

Denmark is a highly decentralised unitary state with a three-tier administrative system consisting of a central government, five regions and 98 municipalities. Danish municipalities are some of the largest, compared to the rest of Europe. They serve a broad range of functions and have a high level of autonomy. Taxes are the most important revenue source and account for nearly 60% of all municipal revenues, of which income tax is the most relevant and locally flexible. Municipalities are responsible for approximately half of the total public expenditure. The overall status of public finances in Denmark is solid. National accounts have been balanced since 2011. The financial crisis hit Denmark in 2009 and the general government saw a subsequent decline in revenue. Due to compensatory payments from the central state, local finances were directly affected.

The central government considered local (over-)spending and rising tax rates as a problem prior to the crisis. It tried to curb local spending and taxation levels via a system of annual agreements targeting local governments in sum (budgetary cooperation). As a reaction to the financial crisis, the central government introduced legislation, which imposes sanctions for breaking these annual agreements. If the local level fails

to meet the agreements, the central government has the right to withhold grants.

Danish municipalities are subject to a system of clear and strict fiscal rules consisting of several elements, such as a balanced budget rule, limitation on short-term credits, expenditure and tax limits and loan dispensations. If rules are violated, a standardised procedure automatically starts which is implemented by the Ministry for Economic Affairs and the Interior. In turn, the municipality must implement measures agreed upon with the Ministry, and is obliged to send quarterly reports. This procedure has proved to be very effective, and no further sanctions have yet had to be implemented.

## 1 Administrative Structure

Denmark is a unitary state consisting of a central government, five regions (Nordjylland, Midtjylland, Syddanmark, Hovedstaden and Sjælland) and 98 municipalities (Figure 5.1). Municipalities are not subordinated to the regions; instead, both groups have different tasks and responsibilities.<sup>1</sup>

The classification of regions as local governments is vague. On the one hand, they are a result of the 2007 local government reform, have elected councils and are classified as local governments by Eurostat. Nonetheless, the central government does not adhere to this classification.<sup>2</sup> Due to their overwhelming relevance, this report focuses on municipalities, but is responsive to regions when appropriate.

The roots of municipalities go back to the parishes of the 11th and 12th centuries (Lotz et al. 2013: 4). Danish municipalities were small in origin but grew in size and importance over the years due to fusion as well as the repeated delegation of tasks to them by the central government. In 1970, 1,389 municipalities amalgamated into 275, and 24 counties merged into 14. A further major local government reform in 2007 turned the 14 counties into five regions and merged the 271 municipalities into 98. One of the objectives of this reform was to make the local governments more professional, efficient and capable of fulfilling their numerous tasks.<sup>3</sup> Thus, Danish municipalities are some of the largest in Europe (Ministry for Economic Affairs and the Interior 2014: 12).

Denmark is a highly decentralised country. The central government has not only delegated the implementation of the majority of welfare policies to municipalities and regions, but municipalities also have a general mandate to take on further

- 1 [http://www.kl.dk/ImageVaultFiles/id\\_38221/cf\\_202/Background\\_Paper\\_-\\_Local\\_Government\\_in\\_Denmark.PDF](http://www.kl.dk/ImageVaultFiles/id_38221/cf_202/Background_Paper_-_Local_Government_in_Denmark.PDF) [9.2.2018].
- 2 <https://english.oim.dk/responsibilities-of-the-ministry/governance-of-municipalities-and-regions/about-municipalities-and-regions/> [9.2.2018].
- 3 <https://english.oim.dk/responsibilities-of-the-ministry/governance-of-municipalities-and-regions/about-municipalities-and-regions/> [9.2.2018].

FIGURE 5.1 Denmark – Administrative Structure, 2017

Central Level	Central Government	
Regional Level		
Local Government	5 regions	98 municipalities

Source: own preparation

TABLE 5.1 Denmark – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Regions	North Denmark (587,000)	Capital region (1,807,000)	1,157,200
Municipality	Laeso (1,900)	Copenhagen (1,800,000)	59,000

Source: Statistics Denmark

tasks (Sørensen 2016: 7). Yet, there are some restrictions in this regard. For example, they are not allowed to handle tasks which have been transferred to other authorities, and they are not allowed to engage in commercial activities. Local governments are allowed to execute most of their functions with full discretion, except for some social security benefits. The right of municipalities to manage their own affairs, while supervised by the state, is codified in the constitution of 1849. By means of supervision, the central government ensures that municipalities and the regions work within the laws. Further rules concerning municipalities are specified in the Local Government Act.

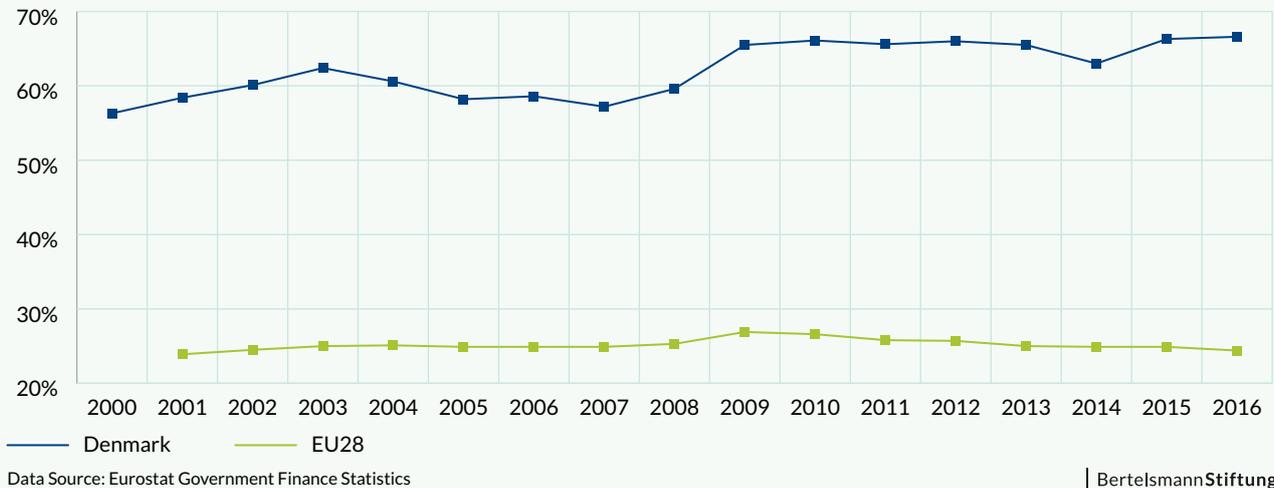
Danish municipalities have many tasks to fulfil and the local government reform of 2007 even increased their range of responsibilities. Most of those tasks had previously been executed by counties or the central state. Thus, municipalities are currently responsible for, inter alia, social care for socially vulnerable and physically and/or mentally disabled citizens,<sup>4</sup> child daycare, primary and lower secondary schools, eldercare, healthcare (outside hospitals), integration and language lessons for immigrants, support services in cases of unemployment, retirement or sickness, active employment efforts, transport and roads, libraries, music schools, local sports facilities and other cultural sites as well as the utility sector (Ministry for Economic Affairs and the Interior 2014: 19 f.). However, Danish municipalities do not always provide the services themselves. Instead, they have a strong tradition of using independent, but wholly owned subsidiaries (Kommunekredit et al. 2012: 25).<sup>5</sup>

In contrast to the municipalities, the regions have a significantly smaller range of functions and are only responsible for hospital services, psychiatry and the National Health Service, regional development, institutions for vulnerable groups and groups with special needs as well as participation in transport companies (Ministry for Economic Affairs and the Interior

4 The local governments became the sole responsible authority for this area after the reform of 2007. The regions are only responsible for running a few specialised institutions.

5 Recently, many utility companies have also been contracted out or privatised (Ministry of Economic Affairs and the Interior 2014: 24).

FIGURE 5.2 Denmark – Local Government Aggregate Revenue  
As Share of General Government Revenue – From 2000 to 2016



2014: 20). This small range of functions is mainly due to the 2007 reform, which has deprived the old counties of almost all their previous functions (Blom-Hansen 2012: 50).

## 2 Revenue

Although the central government denies local status to regions, they are classified as local governments by Eurostat statistics. Therefore, the following figures and data contain the sum of both types.

Danish local governments account for an extraordinarily high share of general government public revenue (and spending); this underlines their high relevance (Figure 5.2). Taxes are a very important revenue source for municipalities. Additionally, both groups receive state grants and state reimbursements as well as user payments (Figure 5.3). Local governments cannot freely decide to borrow money except for investments in utilities (Blom-Hansen 2012: 50 f.).

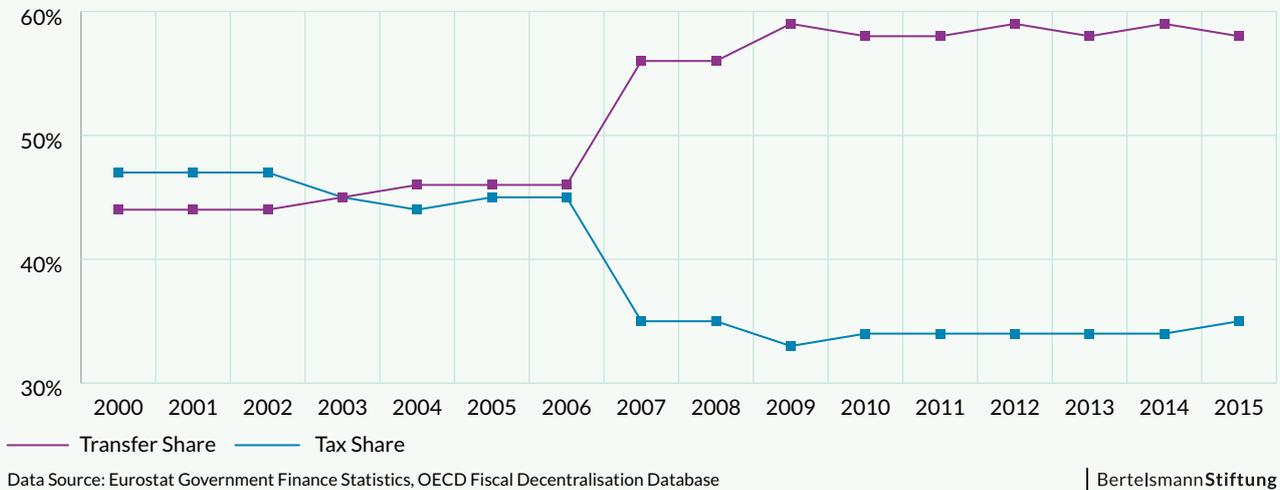
Local government tax revenue consists largely of the municipal income tax. In addition, there are the land tax (including a service charge), the company tax, researcher tax and estate tax. In terms of the income tax, and the land tax municipalities are allowed to influence their proceeds by determining the respective rates within specific limits. Regarding the latter three taxes, the rates are set by the state and the municipalities just receive a fixed share of the overall revenues (Ministry for Economic Affairs and the Interior 2014: 28). There is no taxation right and no tax revenue for regions; they are fully financed by state grants.

During the past decades, however, Danish municipalities have made strong use of their right to set income tax rates. Thus, they have been able to generate higher proceeds in order to increase their expenditures. On average, the municipal income tax rates rose from circa 15% in 1976 to approximately 25% in 2013. Although some parts of this increase can be traced back to national decisions, in general, the central government observed this development with growing concerns due to its macroeconomic consequences. A corporatist arrangement, the so-called “budgetary cooperation”, was established in 1979: This arrangement determined, among others, that the central government and the association of local governments annually agree on targets for the aggregate level of expenditure as well as local tax rates (Sørensen 2016: 7).

However, these attempts were obviously not very effective. Instead, the agreements between the central government and the association of local governments were consistently broken. After all, the political climate was not favourable to fiscal constraints at the time. As public finances were in a very good state, citizens and politicians alike supported strong public services (going along with high expenditures/tax rates). To solve the problem of continuous tax increases, the central government introduced a new system of sanctions following the local government reform of 2007.<sup>6</sup> Since then – but also due to the changed political climate following the financial crisis – the local tax rates have been almost constant and inter-municipal differences in taxation continue to decrease (Lotz et al. 2013: 6 f.).

<sup>6</sup> This virtually means a tax stop for the aggregate municipal level. If a local government must increase its tax rate, another municipality must decrease theirs in order to prevent violation of this law.

FIGURE 5.3 Denmark – Local Government Aggregate Transfers and Taxes  
As Share of Total Local Government Revenue – From 2000 to 2015



However, as mentioned above, Danish municipalities do not only get tax revenues, they also benefit from state grants and subsidies, which are allocated to them via an equalisation scheme. The main objective of this scheme is to level off differences in the economic situation of municipalities, which might be caused by differences in their tax base, their composition of age groups or their social structure (Ministry for Economic Affairs and the Interior 2014: 30). The equalisation scheme is needed because there are discernible differences in the economic development of different geographic areas.

The equalisation scheme consists of several components. First, there is the so-called “national equalisation”. It includes all 98 municipalities in Denmark and compares their respective estimated expenditure needs with their estimated tax revenues. The municipality’s expenditure need is calculated on the basis of its population size, the composition of age groups and an index of the socioeconomic structure within the municipality. If the estimated expenditure need is higher than the estimated tax revenues (thus, if the municipality has a structural deficit), it receives a subsidy equal to 61% of the deficit. If it has a structural surplus, on the other hand, it has to pay 61% of that surplus. However, the majority of the national equalisation scheme is paid by the central government, as only very few municipalities have a structural surplus. In addition to the national equalisation, there is a further equalisation scheme for the capital region<sup>7</sup>

7 The special equalisation scheme for the capital region (still) exists for mainly two reasons. First, it has historical roots, as the whole equalisation system was first introduced in the capital region. Secondly, there are many small, adjacent municipalities in the capital regions. Large differences in tax levels and services between the single municipalities are prevented by the special equalisation system, since those differences mean instability against the background of short distances between municipalities and the high proportion of daily commuters.

(financed only by the municipalities within the capital region) as well as a special subsidy for municipalities with a structural deficit per inhabitant which is higher than the national average.

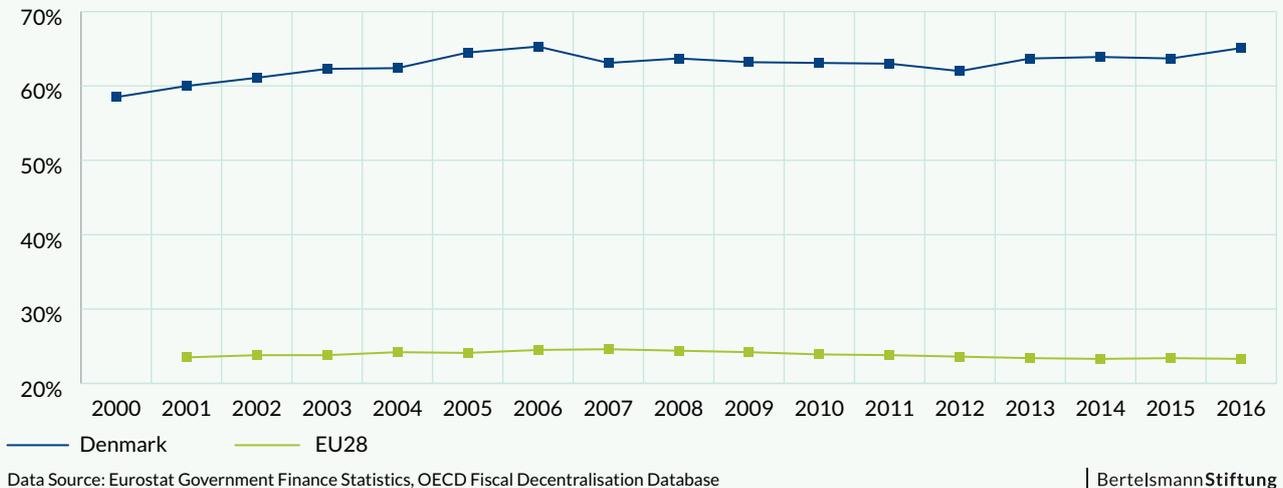
Furthermore, the central state pays a block grant to municipalities, which is allocated largely based on their population (Ministry for Economic Affairs and the Interior 2014: 30 ff.). The total amount of the annual block grant is calculated based on the block grant of the previous year adjusted for inflation and increases or decreases in municipal expenditure.<sup>8</sup>

Finally, there are still some special subsidies and further equalisation schemes, including, among other things, an employment subsidy for municipalities with especially high unemployment rates, a subsidy for particularly disadvantaged municipalities or a subsidy for municipalities with a large share of socially disadvantaged citizens. The latter two are only granted upon application (Ministry for Economic Affairs and the Interior 2014: 35 ff.).<sup>9</sup>

8 These adjustments serve as an important shield for the local level: “The municipal sector is compensated if expenditure and/or revenues change due to factors that are business-related and external to the municipalities, i.e. not depending on their decisions. For instance, this happens if outlays for unemployment benefits increase or decrease due to business cycle movements or the municipal income tax base reacts to the general economic development in the country” (Mau 2015: 229 f.).

9 Currently, the central government even allocates a further grant (the so-called “extraordinary financing grant”) to the local level. The reason is that during the last several years, some of the Danish municipalities complained that the equalisation system did not redistribute enough money to those municipalities which have especially severe (socio-)economic problems and low incomes. They argue that the balance between expenditures and revenues only works in the aggregate but not for every individual municipality. Since the government has not yet resolved this problem and adapted the equalisation scheme accordingly, it pays an extraordinary financial grant during the transition period to pacify dissatisfied municipalities.

FIGURE 5.4 Denmark – Local Government Aggregate Expenditures  
As Share of General Government Expenditures – From 2000 to 2016



Finally, Danish municipalities in general are well protected in economic terms. This is necessary because municipalities are responsible for a number of important tasks, which are influenced by economic cycles. Furthermore, the financial protection of Danish municipalities is a manifestation of the principle of compensation, which gives the association of local governments (LGDK) the right to negotiate the economic consequences of new legislation with the central government. According to the principle of compensation, there must be some sort of financial coverage for any new legislation which is expected to be implemented by the local level. Therefore, only very few Danish municipalities experience economic and, subsequently, fiscal problems (Mau 2015: 230).

In contrast to municipalities, regions do not have individual taxation rights. Thus, they mainly finance their needs through state subsidies and activity-based municipal co-financing (Ministry of Economic Affairs and the Interior 2014: 43).

### 3 Expenditure

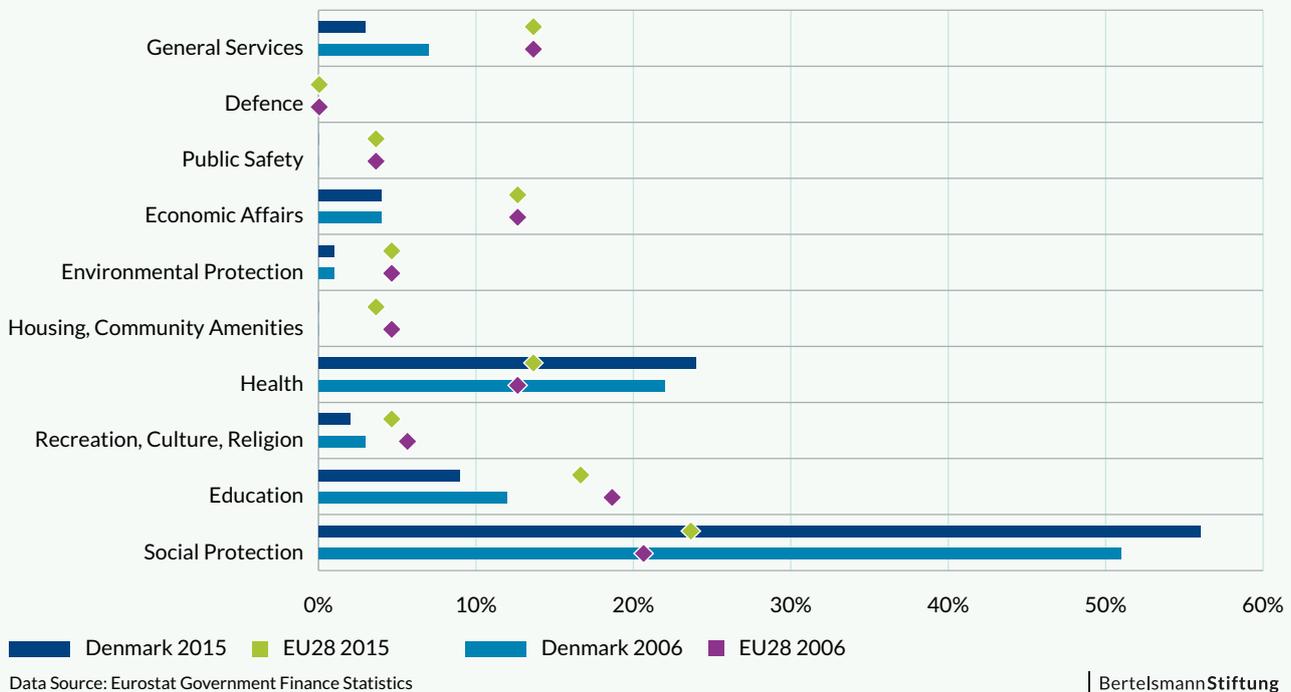
The local government sector in Denmark makes up a major part of the public sector. Approximately two thirds of public expenditures are spent by the sub-central level, which comprises municipalities as well as regions (Mau 2015: 229; Figure 5.4). Municipalities alone are still responsible for about half of total public expenditure. Considering the tasks of the Danish local governments, the division of their net operating expenditures is not very surprising: they spend the largest share of all local expenditures on social protection

(e.g. children and young people, elderly and disabled adults, transfer payments). The second largest function with regard to spending is health (only regions; Figure 5.5).

In a long-term perspective, municipal expenditures have increased. There are several reasons for this. On the one hand, the central government delegated more and more functions to the local level (while maintaining the right of regulation and inspection of services at the same time). On the other hand, the extensive taxation rights of Danish municipalities provided them with a sufficient funding base for increasing their level of services/activities. Additionally, the general political climate was supportive of a strong and comprehensive welfare state. Over time, however, the central government became more and more concerned about increasing local expenditures. Because Danish municipalities are economically very important, this behaviour had discernible macroeconomic consequences. Since these did not coincide with the actual macroeconomic aims of the central government, it restricted local borrowing and, later on, made efforts to curb the rise in local expenditure and tax rates by annual agreements (Lotz, Blom-Hansen, Hartmann Hede 2013: 4 ff; Mau 2015: 228; Sørensen 2016: 7).<sup>10</sup>

<sup>10</sup> The interests of local actors often coincided with the interests of the local citizens (Lotz, Blom-Hansen, Hartmann Hede 2013: 6). This is quite surprising from the perspective of other European countries, whose local citizens at some point would probably put an end to continuous tax increases by means of their voting power. However, this does not seem to be the case in Denmark. On the contrary: "Citizens in the three countries [Denmark, Sweden and Finland] are not unhappy with the high tax levels. Research shows they are willing to pay taxes if they feel they get their money's worth" (Kommunekredit et al. 2012: 15).

FIGURE 5.5 Denmark – Local Government Expenditures by Function  
As Share of Total Local Government Expenditures



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## 4 General Fiscal Status

The overall status of public finances in Denmark is solid. Danish fiscal policy is considered as “overly sustainable”.<sup>11</sup> According to the latest report of the Chairmanship of the Danish Economic Council, “the planned fiscal policy complies with the fiscal policy rules”. Budget surpluses are expected between 2019 and 2025.<sup>12</sup>

There have been serious financial challenges at the local level within the last decade (Figure 5.7); this was one reason for the local government reform of 2007. The local government level is currently even a bit better off than the central government level; taken together, its budget has been in a slight surplus since 2011 (Figure 5.7) and grew to nearly 0.4% of the GDP in 2016. Moreover, the Danish Economic Council states that the “agreements with municipalities and regions as well as the budget for 2016” and also “the accounts for municipalities, regions and central government for 2015 comply with the

budgets and expenditure ceilings”.<sup>13</sup> Although, comparably high to other EU states and constantly rising, local government debt is not a serious issue in Denmark (Figure 5.8; Sørensen 2016: 7).

## 5 Effects of the Financial Crisis

The economic crisis hit Denmark in 2009 (Figure 5.6). While Denmark experienced significant budget surpluses from 2005 to 2007 and thus found itself in a very good fiscal position, the budget dropped dramatically to -2.8% in 2009. Subsequently, the debt level grew until 2011, although it remained well below the EU average.

Due to compensatory payments from the central state, local finances were not directly affected by the crisis.<sup>14</sup> In contrast, the increase in revenue as expenditure went on (Figure 5.9). However, continuing local (over-)spending resulted in a fiscal deficit from 2009 onward (Sørensen 2016: 8). The central government had already considered local (over-)spending

11 [https://www.dors.dk/files/media/rapporter/2017/F17/F17\\_English\\_Summary.pdf](https://www.dors.dk/files/media/rapporter/2017/F17/F17_English_Summary.pdf) [16.2.2018]

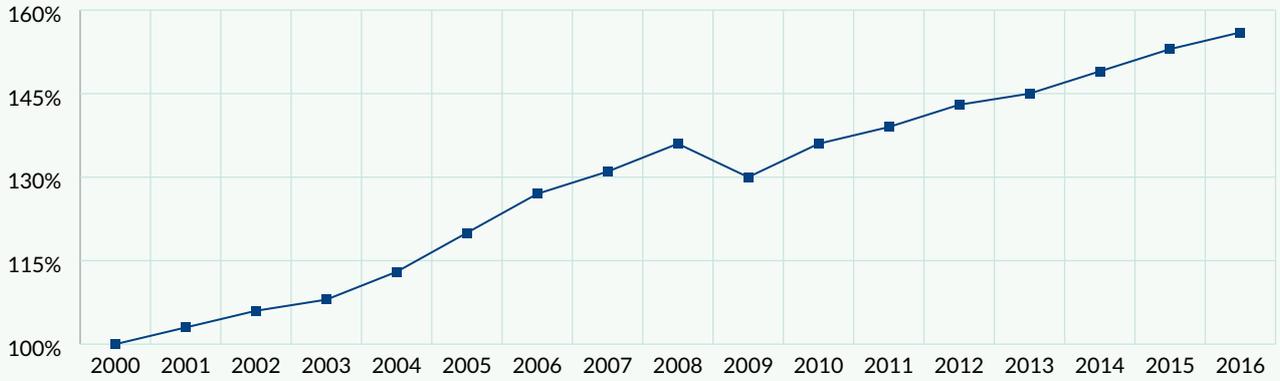
12 [https://www.dors.dk/files/media/rapporter/2017/E17/english/e17\\_english\\_summary.pdf](https://www.dors.dk/files/media/rapporter/2017/E17/english/e17_english_summary.pdf) [13.2.2018]

13 [https://www.dors.dk/files/media/rapporter/2016/F16/f16\\_english\\_summary\\_1.pdf](https://www.dors.dk/files/media/rapporter/2016/F16/f16_english_summary_1.pdf) [13.2.2018]

14 In fact, there are very strong automatic stabilisers at work in Denmark. If local tax revenues decrease from one year to the other, the block grants from the central government automatically increase for the municipal level as a whole. This functions like a fiscal buffer.

FIGURE 5.6 Denmark – Nominal Gross Domestic Product

Index: 2000 = 100

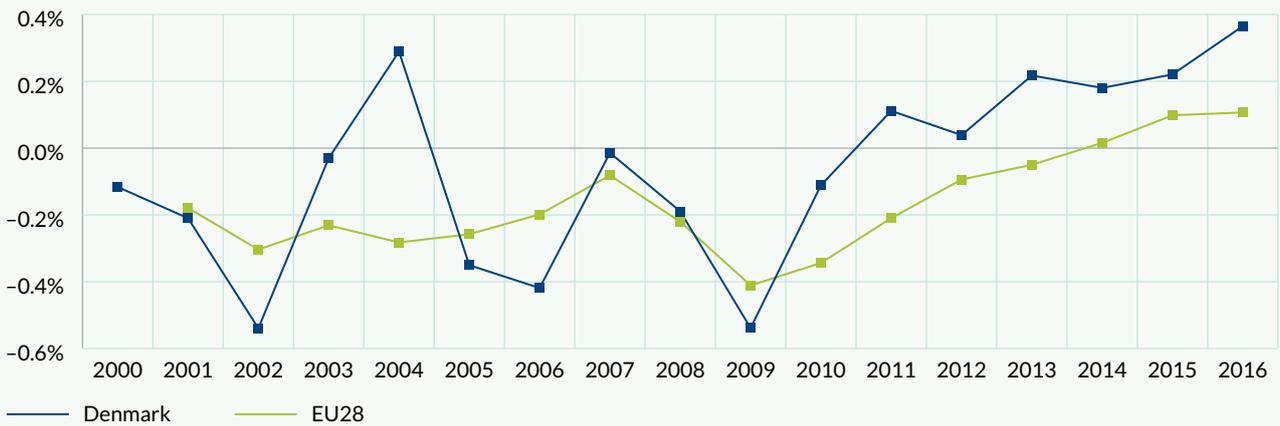


Data Source: Eurostat Government Finance Statistics

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FIGURE 5.7 Denmark – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 5.8 Denmark – Local Government Aggregate Debt

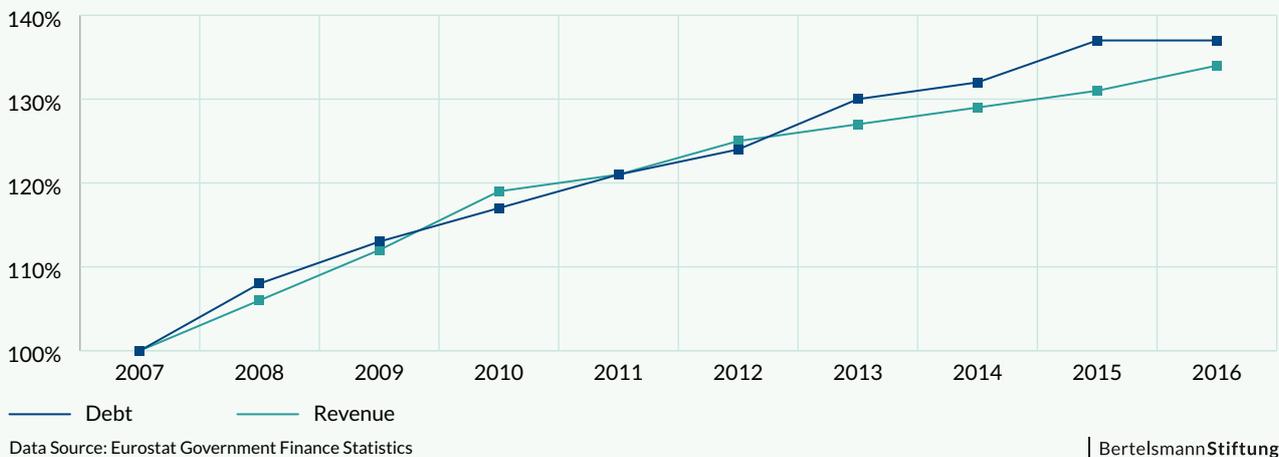
As Share of General Government Debt – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 5.9 **Denmark – Post-Crisis Developments**  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



as a problem prior to the crisis. However, because of the strong economic boom in the mid-2000s and the support for a comprehensive/growing welfare state by citizens and politicians alike, the political climate was not very favourable for reforms aiming at a tightening of fiscal regulations (Ghin 2018: 188). Thus, the central government tried to curb or even freeze the local spending and taxation levels via its system of annual negotiations and agreements, the so-called budgetary cooperation between central, local and regional government (Blom-Hansen 2012: 71).

As it turned out, this was not successful: in 2008, the annual agreement was broken to an unprecedented extent. As a reaction, the central government introduced legislation which imposed sanctions for the breach in agreements. Over the years, these sanctions became stricter and stricter. Finally, a general Danish budget law was introduced in 2012, which tightened the screws (Blom-Hansen 2012: 72 ff.). The EU Fiscal Compact influenced the content of this law; nevertheless, the independent desire of the Danish government to prevent (local) politicians from steadily increasing public spending was also a major reason for its introduction (Lobe Suenson et al. 2016: 4 f.).

Meanwhile, it has turned out that the sanctions actually work. But it was not only the sanctions which had an effect: public opinion changed. Following the financial crisis, Danish voters showed a preference for lower public expenditures (Lobe Suenson et al. 2016: 3). This made it easier for local politicians to actually curb local expenditures. Thus, local government budgets have greatly improved since 2011, and the agreements have not been broken again (Figure 5.7). Thus, no sanctions have yet been imposed.

Finally, the financial crisis fostered a “cascade of fiscal centralisation”, which had already started some years before (Moll Sorensen 2016).

## 6 Fiscal Rules and Fiscal Oversight

Danish municipalities and regions are subject to a system of very clear and rather strict fiscal rules. On the individual level, they are legally bound to pass balanced budgets, to keep short-term credits balanced, and require loan dispensations. Violating these rules starts an automatic procedure by the Ministry of Economic Affairs and the Interior. On the aggregate level of local governments, they face expenditure and tax limits. Compliance with these rules is monitored by the Economic Council.

Generally, municipalities and regions are able to finance their ongoing investments (construction and restoration) by means of tax revenues and state grants. An exception to this rule is investments in utilities which are paid by the users and which are therefore expenditure-neutral for local governments.<sup>15</sup> In these cases, local governments are completely free to raise loans. Furthermore, local governments can also take loans within strict limits for special capital spending reasons. However, loan dispensations can only be given from so-called loan pools upon application.<sup>16</sup> The purpose and the size of the

<sup>15</sup> Thus, there are some municipalities (e.g. small municipalities or island municipalities) which have a relatively high debt-to-inhabitant ratio because they have invested in a train/metro system or in ferries to the mainland, for example. However, this is not problematic in itself.

<sup>16</sup> The Ministry for Economic Affairs and the Interior takes a discretionary decision on the applications based on the general financial situation of each municipality, the size of the planned project and sometimes the purpose of the project (e.g. improved efficiency).

loan pools are agreed upon during the annual negotiations between the central government and the association of local governments concerning the municipalities' economic issues for the coming year (Ministry for Economic Affairs and the Interior 2014: 39). Thus, raising loans by local governments is not only qualitatively but also quantitatively restricted. To raise loans, Danish local governments can borrow money from banks but they are not allowed to issue bonds. "Kommunekredit", a publicly-owned "non-profit organisation with the objective to secure cost-efficient financing for its clients" offers very favourable conditions, which are accepted in most cases. As the loans are generally very small and the financial safety net protecting local governments is very tight, there is no need for any further checks or ratings by Kommunekredit.

However, as there might be some unprecedented fluctuations in the level of revenues and expenditures during the budget year, municipalities and regions may use so-called overdraft facilities (cash credits) on the condition that the annual average of these deposits is positive over the last 365 days. This rule of a positive balance over a period of one year is very important and closely monitored by the Ministry for Economic Affairs and the Interior. A violation of this rule is considered as an early warning signal regarding potential economic and/or fiscal unsustainability.

If a municipality violates this rule, a standardised procedure automatically starts. It aims at preventing a bailout by the central government and/or the municipal community.<sup>17</sup> This procedure is characterised by a minimum of discretion. The Ministry for Economic Affairs and the Interior "both has the right and the obligation to react" (Mau 2015: 231). Thus, representatives of the involved municipality as well as civil servants from the ministry meet in order to analyse the reasons for the municipality's financial problems and to discuss possible courses of action. The municipality then receives the temporary right to violate the overdraft rule for a limited period (normally no more than three years).<sup>18</sup> In turn, the municipality must implement measures which aim to restore its economic situation as well as improve its economic management. Furthermore, it is obliged to send quarterly reports on its financial situation to the ministry. This procedure is called being "put under administration". If the municipality refuses to comply with the rules of this procedure, it must expect severe sanctions by the government.<sup>19</sup> However,

the procedure has proven to be very effective, and no sanctions have had to be imposed thus far. Since 1988, approximately 30 municipalities have been put under administration and all of them have been able to successfully restore financial sustainability.<sup>20</sup> The reasons for the procedure's success are manifold. First, the procedure is very credible and due to the lack of discretion, there is a general confidence about its implementation. Moreover, the procedure is regarded as stigmatising. The local media covers it critically and constituents usually penalise the municipality in the next election. Thus, the possibility of being put under administration has a deterrent effect.

In addition to this rule on overdraft facilities there are further rules which must be adhered to by the municipalities. As already mentioned, there are annual agreements in Denmark regarding an expenditure limit for local governments as well as a tax stop prohibiting them from raising their tax rates in aggregate. The Economic Council monitors compliance of these rules.<sup>21</sup>

In former years, the annual agreements did not bring about the intended results as they are, first, not individually binding for a single municipality and, secondly, the violation of agreements was not sanctioned by central government. Over time, however, the rules were tightened (Sørensen 2016: 12 f.). Yet, the situation did not actually improve until the adoption of the Budget Law in 2012, with its tight sanction system as well as the change in political opinion due to the financial crisis. Nowadays, the sanctions for exceeding the expenditure limit or disregarding the tax stop are automatic and permanent, they are known in advance and they do not only entail collective but also individual elements (Lotz, Blom-Hansen, Hartmann Hede 2013: 13). Thus, the central government has the right to withhold money, which is otherwise allocated to the local level via the block grant. Furthermore, it can reduce grants, which are otherwise given to a specific municipality, in the same amount of the illegitimate increase in the tax rate. Thus, municipalities are not allowed to keep any of the surplus money from the tax increase.

As there are no exact limits to expenditure growth and taxation for individual municipalities, they must coordinate their budgets in order to prevent breaking the limits collectively. After all, all municipalities claim financial demands which would exceed the agreement made with the central government. Joint solutions can be found only through

17 A municipal bailout has occurred only once (municipality of Farum).

18 Furthermore, the municipality might also receive discretionary grants from the central government in order to help it in its attempts to financially get back on track. However, the central government is rather reluctant to allocate those grants. After all, the aim of this procedure is to prevent a bailout. Yet, generously allocating a grant could be considered a kind of a bailout in itself.

19 Local representatives who wilfully violate the law and refuse to cooperate with the central government might even be held responsible for those actions.

20 The most recent procedure was initiated in 2008.

21 The Danish Economic Council is an independent advisory body consisting of 25 members representing unions, employers, the Danish Central Bank and the Danish Government. Its primary objective is to provide independent economic analysis and policy advice.

discussions, but sometimes also through certain pressure. The association of local governments, Local Denmark (LGDK), plays an important role in this regard. It conducts the so-called “phased budgeting procedure” that ensures compliance with the economic agreement without any interference from the state. For example, it provides the municipalities with figures, benchmarks and general guidance. Furthermore, the mayors of all 98 municipalities meet regularly for coordination reasons (Sørensen 2016: 13 f.). The role of LGDK is highly informal and can only be carried out based on the political legitimacy derived from the economic agreements with the central government. Until now, this system has worked well and no sanctions have yet been imposed. However, as there are no individually defined limits, there is still some uncertainty on how the actual “culprits” could be made out, should local governments violate these limits at some point (Lotz et al. 2013: 11 f.).

Finally, local governments must undergo an “independent audit” of their financial accounts. The auditors primarily check whether the municipality or region complies with the formal rules (e.g. correct accounting). For this reason as well as for additional services where required, local governments usually hire an independent private audit company, which is not allowed to fulfil the task of auditor for more than five years.

Similar to the situation in the other Nordic countries of Finland and Sweden, Danish municipalities are also not allowed to declare bankruptcy. This, however, has not adversely affected the high levels of accountability and good governance in these countries. On the contrary, local governments fear being put under administration by the central government so much that, accordingly, they try to prevent such an intervention at all costs (Kommunekredit et al. 2012: 24).

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# 6 | England

René Geißler, Kai Wegrich

### Summary

England is a unitary country and by far the largest part of the United Kingdom (UK). In contrast to Scotland, Wales and Northern Ireland, there is no specific English parliament. The British parliament passes legislation and the British government exercises authority directly. Structures at local level are complex. Depending upon the geographic area they cover, there are five types of local government, the functions of which are lacking transparency in detail. Local governments account for about a quarter of public expenditure. Education, housing and policing are the most relevant functions. Although local taxes account for about a quarter of local revenue, autonomy of taxation is limited by state regulation.

As a consequence of its economic structure, England was hit hard by the financial crisis. In reaction to it, the national government fundamentally cut transfers. Furthermore, the 2010-elected Conservative government changed the normative principles with regards to devolution, deregulation and austerity. The financial crisis did produce tremendous consequences for English local governments with regards to budgetary figures, regulation, functions and structure. Nonetheless, some of those measures had been planned before.

There is a strict system of fiscal rules and supervision, which was implemented in spite of the backdrop of the financial crisis. Local governments are obliged to adhere to a balanced budget rule. There is no external debt limitation, but a framework of self-regulation, through codes of practice, adds authority and credibility to these rules. Every local government must set its own debt limits. The responsibility of supervision of these fiscal rules is widely transferred to private auditing companies. In the event of any failure, senior officials in the respective local government must answer to the self-regulation body and may lose their professional reputation. Overall, this system is very efficient in the eyes of central government. Auditors and peer-pressure from senior officials safeguard its implementation. There are no general indications, as of yet, of any failure to implement budgetary laws. The Department for Communities and Local Government (DCLG) is in charge of this framework of regulation.

## 1 Administrative Structure

England is a unitary country and by far the largest part of the UK.<sup>1</sup> Generally, the local government level is structured in two different ways (Figure 6.1): (1) 27 non-metropolitan two-tier county councils (upper tier), subdivided into 201 district councils (lower tier); (2) 125 single-tier councils (unitary authorities), of which 32 are London boroughs and 36 metropolitan boroughs (Sandford 2017: 4). All tiers have elected representatives. Local governments are free to decide whether mayors are elected directly by the citizens or by the council. Beyond these principal local governments, there are also special bodies of local cooperation, which oversee fire and policing (joint boards). The representation of local government below does not cover such joint boards.<sup>2</sup>

In some areas, districts are subdivided into another lower level of local government: there are about 10,000 parishes and towns, which are often referred to as “local councils” (Sandford 2017: 4). Their areas of responsibility are equivalent in general to those of districts. Finally, most of them are rather small entities with limited administrative capacities and do not deliver much in terms of essential services. They are favoured legally by the absence of some regulations (e.g. audit or ombudsman).

The Labour Party made considerable efforts in the regionalisation of central government between 1997 and 2010, which was meant to foster economic development. A network of organisations, offices and policymaking responsibilities was created (the Regional Development Agencies Act 1998).

1 Due to its relevance for the UK with regards to the budget (82%) and population (83%), this research focuses on England. Nonetheless, as Eurostat is restricted to national data, this paper is illustrated with UK data.

2 There are 45 local authorities in charge of fire service and 38 local policing authorities (Sandford 2017: 4 f.).

FIGURE 6.1 England – Administrative Structure, 2017

Central Level	Central State	
Regional Level	9 combined authorities	
Local Level	125 single-tier authorities	27 counties
		201 districts
		10,000 parishes

Source: Sandford 2017: 4

TABLE 6.1 England – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Single-tier authority	Rutland (39,000)	Cornwall (554,000)	198,000
Counties	Dorset (423,000)	Kent (1,542,000)	733,000
Districts	Melton (50,900)	Northampton (225,000)	133,000

Source: Office for National Statistics (ONS)

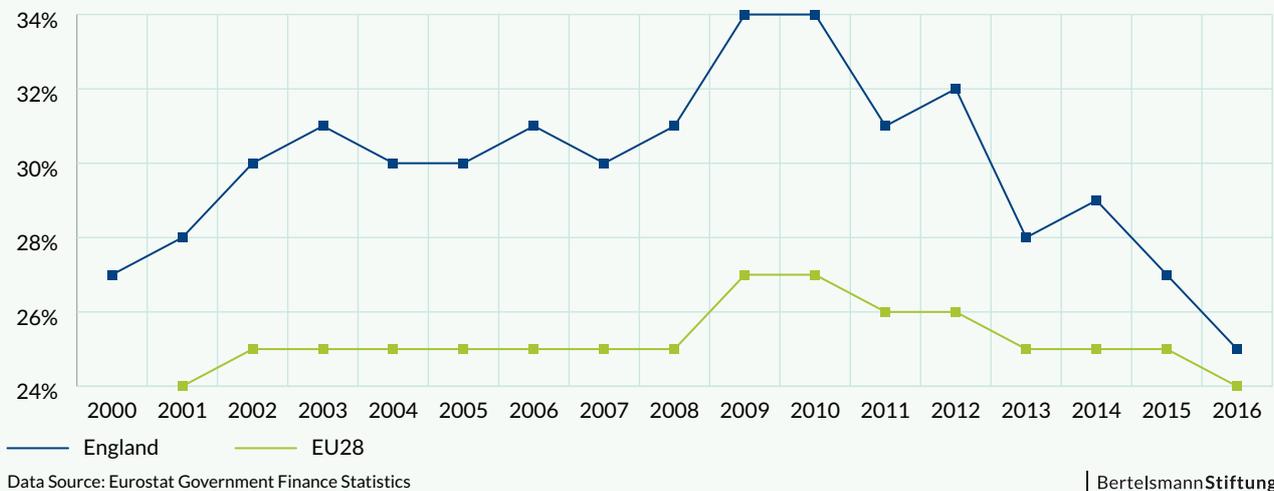
However, the vast majority of regional institutions were disbanded by the Conservative government in 2010. This decision was driven as much by budgetary constraints as it was by the ambition to devolve responsibilities to the local level.

Since 2014, national government has fostered the devolution of services to local authorities (known as city deals and growth deals), each of them individually negotiated between central government and local councils (Sandford 2016a: 5 f.). As a precondition, a new local body (combined authority) must be set up by a group of two or more councils. A number of functions have been made available to most areas, but each deal also contains unique elements. However, establishing those combined authorities is a voluntarily endeavour of the local governments concerned. With this, local government's complexity in structure, governance and funding has grown.

The set of functions carried out by local government is complex. Local authorities provide primary and secondary schools, various types of social services for adults, fire services, libraries and sports facilities, secondary and tertiary roads, waste disposal and housing. As measured by spending, education is by far the most relevant policy. Considering recent devolution, history and differing administrative structures, a general list of local level services is hard to give. In addition to that, a varying set of external bodies and private finance initiatives exists. Usually, local units are rather large and lacking in transparency. There is a variance in the organisational models and terms. In some cases, even the basic question of task distribution between state and local level remains vague.

There is no written constitution in England. Consequently, all local matters can be adopted quite easily through national legislation. Local governments enjoy only partial autonomy and are relatively centralised even in comparison to other unitary countries (Jones 2017: 75).

FIGURE 6.2 **England – Local Government Aggregate Revenue**  
As Share of General Government Revenue – From 2000 to 2016



## 2 Revenue<sup>3</sup>

Since 2009, local revenue has been in decline and its structure has changed to some extent (Figures 6.2 and 6.3). Nowadays, local funding is built overwhelmingly on central government grants (about 67%) and minor shares of local taxes (Figure 6.3).

There are a number of different grants available, for example, ring-fenced (e.g. schools) and non-ring-fenced grants, meant to fund current expenditure or capital spending. Each of these is distributed by a separate formula. A particular type of transfer is the revenue support grant, which is meant to fund particular local governments for different reasons (DCLG 2018: 9 ff.).

With regards to taxation, local authorities collect business tax and council tax. This refers to unitary councils (single-tier authorities) and district councils (lower level in two-tier authorities), which are called billing authorities. In the case of the two-tier structure, county councils receive funding indirectly by collecting from their district councils (DCLG 2017: 5). Nonetheless, county councils do set the tax rates. In practice, council tax revenues may be split between different bodies, e.g. parish, districts, county, policing and fire authorities.

Council tax is levied on residential property. Property values, as the basis of council tax, were most recently revalued in

1992. Raising council tax is regulated in different ways, e.g. there are valuation bands into which the property is classified. Due to macroeconomic concerns, national government started to cap tax rises in the 1980s. Since 2012, billing authorities have needed to hold a referendum if they want to raise tax rates above this centrally prescribed level. Since 2016, there has been an additional option to raise council tax, which is meant to support adult social care.

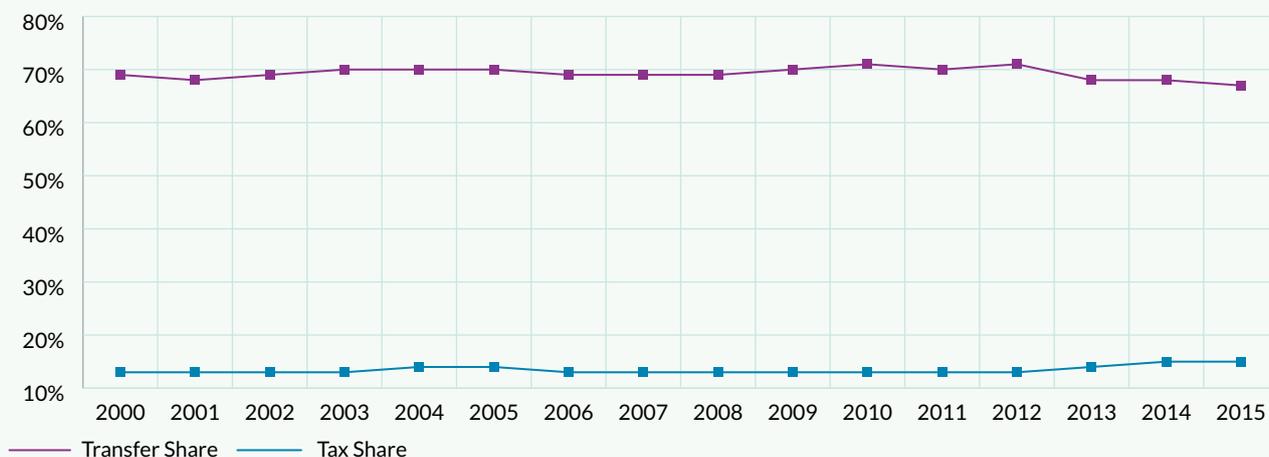
Business rates apply to non-residential-properties (e.g. factories, warehouses, pubs, etc.). The valuation is based upon annual rents. Central government sets the annual rates (DCLG 2017: 11 f.). In 2013, the distribution of business taxes was changed substantially (the business rate retention scheme). Before 2013, business taxes in total were paid to central government, funding the revenue support grant, which was then distributed according to socio-demographic indicators; hence, it was a kind of fiscal equalisation. Since 2013, local authorities have retained half of the growth in business rates that they collect above a certain level. The rest of the revenue is still transferred to central government to fund the revenue support grant. Government's intention is to incentivise local authorities to foster economic growth.

Local authorities are free to set fees and charges, which vary widely between services, revenue-to-cost rates, etc.

<sup>3</sup> All statistics presented in this country chapter build on EUROSTAT data and contain United Kingdom in total. In consequence of its dominating relevance and in lack of international comparative data for England in particular, we use these statistics to illustrate this chapter.

FIGURE 6.3 England – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015

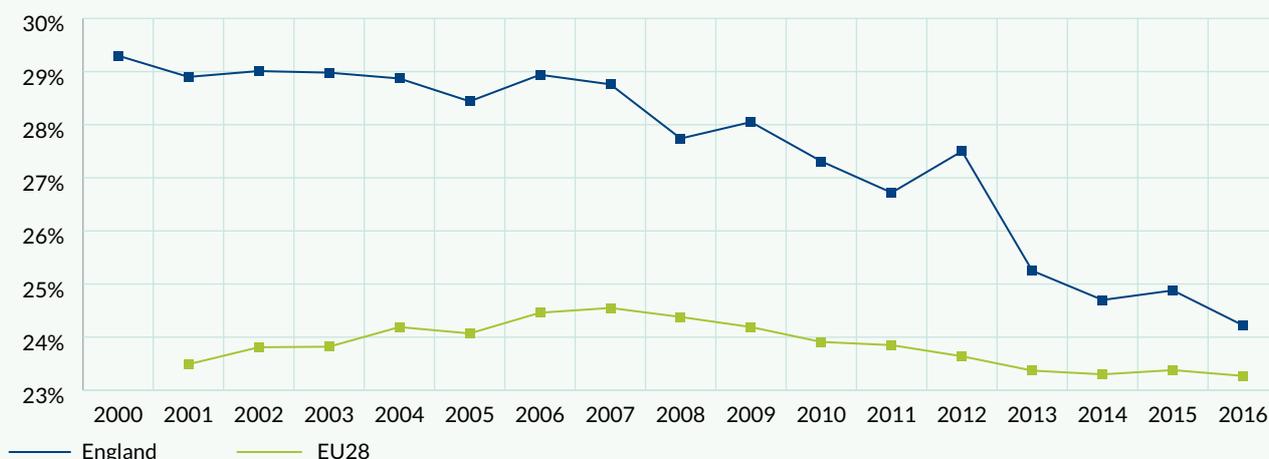


Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

| BertelsmannStiftung

FIGURE 6.4 England – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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### 3 Expenditure

Local governments account for about a quarter of the total public spending in England, showing a declining trend since 2009 (Figure 6.4). This trend goes back to spending cuts caused by declining transfers as a consequence of the financial crisis.

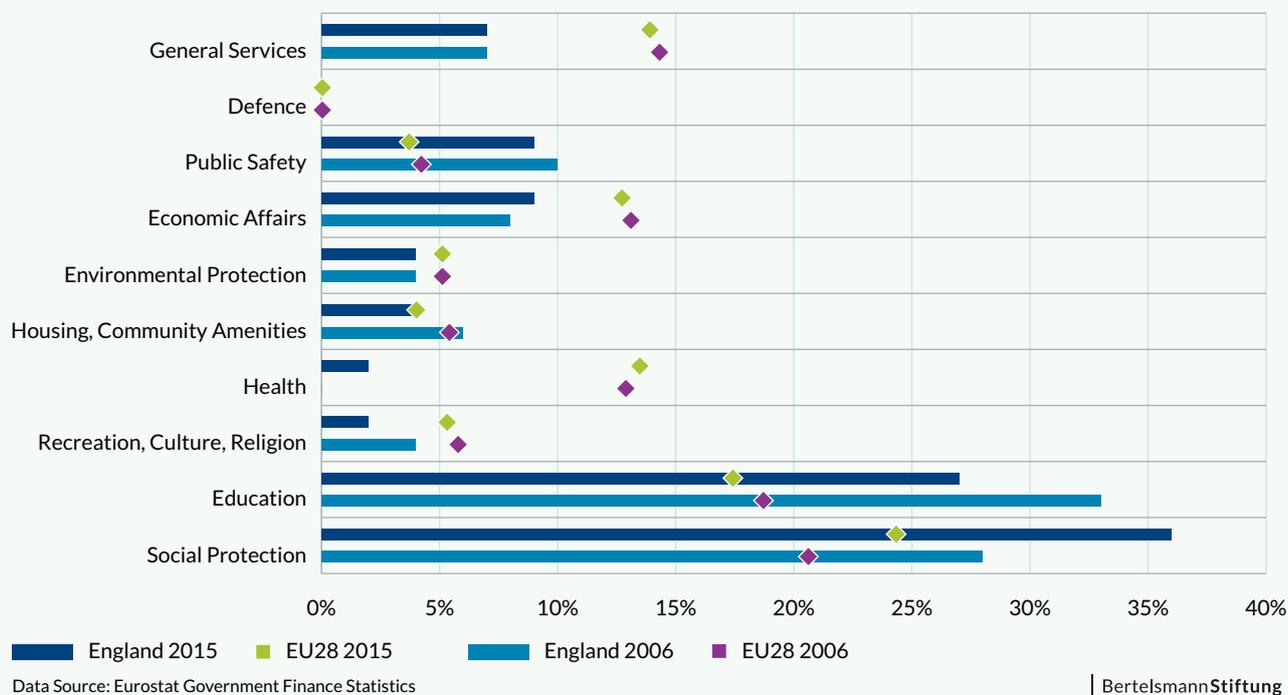
Local expenditure is differentiated in current spending (the cost of running services), of which labour is the most relevant category. Local governments employ more than one million full-time equivalents, of which teachers and police officers

account for the largest shares. Measured by functions, education and social care make up more than half of service expenditure (Figure 6.5). Due to socio-demographic reasons, welfare spending has seen remarkable growth within the last years and absorbs the rising shares of local budgets.

Due to structural changes since 2010 and as a consequence of austerity, the focus of local spending has shifted. Local governments try to protect socially vulnerable groups (adult and care of children). Relative reductions in spending can be observed with regards to community safety or traffic management (NAO 2014: 27).

FIGURE 6.5 England – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



## 4 General Fiscal Status

In the aftermath of the financial crisis, the landscape for local governments has changed significantly following the period of austerity and the new government's agenda of localism. Since 2010, central government has reduced funding and changed the funding structure in order to deal with national deficits. At the same time, changes in government policy and devolution have created a number of new burdens, many of which are underfunded (Jones 2017: 76). The National Audit Office (NAO) estimates a decline in spending power by 37% within the period 2011/2012 to 2015/2016 (NAO 2014: 13).

Total borrowing has risen from about £67 billion to about £73 billion since 2011/2012. Short-term borrowing, with regards to liquidity, has stagnated at minimal levels for years. With the intention of building up reserves, local authorities have reacted with an accumulation of deposits to balance unplanned and thereby unbudgeted spending (29% rise by 2011/2012) (Department for Communities and Local Government 2017: 29).

Local governments have been running deficits for many years (Figure 6.7). Beyond this, trends in revenue and expenditure

are also quite telling. Their stagnation since 2012 means enormous pressure has been placed upon local budgets and resulted in ongoing cuts to services (Figure 6.9). In comparison to 2014, the latest NAO report on financial sustainability essentially shows a further worsening, growing overspends, dwindling reserves and limited room for local measures (NAO 2018: 43 ff.).

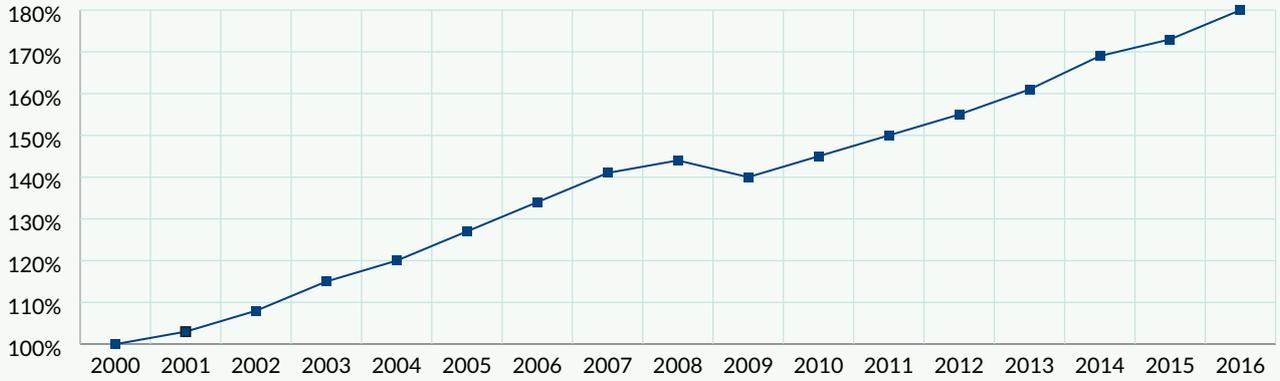
## 5 Effects of the Financial Crisis

The financial crisis did prove to have manifold consequences for English local governments (Geißler 2018: 8 f.). This relates not only to budgetary figures, but also to regulation, functions and structures. Some of those measures have been on the national agenda before (e.g. localisation of business rates). It is fair to say, the newly elected Conservative government used the financial crisis as a "window of opportunity" to implement fundamental changes, which are driven normatively, too.

The crisis hit the UK in 2009, with a sharp decline in GDP (Figure 6.6). Prior to the financial crisis, local governments were used to financial growth. To deal with central government deficits, the Treasury reacted with a substantial decrease in government funding (HM Treasury 2010). In particular, new regulations on

FIGURE 6.6 England – Nominal Gross Domestic Product

Index: 2000 = 100

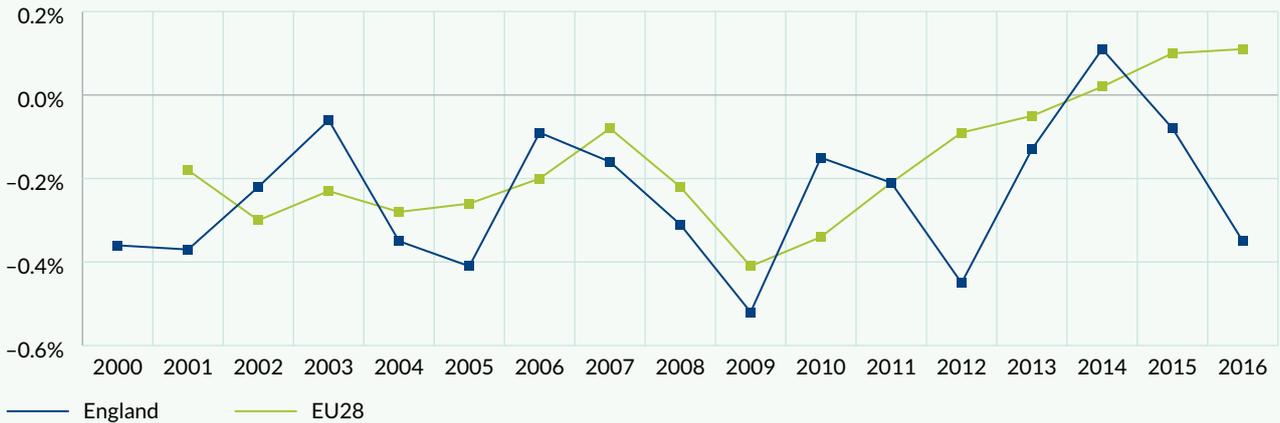


Data Source: Eurostat Government Finance Statistics

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FIGURE 6.7 England – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016

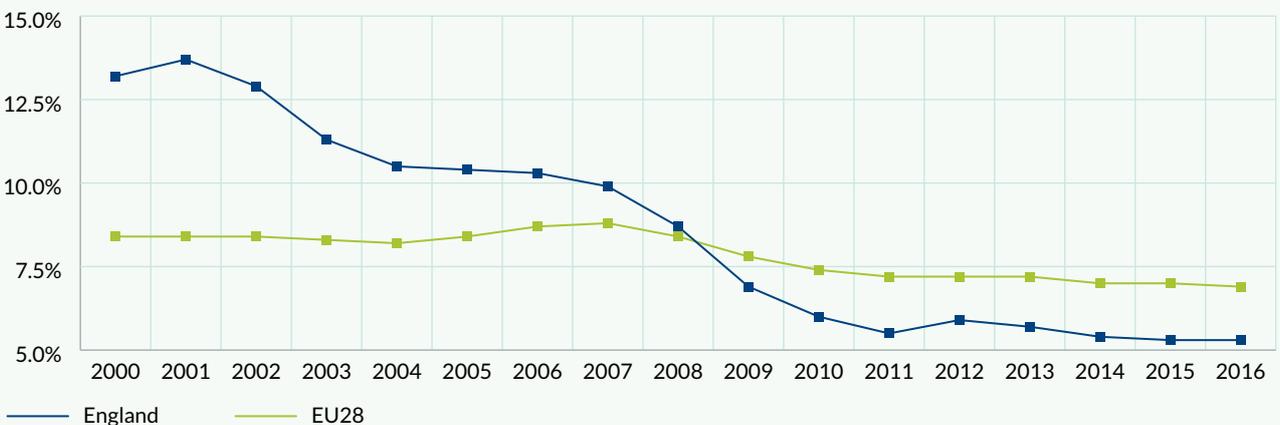


Data Source: Eurostat Government Finance Statistics

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FIGURE 6.8 England – Local Government Aggregate Debt

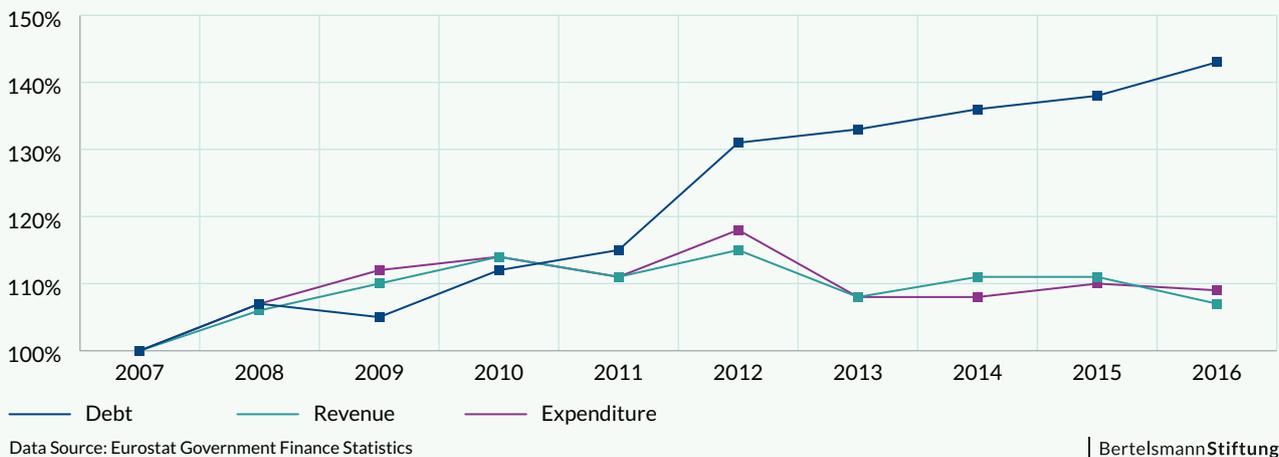
As Share of General Government Debt – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 6.9 **England – Post-Crisis Developments**  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



business rates and council tax were supposed to permit greater flexibility for local councils. In practice though, council tax caps hampered the autonomy of local taxation. As a consequence of the new business rates retention scheme, the level of fiscal equalisation declined and caused a redistribution of revenue among local authorities. In parallel, changes in government policy and devolution created new burdens, many of which were unfunded (Lowndes 2016; Jones 2017: 76) (Localism Act 2011). For the first time in history, local governments received the power of general responsibility, whereas they were dependent on explicit authorisations before. National government wanted to enlarge local autonomy to deal with the cuts and foster economic growth.

Local authorities implemented hard spending cuts to balance their budgets (NAO 2014: 17). Total employment expenditure has fallen by 9% since 2011/2012 (Department for Communities and Local Government 2017: 31). There has been a slight increase in local taxation, but tax rate ceilings have prohibited rapid growth. The increase of reserves is an indicator of financial uncertainty and mirrors negative expectations for the coming years (NAO 2014: 17). Another trend is the significant increase in the maturity of borrowing, due to minimal interest rates.

Central government has substantially changed local funding in scale and structure, be it through new regulation on council tax, a new scheme for business taxes or housing subsidies. These changes have created uncertainty and risks and have not shown redistributive effects among local authorities. Finally, local authorities had to strengthen their self-funding or adapt their expenditure. They also reacted

by a transformation of services, optimising costs by shared services or outsourcing (NAO 2014: 20). Experts have also observed a significant reduction in the service levels for particular functions such as planning, housing, culture and the environment (NAO 2014: 17 f.).

## 6 Fiscal Rules and Fiscal Oversight

Local governments cannot borrow to finance service expenditure or run deficits. They face a balanced budget rule for current spending. Borrowing is restricted to capital finance. For more than a hundred years, local governments needed permission from central government to borrow. Central government set a limit for each authority and had to approve every credit approval (Bailey et al. 2012: 212 f.). Since this system proved bureaucratic and insufficient, it was transformed in 2003 (De Widt 2017: 203). In particular, Chapter 1 of the Local Government Act 2003 laid down a new regulation on capital finance and a new framework for fiscal rules in general.

This law established the current system of self-regulation of local fiscal policies. It builds upon several codes of practice prepared by the Chartered Institute of Public Finance and Accountancy (CIPFA), a professional body for people in local public finance. The codes are updated regularly. Its objectives are to ensure, within a clear framework, that capital investment plans, treasury management and budgeting in general are undertaken in accordance with good professional practice.

Since 2004, any local authority has had to determine and keep under review its own borrowing limit in accordance with the

Prudential Code for Capital Finance (DCLG 2017: 28). There is no exact formula to calculate this debt limit. It relates to the revenue stream available to repay debt. Local authorities are able to borrow without governmental consent, but are required, by law, to “have regard” to the Prudential Code. Local professionals usually need some form of licensing by the CIPFA. In general, this system emphasises the role and responsibility of the local CFO (De Widt 2017: 217).

The second cornerstone of this framework is annual external auditing. Auditing focuses on the implementation of the budget. There is no proof of budget drafts. Central government has changed the local auditing framework substantially (Local Audit and Accountability Act 2014). The Audit Commission, in place since 1983, was abolished. Its main task, the appointing of auditors to local bodies, was transferred to local governments (called Public Sector Audit Appointments) themselves and is supported by a newly established agency (e.g. by tenders and contracts). The intention follows the idea of local flexibility, transparency and efficiency. With this audit, the accurate implementation of the Prudential Code is also under review. The National Audit Office (NAO) regulates the private auditors. The terms of service of a selected auditor is limited.

In the case of a financial emergency within the fiscal year, i.e. revenues will not cover the level of spending, the person in charge must issue a Section 114 report (paragraph 114 of the Local Government Finance Act). This happens only very rarely. As a consequence, the Department for Communities and Local Government (DCLG) sends a commission to review the budget and the council itself. Any further consequences are at the discretion of DCLG. There is no formalised follow-up procedure by DCLG and uncertainties therefore remain for all actors involved (De Witt 2017: 218). There is also no mechanism or experience with bailouts and no bankruptcy regulation either. The only option to deal with lacking liquidity is to prevent it by internal measures.<sup>4</sup>

Local authorities usually cover their borrowing needs by borrowing from the Public Work Loan Board (PWLB), which is a statutory body that originated in 1793. The PWLB is directed by a commission. In practice, it operates under a policy framework set by HM Treasury and its function is administered by the United Kingdom Debt Management Office (DMO) (DMO 2017: 8). National government recently decided to abolish the PWLB and to integrate its functions into the DMO.

Within the fiscal year 2016/2017, the PWLB advanced 622

new loans with a value of £3,634 billion to local authorities. Most of the new loans have a very long maturity period of 40 years and more (DMO 2017: 21). In 2017, the PWLB held loan assets for English local authorities to the tune of £53.4 million (DMO 2017: 14). The PWLB does not require information on the purpose of a loan. Responsibility for local authority spending and borrowing decisions lies with the council. Loans to local authorities are secured by statute on the revenues of the authority, which removes the need for specific collateral. The PWLB requires assurance from the authority that it is borrowing within relevant legislation.

English local governments have always been able to issue bonds but have rarely made use of this option for decades. Recently, this revenue stream has been fostered by a newly-established municipal bond agency, owned by some 56 local authorities (Sandford 2016b: 16). Ratings are necessary. However, this agency has not yet issued any bonds. Towns and parishes need borrowing approval from DCLG, for which they can approach their County Association of Local Councils.

With the implementation of the new “Housing Revenue Account Subsidy”, a special regulation on borrowing and financing has been implemented. Local authorities are permitted to borrow against their rental income to finance housing investments. At the same time, there is a national cap on HRA borrowing of about £30 billion. This borrowing cap was imposed individually on each of the 169 councils that had housing stock back in 2012.

DCLG controls the legal framework in general. Within recent years and against the background of a critical NAO report and rising fiscal stress, it has strengthened its monitoring capacities. Beyond overseeing, it is in charge of distributing state grants and the regulation of taxes. The system predicated upon the idea of DCLG as a watchdog of last resort. Self-regulation must be practiced for as long as possible. In the case of imminent failures, DCLG can intervene by sending a commission or, in the end, can take over local responsibilities.

Responsibility of adhering to these rules has been transferred widely to local professionals. In the event of any rule-breaking, CIPFA can follow up on the responsibilities of the local professionals and withdraw a treasurer’s license.

Overall, this system is very efficient in the eyes of the state. Developing the codes for budgeting by professional bodies adds to their authority and credibility. Auditors, peer-pressure and the personal liabilities of senior officials safeguard its implementation. There are no indications yet of any failing implementation of budgetary laws.

<sup>4</sup> Emergency loans do exist granted by DCLG in case of exceptional disasters (Bellwin Scheme). They are not meant to support financial recovery in times of fiscal stress.

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# 7 | Estonia

Christian Raffer, Nastasha Valesco

## Summary

The Estonian public administration consists of a two-tier system with a central and a local level. From 2014 to 2017, the Estonian local level underwent a fundamental reform. The underlying rationale for merging municipalities was a more (cost-)efficient delivery of public services. Following a series of mergers, there are currently 79 municipalities. The main functions of local authorities include education and economic affairs, such as roads or utilities.

Estonian municipalities are highly dependent upon transfers from the central government. Real local taxes are negligible in size. Since 1994, income from personal income taxes has been split between state and local level. There are various state grants, such as general-purpose block grants, equalisation grants and earmarked grants, e.g. for education. The total amount of resources transferred from the central to local level depends on negotiation between the central government and local authorities.

The Estonian local government sector has been in a relatively sound fiscal condition in recent years. Although local public debt made up a large part of general government debt, Estonia as a whole showed a very low ratio of public debt to GDP.

However, due to a high degree of concentration in terms of municipal revenue bases, bailouts of some less affluent municipalities have been a common phenomenon in the past several years. In reaction to the fiscal crisis, the state government cut transfers and tightened fiscal regulation.

In order to avoid fiscal distress, Estonian municipalities are subject to strict fiscal regulation and supervision, primarily by the Ministry of Finance. By 2012, limits to local debt were introduced, aimed at local revenue. Since 2014, municipalities have been obliged to comply with a balanced budget rule. If fiscal rules are broken two years in a row, the Ministry of Finance can demand a plan to ensure fiscal discipline. Local public debt requires approval from central government. Budget strategy, final budget and supplementary budgets need to be submitted to the Ministry of Finance for external audit. Each municipal council establishes an audit committee, which also monitors the conformity with budgeting. If a municipality comes under financial distress, it has the right to apply for bailout grants from central government. In this case, it must prepare a four-year recovery and financial plan, which is analysed by a special commission.

## 1 Administrative Structure

The Estonian public administration is organised as a two-tier system consisting of a central and a local level. The latter is composed of 79 municipalities. Since Estonia regained its independence, its public administration has moved away from the inherited Soviet system and worked towards European integration. The EU accession process has been one of the most influential driving forces behind administrative reforms and has strengthened local public administration (OECD 2011: 99). The creation of democratic decision-making processes, optimisation of public sector functions through privatisation, introduction of an orientation towards quality and digitalisation, as well as improvement of the civil service and local autonomy have been the focus of a national agenda (Savi and Metsma 2013: 8). From 2014 to 2017, the local level underwent another fundamental government reform. The territorial implications of the Administrative Reform Act of 2016 dramatically changed the landscape of the local level.

The state administration consists of ministries, their subordinate agencies and constitutional institutions (OECD 2011: 107). Until 2017, there were 15 county governments, headed by state-appointed county governors. They monitored municipal services, gave advice and were in charge of county-level planning. However, by 2018, the Estonian parliament had dissolved the county governments (Rahandusministeerium 2018b; ERR 2017). Their functions were split between municipalities and state institutions. The Ministry of Finance (Rahandusministeerium) took over the supervision of municipal budgets. The official administrative division into counties will stay in effect for the time being, so that every municipality remains within a county (UN 2017). This division only serves a territorial function, as counties no longer exist as entities.

The main legal framework for the local government structure builds on: 1) the Constitution of the Republic of Estonia, 2) the Local Self-Government Organisation Act, 3) the Territory

FIGURE 7.1 Estonia – Administrative Structure

Central Level	State of Estonia	
Regional Level		
Local Level	64 municipalities	15 cities
	municipal districts	city districts

Source: own representation

TABLE 7.1 Estonia – Population of Local Government Areas, 2018

	Smallest	Largest	Average
City	Loksa (2,568)	Tallin (430,805)	52,144
Municipality	Ruhnu (141)	Saaremaa (31,205)	8,369

Source: Statistics Estonia (2018)

of Estonia Administrative Division Act, and 4) the Local Self-Governments Financial Management Act.

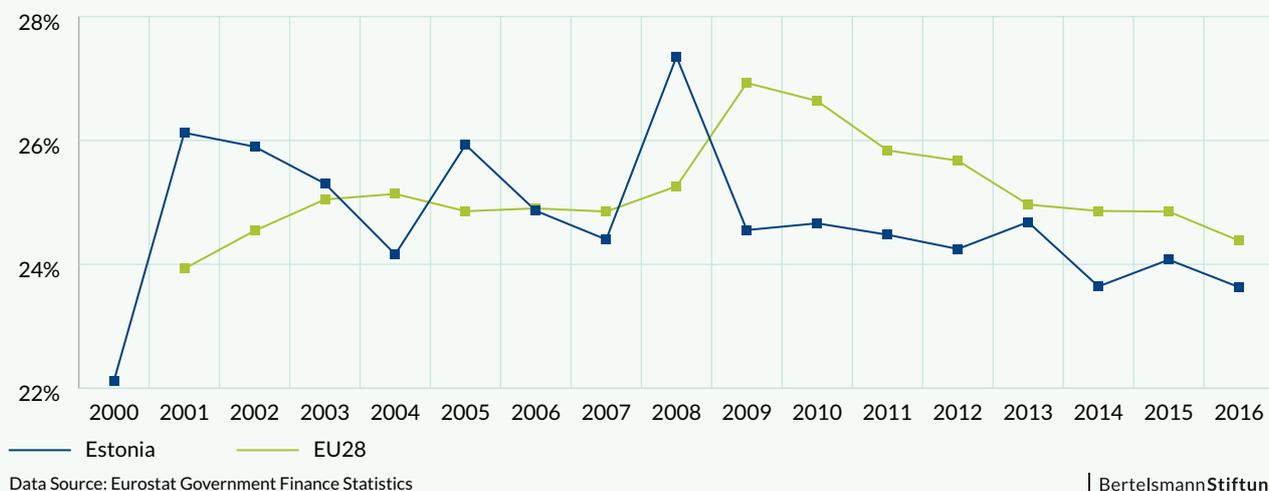
Rural municipalities (vald) and cities (linn) are the only local tier and units of local self-government, although other units of local self-government may be formed (Constitution of the Republic of Estonia 1992, Article 84). Until 2016, there were 213 local government units divided into 15 counties (OECD 2016a). However, due to the recently completed local government reform which obliged municipalities with less than 5,000 inhabitants to merge, this number decreased tremendously (Rahandusministeerium 2017). After voluntary mergers, forced mergers and litigations, there are currently only 79 municipalities left in Estonia (Baltic Times 2017). 64 of them are rural municipalities, 15 are cities.

Cities and rural municipalities may be sub-divided into city districts (linnaosa) or rural municipality districts (osavald) with limited right to self-governance. The competence of a city or rural municipality district derives from the statute of the city or rural municipality (Mäeltsemees 2016: 81).

Before the current territorial reform, local governments oversaw small numbers of inhabitants (Mäeltsemees 2016: 82). Only 18 cities or rural municipalities had a population of more than 10,000 people, but close to two thirds of the total population lived in those units. Obviously, these numbers changed during the course of the reform process, with the average number of residents per municipality tripling (Baltic Times 2017). The largest unit is the capital city Tallinn, where 30% of the country's inhabitants live. This is one of the highest rates of capital-based population in Europe (Mäeltsemees 2016: 82).

In terms of organisation and autonomy, the Local Self-Government Organisation Act determines the general principles of institutional structure and administration. According to the constitution, local self-government in Estonia enjoys "slightly limited legal autonomy" (Mäeltsemees

FIGURE 7.2 Estonia – Local Government Aggregate Revenue  
As Share of General Government Revenue – From 2000 to 2016



2016: 85). Each municipal and city statute prescribes its own institutional structure and rules of procedure. This leads to the application of idiosyncratic rules of procedure by local self-government units, which differ from municipality to municipality. However, the typical bodies of local self-government in each municipality and city are the council (volikogu) and the government (valitsus).

The main functions of local authorities include the organisation of social assistance and services, welfare services for the elderly, youth work, housing and utilities, water and sewerage, the provision of public services and amenities, waste management, physical planning, public transportation, and the maintenance of local roads (Mäeltsemees 2016: 88). Other functions can be assigned to local self-government only by law or mutual agreement. All municipalities irrespective of size or type are obliged to provide the same basic services. As there is no second-tier sub-national government in Estonia, cooperation among municipalities is of significant importance. Until the abolishment of counties, there was a County Municipal Union in each county; membership was voluntary.

There are two national municipal associations: the Association of Estonian Cities and the Association of Rural Municipalities of Estonia. These associations represent the member municipalities in negotiations with the central government. Not all local governments necessarily belong to either of these associations (OECD 2011: 109).

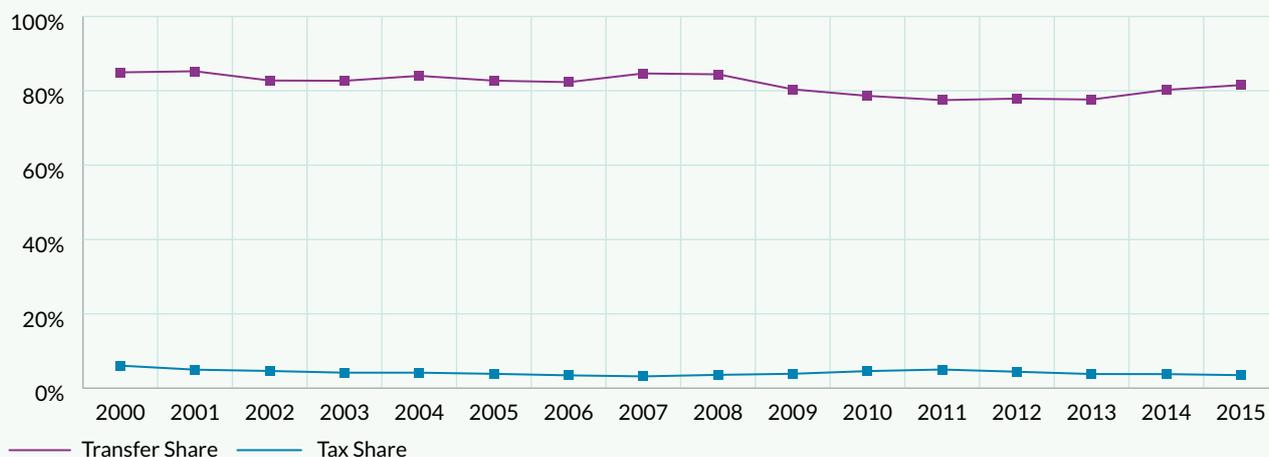
## 2 Revenue

Municipalities are highly dependent upon transfers from the central government (OECD 2016a; Figure 7.3). The local share of taxes is negligible in size, especially since the statistical System of National Accounts was introduced in 2014 and some hitherto shared taxes were re-classified as transfers. Revenues subject to local decision-making constitute approximately only one fifth of the local self-government revenue (Mäeltsemees 2016: 81). The current mix of financing sources does not create strong incentives for attracting business and developing entrepreneurship (European Commission 2017: 36). Between 2000 and 2016, local government revenue as a share of general government revenue varied closely around the EU28 average (Figure 7.2). After peaking in 2008, it has been decreasing and remained at an average of 24% between 2012 and 2016. One reason for this tendency is the post-crisis cutback of transfers from the central level.

General government revenues as a share of national nominal GDP increased from 36.3% in 2000 to 40.4% in 2016. Local aggregate revenues grew more moderately and barely reached the 10% ceiling of nominal GDP. These aggregate values mask a considerable fluctuation in municipal fiscal strength (Friedrich and Reiljan 2015: 12). Since the local share of the personal income tax and charges for natural resource extraction contribute to local budgets, municipalities close to the capital Tallinn and those in the northeast of the country, where abundant oil shales are exploited, enjoy relatively high revenues (Mäeltsemees 2016: 101).

FIGURE 7.3 Estonia – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

| BertelsmannStiftung

The Estonian Constitution does not provide an own and independent tax base for municipalities (Friedrich and Reiljan 2015: 13). The Local Taxes Act (1994) determines the types of local taxes, the subject of taxation, exemptions, etc. (Mäeltsemees 2016: 103). Although there is a broad range of taxes, such as advertisement tax, road and street closure tax, motor vehicle tax, animal tax, entertainment tax and parking charge, more than 75% of all municipalities have not imposed any at the local level. This indicates a widespread absence of fiscal pressure. Consequently, own-sourced taxes are of minor importance for municipal budgets, compared to the revenue that originates from shared taxes. Municipalities levy a land tax, which is a national tax but fully contributes to the local budget (Mäeltsemees 2016: 101). Municipal councils are free to set the rate within specific zones (OECD 2016a). A distinct shortcoming of this tax is the outdated valuation of taxable land. The land tax makes up approximately 6% of local tax revenues (European Commission 2017: 36). In 2014, local government reform included a revision of the local financing system (OECD 2016a), which provided more leeway for municipalities in designing their own tax revenues.

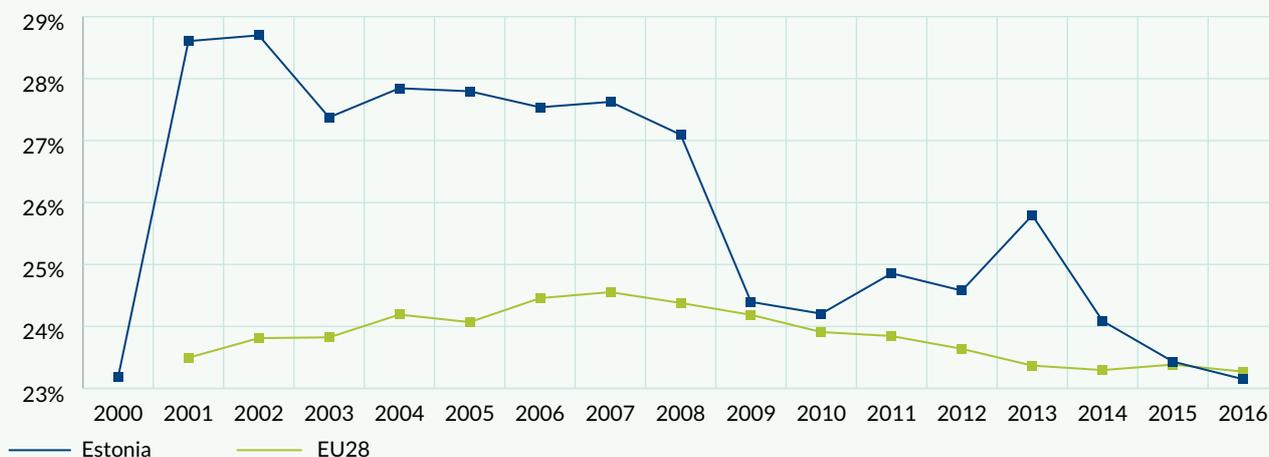
Until 1994, the personal income tax (PIT) was paid completely to the municipality of residence (Mäeltsemees 2016: 99f.). In 1994, central government regulation limited municipal access to PIT revenues to 52% (from 1994 to 1996), and from 1996 onwards to 56%. Since the reform of local government tasks and financing in 2003 by the Estonian government, municipalities receive a fixed share of all calculated PIT revenues, which varies between 11% and 12% (Friedrich and Reiljan 2015: 14; Mäeltsemees 2016: 100; Ministry of Finance

2017); the central government keeps the remainder. There are, however, deductions decreasing the central government PIT revenue quite substantially. The central government can even end up in the paradoxical situation in which it has to transfer more PIT-related funds to municipalities than it actually levies. The actual PIT rate is 20%. With deductions, municipalities currently receive 80% of total PIT tax revenue. In addition to transfers, the PIT share is one of the major resources of local budgets. It makes up more than 90% of local tax revenue and approximately 50% of total local revenues (European Commission 2017: 36; Mäeltsemees 2016: 99).

The second major source of municipal revenues is grants and subsidies. General purpose block grants from the state budget roughly account for one fifth of municipal budgets and can be self-administrated (OECD 2016a; Friedrich and Reiljan 2015: 13; Mäeltsemees 2016: 103). The share of conditional (earmarked) grants grew from 18% in 2003 to 28% in 2012; they are designated for teacher salaries, family doctors, investments, etc. Furthermore, an equalisation scheme makes up 6% of municipal revenue and ensures a quasi-automatic redistribution of revenue to the poorest municipalities (OECD 2016a; European Commission 2017: 36). Equalisation transfers are formula-based and defined in the annual state budget. The distribution of those grants depends on two main principles: an average spending need based on age structure and population size, and revenues of the local government. However, according to national experts, the concrete mechanism of equalisation is slightly modified each year and is therefore in a state of dynamic change. The amount of the equalisation fund in a draft state budget is subject to

FIGURE 7.4 Estonia – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

| BertelsmannStiftung

negotiation between the central government and municipal associations (Mäeltseemes 2016: 101).

The total amount of resources transferred from the central to the local level also depends on negotiation between the central government and local authorities (Rahandusministeerium 2018a). Established by the government and the delegation of the Local Government Associations Cooperation Assembly, this annual budget negotiation is the main form of cooperation between the central and local governments. The support allocated to local authorities, their cost base and matters concerning tax policy are discussed in the financial and tax policy workgroup formed by the Ministry of Finance.

Experts also count natural user fees (charges on resource extraction) among those taxes for which the central government sets the level (Mäeltseemes 2016: 98). The Environmental Charge Act stipulates that half of all revenues stemming from user fees for oil shale, sand, gravel, etc. remain municipal revenue. The second half goes to the state budget. In addition, municipalities may freely decide upon further fees and charges paid by users for public services (Mäeltseemes 2016: 103). In addition to these user fees, there is property income in the form of rents and asset sales (OECD 2016a). However, there are significant differences between the cities and rural municipalities in their capacity to source these revenues (Mäeltseemes 2016: 104).

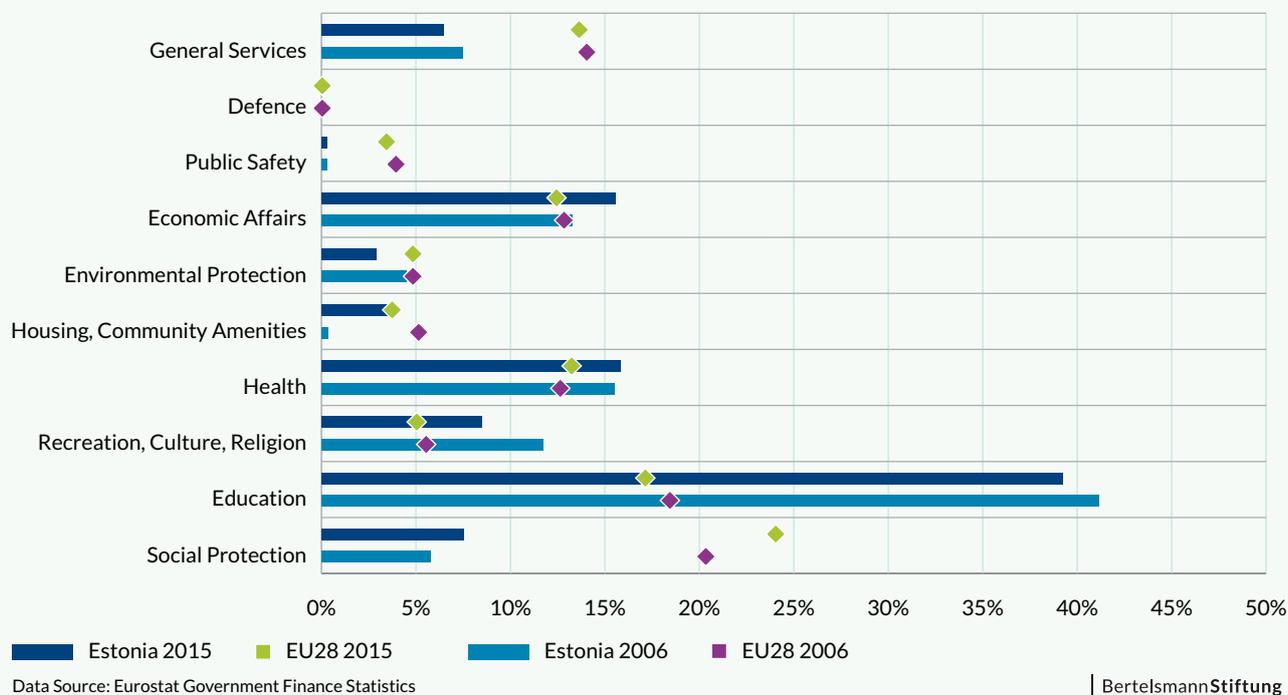
### 3 Expenditure

Local government expenditure as a share of general government expenditure was higher in Estonia than the EU28 average for most of the years between 2000 and 2016 (Figure 7.4). This changed in 2016, when local government expenditure dropped slightly below the EU28 average after a more or less constant development (measured as a share of GDP) beginning in 2010, paired with increasing expenditure by the central government especially in 2015/16. At the same time, Estonia's share of local expenditures as a share of nominal national GDP is below the EU28 average. In recent years, this combination indicates a high-to-average degree of service decentralisation within a relatively slim public sector.

What is significant is the municipal share in public staff spending. As municipalities are responsible for teacher salaries (OECD 2016a), local governments receive an earmarked grant to pay school and pre-school teachers. Formally, they can differentiate those salaries and pay more from own funds. Consequently, the largest portion by far of public spending on the local level is education, which, however, decreased slightly from 2006 to 2015 (Figure 7.5). Other relevant expenditure functions are health and economic affairs, which cover local roads and public transportation but also development projects in tourism and business infrastructure (OECD 2017). The local expenditure share in social protection is significantly below the EU28 average.

FIGURE 7.5 Estonia – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



According to Friedrich and Reiljan (2015), the development of revenues and expenditures by the central and local governments reflects the tendencies of so-called unfunded mandates. This is an unfunded decentralisation of public services, especially during the post-crisis years 2009 to 2011, which could put municipalities with a small revenue base under financial distress and cause them to limit their provision of basic public services. According to national experts, funds provided by the central government are permanently below the claims made by municipalities.

#### 4 General Fiscal Status

Public debt at the local level makes up a significant share of total public debt. As Figure 7.8 shows, the share increased from 38% in 2000 to 72% in 2007. Until 2016, however, it dropped to a level of 35%. These values are dramatically above the EU28 average. Although this may sound alarming, it is not because general government public debt as a share of nominal national GDP is considerably low. Compared to other member states, the general public debt situation appears to be quite stable. Consequently, the variation depicted by Figure 7.8 actually builds upon minor changes over time in local debt over GDP.

Since 2009, local public debt as a share of GDP has varied closely around 3%, which is well below the EU28 average. Although certain municipalities declared bankruptcy in the period of interest (e.g. the city of Püssi), local government's aggregate fiscal performance has been sound in recent years due to legal restrictions imposed on individual municipalities concerning deficits and debts (European Commission 2017: 36; Bertelsmann Stiftung 2010). Central government took preventive measures against local government debt and national deficit growth especially after the financial crisis (Mäeltsemees 2016: 100). In late 2008, the government introduced a bill to bring municipal fiscal planning procedures under tighter control (Bertelsmann Stiftung 2010). In addition, Estonia protects its local governments against cyclical revenue fluctuations by special financial support when they face budget difficulties (OECD 2016b: 113). This may be one explanation for the decreasing budget deficits between 2000 and 2016 (Figure 7.7). Whereas the average local-level deficit was 0.6% of the national nominal GDP between 2000 and 2005, it improved to an average of 0.1% between 2012 and 2016. Local government debt is comprised to a considerable extent of securities (OECD 2016a). According to Eurostat data, in 2006 and in 2016 the securities share was close to one quarter. This is far above the EU28 average. Although not depicted in the average of local-level government debt, during the early 2000s

many municipalities incurred sizeable amounts of debt while undertaking or co-financing various infrastructure projects (Bertelsmann Stiftung 2010). The town of Püssi eventually declared insolvency in 2005, while the central government has needed to bail out eight further municipalities.

Although filing for bankruptcy is technically not possible according to the national Bankruptcy Act, some local governments have been in a position of financial distress in the past (Ainsoo et al. 2002: 296). Since there is no fixed mechanism, the government had to deal with each of these cases separately. Instead of a general bankruptcy framework, there are one-time solutions, which often lead to bailouts that may soften the budget constraint. Local debt is not concentrated within geographical regions; however, according to experts some rural regions are poorer in terms of personal income tax revenue than urban regions.

## 5 Effects of the Financial Crisis

After 2007, the central government of Estonia introduced cuts to municipal support funds, and cut back the local share of national tax receipts (Friedrich and Reiljan 2015: 11). The intention was to put the central government budget on a sound footing. In 2009, the budget act was amended twice, in order to reduce government expenditure and revenues, which consist primarily of central government transfers (Mäeltsemees 2016: 100). The amount of local PIT revenues was cut from 11.9% to 11.4%. A number of specific earmarked grants, such as subsidies for education, culture, and road maintenance, were also reduced. Consequently, local-level revenues shrank, especially from 2008 to 2010, and municipal debts increased during the first post-crisis years (Figure 6.9). A local debt limit in effect from 2009 to 2011 temporarily eased the situation; however local debts again increased until 2014.

It was also in 2014 that the most current local government reform took place, which included a revision of the local financing system and the introduction of a balanced budget rule for the general government (with breakdowns by level of government) through the State Budget Act (OECD 2016a). Obviously, this fiscal regulation at the municipal level has proven to be effective, since debts are decreasing once again. It took four years for local government revenues to reach their pre-crisis level.

## 6 Fiscal Rules and Fiscal Oversight

The current situation for local governments is sound. This positive finding refers to legal restrictions imposed on individual municipalities, which limit the size of their deficits and newly incurred debt (European Commission 2017: 36). Although subsection 154(1) of the Estonian Constitution stipulates that a local authority has the right to draw and execute its own budget, the power to regulate fiscal affairs on the municipal level is mostly in the hands of the central government (Friedrich and Reiljan 2015: 10f; Mäeltsemees 2016: 104). Budget supervision is a shared responsibility between the Chancellor of Justice and the Ministry of Finance.

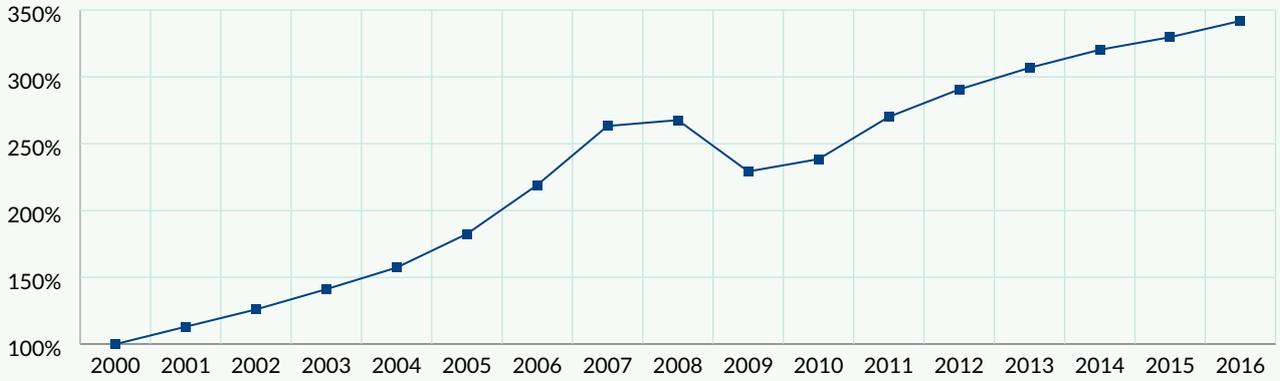
The Law of Municipal Financial Management states that central government can intervene in municipal activities when it deems necessary changes in the way municipalities manage local issues, such as budget execution. Whereas budget deficits and debts are clearly regulated, the central government does not directly control municipal spending behavior (Fiscal Council 2017: 15). However, in order to avoid situations which could lead to insolvency, the central government strongly monitors local government compliance with deficit and debt regulation. In general, experts assume that the local government sector complies with fiscal rules (Trasberg 2006: 1).

The 2014 State Budget Act introduced a balanced budget rule for the general government, with a breakdown for the different levels of government (OECD 2016a). The Local Government Financial Management Act calls for compliance with a permitted zero or positive value for the operating result. Hence, budget deficits are basically illegal. If a municipality comes under financial distress, it has the right to apply for bailout grants from the central government (OECD 2016b: 133).

Limits to local debt were introduced between 2009 and 2012 (OECD 2016a). According to the Financial Management of Local Authorities Act of 2012, the local government debt ceiling is in general 60% of operational revenues during the respective budget year; depending on a local government's self-financing capacity, the ceiling may rise to 100%. Within this restriction, municipalities are free to take long-term loans or issue bonds to fund investment projects (OECD 2016a; OECD 2016b). Local public debt requires approval from the central government. According to national experts, municipalities must report their financial situation to the central government, which ensures that debt issuance does not exceed the legally binding ratios.

FIGURE 7.6 Estonia - Nominal Gross Domestic Product

Index: 2000 = 100

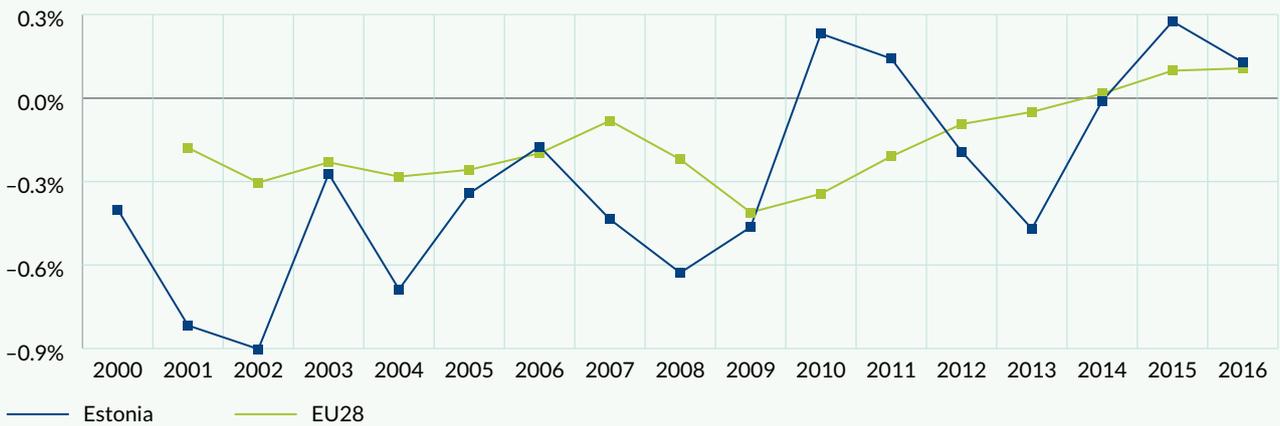


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 7.7 Estonia - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 7.8 Estonia - Local Government Aggregate Debt

As Share of General Government Debt - From 2000 to 2016

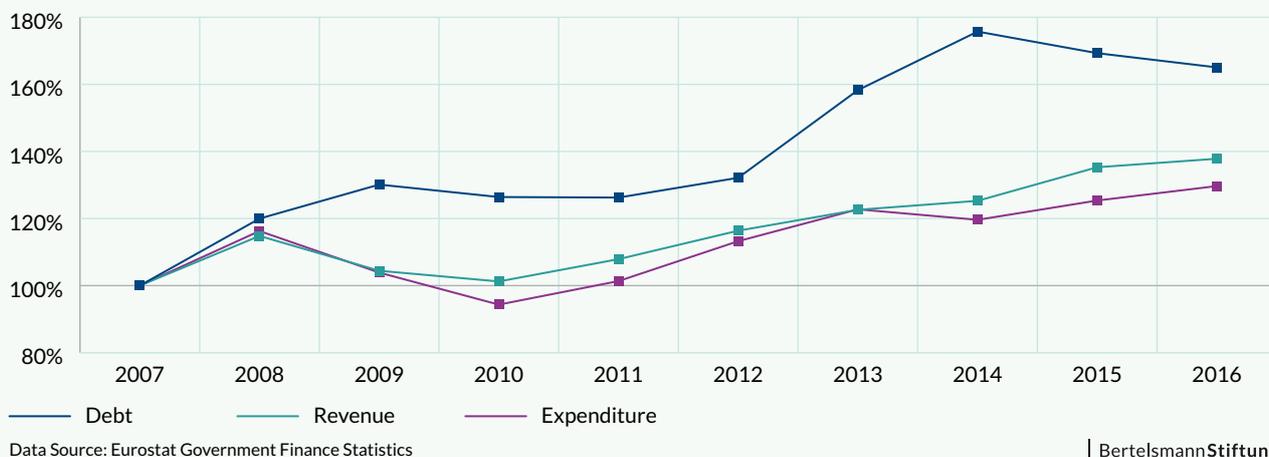


Data Source: Eurostat Government Finance Statistics

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FIGURE 7.9 Estonia – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



If existing rules are not met, the central government can take action and enforce the law. The legal basis is the Local Government Financial Management Act. If a municipality fails to meet the balanced budget rule and the debt limitations in one year, the Ministry of Finance issues a warning. If the rules are broken two years in a row, a municipality is obliged to set up a plan that ensures financial discipline. This plan has to be approved by the Ministries of Finance and Internal Affairs. If the local government refuses to establish a plan, if the plan is insufficient or not implemented, but also if a municipality is in general unable to repay its debts, it runs the risk of entering into financial distress. In this case, the local government can apply for central government aid (Blöchliger and Junghun 2016: 133). There is a support fund in the state budget to cover revenue deficits at the local level (Friedrich and Reiljan 2015: 13). If a local government applies for a bailout, it must prepare a four-year recovery and financial plan, which is analysed by a special committee from the Ministries of Finance and Internal Affairs, as well as from national associations. This commission also makes the final decision as to whether to grant financial aid. Since this procedure imposes drastic fiscal consolidation plans, it may be understood as a conditional bailout.

The budgetary year of a local government begins on the 1st of January and ends on the 31st of December. Corresponding to the Local Government Financial Management Act, municipalities are free to choose between cash or accrual accounting. In order to have a sound basis for budget preparation, municipalities must prepare a budget strategy which formulates their plans to reach the goals of the corresponding development plan; both are legally based upon the Local Government Organisation Act §37. The development plan and the budget strategy need to be

finalised by the 15th of October and must cover at least the next four budgetary years. A draft budget must be submitted to the municipal council no later than one month before the beginning of the new budgetary year; supplementary budgets during the year are possible. If the budget is not adopted by the beginning of the budgetary year, preliminary month-to-month expenditures are allotted according to the previous year's expenses. If the council is unable to adopt a budget within three months after the beginning of the budgetary year or after the adoption of the state budget, the council is unable to act. The budget strategy, the final budget and supplementary budgets must be submitted to the Ministry of Finance for external audit. In addition, an annual report must be prepared and audited by the internal control bodies before being presented to the council by the 31st of May, at the latest. It must be approved within one month.

Local governments are required to conduct internal control (Mäeltseemes 2016: 106). Each municipal or city council must establish an audit committee. Its function is to monitor the conformity of the municipal executive board's activities with the municipal councils' decisions; the accuracy of accounting and the purposeful use of municipal funds: the timely collection and registration of revenue; the conformity of expenditure with the development plan; the performance of running contracts; and the lawfulness of administrative action. The major challenge of the audit committee is its members' lack of competence (Kriz 2008: 176; Ainsoo et al. 2002: 316). Audit committees do not properly function in many local governments. Many larger cities, such as Tallin, Tartu, or Pärnu, run professional internal control offices. Since 2003, an additional independent auditor must control the financial

accounts of the local government and submit a report. (In Tallin, for example, the private auditor is KPMG.) The auditor is selected in an open competition (Ainsoo et al. 2002: 317).

External state control and supervision is effected by the Chancellor of Justice, the National Audit Office (Riigikontroll) and – until recently – the county governor (Mäeltseemes 2016: 106). This supervision is supposed to guarantee the compliance of local governments with existing law.

The National Audit Office is in charge of supervising the use and control of state assets, which have been transferred into the possession of local jurisdictions. This refers to the decent use of earmarked grants and subsidies from the state and the EU budget. Since 2006, the National Audit Office has an own department for auditing municipalities. It focuses mainly on the legality of internal control systems, financial management, financial accounting and economic transactions, and the efficiency and legality of the use of state assets transferred to the local level.

In addition to this, the Ministry of Finance is also responsible for local finance and budget issues. It has a clearly defined role within the municipal budget process. It also develops the financing (equalisation and support fund division) and financial management principles of local authorities (Rahandusministeerium 2018a).

Until 2018, a representative of the central government at the municipal level, the county governor, had to ensure compliance by the local government with the legal norms of budget implementation (Ainsoo et al. 2002: 317). County governments, however, were abolished in January 2018. Their tasks were assumed by ministries and local governments.

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# 8 | Finland

Friederike-Sophie Niemann

### Summary

Finland is a unitary, highly decentralised state. It consists of a central government level and a municipal level. Finnish municipalities have to fulfil a very broad range of functions and services. Among those most important are social services, health and education. On average, tax revenue makes up about half of total revenue. The most important tax is the municipal income tax, followed by property tax. For years, income tax revenue has been steadily rising. Due to the large heterogeneity of municipalities, individual distribution does vary. Challenges such as an ageing population and the erosion of tax bases in rural municipalities threaten the operational and fiscal capacity of many municipalities. The Finnish economy struggled to recover from the economic downturn brought about by the financial crisis. Overall, local governments have recovered quite well, also because central government absorbed a large part of this external shock. Finnish municipalities hold rather low levels of debt. Yet, municipal debt level is rising due to pressures on expenditure and the volatility of the municipal tax base. MuniFin, a publicly owned credit institution, finances a large share of municipal debt.

Traditionally, fiscal regulation of local governments was light. There have still been aspects of monitoring and coordination by the Ministry of Finance. However, the situation changed in the context of the financial crisis. In 2015, a new regulatory system with tighter fiscal rules was established. The existing balanced budget rule was complemented by sanctions. Besides this, there have been some consequences of the EU Fiscal Compact. State government sets a balance target for local finances for the ensuing four years and decides upon measures on how to accomplish this.

## 1 Administrative Structure

Finland is a unitary state. The Finnish government sector consists of only two tiers, a central state tier and a municipal tier (Figure 8.1). The central government comprises the national government as well as a wide range of central and local offices and agencies. At the regional level, there are six Regional State Administrative Agencies as well as 15 Centres for Economic Development, Transport and the Environment. At the local level, there are 11 police departments, 11 local registry offices, 22 enforcement offices, 11 prosecutor's offices and 15 Employment and Economic Development Offices, acting as local state authorities.<sup>1</sup>

These regional and local state agencies are, among other things, responsible for steering and supervising the implementation of national policies concerning basic rights and legal protections as well as providing access to basic public services.

Finland is highly decentralised. In accordance with that, Finnish municipalities have a high degree of local autonomy. The Finnish constitution has guaranteed the right to local self-government since its enactment in 1919. The right itself even dates back to earlier times (at least the 1800s), drawing on the tradition of strong parish councils (Kommunekredit et al. 2012: 25).

Currently, there are 311 municipalities in Finland. The average population is rather large in comparison with other European countries (Table 8.1). Yet, the evaluation of the average is misleading, since more than half of Finnish municipalities have fewer than 6,000 residents. In contrast, only nine cities show a population of more than 100,000 inhabitants. Second, there are many more tasks devolved to municipalities in Finland compared to the task allocation in other European countries (André and García 2014: 13). Thus, compared to their broad range of responsibilities, Finnish municipalities are rather small. Consequently, there are many concerns and discussions

<sup>1</sup> Ministry of Finance. Administrative structures (<https://vm.fi/en/administrative-structures>; accessed 29/08/2018).

FIGURE 8.1 Finland – Administrative Structure, 2017

Central Level	Central State
Regional Level	
Local Level	311 municipalities

Source: own representation

TABLE 8.1 Finland – Population of Local Government Areas, 2016

	Smallest	Largest	Average
Municipality	Kaskinen (1,300)	Helsinki (635,000)	17,600

Source: Statistics Finland

about equal service provision in Finland, taking into account the very different capacities of Finnish municipalities (André and García 2014: 19).

At present, Finnish municipalities have to fulfil more than 500 statutory tasks.<sup>2</sup> Among the most important of these are social services, health, educational and cultural services, technical services, building control, environmental protection, rescue services and public waste management. Besides these statutory functions, municipalities may also carry out discretionary and optional functions, the latter without regulation by central government.<sup>3</sup> The statutory tasks, in contrast, are regulated by more than 900 norms (Moisio 2013: 9). Nevertheless, municipalities are free to decide on the scope, content and how they are to be organised (Moisio 2011: 4).

As many Finnish municipalities have a population base regarded as being too small to perform all of their tasks, inter-municipal cooperation is not only legitimate but also plays an (increasingly) important role in the organisation and provision of public services. For instance, it is very common for several municipalities to create so-called joint municipal authorities in order to provide specific services. These joint municipal authorities do not have any taxation power of their own but are financed by their member municipalities. Membership is usually voluntary except for specialised hospital districts, social welfare for the disabled and regional councils (André and García 2014: 12).

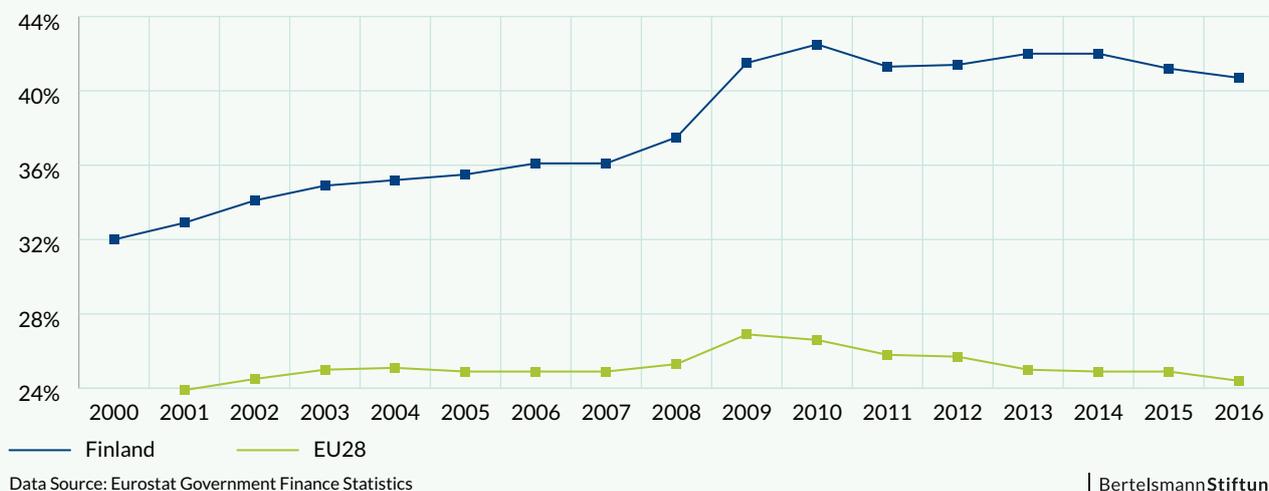
The 18 regional councils are a particular kind of inter-municipal cooperation, with regards to how Finland is structured. They are formed and financed by municipalities. Their main functions are in relation to land-use planning and general regional development. Member municipalities elect their officials.

<sup>2</sup> In the past, municipalities were rather poor and had to provide basic services only. Yet, gradually, central government assigned more and more tasks at local level, with an especially prompt enlargement of local government tasks in the 1970s and 1980s. At present, the Finnish government has promised not to increase municipal tasks any further but instead to reduce them (Moisio 2015: 3 f.).

<sup>3</sup> <https://www.localfinland.fi/expert-services/finnish-municipalities-and-regions/functions-municipalities-and-joint-municipal-authorities>; accessed 19/01/2018.

FIGURE 8.2 Finland – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



In general, inter-municipal cooperation works quite well in Finland. However, challenges such as an ageing population and the erosion of tax bases in rural municipalities threaten the operational and fiscal capacity of many municipalities – even despite existing forms of inter-municipal cooperation (André and García 2014: 14). Several times, state government tried to implement municipal amalgamation. The last attempt focused on a centralisation of functions such as health, social welfare and regional development into autonomous regions. This reform was most controversial. State government skipped the endeavour in 2019 after the resignation of the acting head of government.

## 2 Revenue

Compared to other European and OECD countries, local government revenue as a share of general government revenue is very high in Finland at around 40% (Figure 8.2). Taxes account for an extraordinarily high share of revenue, even higher than the share of grants (Figure 8.3). Beyond this, there are user fees and income from sales (André and García 2014: 13). Due to the large heterogeneity of municipalities, there is a large variance in the distribution of revenue types. For example, state grants make up more than 50% of the total revenue for every fourth municipality. This applies, in particular, to small, rural municipalities (André and García 2014: 2). Taking both the tax revenue as well as the state grants into account, it can be said that Finnish municipalities have a very good funding base at their disposal.

The most important municipal tax is the municipal income tax. On average, it makes up about 40% of total revenue. In principle, this municipal income tax is a flat rate tax.<sup>4</sup> However, due to central government provisions regarding tax allowances for persons with low incomes, it appears more like a progressive tax. Whereas central government determines the local income tax base, the municipalities are mostly free to decide on their tax rates.<sup>5</sup> Since municipal service responsibilities have continuously increased over time, municipal income tax rates have also been steadily raised (Moisio 2013: 4).

Since 1993, municipalities have been assigned a share of the corporate tax revenue, which is regularly adopted. After several major reductions between 1995 and 2003, the share was increased again in 2005 (as compensation for the overall tax rate reduction) and in 2009 (as part of the central government's fiscal stimulus package). At present, the municipal share of corporate tax revenue makes up 7%<sup>6</sup> of total municipal tax revenue. Due to the volatility of the tax base, the municipal share of corporate tax revenue is very controversial among experts. Some even make a case for its replacement by higher state grants. However, cities like Helsinki oppose these plans severely (Moisio 2013: 8 f.).

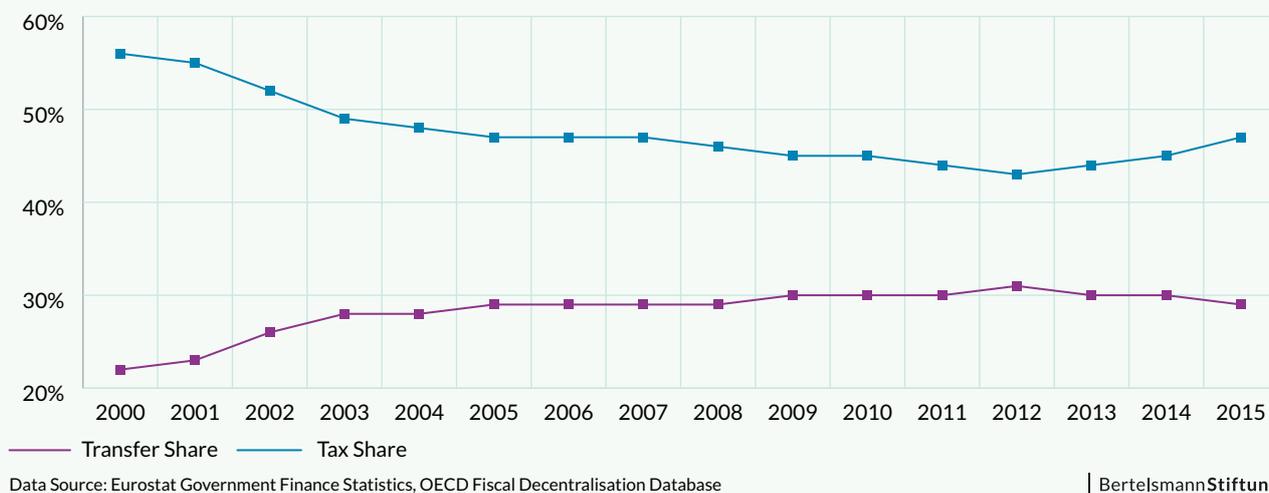
4 The average local tax rate is 19.91% of taxable income (<https://www.localfinland.fi/expert-services/finnish-municipalities-and-regions/local-self-government>; accessed 19/01/2018).

5 Tax increases must be approved, however, by the regional councils.

6 <http://vm.fi/documents/10623/3856530/Budget+review+2017%2C+January+2017/4c438d7f-1f95-47e2-a3fe-2267bd901c03?version=1.0>; accessed 19/01/2018.

FIGURE 8.3 Finland – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



Finally, property tax makes up about 8%<sup>7</sup> of municipal tax revenue. Currently, it consists of five taxes: a general property tax, a tax on permanent residential buildings, a tax on other residential buildings, a tax on power stations as well as a tax on nuclear power stations. Municipalities have a certain freedom to determine property tax rates, which is constrained by upper and lower limits set by central government. The mean rates of property tax have increased over time, although not to the same extent as municipal income tax rates. Due to the fact that high property taxes may keep investors away, municipalities rather refrain from utilising property taxation more intensely. However, central government increased the limits twice (in 1999 and 2010) (Moisio 2013: 6 f.).

State grants are given out to municipalities in the form of a single block grant. The individual amount of this block grant is determined on the basis of a formula, which takes a municipality's service needs and cost factors into account (Moisio 2011: 3). The formula also contains a tax base equalisation element. However, the weight of cost factors is dominant. It is important to know that tax revenues are not redistributed horizontally among different municipalities, but municipalities with a potential tax revenue per capita below a certain percentage of the national average receive higher (vertical) transfers from the state (André and García 2014: 15). Even though there is no redistribution mechanism between richer and poorer municipalities but different levels of state transfers instead, the formula-based block grant system is highly contentious in Finland, as many experts criticise the poor

quality of the indicators upon which the calculation is based. Furthermore, the actual costs of service provision are often underestimated by central government. This leads regularly to conflicts between central government and municipalities, as the latter demand full and immediate compensation for the differences between the actual and estimated costs (Moisio 2011: 6).

Beyond state grants, shared taxes and local taxes, there are fees and charges for particular services.

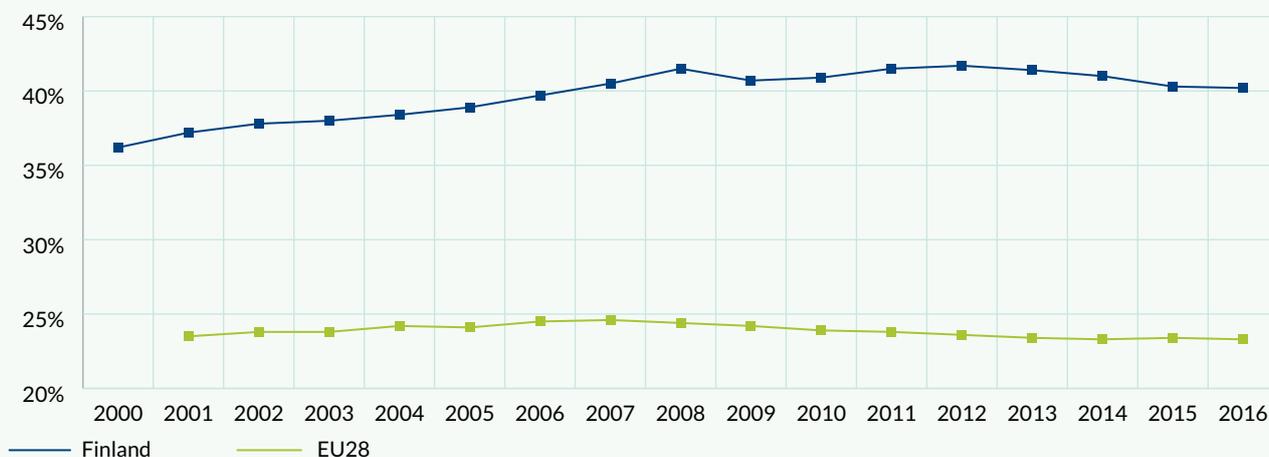
### 3 Expenditure

Local government expenditure, as a share of total general government expenditure, is around 40% in Finland and therefore (like the share of revenue) also very high in comparison with other EU/OECD countries (Figure 8.4). The most important types of municipal expenditure are wages, purchases of goods and services, and investments. After all, local authorities do not only account for over 70% of public investment (André and García 2014: 9) but also employ about 20% of the total Finnish workforce. About one half of municipal sector expenditure is spent on health and social services (Moisio 2015: 4; Figure 8.5). This significant share comes as no surprise, since municipalities or joint municipal authorities provide nearly all basic social and health-care services.

<sup>7</sup> <https://www.localfinland.fi/expert-services/finnish-municipalities-and-regions>; accessed 19/01/2018.

FIGURE 8.4 Finland – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

| BertelsmannStiftung

Due to their large shares of tax revenue and non-earmarked block grants, municipalities can take their spending decisions very autonomously, even though they are partly restricted by national standards and regulations to which they must adhere (André and García 2014: 14 f.). These standards and regulations also entail certain expenditure requirements. Thus, they are in part very burdensome, at least for poorer municipalities. Yet, on average, municipalities are given enough of their own resources, so that they are able to fund the majority of their expenditure by themselves (Moisio 2013: 11 f.).

## 4 General Fiscal Status

At present, Finland has comparatively strong public finances. Sound fiscal policy laid the groundwork for funding high-quality public services (André and García 2014: 6). After a major slump in GDP in 2009, economic growth has accelerated with positive effects not only in the private sector but also in relation to public finances.

Nevertheless, there are some serious challenges, which the Finnish state and its municipalities face. Local governments have been continuously in deficit since 2001 (Figure 8.7). An ageing population is a particularly pressing problem as it fuels expenditure growth, mainly due to rising expenses for pensions and health-care services, while the working-age population and tax revenue are thus declining at the same time. These problems are especially severe at the local level, since Finnish municipalities have vast responsibilities in the areas of social and health-care services. Thus, the intended reform of health

care, social services and regional government might ease the situation for municipalities.

In order to ease the fiscal burden, the so-called Tripartite Competitiveness Pact was signed in 2016 involving, among other things, reduced pay for public-sector employees, partial transfers of the liability for social security contributions from employers to employees and an extension in annual working time of 24 hours without additional compensation.<sup>8</sup> The reduction in pay and social security contributions for public-sector employees as well as the extension of their working hours benefit the Finnish municipalities (as employers). On the other hand, the reduction of taxes, which are also a component of the Competitiveness Pact, will not weaken their budgets, since “municipalities will [...] be compensated in full for changes in tax revenue arising from tax criteria changes”.<sup>9</sup>

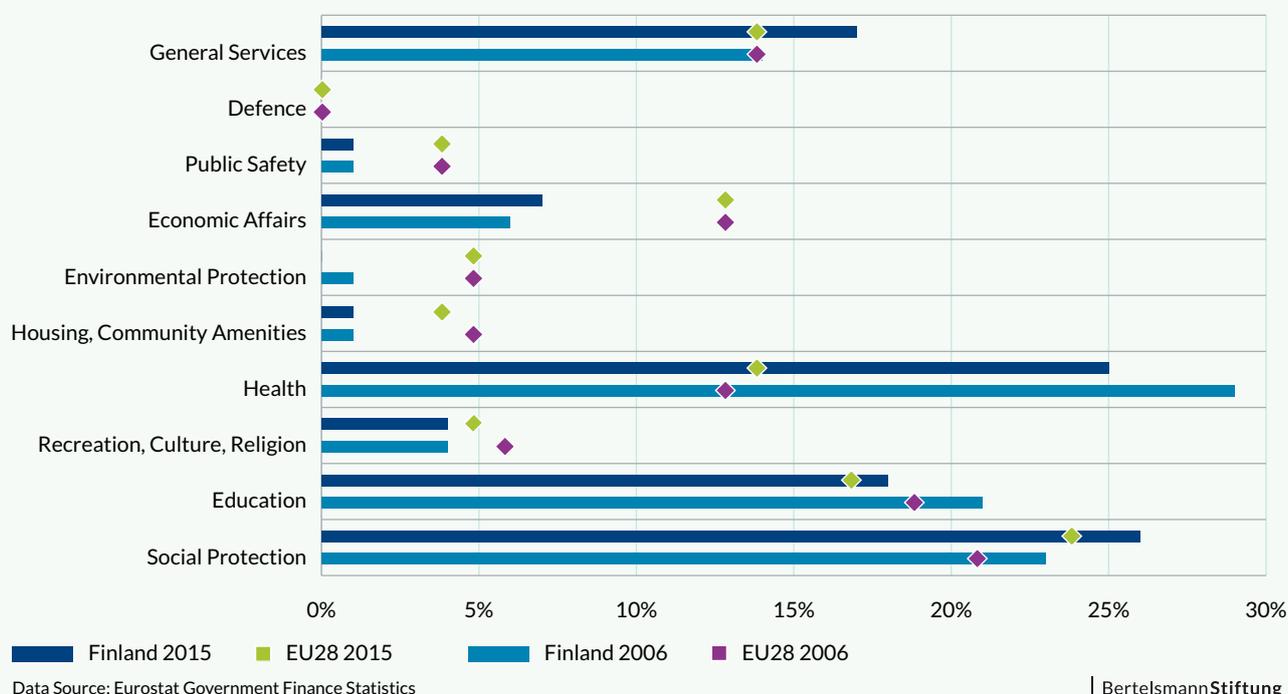
At this time, Finnish municipalities are not heavily indebted compared to other EU/OECD countries. Yet, municipal debt level is rising due to the aforementioned pressures on expenditure and the volatility of the municipal tax base (Moisio 2011: 7). In relation to total public debt, local debt rose from 9% in 2001 to 16% in 2008 (Figure 8.8). Although Finnish municipalities are capable of increasing their tax rates in order to tackle fiscal problems, the tax level in Finland is already very high, so the leeway for further increases is

8 <https://www.eurofound.europa.eu/observatories/eurwork/articles/working-conditions-industrial-relations-business/finland-tripartite-competitiveness-pact-signed>; accessed 18/01/2018.

9 <https://www.localfinland.fi/expert-services/finnish-municipalities-and-regions>; accessed 19/01/2018.

FIGURE 8.5 Finland – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



narrow. Furthermore, solving regional fiscal problems through tax increases will have negative side effects in the form of a widening of the regional economic differences (André and García 2014: 16). Whereas the southern part of Finland is rather densely populated and comparatively rich, the northern part is very sparsely populated. Population size and density as well as fiscal status often correlate, since it is very difficult for small and sparsely populated municipalities to bear the high costs of public service provision.

Therefore, municipalities may also choose the alternative of increased borrowing in times of need.<sup>10</sup> The local government loan portfolio rose in 2015 to a total of €17.4 billion and might even grow to more than €20 billion by 2020. In 2015, the local government deficit was 0.6% of the national nominal GDP. According to the General Government Fiscal Plan, a local government deficit of 0.5% of GDP shall not be exceeded in 2019.<sup>11</sup>

10 Usually, Finnish municipalities proceed in a very balanced way when confronted with economic problems or even shocks. According to experts, they increase their tax rates, reduce their expenses and increase their debts to quite a similar extent.

11 <https://www.localfinland.fi/expert-services/finnish-municipalities-and-regions>; accessed 19/01/2018.

A large portion of municipal debt is financed through MuniFin, a publicly-owned credit institution with the aim of ensuring competitive funding for the local public sector in Finland. It has strong long-term credit ratings (Aa1/AA+),<sup>12</sup> yet, it does not discriminate between different borrowers (André and García 2014: 18). Thus, it does not have the means to strengthen municipal budget discipline when necessary. Moreover, Finnish municipalities cannot go bankrupt, as this is barred by the Act of Bankruptcy. Nevertheless, this has not impaired the generally high levels of accountability and good governance of Finnish municipalities (Kommunekredit et al. 2012: 24 f.). Thus, rising municipal debt levels can be traced back mainly to the aforementioned structural problems.

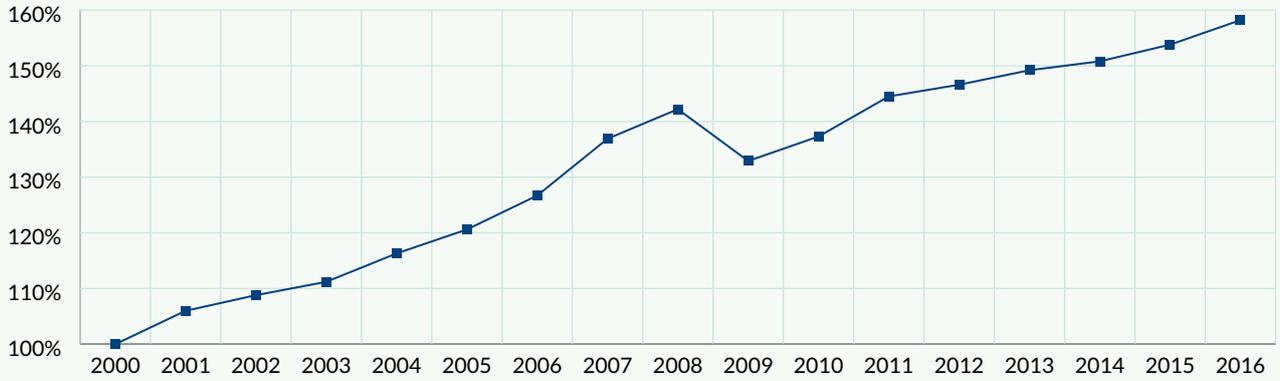
## 5 Effects of the Financial Crisis

The Finnish economy struggled to recover from the downturn experienced as a consequence of the financial crisis (Moisis 2015: 10; Figure 8.6). The general government structural balance deteriorated considerably in 2009, subsequently improved, but worsened again when the Finnish economy had a new three-year slump in 2012. In 2015, the deficit

12 <https://www.munifin.fi/>; accessed 19/01/2018.

FIGURE 8.6 Finland - Nominal Gross Domestic Product

Index: 2000 = 100

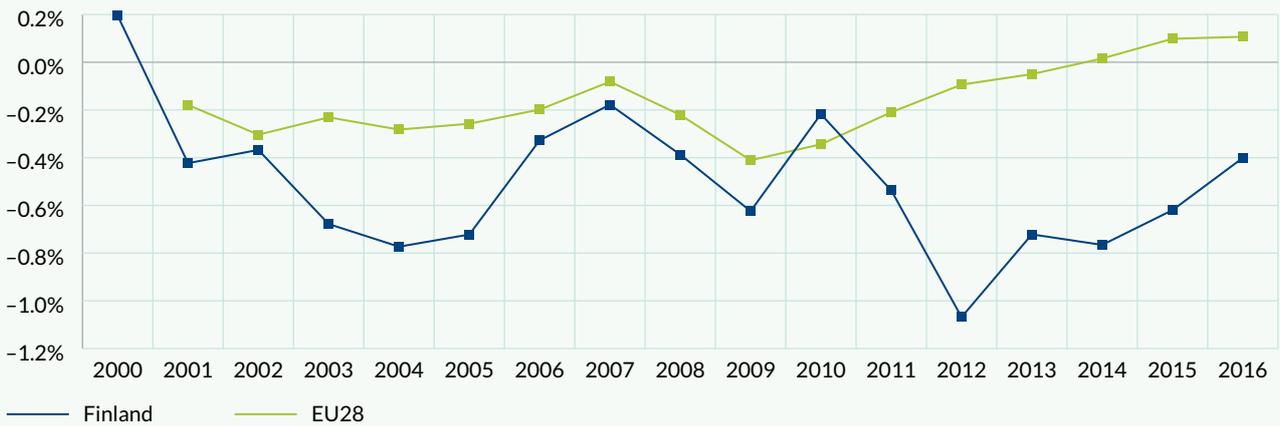


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 8.7 Finland - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 8.8 Finland - Local Government Aggregate Debt

As Share of General Government Debt - From 2000 to 2016

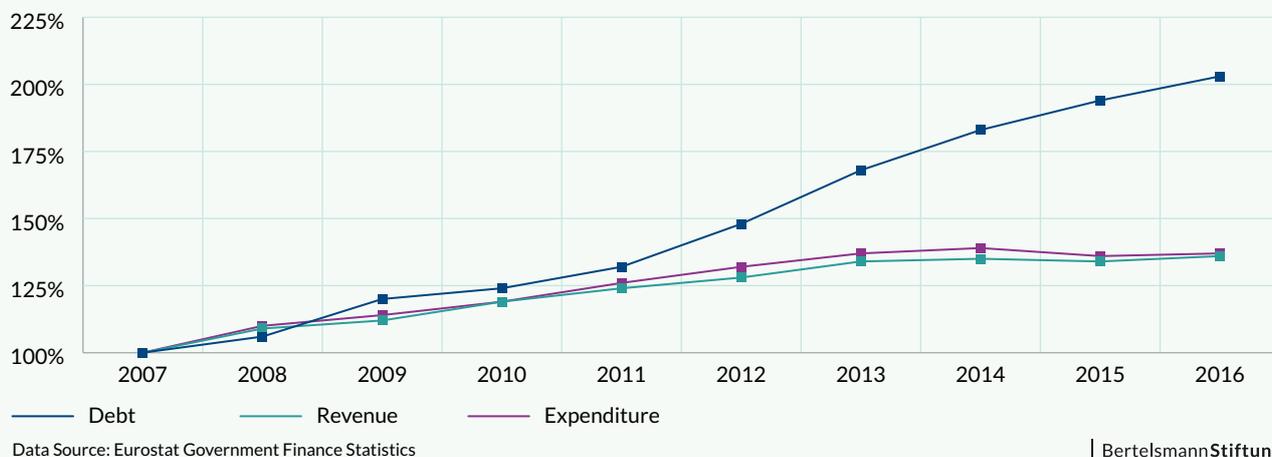


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 8.9 Finland – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



decreased again due to cuts in public-sector employment and public investment. The recent strengthening of Finland's economic growth has had positive effects on the general government budget balance, but has not been able to resolve the structural problems in public finances. Overall, local debt has risen substantially in nominal terms (Figure 8.9). Revenue and expenditure have stagnated since 2013.

For the most part, this assessment also applies at the local level. The recent economic turmoil means that Finnish municipalities have had a worse starting point when it comes to taking precautions against future problems, more so than in years gone by (Moisio 2015: 11). Nevertheless, taking the aforementioned structural problems into account, central government has proceeded with reform. For example, the introduction of the European Fiscal Compact has led to a tightening of fiscal rules at the local level because central government wishes to be able to steer the public sector, as a whole, in a more pronounced way (Moisio 2015: 13).

## 6 Fiscal Rules and Fiscal Oversight

Traditionally, there has only been light fiscal regulation of the local government sector. Instead of tight rules, central government has steered the local tier mostly through detailed service regulations (Moisio 2015: 13). However, this situation changed in the context of the financial crisis. In 2015, against the background of the financial crisis, economic downturn and financial challenges, a new regulatory system with tighter fiscal rules was established.

At present, the fiscal oversight system consists of several elements, some of them tried-and-tested, some of them new. First, there are the traditional aspects of monitoring and coordination. According to the Local Government Act, the Ministry of Finance "shall monitor the activities and finances of municipalities in general". That means that there has to be a negotiation process between central and local government, which, among other things, deals with the finances and administration of local government as well as the coordination of central and local finances. The latter is, among other things, brought about by the preparation of a programme for local government finances, since it "shall form part of the preparatory work for the general government fiscal plan and the central government's budget proposal". The main components of this programme for local government finances are an assessment of the adequacy of funding, an assessment of changes in the municipal operational environment in the demand for services and in the functions of local government as well as an estimate of the trend in local government finances. The programme will be prepared mainly by the Ministry of Finance together with other relevant ministries. The Association of Finnish Local and Regional Authorities will also participate in this process.

Second, there are some new (or at least tightened) fiscal rules. For example, there has been a rule that municipalities must balance their budget within a four-year planning period. However, there were no sanctions stipulated if they were to fail in achieving this aim. This changed in 2015. If this rule is violated, an assessment procedure is started.<sup>13</sup> The procedure "shall be performed by an assessment group, one of

<sup>13</sup> The procedure may also start if key figure limits, laid down in Section 118, subsection 3 are exceeded.

whose members shall be appointed by the Ministry of Finance and one by the municipality. [...] The group shall formulate proposals for the measures required to secure the services for the municipalities' residents" (Section 118, subsection 5). Due to high local autonomy, central government cannot easily dictate that a local government adopt specific measures. Thus, measures are proposed instead. After all, the group also consists of several external experts. Therefore, the proposals are primarily regarded (and appreciated) rather as neutral expert opinions (instead of strict instructions from the central government). Nevertheless, if a "crisis municipality" completely defies all the recommendations of the group, it risks a forced merger (Moisio 2015: 14).<sup>14</sup> Forced mergers are regarded as a very extreme sanction, however, with the intention that such a measure will neither be easily nor often adopted. So far, there have only been one or two cases.

Finnish municipalities do not face any formal expenditure ceilings or debt limits (André and García 2014: 20). In general, Finnish municipalities do not have to present budgets as budget reports and do not need any approval from state government. Monitoring by the state treasury builds on published budgets and public statistics. The Ministry of Finance follows municipal finance using financial indicators. If certain indicators turn "red", the procedure mentioned above starts.

Municipalities in economic and fiscal stress may apply for discretionary grants from central government. These grants are a type of partial bailout and come with stringent adjustment programmes, for example, tax increases, asset sales or staff cuts. In the period from 2006 to 2011, 36 municipalities entered this programme. In 17 cases, it was associated with a merger (André and García 2014: 22).

Besides the individual balanced budget rule, the government also sets a balance target for local government finances for the ensuing four years and decides upon measures on how to achieve it. This rule can be reduced to the provisions of the Fiscal Compact. It actually applies to the indicator of net lending. However, as this indicator is not applicable to the system of municipal accounting in Finland, usually the indicator of the operating balance is taken into account. In general, municipalities should have operating surpluses. However, if the local level, as a whole, cannot meet this provision, central government may lower its grants for the

municipalities or reduce the municipal share of corporate tax. Yet, as the municipalities have very important tasks to fulfil, central government does not easily decide to do so. In addition, there is an indirect local government spending limit. Central government specifies euro limits for each line ministry for the change in expenditure in relation to municipalities from central government measures for each parliamentary term. Even more important is the fact that, meanwhile, central government has to take into account the full costs of new tasks (unlike the former situation, in which grants for new tasks only had to cover 50% of the costs). Finally, the fiscal rules are now directed at the whole "municipal enterprise", i.e. also encompassing its companies (Moisio 2015: 13f.). In this regard, it helps that financial reporting by Finnish municipalities already follows standards akin to those of private accounting (André and García 2014: 23). Nevertheless, there are still no (individual) limits on municipal borrowing (André and García 2014: 20).

Audits must be performed by "firms of authorised public accountants" (Section 122, subsection 1 of the Local Government Act). Auditors are subject to liability for acts in office and are not allowed to audit the administration and finances of a municipality for more than six accounting periods.

Overall, "Finnish fiscal rules appear particularly weak at ensuring debt sustainability. They are also quite weak at restraining public spending [...]. On the other hand, they strongly support allocative efficiency and provide high flexibility to cope with shocks" (André and García 2014: 22). Nevertheless, the system seems to work well. This good result, in part, might go back to specific cultural traits. However, the generally good state of local public finances in Finland is mainly ascribed to the ample funding base of the municipalities and the responsible behaviour of local actors. Some experts within the Finnish system argue that Finnish municipalities do not need very strict fiscal rules because of the latter aspect (and stricter fiscal rules may even lead to contrary results, by destroying the inherently responsible behaviour of local actors).

14 Several Finnish municipalities also merged voluntarily within the last years. Municipalities in fiscal turmoil may receive discretionary grants from central government. However, in these cases, they are obliged to implement stringent adjustment programmes including tax increases, cuts in personnel and reorganisation of service provision, etc. Between 2006 and 2011, 36 municipalities entered such a programme with 17 of them agreeing voluntarily to a merger process (André and García 2014: 22).

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# 9 | France

Quentin Millet

### Summary

France has always been a very centralised country, and only in recent decades have three waves of decentralisation brought more autonomy to local-level governments (that is: regions, departments, municipalities and intermunicipal partnerships). In no other European country are there more local governments: The 67 million French live in more than 35,300 municipalities. In terms of public expenditure, the local level plays a smaller role than in other European countries. When it comes to public investments, however, 70% are made by local governments.

Although fiscal decentralisation is at a comparatively low level, local governments' fiscal autonomy is increasing. For years, the importance of transfers has been decreasing. Around 70% of these transfers are subject to vertical equalisation. Taxes (on property and on economic activity) are becoming more and more important in the local revenue basket. Local governments have some discretion in setting the tax rate within pre-set relative boundaries. Most important expenditure functions on the local level are economic affairs, social protection and general services.

French local governments have experienced some impacts of the global financial crisis; after 2007, expenditures and revenues increased only very moderately. In France, local governments hold more general government debt than in the average EU28 country. However, this share has been decreasing since at least the year 2000. Local government debt is restricted to investment expenditure but – beyond that – is not bound to any further limits. A strict, ex ante, monitored balanced budget rule exists. If local governments fail to present a balanced budget for the subsequent year, the prefectures as oversight bodies and central government representatives in the region can take over; but this happens only rarely.

## 1 Administrative Structure

France has been a unitary semi-presidential republic since the 1958 Constitution was adopted. Governance is shared between the president and the prime minister, from which the other administrative tiers derive, making France a very centralised country. Historically, the system was characterised by a great degree of control by the central state authorities, but several reforms in the last decades have pushed forward the decentralisation agenda (Garello 2016; Sauviat 2017: 157). So far, the French history of decentralisation is a story with three acts: The first one in 1982<sup>1</sup> gave shape to the constitutional principle of local autonomy, allowing municipalities to vote on local tax rates (within a legal framework) and giving them greater fiscal autonomy (Sauviat 2017: 163). At the core of the second act from 2002 to 2005 was the constitutional law of 28 March 2003 concerning the decentralised organisation of the republic. This law confirmed financial autonomy of local authorities and raised the principle of equalisation, guaranteeing that the poorest administrations are still able to deliver the same quality of public services through a redistribution mechanism (Garello 2014). The most recent wave of reforms, called Act III, started in 2012 and ended in 2016.<sup>2</sup>

There are four administrative tiers (Halásková et al. 2016: 66);

- 1 Law No 82-213 of 2 March 1982 concerning the rights and freedoms of communes, departments and regions.
- 2 Act III was a package of three laws: the Law of 27 January 2014 (MAPAM) modernising territorial public-sector action and reaffirming the metropolitan areas; the law of 16 January 2015 on regional boundaries and on regional and departmental elections; and the law of 7 August 2015 (NOTRe) addressing the republic's new territorial organisation (Jouen 2015: 3).

FIGURE 9.1 France – Administrative Structure, 2018

Central Level	Central Government
State Level	
Local Level	13 regions
	101 departments (96 in Metropolitan France and 5 in Overseas France)
	1,263 EPCIs (Établissements Public de Coopération Intercommunales)
	35,367 municipalities

Source: own representation

TABLE 9.1 France – Population of Local Government Areas, 2018

	Smallest	Largest	Average
Regions	Corse (337,796)	Ile-de-France (12,246,234)	5,001,392
Departments	Lozère (75,463)	Nord (2,613,874)	665,214
Municipalities	Rochefourchat (1)	Paris (2,206,488)	1,700

Source: INED 2018

beneath central government, there are regions, departments and municipalities (Figure 9.1). The president chooses the prime minister, who in turn appoints the government, which determines the policies implemented by regions, departments or municipalities. The Ministry of Finance and Economy and the Ministry of Public Action and Accounts are in charge of local-level fiscal regulation. The Ministry of Public Action and Accounts is also in charge of the structural change of the French administrations, and therefore the reallocation of funds between administrative tiers. Local representatives of the central governments are the prefects (one in every department) responsible for fiscal supervision. For this task, the prefect cooperates with the regional Chamber of Account.

There are 13 regions in France. The law NOTRe (New Territorial Organisation of the Republic), effective since January 2015, has reduced the number of non-overseas regions from 22 to 13, and reorganised their competencies (Jouen 2015: 1). Regional councils are directly elected, which in turn elect the president of the region (Régions de France 2018). The historical role of the regions was to foster economic development, but over the years their tasks have accumulated, ranging from sustainable economic development, waste management, tourism, transport infrastructures (railroads, harbours, highways, etc.) and management of secondary education (Doré et al. 2014: 127). Further responsibilities include the coordination of policies at lower levels of government under its jurisdiction, as well as the implementation of national policies in their specific area of competence. There has been a trend of reinforcing the political autonomy of regions by adding competencies from either the national government (such as the territorial cohesion policies) or from municipalities (such a waste management). The goal was to create larger regions that would be more suited for European integration dynamics.

Out of 101 departments, there are 96 in metropolitan France and five overseas. In each department there is a prefect who

holds central government power in the department in addition to being in charge of executing the central government's development policies within the department. Prefects are also in charge of controlling the acts of local governments. Although they can't refuse these acts, they have the authority to delay their implementation. The dissolution of departments by 2020 has been debated many times since the constitutional reform of 2003 (Attali 2008: 195 ff.), but despite that, they still exist and retain a number of competencies. Neither the dissolution nor the subsequent redistribution of tasks has been decided so far. The law for the modernisation of public action in 2014 (MAPTAM) put the department on the front line for all matters regarding social aid, individual autonomy and territorial solidarity (Vie Publique 2018a). The NOTRe law of 2015 promotes the specialisation of departments, limiting their range of actions. A few of the departments' historical competencies were shifted to the regions while competencies promoted by the MAPTAM law were retained, such as the management of departmental roads. Social aid is of key importance when looking at a department's functions. The department handles aid for the elderly, infants and disabled and addresses energetic precarity, connecting the most secluded parts of the territory to the electric grid. It also manages and maintains education infrastructure, handles the maintenance of its transport infrastructure and the promotion of sports and cultural activities.

The *Établissements Publics de Coopération Intercommunales* (EPCIs) are a type of territorial entity that are responsible for the joint management of tasks which historically and individually belonged to a group of municipalities (Vie Publique 2018b; Joye 2003: 4). In other words, these entities are in charge of inter-municipal cooperation. Municipalities are free to form an EPCI; the legislative framework supports this decision. An EPCI has its own council which is elected by the independent boards of all member municipalities. The EPCIs were created to foster efficiency in the following domains: economic development, promotion of tourism, and water and waste management, and, for urban EPCIs, local urban planning. Some controversies have arisen in the past as the EPCI board members are elected by the board members of municipalities, making them not directly democratically elected (Desage et al. 2010: 19). Given the current trend of more tasks being attributed to the EPCIs and consequently more funding, this issue ought to be addressed soon. In 2018, there were 1,263 EPCIs in France (Collectivités Locales 2018a). A particular form of EPCI is called "métropole" created after a 2010 law, which is an EPCI centred around a large municipality that has at least 500,000 inhabitants. It bears some of the tasks of municipalities, departments, regions. Its tasks encompass economic development, housing policies, management of public

services (water and sewage), cemeteries and slaughterhouses (Vie Publique 2018e). The first "métropole" was the one for Nice created in 2011.

Finally, the lowest tier of France's administrative system comprises the municipalities. There were 35,367 municipalities in 2018, which is by far the highest number of municipalities compared to any other European member country (Insee 2018). The number of municipalities has decreased over the years (by 1,323 since 2000). This trend of municipal mergers was supported by several laws, the most important one being law 2015-292. The status of "commune nouvelle" has been reactivated in order to promote municipal mergers while maintaining historical municipalities as "localities" (OECD 2016). The current decentralisation trend has led the municipalities to take on new tasks which used to be carried out by the central government regarding urban planning, social services (e.g. centres for the elderly), sanitation (sewage), primary education and cultural matters. Those tasks were added to the traditional functions of municipalities, such as road maintenance, public order, the organisation of elections and administrative matters at the local level (Vie Publique 2018c). Municipalities have traditionally played a very central role in day-to-day life in France.

## 2 Revenue

Since French local governments (regions, departments, municipalities and EPCIs) provide a wide range of services, they have a substantial sum of money at their disposal (Du Boys 2017: 96 f.). However, they have only limited fiscal autonomy as 23% of operating resources and 62% of investment resources come from the central government (municipalities and EPCIs receiving 56% of all the grants handed out by the central state, departments 31% and regions 13%). Figure 3 describes the fiscal autonomy of local governments: The trend is for local governments to become less and less dependent on grants as the tax share has been slowly increasing over time, except the years 2009-2010, the post-financial crisis period, in which the central government had to increase transfers as local governments could not meet their obligations. The notion of local transfer dependency is particularly relevant as only the central government is authorised to create new taxes (Art. 34 of Law 77-574 1977). The rest of the local governments' revenues comes from local service fees and makes up an estimated 17% (Du Boys 2017: 96). Within this financing system, local authorities are still able to fix the rate of the main direct taxes (such as the waste collection tax, property tax or apprenticeship tax) but are not responsible for their collection. The central government also bears the risk of non-payment,

FIGURE 9.2 France – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016

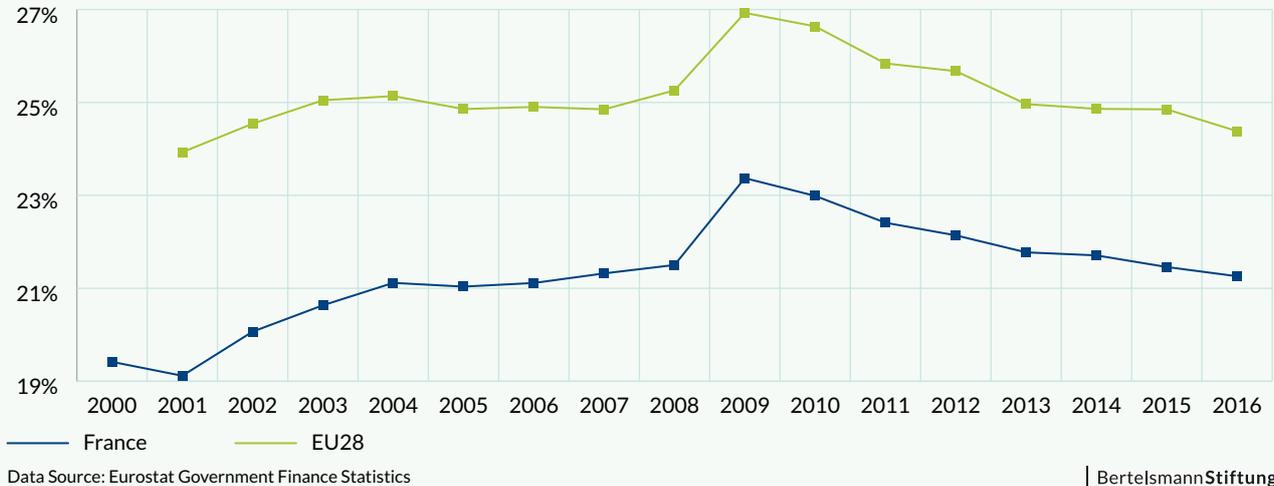
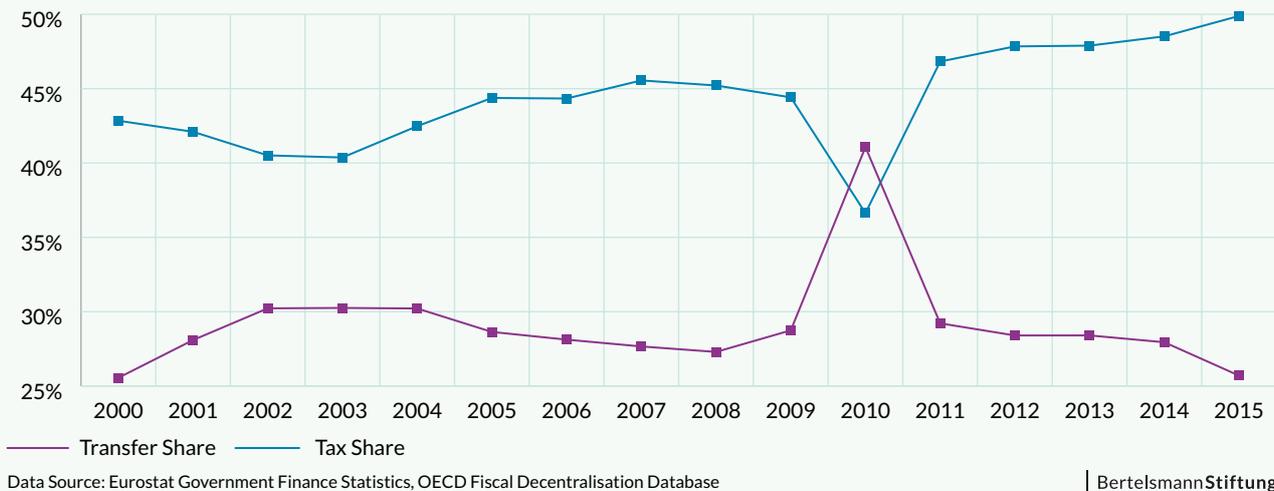


FIGURE 9.3 France – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



providing a safety net for the budget of local governments that have been put under stress after the crisis due to cuts, non-performing loans and poor access to capital markets. As Figure 9.2 shows, the aggregate local government revenue represented 21% of general government revenue between 2000 and 2016, starting at 19% in 2000, increasing to 21% in 2016 and reaching a peak in 2009 of 23%. It decreased thereafter, as central government enforced budgetary cuts through a reduction of transfers following the crisis. The case of France is very similar to its European peers with the one difference that the local government revenue share is regularly 4% lower.

Transfers emanating from the central government amounted to €99.4 billion in 2017, corresponding to a 0.6% decrease from the previous year. (Direction du Budget 2018: 30f.). These transfers consist of (1) financial contributions supporting core competencies of local governments and (2) financial contributions supporting local governments which help execute larger-scale policies, and (3) further grants including transfers for professional training.

1. Financial transfers supporting core competencies: State grants to local governments include all financial transfers to local governments and their regroupings (such as EPCs in

FIGURE 9.4 France – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

| BertelsmannStiftung

the case of municipalities), which are financed by local taxes collected by the central government on behalf of those local authorities as well as revenues specifically earmarked for the interrelations between local governments. These grants amounted to €47.9 billion in 2017, representing 48.2% of all transfers. These transfers are categorised by EUROSTAT as local taxes, as the central government is only responsible for collecting the local taxes and redistributing them according to the equalisation mechanism.

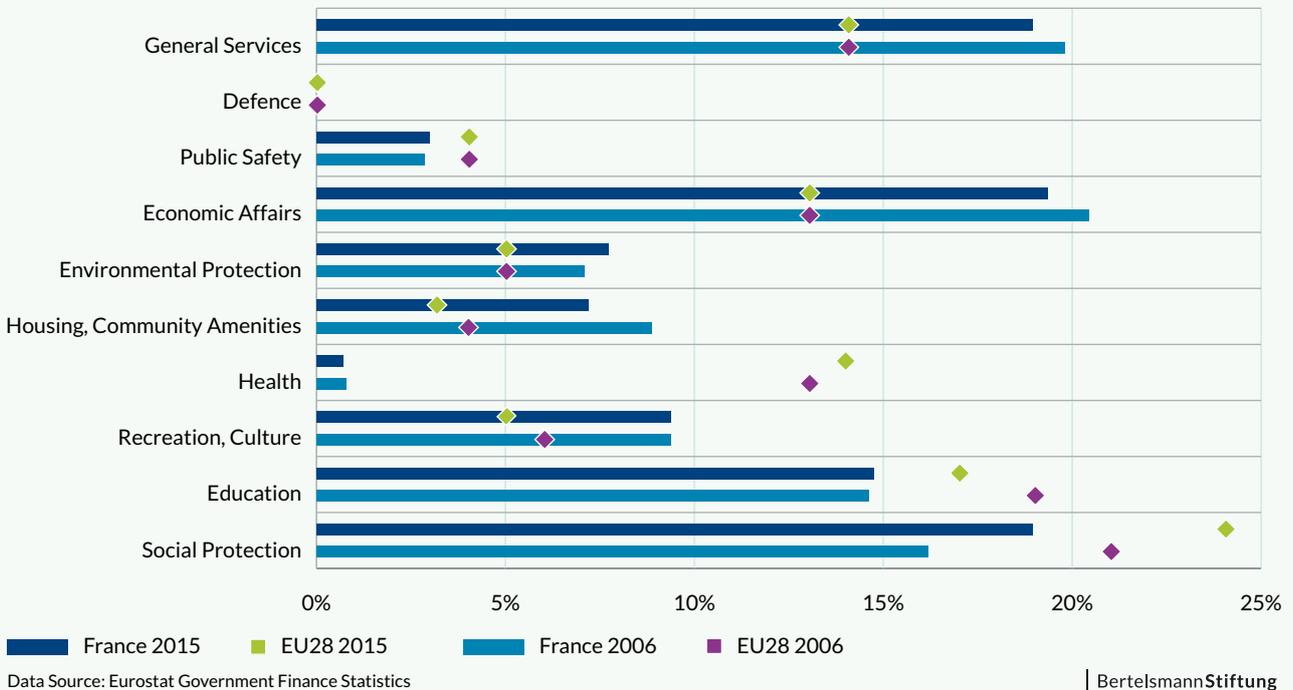
2. Earmarked grants for wider-range policies: State transfers that aren't financed by local taxes. These funds are destined to support wider-range policies in which local governments are one of many actors. They are earmarked for the mission they are associated with. These earmarked grants come from subsidies emanating from various ministries, fiscal relief schemes, traffic fines and other public projects excluding professional training. These earmarked grants amounted to €15.1 billion in 2017.
3. Finally, the last type of grant consists of earmarked regional transfers for professional training. These grants amounted to €36.4 billion in 2017.

71% of transfers are paid in order to achieve vertical fiscal equalisation (Vie Publique 2018f.). This represents a willingness by higher administrative tiers to compensate for underprivileged parts of the administered territory. Horizontal fiscal equalisation, which corresponds to transfers occurring from other administrations at the same level, represents 10% of those transfers (through EPCIs). To address local inequality

issues, the government created the FPIC (Fonds national de péréquation des ressources intercommunales et communales), which amounted to €1 billion in 2016 (Boeton 2013: 3).

Local taxes in France are a large funding source, representing 44% of a local government's budget on average between 2000 and 2015, reaching around 50% in 2015, with an inflexion point in 2010 when the figure reached 36.6% (Figure 9.3). Municipalities receive three quarters of the three main taxes grouped as "household taxes", representing two thirds of local taxes (Direction Générale des Finances Publiques 2013: 20). They include the council tax as well as property taxes on built and non-built properties (Direction Générale des Collectivités Locales, 2018: 62). The remaining local taxes are called "taxes économiques" and are linked to the economic activity of the firms within the considered jurisdiction. These taxes make up for the remaining third of local taxes, and typically are split between regions and departments. Local taxes as a share of total local government revenue gradually increased by 2.6% every year from 2006 to 2016, even if the rate of increase has decreased in the last year of the period under review (Figure 9.3). The decision on what tax rate to use has been determined by the local governments themselves since 1980. However, in 2010 a law was passed that takes away that right from regions from 2011 onwards (Vie Publique 2017a) and sets boundaries for the rest of local government. Indeed, departments, municipalities and EPCIs still can decide on the rate, which must not exceed 2.5 times the national average for the three household taxes, and twice the national average for the taxes on economic activities.

FIGURE 9.5 France – Local Government Expenditures by Function  
As Share of Total Local Government Expenditures



Further types of local government revenues comprise fees and charges. This additional source of income is generated by the exploitation of the local governments' assets, whereas fees correspond to the payments charged for a service delivered by the administration. However, this type of resource remains marginal (Vasseur 2017: 14).

### 3 Expenditure

Local expenditures (combined expenditures of municipalities, departments, regions and further inter-municipal organisations) accounted for 19.5% of general government expenditure between 2000 and 2016 (Figure 9.4). This average value is below the EU28 average of 23.9% from 2001 to 2016 and therefore indicates a relatively low relevance of French local-level governments compared to other European member countries. This once more reflects the traditionally very centralised state structure of France. Over the whole period under review, however, this local government share increased from an average of 19% in the early 2000s to 21% in 2008, settling at 20% in 2016.

With 50% of local expenditures covered by local taxes in 2015 (Figure 9.3) and a certain freedom to set tax rates,

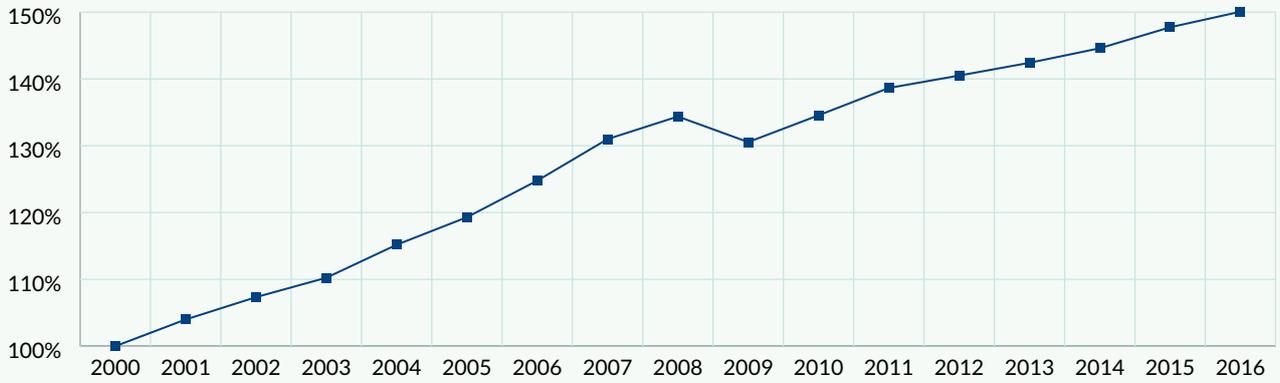
France's local governments have greater financing autonomy when compared to their European peers, averaging 36% in the same year. Social protection, economic affairs, general services and education are the most important expenditure pools for local governments (Figure 9.5). While most of the local governments' functional areas decreased over the 2006–2015 period, social protection and education expenditure increased. That trend is mainly due, on the one hand, to the 2012 territorial reform (Hertzog 2012: 925) aiming at controlling the budget balance of local governments and, on the other, the transfer of competencies enacted by the NOTRe law of 2015 (Jourdan 2016: 51 ff.).

### 4 General Fiscal Status

Local government debt in France amounts to an average of 10% of national nominal GDP between 2000 and 2016; it ranges slightly above the EU28 average. Although local government debt as a share of GDP gradually increased over the whole period, the share of general government debt decreased slightly (Figure 9.8) from an average of 11% in 2000–2004 to an average of 9.5% in 2012–2016. This indicates an over-proportional increase in central government debt over GDP at the same time, which is at least partly due to the bailout

FIGURE 9.6 France – Nominal Gross Domestic Product

Index: 2000 = 100

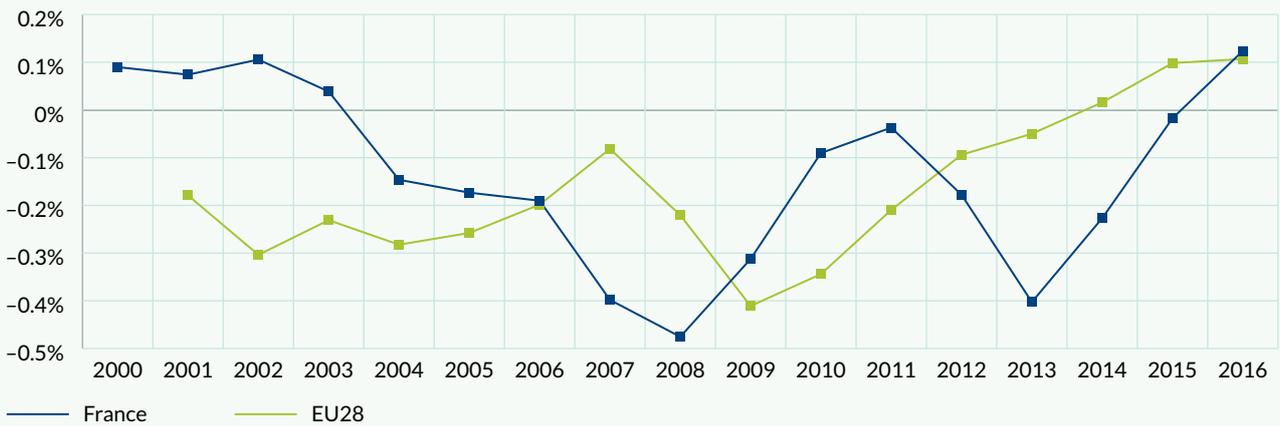


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 9.7 France – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 9.8 France – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016

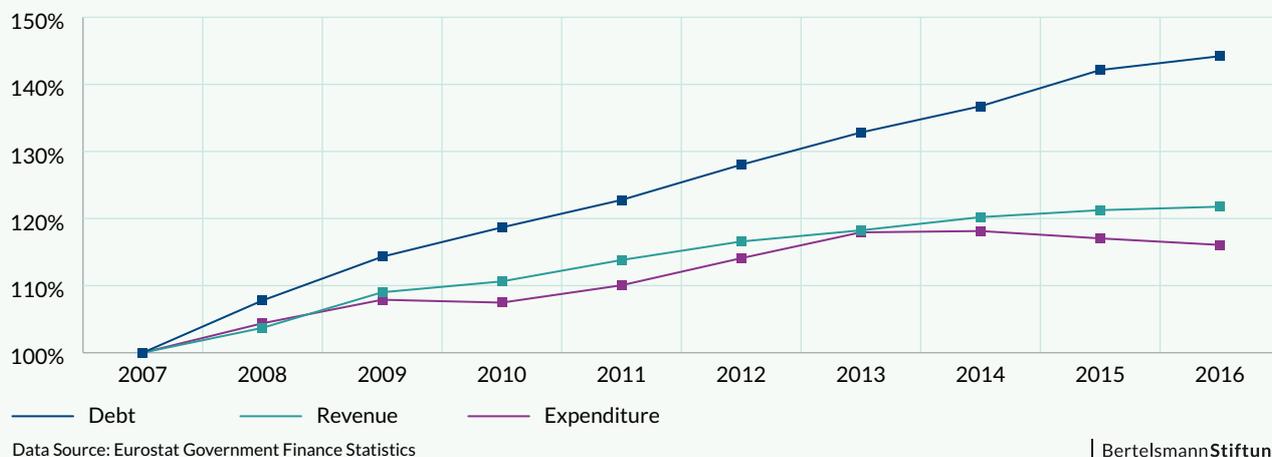


Data Source: Eurostat Government Finance Statistics

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FIGURE 9.9 France – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



of private-sector financial institutions, such as Dexia<sup>3</sup>. Since central government debt is significantly larger than local government debt, the slight increase of local government debt as a share of GDP was largely compensated for by the growth of central government debt. Compared to other European countries, local government public debt as a share of general government debt is constantly and considerably above average.

The local governments' budget balance in France amounts to an average deficit of 0.1% of nominal GDP over the entire period of interest. As Figure 9.7 shows, there is significant variation in the deficit: After a heavy post-crisis hike in 2011 to almost being in balance, which represented a temporary brightening following constant year-after-year deficits since 2004, it decreased again to minus 0.4% of GDP in 2013. As in many other European countries, it turned into a surplus in 2016.

The moderately increasing local government debt level as a share of nominal national GDP points to rising financial tensions on the local level. This impression is underlined by the fact that since the financial crisis three municipalities (Pont-Saint-Esprit, Bussy-Saint-Georges and Hénin-Beaumont) have lost their financial autonomy and have been put under regional

supervision due to financial mismanagement, whereas other municipalities like Argenteuil even declared bankruptcy.

## 5 Effects of the Financial Crisis

The financial crisis of 2007/08 hit local governments and affected their budgets as their revenues have been growing slowly (Figure 9.9). One reason was the shrinking tax on economic activity in consequence of the economic slowdown. Similarly, access to capital markets worsened since banks were no longer lending at affordable rates, which had serious implications as local governments are in charge of 70% of public investment (Le Gand 2012: 943). For example, ongoing projects that required additional funding had to be interrupted, even in cases where local governments were in a healthy financial situation. This situation incentivised municipalities to either raise tax rates or postpone necessary investments (Le Gand 2012: 951). Since 2007, the absolute debt level of local governments in France increased by 44% until 2016. Post-crisis expenditures increased more moderately than revenues; since 2014, they have even been decreasing. This provides ample explanation for the budget surplus in 2016 (Figure 9.7).

Parts of the overall increase in revenues can be traced back to the territorial reforms of 2015, when more tasks were pushed on local governments alongside the corresponding transfers. The decrease in overall expenditures after 2012/13 can be traced back to economies of scope that were realised thanks to the territorial reform of 2012, which got local governments to specialise instead of having multiple tiers with overlapping responsibilities. Another consequence resulting from the

<sup>3</sup> The Franco-Belgian bank Dexia was the only bank bailed out by the French government in consequence of the financial crisis. Coincidentally, it was the primary lender for local governments. The bank was bailed out twice: first in 2008 following the collapse of one of its American subsidiaries specialised in credit default swaps (Plane et Pujals 2009: 206), and then in 2012, as a consequence of the Eurozone crisis. Today, the bank has been dismantled and merged with other French and Belgium financial institutions.

territorial reform was to make local governments control their budget balances (Hertzog 2012: 925). Quite obviously, the ongoing trend towards decentralisation described in Chapter 1 was fostered and reinforced by the financial crisis, during which public budgets were put under pressure (Attali 2008: 195 ff.).

## 6 Fiscal Rules and Fiscal Oversight

Prefectures and regional Chambers of Accounts act as oversight bodies. All local governments must submit their budget to the regional prefect, who bears the responsibility of supervising and verifying that rules and procedures have been respected (Art. 72 of the Constitution and Article L2131-1 to 6). In normal times, prefects conduct an *ex ante* supervision. They evaluate if municipalities comply with budgeting principles based on four points: (1) adoption and transmission date, (2) balance of the budget, (3) validation and date of vote or, eventually, the rejection by the local board, and finally (4) the registration of mandatory expenses and the representative in charge of paying those expenses. If one of these points is violated, the prefect summons the regional Chamber of Accounts, which is a public institution and is in charge of issuing a proposal addressing the problem encountered with the budget (Collectivités Locales 2018b).

The budget approved by the local council must be balanced. In case there is no agreed budget respecting the balanced budget rule, the local authority loses its autonomy to the prefecture and the regional Chamber of Accounts. This procedure of taking over the financial steering by a higher level of the government has not been written into the law, as cases are rare. Most (three cases: Pont-Saint-Espirit, Bussy-Saint-Georges and Hénin-Beaumont) happened right after the 2008 crisis as structured loans guaranteeing cheap financing costs turned out to be unsustainable in the context of economic turmoil (Le Gand 2012: 943 ff.). According to the European Commission's fiscal rule database, the statutory basis for the current rules is a law from 1983. One major peculiarity of the French balanced budget rule is that although the budget has to be balanced for the following year, *ex post* deficits during budget execution are allowed. They must stay, however, below 5% of the current revenues (10% for small municipalities). This explains the discrepancy between the existence of a balanced budget rule and the actual occurrence of aggregate budget deficits as depicted in Figure 7. The discrepancy between the budget and the actual money flows during the budget year may stem from incorrect estimations of either revenues or expenditures or changing debt service repayments.

Given the increased fiscal pressure witnessed in certain departments in continental France and its overseas territories, a fund split in two parts was created to support departments facing a state of insolvency (Nord, Creuse, Corrèze, Seine-Saint-Denis and Pas-de-Calais) (Art. 131 of Law No. 2016-1918). The first part of that fund (€170 million) is dedicated to the departments in continental France and the specific case of Lyon, and the remainder (€30 million) to the overseas territories. The creation of the fund was welcomed by local governments despite the general feeling of underfunding (Mascre 2017). Access to those funds depends on the decision of the regional prefect, who is the supervisor of departments' budget and can make an exceptional claim to help a department facing insolvency. The funds are then granted with no obligation of repayment, according to the level of precarity existing in those departments (such as the proportion of the population benefitting from special subsidies linked to age, poverty, handicap or unemployment). The logic behind the attribution of those funds is that they should be given to departments that are structurally less able to regain economic momentum.

Corresponding to the law CE No. 234917 of 12 February 12 2003, French local administrations are allowed to borrow from any authority related to the central government without approval. The borrowing contract does not fall under the regulations of public markets, but under private law in conformity with European directive 2004/18/CE. There is no limit to the amount borrowed for all local governments. Local governments can only borrow long-term funds for investment purposes (OECD 2016). The local authority is free to allocate the funds to run the project as it likes but is not allowed to incur new loans in case of cost overruns (Sutherland et al. 2005: 159 f.). Without implementing further direct restrictions for local governments, the borrowing framework was strengthened after the crisis by the 2013 banking law that authorised the creation of Agence France Locale, which functions as loan intermediary between the financial market and local governments (OECD 2016). It pools loans of local governments and provides a more diversified access to financing markets (Delaunay et al. 2015: 58). This aims at risk reduction.

Local governments do not face capped expenditures, as long as the budget remains balanced, and they still have the freedom to decide tax rates. There is neither a revenue nor an expenditure rule. The central government maintains the right to cap tax rates if they are deemed to be too high (Sutherland et al. 2005: 161 f.). It is a reserve right that has not been utilised yet, although the right to decide on tax rates that had been granted to all local governments was abolished for regions in 2011 (Vie Publique 2017).

Local budgets in France are not audited (Vie Publique 2018d). The only type of verification that takes place is ensuring that the norms and principles are being respected. This task is borne by the prefect, who can turn to the regional Chamber of Accounts if necessary. The NOTRe law of 2015 created a commission in charge of certifying the public accounts of 25 local governments, a representative sample with a view to formalising public account certification by 2020. This project should produce its final results in 2020. Then the central government will decide on whether to adopt an official procedure for public account certification (Vie Publique 2018g).

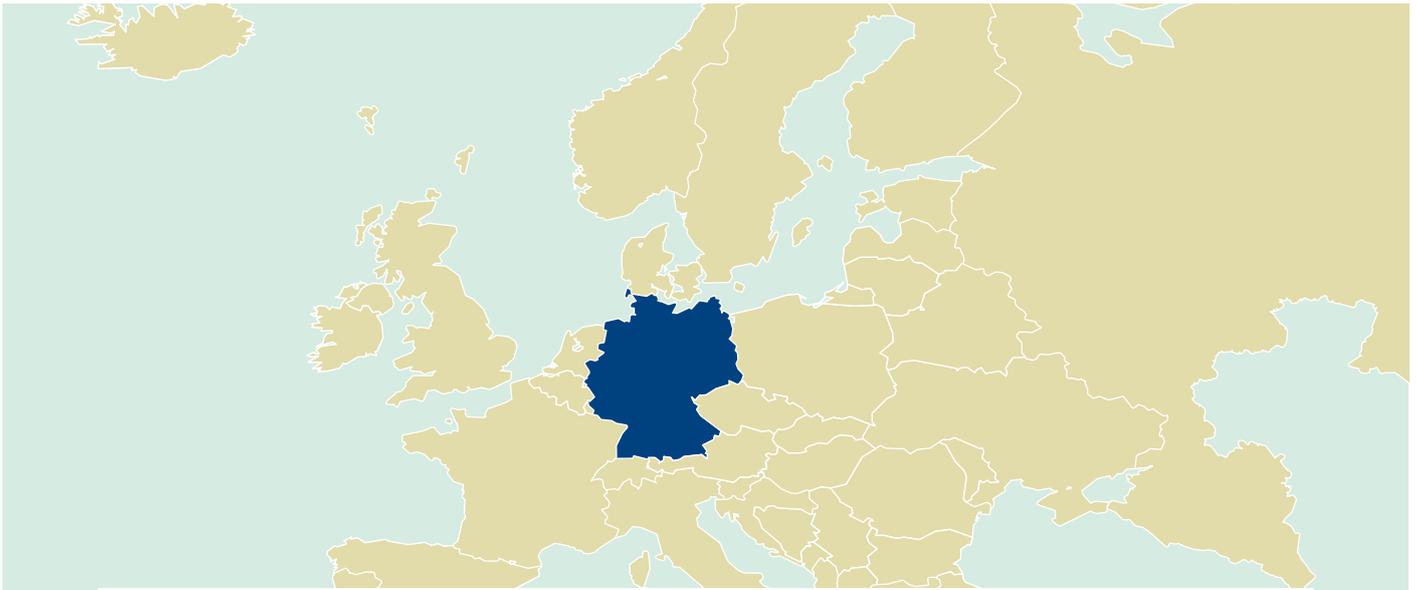
Although the additional funds for departments may be interpreted as bailouts, official bailouts for local governments are structurally unfeasible. There is no bailout procedure, as borrowings are capped at investment expenditures and all budgets ought to be balanced. The budgets have historically been quite small, but with the dynamics of decentralisation, local governments have been responsible for more and more tasks and have to plan more types of investment decisions, and with that more borrowings. After the crisis year of 2008, three municipalities (Pont-Saint-Esprit, Bussy-Saint-Georges and Hénin-Beaumont) were put under supervision, as they were facing financial difficulties due to poor management. This meant they were no longer able to decide on the local budget, tax rates and investment projects. The procedure was launched after the municipal boards had refused to vote for a balanced budget, implying a drastic increase in local taxes. The regional Chamber of Accounts ended up voting on a budget with the same tax increases that had initially been proposed, as well as the interruption of investment projects and the cancellation of a few public services. At no point were additional funds provided by central government. As mentioned above, this supervision by the regional prefect is not a legally defined procedure.

About 20 years ago, the municipality of Argenteuil made headlines. Due to unaffordable financial products, it declared itself insolvent in 1997. Since there is no bankruptcy procedure, drastic financial measures were taken, allowing the municipality to be placed under supervision.

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# 9 | Germany

René Geißler

## Summary

Germany is a federal state consisting of three levels: federal, state and local government level. Local governments are part of and subject to 13 territorial states.<sup>1</sup> The local level consists of about 11,000 municipalities, 295 counties and 103 cities with county rights. Through revenue, local governments are funded predominantly by state grants and taxes. The structure and amount of grants are subject to the states and, hence, differ widely among them. With regards to taxes, business and property taxes are locally autonomous. Beyond this, local governments receive shares of value added tax and personal income tax, as shared taxes. Due to the major impact of business taxation, the individual municipal revenue composition is subject to the strength of the local economy. Local governments oversee a wide range of services, varying significantly among the states. The largest (and growing) share of expenditure goes into welfare.

The financial crisis directly hit local governments in 2009 and 2010 due to a decline in business tax revenue. In order to preserve short-term liquidity, many municipalities made use of short-term credit, which escalated by 50% in aggregate

terms. However, on average, local governments recovered quickly. Since 2012, the local level (in total) has recorded an annual budget surplus. Nonetheless, there are rising regional disparities and one in five local governments finds itself in a long-term budgetary crisis. The global financial crisis was the starting point of growing federal involvement in local budgets.

Local governments are subject to a balanced budget rule and loans are restricted to capital spending in general. However, these fiscal rules are broken regularly in some states. The states are in charge of local government fiscal supervision. If fiscal rules are broken, the overseeing bodies can reject local budget plans and enforce cutback programmes; in taking their decisions, they enjoy far-reaching discretion. There are some known incidences of failing supervision. Against the backdrop of the financial crisis, some states have adjusted their systems and introduced conditional bailouts.

<sup>1</sup> In addition, there are three so-called city states, which are cities and states at the same time. They are subject to state fiscal regulation.

## 1 Administrative Structure

Germany is a federal state consisting of 13 territorial and three city states (Figure 10.1). Local governments are part of and subject to the states (Scheffold 2012). Through federal and state constitutions, they are granted fiscal autonomy. They can raise local taxes and have budgeting rights.

The local level consists of about 11,000 municipalities. 103 of them are independent cities, are not subordinated to a county and are in charge of a broader set of services. The remaining municipalities are part of one of the 295 counties. Hence, there are three types of local government (“normal” municipalities, independent cities and counties) in every state. Beyond these, we find two forms of local authority associations in some states. In most of the states, there are administrative partnerships consisting of smaller municipalities within a county. Small municipalities remain autonomous legally, politically and in terms of budgeting, but delegate the execution of most of their functions to the administrative partnership. In five out of 13 states, there are also associations of counties and cities with county rights (höherer Kommunalverband). Their members delegate particular functions (welfare) to such associations in order to reach a higher level of effectiveness.

In recent times, the number of local governments has been shrinking due to (mostly forced) mergers in the eastern German states. There are large differences in local structure and a huge range in the number of inhabitants within local authorities (Table 10.1). The states set the structure and range of services; consequently, there is substantial variation between states. Most significant differences exist with regards to welfare services, which have a direct impact on local budgets. Local governments are in charge of delivering a broader range

FIGURE 10.1 Germany – Administrative Structure, 2017

Central Level	Federal Level	
State Level	13 territorial states	3 city states
Local Level	Higher associations of counties and cities	
	295 counties	103 cities
	Administrative partnerships of municipalities	
	11,000 municipalities	

Source: own representation

TABLE 10.1 Germany – Population of Local Government Areas, 2016

	Smallest	Largest	Average
County	Luechow-Dannenberg (49,000)	Recklinghausen (617,000)	188,000
City	Zweibruecken (31,000)	Munich (1,500,000)	196,000
Municipalities as part of a county	Groede (9)	Neuss (153,000)	5,100

Source: Federal Office of Statistics, 2016

of welfare services that bear higher risks of underfunded mandates and unbalanced budgets.

The administrative system of the Federal Republic of Germany is quite complex. In most cases, basic legal principles are set at the federal level and complemented by state law. Some flexibility is left to local governments. However, there are hardly any essential services delivered autonomously at local level.

The German capital, Berlin, as well as Hamburg and Bremen are city states. Thus, they have a different setup and, subsequently, are not included in this representation of local government.

## 2 Revenue

In general, the local share of general government revenue has been rising for several years, driven by higher intensities in welfare and with this, growing state grants (Figure 10.2).

Higher-level grants and local taxes make up equal shares of local government revenue (Figure 10.3). In addition, there is a range of charges and user fees for particular services (e.g. utilities and kindergarten). The structure and amount of grants can be decided upon by the states and, hence, differ widely among them. The most relevant type of grants are unconditional grants, calculated based on the number of inhabitants, fiscal capacity and fiscal need. Due to some state court decisions, the relevance of state reimbursements for services transferred to the local level is rising.

Municipalities and independent cities receive shares from income tax as well as value added tax, which are regulated at federal level. Additionally, municipalities levy two property taxes (one for residential property and one for land used in agriculture) and business tax.

FIGURE 10.2 **Germany – Local Government Aggregate Revenue**  
As Share of General Government Revenue – From 2000 to 2016

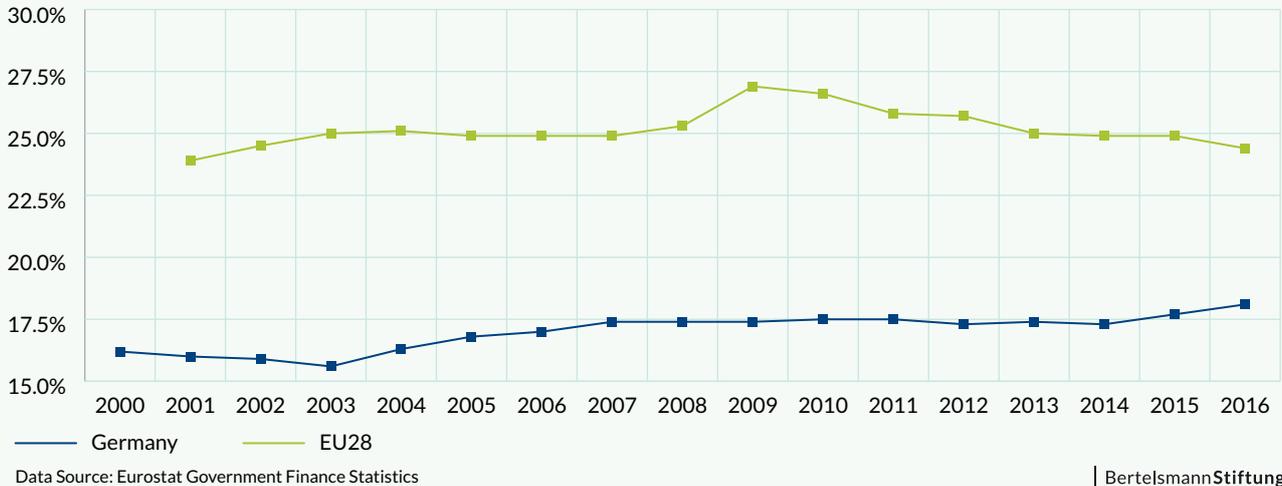
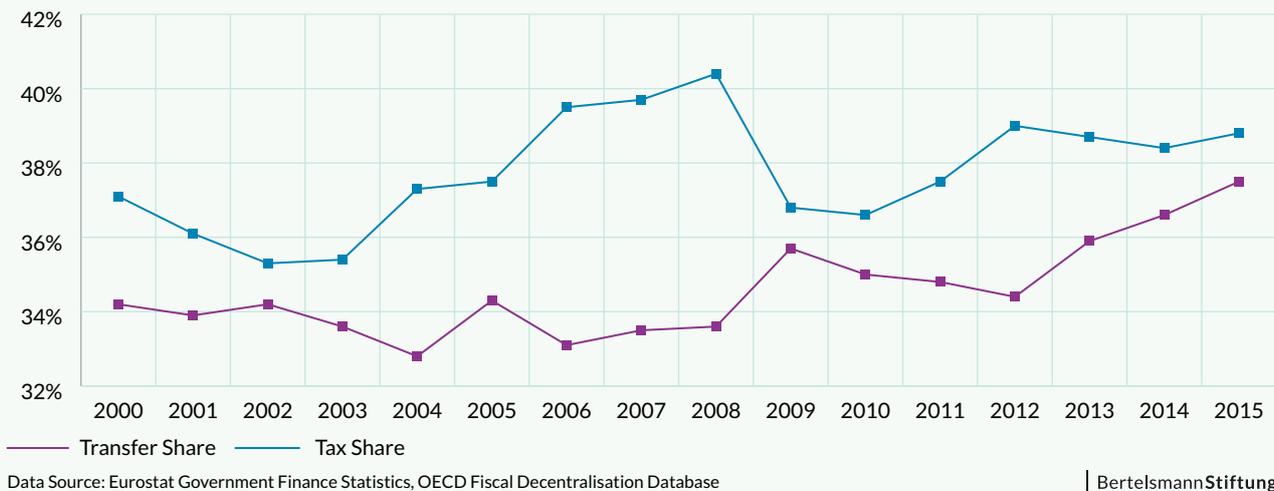


FIGURE 10.3 **Germany – Local Government Aggregate Transfers and Taxes**  
As Share of Total Local Government Revenue – From 2000 to 2015



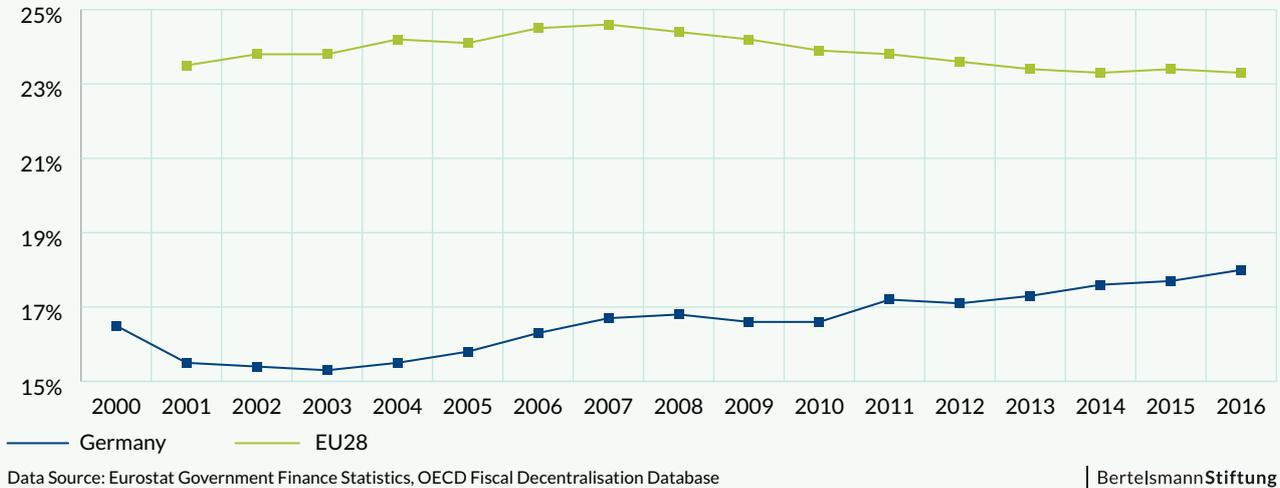
Business tax derives, more rather than less from a company's profit. Municipalities set their own tax rate, regulated through a minimum rate since 2004. About a third of municipal business tax revenue has to be transferred to state and federal levels. As a consequence of the positive economic development, there has been a robust growth in business tax revenue; from €35 billion in 2010 to €50 billion in 2016. On the other hand, business tax is volatile. There is a very close link between business tax and the local economic structure.

The second relevant local tax is property tax, which is levied both on residential and on business properties. There has been

a robust trend of growing property tax rates and also revenue. In contrast to business tax, this growth is a consequence of higher tax rates. From 2006, to 2016 revenues rose from €10 billion to €13 billion. There has not been a revaluation of property values for decades and the system of property tax is now under review.

Municipalities enjoy a high degree of autonomy with regards to tax rates. Nonetheless, there is a state influence on tax rates as a consequence of fiscal equalisation. To avoid tax competition and a race to the bottom, municipalities that have tax rates below a certain level will be disadvantaged during the distribution of general grants.

FIGURE 10.4 **Germany - Local Government Aggregate Expenditures**  
As Share of General Government Expenditures - From 2000 to 2016



In recent years, one has observed widening disparities in tax rates within municipalities. Municipalities facing budgetary crisis or benefitting from conditional bailouts have had to raise their rates, especially regarding property tax. In the end, an adverse situation has evolved, in which weak municipalities with lower infrastructure and service levels have higher tax rates than the stronger ones.

The economic strength of the individual municipal revenue composition is based on the major impact of business taxation. In every state, there is an individual municipal financial equalisation system. Most states have based the level of redistribution of revenues, at least partly, on the socio-economic structure of the municipalities and their concomitant needs. In most states, there are also types of tax redistribution within the local level, meaning that richer municipalities must transfer shares of their revenue to weaker ones. Another trend has been a higher relevance of redistribution amongst municipalities due to growing economic disparities. Counties are financed by state grants and contributions from their municipalities. They have no (essential) taxation rights.

### 3 Expenditure

Local share of total public spending (as revenue) is below the EU average (Figure 10.4). Nonetheless, this data is somehow misleading when interpreting the relevance of the local level in public policy and public services. The rather low share refers to the existence of a separate social insurance system bearing the cost of unemployment, health and pensions. Taken together,

spending by local governments is rather close to the aggregate budgets at the state and federal levels.<sup>2</sup>

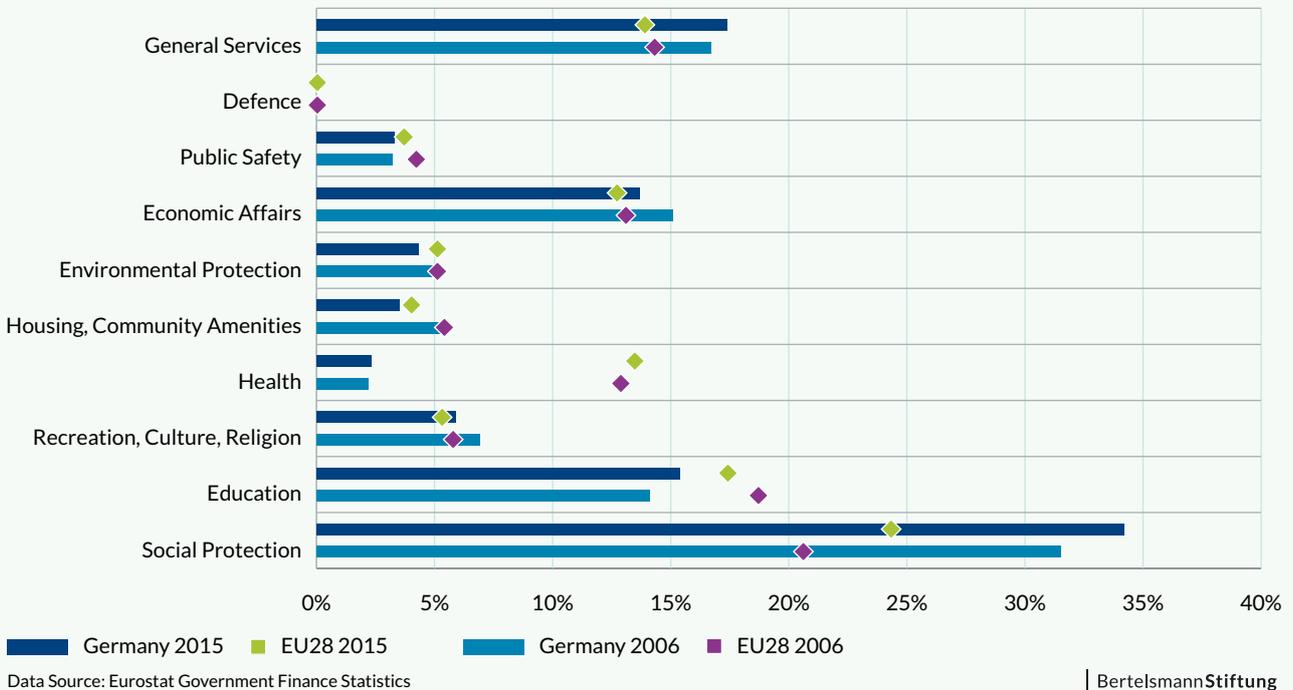
Local governments are in charge of a wide range of services, mostly devolved by state law (Figure 10.5). The largest (and growing) share of expenditure is welfare, the costs of which have proven to be highly dynamic over time (e.g. the costs for kindergarten, social protection/social welfare benefits, etc.). This is the major reason why the local share of general government expenditure has been rising for several years (Figure 10.4). Regarding education, local governments must provide the infrastructure.

Local governments implement the majority of public investment (about 60%). In the aftermath of the financial crisis, total amounts of local capital spending were on the rise, not least encouraged by special federal grants that were meant to stimulate economic growth. Nonetheless, the share of capital spending on total local spending shrank from 17% in 2000 to 10% in 2016. With this, a debate has ensued about investment backlog, especially in western local governments.

There are significant disparities among municipalities when it comes to expenditure by functions. Economically weak cities show higher spending levels for welfare and lower levels for capital spending.

<sup>2</sup> In 2017, federal spending was €376 billion, state spending €383 billion and local spending €248 billion.

FIGURE 10.5 Germany – Local Government Expenditures by Function  
As Share of Total Local Government Expenditures



Generally, local expenditure and the local share of general government expenditure have been constantly rising (Figures 10.4 and 9). This trend reflects the expansion of some welfare services, which are executed by local governments.

#### 4 General Fiscal Status

Since 2012, the local level (in total) has recorded annual budget surpluses (Figure 10.7). Local revenues have risen strongly within the last five years, but so has local spending (Figure 10.9). Nonetheless, there are growing regional disparities among local governments (e.g. regarding tax revenues, budget crises and capital spending). A major debate is taking place on investment needs (German Institute of Urban Affairs 2018). Additionally, rising welfare spending is a long-term challenge (Färber and Salm 2015).

Local debt, in total, has been stagnating (more or less) since 2012, at a level of about €130 billion (Figures 10.8 and 10.9). Simultaneously, its structure has been worsening for decades. A growing amount of local debt is short-term, reflecting budget deficits. Although this type of debt is regulated and heavily restricted, it increased from €6 billion in 2000 to about €48 billion in 2012 and then stagnated until 2016. Recently, in 2017

and 2018, there was a remarkable decline. This debt category is the usual indicator of a budget crisis. Long-term debt, on the other hand, is shrinking.

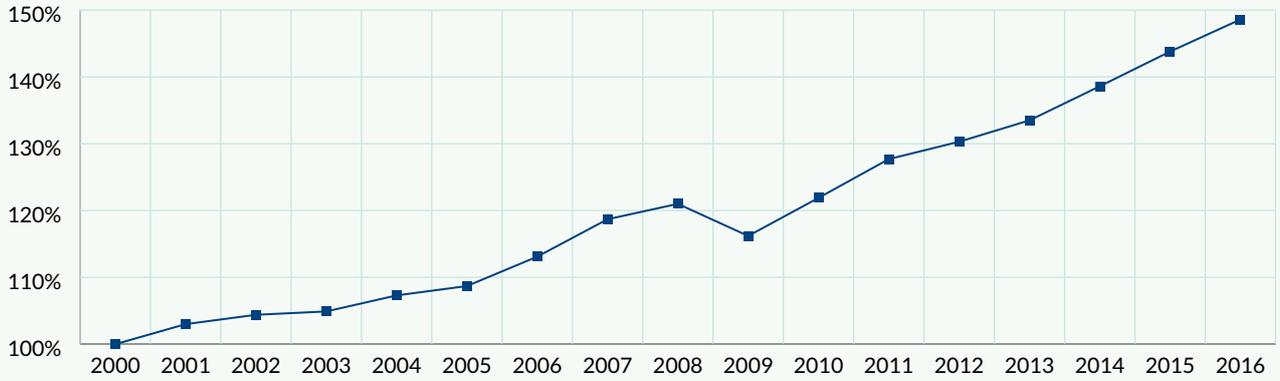
As recently as 2015, about one in five local governments found itself in a long-term budget crisis. Welfare spending is one of the major causes of fiscal challenges. Crises have been and are still cumulating in the states of North Rhine–Westphalia (NRW), Saarland and Rhineland-Palatinate. The state of Hesse was member of this group for decades, but bailed out its local authorities in 2018. Generally, the years of 2017 and 2018 ended with historical surpluses due to strong economic growth. Even long-term crisis cities showed positive balances.

Local governments are permitted to issue bonds but have rarely made use of this. In 2017, bonds made up about 2% of local debt.

Loans are taken out from private as well as public banks. There is no special municipal bank dominating the market. Nonetheless, there is a strong position for locally-owned banks (Sparkassen), especially in the case of smaller municipalities. In addition, there are several special publicly owned banks, intended to encourage economic development, which give out subsidised loans.

FIGURE 10.6 Germany - Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

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FIGURE 10.7 Germany - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2000 to 2016

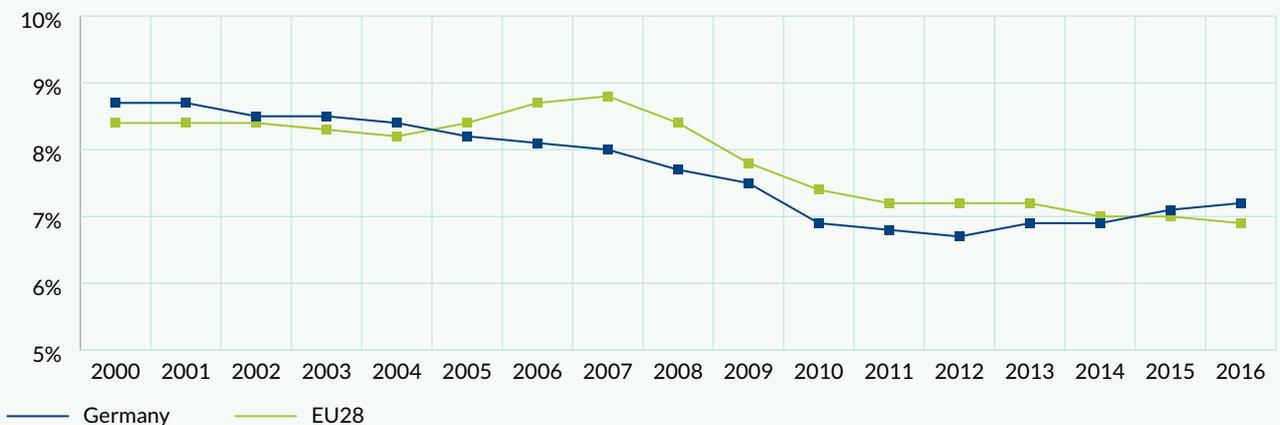


Data Source: Eurostat Government Finance Statistics

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FIGURE 10.8 Germany - Local Government Aggregate Debt

As Share of General Government Debt - From 2000 to 2016

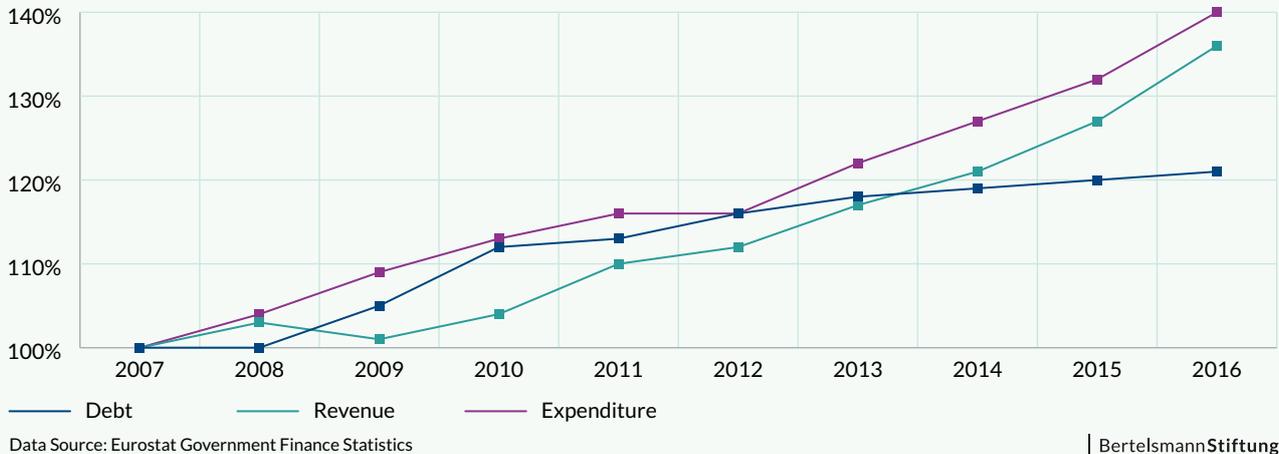


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 10.9 Germany – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



## 5 Effects of the Financial Crisis

The financial crisis directly hit local governments in 2009 and 2010 due to a decline in business tax revenue (Papenfuß et al. 2017: 131 f.; Figure 10.6). Short-term credit, a usual measurement of financial crises, escalated by 50% within four years (Figure 10.9). The financial crisis was a shock to local governments, as they had just recovered from even harder budgetary challenges in previous years (Figure 10.7). Local budgets tumbled and went from boom to bust.

However, on average, local government budget deficits had recovered by 2012. The financial crisis was a starting point for increasing federal involvement in local budgets. Against the background of valid local claims and solid federal budgets, a bundle of special transfer measures was set up, benefitting the local level (e.g. reimbursement of welfare spending, enhancement of capital spending) (Scheller and Walker 2017). As a result, there was a strong rise in revenue as well as expenditure. Declining interest rates turned out to be very helpful in relieving the burden for the weakest and highly indebted municipalities. Finally, due to the fast economic recovery and robust federal interaction, the financial crisis did not lead to an overall budget crisis among German local governments. On the contrary, the existing trend of rising local spending has continued (Figure 10.9).

Several states (9 out of 13) reacted with adjustments in fiscal regulation, namely, by setting up bailout programmes (Boettcher et al. 2018). These programmes differed in size, funding, duration or type of assistance. Some states

implemented larger conditional bailouts focusing on short-term credit (Hesse and Lower Saxony). Others gave out special annual grants to stabilise budgets (NRW). Finally, hundreds of municipalities benefitted from these programmes. On the other hand, such partial and conditional bailouts were not just created around that time. Generally, in most states this option had existed and had been carried out within regular equalisation systems for decades.

Last of all, there is a long-term effect of the rise of short-term credit, especially when it comes to the risk of rising interest rates, but a number of positive reactions have been made at state and federal level.

With regards to the existing fiscal framework, two things were adopted (Spahn 2016: 92 ff.). First, a rigid debt brake was decided on at federal level, establishing the principle of structurally balanced budgets at federal and state level, beginning in 2020. Secondly, an independent body (Stability Council) was set up to oversee these principles and, if necessary, enforce the measurement thereof. Constitutional law does not directly affect local governments (De Witt 2017: 201). With this, impacts from the federal-state agreements at local level are still vague. There are definitely additional incentives for the states to enforce financial supervision and shift financial burdens.

## 6 Fiscal Rules and Fiscal Oversight

Local fiscal autonomy, as a constitutional element, finds its restrictions in state law. There is no claim to supervision in the federal constitution. In every state, local governments are obligated to adhere to the balanced budget rule, although some states take a mid-term perspective. In general, debt is restricted to funding capital spending. Short-term credit is restricted to ensuring liquidity needs. There is no bankruptcy regulation for municipalities but an implicit expectation of bailouts by the states. Thus, every local government is creditworthy and benefits from minimal interest rates.

The idea of fiscal oversight is a very old one (originating in Prussia in mid-19th century). The principles are the same in every state. Nonetheless, details differ and in the aftermath of the financial crisis, some states have broken new ground. Several states set up bailout programmes. With this and other fiscal rules, oversight procedures and the bodies in charge have changed.

As a counterpart to local autonomy, state authorities intensively supervise local budgets in order to make sure that they remain within the state regulation/budgetary framework. Depending on the respective states, there is a two or three-layer system of fiscal oversight. The highest office is always located at the State Ministry of the Interior; lower cases are delegated to the county administrations, which oversee their own municipalities. This situation regularly creates political tensions within the counties (Roeseler 2017; De Widt 2017: 209 f.). In some states, there is also a middle level, which is part of the state administration, focusing on counties and independent cities. In other cases, the Ministry of the Interior also carries out these duties. Generally, the Ministries of the Interior are in charge of both the legislation as well as the steering of the lower supervision authorities.

Every local government is obliged to hand over its budget plan/proposal to the oversight body for examination of its consistency with the fiscal rules before the end of the preceding year. Beyond the violation of the balanced budget rule, fiscal oversight bodies also assess the general sustainability of local budgets. Some states define this status, for example, by maximum credit limits but generally this term is left to the discretion of the oversight bodies.

If fiscal rules are broken, the oversight bodies will reject the budget proposal and local governments must then revise it. This procedure is quite normal and without any personal consequences for local officials. The role of financial oversight

and its influence on budget plans and execution has been increasing since the 1990s, as there have been more and more disrupted local budgets. Although fiscal oversight has been publicly criticised, research has demonstrated a widely accepted system of partnership in the eyes of local governments (Ebinger et al. 2018). Oversight bodies have a range of escalating instruments to enforce fiscal rules (De Widt 2017: 213 f.). A rather common consequence for a local government is ending up without an approved budget and being very limited in its freedom to decide on the budget. There is no federal data on the number of local governments with such a status. For example, in NRW in 2011, one out of three municipalities ended up in this category.

In the end, in theory, supervisory bodies can do whatever is necessary and proportionately enforce fiscal rules. Maximum escalation would be sending in a state commissioner, replacing the local government and taking measures to improve the budgetary situation and restore sound public finances (for example, in raising taxes or cutting expenditure). In practice, this escalation has hardly ever been implemented. Supervisory bodies tend to take an intermediate role between supervision and partnership, taking care to maintain working relationships.

Despite this strict regulation, the system of financial supervision did not quite work out as intended in some states (Spahn 2016: 92). This shortcoming of German local government fiscal regulation can be attributed to lack of political support in state government, the disadvantages of a decentralised system of oversight or too many cases of disrupted local government. Not least, the budgetary crisis in many cities was far too extensive to be solved by local measures. This observation can be traced back to exogenous drivers of budget deficits such as a declining economy, changes in federal tax systems, rising welfare spending and decreases in the population.

Due to regional financial crises, a number of states (9 of 13) started to set up special programmes aimed at supporting local governments with additional funding (Boettcher et al. 2018). One case worth highlighting is the state of Hesse, which bailed out key cash credits and, finally, all of them in 2018. In every state, participation in this programme (mostly voluntary) goes hand in hand with passing strict programmes of spending reduction.

Parallel with the setting up these programmes, most of these states modified their systems of fiscal oversight. Some states (e.g. Hesse, NRW, Rhineland-Palatinate) shifted the duty of overseeing small municipalities from county to district level. Additionally, oversight bodies strictly monitor the implementation of cutback programmes. In some states,

Ministries of the Treasury have been brought in, since they are seen as being stricter when it comes to implementing fiscal rules than the Ministries of the Interior, which sometimes may have been hijacked by local governments.

There is a system of auditing local governments in parallel. Audits are conducted by special public bodies (excluding those with fiscal oversight) focusing on the legal aspects beyond the fiscal rules and on the economy of a local administration. These audit courts are part of state administration and independent by law. With the exemption of North Rhine-Westphalia, where auditing takes an official role in drafting cutback programmes, there is hardly any cooperation between the oversight and auditing bodies.

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# 11 | Greece

Maria-Artemis Kolliniati

### Summary

Greece is a unitary state, with a comparatively small local level. As a consequence of the financial crisis and the joint IMF-EU-ECB bailout plan, the Greek central government implemented a fundamental restructuring of subnational government. Since 2011, the Greek local level has consisted of 13 regions (the second tier of local government) and 325 municipalities (the first tier of local government), which are in a non-hierarchical relationship.

In general, local influence in public administration and finance is low. Local revenue mainly depends on state grants. Local autonomy on self-sourced revenue, in particular taxes, is minimal. There is no dominating public service implemented by the local level. Local authorities have hardly any say in typical local functions such as welfare, housing or education.

The economic crisis affected local authorities by way of cuts in central government funding, restructuring of the local level and the tightening of the fiscal framework. In practice, the state implemented horizontal measures, causing a sharp decline in revenue and expenditure of about 30% since its peak in 2009. Nonetheless, local budget balances recovered in 2011 and have remained positive ever since. Beyond this, the

state implemented administrative reform, restructured the local level, devolved state functions to local governments and strengthened the fiscal framework. In 2010, the state imposed two debt limits, restricting local debt to a maximum of 60% and debt servicing to a maximum of 20% of annual revenue. In all, three new agencies are charged with monitoring and enforcing fiscal rules: The Independent Supervisory Authority, a decentralised agency by the Ministry of the Interior, is in charge of reviewing and approving a number of local budgetary decisions. The Economic Observatory for Financial Autonomy executes strict monitoring of budget execution, reports deviations to the Ministry of the Interior and evaluates every municipality annually. Moreover, the Financial Assistance Account of Local Government was established, aiming to support local budgets by conditional bailouts in the case of an emergency.

## 1 Administrative Structure

Greece is a unitary and highly centralised state. The state's constitution guarantees the existence of local governments: "The administration of the state shall be organised according to the principle of decentralisation" and "the administration of local affairs shall be exercised by local authorities of the first and second levels. For the administration of local affairs, there is a presumption of competence in favour of local authorities."<sup>1</sup>

Greece, like most of the southern European countries, has adopted a "Napoleonic" administrative tradition (Hlepas 2014: 4).<sup>2</sup> The number of municipalities has changed radically during past years and the recent economic crisis has imposed further restrictions on municipalities. The first Memorandum of Understanding, signed by Greece and the IMF-EU-ECB (the Troika) in 2010, included explicitly that the "parliament should adopt legislation to reform public administration at the local level, notably by merging municipalities, prefectures and regions with the aim of reducing operating costs and the wage bill." (Chortareas and Logothetis 2016: 135f).

Therefore, the Kallikrates Programme Law 3852/2010 fundamentally changed local government in terms of structure, responsibilities, population and the size of municipalities. The aim of this plan was to create economies of scale, to increase local government efficiency, to decentralise public administration, to simplify the structure and to reduce the number of elected officials (Hlepas 2012: 259 ff.). The number of municipalities decreased to 325 (from 1,034). Only 87 municipalities retained their spatial and population size, 937 municipalities amalgamated with others, forming 238 new municipalities. Finally, there are 325 municipalities, which belong to six different categories (Table 1). Existing prefectures (50) were reorganised into 13 administrative regions, which became part of local government (Ministry of the Interior 2013: 10 ff.). Seven decentralised administrations have been constructed as decentralised units of central government.

TABLE 11.1 Greece – Types of Municipalities

Metropolitan municipalities of urban centres (municipalities of Athens, Piraeus and Thessaloniki)
Large continental municipalities and capitals of prefectures with a population of more than 25,000 inhabitants
Medium continental municipalities (including the islands of Crete and Evia) with a population between 10,000–25,000 inhabitants
Small continental and small mountain province municipalities (including the island of Crete) with a population of less than 10,000 inhabitants
Large and medium insular municipalities with a population of more than 3,500 inhabitants
Small insular municipalities with a population of up to 3,500 inhabitants
Source: Law 4555/2018: Cleisthenes I programme, Art. 2.

The population of municipalities ranges from less than 1,000 inhabitants to more than 650,000 inhabitants (Athens). Municipalities with less than 3,100 inhabitants enjoy some privileges (for example, tax reductions for citizens) compared to those that are larger (Nikolaos 2014: 5 f.).

TABLE 11.2 Greece – Municipal Size by Population, 2011

Population	Number of municipalities	Percentage of the total number of municipalities
<1,000	15	4.6
1,000 to <3,100	23	7.1
3,100 to <10,000	42	12.9
10,000 to <20,000	85	26.2
20,000 to < 50,000	95	29.2
50,000 to < 80,000	38	11.7
80,000 to < 120,000	18	5.5
120,000 to < 200,000	6	1.9
200,000 to < 350,000	2	0.6
664,610	1	0.3
Total	325	100.0
Source: Hellenic Statistical Authority, 2011 census.		

1 See Greek Constitution 1975/1986/2001/2008, Art. 101 and Art. 102 (1) and (2).

2 A Napoleonic administrative tradition has four dimensions. First, an "organic conception of the state" to the extent that, in the field of public policy making, the role of "societal and non-co-opted actors" is limited. Secondly, there is a career civil service. Thirdly, the law defines basic functions of administration, guaranteeing a "uniform treatment of citizens" as one of the fundamental values of public administration. Fourthly, the law and the courts are predominantly for the enforcement of public accountability. In Europe, in the main, five countries have adopted a Napoleonic administrative tradition: France, Greece, Italy, Portugal and Spain. See Ongaro 2018.

FIGURE 11.1 Greece – Administrative Structure

Central Level	Central Government	
Regional Level		
Local Government	13 administrative regions	325 municipalities

Source: own representation

Greece has a two-tier local government structure composed of 325 municipalities (first tier of local government) and 13 administrative regions (second tier of local government) (Figure 11.1).<sup>3</sup> The relationship between these two tiers is not hierarchical. Both coordinate with each other and neither of them control each other.<sup>4</sup> Citizens directly elect a mayor, municipal councils, regional councils and governors;<sup>5</sup> the councils take decisions at the municipal or at the regional level (Ministry of the Interior 2013: 14 ff.; Hlebas 2012: 267 ff.).

According to the Cleisthenis I Programme, municipal categories (see Table 1) are taken into consideration for the allocation of “central autonomous grants” and any other sort of funding, for the specification of the responsibilities of municipalities.<sup>6</sup> In accordance with the Kallikrates Programme, the state devolved additional functions to insular municipalities and the municipalities of continental Greece, which otherwise were executed by the administrative regions (Hlebas 2012: 264 ff.).<sup>7</sup> These tasks are related to the fields of: (a) agriculture, livestock and fisheries; (b) natural resources, energy and industry; (c) employment, trade and tourism; (d) transport and communications; and (e) works, urban and spatial planning and environment.<sup>8</sup> In the same vein, the Greek Constitution provides different treatment for mountain-province municipalities. The mountain municipalities exercise powers in the fields of: (a) energy; (b) water; (c) forestry; (d) agriculture and livestock; and

(e) support of the local community and the economy.

When central government delegates new responsibilities to local government, additional funding has to be allocated to the local level in parallel.<sup>9</sup> However, this rule has not been implemented (Kolliniati et al. 2017: 138 f.).

Municipalities are responsible for the administration of local affairs. For example, they are responsible for providing services to citizens (for example, civil ceremonies, civil marriage licenses and licensing of shops, theatres, cinemas and entrepreneurs). Moreover, municipalities have responsibilities related to the fields below (Hlebas 2012: 264 ff.):

- Development (for example, the development of local and natural resources, management of gas networks, electricity, programmes for tourism);
- Environment (waste management, drainage systems, protection and management of water resources from fishing, lagoons, actions against environmental pollution, assistance to the fire brigade);
- Quality of life and the proper functioning of cities and settlements (for example, water supply systems, desalination, lighting of communal spaces, development of green spaces, squares and parks);
- Employment (for example, the promotion of entrepreneurship and vocational training services);
- Social protection and solidarity (for example, welfare allowances,<sup>10</sup> kindergartens and day care for the elderly);
- Education, culture and sports (for example, the management of school buildings, management of libraries, management of museums and archaeological areas);
- Civil protection (for example, the coordination and oversight of civil protection actions for prevention and recovery in the case of disasters);
- Rural development, livestock and fisheries<sup>11</sup> (for example, the operation of Rural Development Offices, management of actions related to agriculture, livestock farming and fishing).<sup>12</sup>

Municipalities may set up legal entities either through public or private law in order to provide their services.

Administrative regions, as with local governments, have responsibilities at the regional level. These responsibilities

3 This two-tier local government structure stems from Greek constitutional law after 2001, namely, since the Greek constitutional amendment of 2001. As mentioned above, the Greek constitution guaranties that “the administration of local affairs shall be exercised by local authorities of the first and second level.” Nevertheless, until the Kallikrates Programme law, the two-tier local government structure concerned municipalities (the first tier) and prefectures/nomoi/nomarchies (Νομοί/Νομαρχίες) (the second-tier). Since the Kallikrates Programme law 3852/2010, the two-tier local government structure has concerned municipalities (the first tier) and regions/peripheries (Περιφέρειες) (the second tier).

4 See the Kallikrates Programme law 3852/2010, Art. 4.

5 The candidates are included in different “electoral lists/”combinations” in which leading candidates are the candidates for mayor of the municipalities and the candidate governors for the regions (peripheries).

6 Law 4555/2018: Cleisthenes I Programme law, Art. 2 (2).

7 See the Kallikrates Programme law 3852/2010, Art. 204 and Art. 209.

8 Art. 204, Art. 209 of the Kallikrates Programme law 3852/2010.

9 See Greek Constitution 1975/1986/2001/2008, Art. 102 (5).

10 The task of welfare allowances (for the blind, deaf, disabled, etc.) is an additional responsibility introduced with the Kallikrates Programme Law 3852/2010, Art. 94 (3B) (17).

11 This function was added by the Kallikrates Programme Law 3852/2010, Art. 94 (5).

12 See the Code on Municipalities and Communities Law 3463/2006, Art. 75, and the Kallikrates Programme Law 3852/2010, Art. 94.

TABLE 11.3 Greece – Administrative Structure

Decentralised Administration	Region (periphery) (second tier)	Number of municipalities (first tier)	Population 2011	Population (%)
Macedonia/Thrace	East Macedonia-Thrace	22	608,182	5.6
	Central Macedonia	38	1,882,108	17.4
Epirus/West Macedonia	West Macedonia	12	283,689	2.6
	Epirus	18	336,856	3.1
Thessaly/Central Greece	Thessaly	25	732,762	6.8
	Central Greece	25	547,390	5.1
Peloponnese-West Greece and Ionian	West Greece	19	679,796	6.3
	Peloponnese	26	577,903	5.3
	Ionian Islands	7	207,855	1.9
Attica	Attica	66	3,828,434	35.4
Aegean	North Aegean	9	199,231	1.8
	South Aegean	34	309,015	2.9
Crete	Crete	24	623,065	5.8
	Total	325	10,816,286	100.00%

Source: Ministry of the Interior and Hellenic Statistical Authority, 'Ellas me arithmous', quarterly publication, April–June 2018: 18, Hellenic Statistical Authority, 2011 census.

are: (a) planning and development; (b) agriculture, livestock and fisheries; (c) natural resources, energy and industry (water management, mineral wealth, energy, industry and manufacturing); (d) employment, trade and tourism; (e) transport and communications; (f) planning, spatial planning and the environment; (g) health; (h) education, culture and sports; and (i) civil protection and logistics.

Table 11.3 provides a numeric overview of the Greek administrative structure.

## 2 Revenue

The local share of general government revenue is low (Figure 11.2). In 2016, local governments accounted for about 8% of general government expenditure. There has been a sharp drop of one third in local revenue from its peak in 2009 to 2011, as a consequence of the financial crisis.

According to Greek Constitutional Law, local authorities enjoy financial autonomy including the management of their revenue and expenses.<sup>13</sup> The state has the obligation to provide local government with appropriate funding in order to fulfil their tasks and duties<sup>14</sup> (Hlepas, 2014: 23).

<sup>13</sup> Article 102 (2) of Greek Constitutional Law.

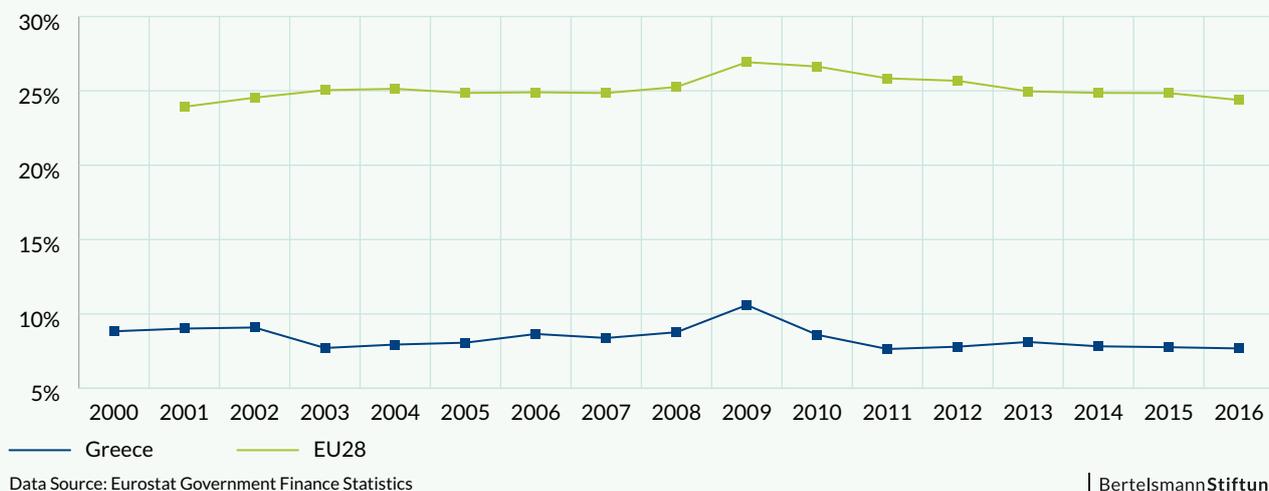
<sup>14</sup> Article 102 (5) of Greek Constitutional Law.

Greek local government mainly depends on state grants, namely the non-earmarked “central autonomous grants” and the “earmarked investment grants” (Kolliniati et al. 2017: 136). Tax autonomy in Greek municipalities is minimal. Administrative regions, as second-tier local governments, depend even more upon state grants (Hlepas 2012: 275). More specifically, the revenues of the municipalities and administrative regions in Greece separate into regular revenue and extraordinary revenue (Hlepas 2013: 274 ff.). The regular revenues of local government come from: (a) central autonomous grants; (b) earmarked investment grants; (c) compensatory fees and entitlements; (d) taxes, fees, entitlements and contributions; and (e) local potential fees, entitlements and contributions. The extraordinary revenues of municipalities and regions are built upon: (a) revenues from private bank loans or from the Consignment Deposits and Loans Fund, donations, bequests and legacies; (b) the disposal, sale and use of assets; (c) participation in business activities; (d) administration fines and penalties; and (e) European Union funding.

Fees imposed by the municipalities have a reciprocal character and are called compensatory fees. These fees may concern goods or services such as cleaning and lighting, water supply, irrigation and drainage, use of public spaces or parking fees. Moreover, municipalities may set up fees and entitlements for services or local projects, which positively contribute to the quality of life of citizens and to the development of the area.

FIGURE 11.2 Greece – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



The central autonomous grants provide funding to municipalities and administrative regions on an annual basis. These grants are derived from three state tax revenues, whereof property tax is restricted to funding municipal grants (Ministry of the Interior 2013: 33 f.):

- Income tax for individuals and legal entities
- Value added tax (ΦΠΑ)
- Property tax (ΦΑΠ)

There are no regular local taxes in Greek municipalities. Nonetheless, there are some self-sourced revenues with a vague character. Examples of taxes, fees, entitlements and contributions, obligatorily imposed by local governments, are:

- Real estate/property fee on immovable property;
- Discretionary tax on electrified sites, collected by the Public Electricity Company on behalf of local authorities; and
- Fees for advertisements within municipal boundaries.

Additionally, municipalities levy the fees below on either a compulsory or an optional basis:

- Residential fees for hotel businesses of any type (hotels, motels, camping sites, etc.);
- Fees on the gross income of entertainment centres, restaurants and stores;
- Fees for trading natural medicinal mineral drinking or non-drinking water; and
- Fees for the sale of aggregate and quarry products.

In some cases, the state government collects these fees and allocates them to local government by way of ministerial decisions. For example, this is the case for certain categories

of publicity fees, tax on beer, fees for decommissioned ships or fines for building violations (Ministry of Interior 2012).

Although Greek local governments have seen reforms regarding their territory and functions (e.g. the Kallikrates Programme), financial autonomy remains very low. According to Eurostat, local government in Greece mainly depends on direct state grants (61%; Figure 11.3). Self-sourced revenues amount to about 24%, mainly consisting of local fees.

Within the period of 2011–2013, the state implemented horizontal measures in the Greek municipalities. This policy is attributed to the “Medium Term Fiscal Strategy Framework 2012–2015” (MTFS) following the Troika plan. The MTFS’s objective was to increase revenue and to reduce expenditure. In particular:

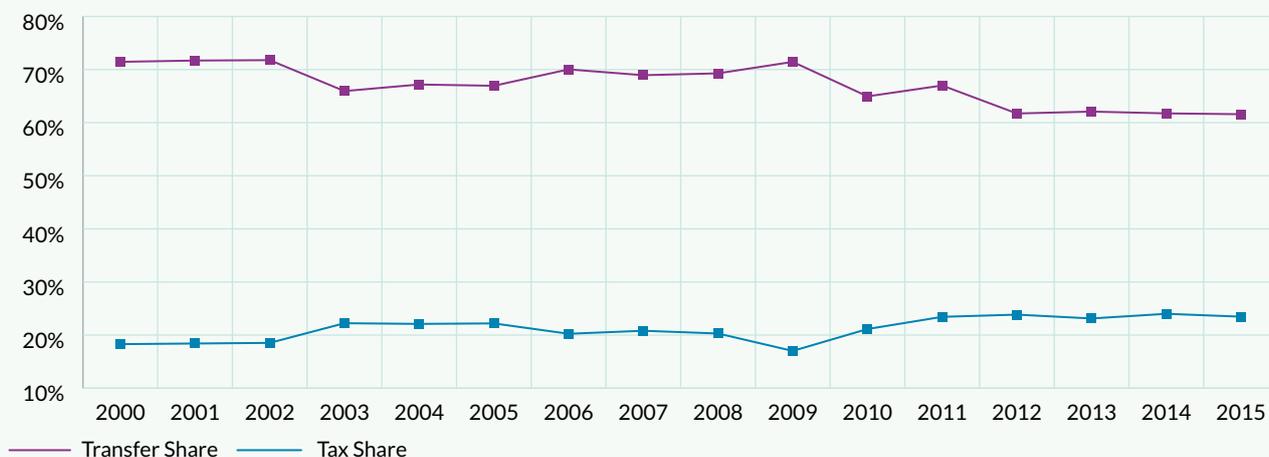
- From 2009–2016 the central autonomous grants to the municipalities decreased by about 60%;
- The earmarked investment grants decreased by more than 80% from 2009 to 2017.

From a long-term perspective, local revenue as share of total government revenue increased from 2003 to 2009 and faced a sharp decline within the two years thereafter (Figure 11.2).

As a consequence of declining state grants and pressure to raise self-sourced revenue (fees), the local transfer dependency has steadily decreased since 2009 (Figure 11.3). It is worth mentioning that these figures refer to the structure of revenue and not its nominal value. The latter has been shrinking since 2009 (Figure 11.9).

FIGURE 11.3 Greece – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015

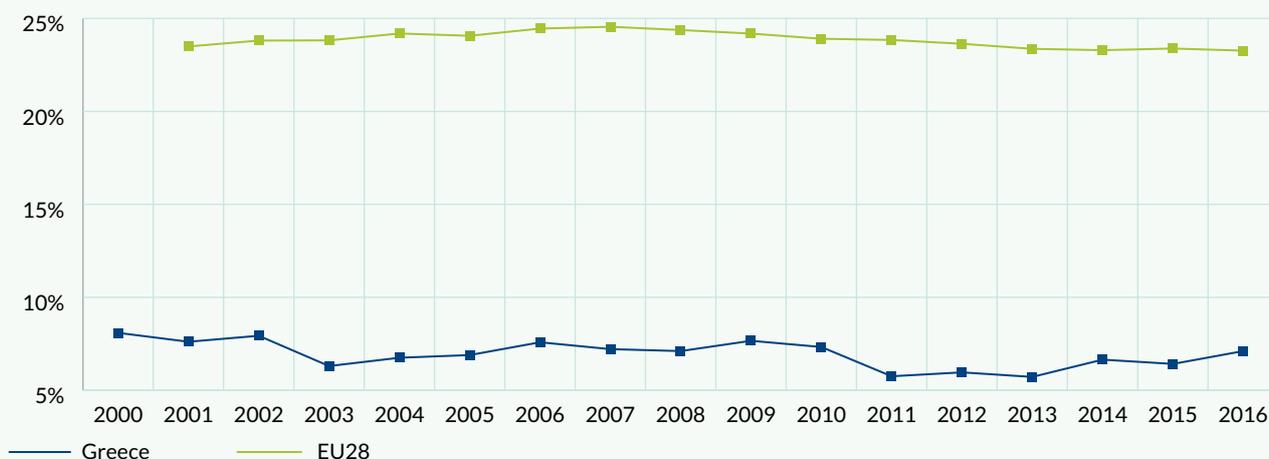


Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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FIGURE 11.4 Greece – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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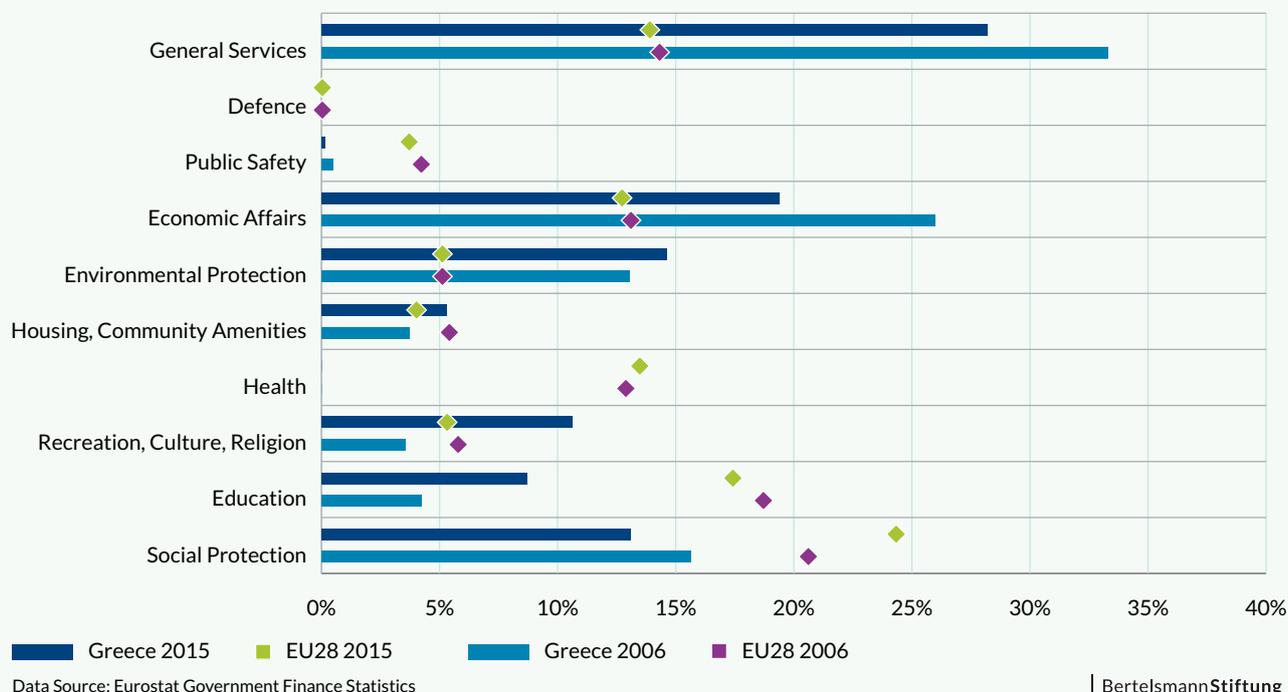
### 3 Expenditure

As with revenue, the local share of Greek local governments in terms of general government expenditure is also low (Figure 11.4). Expenditure saw its peak in 2009 and dropped by about one quarter in the following years. Since 2013, expenditure in relation to general government expenditure only rose slightly and almost reached its pre-crisis level. However, this finding holds true from a relative perspective. In nominal terms, as a consequence of the financial crisis, local expenditure is far below previous levels (Figure 11.9).

When it comes to functions, no one dominates with regards to expenditure (Figure 11.5). Against the background of a low local-level expenditure share in general, this indicates a small role in public services. Eurostat data show a share of local spending below average in most fields, without including environmental and economic matters. Greek local governments do not have a (major) say in typical local policies such as health and education. In addition, the structure of local expenditure has not changed significantly over time. This finding might be surprising, in reference to the devolution of several state tasks and duties to local governments and the categorisation of regions as local governments.

FIGURE 11.5 Greece – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



## 4 General Fiscal Status

The financial and economic crisis did show striking effects on local governments. Over the period 2009–13, state transfers decreased drastically (Hlepas 2014: 4). Finally, against the backdrop of declining revenue and increasing expenditure needs due to the financial crisis, local governments managed to limit and fulfil their obligations by 70% (Galanos et al. 2016), while state government implemented a bailout of overdue local liabilities.

From a long-term perspective, local budgets are in better shape than they were in the early 2000s (Figure 11.7). In 2000, the local budget balance in relation to GDP was slightly negative. The financial crisis hit local budgets in 2010, when this deficit increased up to  $-0.30\%$  of GDP. Nevertheless, after 2011, local budget balancing gradually improved, not least due to state measures. For the years thereafter, local budgets reached remarkable and constant surpluses in relation to nominal GDP. By this time, local governments did find a new level of balance but on a significantly lower level of revenue and expenditure (Figure 11.9). In a similar vein to budget balancing, local government debt as a share of general public debt was on a minimal level for the whole period from 2000 to 2016 (Figure 11.8). Finally, the local level did not drive the Greek debt crisis.

## 5 Effects of the Financial Crisis

The financial crisis did show striking effects among Greek local governments. The state changed their territorial structure, functions, funding and institutional framework.

Greece enjoyed strong economic growth in the years before the financial crisis (Figure 11.6). By 2008, Greece had gone from “boom to bust”, seeing an enormous decline in GDP by 25% within four years. Nonetheless, local governments had been in deficit frequently since the economic growth prior to 2008. The economic downturn and measures decided by the state had a deteriorating effect on local budgets in 2010. However, Greece’s local governments had already recovered and reached positive figures by 2011 (Figure 11.7).

The Greek state had seen high debt limits even before the origin of the financial crisis. The situation of funding, in particular interest rates, eased with the introduction of the common Euro currency in 2001. By 2008, Greece had slipped into an economic recession and was challenged by an increasing need to borrow. Given the disclosure of manipulated public statistics, high debt limits, financial markets in turmoil and an unwilling Greek government, Greece faced the risk of insolvency. In April 2010,

the Greek government applied for financial assistance from the IMF, ECB and European Union (the Troika) (Directorate-General for Economic and Financial Affairs 2010). Based on a Memorandum of Understanding that defined a detailed list of austerity measures, the Troika granted a first tranche of emergency loans. Further programmes and measures followed in the years thereafter. These caused enormous negative consequences on the deteriorating economy, labour market, public services and political system.

Economic crisis in Greece did have several impacts on local government (Stolzenberg et al. 2016: 66). In 2011, the Ministry of the Interior evaluated the financial status of the municipalities. The over-indebted municipalities characterised as “red” had to follow a fiscal consolidation programme, whereas the “healthy” municipalities had been characterised as “green”. The Ministry of the Interior decided to bail out overdue municipal liabilities.

Moreover, the legal entities of municipalities (for example, municipal enterprises) closed down or merged, local budgets came under strict monitoring, and there was a suspension in the hiring of new employees and cutbacks in salaries. Central government imposed horizontal measures not only on over-indebted/red municipalities but also on healthy municipalities.

These measures, caused by the Memorandum of Understanding, were applied by the Medium Term Fiscal Strategy Framework 2012–2015 (June 2011), the Medium Term Fiscal Strategy Framework 2013–2016 (October 2012) and legislation such as Law 4093/2012 (12-11-2012/ΦΕΚ 222) (Kolliniati 2017).

In accordance with the Medium Term Fiscal Strategy Framework 2013–2016, the central state implemented some serious changes in funding, functions and the institutional framework. The central autonomous grants and the earmarked investment grants were cut. From 2009 to 2012, the municipalities’ grants from the state budget for operational expenditures decreased by almost 60% and for investments there was a reduction of 55%. There was also a cut in municipal employees’ salaries and a freeze on recruitment.

The fiscal framework expanded by establishing three new bodies: the Independent Supervisory Authority, the Economic Observatory for Financial Autonomy and the Financial Assistance Account of Local Government.

The implementation of administrative reforms as designed by the Kallikrates Programme faced numerous difficulties. More specifically, the ELL.A.D.A Programme was not implemented and, as a consequence, the municipalities did not receive the

necessary funds for the new responsibilities transferred to them.

Data from Eurostat indicate that local-level debt and expenditure decreased significantly in the period from 2009 to 2016 (Figure 11.9). Revenue and expenditure reached their peak in 2009 before state measures caused a rapid decline of about one third within two years. By 2011, local budgets reached positive balances overall. In 2009, local debt was at its peak, reaching 115% of its 2007 pre-crisis level. Against the backdrop of the financial crisis, this is a rather slow increase. By 2011, local debt had already gone below the pre-crisis limit. This trend was related to the measures implemented in 2011 and direct endeavours to reduce local debt (for example, funding given by the Ministry of Interior for repaying overdue debts of the first level of local government).

Fiscal measures implemented by the state government did show two effects. On the one hand, citizen demand for local welfare services was rising and, on the other, municipalities were under fiscal pressure because of the cutbacks in state funding (CAG/KAP and SATA). As a consequence of these challenges, there has been a civic reaction and social cohesion has been strengthening in the Greek cities. Citizens are contributing voluntarily to several actions run by themselves or by NGOs or by the social policy division of the municipality. For example, actions relating to social pharmacies, social dispensaries, social grocery systems, time banks, municipal vegetable gardens, mobile schools and social tutoring schools are mainly supported by volunteers in several Greek municipalities. Parallel to this, in the field of social cohesion several refugee-support programmes have also taken place and the social policy division of the municipalities is also running several projects (Kolliniati et al. 2017: 144).

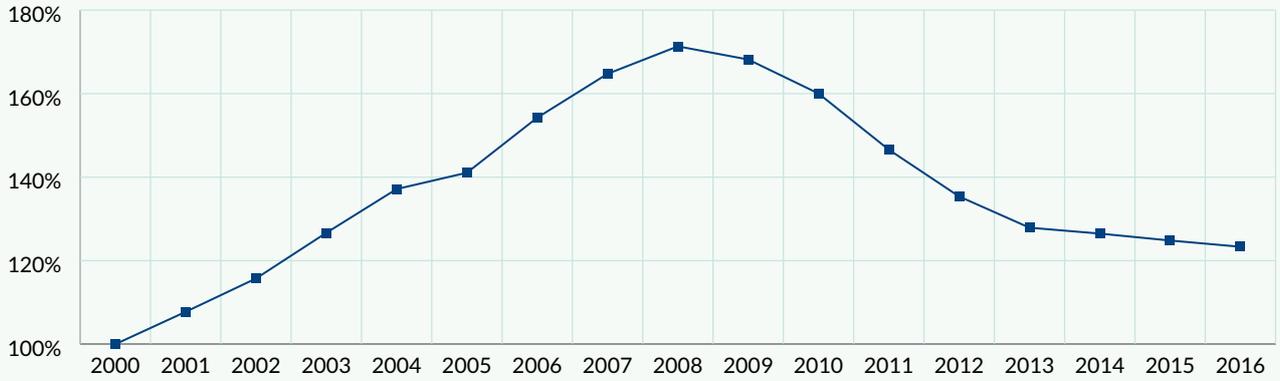
## 6 Fiscal Rules and Fiscal Oversight

Traditionally, there has been a complex system of state supervision over local authorities by various bodies. Although Greek public administration has been centralised, the fiscal framework of local governments in Greece has been rather weak, not least due to party politics. Therefore, the Kallikrates Programme implemented a fundamental change. The state fixed formal debt limits and a tight monitoring system and established procedures to deal with financial emergencies (Directorate-General for Economic and Financial Affairs 2010: 19).

The Kallikrates Programme in 2010 set two debt limits: one focusing on the total amount of debt, which should not exceed

FIGURE 11.6 Greece – Nominal Gross Domestic Product

Index: 2000 = 100

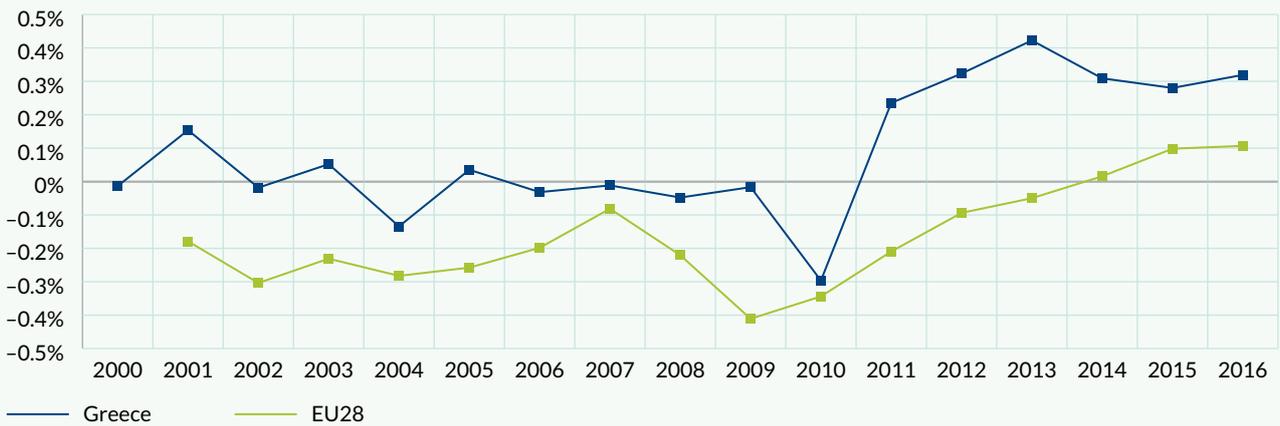


Data Source: Eurostat Government Finance Statistics

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FIGURE 11.7 Greece – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016

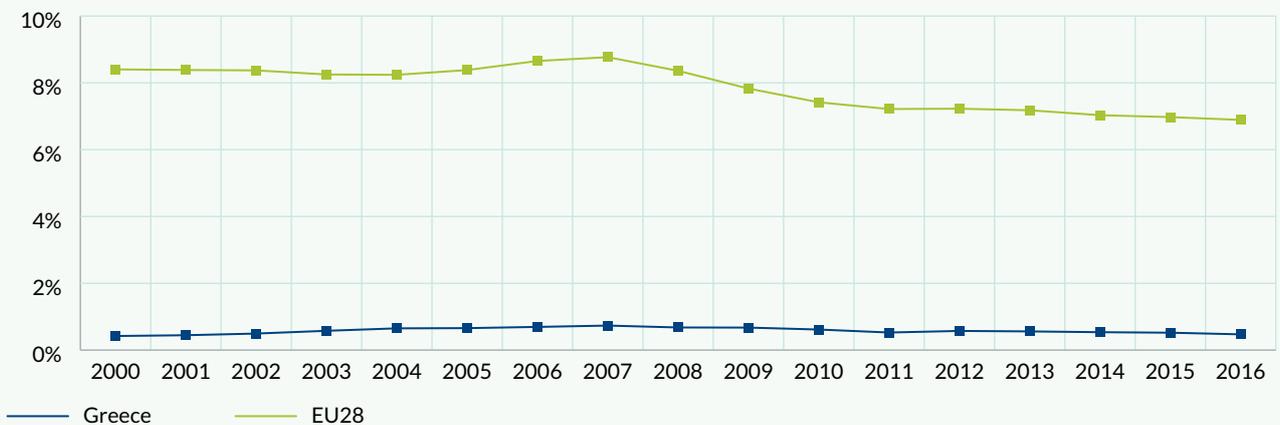


Data Source: Eurostat Government Finance Statistics

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FIGURE 11.8 Greece – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016

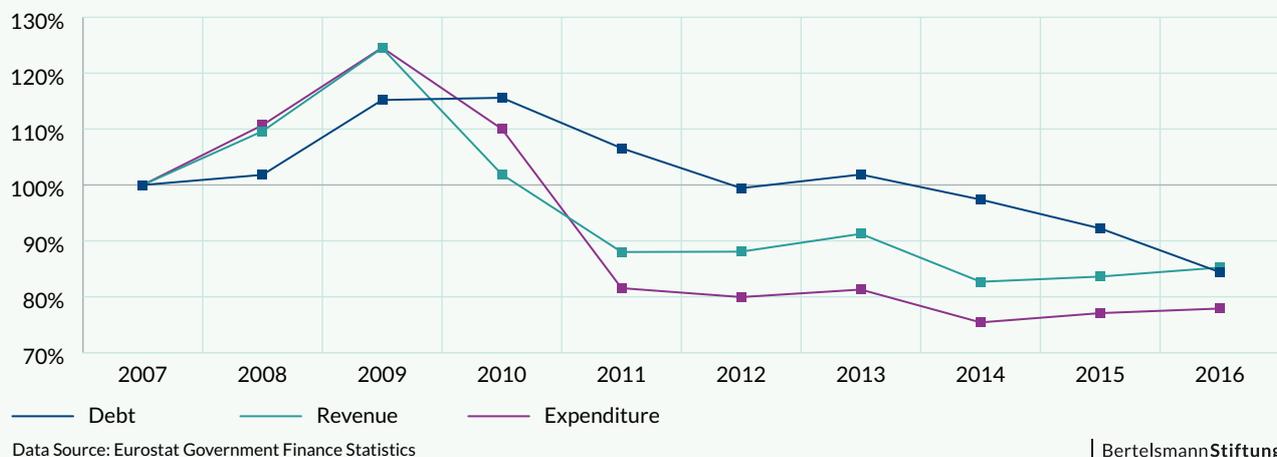


Data Source: Eurostat Government Finance Statistics

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FIGURE 11.9 Greece – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



60% of annual municipal revenues. Beyond this, there is a restriction on interest payments, which may not exceed 20% of annual regular revenue. There are exceptions for loans, which concern actions to improve the energy efficiency of facilities, machinery or vehicles and general investment projects. These actions should result in a reduction in operating costs and this saving should cover the cost of servicing the relevant interest payments.

If one of the abovementioned debt limits is broken, the municipalities or regions can apply to take part in the special Fiscal Consolidation Plan (Ειδικό Πρόγραμμα Εξυγίανσης), which was launched by the Kallikrates Programme Law 3852/2010, also aiming to consolidate the municipal and administrative regions' budgets. In this case, the municipality has to schedule all measures to resolve its financial problems. The municipal council has to decide on the plan and submit it to the Observatory (see below).

The fiscal framework's supervision takes place through two newly established bodies:

- the Independent Supervisory Authority; and
- the Observatory for Financial Autonomy of the Local Government Organisations.

The Kallikrates law introduced an Independent Supervisory Authority over local government in each of the seven decentralised administrations, which is responsible for the disciplinary control of political leadership and for the control of the legality of the acts of local government. The Independent Supervisory Authority is headed by the Auditor of Legality. The auditor is in charge of reviewing the legality of a number of

local decisions, amongst others, projects of more than €60,000, obligatory expropriations and loans. In the case of illegality, he/she can cancel such decisions (Hlepas 2012: 278). The Independent Supervisory Authority is a decentralised part of the Ministry of the Interior.

In 2012, implementing the second Memorandum, the Greek government established the Observatory for Financial Autonomy of the Local Government Organisations (the Observatory) and an overdue liabilities programme, the so-called Financial Assistance Account of Local Government (Kolliniati et al. 2017: 139). In practice, if municipalities agree to fixed consolidation agreements, this programme transfers municipal debt from the local to the central level (Hlepas 2015: 273 ff.). The Observatory is part of the Ministry of the Interior and is responsible for monitoring local finances and gathering real-time budget execution information. On a quarterly basis, it controls the implementation of budgets, aiming to be balanced and realistic. The evaluation of the budget by the Observatory takes into consideration the goals and the limits set by the central government budget and the current Medium-Term Fiscal Strategy Framework. If the Observatory identifies a negative deviation from the quarterly budgetary targets of more than 10% (compared to the provisions of Article 4E of the Integrated Action Plan [Ολοκληρωμένο Πλαίσιο Δράσης – Ο.Π.Δ.]), it informs the respective municipality and the responsible supervisory authority and the Minister of the Interior. The Observatory reports its opinion about the methods of budget implementation or the setting of realistic objectives. The Observatory might also scrutinise liabilities for loans, in particular, focusing on overdue liabilities, self-sourced revenues in relation to total revenue, the rate of

change in total borrowing or the rate of change in total overdue liabilities. At the end of each quarter and financial year, the Observatory drafts a report on the results of the implementation of the budgets, which has to be published by each local authority. This report portrays the main financial situation of the local government and its legal entities and, in the case of participation, the account statement from the Financial Assistance Account of Local Government.

The Financial Assistance Account of Local Government was established in 2013 aiming to support balanced budgets in the case of an emergency. This account is funded by the Central Autonomous Funds (ΚΑΠ) and was established by the Consignment Deposits and Loans Fund. Local governments can take part in this programme upon request and on fulfilment of a number of requirements (Ministry of the Interior 2013: 38). There is no bankruptcy regulation.

Last but not least, local governments, as with all Greek public agencies, are audited by the Court of Auditors (Greek Constitutional Law, Art. 98). Therefore, a preventive and partial sampling ex post check on expenditure is applied (Hlepas 2014: 23; Ministry of the Interior 2013: 39). The Court of Auditors controls all contracts of the municipalities valued at over €200,000 (Hlepas 2014).

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# 12 | Hungary

Christian Raffer

### Summary

Hungary is a unitary state with a decentralised state administration. In 2011, the new constitution (Fundamental Law) and a new Local Government Act were adopted and went into effect in January 2012. They mark a watershed in the country's multilevel administrative system. The national government established new administrative districts representing the central level all over the country and reclaimed a wide set of once local services. Major reasons for this reform were a lack of central government control and accumulated financial distress at the local level. Consequently, local governments experienced a sharp decline in revenue and expenditure. State grants make up approximately half of local government revenue; about one third of funding stems from taxes. Municipalities benefit from own local taxes like the business turnover tax and the property tax. Counties do not levy any taxes. Due to an uneven distribution of tax capacity and financial needs, there is a system of equalisation by grants.

Local governments were fully bailed out by the central level between 2011 and 2014, parallel to service recentralisation. Moreover, central-local fiscal regulation was tightened by a new regulation in 2012. For example, the state treasury has intensified fiscal monitoring. Despite extensive bailouts, a

formal bailout regulation is still lacking. Local governments have had the right to file for bankruptcy since 1996; since then there have been 45 cases. Local governments face a balanced budget rule. Debt limits were first imposed in 1995, but only with limited efficiency until 2011, when regulation was overhauled. State emergency grants are available in the case of fiscal stress.

## 1 Administrative Structure

During the past three decades, Hungary has experienced three main waves of legislation (Barati-Stec 2014: 1 f.). The first one, in the early 1990s, changed the preceding administrative structure towards a decentralised public administration system with autonomous municipalities and notary districts at the local level. Notary districts were a form of compulsory cooperation between small, autonomous municipalities, which had one common “notary” (head of administration). In 1990, the Act LXV on Local Governments replaced the Soviet-style council system of the centrally planned economic system and gave broad responsibilities and a high degree of autonomy to local governments (Lentner 2014: 311; Temesi 2017: 418 f.). The second wave (Act XCII of 1999 and LXXV of 2003) preceded the accession to the EU in 2004 and ensured enhanced public accountability by introducing statistical micro-regions and higher-level regions, both without any administrative duties (KSH 2017; Barati-Stec 2014: 2). In 2010, Hungary’s public administration entered a third phase with the recentralisation of certain tasks and finances (Barati-Stec 2014: 2). The 2011 constitutional reform and the 2011 Local Government Act CLXXXIX (henceforth LGA) have transformed subnational governments (counties and municipalities), reducing their scope, functions and financing resources (OECD 2016: 198). Two major reasons for this reform were a lack of central government control and accumulated financial distress at the local level by 2010 (Temesi 2017). The aim was to establish a modern, task-oriented, democratic and efficient system of local self-governance, but with stricter fiscal and legal regulation and supervision. In this regard, a large state reform in 2013 introduced a new administrative structure in the form of 175

FIGURE 12.1 Hungary – Administrative Structure

	Central Government		
Central Level	Járás Districts (197 including 23 in Budapest)		Regions (7)
State Level			
Local Level	Counties (19)	Cities with county status (23)	Budapest
	Municipalities (Communes and Towns) 3,177, including 346 towns (In 2017, communes with less than 2,000 inhabitants operated 378 “common municipal offices.”)		

Source: own representation

TABLE 12.1 Hungary – Population of Local Government Areas 2012

	Smallest	Largest	Average
Counties	Salgótarján (202,472)	Pest (1,217,476)	431,812
Cities with county status	Szekszárd (33,311)	Debrecen (207,594)	88,865
Municipalities (excluding Budapest)	Iborfia (9)	Dunakeszi (40,334)	1,973

Source: Hungarian Central Statistical Office (2012)

districts (járás) – which were reduced to 174 by a merger in 2014 – and an additional 23 districts in the capital.<sup>1</sup> They are part of the central government. Moreover, the LGA replaced notary districts with offices jointly operated by municipalities with under 2,000 inhabitants. There is currently a two-tier system of local government below the central level and its decentralised branches, which is made up of 19 counties and 3,178 municipal authorities (OECD 2016: 198). Neither the Hungarian constitution nor the LGA explicitly mentions the principle of local self-government (Pereira and Cukur 2013: 100); however, the LGA refers to the European Charter of Local Self-Government.

Hungary is a parliamentary representative democratic republic with a central government, which exerts far-reaching powers at the local level. The new central government offices at the local level took over many functions exercised previously by municipalities and are also in charge of the legal and financial supervision of subnational governments (Table 12.2).

There are two types of municipal responsibilities: delegated tasks, which are in the national interest, and local tasks, which are either obligatory or voluntary (Temesi 2017: 426). Today, local governments are responsible for local affairs, which fall under the competencies attributed to them by law. The LGA distinguishes between the following groups of compulsory tasks:

- Providing residents with public services (such as road maintenance, organisation of public transport, education, the provision of health and social services, etc.)
- Exercise of public authority, including issuing various permits

1 The járás districts have a long history; they had been the most important unit of local administration since the Middle Ages but were abolished in 1983.

TABLE 12.2 Shift of local tasks to the central government

List of responsibilities and competencies to be transferred to district offices	List of competencies remaining with local government
<ul style="list-style-type: none"> <li>- Document office duties:               <ul style="list-style-type: none"> <li>• residence registration</li> <li>• issuance of identification documents</li> <li>• passport administration</li> <li>• vehicle registration</li> </ul> </li> <li>- Certain guardianship and child protection cases</li> <li>- Certain social administration cases, e.g. :               <ul style="list-style-type: none"> <li>• allowances of the elderly</li> <li>• free medical services on personal eligibility grounds</li> </ul> </li> <li>- Family support cases</li> <li>- Public education responsibilities</li> <li>- Asylum cases</li> <li>- Authorisation of individual entrepreneurial activities</li> <li>- Certain communal-type cases (e.g. authorisation of cemeteries)</li> <li>- Certain veterinary hygiene tasks (e.g. circus menagerie, authorisation of animal shelters)</li> <li>- Breach duties taken over by the metropolitan and county government offices (competence delegated to the metropolitan and county government offices since 15 April 2012)</li> <li>- Management of local defence committees</li> <li>- Certain water works competencies</li> <li>- Construction supervision and certain planning permission responsibilities</li> </ul>	<ul style="list-style-type: none"> <li>- Proceedings for the protection of proprietary rights</li> <li>- Estate proceedings</li> <li>- Birth certificate administration</li> <li>- Tax administration and tax collection</li> <li>- Certain construction administration tasks</li> <li>- Trade authorisation</li> <li>- Ragweed pollen relief in residential areas</li> <li>- Industry administration</li> <li>- Social provision tied to local government ordinances</li> <li>- Child protection support</li> <li>- Regulation of local animal husbandry</li> </ul>

Taken from: OECD (2014: 67). Original source: Ministry of Public Administration and Justice (2012: 27).

- Ensuring organisational, personal and financial resources for the above-mentioned duties

Companies in municipal ownership (Molnár and Hegedüs 2018: 90) perform most of the 21 mandatory duties imposed by the LGA. During the LGA reform, municipalities and cities lost most of their education and health-care institutions (Temesi 2017: 428).

In 2014, Hungary had 3,178 municipalities – including Budapest with its 1.86 million inhabitants (OECD 2016: 198). However, the majority of municipalities have less than 1,000 inhabitants (Barati-Stec 2014: 2). Municipalities can build purpose-related municipal associations; hence, one municipality can be part of more than one municipal association (Barati-Stec 2014: 2). In terms of Hungary's legislative structure, these associations are located between the local and the county level. Municipal associations are financed by their members and are entitled to state subsidies; they cannot levy taxes. Associations are created to deliver public services; membership is voluntary for municipalities. Small municipalities with less than 2,000 inhabitants are obliged to form common municipal offices. According to national experts, there are currently 738 of these offices. Mayors and local councils are directly elected (Patyi and Rixer 2014: 326).

Before the 2013 state reform, counties were responsible for many tasks that needed to be carried out at a higher level than that of municipalities, although a municipality could have taken such tasks over if it had the necessary fiscal and management capacity (Barati-Stec 2014: 2). Since they were not allowed to source own revenues but were in many cases responsible for costly services (like health, secondary and specialised education, economic development, spatial planning, environmental protection, tourism), counties were prone to indebtedness. In November 2011, their debt amounted to HUF 187 billion – a level that threatened the daily provision of services (Temesi 2017: 424 f.). In contrast to municipalities and cities, counties played a subsidiary role in service provision right from the early days of post-Soviet transition (Temesi 2017: 424), but reforms by the LGA weakened their position even more. In 2012/13, many of their tasks were assigned to the central government. Now they are primarily responsible for regional development (OECD 2016: 198). Since January 2012, counties have lost 475 educational institutions, 132 welfare and youth institutions, 74 cultural institutions and 25 other institutions of public service (Temesi 2017: 425). In return, the central government has assumed county debt. There are currently 19 counties and 23 cities have county status. The county council is elected by direct universal suffrage (Pereira and Cukur 2013: 52). Counties play a certain role in the administration of the

FIGURE 12.2 Hungary – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016

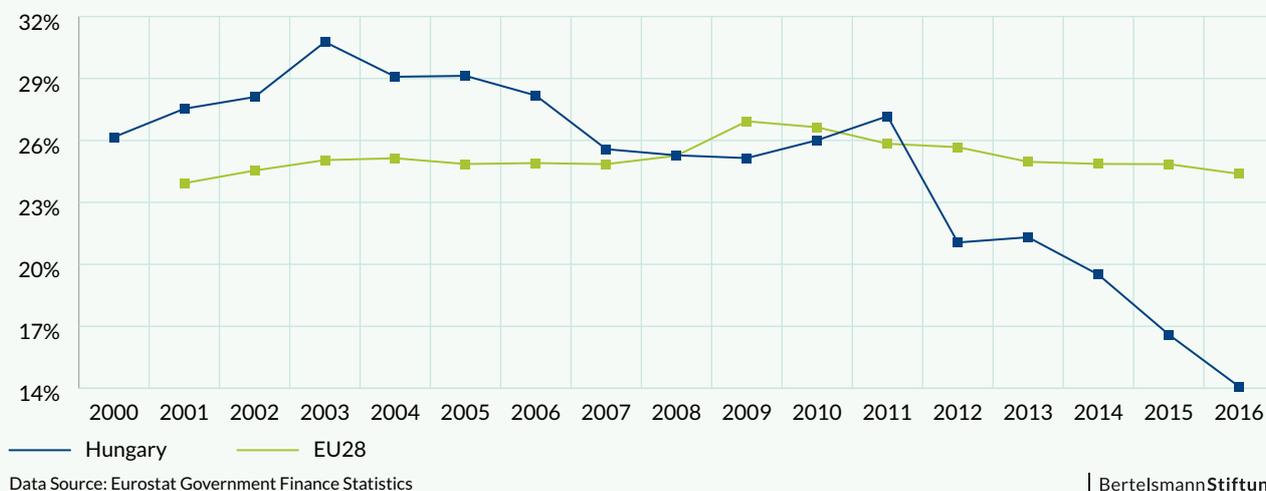
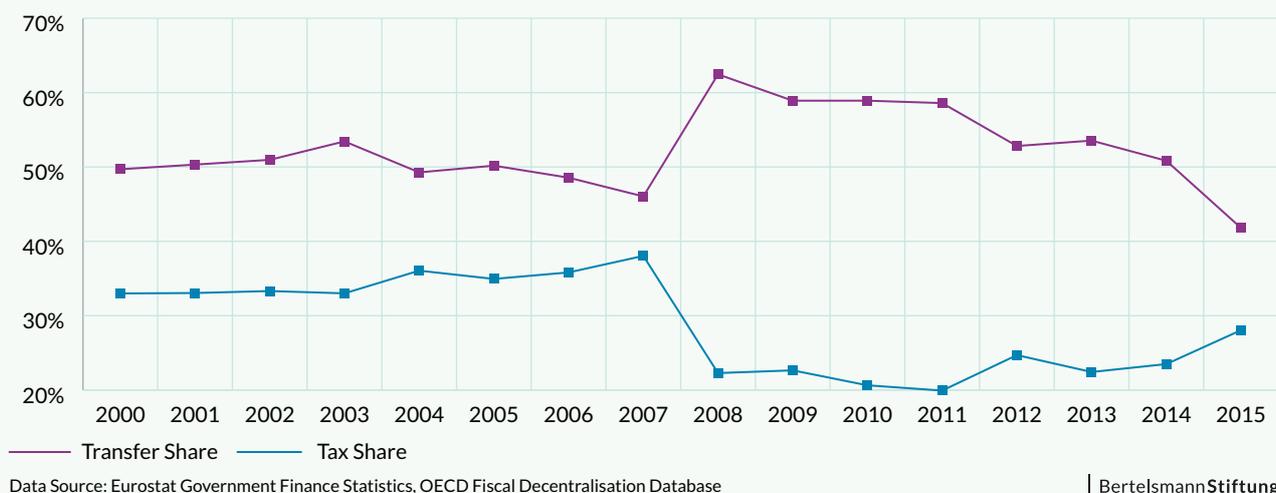


FIGURE 12.3 Hungary – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



central government járás districts, since their offices are units/divisions of the county office.

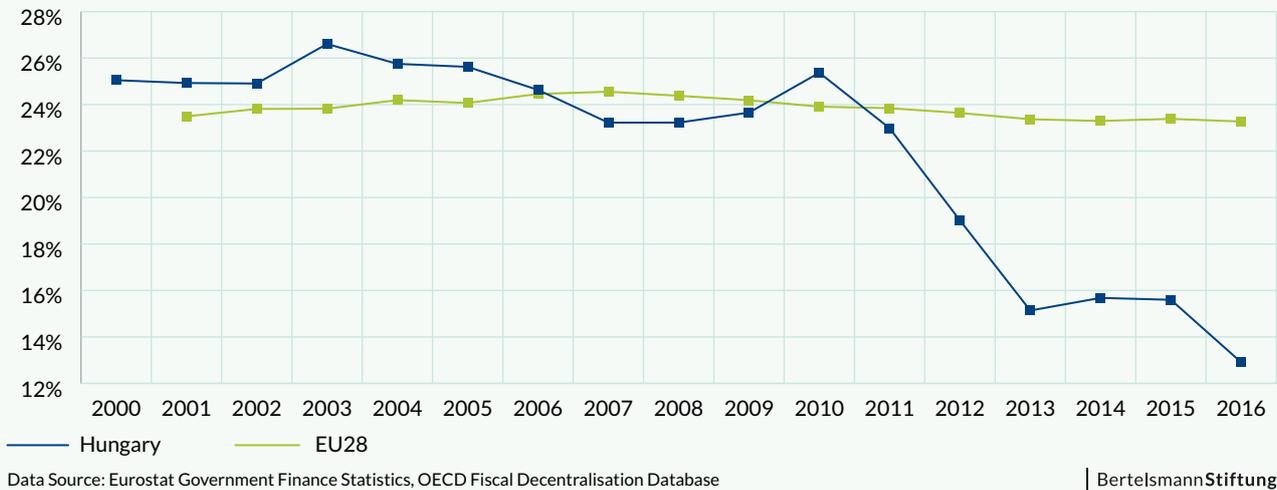
Hungary's territory divides into seven regions. Similar to micro-regions, they were created for statistical reasons following EU accession by the Act XCII of 1999 and LXXV of 2003 (KSH 2017). They are merely administrative structures and have no political functions (Pereira and Cukur 2013: 50).

## 2 Revenue

In recent years, the local level has experienced a rather dramatic decline in revenues (accompanied by an equivalent decline in expenditures, Figure 12.4) which began with the introduction of the LGA in 2011. This fundamental reform has recentralised public services on a large scale, which has decreased public funding at the local level. In 2004, the year in which Hungary joined the EU, subnational revenues were 12.3% of the nominal national GDP. Although it decreased moderately until 2011 (12%), it literally dropped to 6.3% in

FIGURE 12.4 Hungary – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



2016, which is far below the EU28 average. This becomes even clearer when the local government revenue share in general government revenues is considered (Figure 12.2). After a local maximum of 27.2 % in 2011, it dropped to 14.1 % in 2016.

Local-level revenues are comprised to a great extent of grants and subsidies from higher levels of government, which totalled 42 % in 2016. During the period 2000 to 2016, the average value was 52 % (Figure 12.3). Tax revenues had a share of 28 % in 2016 and an average of 29 % between 2000 and 2016. The remainder is sourced from user tariffs and fees. Linking revenue types to expenditures, the LGA foresees that tasks prescribed by law are financed by central government funds; these grants must not be used for covering expenses for non-delegated voluntary tasks, which have to be financed by own-sourced revenues only (Temesi 2017: 435 f.).

In Hungary, municipalities source only a minor part of their revenues from local taxes (Barati-Stec 2014: 6f; OECD 2014: 68). All local taxes are defined within the 1990 Act No. C.; it also safeguards the municipal right to levy taxes and to set the specific tax rate. However, there are centrally stipulated caps, which significantly decrease tax autonomy at the local level. Moreover, not all municipalities levy local taxes. One of the main local taxes is the business turnover tax with a maximum rate of 2%. It is imposed on companies located or registered in the municipal area and based on corporate gross margins (OECD 2016). In 2013, it generated approximately 10% of local revenues and accounted for 74% of local tax revenue. The property tax includes a building tax and a land tax, paid by owners, based either on area or floor space or on the

adjusted market value. The maximum tax rate is 3%; in 2013, it accounted for 18 % of the local tax revenue, which was 0.4 % of the Hungarian GDP. The communal tax is a lump-sum tax on households levied by approximately 60 % of municipalities; it generates approximately 2 % of local revenues. The tourist tax is negligible. In addition to these local taxes, municipalities benefit from shared taxes with the central government. Until recently, the personal income tax was one of the major shared taxes, which was centrally collected and then partly redistributed to municipalities in the form of grants (Nemeth 2012: 8). Following national experts, this source of income was abandoned in the course of centralising the school system. Another shared tax is the vehicle tax, which is levied on the basis of horsepower (OECD 2016). This tax generates about 2 % of local revenues. The formulas for tax sharing and grant design have shown great volatility in the past (Jókay 2013: 270). Counties are not allowed to levy taxes (Pereira and Cukur 2013). Altogether, taxes made up 28 % of aggregate local government revenue in 2016 (Figure 12.3). The increasing relative share after 2011 is mainly the statistical counterpart to the decreasing transfer share following service recentralisation.

Grants aim to balance the revenues and expenditures of different regions, and therefore are an integral part of the equalisation system (Barati-Stec 2014:7 f.). The 2011 reform modified the grants system and reduced their amounts in accordance with the recentralisation of several responsibilities (OECD 2016: 199). A stricter grant system was set up in 2013, going from an income-based system to a task-based, expenditure-oriented system. Since then, grants are earmarked. The reform included tightening the distribution rules and

new equalisation criteria based on the tax capacity of each municipality. Three forms of grants are common (Barati-Stec 2014: 7 f.): (1) grants for capital investments, (2) grants for operating purposes – so called “normative grants” (conditional or unconditional), which generated approximately 20 % of local income in 2014, and (3) emergency grants to cover municipal deficits. The share of municipalities which needed emergency grants soared between 1993 and 2013 from 5 % to 61 %. Although not declared as such, these emergency grants may be considered as bailout grants. Overall, the transfer share has decreased significantly since 2008, with the cutback of locally provided services (Figure 12.3).

User tariffs and fees for public services represented approximately 9 % of municipal revenues in 2013.

Tax revenues and expenditure needs unevenly distribute in Hungary (Kraan et al. 2007: 56). Without an equalisation mechanism, many counties and municipalities would face difficulties in delivering local services. The strong financial disparities can be historically explained, at least in part (Barati-Stec 2014: 4 f.). The first local government act of 1990 provided municipalities with the assets necessary to fulfill services (such as water treatment plants, garbage dumps, buildings, etc.). Many of these assets were sold in the early 1990s either for reinvestment or to cover operating expenses. Since the value of these assets varied depending on the regional economic power, revenues varied as well. Assets were also used for PPPs, which in wealthier regions yield higher corporate tax revenues. These disparities have grown since foreign direct investments (FDIs) were concentrated in wealthy regions: In 1993, 62 % of all FDIs were directed to central Hungary, which is the region surrounding Budapest. Altogether, this may have created path dependency and resulted in a gap in municipalities’ fiscal capacities.

### 3 Expenditure

Because of the recentralisation of a large portion of local responsibilities, local-level expenditure as share of nominal national GDP decreased from 12.5 % in 2010 to 6 % in 2016, therefore dropping below the EU28 average. The relative share of local spending in total general government spending bisected simultaneously from 25 % in 2010 to 13 % in 2016 (Figure 12.4). This indicates a rather severe loss in public service relevance at the local level relative to EU28 standards. The decreases in expenditures are at least partly driven by staff movements: Many staff members moved from local governments to the new government offices (járás districts); consequently, expenditures for local government staff decreased.

The most relevant expenditure function in 2015 was general services, which made up 23 % of all subnational expenditures (Figure 12.5). During the preceding ten years, this share had increased from an initial level of 15 % in 2006. However, this shift was driven by the overall change in relative shares based on the reform-induced recentralisation of services. Since many other expenditure functions were recentralised, their relative share of total expenditure shrank. In turn, the relative share of inalienable services provided by the local level (summarised by “general services”) increased. Consequently, the time shift within and across expenditure functions from 2006 to 2015 says a great deal about which level provided the related services before the LGA took effect and which level currently provides it.

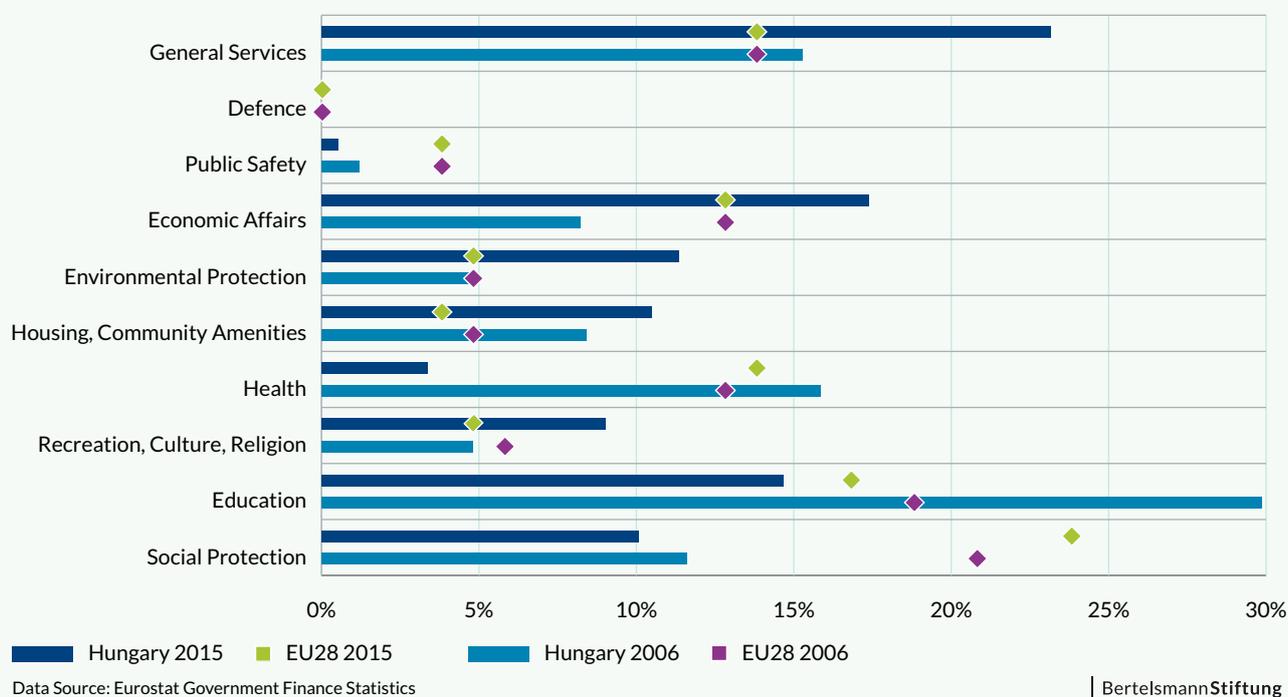
## 4 General Fiscal Status

Municipalities today are mainly free of debt since a complete and nationwide bailout took place between 2011 and 2014 (OECD 2016: 199). In 2014, less than 1 % of general government debt was attributable to local governments. Since 2011, aggregate local budgets are in surplus (Figure 12.7). However, this bailout was preceded by uncontrollable local debt levels, which piled up during the two decades since 1990. The starting point was an asymmetry between local spending autonomy and centralised resource collection created by the first wave of administrative reforms in the early 1990s (Barati-Stec 2014: 1). By 2000, this asymmetry had led to a significant operating deficit in the local public finances (Lentner 2014: 312). In the years thereafter, especially following the EU accession of Hungary in 2004, municipalities fell even further into debt because they did not have the funds to cover their own contribution to EU development grants. Therefore, municipalities took out loans and issued foreign exchange bonds. Centrally imposed rules were meant to limit liabilities; these failed due to the relatively high limit and the absence of any penalty (Homolya and Szigel 2008: 24 f.). With the 2008 economic crisis, the financial instability at the local level affected the whole of Hungarian public finances. Eventually, the central government took over all local government debt in several waves of unconditional bailouts. Since January 2012, transactions by local governments which create debt, such as taking out loans or issuing securities, are limited (Lentner 2014: 323).

In 2010, municipal debts amounted to \$6 billion, which was roughly 5 % of the country’s GDP (Barati-Stec 2014: 8 ff.). This amount is not yet alarming. However, what made the Hungarian data problematic was not the level but the rate of change. As a share of nominal national GDP, the amount of public debt rose from 1 % to 4.6 % between 2000 and 2010,

FIGURE 12.5 Hungary – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



which is a 460% increase. In absolute terms, subnational debts soared by even 963%. Between 2001 and 2007, local debts were concentrated: Approximately 50% of local debt was created by 30 municipalities (Barati-Stec 2014: 8 ff.). 22 municipalities declared insolvency between 1996 and 2007 and 23 between 2009 and 2014. Although mainly small towns declared insolvency during the first 10 years, the more recent cases also involved larger municipalities. In 2011, the amount of local debt had become a threat to financial stability (Lentner 2014: 313). Hence, the state started to take over – through the county government offices (district offices) – the costs of the tasks previously performed by the local governments. In a first wave, the state took on a debt of HUF 198 billion in December 2011. At the end of 2012, the debt portfolio of the municipalities was consolidated. Barati-Stec (2014: 14) calls this a partial bailout. In March 2014, the central government took over the debt of the remaining towns with more than 5,000 inhabitants (Lentner 2014: 313). This completed the bailout, regardless of the cause of the debt, its size and the financial situation of the indebted municipality (Barati-Stec 2014: 13f.). Most of the debt assumed by the central budget was denominated in foreign currency, which involved high exchange risk and, therefore, financial instability for both the central and the local subsystems of public finances (Lentner 2014). In general, it was feared that the disastrous

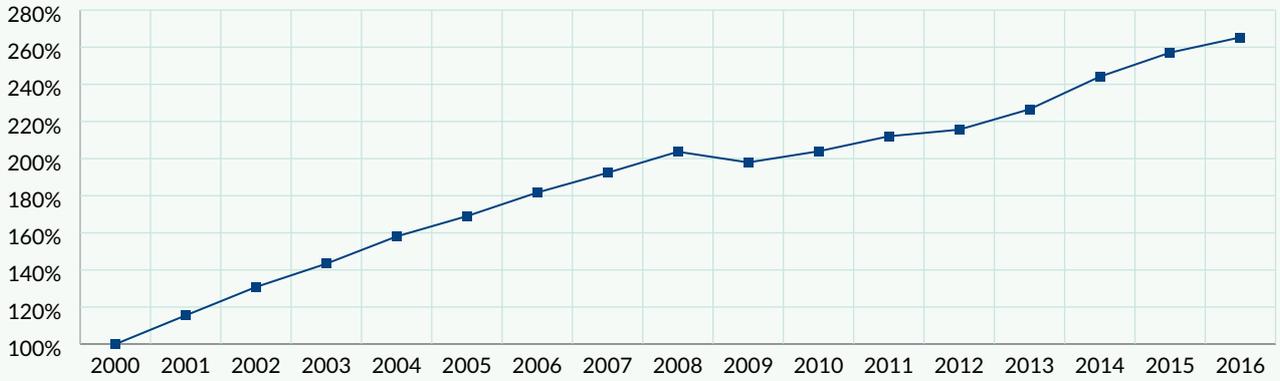
financial situation at the local level would result in massive bankruptcies of local governments, negligence of local tasks, social conflicts and eventually national bankruptcy. Since the local governments were not able to resolve this situation, the central government stepped in.

Consequently, subnational debt dropped to almost zero in 2014. It increased again to 0.23% by 2016. There has not been a municipal bankruptcy since 2014. However, municipalities which came under fiscal distress received state aid to prevent bankruptcy, e.g. the city of Pecs, which received a considerable grant in 2017. In addition, Hungarian counties saw a large-scale bailout. As Temesi reports (2017: 425), the debt of self-governing county institutions reached HUF 187 billion in November 2011. To ease the debt situation, the central government took over this debt with the Act No. CLIV 2011.

It is no surprise then that (according to Eurostat Government Finance Statistics) since 2010, the local-level budget balance has improved immensely. Between 2011 and 2016, it showed no budget deficits in aggregate terms (Figure 12.7). The average yearly surplus during this period was 0.9%; in 2013, it even reached a level of 2.48% of the nominal national GDP. Hence, budget surpluses seem to be fully sufficient to cover current debt levels. In combination with aggregate budget

FIGURE 12.6 Hungary – Nominal Gross Domestic Product

Index: 2000 = 100

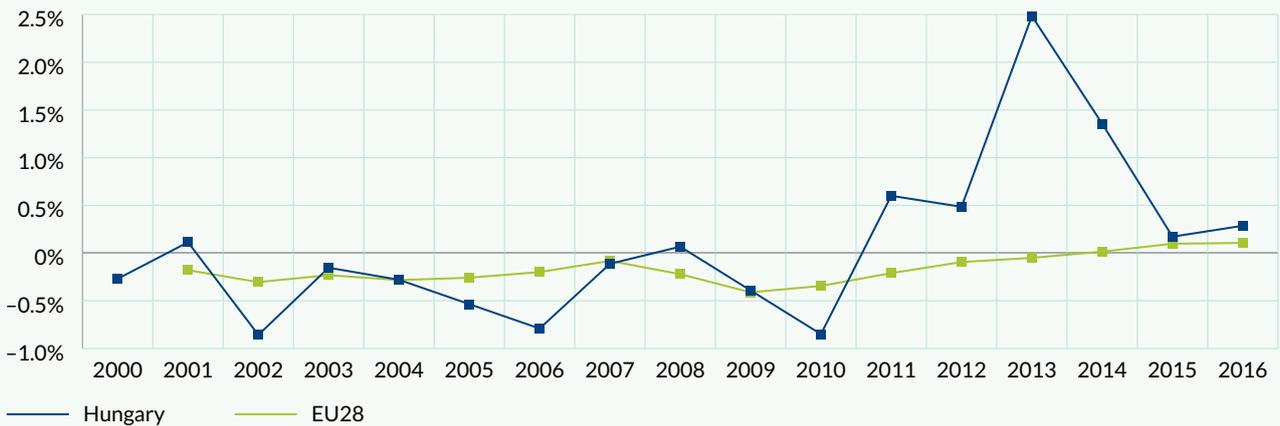


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 12.7 Hungary – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 12.8 Hungary – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 12.9 Hungary – Post-Crisis Developments  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



surpluses, the rise of aggregate debt since 2014 indicates that only a few municipalities incur debts, whereas most of them seem to be in stable fiscal condition.

Most Hungarian public debt is in the form of bank loans. Whereas the loan share in 2006 was 95 %, it decreased slightly to 92 % in 2016. Correspondingly, the level of debt issued as securities increased from 5 % to 8 %. These levels are similar to EU28 average values.

## 5 Effects of the Financial Crisis

As in most European countries, the financial crisis had an impact on Hungarian economic development in 2007 and the years following, and consequently on local-level fiscal policies (Figure 12.6). Local debts rose after 2007 – however, they had already risen at a similar pace in the years before. Since the recentralisation reform after 2011 and the bailouts in 2011 and 2014 had a major impact on debt, revenue and expenditure development, it is unclear just how strongly the reaction by these aggregates to decreasing economic performance can be attributed to the fiscal crisis. There is no doubt that European post-crisis fiscal regulation had an impact on Hungarian local government regulation. The timing of the Local Government Act in 2011 indicates this relation (although fiscal distress at the local-level already existed prior to 2007). This holds true also for the implementation of local level administrative reforms as well as the municipal bailouts, which were implemented not immediately after the crisis but in the post-crisis years. According to national experts, the Act on Economic Stability (which regulates, among other things,

local borrowing) as well as further post-crisis regulation at the Hungarian local level were motivated by the European Fiscal Compact.

## 6 Fiscal Rules and Fiscal Oversight

In 2013, Jókay (2013) called the Hungarian local level a system of de jure under-supervision (Jókay 2013: 270). This may have changed, since all municipalities must now use the mandatory Application Service Provide (ASP) system, at the latest by 2019. It gives the national treasury access to all the transactions of each municipality. In addition, the central government must approve a large part of newly incurred debts (Pereira and Cukur 2013). In terms of the legality of economic decisions and therefore rule-adherence, the central government's *jaras* districts have the right of supervision (Balázs 2014: 61; Patyi and Rixer 2014: 345 ff.). The head of the district government office as central government representative oversees municipal and county budgets. The head of the district office must submit the budget decree after approval by the municipal council. The government office can also initiate financial management audits by the State Audit Office. With the introduction of the central government offices, the rather passive form of borrowing control was transformed into an authorisation process (Barati-Stec 2014: 1). If municipalities do not comply, the mayor and the body of representatives can be dismissed.

Hungary introduced the first limits on municipal borrowing with the Budget Act in 1995 (Barati-Stec 2014: 9; Jókay 2013: 272). The relevant paragraph was abolished by the

Constitutional Court, however, for violation of procedures, but the main ideas on setting constraints to local borrowing were incorporated into the Act on Local Governments in 1996. According to these rules, municipal borrowing could not exceed 70 % of the difference between local-level short-term income and short-term obligations in a given year. However, this limit was not only rather high but also not linked to any penalties (Homolya and Szigel 2008: 24f.). After the financial crisis in 2008, the government set new regulations on local borrowing (Act CXCV on Economic Stability in 2011) (Barati-Stec 2014: 13), which entered into force on January 2012. The new rules obligate municipalities to ask the central government directly (not the *járás* district offices) for permission when larger investment loans exceeding pre-determined thresholds are needed. No permission is required for loans used to pre-finance EU funding, loans guaranteed by the government, operating loans for less than one year and restructuring loans taken out under bankruptcy protection agreements (for the concrete process of municipal bankruptcy, see below). Moreover, debt can only be taken on if the borrowing does not exceed 50 % of the yearly net own-sourced municipal revenues (excluding all transfers, shared taxes and capital revenues). There is no stock limit (Jókay 2013: 273). Furthermore, no golden rule (borrowing only for capital expenditure) exists. Operational deficits have often been financed by borrowing or disinvestments (CoR 2016). According to the European Commission's Fiscal Rule Database, local governments are obligated to propose corrective measures in case of rule breaking.

By law, local governments must submit a balanced budget (Goglio 2007: 32). The requirement that "local government budgets shall not set forth planned budget deficits" is part of the LGA, Paragraph 111(4). It is considered a statement of primary importance within the act regarding fiscal rules (Temesi 2017: 435). According to national experts, the decree on the local government budget is legally supervised by the head of the county government office. If there is a budget deficit, the head of the county office begins a procedure of legal supervision.

Although the central government conducted a comprehensive local government bailout and took on the entire local government debt in the years 2011 and 2014, there is no official bailout procedure enshrined in the law (Barati-Stec 2012). Emergency grants exist to ease the fiscal distress of individual municipalities (regulated by the Act No. XXV of 1996) but are not considered bailout grants. Instead, they are seen as prevention against bailouts.

The Act XXV on Municipal Bankruptcy introduced in 1996 aimed to impose hard budget constraints on local governments by asserting that the state is not responsible for local debt (Barati-Stec 2014: 9). In addition, it laid down procedures for when a municipality falls 60 days behind in its obligations (emergency budget, freeze on unnecessary services, debt restructuring and reorganisation of service provision). With this regulation, Hungary has one of the few insolvency systems in the world where municipal insolvency can lead to a court-supervised "bankruptcy and reorganisation" process led by an independent receiver or trustee (Jókay 2013: 261).<sup>2</sup> Since lenders preferred waiting for new emergency grants instead of claiming their money, most municipal bankruptcies were initiated by the municipalities themselves (Barati-Stec 2014: 9). In many cases, municipalities agreed with their creditors before the process could begin. Although there were 45 cases of municipal insolvency between 1996 and 2014, there were none after 2014.

Local government budgeting is regulated by the Act XXXVIII of 1992 (Németh 2012: 18). Local governments are obliged to provide a budget plan, a local decree, periodical reports and final reports. The final reports must include consolidated balance sheets, budgeted values as previously projected and detailed summaries of the previous year in terms of revenues and expenditures. Local governments are obliged to send their decrees to the county government office (Patyi and Rixer 2014: 323). The 2011 Local Government Act states that if a commune has not generated a decree on the annual budget by 31 March, some state subsidies may be suspended (Temesi 2017: 437). A further consequence may be a revocation of financial management autonomy.

Hungarian local and regional authorities are subject to external audit by the State Audit Office (Pereira and Cukur 2013: 139; Temesi 2017: 438; Balázs 2014: 61). It not only checks the correct state of accounts and the viability of budgets but also spending efficiency and whether targets are reached. Audits can be initiated by the regional government office (Patyi and Rixer 2014: 347). The audit report is public and attempts by local governments to bar any testified shortcomings are closely monitored. Internal controls must be carried out by the clerk; the financial committee as part of the local council is entitled to monitor the budget execution (Temesi 2017: 439). The internal audit has been simplified by the new Municipal Law, because audits by independent auditing companies are no longer required by municipal law (Balázs 2014: 61).

<sup>2</sup> See Jókay (2013) for a detailed description of the local government bankruptcy process.

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# 13 | Ireland

René Geißler

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### Summary

Ireland, as a unitary country, has a relatively small local government sector regarding functions and fiscal indicators (e.g. budget size). Among the few local functions, housing and local roads are of higher relevance. Historically weak consequences of the financial crisis brought about a further shrinkage at local level. Local budgets, in sum, have been in deficit from 2007 to 2012. Irish local governments have seen rapid declines in central government grants and, in parallel, strong increases in taxation on commercial properties. Nonetheless, there are remarkable disparities and crises of perspective in some local governments.

The latest restructuring in 2014 reduced the number of local governments from 114 to 31. At the same time, one of few relevant functions, water services, was assigned to a national agency. Local governments face a balanced budget rule, which is breached frequently. They need single approval for loans by the Department for Housing, Planning and Local Government. Fiscal regulation is built upon intensive reporting obligations to and in close collaboration with the department.

## 1 Administrative Structure

Ireland is a unitary country, showing a considerably weak local level of government (Robbins et al. 2016: 10; Boyle 2014: 5; Considine and Reidy 2015: 121; Figure 13.1). The central state, in form of the Department of Environment, Community and Local Government (DECLG), plays a very major role in all local issues, e.g. oversight, foresight, policy formation or funding (Scannel 2015: 311). The Irish constitution recognised local governments for the first time in 1999, when a new article, Article 28a, was introduced to strengthen democratic principles in local authorities.

There is no coherent regional level, but there is a set of regional public organisations subordinated to central government (e.g. regional assemblies, local enterprise offices, local community development committees, childcare committees, education and training boards; Shannon 2016: 12 ff.).

The current administrative structure goes back to changes in 2014. Those adoptions in local administration were outlined in the governmental programme “Putting People First” in late 2012 and predominantly came into force through the Local Government Reform Act 2014 (Shannon 2016). Beyond this, a number of public-sector reform programmes have been published, not least against the backdrop of the financial crisis. Nonetheless, a discussion on shortcomings of traditional government had already been triggered by an OECD report in 2008 (OECD 2008).

In 2014, the number of local authorities was reduced from 114 to 31. Before this, there was a two-tier structure of local government of city/county councils and town councils. By the time of the 2014 reform, some county councils had merged, and all town councils were abolished. This restructuring reflected the ideas of simplification, efficiency and democratic accountability. There was little or no intention to expand local government

FIGURE 13.1 Ireland – Administrative Structure, 2017

Central Level	Central Government		
Regional Level			
Local Level	26 county councils	2 city and county councils	3 county councils
	95 municipal districts		

Source: own representation

TABLE 13.1 Ireland – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Local councils	Leitrim County Council (32,044)	Dublin City Council (554,554)	153,608

Source: Central Statistics Office 2016; census figures above

functions. Since then, Ireland has had 31 councils operating as unitary authorities. In more detail, there are three types of local councils. In general, they fulfil the same set of functions. County councils are rural areas and are subdivided into municipal districts (95 in total) with councillors representing the municipal district and the local authority in parallel. Municipal districts serve as electoral areas, performing reserve functions (albeit very limited) and monitoring the implementation of public programmes. Municipal districts are not nationwide and are, in general, of negligible importance. City councils, in contrast, are highly populated urban areas without further structuring. In general, there is no direct election of council mayors.

## 2 Revenue

Revenue funding of local government is mainly split into central government grants (44%) and taxes (21%) (Figure 13.3). Beyond this, there is a range of fees and charges (e.g. housing and utilities). The level of local revenue compared to general government revenue is low (Figure 13.2). Fiscally, Ireland is one of the most centralised countries in the EU.

From a longer perspective, there has been a radical decline in local revenue (and spending) since 2004, due to the creation and the centralisation of the Health Service Executive (Figures 13.2 and 13.4). This restructuring of public administration and reduction of local functions halved local revenue (Considine and Reidy 2016: 132).

Measures to overcome the recent financial crisis caused further declines in revenue. Beyond general cuts in funding, the centralisation of the water service from local governments to state administration and the corresponding decline of state transfers to local governments meant a noticeable loss in revenue in 2014. In sum, the local share of general government revenue was halved once again from 2008 to 2014.

In 2015, self-sourced taxes accounted for about 21% of total local revenue, which means a remarkable doubling since 2008 (Figure 13.3). Nonetheless, the real tax raising power of Irish

FIGURE 13.2 Ireland – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016

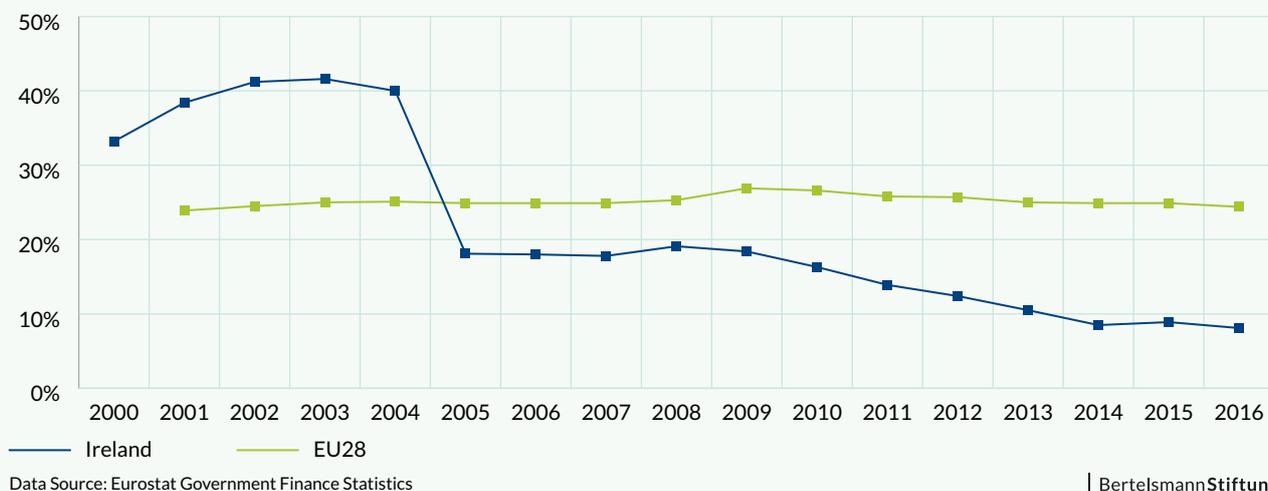
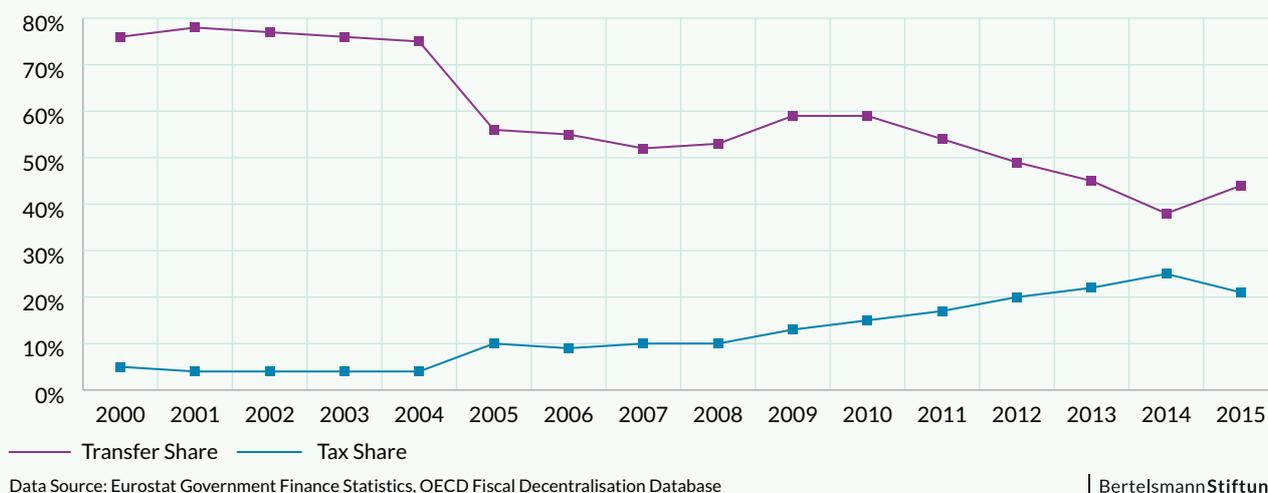


FIGURE 13.3 Ireland – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



councils is relatively low. There are no shared taxes. The largest single source of revenue comes from the taxation of commercial properties. Finally, rates on commercial properties (commercial rates) are the only tax source offering considerable local room for manoeuvre. Commercial rates have been rising for several years, predominantly due to rising tax rates.

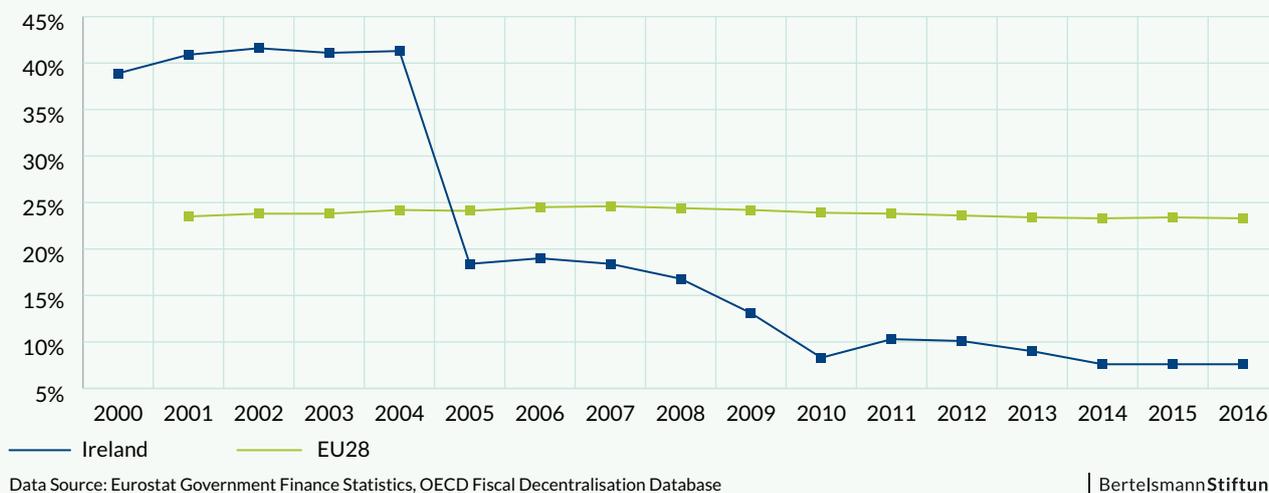
Tax on residential properties has a long and difficult history in Ireland. Due to public pressure, this tax was abolished in 1977 and refunded by state grants (Considine and Reidy 2016: 138). Against the background of the financial crisis and Troika conditions, taxation of residential properties was reintroduced

in 2013. Since then, local governments must raise revenue from a property tax on residential properties, within bands, and based on periodic market values. A state agency (Revenue Commissioners, the national tax collection agency) collects this revenue and transfers it to the Local Government Fund. 80% of residential property tax receipts flow back to the county where the tax is collected. The rest funds fiscal equalisation. The state sets an initial rate of residential property tax but local authorities may vary this rate by up to 15%.

The Local Government Fund is a central fund, which was established in 1999. Until 2017, there were three sources

FIGURE 13.4 Ireland – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



of income: property tax on residential properties (added in 2014), motor tax and state contributions (Department of Housing, Planning and Local Government 2017: 6). Motor tax, previously the largest source, had been eliminated by 2018. This change came along with centralisation of water services and did not affect funding of local authorities in practice.

Due to declining grants (predominantly capital grants) and the newly introduced residential property tax, the mixture of local funding has changed considerably (Figure 13.3). In 2008, the share of transfers was five times larger than that of taxes. In 2013, this relation was to 2 to 1.

### 3 Expenditure

Local governments in Ireland play a very limited role in public services and have a reduced range of functions (Boyle 2014: 5). In contrast to most European countries, they have no say in policies such as education and welfare. In addition, the recent centralisation of the water service from local to central administration has meant a further loss of power (National Oversight and Audit Commission 2015: 83). On the other hand, there is a growing relevance with regards to local and economic development and enterprise support.<sup>1</sup>

Going by national statistics, housing and local roads accounted for almost half of current expenditure in 2017 (Department of Housing, Planning and Local Government 2017: 11). Local

expenditure consists of €4.3 billion of current spending and €1.9 billion of capital expenditure in 2017. Expenditure has been declining in the long run due to the centralisation of services (health) and the recent financial crisis (Figure 13.4).

### 4 General Fiscal Status

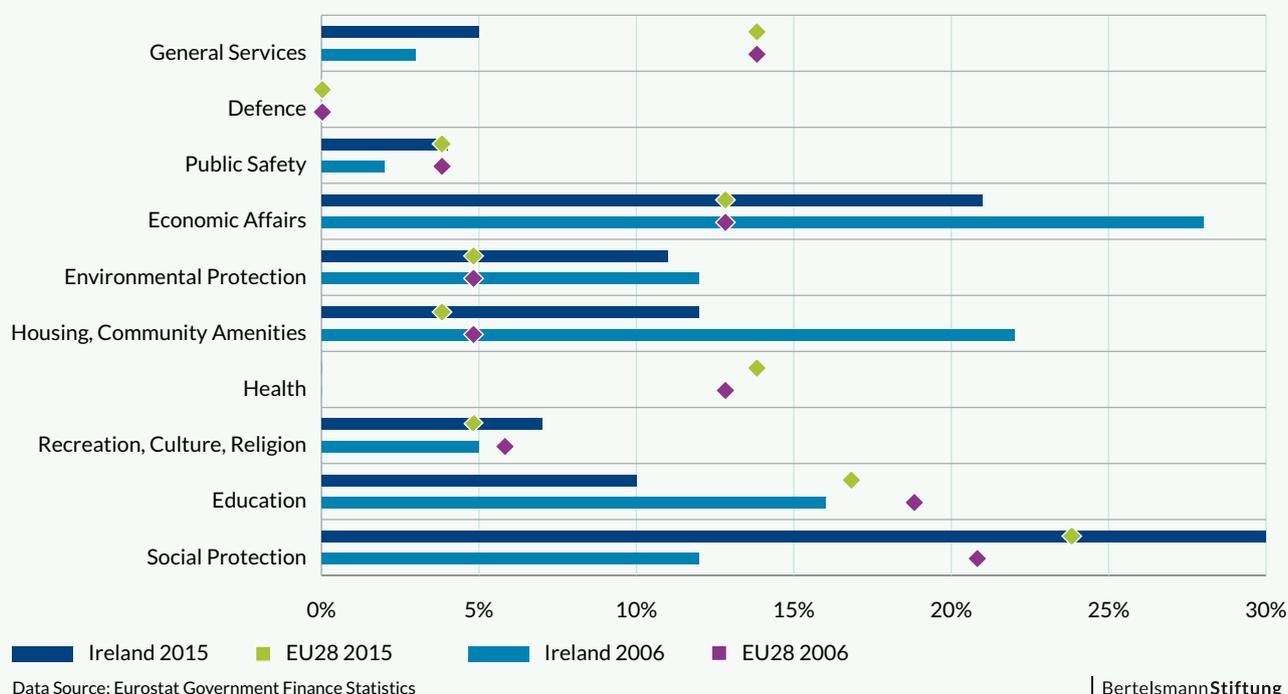
The financial crisis put serious pressure on local budgets (Figures 13.7 and 13.9). Consequently, by 2012, the majority of councils (18 out of 31) operated at a deficit (National Oversight and Audit commission 2018: 68). However, by 2013 budgets had started to recover and in 2016 the number of local authorities in deficit fell to 13 out of 31 (National Oversight and Audit Commission, 2018: 68). Local budgets, in sum, were in deficit from 2007 to 2012, showing remarkable differences among the counties. Twelve out of 31 councils weathered this period without any accumulated deficits. On the other hand, there are councils such as Sligo County Council which are still reaching accumulated deficits in recent years of about 40% of income revenue (National Oversight and Audit Commission, 2016a: 14).

Shrinking delays in auditing local budgets and increasing collection of taxes are indicators of financial recovery (National Oversight and Audit Commission 2018: 70; National Oversight and Audit Commission 2016a: 11). The economic situation in Ireland has improved considerably since the crisis and so have local budgets. Nonetheless, this recovery is still fragile and faces various external risks, not least of all Brexit.

<sup>1</sup> Data on expenditure on public services is not available in the case of Ireland.

FIGURE 13.5 Ireland – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



## 5 Effects of the Financial Crisis

Due to its economic structure, the financial crisis hit the Republic of Ireland comparatively early and hard (MacCarthaighy and Hardiman 2017). It took eight years until Irish GDP had fully recovered (Figure 13.6). From a local perspective, the financial crisis resulted in a change from boom to bust (Turley and Flannery 2013: 38). GDP started falling in 2008 and reached its lowest point in 2010 with a loss of 27%. Preceding growth had come widely from property values and financial industries. As these sectors collapsed, Ireland was forced to bail out some major banks and ended up close to bankruptcy itself. Greece and Portugal and the Republic of Ireland applied for financial support from the IMF and the EU (Troika). These parties signed a Memorandum of Understanding in late 2010 containing a bundle of measures and structural reforms covering the whole of the public sector as well as the financial sector. Those measures were due for implementation between 2011 and 2014. Generally, there was little public opposition to these measures.

Austerity has been the driver, starting point and somehow the excuse for the fundamental reorganisation of public services and administration within Ireland. Some of the changes had

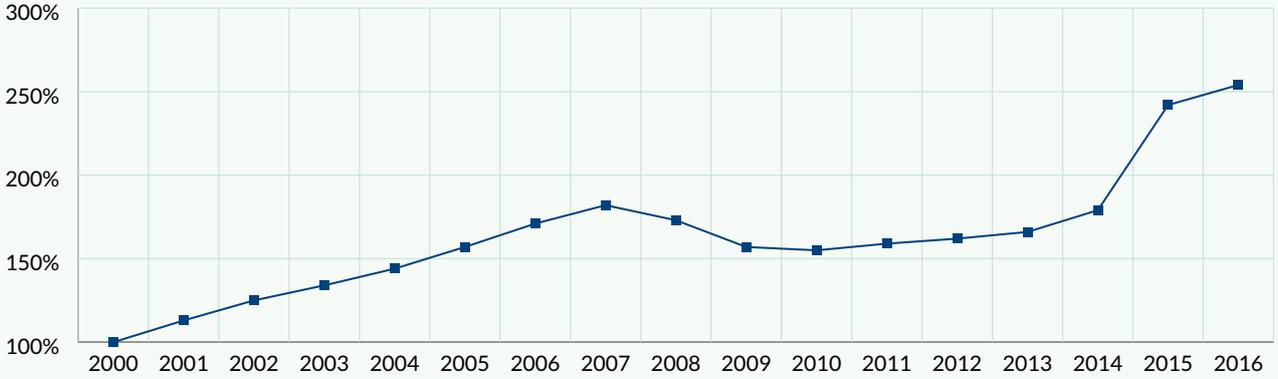
been in discussion for decades. Irish local governments, which already had suffered from limited functions and autonomy before this, witnessed further pulls towards centralisation and weakening (Considine and Reidy 2016: 136).

In 2012, the central government presented a comprehensive programme of local government reform (“Putting People First”), focusing on the institutional framework, expenditure and revenue (Turley and McNena 2016: 303). These reforms were implemented legally through three acts (Robbins et al. 2016: 11). The Local Property Tax Act reintroduced property tax as a local tax, thereby burdening the owners of residential properties. The Water Services Act transferred water services to a new state agency. The Local Government Reform Act restructured territories and set up the National Oversight and Audit Commission. At the national level, the establishment of the Irish Fiscal Advisory Council in 2013 also goes back to the Troika. Local councils are indirectly affected by its annual monitoring and assessment of financial stability.

When it comes to numbers, local budgets were shrinking massively (Figure 13.9). However, the post-crisis reduction of revenues and expenditure was, largely, an indirect effect of state measures to overcome the financial crisis. There have been sharp cuts in transfers following 2008. Amongst other

FIGURE 13.6 Ireland – Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 13.7 Ireland – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016

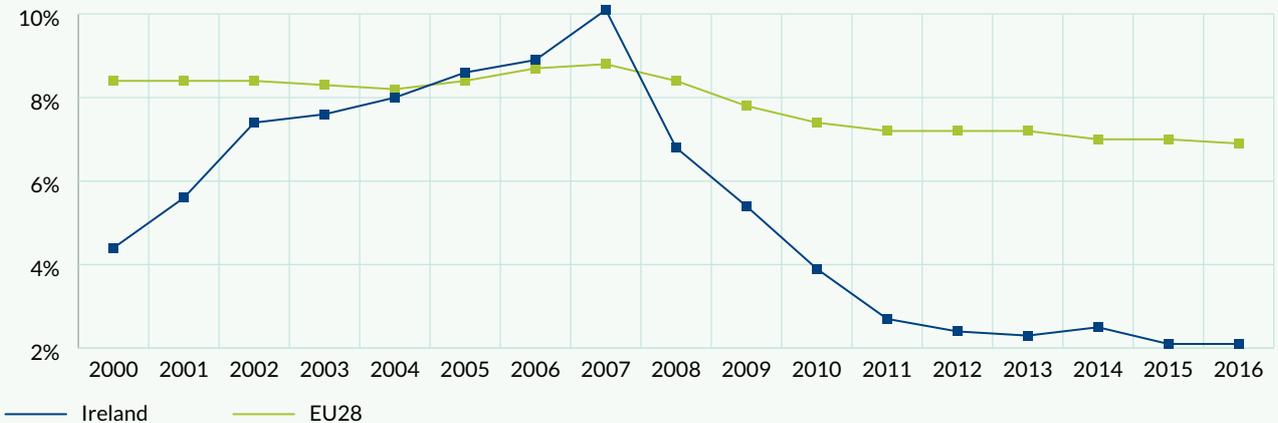


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 13.8 Ireland – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016

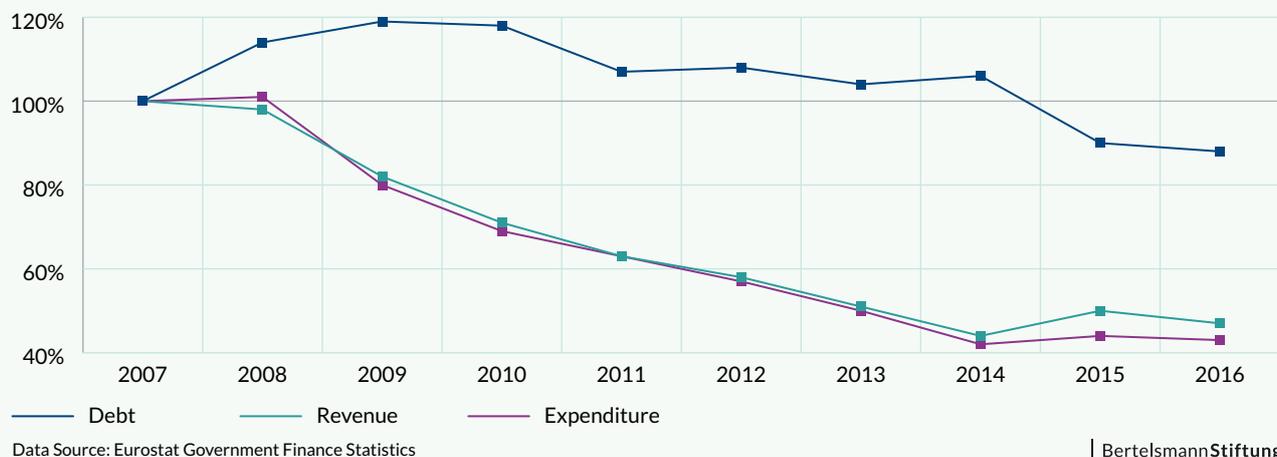


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 13.9 Ireland – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



things, local governments reduced their staffing level by about 23% and faced a general public-sector recruitment embargo (National Oversight and Audit Commission 2016: 95). Capital spending decreased by more than two thirds between 2008 and 2015.

In sum, from 2007 to 2012, local governments went into deficit (Figure 13.7). In 2012, 19 out of 31 counties could not balance their current budgets (National Oversight and Audit Commission 2018: 68). Nonetheless, local aggregate debt was rising only slightly and fell below its pre-crisis level in 2015 (Figure 13.9). Revenue and expenditure showed a sharp decline, although in parallel. Indications of fiscal stress can be drawn by the failure to collect commercial taxes and delays in budget auditing. Local government compliance with regulation was insufficient. By 2014, the financial situation started to recover at a modest level.

As outlined in Section 2, the revenue structure has changed substantially due to several changes in taxation and grant distribution. State grants declined, charges and commercial rates (self-sourced revenues) increased (Considine and Reidy 2016: 129). Due to this, the vertical fiscal imbalance of local-central fiscal relations decreased, whereas horizontal disparities among local governments were on the rise (Turley and McNena 2016: 317). The decline in grants affected capital grants by an even larger extent. As a consequence, local governments reduced their capital expenditure significantly.

On the side of governance, the following measures are relevant: administrative structures were tightened by the abolishment of the lower local government level of municipalities, the

merging of councils and the transfer of water services as well as the extension of shared services. In 2014, the National Oversight and Audit Commission was established to provide independent oversight and deliver performance monitoring and value for money studies on a broader basis.

## 6 Fiscal Rules and Fiscal Oversight

Irish local governments face a balanced budget requirement with regards to their revenue accounts. Borrowing is limited to capital spending and must be approved in every single case by the Department of Housing, Planning and Local Government. There are no formal criteria for approval. The department makes its decision based upon budget indicators, auditing and its own observations. Recent reforms in local finance and governance did not affect these basic rules and the framework itself.

Budgeting is left to local officials. Due to the low number of local governments, limited functions and high demands in reporting, there is a high degree of inspection and close collaboration between locals and the department. Central government has hardly any formal rights when it comes to sanctioning any rule-breaking by local governments. In the case of failing to balance budgets, a negotiation process will ensue, culminating in a list of measures to be implemented by the council. In theory, the department can take over a local authority in cases of extensive and permanent failing. In practice, this has not happened for a long time.

When it comes to monitoring, two further bodies are involved: the Local Government Audit Service and the National Oversight

and Audit Commission. Each local authority must prepare an Annual Financial Statement on time. These statements undergo an independent audit by the Local Government Audit Service as part of the Department of the Housing, Planning and Local Government. Audits are implemented based on a statutory Code of Audit Practice. As usual, auditors are limited in pointing out eventual failures but do not hold any rights with regards to sanctioning or enforcing implementation.

Based on the Local Government Reform Act and the Troika requirements, the fiscal framework has been strengthened with regards to monitoring. In 2014, the National Oversight and Audit Commission was established with the intention of providing independent oversight on local finances with regards to the delivery of services, value for money and fiscal sustainability. The NOAC produces its analysis based upon public statistics and local official documents. There are no rights in relation to intervention.

One final thing to note, there is no bankruptcy code for local governments.

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# 14 | Italy

Christian Raffer, Emanuele Padovani

### Summary

Italy is a unitary country in which the regions have extensive rights and responsibilities. Overlapping constitutional task assignment causes ongoing litigation about the distribution of services between regions and central government. Strictly speaking, regions are part of the local level, together with provinces and municipalities. In 2013, Italian provinces were widely relieved of their duties. Due to the rejected constitutional reform of 2016, their complete abolishment failed. Alongside regions, municipalities play a significant role in public service delivery on the local level.

A relatively big share of Italian local governments' revenue stems from local taxation and surcharges on the national personal income tax. Whereas regions tax business output, municipalities focus on property taxation. Although, regions and municipalities have been provided with a pronounced financial autonomy, considerable power has been conferred on the central government over regional and local finances by the constitution. Furthermore, while municipalities are recognised to have a certain degree of autonomy to set their revenues (e.g. tax rate within certain limits, specific rules for tax base, etc.), this is not valid for regions. Since large parts of Italian health-care provision are organised by region, a considerable share of local expenditures flows (ca. 40-50%) to this field.

The fiscal situation of local governments in Italy is difficult to evaluate due to the opacity of the traditional accounting system (which was reformed in 2015) and incentives to window dress. However, the local level has seen repeated aggregate budget surpluses in the past years. There was a massive debt-restructuring in the years 2013/14 in which central government paid a big chunk of local governments' debts to private creditors. Local governments have suffered quite intensely from the financial crisis and the following double-dip recession.

Fiscal regulation of local governments in Italy is under permanent construction. Between 2011 and 2013, municipalities were subject to considerable fiscal framework uncertainty. A major change came with the abolishment of the Internal Stability Pact in 2015/16. Next to a simplified balanced budget rule for local governments, there are expenditure growth ceilings for regions. Rule-setting and oversight is concentrated at the national Ministry of Economy and Finance; the Court of Auditors also plays a part as external auditor body. Italian municipalities know the official state of financial distress, which is a structured process in terms of a situation close to bankruptcy.

## 1 Administrative Structure

Italy is a unitary country with a highly regionalised structure (Bettoni 2017: 103). A rather fundamental constitutional reform in 2001 and the fiscal federalism law of 2009 both weakened centralism and granted greater autonomy to the regions (OECD 2016). Today, regions and the central government have equal jurisdiction even in fields like national territory and infrastructure (Bettoni 2017: 103f.). Still, since Italy is not a federal country, the regions are by definition part of the local level. The Italian parliament has a bicameral system and consists of the Chamber of Deputies and the Senate. Head of state is the president of the republic; head of government is the prime minister. Currently, there are 13 ministries (plus six ministries without portfolio) of which the Ministry of Economy and Finance plays the central role in local government fiscal supervision (Ambrosanio et al. 2016: 219). A renewed constitutional reform initiated by former Prime Minister Matteo Renzi, which was meant to restate the supremacy of the central state, did not survive the constitutional referendum in December 2016 (Povoledo et al. 2016). Consequently, the blurred lines of responsibility between the central government and the regions and the resulting load of litigation at the Constitutional Court remain (Bettoni 2017: 111f.). On the provincial level, the central state is represented by 103 prefectures, which ensure the proper functioning of local governments and even can take over in cases relating to public safety, corruption or non-approval of the municipal budget, among other issues (Meoli 2012). Prefectures' principal functions are policing, public safety and civil security. Beneath the central government, the local level consists of municipalities (comuni), provinces (province), metropolitan cities (città metropolitane), unions of municipalities (unioni di comuni) and regions (regioni), which enjoy constitutionally ensured revenue and expenditure autonomy (Article 119). Local self-government

FIGURE 14.1 Italy – Administrative Structure

Central Level	Central Government (Local representation: 103 prefectures)
State Level	
Local Level	20 regions
	100 provinces (of which 14 are "città metropolitane")
	7,978 municipalities

Source: own representation

TABLE 14.1 Italy – Population of Local Government Areas, 2018

	Smallest	Largest	Average
Regions (20)	Valle d'Aosta (126,202)	Lombardia (10,036,258)	3,024,199
Provinces (100)	Isernia (85,237)	Rome (4,355,725)	562,271
Metropolitan Cities (14)	Cagliari (431,955)	Rome (4,355,725)	1,566,116
Municipalities (7,978)	Moncenisio (29)	Rome (2,872,800)	7,581

Source: Istat 2018

is a constitutionally enshrined right (Bespalova and Andersen 2013). While regions frame the competences and distribute funds, functions and responsibilities to lower levels of local government, municipalities (and provinces, etc.) define their programmes in accordance with the respective region.

Overall, 15 out of 20 Italian regions have ordinary status and five are special-status regions (Valle d'Aosta, Friuli-Venezia Giulia, Sardegna, Sicilia and Trentino-Alto Adige/Südtirol) (OECD 2016). The special status brings with it major legislative, administrative and financial autonomy. It was assigned due to historical reasons in order to avoid secession and to protect cultural characteristics. Each region has a regional council, an executive board and a president, directly elected by the citizens. All the regions have the power to raise taxes, even though the central government keeps most of the tax revenues. The 2001 constitutional reform gave them exclusive legislative power with respect to any matter not expressly reserved to the central government (OECD 2016). In the very centre of regional responsibilities stands health care, managed through local health authorities and hospitals. It is a jointly provided function, where the central government defines standard levels and guarantees financing (Ambrosanio et al. 2016: 217). Further tasks relate to environmental protection, transport, universities and higher education, social services and housing, culture, and agriculture. The so-called concurrent responsibilities are shared with the central government (OECD 2016); about 80% of regional expenditures can be linked to these concurrent responsibilities (Ambrosanio et al. 2016: 220). In 2017, Emilia Romagna, Lombardia and Veneto, which represent 40% of national GDP, started negotiating with the central government for the acknowledgement of a higher fiscal and administrative autonomy, which is possible according to Article 116 of the constitution. While this may lead to 90% of

national taxes remaining in the regional jurisdictions, this is still open to political debate.

The provinces of Italy have been an intermediate administrative level until Law 56/2014 widely discharged their responsibilities (OECD 2016). After several failed attempts and due to fiscal pressure after the financial crisis, this law was a big step towards full abolishment, which was supposed to be completed by the constitutional reform in 2016. Since the referendum failed, however, provinces still have their constitutional right to exist (Article 114). The provincial government is no longer directly elected by citizens but composed of representatives of the mayors of the cities belonging to the region (Ambrosanio et al. 2016: 231–233). These days, there are 100 provinces; 14 of them were replaced by metropolitan cities which inherited both the territory and the funding. However, this rather new construct of città metropolitana is not yet fully implemented. According to the 2014 law, provincial responsibilities are related to provincial roads (building and maintenance), school infrastructure (building and maintenance), public transportation planning, local (provincial) police, environmental protection planning at the provincial level, and other services in the form of a consortium of municipalities; previous functions have been transferred to the regions, municipalities or inter-municipal bodies. Although steps have been taken to abolish them, provinces still provide essential services. Due to severe budget cuts and the abolishment of provincial taxes, some provinces were in severe fiscal distress and received extraordinary funding from the central state. Recently, the government has announced provinces are to be revived in order to retain current functions, foster their coordinating role among municipalities and re-establish direct election of council members and the president.

In 2018, there were 7,978 municipalities which are the local authorities closest to the citizens. According to the national office of statistics, this number has slightly decreased in recent years. Before the crisis, however, Italy was unique in Europe due to an increasing number of municipalities (Ambrosanio et al. 2016: 231 f.). It grew since splitting one territory into more governments has been regarded as a way to increase the number of positions for the local political class and to attract more central money. The excessive number of municipalities is a well-known problem in the Italian system of government: 56 % of them have 3,000 inhabitants or less and are considered to be too small to provide services efficiently. According to the constitution (Article 117), there are fundamental functions over which the state has exclusive legislative power and which local governments have to implement (Vandelli 2012: 345). In general, municipal responsibilities include town planning, building and commercial permits, social housing,

local (municipal) police, public transport and roads, water and waste management, education (preschool and primary school buildings), social services, local economic development, recreation and culture, etc. (OECD 2016). Municipalities have elected councils and mayors (Vandelli 2012: 348). Inter-municipal cooperation in the form of municipal unions (unioni di comuni) and mountain authorities (comunità montane) are common; according to ANCI (the national association of municipalities) there are currently 627 of them, involving 4,486 municipalities. In addition, there are several other forms of inter-municipal cooperation, among which state-owned enterprises (SOEs) at the local level are particularly prevalent. They represent 47,700 shareholdings in 8,387 SOEs each shared by 5.7 local governments (Senato della Repubblica, 2017).

## 2 Revenue

In terms of Italian local governments' fiscal structure, the 2001 constitutional reform and Fiscal Federalism Law No. 42 of 2009 aim to increase autonomy, efficiency and accountability (OECD 2016). The reason behind this was the devastated fiscal situation prior to 2001 which resulted from a financial crisis after Italy's exit from the European Exchange Rate Mechanism in 1992 (Ambrosanio et al. 2016: 214 ff; Delivorias 2015: 4). The new constitutional Article 119 of 2001 stipulates that a local government's activities should be financed totally by its own revenues and tax shares. Transfers must serve equalising purposes only; there is no room for earmarking. However, these provisions turned out to be not implementable and today there is a practical difference between the constitution and the true funding practices of local governments. This was not healed by the 2009 fiscal federalism law. But still, over the years, fiscal decentralisation triggered an increase in own-sourced taxes and a decrease in central government grants (Figure 14.3).

According to the Eurostat classification, local government revenue for Italy comprises revenues of all government levels below the central level. Hence, regional revenues are included in the provided empirics. Measured as share of general government revenue, local government revenue decreased after 2009 whereas it had steadily increased in the years before (Figure 14.2). One reason for the decreasing share after 2009 was central government cuts of transfers to the regions and municipalities (Ambrosanio et al. 2016: 223). On average, local government revenue as share of general government revenue was 32 % between 2000 and 2016, which was considerably above the EU28 average value. This is caused by regions, which provide cost-intensive services

FIGURE 14.2 Italy – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016

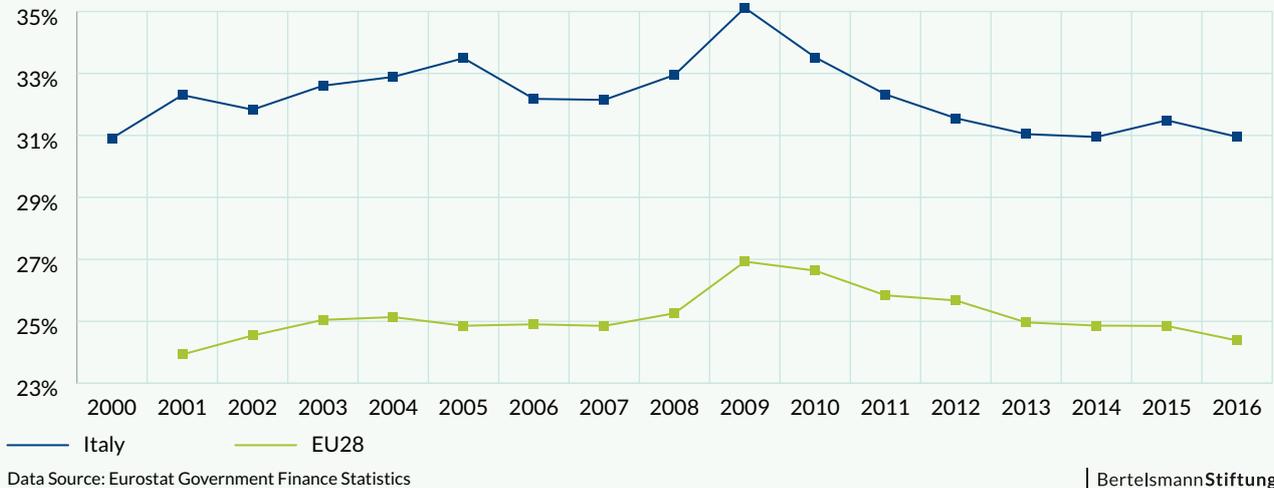
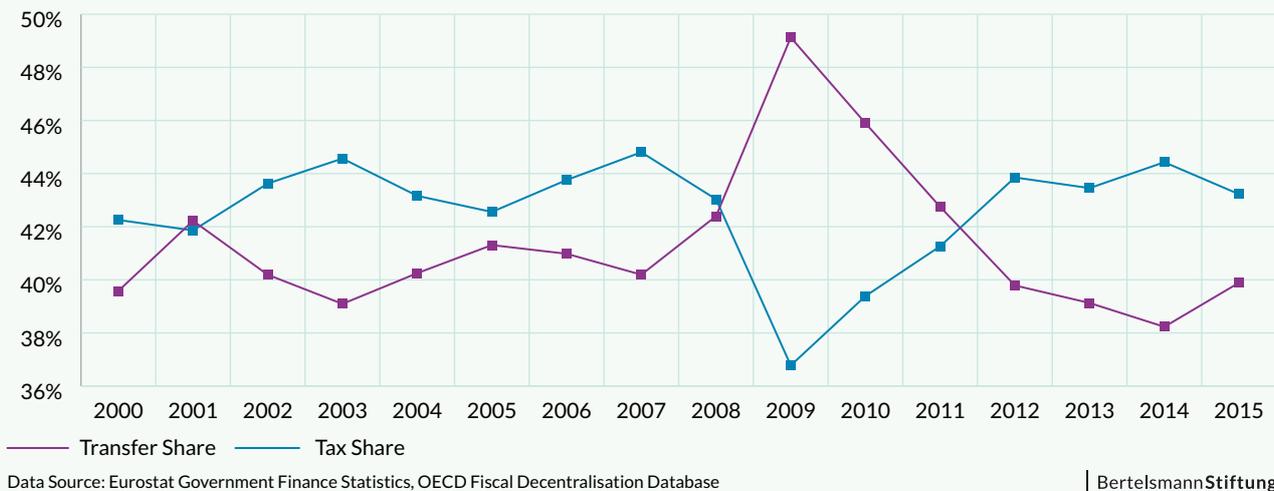


FIGURE 14.3 Italy – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



especially in the field of health care. Except the post-crisis years, most Italian local government revenues stem from taxes (Figure 14.3). Whereas in 2016 the tax revenue share of total local government revenue was 43%, the transfer share was 40%. Moreover, there is a far-reaching divergence between the South and the North of Italy (Ambrosanio et al. 2016: 225). Whereas northern municipalities' budgets show a relatively high share of own-sourced revenues, grants are still very important for municipalities in the South. Falling tax revenues and peaking transfers (as depicted in Figure 14.3) are a striking pattern of the crisis year 2009. Irrespective of their relative shares, absolute revenues decreased after 2009, which

points to an eroding revenue base not being counteracted by additional central government grants.

Local governments receive both shared and own-sourced taxes (OECD 2016). The most important own tax for regions is the IRAP, a business tax imposed on productive output with a rate of 3.9% and a possible variation up to 0.92% (Ambrosanio 2016: 216). Moreover, there is a regional automobile tax (bollo, calculated on the base of the vehicle engine power and emission standard) and a regional surtax on the national personal income tax (addizionale regionale IRPEF) of 0.7% to 3.33%. Regions are free to set the rate within this corridor

(OECD 2016; Deloitte 2018). In terms of shared taxes, regions benefit from the national value added tax which replaces direct transfers from the central government and is needed, together with IRAP and addizionale regionale IRPEF, to finance health-care provision (Box 1). Minor taxes are tax on natural gas, landfill tax and the regional tax for university students.

Provinces levy a vehicle insurance tax and a vehicle registration tax; a former surtax on electricity consumption was abolished in 2011 (OECD 2016). They also benefit from the personal income tax (compartecipazione IRPEF).

Municipalities' sources of tax revenue comprise the municipal property tax (IMU), a surcharge on the personal income tax (addizionale IRPEF) and the waste collection and disposal tax (TARI). Moreover, there is a municipal tax on building licenses (OECD 2016) and, in certain municipalities, a tourist tax (Di Conti et al. 2018). In terms of the addizionale IRPEF, municipalities have some discretion on the tax rate in the range of an additional 0 to 0.9%. However, in the past the central government repeatedly froze the tax rates for some years. Especially the municipal property tax has a long and diverse history (Ambrosanio et al. 2016). Abolished in 2006, it was re-established in 2012. In 2014, the government of Enrico Letta introduced a new municipal tax (IUC), which integrated existing property-related taxes. It is made up of the IMU, levied only on the cadastral value of land and buildings different from the main residence (base rate of 0.76% +/- 0.3 percentage points subject to municipal discretion), the TARI, a service tax to finance garbage collection (rate varies among municipalities), and the TASI, a service tax to finance all the other services provided by the municipality (rate: 0–3.3% depending on the municipality). Whereas TARI is calculated on the base of the net living space of a resident's property, TASI is calculated on the base of the cadastral value of the property (Deloitte 2018). TARI and TASI are also levied on property in which the proprietor resides. Rates are set by the municipality.

Thanks to the fiscal federalism reform of 2009, central government (non-capital) transfers to municipalities consist exclusively of general-purpose equalisation grants, which are distributed according to an equalisation mechanism (OECD 2016). The national equalisation fund called fondo di solidarietà comunale receives its money from IMU revenues computed using the basic rate.<sup>1</sup> Expenditure needs and fiscal capacity of a municipality are considered in this equalisation mechanism. Municipal governments below the national average (with lower capacity to tax) are eligible for transfers (Mostacci 2016: 198). This equalisation mechanism is valid

<sup>1</sup> It was frozen in 2019 as some municipalities were worried their revenue would decrease too drastically.

for municipalities falling into ordinary statute regions, while special statute regions have the power to regulate their transfer disciplines with different patterns. Some earmarked grants, however, do exist. These transfers are provided from central level to cushion regional disparities and for economic development, social cohesion, natural disaster, etc. However, the central government strives to limit these earmarked transfers since they are basically banned by the Italian constitution. Within the local level, regions transfer some earmarked capital grants to municipal governments and their second-tier governments (unioni di comuni and comunità montane).

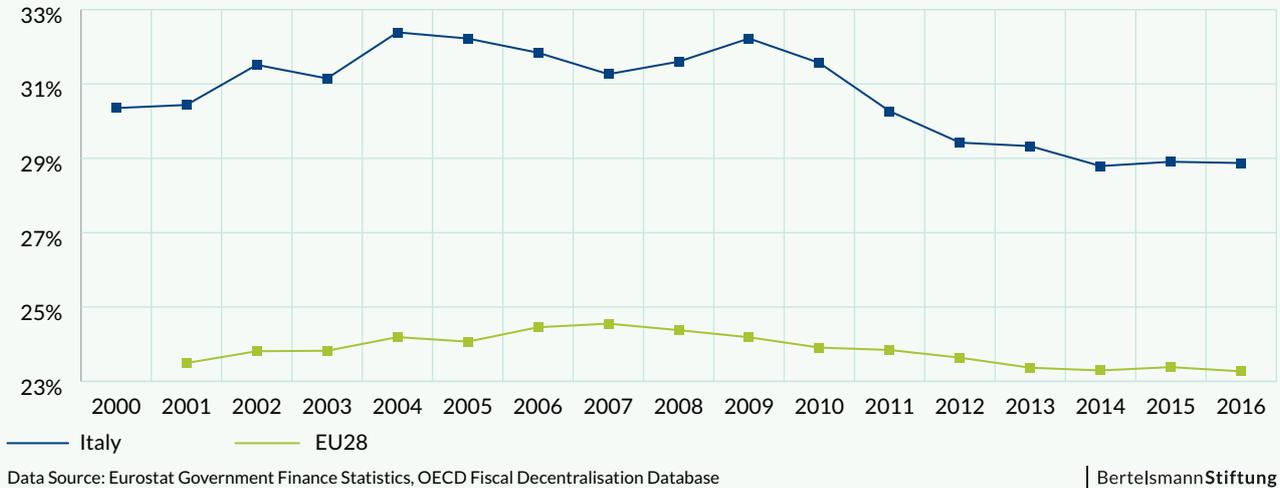
### BOX 1 Regional Health-Care Funding

Health-care standards and expenditure needs are defined at the national level. Every year the state-regions conference releases an agreement to compute the funding for each region. The criteria used for distribution mainly build on population and age demographics. Regional health care is financed primarily by regional own taxes like the corporate tax IRAP and the additional regional tax on actual personal incomes (addizionale regionale IRPEF). Both tax levels are computed according to the national base tax rates; therefore any higher tax rate decided at the regional level is not considered. Regions can decide in autonomy to use further amounts of their own revenues to finance health-care services, specific health-care goals (e.g. specific services) or as a counterbalance to lower service fees. Another source of finance is the health-care organisations' own revenue. Central government provides a fixed proportion of national value added tax (VAT) revenue and redistributes to regions unable to raise sufficient resources to provide the minimum standards. In addition, a co-funding mechanism among special status regions exists. In general, there are large interregional financial inequalities.

## 3 Expenditure

In terms of local government expenditures, Italy ranges far above the EU28 average over the period 2000 to 2016 (Figure 14.4). Again, this is mainly due to the incorporation of regional expenditures into the reported fiscal aggregates following the Eurostat convention. In 2013, for example, regions represented around 65% of total local government expenditure,

FIGURE 14.4 **Italy – Local Government Aggregate Expenditures**  
As Share of General Government Expenditures – From 2000 to 2016



municipalities 30 % and provinces only 5 % (OECD 2016). This clearly shows: If regional spending were separate, provincial/municipal spending would drop below the EU28 average. The most striking part of expenditure development between 2000 and 2016 is the post-crisis period after 2009 when local government spending as share of general government spending dropped from 32 % to 29 %. Local government spending also decreased in absolute terms, driven by crisis-related austerity (Ambrosiano et al. 2016: 229). The drop in the relative share in Figure 14.4 was additionally pushed by increasing absolute central government expenditures after the crisis. Still, Eurostat government finance statistics indicate that Italy is today among the most unitary decentralised countries, after the Nordic countries (OECD 2016). This is the result of the decentralisation process initiated by the 2001 and 2009 reforms.

Health expenditure is by far the most important expenditure function of Italian local-level governments (Figure 14.5); this is attributable to the regions and their extensive responsibilities in this field. In sum, regions dedicate about four fifths of their funds to health care (Unicredit 2016: 8). This money is spent via special-purpose autonomous bodies like local health agencies, called *azienda sanitaria locale* (or *azienda unità sanitaria locale*, or other names used by different regions). Between 2006 and 2015, health-related expenditures even increased irrespective of the transfer cuts in this area stemming from the financial crisis. This holds for social and environmental protection, too. The second and third most important expenditure functions of local governments in 2015 were general services and economic affairs. Whereas health expenditures are far above the EU28

average in the years 2006 and 2015, social protection and education-related spending at the Italian local level is lower than in the average EU28 country. Both functions are among the primary functions of the central government (OECD 2016).

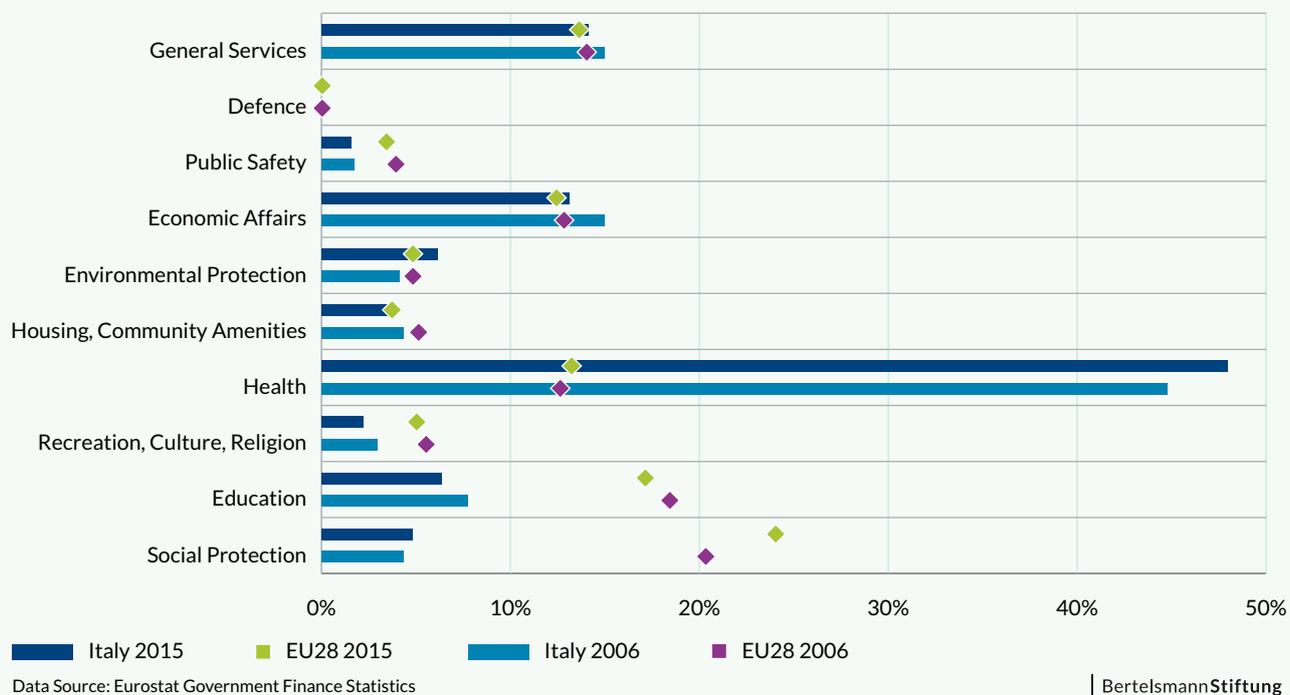
#### 4 General Fiscal Status

Local government debt as share of general government debt shows considerable variation between 2000 and 2016 (Figure 14.8) but remained below the EU28 average over the whole period. This is remarkable since the aggregate values include regional debt, too. The post-2007 decreasing share of local public debt can be linked to increasing central government debt and fiscal consolidation measures adopted by local governments during the crisis (Ambrosiano et al. 2016: 221).

Another indicator of fiscal tensions is the number of local governments formally in financial distress. The law does not provide any default rule for regions. Regions in structural financial distress mainly caused by the health-care function (on which regions spend most of their resources) are subject to health-care sector recovery plans (*piani di rientro*). In 2007–2010, one half of regions entered into the recovery procedure (in chronological order): Lazio, Abruzzo, Liguria, Campania, Molise, Sicilia, Sardegna, Calabria, Piemonte, Puglia. Liguria, Sardegna and Piemonte have recovered, while the other regions are still under surveillance. In general, according to the Court of Auditors, the former high regional imbalances in health care have been overcome and regions have now entered a positive trend.

FIGURE 14.5 Italy – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



In contrast to regions, Italian municipalities and provinces are subject to bankruptcy procedures (Padovani et al. 2018: 6; Ambrosanio et al. 2016: 233). The law provides three typologies of financial distress. The most severe is default or bankruptcy (*dissesto*), followed by an intermediate pre-default (*predissesto*) and – the least acute – a rebalancing procedure (*procedura di riequilibrio*) which provides an alternative to default (see below). Only 495 provincial and municipal governments, most of them in the South of Italy, experienced the most severe fiscal distress between 1989 and 2013. But in just six years after the financial crisis, between 2012 and 2017, 127 municipal and provincial governments entered the default procedure and 196 the rebalancing procedure. According to Ambrosanio et al. (2016), there are incentives to postpone the declaration of default as long as possible. Moreover, as a result of these different options for handling fiscal distress (default versus rebalancing), several cities especially in the South are still on the brink of insolvency. A total of about 1,400 municipalities had to request cash advancements continuously from 2015 to 2017 (source: Ministry of the Interior municipal financial reports), suggesting cash shortages, i.e. index of solvency difficulty.

At the same time, local governments' off-budget debt has increased in the last few years, by 54% between 2011 and

2016. Off-budget debt is represented by (usually current) expenditures not registered in previous years' accounting, which must then be covered extraordinarily by the local government council. For the fiscal year 2016, the Italian Court of Auditors has assessed off-budget debts at a level of €1.4 billion, or 2.6% of current expenditures, involving about one quarter of all local governments (Corte dei conti 2012; 2018).

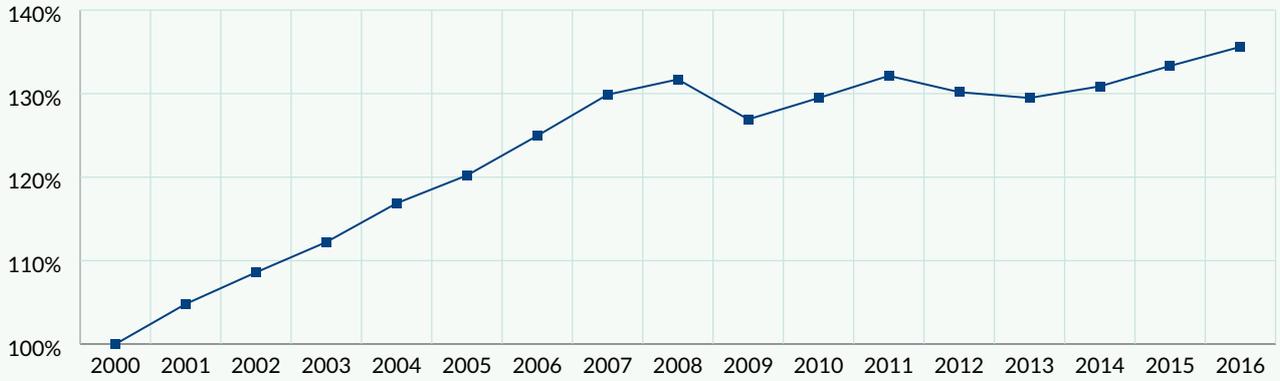
Another way to assess fiscal tensions of local governments would be to point to the sum of their arrears. Unfortunately, as in most EU countries, there is no reliable data about the exact sum. In 2013, they were officially estimated to be about €90 billion (Wall Street Journal 2013; Financial Times 2013). Moreover, the Ministry of Economy and Finance organised a large-scale buyback of local debt causing these arrears (Unicredit 2016: 10).<sup>2</sup>

Expenditure cuts, the higher level of autonomy to raise local revenues and the Internal Stability Pact (ISP) fiscal discipline add to the improving budget balance situation as depicted in Figure 14.7. Overall, the fiscal situation of local governments in Italy improved significantly in recent years. Most of Italy's local debt is in the form of bank loans, largely issued to domestic

<sup>2</sup> Relevant laws are Decree 35 of 2013; Decree 66 of 2014; Decree 102 of 2014.

FIGURE 14.6 Italy - Nominal Gross Domestic Product

Index: 2000 = 100

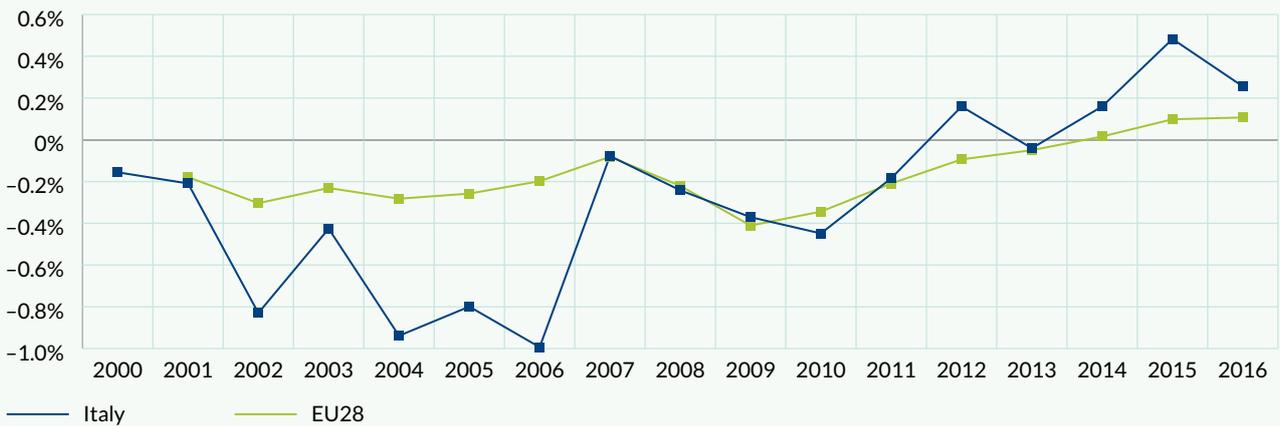


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 14.7 Italy - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2000 to 2016

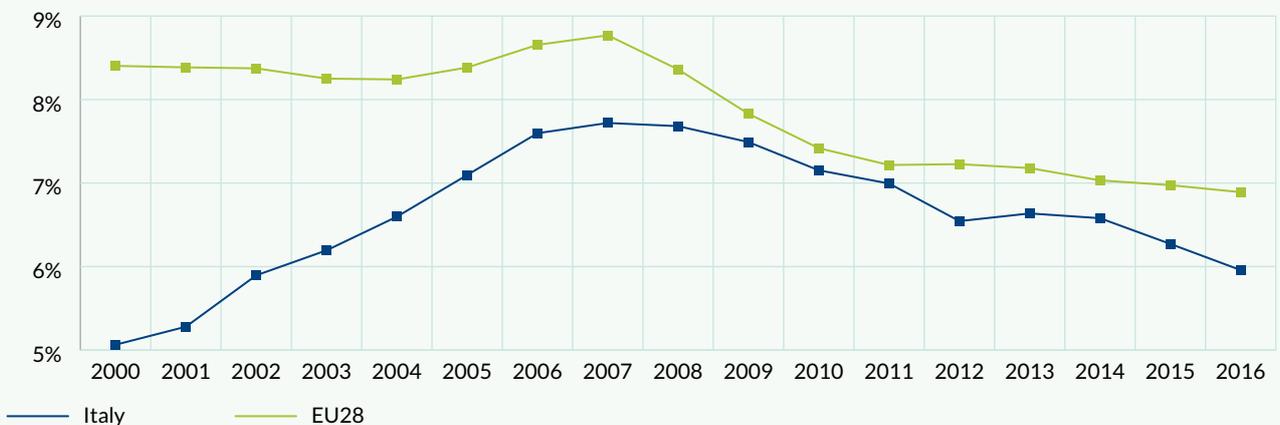


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 14.8 Italy - Local Government Aggregate Debt

As Share of General Government Debt - From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

banks (Unicredit 216: 1). However, after the two federal countries Germany and Spain, Italian local governments are the biggest issuers of bonds in the EU. Bonds currently account for about €8.5 billion of Italian local governments' total outstanding debt of €49.5 billion (Padovani et al. 2018).

## 5 Effects of the Financial Crisis

Italy, especially its South, was severely hit by the global financial crisis in 2007/08. The national economy even suffered a double dip (Figure 14.6). The local level had to deal with harsh direct and indirect consequences (Ambrosanio et al. 2016: 212). Since local governments are responsible for large parts of Italian public expenditure, the fiscal adjustments from 2008 to 2012, initiated by the Berlusconi and later the Monti government, showed major impacts. The constitutional amendments resulting from the European Fiscal Compact in the year 2014 imposed further consolidations on all levels of government. The number of local-level administrative employees was lowered, and central government cut transfers for health and other functions for the regions and for municipalities, too (Ambrosanio et al. 2016: 222 ff.). Overall, the local level delivered more than half of total public expenditure reductions. All this aimed at meeting the general government deficit targets and was accompanied by increasing fiscal autonomy for municipalities (e.g. by the re-introduction of real-estate taxation in 2012) and regions.

Moreover, local-level fiscal regulation was tightened through changes to ISP fiscal discipline (see below). This led to a post-crisis drop in local investments. In order to counteract this drop, cost-neutral intergovernmental lending schemes (surplus jurisdictions could lend their money to investment projects in non-surplus jurisdictions) were introduced but widely failed, according to experts (Ambrosanio et al. 2016: 226 ff.). Also, the 2014 territorial reform (elimination of provinces, introduction of metropolitan cities, forced inter-municipal cooperation for small municipalities) needs to be seen in the light of the financial crisis. In 2015, Italy finally came out of its deep and prolonged recession (Unicredit 2016: 1).

All the above-described Italian reactions to the fiscal crisis can be recognised in the development of local fiscal aggregates, such as expenditure and revenue, over time (Figure 14.9). The post-crisis debt development has to do with consolidation on all levels of government. The large-scale local debt buyback after 2012 brought a change of lenders for local governments only. Therefore, this remarkable reaction should not impact the debt development showed in Figure 14.9.

## 6 Fiscal Rules and Fiscal Oversight

Until 2015/16, local government fiscal regulation in Italy was subject to the so-called Internal Stability Pact (ISP) (*patto di stabilità interno*), introduced in 1999 (OECD 2016). It aimed at ensuring that the fiscal situation of municipal, provincial and regional administration was consistent with Italy's obligation under EU fiscal rules.<sup>3</sup> The pact has been under constant modification, which has caused widespread uncertainty among local governments (Ambrosanio et al. 2016: 218 f.). From 2013 to its replacement in 2015/16, it covered all local jurisdictions with more than 1,000 inhabitants (in 2018, 25 % of all municipalities had less inhabitants).<sup>4</sup> In 2016, the ISP was replaced by a simpler balanced budget rule for all local governments which still had some inconsistencies (Alpino et al. 2018: 6; Camera dei deputati 2018). Regions had to obey this simplified normative framework from 2015 onwards. From 2019, the fiscal regulation is limited to the general golden rule, i.e. current revenues must at least cover current expenditures and debt service, and annual total revenues must be at least equal to annual total expenditures.

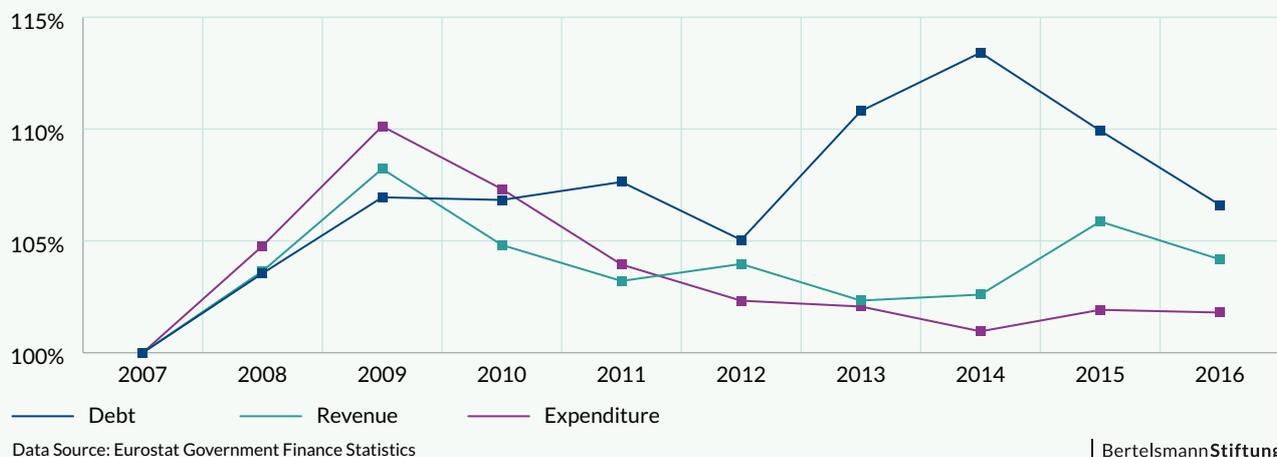
Fiscal rule-setting and supervision is located at the central government level (Ministry of Economy and Finance) (Ambrosanio et al. 2016: 219). The external auditors for regions and further local governments are the Court of Auditors (*Corte dei conti*) – with its two coordinating sections (*Sezione delle autonomie* and *Sezioni riunite di controllo*) at the central level and 21 regional audit units (*Sezioni regionali*) – and the Ministry of Economy and Finance's state general accounting department (*Ragioneria generale dello stato* – RGS).

The 21 regional audit units of the Court of Auditors carry out a priori audit and a posteriori audit for (central and local) governments located in their territory. Each year, a subgroup of all local governments is audited by the regional units.

3 Due to repeated reforms, the specific fiscal rules within the ISP framework changed a lot. Regions, for example, had (and still have) to constrain their expenditure growth (Ambrosanio et al. 2016: 219; EC 2018). Before a reform in 2007, municipalities in contrast were subject to a deficit-reduction target based on past expenditures. After 2007, there was a municipal balanced budget rule which foresaw the adherence to a pre-defined budget balance; these balances were different for local governments compliant or non-compliant with the ISP in 2007 and could also vary according to the value, positive or negative, of the financial balance in the year 2007. The budget balance was defined as the comprehensive financial budget in cash and accrual terms. According to Coviello et al. (2018: 9), the 2008 ISP required zero deficit and, in addition, a 20 % ceiling on total spending growth. As early as 2005/2006, there was a system of ceilings on the actual increase in nominal local expenditure (Ambrosanio et al. 2016: 219).

4 This threshold changed many times. From 2001 to 2004 and from 2007 to 2012, it was 5,000 inhabitants (thus excluding a significant proportion of municipalities from fiscal regulation); in 2005 and 2006 it was 3,000.

FIGURE 14.9 Italy – Post-Crisis Developments  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



If they ascertain financial imbalances, non-achievement of fiscal objectives, serious anomalies in accounting procedures/information, and, in general, misconduct that may prove financially damaging, they issue a special verdict. It is addressed to the local government's council that needs to respond in terms of the highlighted concerns. Then the regional audit unit monitors that corrective actions are actually and effectively taken. Each regional unit has a certain degree of autonomy in carrying out its duties. In other words, despite national guidelines, state supervision differs in the different regional jurisdictions. At the central level, the local governments section (Sezione delle autonomie) represents and coordinates the regional audit units, and reports the status of local finances to the parliament.

In addition, the Ministry of Economy and Finance's RGS department conducts supervision and control of public financial management through an integrated system of public finance controls which operates nationwide. This system comprises the accounting inspections conducted by the central accounts balance offices (Uffici centrali del bilancio) at the central level, by the territorial accounts units (Ragionerie territoriali dello Stato) located in each provincial capital on local state administrations, and by the public finance inspection service (Servizi ispettivi di finanza pubblica, SIFIP). It also includes the supervision and control of non-territorial public bodies by representatives of the treasury appointed in the audit boards of public entities. As to regions and further local governments, SIFIP carries out legal, accounting and financial audits based on Law 1037/39, which aims to foster value-for-money policies, inspect for legitimacy and suggest measures for management improvements.

From 2007 to 2016, municipalities had to report cash and accrual information bi-annually (before: quarterly). Since 2016, every local authority must only submit a report certified by the local governments' external auditor by 31 March (Camera dei deputati 2018). If the report is not submitted within 30 days after the deadline, various financial flows from the Ministry of the Interior can be suspended. As for the regions, the regional council has to provide a report on the adequate budget execution every six months. Regional health expenditure is monitored in the context of a computerised system (Tavolo di monitoraggio), also maintained by the Ministry of Economy and Finance (Ambrosanio et al. 2016: 219).

Due to the 2011 Harmonisation Law (Decree 118), the budgeting procedure has been the same for all local governments since 2015 (Manes-Rossi 2015: 134–138). The budget is to be prepared for a three-year period and separately for the subsequent year. It has to be approved by 31 December but most local governments go beyond that time limit (usually February or March). If a local government council does not approve the budget, the prefect has the right to intervene (Meoli 2012). At the end of each year, the multi-annual budget has to be updated (Manes-Rossi 2015: 134–138). A budget consists of missions (missioni), representing the main functions and strategic objectives, and the programmes (programmi), which represent the activities for achieving these objectives. A short version of the budget has to be made public. For municipalities, auditors also have to prepare a report on the budget to certify whether it is consistent with accounting principles and fiscal rules. Financial reporting covers the balance sheet, the operating statement, a budget execution statement, and notes.

Despite the recent accounting reform, traditional public accounting has not been replaced by accrual accounting yet. Italian provinces and municipalities were subject to a reform of financial reporting in 1995. The new legislation was also enacted with the aim of providing better transparency and accountability (Anselmi 2001; Mussari 2005; Farneti 2004). A new set of financial and non-financial information was required to measure economy, efficiency and effectiveness; this included accrual accounting, but the traditional obligation-based budgetary accounting system continued to play a pivotal role (through the annual budget and report). According to a European Commission study, Italy was in the lowest quartile of EU countries in terms of development of accrual accounting in 2012 (EY 2012).

For regions, the internal audit is carried out by their accounting department and has to verify the proper use of resources given existing plans and programmes (Manes-Rossi 2015: 136 f.). For an external audit, a board of three auditors has to be appointed to verify legal and fiscal rule compliance. In addition, the ability to maintain fiscal health and the effectiveness of internal control is assessed. For municipalities, the law requires a single auditor for jurisdictions with less than 15,000 inhabitants and a board of three auditors for bigger cities and provinces (Manes-Rossi 2015: 138). To ensure independence, they are randomly appointed professionals from a regional list managed by the Ministry of the Interior. These professionals may be the members of auditing companies being contracted as individuals; contracts with private audit companies are not allowed. They are in charge for three years with the possibility of extension for another three years. Among other things, they evaluate compliance with accounting principles and, as in the regions, appropriate use of resources.

For regions, provinces and municipalities, Article 119 of the constitution foresees that deficits are only possible for investment purposes (Mostacci 2016: 198; Vandelli 2012: 355). Since 2016, there has been only one unique budget balance target for all local governments (municipalities, provinces, metropolitan cities and regions), calculated on an accrual basis<sup>5</sup> (Camera dei deputati 2018). Regions have to comply with a growth ceiling for non-health-care expenditure, with an additional expenditure ceiling for pharmaceutical products and with conditions formulated in the so-called health-care pact, which regulates transfers from governments to regional health bodies (*aziende sanitarie locali*). Since 2012, the so-called *tesoreria unica* have existed which oblige provinces and municipalities to deposit their revenues at an Italian central bank account and no longer at their own bank (Ambrosanio

et al. 2016: 231). Positive interest rates for these deposits are transferred to the central government.

Non-compliance with the ISP has been sanctioned since 2003; however, in the first years, sanctioning was often not applied (in order to give room to manoeuvre to local governments) and was subject to repeated reforms (Ambrosanio et al. 2016: 219). An ISP reform in 2008 increased rule-compliance by making sanctions both much harsher and more effective (Coviello et al. 2018: 9). These included transfer cuts and an automatic 30% cut to the salary of mayors and city councillors. Until the financial crisis, regions' deviations had by law led to automatic increases in tax rates and a loss of autonomy with regards to health expenditure (Ambrosanio et al. 2016: 219; Unicredit 2016: 6). Under the simplified balanced budget rule framework in place since 2015/16, a rule-breaking municipal government faces reduced financial resources from the equalisation fund (*fondo di solidarietà comunale*), can no longer use loans for investments and faces a hiring freeze plus a 30% cost-reduction obligation in the subsequent year (Camera dei deputati 2018). Meeting the balanced budget rule, however, is linked to increased financial freedom.

There is a long bailout history among Italian local governments. The Ministry of Economy and Finance organised a large-scale buyback of local debt (Unicredit 2016: 10).<sup>6</sup> Between 2013 and 2015, Italian local governments received €29 billion in loans from the central government to clear their overdue payables. These loans were funded through sovereign debt bonds and lent to local governments with a 30-year maturity at a price in line with Italy's 5-year treasury bond. In general, this eased the interest rate burden of local governments and may be understood as counter-cyclical injection to the private sector, since some of these funds were channelled to companies waiting for their money (Unicredit 2016: 11; Ambrosanio et al. 2016: 236). Although for local governments only the lender changed, the long-term time horizon of repayment (30 years) brings this move conceptually near to what is usually called "unconditional bailout". Ambrosanio et al. express certain doubts that the money will ever be paid back and therefore speculate – not without reason – that soft-budget constraint problems might be the consequence.

There are similar examples: In 2014, the central government transferred €400 million to the city of Rome in order to avoid its almost certain bankruptcy (Ambrosiano et al. 2016: 244). Based on Law 154/2008, the central government provided exceptional subsidies as free, non-recurring grants to the municipality of Catania for an amount equal to some 20%

<sup>5</sup> But using modified-accrual (commitment-based) accounting.

<sup>6</sup> Relevant laws are Decree 35 of 2013; Decree 66 of 2014; Decree 102 of 2014.

of its annual current expenditures; in the same decree, the central government again provided an exceptional subsidy to the city of Rome as an annual amount of €500 million. An early example was the massive bailout of cities' debts in the early 1980s (known as the "Stammati decrees": Law 62/1977 and Law 43/1978) (Dyson 2014: 548).

One peculiarity of the Italian system of local public finance is the existence of a formal bankruptcy procedure for municipalities, provinces and metropolitan cities (Padovani et al. 2018: 6; Ambrosanio et al. 2016: 233). The law provides three typologies of financial distress: The most severe is default or bankruptcy (*dissesto*); the intermediate condition is pre-default (*predissesto*), which is a condition detected by specific indexes and thresholds ascertained through a series of central government checks; and the least acute is imbalance, which results in the rebalancing procedure (*procedura di riequilibrio*). The latter procedure was introduced in 2012 to help local governments in financial distress to find a solution other than bankruptcy by providing a revolving fund for cash advancements. Nevertheless, even local governments in the bankruptcy procedure have received financial help from the central government through special laws. A local government is considered to be in bankruptcy (*dissesto*) when (a) it is not able to continue its functions and essential services (i.e. service insolvency), or (b) it cannot pay creditors with regular resources (i.e. financial insolvency). There is no bankruptcy regulation for regions, apart from the health-care sector. This special procedure entails specific powers of control by the central government, a mandatory increase in regional taxation, and the provision of extraordinary funds.

In order to avoid the unpleasant state of bankruptcy, municipalities and provinces have the incentive to window dress by counting doubtful accounts receivable (*residui attivi*) as revenues to cover expenses (Ambrosanio et al. 2016: 234). These doubtful revenues are uncollected sums (e.g. due payments for fines or tariffs) that the municipality promises to collect in order to balance the budget in the coming period. However, they often do not fully materialise, and the municipality again uses these doubtful revenues as a recurrent argument in the future. Basically, this keeps the oversight body at arm's length without solving the issue of ongoing deficits. Therefore, the Court of Auditors uses the abnormal size of such accounts, especially those occurring in past years for local revenues (as grants and other capital revenues are fully collected), as one indicator to evaluate fiscal health on the local level.

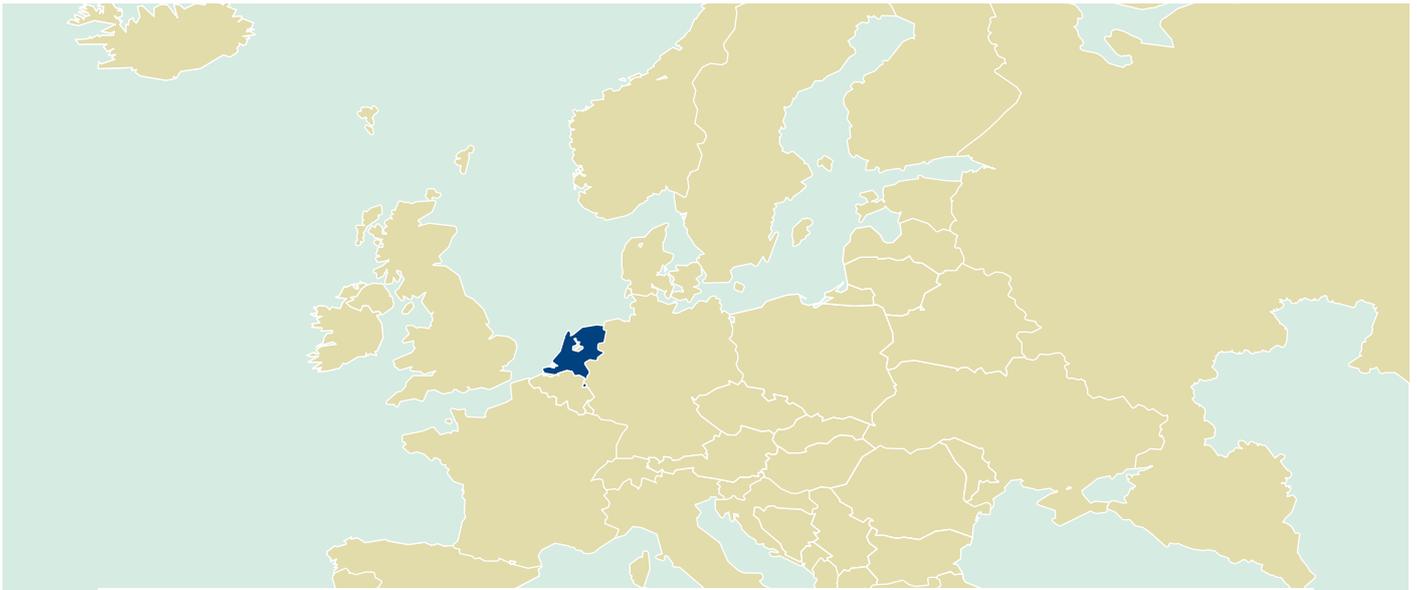
Since 2011, the Court of Auditors has been allowed to officially proclaim a municipality as being in financial distress. Local

governments declared in default are managed by a settlement committee (*organo straordinario di liquidazione*) appointed by the central government, which takes care of assets and credits clearance. This procedure usually increases the delay of creditors' payment by local governments and lasts five years, but with possible extensions to ten years; creditors may accept to be paid in a shorter time, but they may lose between 40% and 60% of their credits. All debts and credits concerning constrained funds, operations starting from the default declaration date onwards and, in particular, long-term and short-term bank loans and bond repayments are excluded from this special procedure and remain managed by ordinary institutional bodies. These must also increase local revenues and reduce expenditures so as to have a balanced financial situation.

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# 15 | Netherlands

Christian Raffer

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### Summary

The Dutch local level of government comprises provinces and municipalities. Moreover, there are also so-called water boards (waterschappen) and different forms of local-level cooperation (i.e. functional regions and common arrangements). The two-tier governmental system has one state level and a wide variety of central-local interrelations. The representation of The Netherlands below summarises the administrative structure, the financial situation and the system of fiscal regulation of the Dutch local level between 2000 and 2016. In general, Dutch local-level governments are in a rather stable financial situation due to extensive property sales in the past and a well-functioning equalisation mechanism. Among other consequences, this has led to a negligible number of local governments under fiscal distress. Although there is a well-established bailout procedure, hardly any municipality needs it. This is supported by a clear-cut oversight structure, where provinces supervise municipalities and central government directly supervises the provinces. Dutch local governments must comply with a set of numerical fiscal rules with a strong balanced budget rule at the centre.

An ongoing discussion was started by the 2015 decentralisation of social services, which was (from the perspective of many municipalities) not accompanied by sufficient additional central government transfers. Among various municipalities, this has led to shrinking reserves and a situation which might become a threat to financial stability.

## 1 Administrative Structure

The Netherlands is a constitutional monarchy and a unitary state (Bos 2012: 11; VNG 2008: 14). The current fiscal decentralisation reflects the constitution of 1848, which was designed by Prime Minister Thorbecke. The two-tier government consists of a national and a local level, whereas the latter comprises different jurisdictional entities. Since the idea of autonomous municipalities is quite alive in the Netherlands, the country calls itself a “decentralised unitary state” (Ministry of Finance 2013: 11).

Although the Netherlands has a two-tier government structure, it is a highly centralised country (Allers and Vermeulen 2013: 245). The Government of the Netherlands consists of cabinet ministers and the King. Many policies are determined at the national level but executed by the municipalities. Currently there are 12 ministries, which are responsible for policies of national relevance. In terms of local-level fiscal regulation, the Ministry of the Interior and Kingdom Relations and the Ministry of Finance are in charge. The decentralisation of central-level tasks to local-level governments causes ongoing debate between the different Dutch administrative layers.

Dutch local governments comprise provinces and municipalities. Additionally, there are so-called water boards (waterschappen), which are responsible for matters with regards to the area of water management (Diamant et al. 2016: 233). There are 12 Dutch provinces (Allers 2014: 5). They are regulated by the Provinces Act and governed by provincial councils, which are directly elected (Brand 2016: 29; OECD 2016). A commissioner, appointed by the King, is the head of each council. Since 2001, however, provincial councils have a certain role in the commissioner’s selection. The responsibilities of the provinces comprise the execution of national policies within their specific area, regional economic policy, regional planning and the financial and administrative supervision of the municipalities and water boards. Provinces should also take action when municipalities have far-reaching administrative problems or when there is a deep political crisis (Bos 2012: 45). Moreover, they provide services in the areas of traffic and transport, environmental protection, recreation, culture and heritage (OECD 2016). Until 2015, youth care was another provincial task, which was then transferred to the municipalities. Additionally, they play a key role in vertical co-ordination. Provinces (as well as municipalities) have tasks that they can fulfil autonomously and tasks for which they are jointly responsible with the national government (Diamant et al. 2016: 232). Although there are various control mechanisms executed at central level, this implies that provinces are, to a

FIGURE 15.1 Netherlands – Administrative Structure

Central Level	Central State
Regional Level	
Local Level	12 provinces
	355 municipalities
	Water Boards and intermunicipal cooperations

Source: own representation

TABLE 15.1 Netherlands – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Provinces	Zeeland (382,335)	Zuid-Holland (3,680,652)	1,432,001
Municipalities	Schiermonnikoog (933)	Amsterdam (855,896)	44,380

Source: own calculations, data: CBS 2018

certain extent, autonomous. The consolidation of provinces into larger regions has been under debate since the 1960s but has never materialised (OECD 2016).

Since the beginning of the modern-day Netherlands in 1848, the number of municipalities has decreased drastically due to a municipal merger process, from 1,209 in 1850 to 390 by January 2016 and 355 in 2019 (Bos 2012: 3; OECD 2016). With more than 40,000 inhabitants on average, Dutch municipalities are relatively large compared to other countries (Allers and Ommeren 2016: 720). They are subject to local elections (Bos 2012: 8). However, the official head of government, i.e. the mayor of a municipality, is by law appointed by the King by presentation of the Minister of the Interior and Kingdom Relations. In practice, the municipal council first selects the candidate who is then appointed. In 2002, a new law was enacted in order to increase accountability and democracy at the local level (Brand 2012: 43). The municipal council monitors and checks local government, i.e. the mayor and the aldermen. In the old system, aldermen were members of the council; this changed in 2002. Municipalities are regulated by the Municipalities Act (OECD 2016).

Today, municipalities are the closest form of government to the citizens (Brand 2016: 29). Part of their responsibility is to execute national policies in areas such as social services, primary education, urban regeneration, education, certain

health-care services, such as care for elderly or young people, and policing (Brand 2016: 37; Bos 2012: 3). This points to the fact that in the Netherlands many policies are determined at the national level and executed by the municipalities (Allers and Vermeulen 2013: 3). A major example is the local administration of welfare according to norms and benefits, which were determined nationally. Since the 1980s, the Dutch welfare state has been in the process of being redesigned in order to be smaller and more decentralised (Bos 2012: 3). In several waves, social services were transferred to municipal level. Social assistance and public care services have become more the responsibility of municipalities. Since 2006, municipalities have taken over various tasks related to the national social security arrangements for specialised care, e.g. nursing and cleaning services for the elderly and disabled. Further social sector provisions were transferred in 2015 (OECD 2016; Vermeulen 2015: 1), namely health care for the youth, long-term care and employment support for the disabled. The motivation behind this decentralisation is not only to make municipalities the main supplier of social services, which will then make them better able to tailor the provision for individual needs, but also the New Public Management (Ministry of Finance 2013: 33). Next to these social services, municipal tasks include urban development and land-use planning, employment policy, local roads and public transport, housing of primary and secondary education, local economic development, culture and recreation. Although municipalities are basically autonomous, according Article 124 (1) of the Dutch Constitution, their functioning is to a large extent subject to various control mechanisms from national government and its central decision over municipal tasks, carried out in cooperation (Diamant et al. 2016: 232 f.).

In relation to issues of safety, such as public order, fire or disasters, 25 functional regions have been established (Bos 2012: 42). Until 2013, there were 10 police regions, financed by the national government but operated by the municipalities (National Police Act 2013). Today, the police regions are regional units of the national police organisation. For the coordination of preventive health care, 63 functional regions were introduced in 1990 but scaled down to 25 regions in 2018. In addition, there is much intermunicipal cooperation, as well as cooperation between the water boards and municipalities on issues of mutual concern (Brand 2016: 29). From 1995, there were eight city-regions, which were intermunicipal cooperation entities (OECD 2016). However, since 2015 these have been abolished. The law created two new metropolitan governance arrangements for transport in Amsterdam and Rotterdam/The Hague. Municipalities may establish as many cooperative arrangements as they please (Allers and v. Ommeren 2016: 720). The Joint Provisions Act

enables them to create public bodies, which are separate administrative entities that may employ staff, own assets, borrow money, etc.

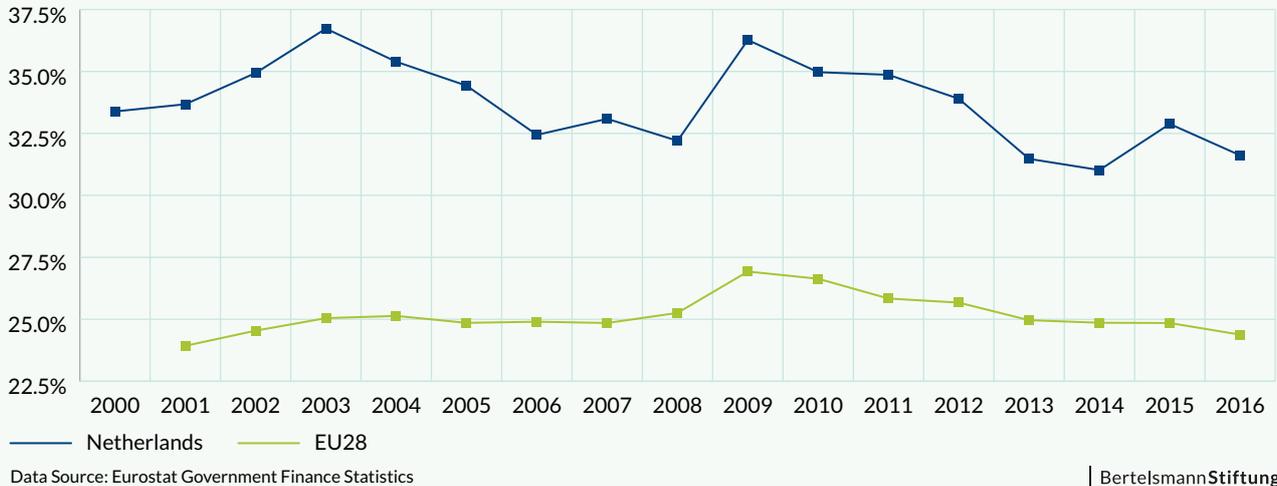
## 2 Revenue

Since Dutch municipalities and provinces provide a great number of services, they have a relatively substantial sum of money at their disposal, much higher than the EU average (Diamant et al. 2016: 233; Figure 15.2). Nevertheless, they are heavily dependent on funds provided by central government (Allers 2014: 5 ff.; OECD 2016). According to Statistics Netherlands, in 2013, two thirds of Dutch municipal revenue came from central government (CBS 2014). From 1997 to 2005, a complex formula-based grant system with 60 indicators was introduced, which has had an equalising function and has cushioned disparities. This applies to the general grant from the municipality fund and allows municipalities throughout the whole country to provide similar levels of service at similar rates of tax. However, since local taxation is relatively unimportant (in 2012, the average Dutch citizen paid €110 with regards to local taxes) and since there is a far-reaching decentralisation of responsibilities, the vertical fiscal imbalance, which comprises all local-level jurisdictions (also the provinces and water boards), is considerable.

The 1996 Financial Relations Act regulates the intergovernmental financial relations (OECD 2016). Transfers comprise general grants and several integration and decentralisation grants, which are all part of the Dutch Municipality Fund (Gemeentefonds). The Municipality Fund provides a major part of revenue to local governments. Additional specific grants cover the expenses of some, not all obligatory delegated tasks. The Municipality Fund consists of a lump-sum payment and covers the intermunicipal equalisation scheme. Another source of transfers are the provinces. These transfers are, however, negligible in size. Municipalities can also apply for bailout grants if they are unable to balance their books (Allers 2014: 451 f.). Provinces themselves receive general grants from the Provinces Fund, which also has an equalisation target, allocated payments from the government funds as well as specific grants for delegated tasks (OECD 2016). As Figure 15.3 shows, the local transfer share of total revenue increased from 2000 to 2015 and hovers around approximately 70%. One reason for this is the ongoing decentralisation of services to the local level paralleled by additional transfers.

Compared to other countries, only a small share of local expenditure can be covered by local taxation (Allers and Vermeulen 2013: 4; Bos 2012: 8; Figure 15.3). Local taxes

FIGURE 15.2 Netherlands – Local Government Aggregate Revenue  
As Share of General Government Revenue – From 2000 to 2016



are levied by municipalities, provinces and the water boards. About half of municipal tax revenue (including user fees) comes from property tax, based on a property's value (OECD 2016). In 2006, part of the local property tax was abolished by the national government and replaced by a general transfer (Bos 2012: 42). In 2006 and 2007, the remainder of the local property tax was subject to maxima for the rate and its annual increase. In 2008, the central government imposed a ceiling on the total rise in property tax revenues of all municipalities (Allers and Vermeulen 2013: 4). However, this ceiling is not legally binding but more of a "gentleman's agreement" between the central government and the association of municipalities (VNG). For individual municipalities it is irrelevant. Other municipal taxes are a tourist tax, dog tax, a tax paid for the use of municipal land, etc. (OECD 2016). Provincial tax revenues come almost entirely from a surtax on the motor vehicle tax; they make up more than 20% of provincial revenue. Unlike many other countries, tax sharing is not a funding mechanism employed in the Netherlands (Ministry of Finance 2013: 12). Water boards are almost 100% funded by the fees they levy for their services.

Another relevant source of revenue are user charges such as the sewerage charge and fees that made up of 13% of total revenue from local-level governments in 2013 (OECD 2016). Municipalities and provinces source additional revenues in the form of dividends from energy companies. However, most of these shares have been sold recently (Essent and Nuon) or are about to be sold (Eneco). This allowed the building up of considerable reserves, which makes withdrawals from reserves a further form of many local governments' revenue.

Revenue of Dutch local-level government (municipal, provincial and water board) amounted to an average of 14.5% of nominal national GDP between 2000 and 2016. Measured as a share of general government revenue, the period average was 33.78% (Figure 15.2). This was well above the EU28 average of 25.2% in this period and implies the relative importance of the local level in the Netherlands. Over time, however, this share decreased from (on average) 34.8% in the first five years from 2000–2004 to 32.2% in the last five years from 2012–2016. Considering the far-reaching decentralisation of services in the past decades, this decreasing local share of general government revenue is somewhat counterintuitive.

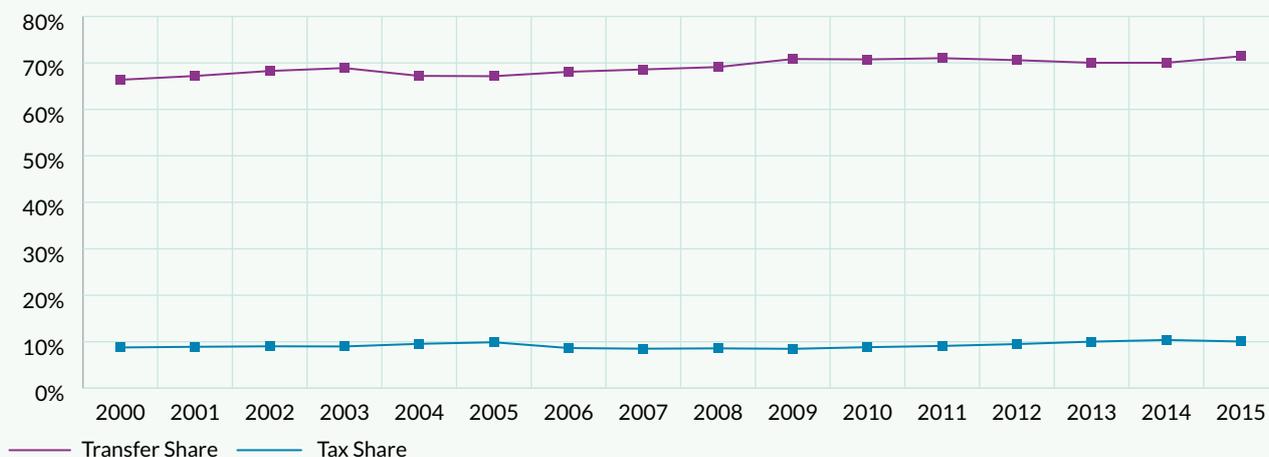
Considering the tiny share of local tax revenue and the relative importance of central government grants, the financial autonomy of Dutch municipalities and provinces seems to be rather limited. This impression is corroborated by the huge vertical fiscal imbalance as depicted by the high transfer share. Hence, although the idea of autonomous municipalities is still relevant in the Netherlands (Ministry of Finance 2013: 11), it cannot fully live up to the reality.

### 3 Expenditure

Local expenditure (combined expenditures of municipalities, provinces, water boards and further intermunicipal organisations) accounted for 33.3% of general government expenditure between 2000 and 2016 (Figure 15.4). This average value is above the EU28 average of 23.9% from 2001 to 2016 and therefore indicates the above-average importance

FIGURE 15.3 Netherlands – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015

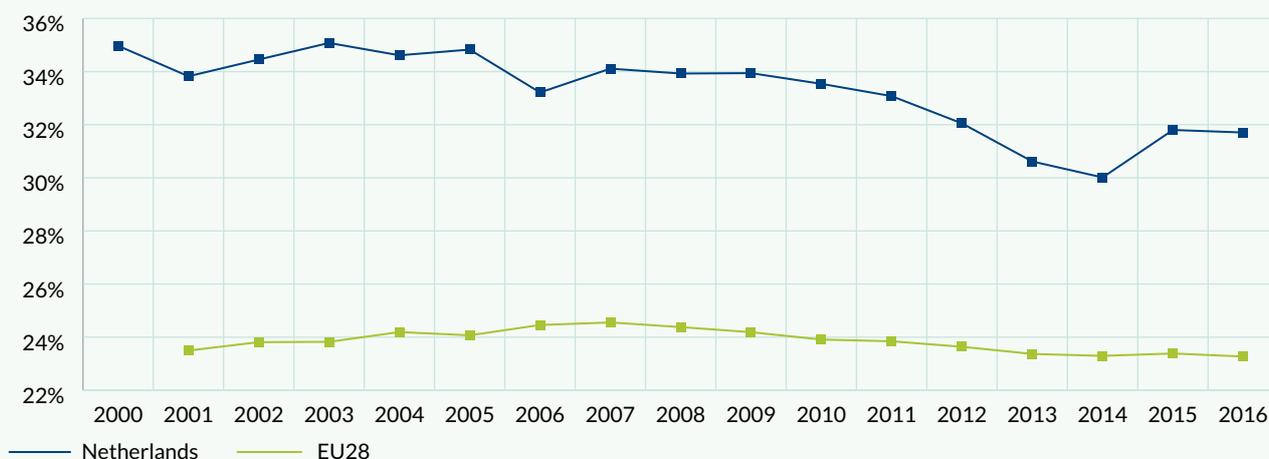


Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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FIGURE 15.4 Netherlands – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

| BertelsmannStiftung

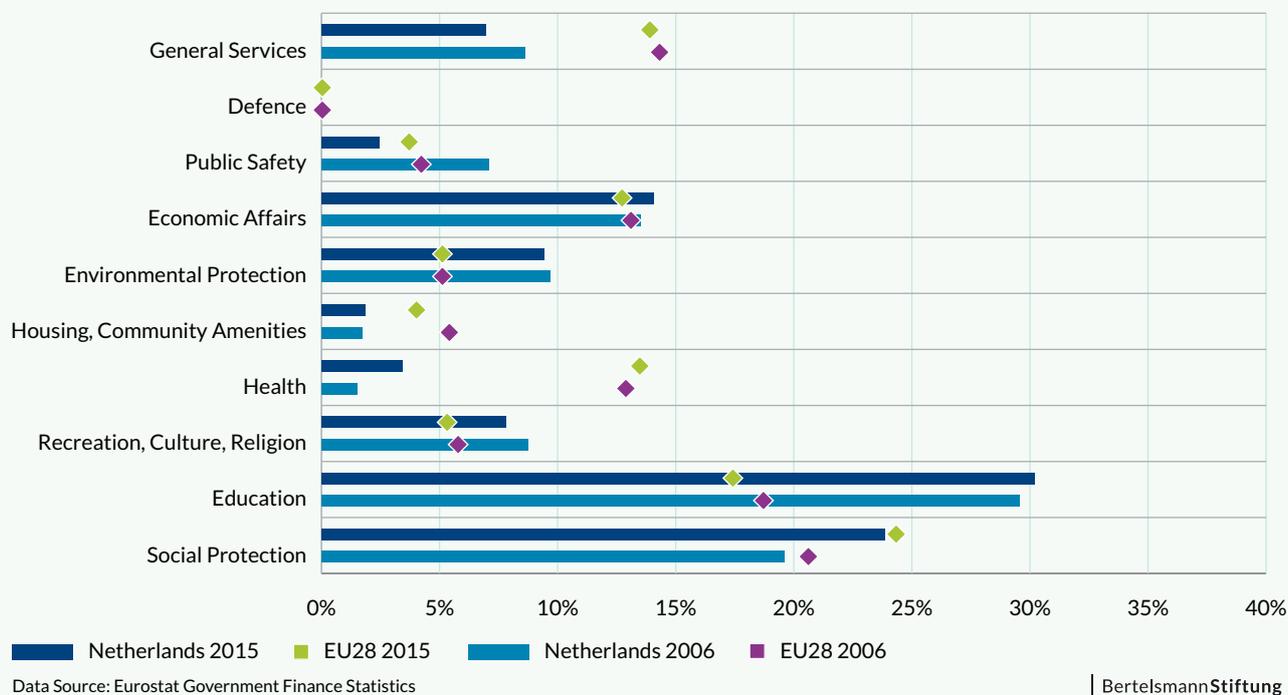
of Dutch local-level governments in the European context. Over the whole period of interest this local government share, however, decreased from an average of 34.6% in 2000–2004 to 31.2% percent in 2012–2016. The 2015 increase of expenditure refers to the decentralisation of social services.

Education, social protection, environmental protection (including waste and sewerage management) and economic affairs are among the most important expenditure functions at the local level (Figure 15.5). Education and social protection increased in relative importance from 2006 to 2015. The changes in the social protection segment have been quite obviously induced

by the decentralisation of social services from the central to the municipal level in 2015, which led to additional transfers of €7 billion (CBS 2016). Still, the changes in this segment are rather similar to the EU28 average. This is different with regards to education, for which the Dutch local level spends a much higher share of its resources than the average EU28 member state. Municipalities are responsible for school buildings. Other costs relating to education (teachers' wages, etc.) are paid by the central government. On the other hand, health and general services are less important in the Netherlands.

FIGURE 15.5 Netherlands – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



Compared to other countries, the expenditure of local governments for salaries are significant (OECD 2016). They also play a key role in public investment. The comparison of the expenditure shares of municipalities and provinces reveals that municipalities are by far the most important type of local government entities (Bos 2012: 7). The amount of money spent by municipalities exceeds the provincial and water boards' share by far.

#### 4 General Fiscal Status

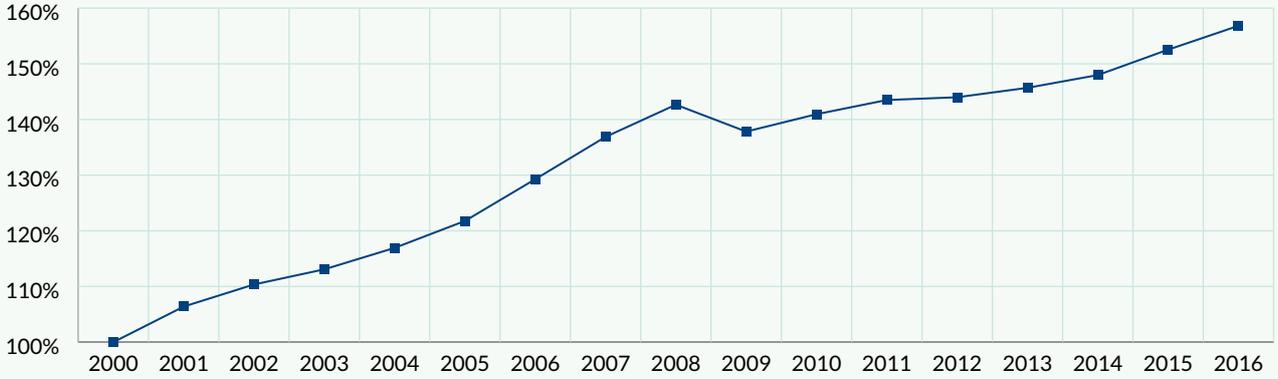
The financial crisis hit Dutch local governments hard and it took some years to overcome the consequences. In 2016, cumulated budget balances reached positive numbers again (Figure 15.7). Local debt rose to its maximum height in 2013 and, after some decline, has been stagnating since 2014 (Figure 15.9). Local government debt in the Netherlands amounted to an average of 8.2% of national nominal GDP between 2000 and 2016; it is slightly above the EU28 average for the same period of time. Although local government debt, as a share of GDP, remained rather constant over the whole period, its share of general government debt decreased significantly (Figure 15.8) from an average of 17.3% from 2000–2004 to an average of 12.8% from 2012–2016. This, however, is due to the post-crisis

increase in central government debt, partly due to the bailout of private sector financial institutions. Since local government debts, as share of GDP, remained stable over the same period, their drop as a share of general government debt is rather a technicality than the result of exaggerated debt reduction at the local level. Compared to other European countries, the local government share of public debt in general government debt is constantly and considerably above average.

The aggregate local government budget showed an average deficit of 0.4% of nominal GDP over the entire period of interest. As Figure 15.7 shows, there is significant variation in the deficit. After a heavy post-crisis drop in 2010 to over 1%, it recovered rather quickly and even turned into a small surplus in 2016. Although the budget deficit shows a development similar to the EU28 average, it exceeds it in absolute values in almost every year – especially in the post-crisis year 2010, in which the Dutch local deficit was more than twice the average EU28 dip. According to experts, this was caused by social support grants, which the national government did not compensate for in 2009 to 2012 and by a dramatic temporary drop of municipal land sales to project developers after the crisis. The value of land had to be reduced on the balance sheet. In accrual accounting, this reduced the budget balance. Nevertheless, the local debt as a share of nominal GDP remained rather stable.

FIGURE 15.6 Netherlands - Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

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FIGURE 15.7 Netherlands - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2000 to 2016

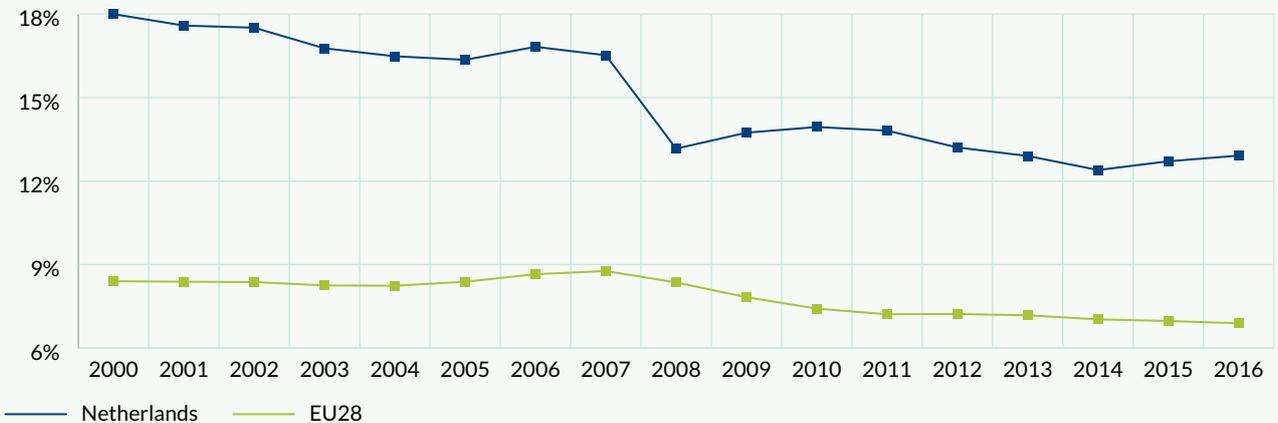


Data Source: Eurostat Government Finance Statistics

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FIGURE 15.8 Netherlands - Local Government Aggregate Debt

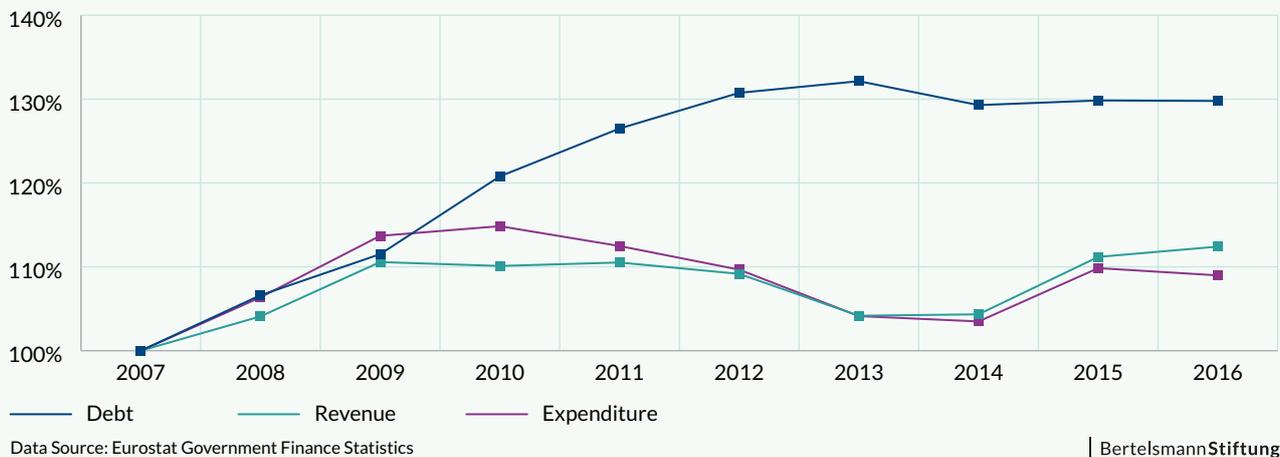
As Share of General Government Debt - From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 15.9 Netherlands – Post-Crisis Developments  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



## 5 Effects of the Financial Crisis

Since the financial crisis in 2007, the absolute debt level of local governments in the Netherlands increased by only 30% compared to its value in 2007 (Figure 15.9). Since then, it has not yet reached its pre-crisis level. Other main financial aggregates at local level, i.e. revenue and expenditure, developed even more moderately. After an increase until 2010, they decreased until 2014 and then increased once again. The latter increase was induced by the 2015 transfer of social services from national to municipal level. This shift towards more decentralisation can also be regarded a consequence of the financial crisis (Vermeulen 2015: 2). As municipalities are expected to provide these services more efficiently, their budgets are being cut considerably compared to prior expenditure on these tasks. In the light of the need for fiscal consolidation after the “Great Recession”, these budget cuts are one of the main motivations for the decentralisation.

## 6 Fiscal Rules and Fiscal Oversight

Provinces and the Ministry of the Interior and Kingdom Relations are in charge of oversight. General fiscal oversight of municipal (and water board) finances is assigned to the provinces (Allers 2014: 12; Brand 2016: 29). In normal times, they conduct ex post supervision, meaning that they evaluate if municipalities are complying with existing fiscal rules such as the balanced budget rule by evaluating their budget estimates for the subsequent four years; they also assess fiscal stability with a set of five key figures (e.g. debt ratio, solvency, etc.).

For this reason, municipalities must submit budgets for the subsequent four fiscal years to the province. However, if the municipal budget is not structurally balanced or if financial problems loom on the horizon, ex ante financial supervision may be imposed. This procedure, known as “preventive supervision”, may also happen if a municipality does not comply with fiscal rules with respect to a timely enactment of the budget and annual accounts. Although all provinces are subject to the same national law, there exists a certain freedom to decide when to force a municipality into preventive supervision. Hence, some provinces are regarded as being stricter than others. Currently, the Ministry of the Interior and Kingdom Relations is working on a reform to equalise this idiosyncrasy within the coming years.

Whereas the water boards are also supervised by the provinces, provincial budgets are overseen by the central government. Once a municipality and a province cooperate on certain projects, the respective municipality is also overseen by the central government in order to avoid conflicts of interest. The legal bases for local government fiscal regulation and existing numerical rules are the Municipal Law (Gemeente wet), the Financing of Decentralised Authorities Act (FDAA), the BBV (Besluit Begroting en Verantwoording) – a law that enshrines the principals of the budget and reporting – and the Financial Relations Law.

By far, the most important regulation for municipal budgets is the balanced budget rule, enshrined in Municipal Law. If a municipality experiences a real and structural deficit, the provincial supervisor can allow it, as long as the budget is balanced over the subsequent three-year period. If not, the

province will force the municipality into preventive supervision. In such a case, the municipality will need to submit budgets to higher levels of government for approval. In addition to this rather severe loss of fiscal autonomy, the municipality will have to work out a distinct recovery plan with expenditure cuts and ideas on how to increase revenue (e.g. by tax rate increases). If a municipality categorically refuses to obey the fiscal rules, in a last step, the central government could take over and send a national commissioner; this happened only once in the 1950s. Dutch municipalities perceive preventive supervision as an unavoidable and a rather embarrassing consequence of fiscal misbehaviour. Hence, not many municipalities have gone into preventive supervision in the past two decades (Raad voor de financiële verhoudingen 2017). Between 2013 and 2017, the average share of municipalities under preventive supervision was 2.4% (from 1997 to 2001 it was 4.3%). This legal obligation and strict compliance with the balanced budget rule, however, does not rule out deficit financing (Allers 2014). Different to the central government, which applies cash accounting (*kas-stelsel*), municipalities use accrual accounting (*baten-lasten-stelsel*). That means that expenditures in order to acquire assets do not appear in the budget in the year of acquisition but are spread out over the economic life of the assets, in the form of interest and depreciation (as in business). Thus, a municipality may borrow heavily while at the same time it presents a balanced budget.

In general, Dutch municipalities do not face far-reaching restrictions with regards to their debt behaviour. The bailout-mechanism effectively prevents bankruptcies and, in turn, municipalities are rated as highly secure borrowers, which gives them free access to cheap loans. These, however, are bound to public services and cannot be taken out for risky (private-sector-like) endeavours. In addition, there is a short and a long-term debt ceiling. These apply more to the term structure of government debt than to total debts (Allers 2014: 11) and therefore aim to prevent interest rate risks rather than high debt levels. The short-term ceiling demands that, for municipalities, the average net short-term debt (due within one year) is limited to 8.5% of budgeted spending for each quarter of a fiscal year. The long-term ceiling limits the amount of long-term debt (maturity more than one year) for which the interest rate is subject to change in a given year to 20% of budgeted spending. These ceilings can indirectly limit the amount municipalities can borrow in practice. As Allers (2014: 11) points out, in 2010, the short-term debt ceiling was broken by a significant number of municipalities in at least one quarter. He concludes that breaking this rule does not immediately result in sanctions from the province. Hence, Dutch law does not subject municipal debt to an effectively binding regulation.

Dutch municipalities mostly borrow from banks (Allers 2014: 13). Since they are free to apply for bailout grants, interest for credit is low and banks are open to provide finance. The two Dutch Banks, BNG Bank and NWB Bank, specialise in loans to local government. There are no legal limits on the amount municipalities or intermunicipal organisations can borrow (Allers and van Ommeren 2016: 721). Only some of the bigger municipalities may issue bonds or hold loan auctions. However, the possibility of issuing bonds is rarely used, since for small municipalities this is impractical and costly (OECD 2016).

The European fiscal policy targets refer to the whole government sector, i.e. including local government (Bos 2012: 43; Diamant et al. 2016: 236). After the Dutch government deficit had surpassed the EMU target of 3% in 2003, due to an unexpected and large local government deficit, municipalities and provinces were obliged to report their net financial balance. If the whole Dutch government deficit comes close to 3%, a deficit ceiling for each municipality and province becomes effective. The Coalition Agreement and the 2013 Sustainable Public Finances Act (SFA) comprise new budgetary rules, which render the national government and the decentralised authorities jointly responsible for adhering to this EMU deficit ceiling and consequently stipulate that local governments must make similar efforts to those of central government to comply with public finance targets (OECD 2016). Currently, local-level government has a share of 0.3 percentage points of the whole 3%. However, these 0.3 percentage points are for local-level government as a whole and not for each municipality or province. In addition, the EMU deficit ceiling refers to the central government cash accounting practice and not to the local government method of accrual accounting. Therefore, local governments report the EMU deficit in their budgets to central government but according to experts this indicator has no practical relevance.

Another recently enacted limitation on the budget authority of local authorities, established in Article 2 (1) of the Financing of Decentralised Authorities Act, involves the obligation to save the surplus in the National Treasury instead of their own bank account. However, the unfavourable interest rate situation incentivises municipalities to stay below the cash limit.

Article 12 of the Financial Relations Act opens the possibility to municipalities to apply for supplementary bailout grants, if revenues are significantly and structurally insufficient to cover necessary outlays (Allers 2014: 6 ff.). However, the applicant's tax rates need to be sufficiently high. Bailout money is taken from the Municipality Fund and is unconditional, so other municipalities effectively pay for the bailout. The central government decides if a municipality is to be

eventually bailed out. The average bailout period lasts three to four years. During this time, the municipality in question is under forced administration and cannot decide freely on increases in expenditure or decreases in revenue. In addition, the municipality must cut back on spending. Receiving municipalities can be subjected to various measures such as the obligation to set up a debt restructuring plan or a recruitment freeze (Diamant et al. 2016: 237). The whole process is overseen by the Ministry of the Interior and Kingdom Relations. According to the ministry, bailout grants are only conceded if the applying municipality came under fiscal distress without any severe fiscal misbehaviour. That means if a municipality needs to be bailed out due to irresponsible and risky decisions, the Ministry of the Interior will not grant the bailout money but, instead, will provide a loan to the municipality, which eventually has to be repaid. In 1976, the first year in which bailout grants, under Article 12 of the Financial Relations Act, were possible, 15% of all municipalities were recipients (Allers 2014). Between 1998 and 2014, only ten bailouts ensued (Allers and van Ommeren 2016: 721). Since 2014, there have been another two municipal bailouts. Currently, the municipality of Vlissingen in the province of Zeeland is the only municipality which is going through a bailout procedure. Due to the ongoing amalgamation of Dutch municipalities and since bailouts occurred mainly in smaller jurisdictions, bailouts have become rather rare in the past years. Another reason for the heavy drop in bailout procedures was the improved fiscal equalisation system, implemented from 1997 to 2005, which improved the situation for less affluent municipalities. Since 1998, only 12 municipalities have been bailed out.<sup>1</sup> A comparable bailout mechanism for provinces does not exist. Due to this effective bailout mechanism, municipal bankruptcy is not possible in the Netherlands.

In terms of public spending at the local level, some components of the provincial and municipal budgets (e.g. specific and additional allowances) are attributed to pre-defined objectives and therefore underlie a strict oversight and regulatory scheme (Diamant et al. 2016: 237). This applies in part to earmarked grants<sup>2</sup> (specifieke uitkeringen), the importance of which has decreased considerably in the last two decades. The Dutch Minister of the Interior and Kingdom Relations checks for the objective-related and rule-conforming spending of these allowances.

Within each fiscal year, municipal councils must approve the budget plan for the subsequent four years by 15 November. These plans are submitted to the province, which then conducts its fiscal supervision. Some municipalities also forward interim reports and budget forecasts to the province, but this is not mandatory. By 15 July of each fiscal year, the municipal council has to approve the report of its annual accounts, which also comprises the audit report from a private sector auditor (exceptions: only Amsterdam and The Hague do not engage private auditors since they have own auditing departments). The annual accounts also need to be forwarded to the overseeing province.

Every municipality must have an independent Court of Auditors (Rekenkamer), which investigates the efficiency and the legality/lawfulness of the municipality's policies. Such a court typically conducts several studies a year for aspects of municipal policy, which it chooses itself. It reports to the municipal council. Furthermore, municipal councils may install audit committees. The administration also employs auditors who prepare the audit of the annual accounts. After approval, the annual accounts are sent to the supervising province.

1 These were Muiden, Vlissingen, Boarnsterhim, Loppersum, Ouderkerk, Neder-Betuwe, Nieuwkoop, Simpelveld, Boskoop, Winschoten, Millingen, and Ten Boer.

2 By far the most important one is the earmarked grant for welfare benefits. Here, however, any surplus in the welfare department can be spent freely.

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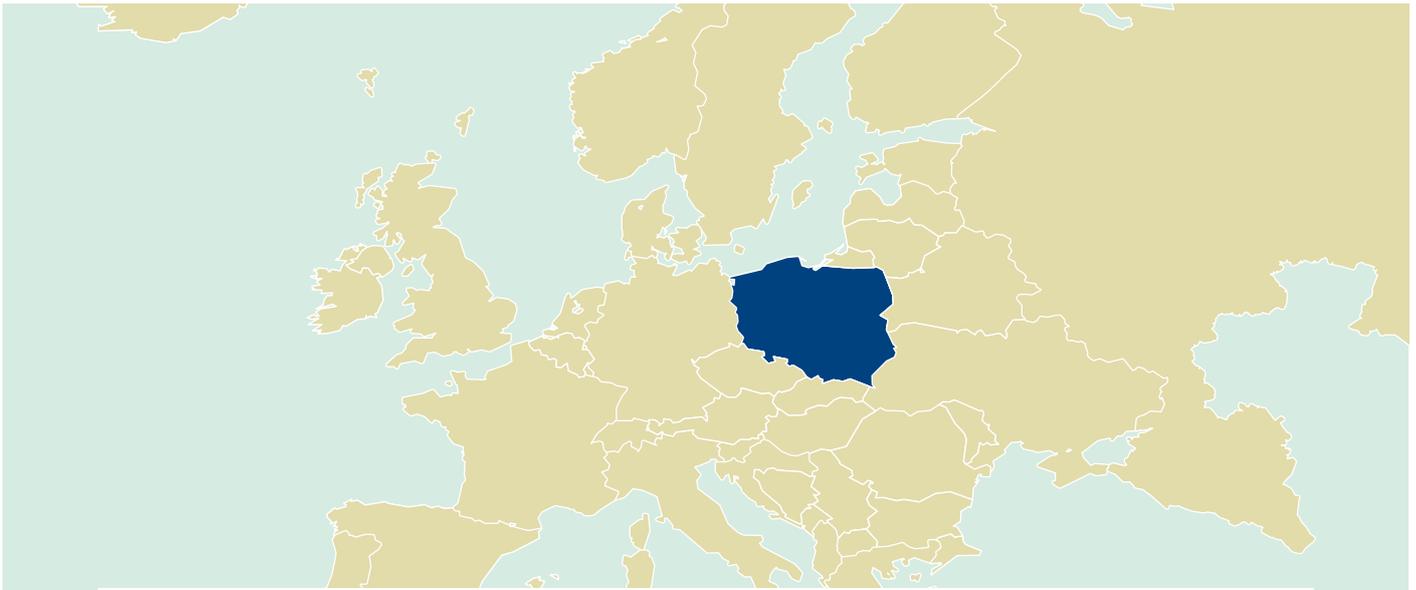
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# 16 | Poland

René Geißler

### Summary

The Republic of Poland is a centralised state, built upon three local self-governing levels: voivodeships, counties and municipalities. More than 50% of local revenue is based on shared taxes (personal income tax and corporate income tax), from which all three local levels of government benefit to different extents. Finally, only the municipal level enjoys financial autonomy and sets its own rates, for example on property tax. Beyond this, there are different types of state grants, of which educational grants are the most important. Education is the most relevant local service, followed at some distance by health and economic affairs. Different levels of local government are in charge of different services within a policy. With this, expenditure by service will vary widely among the tiers of local government. There are large differences in the economic strength among local-level jurisdictions but currently there are no budget crises. Fiscal crisis is reflected in slower economic growth but no recession. Nonetheless, local governments have generated deficits and local debt has become a serious issue.

Generally, debt is restricted to capital spending and budgets must balance. The Public Finance Act of 2009 substantially strengthened the institutional setting by enhancing

transparency, budget consolidation and debt reduction. In particular, this law implemented a new balanced-budget rule and individual debt limits for each local government, which came into effect in 2014. Ever since then, debt ceilings have been based upon a uniform formula integrating several local indicators. Constitutionally, there is legal supervision of all local government activities. Supervision of local finances is delegated to the regional Chambers of Auditors, as statutory and independent bodies.

Local governments are legally obliged to present their draft budget to the regional chamber at the end of the preceding year. If the local government breaks any existing rules, it may lose its right to budget. In such a case, the regional Chamber of Auditors will determine this year's budget as restricted to mandatory duties only.

## 1 Administrative Structure

The Republic of Poland is a unitary state. Following territorial and administrative reform in 1999, it is built upon three self-governing levels of local government. Although, for example, counties are structured into municipalities, there is no subordination of one local tier to another (Sauer 2013: 9). There are 16 voivodeships, which are both units of state administration and regional self-administration. In line with this double structure there are two top executives: (1) the Prefect, as the highest representative of the central government, is appointed by the Prime Minister and is in charge of overseeing self-administration with regards to the implementation of delegated national tasks and (2) the Marshal, elected by representation, is responsible for the activities of self-administration (Sauer 2013: 6). Amongst others, classified as NUTS 2, voivodeships are in charge of implementing EU programmes. This level is seen as financially and functionally weak (Swianiewicz 2014: 296). With regards to EU statistics, voivodeships are categorised as local governments. The actual local level consists of two tiers: counties and independent cities as well as municipalities (OECD 2016). The county level is less important for public service provision and has more restricted discretion than that of municipalities to determine its own policies (Swianiewicz 2014: 303).

When it comes to functions and autonomy in general, municipalities are the most relevant group of local governments. The 1990 Act on Municipalities gave them a wide range of responsibilities, including spatial planning, infrastructure development, utilities, municipal housing, social services (including family benefits since 2004), education (including teachers' salaries), basic healthcare and culture (Sauer 2013: 9 ff.). Constitutionally, municipalities received a general responsibility to fulfil any local task, unless a specific law delegates any service to other bodies.

FIGURE 16.1 Poland – Administrative Structure, 2017

Central Level	Central State	
Regional Level	16 voivodeships	
Local Level	315 counties	65 city counties
	2,478 municipalities	

Source: own representation

TABLE 16.1 Poland – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Voivodeship	Lubusz (1,023,000)	Masovian (5,302,000)	2,400,000
County	Sejny County (21,000)	Poznan County (292,000)	80,800
City counties	Sopot City Council (40,000)	Warsaw City Council (1,701,000)	197,000
Municipality	Krynica Morska (1,300)	Pila (77,000)	10,200

Source: Statistics Poland

All three levels have elected representation and their own budgets. There are special laws regulating the duties, organisation, status, financing, etc. of the voivodeships, counties and municipalities. Local governments carry out their own and delegated tasks (see Sauer 2013: 6 ff. for a list of examples). Overall, considering all three tiers of local government, local relevance is quite high (Figure 16.2).

## 2 Revenue

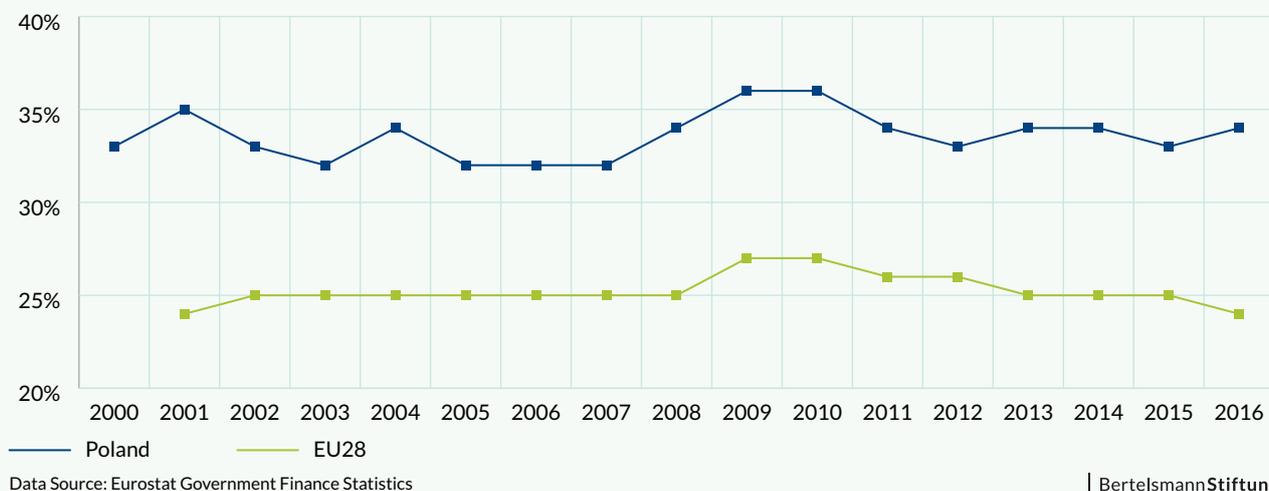
The principle of financial autonomy finds its constitutional expression in Art. 167, paragraph 2 of the Polish constitution. This article provides local governments with a share in public funds according to their tasks, and lists three main categories of revenue (their own revenues, general grants and special grants). The larger share of Polish local funding comes from state grants, whereas the share of taxes is significant and rising (Figure 16.2). Financial provisions stemming from the 1998 Act on Local Government Revenue were reformed in 2003 and 2004. Generally, counties and voivodeships rely mainly on state grants, whereas municipal funding is more diverse.

Local governments receive shared taxes (personal income tax and corporate income tax) as well as their own local taxes (municipalities only). Taxes sourced by municipalities themselves include a property tax on land and buildings, an agriculture land tax and a forestry tax (Sauer 2013: 14 f.). Taxes account for about a third of local revenue.

The largest share of revenue (50%) derives from different types of state grants:

FIGURE 16.2 Poland – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



- Half of the state grants are dedicated to education. Amongst others, this grant is based on the number of pupils and teachers. Nonetheless, hardly any city is capable of covering its educational spending using only these grants (Swaniewicz 2017: 236 f.). Therefore, there is an ongoing debate on the total amount of this grant and its distribution. Although this grant is meant and calculated for the funding of education, there is no specific regulation and follow-up mechanism on how the money is spent in the end. Formally, it is part of the general-purpose grant.
- Equalisation grants are intended to balance differences in taxation capacity among each tier at local government level and are fully financed by the state budget. Balancing grants focus on the distribution of funds among local governments within one tier. They are funded by payments from municipalities with high tax capacity.

Beyond this, there are some types of earmarked grants, of which those relating to funding state-delegated tasks are the most relevant.

Art. 168 of the Polish constitution guarantees local governments the right to set their own taxes. Nonetheless, taxes are regulated by a number of acts and statutes such as the Local Government Act and the Law on Local Revenue. Finally, only the municipal level enjoys financial autonomy and collects its own taxes. Municipalities are free to set rates for local taxes within a range regulated by national law but are not allowed to impose new taxes (Ofiarska 2015: 269 f.). The average tax revenue from municipalities covers about 20%

of their spending; more than half of this is based on property taxation (Swaniewicz 2016: 168). Taxes play a limited role in local politics (Swaniewicz 2016: 187). The Law of County Self-Government and the Law of Voivodeship Self-Government do not include any provisions relating to sources of own their revenue.

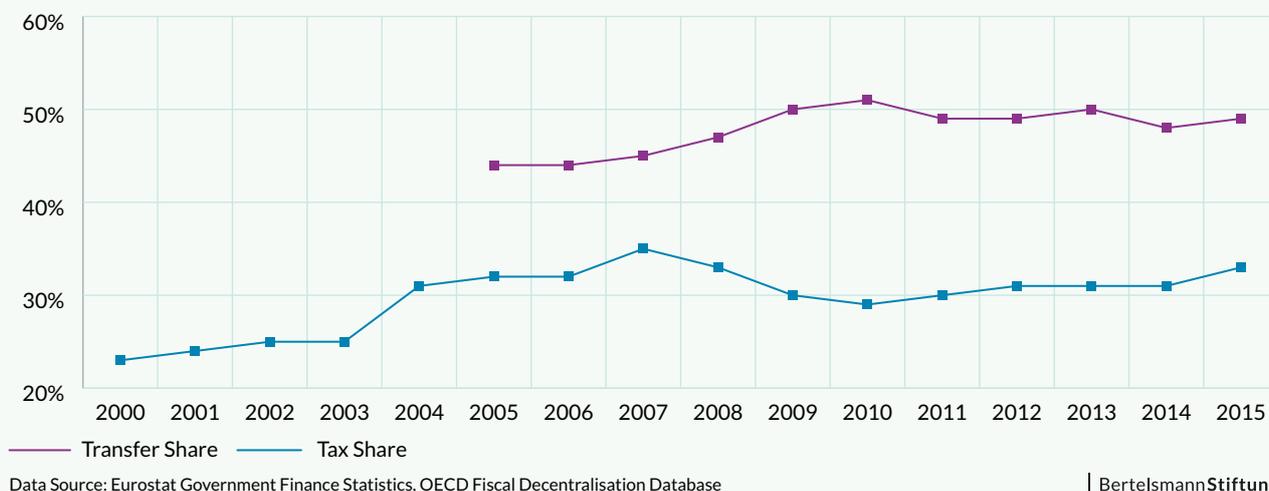
Generally, Poland is a rather decentralised country, showing the highest share of local government spending in Eastern Europe; it is also well above the EU28 level (Swaniewicz 2014: 297; Figure 16.4). Finally, far-reaching autonomy only refers to municipal level. The extent of self-revenue generation is low and local governments rely heavily on state grants. There is a system of financial equalisation based on vertical and horizontal transfers.

### 3 Expenditure

When it comes to spending, education is the most relevant function, followed at some distance by health and economic affairs (Figure 16.5). Different levels of local government are in charge of different services within a policy area. With this, expenditure by function will vary widely among the tiers of local government. For example, municipalities finance primary schools and counties secondary schools. As a consequence of the differing cost intensities and further functions for which they are responsible, the share of each tier's budgets affected by education differs. In general, the lion's share of local expenditure (76% in 2009) is made by municipalities (Kopanska 2011: 115).

FIGURE 16.3 Poland – Local Government Aggregate Transfers and Taxes

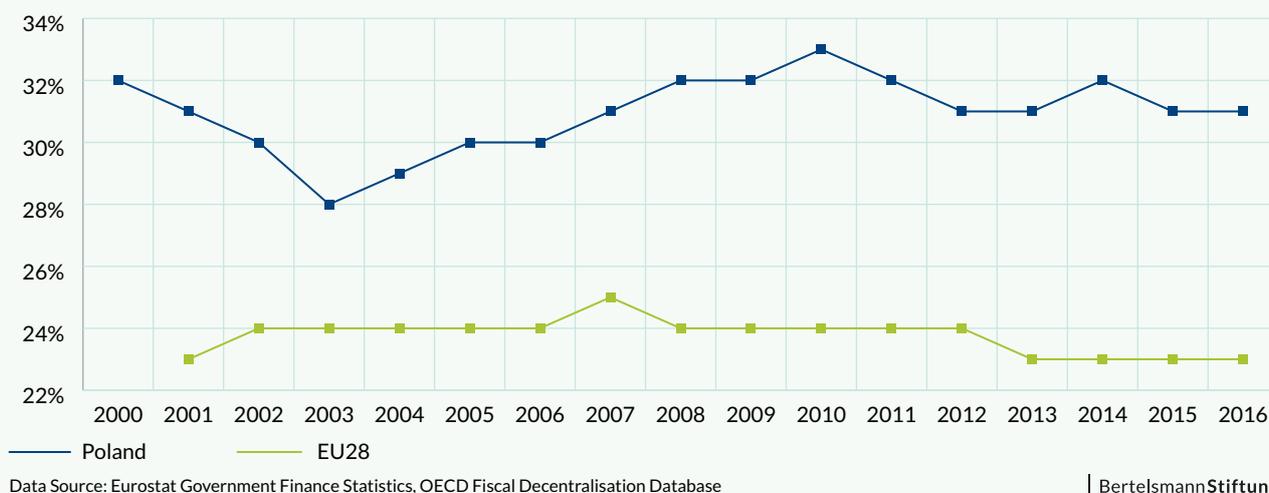
As Share of Total Local Government Revenue – From 2000 to 2015



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FIGURE 16.4 Poland – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



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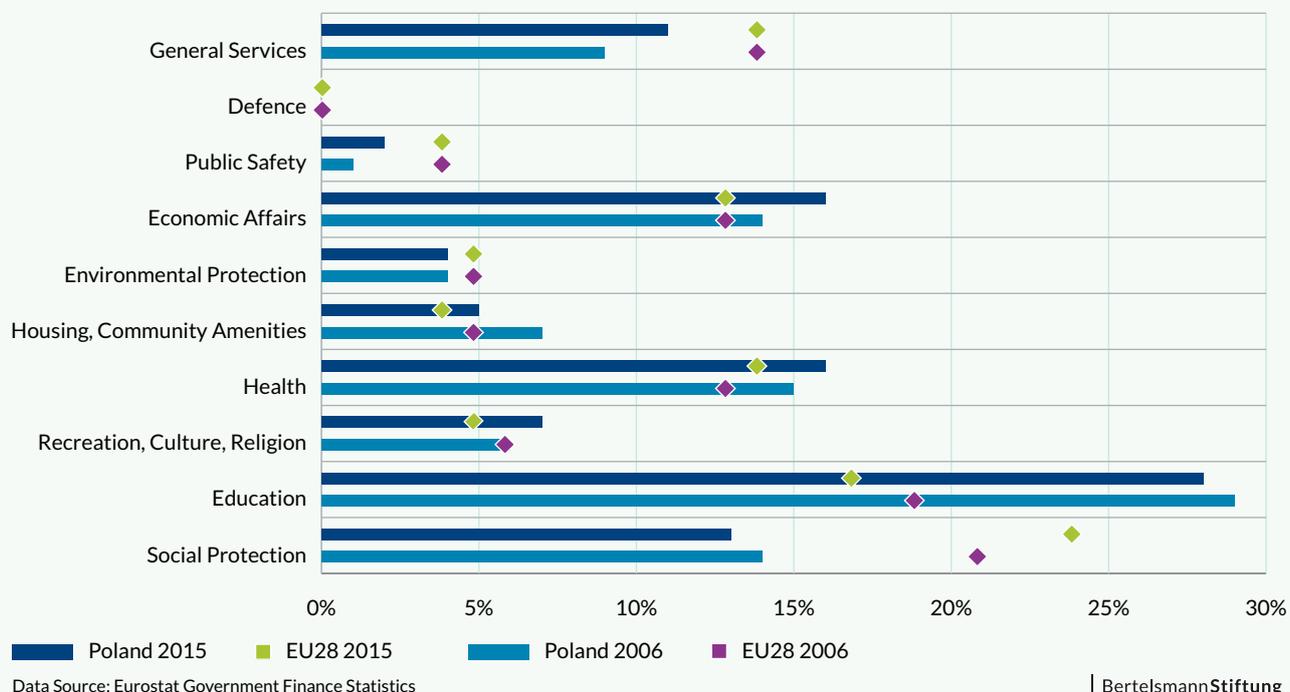
The 1990 Act on Municipalities gave a wide range of responsibilities to municipalities. Amongst others, the most relevant are spatial planning, infrastructure development, utilities, municipal housing, social services (including family benefits since 2004), education (including teachers' salaries), basic healthcare, and culture (Sauer 2013: 9 ff.). Constitutionally, municipalities have a general responsibility to fulfil any local task, unless a specific law delegates a service to other bodies.

Counties are in charge of an enumerated list of functions, devolved by law. In contrast to municipalities, they do not have a general responsibility. Rather, responsibilities include secondary education, social welfare, economic activity and job creation (employment offices).

Voivodeships are responsible for issues pertaining to regional importance, which are also devolved by law. Their role in providing public services is limited. Their main responsibilities lie in regional economic development, regional roads and public transport (including railways since 2009) and higher education.

FIGURE 16.5 Poland – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



## 4 General Fiscal Status

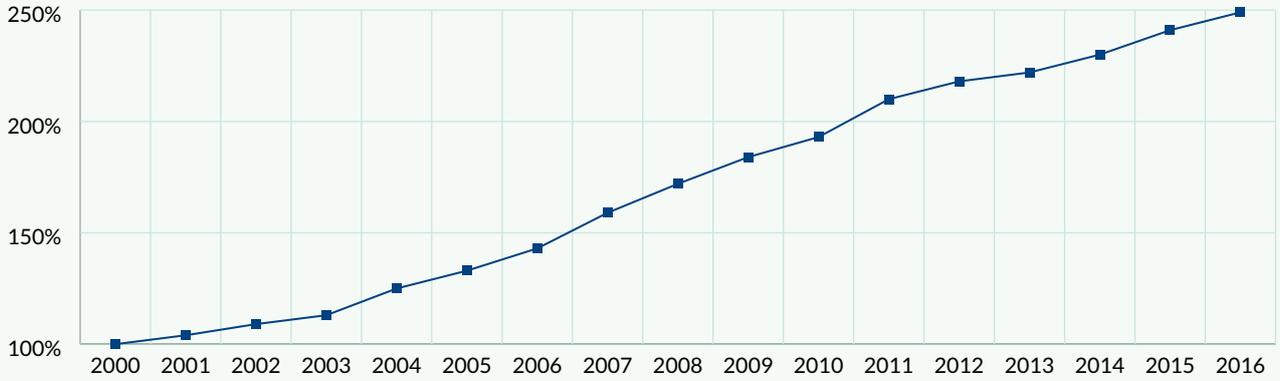
In regional comparison, Poland's system of local finances is quite solid. These days, there are large differences in economic strength (even after equalisation) but there is no real budget crisis. Budget balancing has been improving since 2010, when it hit the post-crisis rock bottom, rising to a surplus in 2015 (Figure 16.7). In terms of aggregate figures, the financial crisis affected Polish local governments between 2009 to 2011. In parallel, the financial crisis escalated the local level of debt, which had been stable throughout the previous years (Figure 16.8). Nonetheless, this aggregate data might be misleading to some extent. Counties with city rights held the relative majority of debt (46%). This situation mirrors the high need for capital spending within metropolitan areas. Counties and voivodeships count for less than 20% in total (Treasury of the Republic of Poland 2014: 16). There is no significant regional spread of local debt.

## 5 Effects of the Financial Crisis

During the financial crisis, Poland did not experience an economic recession but rather stable growth (Figure 16.6). Nonetheless, local governments had been in deficit for several years previously (Figure 16.7). Consequently, deficits escalated by 2009 and local debt became a serious issue (Galinski 2015: 379; Uryszek 2013: 253; Treasury of the Republic of Poland 2014: 16; Figure 16.9). Since existing fiscal rules proved insufficient, the central government substantially changed the institutional setting for budgeting and borrowing in 2009, with the changes coming into force in 2014 (the Public Finance Act). Nonetheless, this change of regulation was designed before the crisis. Coincidentally, legislation came into effect during the crisis, exactly when it was needed most.

FIGURE 16.6 Poland – Nominal Gross Domestic Product

Index: 2000 = 100

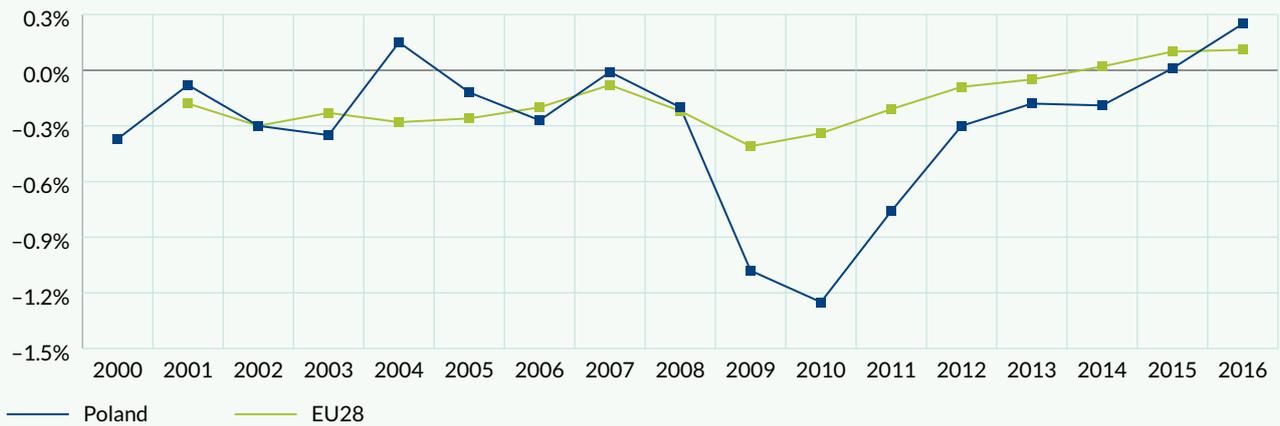


Data Source: Eurostat Government Finance Statistics

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FIGURE 16.7 Poland – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016

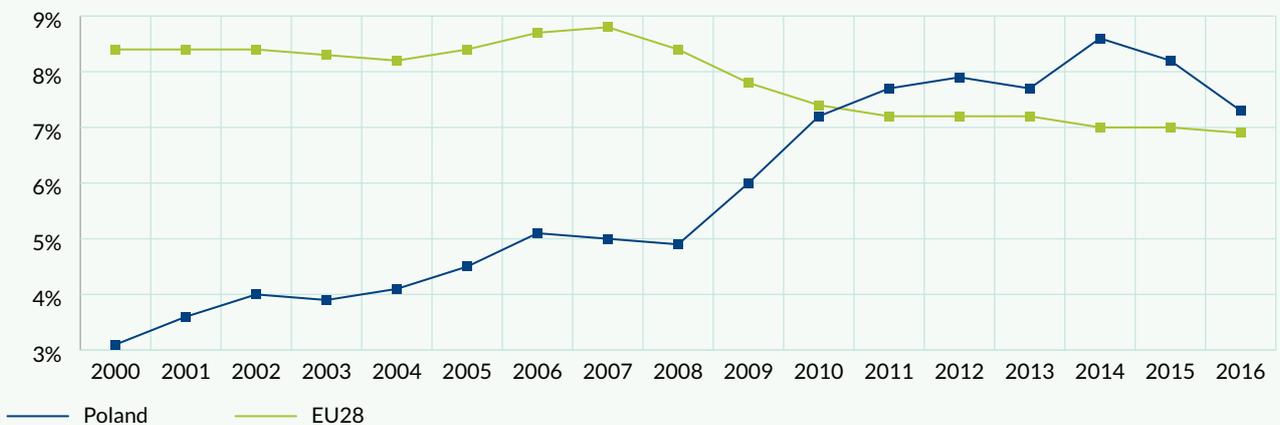


Data Source: Eurostat Government Finance Statistics

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FIGURE 16.8 Poland – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016

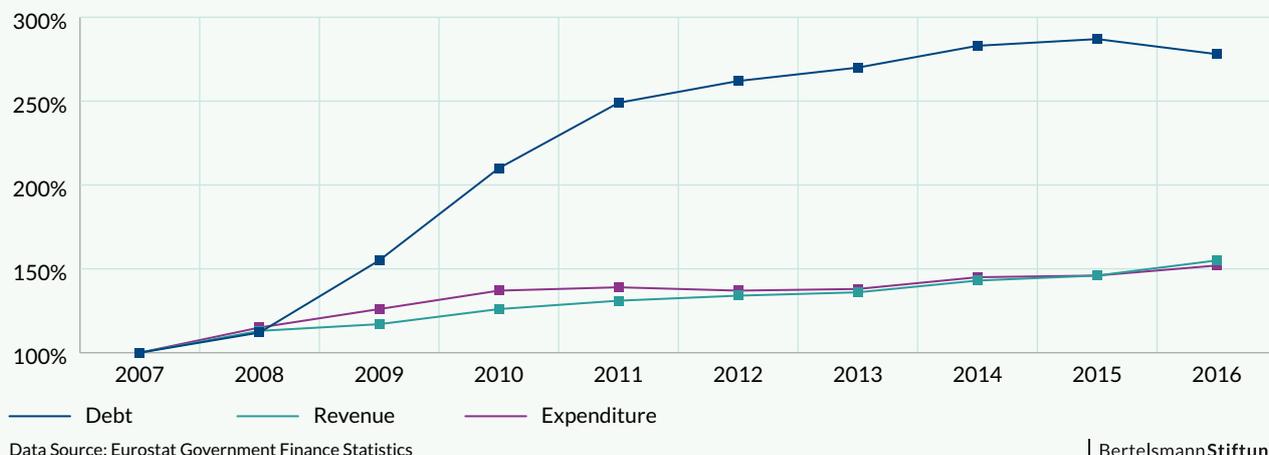


Data Source: Eurostat Government Finance Statistics

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FIGURE 16.9 Poland – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



## 6 Fiscal Rules and Fiscal Oversight

Generally, debt is restricted to capital spending. Before 2009, total debt could not exceed 60% of total revenue and annual debt-related payments had to be lower than 15% of annual revenue. This rule did not apply to obligations assumed to cover the costs of projects cofinanced by EU and to non-repayable foreign funds. During the financial crisis, these fiscal rules proved insufficient. These rules were unable to slow budget deficits and debt growth.

The Public Finance Act of 2009 substantially changed the institutional setting for local government budgeting by enhancing transparency, budget consolidation and debt reduction (Reichardt 2011: 46; Polish Treasury 2014: 46 ff.). In particular, this law has brought about a new balanced budget rule and individual debt indicators, which have been in force since 2014. In terms of aggregate data (Figures 16.7, 16.8 and 16.9), there was a short-term effect from this regulation with regards to budget balancing and local debt.

By then, debt ceilings were calculated by a uniform formula, integrating several local indicators. The debt limit (total debt and debt servicing) would no longer be set based upon revenue but rather on gross savings calculated over a three-year period (OECD 2016). Finally, there was a different per capita amount for every municipality and this individual debt ceiling served as kind of indicator of creditworthiness (Galinski 2015: 381). Since 2011, local governments have also been obliged to adopt multi-annual financial forecasts (Sauer 2013: 19).

Debt is provided by bank credit and loans. In 2010, these accounted for more than 90% of the total. Polish local governments are free to issue bonds but rarely make use of this (accounting for about 8% of local debt).

Constitutionally (Art. 171), there is legal supervision over all the activities of local government. The Marshal of each voivodeship is in charge of general legal supervision. Supervision of local finances is delegated to the regional Chambers of Auditors.

In 1997, the 16 regional Chambers of Auditors were established as audit bodies over local finances (Regional Chambers of Audit Act) (Chouvel 2017: 60). In the prior period of 1993 to 1996, their duties had been restricted to auditing. Regional chambers are fully autonomous. A President heads each chamber for a tenure of six years, appointed by the Prime Minister, based on a nationwide competition and the fulfilment of several requirements. The President of every chamber nominates half of the board members based on competition. The other half of the board members are recruited by means of nomination from local government units from the respective region (Chouvel 2017: 61). There is a national representation body of the 16 regional chambers. The National Council of Regional Chambers coordinates the performance of all the chambers, is involved in legislation and informs the national government. Beyond this, the National Council publishes an annual report on the budgetary implementations of local government (Chouvel 2017: 74).

Regional Chambers of Auditors, as supervisory bodies, focus mainly on the following issues: budgeting procedure, debt limits, balancing of budgets, allocation of subsidies, taxes and

fees, and financial forecasts. Local governments are legally obliged to present their draft budget to the regional chamber by 15 October at the latest. Budget resolutions must be passed before the beginning of the financial year. Finally, the actual deadline has been extended to January. If the local government fails to adopt a legal budget before the end of January, it may lose its right to budget for the intermediate period. In such cases, the regional Chamber of Auditors will declare this year's budget to be restricted to mandatory duties only. This, however, happens very rarely. Experts have not reported any general failures in implementation of the rules of debt limits and budget resolution.

Supervisory bodies have rights when it comes to requesting any information and data necessary to exercise their duties. While investigating the budget resolution, the chamber will point out any irregularities, indicate how to eliminate them and set a deadline. If the local government fails to meet this deadline, the chamber can declare the resolution in question invalid. In the case of a serious breach of the law, chambers can declare resolutions invalid or intervene directly, for example by overturning the local government's decision. Based on the Public Finance Discipline Violation Act of 2004, there is a commission that operates as an "organ of first instance", which adjudicates in every chamber. Its function is to discipline local government executives responsible for violating the fiscal rules. Nonetheless, penalties are not so severe, and they mostly limit themselves to warnings (Zawadzka-Pak 2014: 127 f.)

Regional Chambers of Auditors execute financial supervision and auditing at the same time. Auditing involves financial management and the procurement thereof from all local bodies. Regional chambers implement comprehensive audits about every four years.

There is no bankruptcy regulation for local governments. Since 1999, the state treasury provides a fund for emergency loans to support financial recovery of overindebted local governments. Finally, use of this instrument has been very rare (Kopanska 2011: 122).

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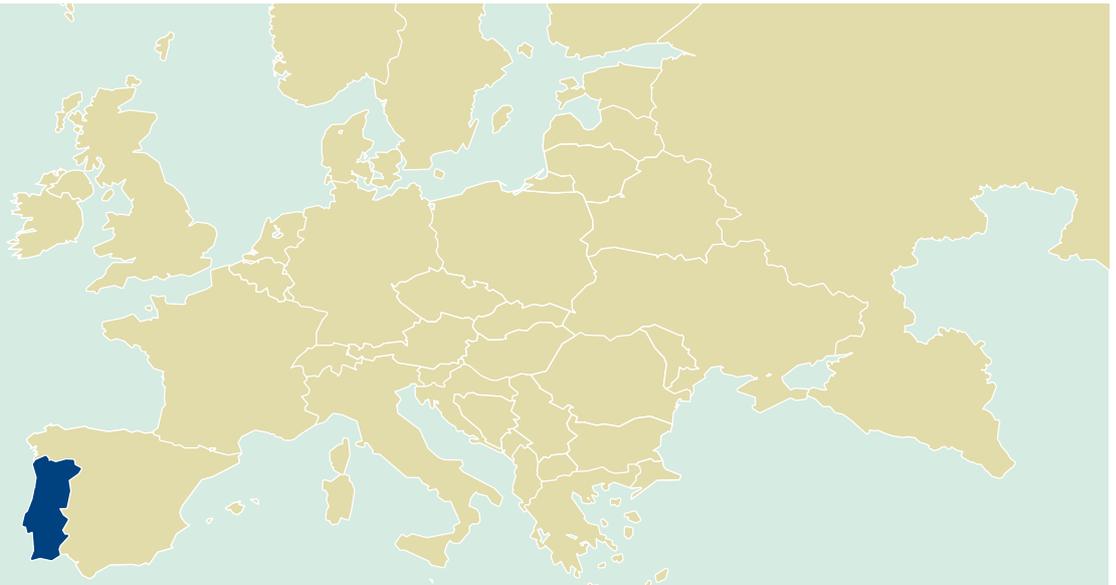
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# 17 | Portugal

René Geißler

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### Summary

Portugal is a unitary country with a local level consisting of two tiers. Traditionally, local governments have been weak in terms of function and services as well as in their share of national public revenue and spending. Current local structure, budgets and the fiscal framework go back to national measures to overcome the financial crisis. Local governments were recording deficits even before the crisis, reaching rock bottom in 2010. Since 2012, the local level, in sum, is back in the black. Portugal was hit hard by the financial crisis and had to agree on extensive measures with the International Monetary Fund, the European Central Bank and the European Commission (Troika).

As a consequence, local governments were challenged by a decline in state transfers, loss of taxation autonomy, strict debt limits and intensive fiscal supervision. By 2007, the national government had already begun to set up strict fiscal rules and regulation. This framework was adopted in 2013. Since then, there has been a formal procedure to recover deteriorated local budgets. The framework of fiscal regulation is quite complex and involves three bodies: the Ministry of the Interior in the person of the General Director of local government, the Treasury, and the Auditing Court. All three of these must give their budget approval in advance of the financial year.

## 1 Administrative Structure

Portugal is a unitary country. Although the constitution calls for the creation of a regional (local) level, a regionalisation process has never been launched (Morais 2012: 5 f.). Purely for administrative reasons, continental Portugal is structured into five regions. Before 2011, there was an additional administrative level consisting of 18 administrative districts.

The local level consists of two tiers (Figure 17.1). The basic tier consist of 3,091 parishes (*freguesias*). The upper tier consists of 308 municipalities (*concelhos*). All of these have directly elected bodies and politico-administrative as well as financial autonomy (Silva 2017: 10). Municipalities consist of parishes. The number of parishes by municipality ranges from one to 61.

There are no counties and, obviously, no cities with county status. The current local structure at the lower tier goes back to the national measures implemented in 2013 to overcome the financial crisis. With this, the national government reduced the number of parishes by about 25%. Simplification and rationalisation was the guiding principle of this reorganisation (Silva 2017: 20). Not least, due to great public opposition, this step was not implementable at the municipal level. Historically, municipalities are the most stable subdivision in Portugal. More than one third of municipalities still have less than 10,000 inhabitants. Nonetheless, their relevance for public services is rather limited. There is hardly a function wherein municipalities enjoy sizable freedom to act. They are in charge of primary education, different types of roads and public transport, some welfare and health services and utilities.

The local structure is facing some challenges. There is a huge diversity in scale, population and economic strength. Transparency is low and governance is complex. Generally, the level's political relevance does not mirror its administrative capacity or funding (Teles 2016: 457).

FIGURE 17.1 Portugal – Administrative Structure, 2017

Central Level	Central State
Regional Level	
Local Level	308 municipalities
	3,091 parishes

Source: own representation

TABLE 17.1 Portugal – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Municipality	Corvo (500)	Lisbon (500,000)	33,000
Parish	no data	no data	3,335

Source: Statistics Portugal

In contrast to political claims and constitutional intentions, the local level has faced several recentralisation trends, for example, regarding structure, central government control, staffing or fiscal autonomy, most of which have been initialised by the post-crisis European Stabilisation Programme (Silva 2017: 14 ff.). Recently, the 2015-elected government promised a political shift towards decentralisation, strengthening local responsibilities, regional governance and democracy (Silva 2017: 21 f.).

Local governments are free to initiate inter-municipal or supra-municipal cooperation for delivering joint services (Silva 2017: 26). Within the last decades, there have been various attempts at implementing forms of metropolitan governance. There are seven so-called Metropolitan Areas, formed by grouping municipalities with the intention of fostering economic growth and regional integration to jointly deliver particular public services on a larger scale.

Due to their specific autonomous status, the representation below does not cover the two overseas regions of the Azores and Madeira (Silva 2017: 10).

## 2 Revenue

Local share of general government revenue had been shrinking during the crisis and its aftermath (Figure 17.2). In parallel, funding changed substantially in structural form; the share of local taxes rose drastically whereas state grants declined (Figure 17.3). Nowadays, local taxes account for a larger share of revenue than grants. This makes Portugal an exception in the European context.

The national constitution and Local Finance Law (LFL) created the system of local finance.<sup>1</sup> The LFL was last amended in 2014, clearly as a consequence of the Economic Adjustment Programme of the Troika. Amongst other things, the law

<sup>1</sup> For a history of amendments, see Fortuna 2017: 153 ff.

FIGURE 17.2 Portugal – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016

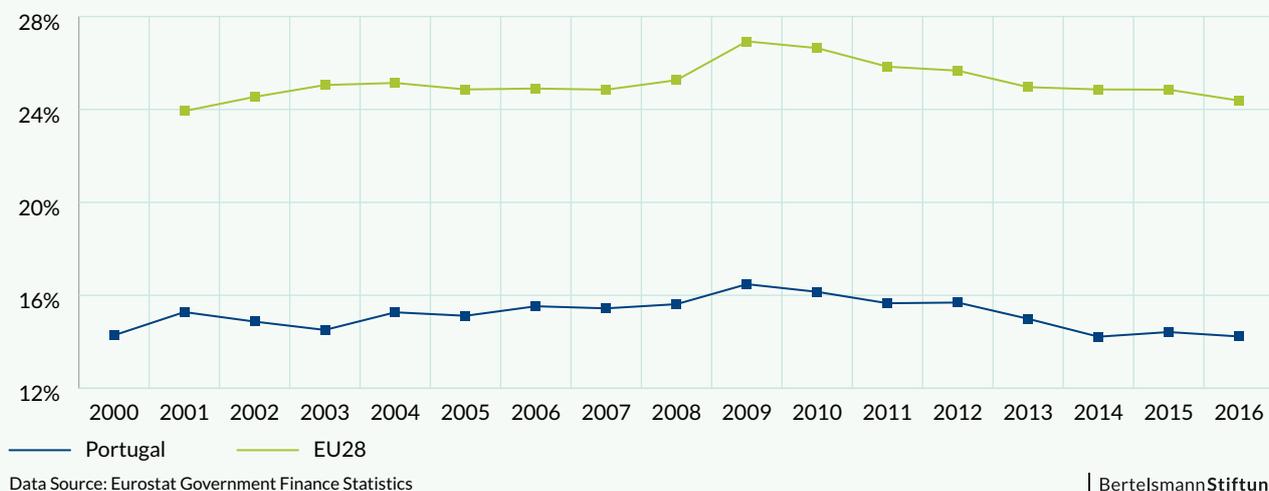
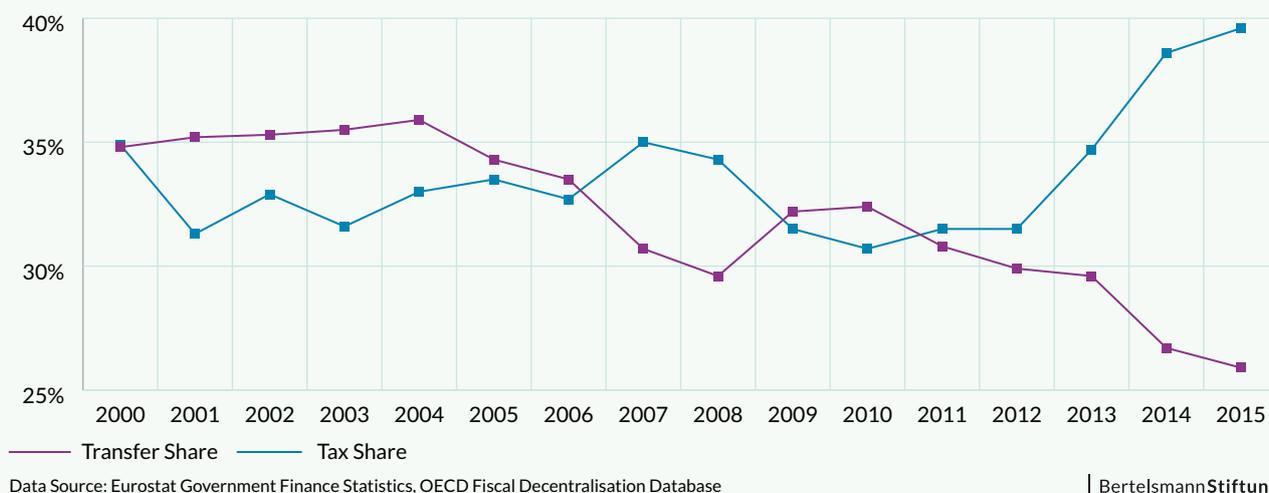


FIGURE 17.3 Portugal – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



increased the local share of income tax and taxation autonomy in general. Grants were involved in several respects: (1) the distribution formula of grants was changed, (2) for the first time horizontal transfers between municipalities were introduced and (3) in parallel with new local services, special funds for social, educational and health spending were established.

Municipalities have received a share of income tax (since 2007) and levy several of their own local taxes, e.g. property taxes, vehicle tax and a municipal surtax on a corporate profit tax. Property tax was adjusted in line with the general aim of reducing local dependence on property markets (Silva 2014: 42).

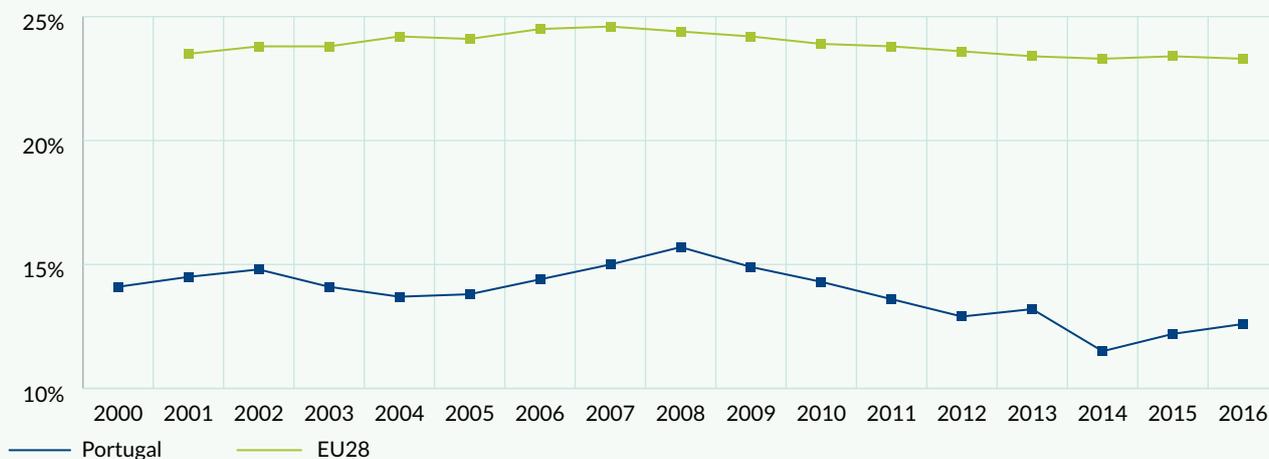
Municipalities are free to set the rate within a range, regulated by central government. Experts anticipate a significant increase mid-term, due to a revaluation of properties.

However, local room for manoeuvre is limited as the state regulates those taxes. For example, property tax rates must be determined within a given range of the property value. The tax on property transactions was abolished in 2018, due to its disincentives with regards to urban sprawl.

There is a range of state grants. Generally, the money comes from an 18.5% share of the average revenue from the three

FIGURE 17.4 Portugal – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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major Portuguese taxes (corporate income tax, personal income tax and value-added tax) (Council on Public Finance 2016: 12 f.). Before 2014, the local share of these taxes was 25.3%. Parishes receive another 2% of these taxes. Half of this sum is transferred by the General Municipal Fund, distributed according to population, area and other cost factors. The second half is transferred by the Cohesion Funds, targeting less-developed and therefore financially weaker municipalities. It equalises taxation capacities. Further relevant grants are the Municipal Social Fund and the Municipal Resolution Fund. The latter was introduced in 2013 to allocate financial assistance to distressed municipalities. It is financed by horizontal transfers among municipalities. Beyond these grants on current spending, there are also capital grants.

In sum, in 2015 state transfers amounted to 26% of local revenue and taxes to 40%. Historically, both categories have been equal. The latter has been on the rise since 2010. Beyond these sources, there are a number of fees and charges.

### 3 Expenditure

The Portuguese constitution is built upon the principle of subsidiarity and contains a clause of general responsibility pertaining to local issues for local governments. When it comes to the local share of general government spending in total, the local level's relevance for Portuguese public services is limited and shrinking (Figure 17.4). Not least, the decline in local spending is a consequence of the financial crisis. All in all, parishes account for less than 10% of local spending (Council

for Public Finance 2012: 6). There is no one single function that dominates local budgets (Figure 17.5). For example, municipalities are in charge of primary education, different types of roads and public transport, some welfare and health services and utilities.

There is a spectrum of organisational models delivering these services. Municipalities can delegate them to intermunicipal entities, parishes, public enterprises or partnerships with state administration. In practice, there is a complex network of functions.

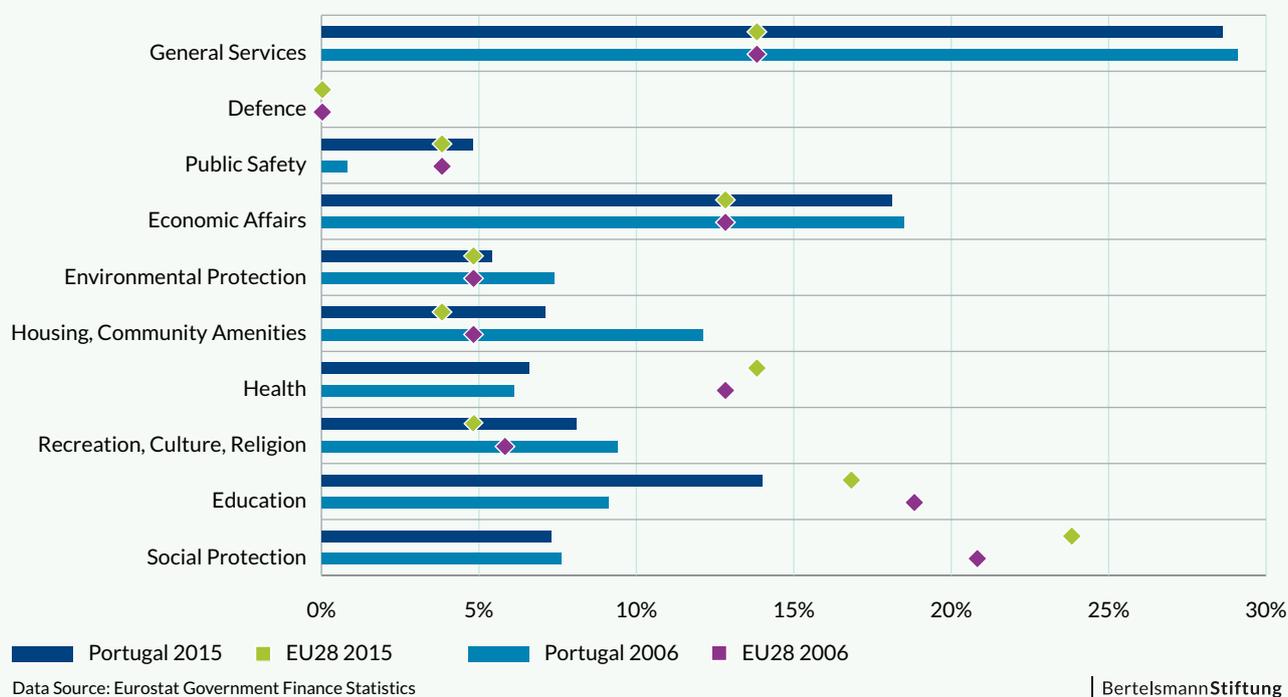
## 4 General Fiscal Status

Portuguese local budgets have been in deficit for many years (Figure 17.7). The situation worsened against the backdrop of the financial crisis and reached rock bottom in 2010 with a deficit of 0.9% of Portuguese GDP. In the years that followed, the aggregate budget balance at local level improved remarkably and turned into a surplus by 2012. Ever since then, local budgets have remained positive. Nonetheless, the aggregate budget balance masks disparities among local governments and cutbacks, which had to be implemented in order to consolidate budgets.

In parallel to the negative budget balances, local debt, as a share of general government debt, was growing in the pre-crisis period (Figures 17.8 and 17.9). In contrast to central government debt, local-level debt has sharply declined since 2009. However, this positive trend goes back to a

FIGURE 17.5 Portugal – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



dramatic increase in central government debt.<sup>2</sup> In 2016, local governments accounted for 4.4% of general government debt. At its height in 2008, it was about 6.6%.

## 5 Effects of the Financial Crisis

Portugal was one of the EU countries hit hardest by the financial crisis (Figure 17.6). Historically, it was economically weak, imbalanced in macroeconomic terms and the state budget was continuously in deficit.<sup>3</sup> Therefore, the state was under intensive EU monitoring and under pressure in relation to measures and structural reforms even before the financial crisis emerged (OECD 2012: 108). In addition, during the financial crisis, two major banks were on the cusp of insolvency and had to be bailed out by government. By 2010 to 2012, GDP had dropped by 9%, the state deficit had soared, public debt grew rapidly and access to financial markets was lost. Portugal was close to bankruptcy.

<sup>2</sup> According to Eurostat, general government debt rose from €128 billion in 2008 to €241 billion in 2016.

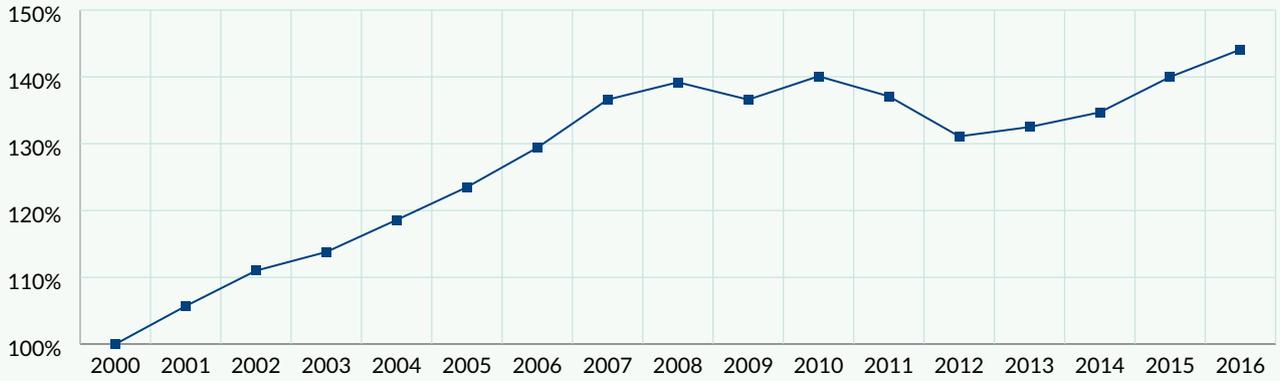
<sup>3</sup> Even before the financial crisis and in the context of rather favourable economic conditions, national debt grew from 50% of GDP in 2000 to 72% of GDP in 2008.

The socialist government reacted with a series of measures; for example, it raised the value added tax and cut public salaries. However, these measures, as general effects of economic decline, were overshadowed by the 2009 election campaign and the socialist government was reelected. Nonetheless, further cutback programmes failed in parliament and Portugal was the third EU country to request a bailout package from the EU, the European Central Bank and the IMF (Troika). The corresponding Economic Adjustment Programme was signed in May 2011, covering the period 2011 to 2014. A bundle of very specific aims and measures was listed in the accompanying Memorandum of Understanding (Silva 2014: 34 ff.). After agreeing upon this programme, the socialist government then resigned.

Finally, all attempts at budget consolidation and the reorganisation of the public sector and of public services had an effect at local government level. A long list of measures focused directly on local governments (Silva 2014: 34). Amongst these were the reorganisation of local government, a freeze on staffing and salaries, cuts in grants, cuts in salaries and the strengthening of the fiscal policy framework (Di Mascio and Natalini 2015: 137 f.). It is worth mentioning that the reorganisation of local government had already been in discussion for decades. The Economic Adjustment Programme

FIGURE 17.6 Portugal – Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

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FIGURE 17.7 Portugal – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 17.8 Portugal – Local Government Aggregate Debt

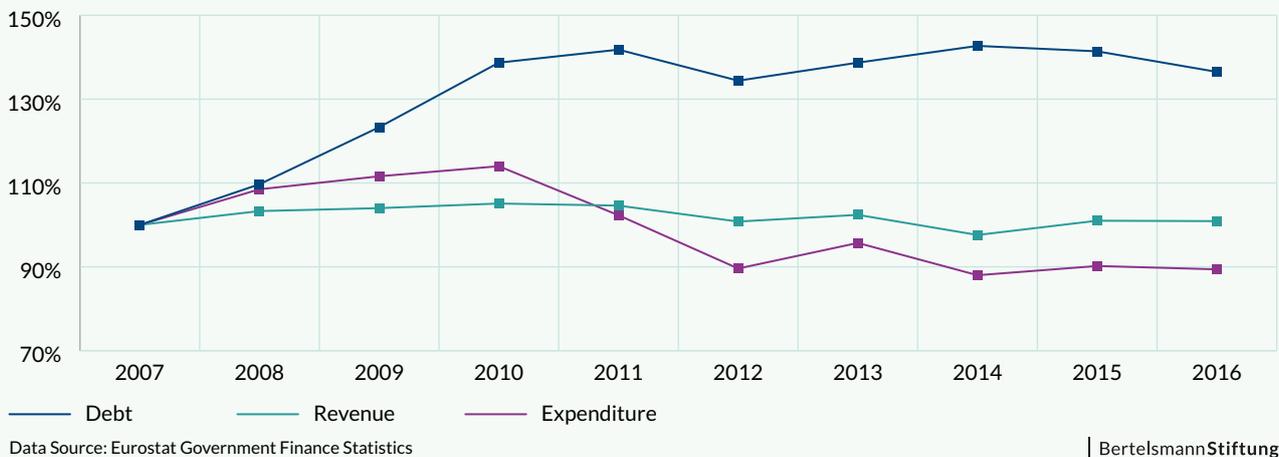
As Share of General Government Debt – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 17.9 **Portugal – Post-Crisis Developments**  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



was a catalyst for such reforms (Silva 2014: 38). In the end, this programme focused on deficit reduction and public-sector efficiency without launching a comprehensive modernisation agenda (Di Mascio and Natalini 2015: 137).

As a consequence of the financial crisis, local governments faced a decline in state transfers, loss of taxation autonomy, strict debt limits and intensive fiscal supervision (Silva 2017: 16 f.). In sum, there was a remarkable trend towards centralisation. When it comes to statistics, figures show a jump in local debt within the early phase of the financial crisis and flatlining since 2010 (Figure 17.9). Due to cuts in state grants, local revenues stagnated nominally over time. Local expenditure even declined, not least caused by the Economic Adjustment Programme; therefore budgets were balanced eventually.

Portugal completed the Economic Adjustment Programme successfully. By 2015, GDP had reached the pre-crisis level and the state deficit was in line with Maastricht criteria. The 2015-elected government announced that it would evaluate some of the measures undertaken in public administration, mainly intending to strengthen local self-government and financial capacities (Silva 2017: 22).

## 6 Fiscal Rules and Fiscal Oversight

The adoption of the Local Finance Law in 2007 was meant to be the starting point for a stricter regulation of local budgets; not least triggered by EU regulation and the Troika. There had been some loose regulation in advance but it did not prevent a significant number of municipalities tumbling into major fiscal

stress. For decades, debt limits focused on annual capital and interest payments in relation to some revenue sources rather than total debt volumes (da Cunha 2002: 55; Fortuna 2017: 153 ff.). Against the backdrop of declining interest rates, this system proved to be insufficient. A general system of financial recovery that supported stressed local governments was missing. In such cases, recovery plans were developed on a case-by-case basis and, in a few cases, went hand in hand with municipal bailouts (Fortuna 2017: 168).

The Local Finance Law of 2007 strengthened fiscal rules and oversight procedures (OECD 2012). In particular, it implemented two debt limits in accordance with tax and transfer revenue. Total municipal debt is limited to 125% and short-term loans are limited to 10%. Some types of debt, for example, those necessary to co-finance European funds, remain excluded by these limits. When debt limits are exceeded, state grants may be reduced by a corresponding amount (OECD 2012: 107).

The adoption of the Local Finance Law in 2013 refers to the Troika programme and the strengthening of fiscal governance was one of its cornerstones (Fortuna 2017: 169 f.). Consequently, the Local Finance Law of 2013 has followed the path of stricter fiscal rules (Council for Public Finance 2016: 20 ff.). It enforces a balanced budget rule on current spending. Moreover, it clarifies a no-bailout provision, preventing the state being liable for local debts, and expands the Treasury's monitoring capacities through an early warning system.

Serious measures were adopted concerning debt limits and implementation. The Local Finance Law of 2013 integrates off-balance sheet liabilities in municipal debt limits. This limit is set

at 150% of average current net revenue in the three preceding years.<sup>4</sup> Secondly, this law regulates a procedure in the case of exceeding this limit. In practice, the amount exceeded must be reduced by at least 10% in the upcoming year.

In the case of a municipality exceeding its debt limit, it is subject to a financial clean-up process, or in excessive cases, subject to a recovery process. A clean-up process is designed to reach terms that are less pressing by refinancing debt via clean-up loans. This procedure is compulsory when debt reaches 225% to 300%. The respective municipality must develop a comprehensive study on its financial situation and a clean-up plan. As a consequence, this municipality will see more intensive oversight from the state. If this clean-up plan fails in draft or implementation, the state will sanction the municipality and cut its grants by a maximum of 20%. This amount will be transferred to the Municipal Regularisation Fund.

In the case that municipal debt reaches 300% of average current revenue in the three preceding years, the municipality is obliged to enter into a financial recovery process. At this point, the Municipal Support Fund comes into play and negotiates a debt adjustment programme, eventually supervised by a commissioner. If an agreement fails, the Municipal Support Fund can refuse to grant assistance. If a municipality fails in implementing an agreed programme, this programme may be cancelled. The Municipal Resolution Fund was introduced to generate special funding for municipalities in financial distress. It requires local governments to implement serious measures regarding taxation and staffing (Fortuna 2017: 173). Thus, this fund is financed by local transfers. It creates solidarity among local governments on the one hand and peer pressure on the other.

Finally, these clean-up procedures and the restructuring are sanctions to strengthen the fiscal rules laid down and to guarantee the no bailout clause (Public Finance Council 2016: 30).

The framework of fiscal regulation is quite complex and involves three bodies: the Ministry of the Interior in the person of the General Director of local government, the central government's Treasury and the Auditing Court. All three of these must give their budget approval in advance of the financial year.

The Public Finance Council (PFC), as an independent advisory body, had already been established in 2012. Its mission is to "undertake an independent assessment of the consistency, compliance and sustainability of fiscal policy". Amongst other things, it assesses the financial position of local governments.

<sup>4</sup> Parishes are restricted to short-term debt to fund revenue shortfalls within a budgetary year and, with this, face very tight debt limits.

For this reason, the PFC gives advice to the legislature, analyses statistics and reports pertaining to different fiscal issues. Finally, it is one element of the fiscal coordination between central and subnational governments.

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# 18 | Slovenia

Iztok Rakar, Maja Klun

## Summary

Slovenia is a unitary state, consisting of 212 municipalities as the only subnational level. Although there are important differences in territory and population, the constitution claims a single-type concept of municipalities.

Local share in revenue and spending is below the EU average. In theory, local taxes fund an essential part of local budgets, so transfers and taxes are about even. In practice, the state regulates and collects most of them. The largest source of tax revenue is the municipal share of personal income tax (PIT), whereof a share is used for fiscal equalisation. The only tax local authorities can set the rate on is property tax. In contrast to revenue, local autonomy in spending is rather high. The most relevant function with regard to expenditure share is education (kindergarten). Further noticeable functions are economic affairs (local roads) and health (primary health care).

After a period of enormous growth, the financial crisis hit Slovenia hard and caused rather long-term economic challenges. Finally, it took six years for the country's GDP to recover. Local budgets experienced deep deficits in 2008 but have experienced a surplus since 2014. The local share in total public debt reached its peak in 2010 and has fallen ever since

to 2.5% in 2016. Because of the persistence of the crisis state government decided on measures in 2012 which reduced local transfers and tax revenues, especially the local share in the PIT. On the side of revenues, the state cut local civil servants' wages. A proposed restructuring of the municipal level failed.

Investment credits only need approval by the Ministry of Finance. Control of budget implementation is delegated to municipal boards and the Court of Auditors. In case of fiscal stress, the Ministry of Finance invites municipalities to prepare a recovery plan. There is no bankruptcy regulation or formal bailout procedure. If municipalities do not meet their financial obligations to private companies, a court can block their bank accounts.

## 1 Administrative Structure

Slovenia is a unitary state. The constitution guarantees local self-government for municipalities and regions. So far, only the municipal level of local government has been established (Figure 18.1). Until 2006, the reason for not establishing regions was twofold: the constitution provides a bottom-up concept, meaning municipalities had to form regions they belong to. The political will forcing this process was missing. In 2006, state government changed the constitution into a top-down concept, when the state had to form regions. However, political parties did not reach agreement on all topics and finally the financial crisis in 2009 consumed all political resources. From then onwards, the second level of local self-government has not been on the table anymore. Governmental strategy on further development of local self-government until 2020 provides a systematic approach, focusing on a model of developmental regions, which would geographically be identical with existent statistical regions.<sup>1</sup>

Slovenia has 212 municipalities, of which more than 50% count less than 5,000 inhabitants. The average municipality has about 10,000 inhabitants and covers an area of around 100 square kilometres (twice as much as the EU average). Only four out of 212 municipalities have more than 50,000 inhabitants. Such organisation has been rather fragmented and weak despite several reorganisation attempts since the mid-2000s. Nevertheless, Slovenia is not among the most fragmented countries in the EU.

There are important differences between municipalities in size and population (size ratio 1:80; population ratio 1:880). Nevertheless, the constitutional concept of municipalities' functions is single-type. Despite the widespread public assumption that municipalities, especially small ones, do not perform their tasks, an OECD analysis rejected this assumption. Nevertheless, the OECD found that tasks could be performed

1 Strategy available in Slovenian language at [http://www.mju.gov.si/fileadmin/mju.gov.si/pageuploads/SOJ/2016/Strategija\\_LS\\_2020/12\\_SRLS\\_1692016\\_vlada.pdf](http://www.mju.gov.si/fileadmin/mju.gov.si/pageuploads/SOJ/2016/Strategija_LS_2020/12_SRLS_1692016_vlada.pdf) (accessed February 15, 2019).

FIGURE 18.1 Slovenia – Administrative Structure, 2017

Central Level	Republic of Slovenia
Regional Level	
Local Level	212 municipalities

Source: own representation

FIGURE 18.1 Slovenia – Administrative Structure, 2017

Central Level	Republic of Slovenia
Regional Level	
Local Level	212 municipalities

Source: own representation

in a less dispersed and more efficient and economical manner (OECD 2011).

According to internationally established indicators, Slovenia belongs to the group of centralised states (Rakar and Klun 2017). Centralisation is based on constitutional provision of municipal powers ("local affairs which affect only the residents of the municipality", Article 140 of the Constitution) and is a logical consequence of the absence of second level of local self-government.

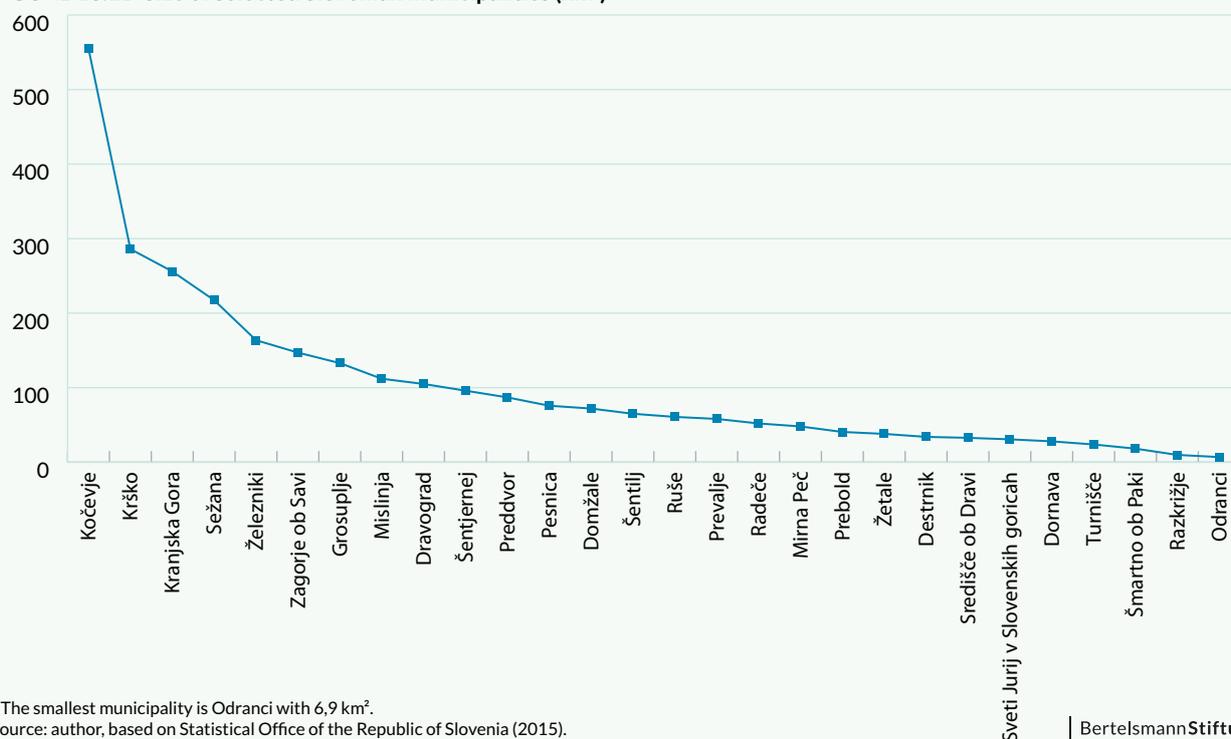
The distribution of powers between local and central level is based on the unitary structure of the state and on the constitutional provision regarding municipal powers. In practice, municipalities mainly perform service functions (providing public services), while the central government mainly exercises regulatory functions (legal regulation) (Virant and Rakar 2017). Public services are rarely provided by state or municipal organs; in most cases specialised legal persons are introduced (e.g. public company, public institution, public fund, public agency) or concessions are granted (Pevcin and Rakar 2018).

The legislation provides a sound framework for inter-institutional dialogue and (legal) protection of local self-government (Rakar 2017). However, municipalities claim that practice does not exploit all of its potential. The Council of Europe monitoring report on implementation of ECLSG in Slovenia acknowledges the latter, too (Council of Europe 2018).

## 2 Revenue

The constitution, the European Charter of Local Self-Government (ECLSG) and several laws like the Local Self-government Act of 1993 (LSGA), the Financing of Municipalities Act of 2006 (FMA-1),<sup>2</sup> the Public Finance Act of 1999 (PFA) and the Fiscal Rule Act (2015) regulate local public finance in

2 In 2008, FMA-1 was amended due to Constitutional Court Ruling No. U-I-24/07 of 4 Oct. 2007. Since then the act hasn't been substantially changed.

FIGURE 18.1B Size of selected Slovenian municipalities (km<sup>2</sup>)\*

\* The smallest municipality is Odranci with 6,9 km<sup>2</sup>.

Source: author, based on Statistical Office of the Republic of Slovenia (2015).

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Slovenia. According to the Constitution and the LSGA, local government financing in Slovenia builds on own resources, additional state funds (so-called financial equalisation) and borrowing.

The FMA-1(Article 6) defines own resources as: tax revenues (devolved or shared taxes), revenues from owned property, charges and duties. Nevertheless, it is worth mentioning that despite the rather high share of tax revenues, the state regulates all taxes. The only shared tax is the personal income tax (PIT). A determined local share is 54%, but not necessarily the whole amount will be transferred to local budgets, since the share is divided into an obligatory share (70%) and a so-called solidarity share (30%). The latter can be transferred to economically weak municipalities. Under good economic conditions, when most municipalities cover their financial needs by own revenues, the solidarity share will partially remain in the state budget.

Other taxes that are collected for the municipalities are: the compensation for the use of building land, immovable property tax, real property transaction tax, taxes on movable property, inheritance and gift tax, tax on prizes from gambling, and other taxes. The state determines all taxes, except taxes on immovable property and municipalities cannot influence tax

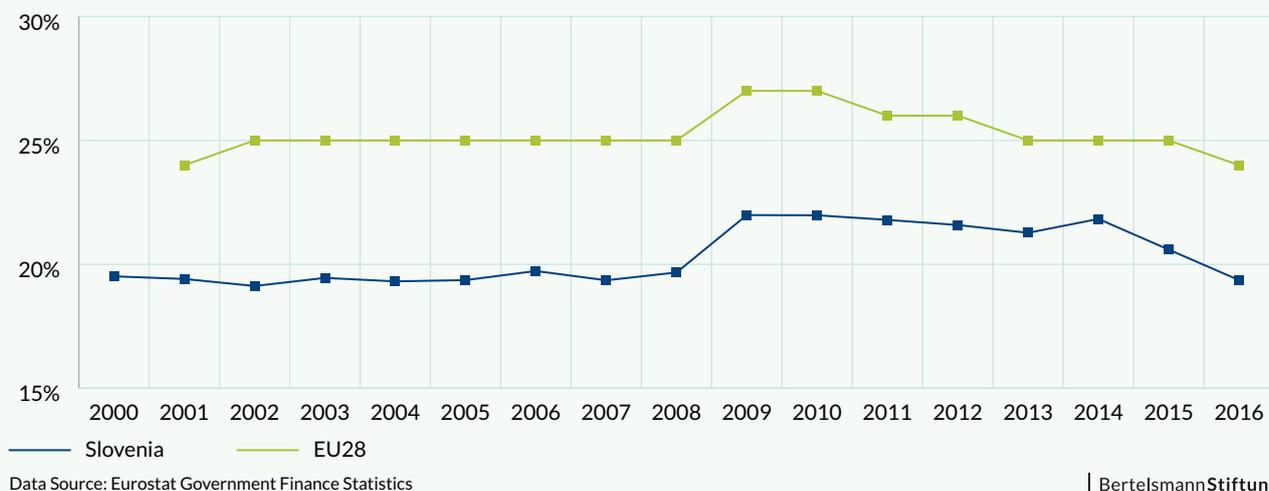
rates, base or allowances. Even the property tax is set by the state. But the tax rate can be changed by municipal decision. The only real completely own tax source is the compensation for the use of building land.

The tax revenue of total local revenues has been rather volatile for the last ten years (Figure 18.3); on average, about 40% of total local revenue. The main tax is a shared proportion of the PIT, which traditionally represents 50% of all collected taxes. Figure 18.2 indicates the high rate of centralisation, where the total share of local revenue in general government revenue is way below the EU average. Taking into consideration that local governments completely determine one tax only, the share would even be lower (around 9%).

Among the municipal tax revenues, only taxes on immovable property can be treated as municipal taxes in terms of ECLSG (Article 9.3). This statement requires further explanation and clarification. Namely, according to the government and ministry in charge of the local self-government (Ministry of Public Administration), the above mentioned PIT fulfils the conditions to be treated as "own resource" of municipalities in terms of ECLSG. They, inter alia, refer to Constitutional Court Ruling No. U-I-150/15 of 10 November 2016. The court reasoned that own resources of municipalities must be

FIGURE 18.2 Slovenia – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



in direct relationship with the municipality. Therefore, it is sufficient that municipalities are beneficiaries. They do not necessarily need to collect them.

Additionally, according to the Constitutional Court, re-allocation of a municipality's own funding among municipalities aiming to support economically weak ones is consistent with the financial autonomy of municipalities (solidarity equalisation, based on constitutional provision of Slovenia as a social state, Article 2) (decisions No. U-I-150/15 of 10 Nov. 2016 and No. U-I-24/07 of 4 Oct. 2007).<sup>3</sup>

Non-tax revenues are the next important group of own revenues. They include rents and leases for the use of municipal property: interests, dividends, profit of public enterprises and concessions, revenues from building rights and servitude, and a special fee: the mandatory contribution for building permits, which can be of significant importance in municipal budget revenue structure. Municipalities are entitled to impose certain other fees and fines.

The relation between municipalities' own resources and transfers changes according to changes in law. The first big change was in 2006, when the share of the PIT was determined by the development indicators of the municipality, and financial equalisation was almost not existent. After the decision of the Constitutional Court it changed to a share of the PIT (in 2009), divided into a fixed share and solidarity share, which is now the main "stabilisation" for the municipality and therefore overrules

transfers. As can be seen in Figure 18.3, transfer revenue share rose again, mostly because of transfers from EU funds.

After the enforcement of the FMA-1 in 2007, some substantive changes in the structure of municipal revenues occurred. The share of tax resources has risen and state transfer revenue has diminished significantly. At the same time, it should be noted that by introducing the new financing system no improvement in fiscal autonomy occurred. The state assigned a higher share of the PIT to local governments. At the same time, the distribution to each municipality in order to adjust the disproportions between available sources and obligations was changed. The sum of transfers decreased by half of the amount of the previous year. The number of municipalities receiving state transfers fell by half, too.

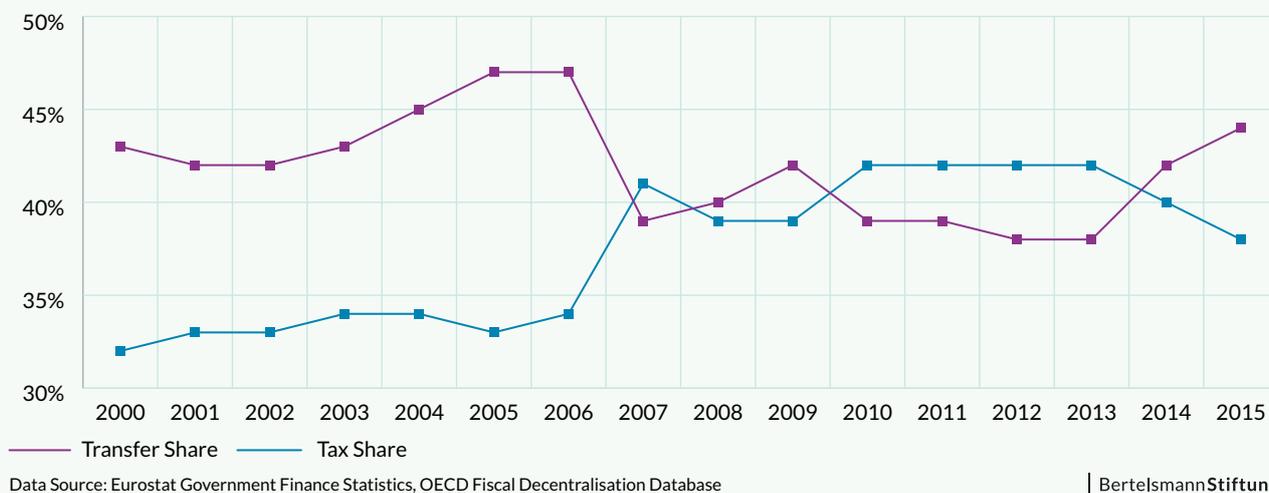
During all this time, financial equalisation has been delivered to local governments as a general grant. Only additional transfers for co-financing local investment purposes and grants for specific purposes are assigned as earmarked grants on the basis of specific criteria/formula defined by law. One should underline that no tendency to widen the base for earmarked transfers can be found. Probably, the main reason is to lower the discretion of local government on the expenditure side.

The financial equalisation grant functions as an equalisation mechanism for economically weaker municipalities. The calculation of the central equalisation grant for municipalities is calculated considering the average costs for appropriate expenditure on the one hand and own revenues on the other. If revenues do not cover the level of appropriate

<sup>3</sup> See Rakar and Klun (2016), Milunović (2018) and Council of Europe (2018).

FIGURE 18.3 Slovenia – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



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expenditure, then the municipality is entitled to receive a financial equalisation grant. In the observed years, there was no need for this additional equalisation. This was due to the lower appropriate per capita amount required to finance the municipalities' statutory obligations and due to a new formula of sharing the PIT, which includes the solidarity mechanism.

Beside financial equalisation as a block grant, special grants are assigned to help municipalities funding investment needs and co-financing specific purposes (such as for national minorities, joint municipal administration functions). This co-financing includes EU funds transferred from the state authority to municipalities. The state co-financing of investments is determined by a special equation determined in the FMA-1 (Article 23).

### 3 Expenditure

Local autonomy on the expenditure side is much more pronounced than on the revenue side. Local authorities are free to decide how they spend their revenues with the exception of earmarked state grants. In conclusion, one can say that municipalities are independent in making expenditure decisions within the regulations of public finance. They have to consider the status of municipal staff (regulation of civil servant system) and their salaries, which are determined in accordance to national law.

Nevertheless, local expenditure as a share of general government expenditure (Figure 18.4) is relatively low.

Moreover, it is far below the EU average. Considering this indicator, one should consider that until now only one tier of local self-government has been introduced in Slovenia. Local share increased until the changes in local government financing in 2009. The reason is partly the regulation of borrowing, which was more favourable before that period, especially for investments. Afterwards, the share decreased, with a particular large drop in 2013 as a consequence of the financial crisis and austerity measures adopted for the whole public sector.

In Slovenia, municipalities perform two types of tasks: so-called 1) original and so-called 2) delegated. According to the constitution, the former are defined as "local affairs which may be regulated by the municipality autonomously and only affect the residents of the municipality" (Article 140, Paragraph 1). The latter is defined as "performance of specific duties within the state competence, transferred to the municipalities by law" (Article 140, Paragraph 2). Original tasks are specified in sector-specific laws. The general law on local self-government (LSGA) only lists examples of those tasks (e.g. planning spatial development; preschool education; waste and water management; some tasks in the field of social protection). Additionally, municipalities may determine further original tasks by their statutes (Article 21 of LSGA, Article 140 of the Constitution). Urban municipalities perform, as being within their original competence, particular duties within the state competence relating to urban development as provided by law (Article 141 of the Constitution). In practice, delegated tasks are almost non-existent, and there are few specific tasks for urban municipalities.

FIGURE 18.4 Slovenia – Local Government Aggregate Expenditures  
As Share of General Government Expenditures – From 2000 to 2016

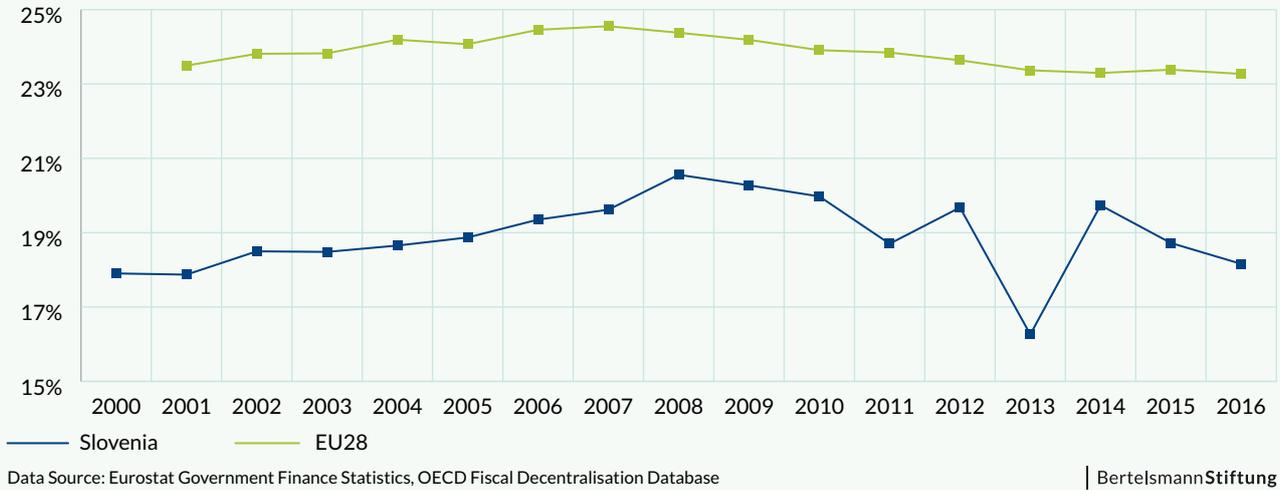
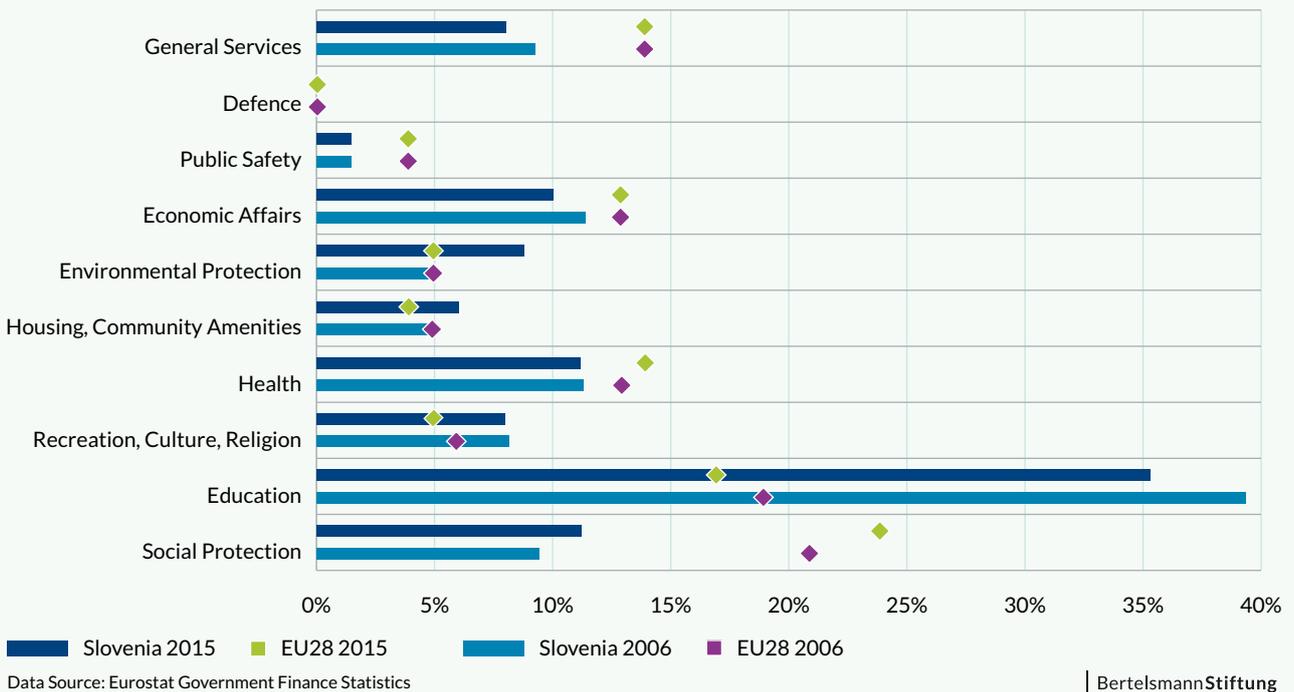


FIGURE 18.5 Slovenia – Local Government Expenditures by Function  
As Share of Total Local Government Expenditures



The commensurability of mandatory tasks and their funding is to be obtained by the formula of the so-called appropriate expenditure. It represents the sum of resources each municipality should be assured of having by law and the provision of calculated revenues needed for the funding. For calculating the appropriate expenditure, the average costs of each statutory task are annually estimated for all municipalities. The calculation is based on real costs of municipalities in the four previous years and on objective criteria set by law (e.g. number and age structure of the population, length of local roads and public paths and area of municipalities – Article 13 of FMA-1). The Ministry of Finance implements those calculations. Results should be submitted to municipalities before starting the preparation of the annual budget.

According to expenditures by function (Figure 18.5), Slovenian municipalities spend the biggest share of resources for education (mostly for kindergartens and above-standards services for primary schools). Other noticeable expenditure functions are economic affairs, related to spending for local roads, and health which principally relates to primary health care. Local governments are important in financing cultural and sport activities, since most public institutions in those fields are established by Slovenian municipalities.

## 4 General Fiscal Status

Local public debt in Slovenia (Figure 18.6) represents only a marginal share of general government debt. It was below 2.5% before 2004 and almost doubled by 2010. There are different reasons for this trend: one is the change in regulation, which determined different ceilings and definitions of borrowing; i.e. borrowing goods was included as well. Borrowing of all public-owned institutions must be reported and aggregated with borrowing in the local budget itself. Secondly, municipalities faced a larger need in borrowing to conclude investments due to decreasing state transfers following the financial crisis.

After the financial crisis, budget balances of local governments improved and there is a budget surplus on average again. In comparison to the EU average, local public debt is much lower and it follows the EU trend. By 2014, nominal debt levels were decreasing again.

Analytical statistics published every year by the Ministry of Finance show that the highest debt per capita cumulates in very small municipalities. The total amount of debt is the highest in main cities. According to this report, 20 municipalities in Slovenia do not have any debt and in 123 municipalities public institutions, which are owned by municipalities, did not

report any debt either (Ministry of Finance 2017). Debt of public institutions, which are established by local governments, represents 16% of all local debt on average.

Since 2010, local government debt, as a share of GDP, has shown a similar trend as the EU average (Figure 18.6). In most years observed, the budget balance of local governments in Slovenia is better than in the EU (Figure 18.7). The financial crisis had significant influence on local budget balances, but from 2014 municipalities have reached a surplus.

## 5 Effects of the Financial Crisis

After a period of enormous growth, financial crisis meant a sharp and rather long-term economic hit for Slovenia (Figure 18.8). It took the state six years to reach the pre-crisis-level in GDP.

The financial crisis had several effects on local government finance. Municipalities got hit from 2011 to 2013, when municipal revenue declined by 5.5% and total expenditure by 9% (Figures 18.2 and 18.4). In 2012, because of the persistence of the crisis, the state parliament adopted austerity measures, which also affected municipalities. Those measures on the revenue side reduced the lump sum per capita share of the PIT for local governments and froze the national government's share of investment co-financing. At the same time, there was a drop in revenue collection, i.e. revenues from the PIT decreased by 10%. The share of other taxes stagnated and non-tax revenues did not change much. On the other hand, the state has increased transfers from EU funds since 2014 and financial equalisation transfers in 2015 (NALAS, 2018).

On the expenditure side, austerity measures caused a reduction in public-sector wages.<sup>4</sup> Pressure was put on social transfers and current expenditures for statutory tasks decreased slightly. As agreed between local associations and state government, in 2013 and 2014 revenue from the shared PIT was reduced, again, forcing municipalities to lower expenditures (NALAS 2018). In 2013, state government proposed a territorial reform aiming to reduce the number of municipalities from 212 to 122. However, this was never realised.<sup>5</sup>

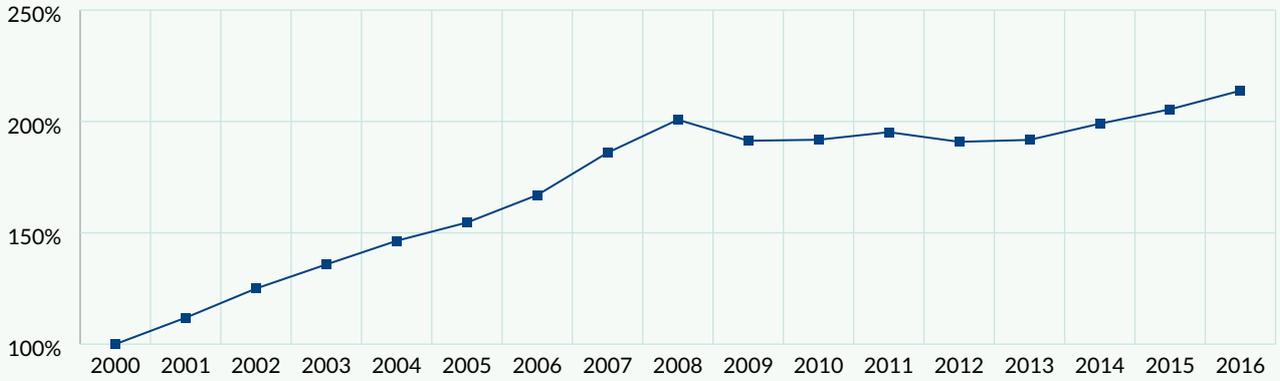
Local debt increased substantially (tripled) during the crisis. Partially, this was a technical effect due to lower debt values before. Before the crisis, the majority of municipalities did not have any budget deficits. During the crisis deficits occurred in

<sup>4</sup> The government reached agreement with public sector trade unions on pay rises in November 2018.

<sup>5</sup> See Virant and Rakar (2017).

FIGURE 18.6 Slovenia – Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

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FIGURE 18.7 Slovenia – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 18.8 Slovenia – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016

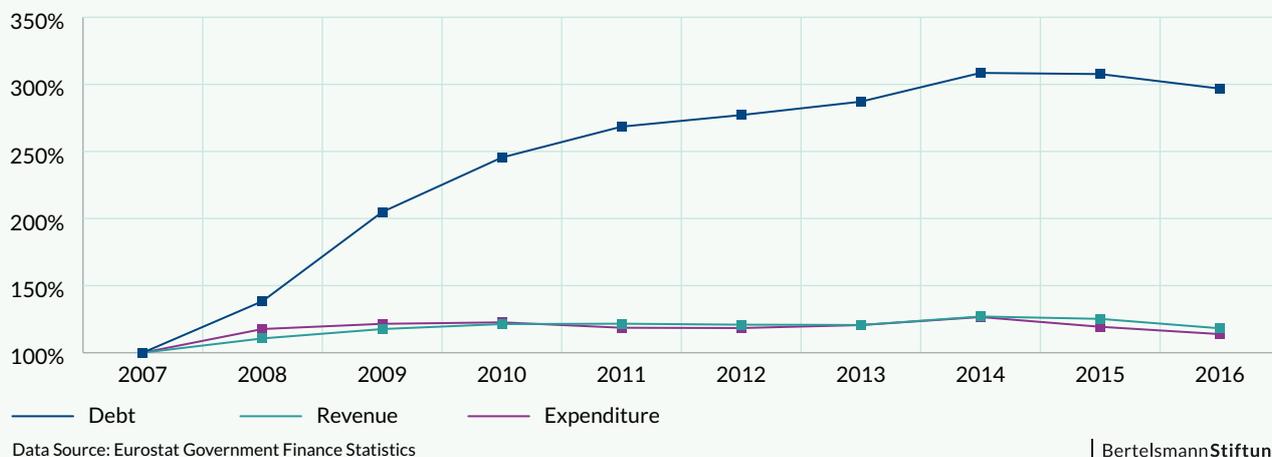


Data Source: Eurostat Government Finance Statistics

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FIGURE 18.9 Slovenia – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



all local budgets and all municipalities have accumulated debt. After 2014, the situation changed. Budgets are balanced and debt is slowly decreasing.

## 6 Fiscal Rules and Fiscal Oversight

As mentioned in Section 2, local finances in Slovenia are regulated by the constitution, European Charter of Local Self-Government (ECLSG) and several laws like the Local Self-government Act of 1993 (LSGA), the Financing of Municipalities Act of 2006 (FMA-1)<sup>6</sup>, the Public Finance Act of 1999 (PFA) and the Fiscal Rule Act (2015).

In general, Slovenian municipalities face a balanced-budget rule. Borrowing is limited to investment. The limit of borrowing within the current FMA-1 restricts debt service payments to 8% of the previous year's revenues (without donations and investment transfers). Municipalities may borrow up to 5% of the adopted budget for liquidity purposes, too. This is not subject to any previous approval by the Minister of Finance, if repayment is done within the budget year. Municipal companies and institutions are only allowed to cause debts, in accordance with the municipal council, if repayment is assured without budget resources. The amount of their borrowing should be included in the municipal annual budget act.

Municipalities can only borrow from banks and similar institutions on the credit market that have approval from the Bank of Slovenia to pursue financial services inside Slovenia. Most of the Slovenian public bodies run their accounts at the national treasury (single account system). Those municipalities can only borrow from the treasury.

Funding investments by credits is seen as adequate when municipalities care for most parts of public infrastructure. Municipalities are allowed to incur debts by borrowing on the state credit market. There is no debt in foreign currencies. According to the law, municipalities need approval only by the Ministry of Finance to incur long-term debt. Usually banks do not approve the credit without ministry approval, since according to regulations such contracts are non-valid. Municipalities are allowed to guarantee liabilities of public companies and public institutions, assuring that the amount of the guarantees is within the limits of indebtedness set by law.

Municipalities can go beyond the debt-service-payment rule (additional 2 percentage points or no more than €750,000) if they co-finance infrastructure project investments gained from EU funds. In the years 2017 and 2018, there was a special procedure for approving investment debts. The Ministry of Economic Development and Technology could approve additional loans meant to co-fund local public infrastructure and goods of special common interest in addition to ministerial funds.

From a regulatory perspective, ex ante rules dominate, since approval from the Ministry of Finance is necessary for any borrowing. Municipalities have to present their budgets to the

<sup>6</sup> In 2008, FMA-1 was amended due to Constitutional Court Ruling No. U-I-24/07 of 4 Oct. 2007. Since then the act has not been substantially changed.

ministry, but do not need approval. Based on these budgets the Ministry of Finance monitors financial health, implementation of fiscal rules and budget balances. Nevertheless, there are no rules on ex post controls. The PFA and FMA delegate control over local budget implementation to municipal councils.

According to fiscal rules, the municipal council annually reports on budget proposals and/or the enacted budget. According to the report, the medium-term budget framework should be stable and within the fiscal rule regulation. The Court of Auditors is the main institution of external control. It is limited to reporting on mistakes, pointing out malpractice, etc. Prosecution of rule violations is the responsibility of the police and other prosecution bodies.

There is no possibility of municipal bankruptcy and no formal recovery procedure, too. The Ministry of Finance usually invites municipalities with budget problems to prepare a stability and recovery plan together with a debt-managing plan. In theory, such plans are voluntary. In practice, municipalities have a strong interest to stick to the rules of the Ministry of Finance due to debt approvals.

The Ministry of Finance can approve additional borrowing in order to solve financial problems determined by a debt-managing plan. Such credits must be confirmed by the municipal council and adopted as a special local act.

When municipalities do not fulfil their financial obligations to contractors, the latter usually sue them in court. Consequently, municipal bank accounts are blocked and revenues, which are not needed for determined tasks, are used for repayment of debt to companies. If the respective account is outside the single account system, the Ministry of Finance has no say in this process. Based on a court decision, bank accounts can be blocked, too, if the municipality has too much debt and this would be the only way to gain control over expenditure. In 2011, six municipalities had blocked bank accounts, most of them only for short periods of time.<sup>7</sup> Only in one municipality was the reason excessive debt. Usually, municipalities sell municipal property in such cases.

The budgetary process of the municipalities is another way of regulation. According to the process rule, the preparation of local budget starts when the state budget framework has been prepared for the parliament and the framework for transfers to local budgets has been determined. At the same time, the lump sum derived from the formula of necessary

expenditure per capita is agreed on between municipalities and the state. Preparation of municipal budget proposals starts in September and the process is to be finished by the end of December. If the budget is not prepared and adopted on time, a provisional budget is used. The mayor invites municipal bodies to prepare proposals and after negotiations and discussions, the mayor presents the budget proposal to the public for further consideration. Subsequently, the proposal is presented to the municipal council, which has to approve the budget and adopt an act on the budget. Finally, municipalities present their budgets to the Ministry of Finance.

According to the Act on Public Finance, each public authority is obliged to maintain internal control systems aiming at the efficient, effective and functional use of public resources. The internal auditor is an independent unit or employee, organisationally separated from the managing executive structures. The municipality can also use external providers of financial control. The main external supervision body is the national Court of Auditors, which, according to the law, must review a determined number of municipalities.

According to the EU budgetary framework and the fiscal stability pact, Slovenian public finance should follow the rules and trends determined by the stability framework. Local public finance is included. Fiscal regulation was integrated into the national constitution and explained by the Fiscal Rule Act in 2015. Fiscal rules determine the framework for fiscal stability over the medium term and the steps to reduce the structural deficit by 2020. This framework is valid for public finance in total. Any tuning at state level influences local public finance.

<sup>7</sup> STA (2011): Šest občin z blokiranimi računi ("Six municipalities with blocked accounts"). Retrived on 11 Feb. 2019 from <https://siol.net/posel-danes/novice/sest-obcin-z-blokiranimi-racuni-215529>

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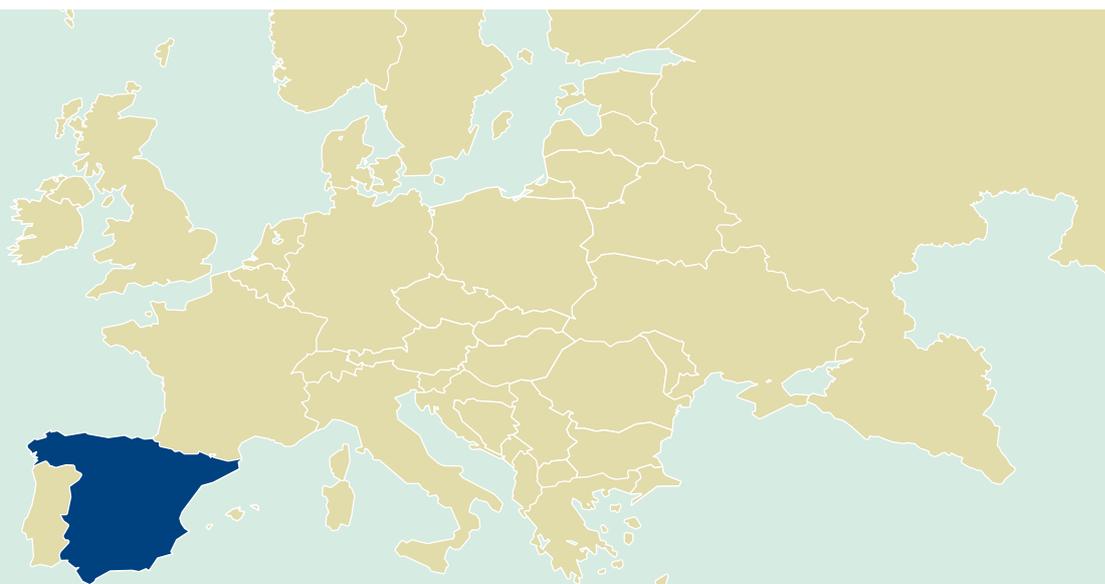
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# 19 | Spain

Nastasha Velasco

## Summary

Although Spain is a unitary state by constitution, it can be seen as a quasi-federation with responsibilities on central, regional (autonomous communities) and local government levels. Within the Spanish local administrative structure, 8,131 municipalities and 50 provinces are the two basic tiers. One of the main provincial responsibilities is overseeing and assisting small municipalities.

Local share of general public revenue (and of public expenditure) is below the EU average, and limited functions are envisioned for local government. Autonomous communities establish local taxes, which municipalities are free to impose. On average, Spanish local governments fund one third of revenue by taxes. More than 50% builds on state transfers. There is a vertical scheme of fiscal equalisation. Regarding expenditures, there is no dominant function. General services form the biggest chunk of Spanish local government expenditures.

Since 2012, Spanish local governments have achieved positive aggregate budget balances. Local debt is low, but highly concentrated among a few municipalities. The financial crisis caused a soft decrease in revenue. In contrast, there was a sharp and lasting effect for expenditures.

The crisis brought about some fundamental changes in fiscal regulation, triggered by EU six-pack. The law on Budgetary Stability and Financial Sustainability (2012) contains regular reports, an early warning system and compliance enforcement measures. There are debt and maximum growth limits. Supervision of local budgets distributes across three bodies: The newly launched Independent Authority for Fiscal Responsibility controls budgeting. The regional level of autonomous communities oversees and approves local credits. And in case a local government cannot follow the regulation, it has to formulate a financial and economic plan, enforced by the national Ministry of Finance.

## 1 Administrative Structure

The Spanish administrative structure consists of a three-tier system with central, regional and local governments (OECD 2016; Figure 19.1): the general state, the autonomous communities and the local entities. According to the 1978 Spanish Constitution, Spain is a unitary state although it can be seen as a quasi-federation with responsibilities distributed among the different levels. Each entity has the autonomy to manage and achieve its interests (Spanish Constitution, 1978, article 137). Competence principles outline the legal ability of each level to exert jurisdiction over specific subjects. From 1970 to 2017, Spain underwent a deep process of public administration reforms (Alonso and Clifton 2013) leading to decentralisation, modernisation and the promotion of public service evaluation. Today, Spain is one of the most decentralised countries in Europe (OECD 2016) and its local level is highly atomised.

According to the 1978 Spanish Constitution, the competencies of the General State Administration (Administración General del Estado, GSA) comprise internal and external policy, civic and military administration, and the defence of the state. The GSA exercises the executive function and regulatory power. Regulation of local public finance is a central state issue, too. It has a subnational presence, notably in the following areas: labour (unemployment and social security benefits), security (police and armed forces), infrastructure, fiscal matters, health and education. Its subnational presence materialises in the “delegate from government” (Delegado de Gobierno) in charge of coordinating with the autonomous communities (ACs) (Spanish Constitution, article 154).

There are 17 ACs within Spain and two autonomous cities, Ceuta and Melilla. Some specificities associated with the ACs are they have their own language, specific statutes and special financial regimes; the latter two are of particular importance. The main government institutions of the ACs are the legislative assembly and the government council.

The statute defines the responsibilities of the ACs. Generally, however, all responsibilities not expressly attributed to the central state by the constitution are devolved to the ACs (OECD 2016). There are also some shared competencies between the GSA and the regions (education, social services, universities, municipal and provincial supervision). Typically, ACs have significant responsibilities in the areas of education, health care, public order, planning, urbanism, housing, transport, environmental protection, agriculture and social assistance, among others.

FIGURE 19.1 Spain – Administrative Structure

Central Level	Kingdom of Spain	
Regional Level	17 autonomous communities	2 autonomous cities
Local Level	50 provinces	
	8,131 municipalities	

Source: own representation, Instituto Nacional de Estadística (2019)

Regarding the special financial regimes generated at the regional level, the OECD (2016) acknowledges an asymmetric decentralisation. Some ACs belong to the common regime (15) and others to the “foral” regime (Basque Country and Navarra); the “foral” regime is characterised by almost complete autonomy for spending and revenue.

The basic regulatory framework for local administration in Spain is the Law/1985 of April 2nd (Moreno 2012: 607). It specifies local institutions and their competencies. In addition, there are different sectorial laws. Within the Spanish local administrative structure, municipalities and provinces are the two basic forms of territorial organisation of the state. In addition, the following primary local entities exist: islands, mancomunidades, comarcas, corporaciones and metropolitan areas.

Provinces are an intermediate political administrative-territorial structure between the ACs and the municipalities. There are 50 provinces in Spain (of which 43 have a Provincial Deputy). The main responsibilities of the provinces are (Moreno 2012: 612 f.):

- Coordinating the provision of municipal services
- Providing technical, economic and legal assistance to municipalities, especially to small towns and cities
- Providing public services having a provincial or supramunicipal dimension (e.g. museums, libraries, etc.)
- Fostering social and economic development and territorial planning
- Managing own interests in the fields of the economy, culture, environment, etc.

Municipalities are the basis for the political and administrative constitution of the Spanish state. Article 140 of the constitution

Table 19.1 Spain – Population of Local Government Areas 2015

	Smallest	Largest	Average
Provinces (without Ceuta and Melilla)	Soria (93,000)	Madrid (6,500,000)	940,000
Municipalities	Villaroya (8)	Madrid (3,142,000)	5,800

Source: National Institute of Statistics

guarantees their autonomy and provides them with executive and legislative bodies (Moreno 2012: 605). As of 2019, there are 8,131 municipalities (Instituto Nacional de Estadística 2019) showing a huge variation in size, as measured in inhabitants (Table 19.1). About 84 % of all municipalities have less than 5,000 inhabitants, making up 13 % of the Spanish population. Municipalities provide different services depending on the size of their populations. These services are stipulated in Article 16 of the law regulating the basis of local administration. Some of the basic services are (Moreno 2012: 609):

- All municipalities: public lighting, cemeteries, waste collection, public cleaning, drinking water supply, sewer system, access to urban areas, road surfacing and control of food and drink.
- Municipalities with more than 5,000 inhabitants: public parks, public libraries, markets and waste management.
- Municipalities with more than 20,000 inhabitants: civil defence, social work, fire safety and sports facilities for public use.
- Municipalities with more than 50,000 inhabitants: urban passenger transport and environmental protection.

Moreover, the state and the ACs can assign additional services to municipalities, considering the principles of self-government and cooperation. Municipalities can also provide further services which are not awarded to other levels and which serve the local population.

Beyond those ordinary local governments, there are special cases which do not exist nationwide. For example, there are 11 islands, which are self-governed territorial entities. Some municipalities have further substructures. Especially in the AC of Castile-León, parishes are common. Municipalities are free to form associations and to mandate functions. These

local entities are made up of counties (81), metropolitan areas (3) and mancomunidades (1,008) that represent 6,190 municipalities or 76 % of the total (Government of Spain 2018).

## 2 Revenue

Spanish local government revenues (of provinces, municipalities and others) amounted to an average of 16 % of the general government revenue between 2000 and 2016 (Figure 19.2). Over time, this share increased slightly from an average of 15 % between 2000 and 2004 to 17 % between 2012 and 2016. This is significantly below the EU28 average of local-level revenues as a share of general government revenues. The temporary peak after 2007 is due to shrinking general government revenues as a consequence of the financial crisis. Compared to these, local government revenues remained relatively stable. The upward development over time indicates a rising level of fiscal decentralisation.

Revenues of local authorities come from different sources: transfers, own taxes and fees, and other resources. With an average of 36 %, an important portion of local government revenues between 2000 and 2015 came from transfers awarded by the state (Figure 19.3). These increased considerably between 2008 and 2011 and peaked in 2009 at a level of 44 %. The relative increases in transfers correspond to the drop in tax revenues. The main fraction of the transfers comes from the *partición en los tributos del estado* which is awarded by the GSA and allows municipalities to participate in the tax revenues from the state (Moreno 2012: 622). This transfer is not earmarked and is calculated according to a statutory formula, which is updated annually.

Furthermore, through the *cesión de recaudación de impuestos del Estado*, municipalities can obtain a portion of some state taxes if they meet either of the following two conditions: (1) being a capital of a province or AC, or (2) having a population equal to or greater than 75,000 people.<sup>1</sup> Moreover, municipalities have access to earmarked transfers through the different state and regional funds aimed at financing or co-financing local works and services (Moreno 2012: 623). Spain has a vertical equalisation scheme aimed at cost equalisation (OECD 2016). This scheme is a “gap filling” mechanism in which the central government transfers payments to subcentral governments in order to reduce differences in the per capita cost of providing a standard set of public services. Because it is close-ended, it is determined either by law or through ex ante central government budget decisions.

1 Law 2/2004, Regulating Local Finances Management, Article 111.

FIGURE 19.2 Spain – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016

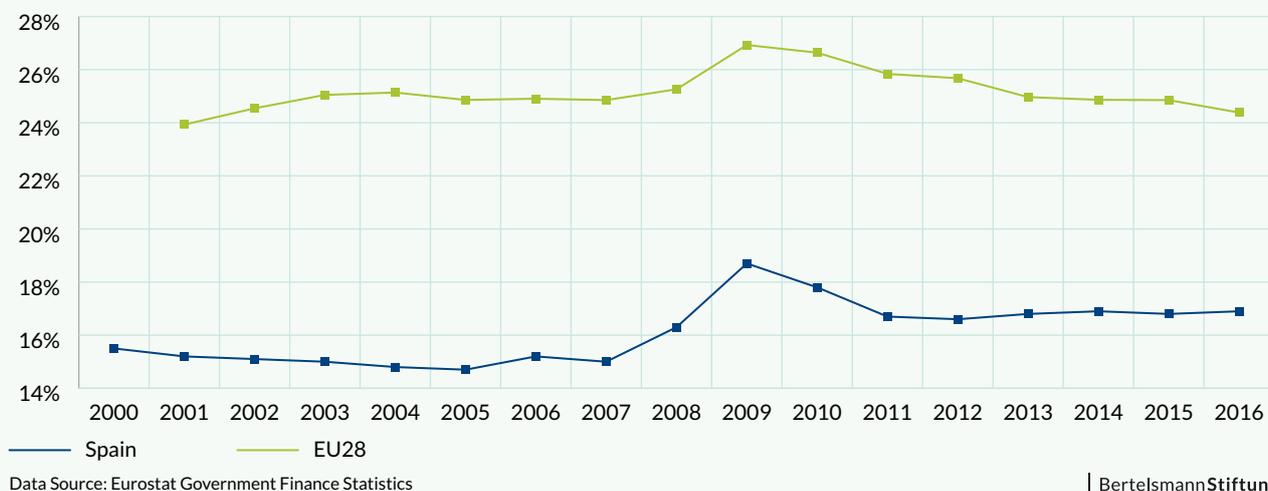
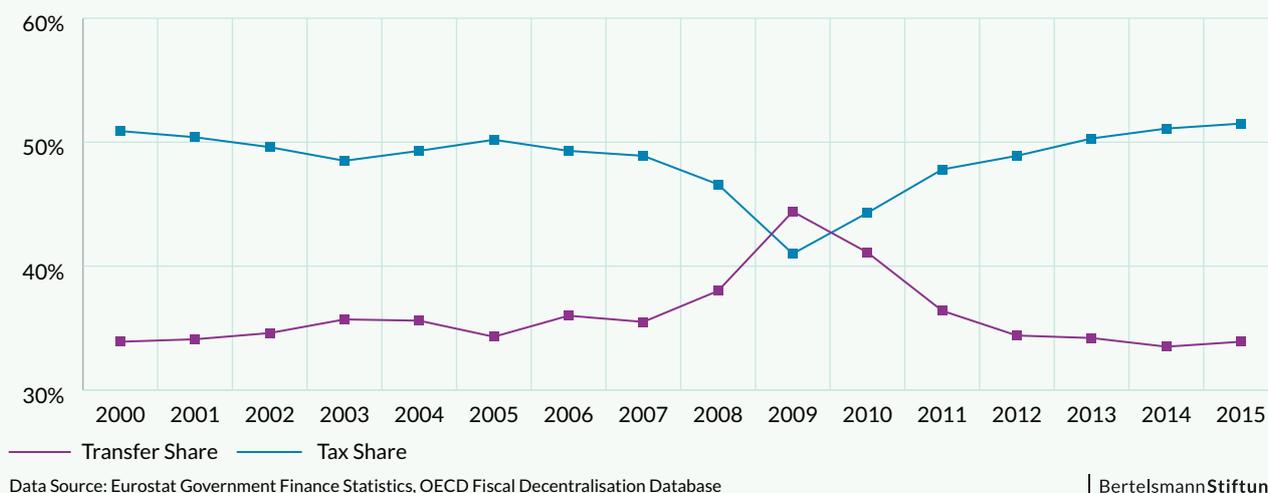


FIGURE 19.3 Spain – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



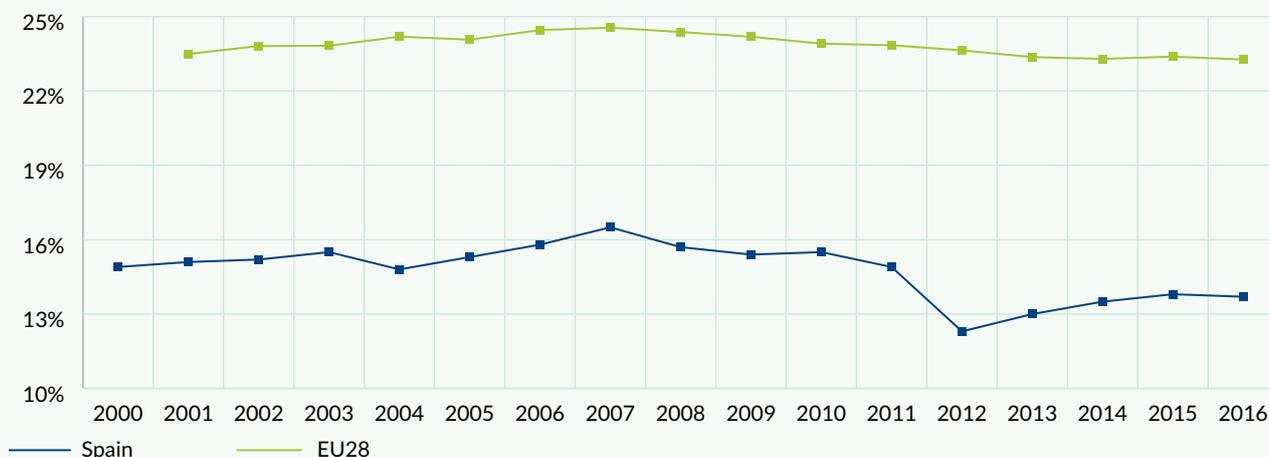
Spanish municipalities cannot freely create taxes (*impuestos*) (Moreno 2012: 621). The regional parliament must establish taxes by legislation. Municipalities can decide to impose those taxes which are stipulated in Act 2/2004 pertaining to local finances. In addition, they have complete autonomy over all tax aspects, such as rates, bases or exemptions (Moreno 2012:

621). Spanish municipalities enjoy high regulatory discretion. Each type of local tax has an *Ordenanza Fiscal* or a specific regulation that contains all the necessary legal and operational information about the organisation and collection of the taxes. According to the Local Finances Act, municipal taxes can be

mandatory or optional. The mandatory taxes are: (1) the tax on real estate (*IBI*), (2) the tax on motor vehicles (*IVTM*) and (3) the tax on economic activities (Moreno 2012: 621). Of all these taxes, the real estate tax is considered the most relevant, usually representing close to 38 % of subnational tax revenue (OECD 2016). Real estate is revalued frequently. Optional taxes are the tax on construction and installations and the tax on capital gains in urban areas. Provinces can levy a surtax on the local business tax and are entitled to some shared tax revenue.

FIGURE 19.4 Spain – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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The Spanish local tax system faces some disadvantages in design. Several of them are driven by economic activity and resulted in skyrocketing revenues during the economic boom before the crisis. In 2009, those revenues collapsed and so did local budgets, causing pro-cyclical public spending.

Besides taxes and transfers, there are further sources of own revenue: (1) charges and fees for the use of municipal or provincial properties (squares, sidewalks, etc.) or for provision of certain services, (2) special contributions for the financing of public works payable by citizens who benefit, (3) sanctions and fines, (4) sale of property and assets, and (5) proceeds from economic activities (Moreno 2012: 622).

### 3 Expenditure

Local expenditures (combined expenditures of provinces, municipalities and others) made up 15 % of general government expenditures on average between 2000 and 2016 (Figure 19.4). This share has varied over time, showing a sharp decline between 2010 and 2012, and it had not yet fully recovered by 2016. Similar to local-level revenues, expenditures are far below the EU28 average. Spanish local expenditures as a share of national GDP averaged 6 % from 2000 to 2016. This is below the EU28 average of 11 % in the same period. This indicates that in Spain, local governments play a far smaller role in public expenditure than in many other EU28 countries.

A closer evaluation of local-level expenditures by function reveals that Spanish local governments spend mostly on general services, economic affairs and recreation, culture and religion (Figure 19.5). This result is appropriate, since the local level is responsible for the general provision of public services and for managing and enhancing general interests (economic, cultural, historic, etc).<sup>2</sup> Between 2006 and 2015, local-level expenditures for general services, public safety and economic affairs increased. For the rest of the functions, they declined, with the sharpest decline in expenditures for housing and amenities. Compared to EU28 average values, expenditures for social protection, education and health are rather low, while they are above average for general services, environmental protection, public safety and recreation, culture and religion.

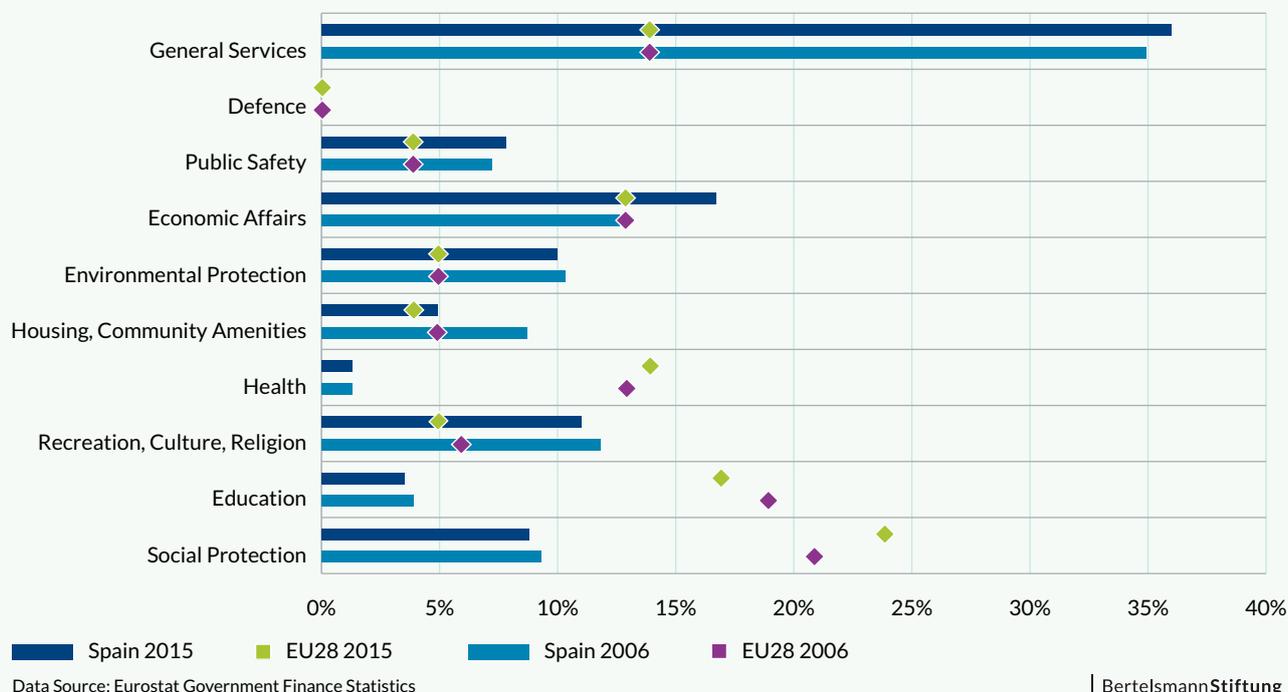
### 4 General Fiscal Status

Local government nominal debt in Spain amounted to an average of 3 % of national nominal GDP between 2000 and 2016. This is only slightly below the EU28 average of 6 %. Furthermore, it remained relatively constant over time. Compared to general government debt (which averaged 63 % of nominal national GDP between 2000 and 2016), local government nominal debt appears to be of minor importance. The development of general government debt explains the behaviour over time of local government nominal debt as a share of general government debt (Figure 19.8). Until the

<sup>2</sup> Law 7/1985, Article 25

FIGURE 19.5 Spain – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



financial crisis, general government debt as a share of GDP had declined due to shrinking central and regional government shares (therefore increasing the local government share). With the onset of the crisis, the central-level debt situation deteriorated, letting the local government share decline. However, this relation is not only a pure technicality. Since local government debt in Spain needs to be authorised by the central government, less debt is authorised when central government increases its own level of debt (Moreno different fiscal prudential mechanisms have been enacted. since 2007. Bank loans, bonds and national and international finance were deregulated to Spanish municipalities as a means of finance. Caps and procedures for authorisation and accountability were added. Compared to the general government and average EU28 values, the local governments' financial situation in Spain seems to be relatively healthy.

In terms of debt concentration, average debt per capita at the municipal level amounted to a low €563 in 2016 (total: €26 million). This debt was held by only half of the municipalities. Municipalities with outstanding debt levels were Jerez de la Frontera, Jaén, Parla, Reus and Alcorcón. These five held 8 % of the total municipal debt.

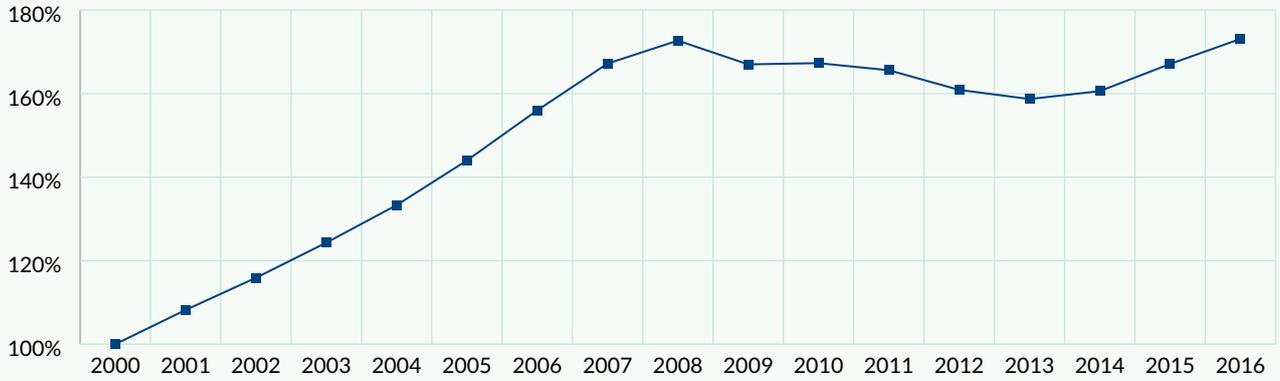
The local government budget balance amounted to an average deficit of 0.03 % of national nominal GDP between 2000 and 2016. One can distinguish three distinct periods. From 2000 to 2006, the share of nominal national GDP was close to zero (-0.04 %). With a share of -0.55 %, the years between 2007 and 2011 depict a period of accelerated deficit. Finally, since 2012 the Spanish local level has experienced considerable budget surpluses (0.49 % between 2012 and 2016) and therefore a period of recovery (Figure 19.7).

## 5 Effects of the Financial Crisis

The international financial crisis hit Spain comparatively early and hard. Real estate markets collapsed in 2007 after a long period of unsustainable growth. In its aftermath, the economy slipped into recession, unemployment doubled, loan defaults rose and, thus, the banking sector found itself in serious difficulties. The Spanish central government reacted with economic stimuli programmes and had to bail out some banks. Such measures increased national debt levels. In 2012, the EU granted €100 billion in a financial assistance programme for the recapitalisation of Spanish financial institutions. Due to the national specifics of the financial crisis, the key elements of the Memorandum of Understanding focused on

FIGURE 19.6 Spain – Nominal Gross Domestic Product

Index: 2000 = 100

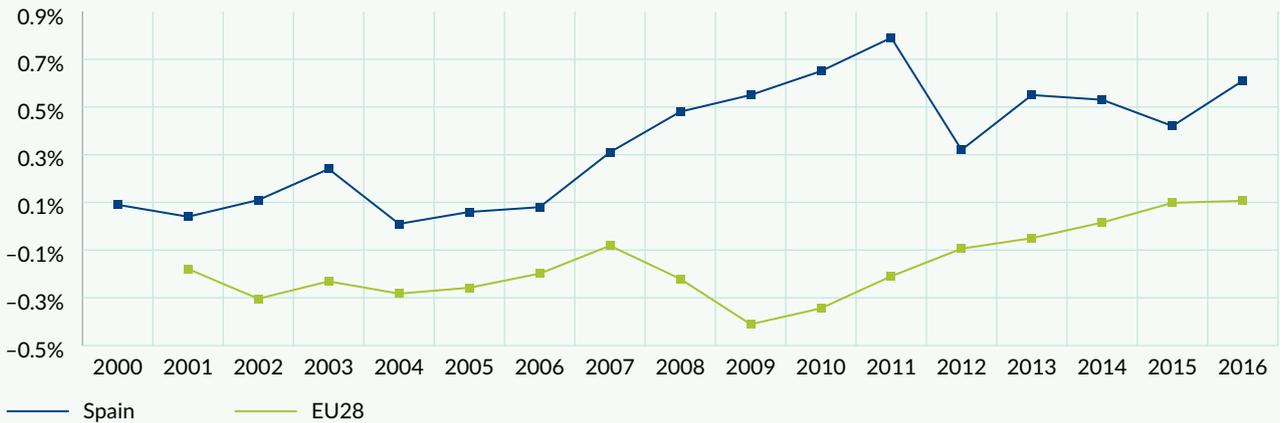


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 19.7 Spain – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 19.8 Spain – Local Government Aggregate Debt

As Share of General Government Debt – From 2000 to 2016

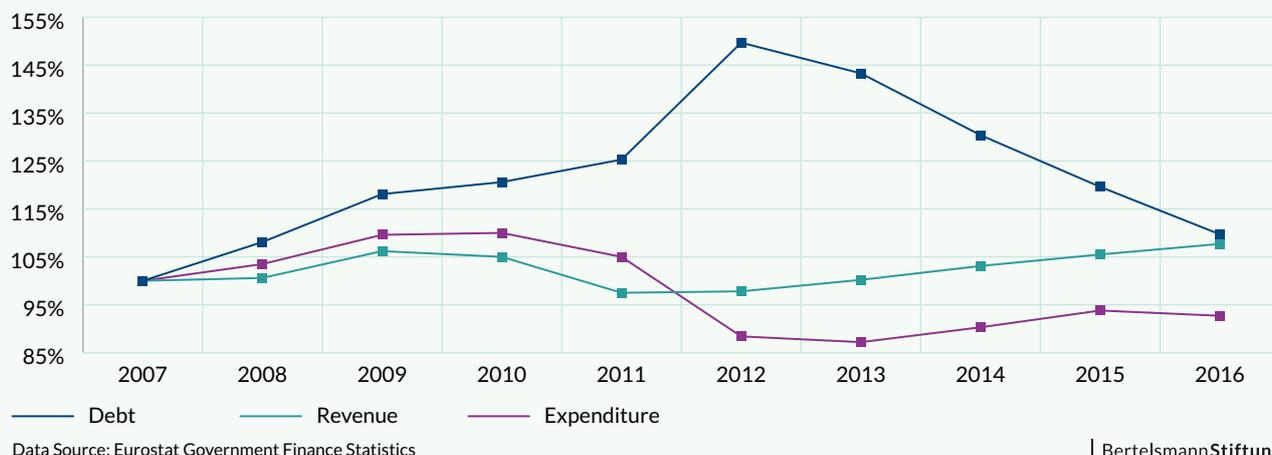


Data Source: Eurostat Government Finance Statistics

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FIGURE 19.9 Spain – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



the regulation of the banking sector (European Commission 2012).

Local government finance was affected by declining tax revenues, counteracted by state spending programmes. In a second phase of austerity, the central state cut grants to restore its own budget. As a result, local expenditure and revenue, which had increased until 2009, dropped from

2009 until 2011 (Figure 19.9). This was driven by debt and expenditure limits set by central government, too. There was a rather soft decrease in revenue. In addition, local-level debt had increased until 2012 and declined afterwards. It took seven years for local-level revenues to return to their pre-crisis level of the year 2009. Expenditures are still far below the level they were at before the crisis and local government debt did not come back down until 2016, either.

However, the Memorandum of Understanding did not directly result in legislation in the Spanish fiscal framework. Yet the financial crisis did bring about some fundamental changes in the fiscal regulation of Spanish local governments. In late 2011, a series of EU measures related to the Stability and Growth Pact (six-pack) came into force. One of the key elements was the strengthening of the budgetary framework (Directive 2011/85/EU).

Following this, the Spanish government introduced several regulations:

- The Organic Law 2/2012 on Budgetary Stability and Financial Sustainability (LOEPSF) defines a set of general fiscal principles for all levels of government. It forces local governments to provide monthly and quarterly budgetary reports and establishes an early warning system and measures to enforce compliance.
- The Organic Law 6/2013 created an Independent Authority for Fiscal Responsibility as a mechanism for efficiently controlling fiscal stability. This new body continuously assesses budgetary cycles and the sustainability of public debt and creates economic forecasts.
- The Law 27/2013 on the rationalisation and sustainability of local administration (De Diego 2014) aims to clarify the distribution of competencies, rationalise local structures, ensure budgetary and financial control, and foster economic growth.

The first two of those laws are of high relevance for local-level administrations since they established a balanced budget rule, limits on debts and new oversight mechanisms.

## 6 Fiscal Rules and Fiscal Oversight

The Spanish Constitution of 1978 and the LOEPSF of 2012 are the legal basis for the Spanish fiscal framework. In the case of local public administration, these legal frameworks together with the ordenanzas fiscales (fiscal ordinance) outline the fiscal rules and oversight mechanisms. Regulation of local public finances is an issue for the central state.

When it comes to fiscal regulation, local governments have to meet three different rules: Since 2012, they have had to adhere to a balanced budget rule, originating in Art. 12 of LOEPSF (MINHAFP 2016: 8). There is a debt limit, too, based on current revenues (75%). Before 2012, the debt limit was 110% of current revenues. Finally, spending growth is limited to the GDP growth rate.

As a result of EU legislation, the debt ratio of the general government must not exceed 60% of GDP. This general debt ratio distributes as follows: central government 44%, ACs 13% and 3% for all local governments (LOEPSF 2012, Art. 13). If the volume of local public debt exceeds this 3% threshold by 95%, treasury operations or payment of interests and capital remain the only operations allowed to local governments (LOEPSF 2012, Art. 18). Furthermore, if a local level does not correct debt deviations within a year, all long-term debt operations then require authorisation from the central administration or the ACs, with tutelage of the local administration (LOEPSF 2012, Art. 20). Finally, Spanish local governments will no longer be able to borrow to finance current expenditure after 2020 (OECD 2016).

The provisions within the Stability and Growth Pact are considered within the Spanish public administrations' expenditure rule. Article 12 of LOEPSF establishes that the growth rate of the adjusted primary expenditures of all levels of government cannot exceed the Spanish medium-term GDP growth rate. Local governments must take this growth rate as the reference for their local budgets. An increase or a reduction in the expected revenues from planned and discretionary taxes can lead to adjustments to the limits on the growth rate of public spending (Burret and Schnellenbach 2013: 33). This growth rate does not take into consideration growth of revenue or debt limits. In practice, many local governments run surpluses.

Fiscal oversight involves three bodies: ACs are in charge of approving new debts. The National Ministry of Finance enforces fiscal rules. Finally, the Autoridad de Responsabilidad Fiscal (AIRF) monitors budgets.

AIRF was established in 2013 as an independent fiscal council to supervise the new budget rule and the correction mechanisms and to publish assessments. Non-compliance with AIRF advice by any public administration has to be justified. AIRF oversees all municipalities, ACs and central government public administrations. Local governments have to present their budgets and budget reports to this body. If local governments want to incur debts, they need approval from the AC, which checks adherence to fiscal rules.

LOEPSF stipulates correction and coercive mechanisms, e.g. noncompliance risk warnings by the Ministry of Finance and Public Administration or further authorisation for long-term debt. Local governments violating fiscal rules have to formulate a financial and economic plan that allows compliance within the subsequent year. This plan has to be presented to the national Ministry of Finance and Public Administration for approval. In 2016 alone, several hundred Spanish municipalities had to implement such a plan. In many cases, they do not violate balanced budget or debt limits, but spending growth limits.

If a local government does not comply with the corrective measures established in the LOEPSF, the law allows for coercive measures. Therefore, the Ministry of Finance is allowed to take the necessary revenue from the respective local government (LOEPSF, Article 18). Only exceptional circumstances (e.g. natural disasters, economic recessions) do not trigger automatic mechanisms when deviations from the deficit and debt rule occur. To date, there has been no need to implement this sanction.

There are special regimes in the AC Navarra and Basque containing particular economic treaties with central administration. Hence, the application of the LOEPSF within these regimes is different. Both regimes have more flexibility in the implementation of fiscal rules and more autonomy in overseeing them.

The LOEPSF includes a no-bailout rule resembling Article 125 of the Treaty on the Functioning of the European Union. This rule stipulates that the central government is not to be held reliable for subnational debts. However, the central government can provide liquidity if the respective jurisdiction agrees with the Ministry of Finance and Public Administration on a binding recovery plan (Burret and Schnellenbach 2013: 34).

There is no procedure for bankruptcy of Spanish municipalities. The Law 2/2012 of Budget Stability and Financial Sustainability established different measures (preventive, corrective and coercive) in order to guarantee that bankruptcies do not occur. Hence, by 2016, some municipalities had become en riesgo de insolvencia (at risk of insolvency) but were not at risk of bankruptcy. The municipalities at risk of insolvency are the highly indebted Jerez de la Frontera, Jaén, Parla, Reus and Alcorcón.

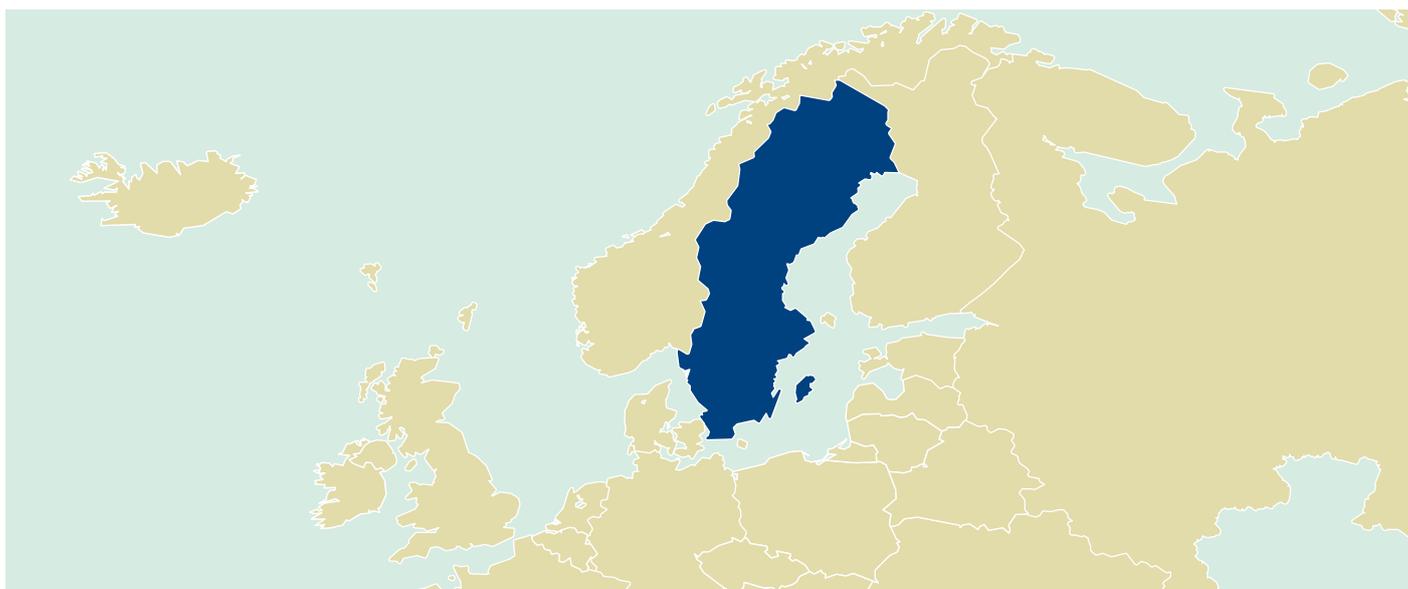
Every trimester local governments must deliver a budget report to the Ministry of Finance and Public Administration reflecting the total amount of revenues (the initial amount projected and the definitive amount obtained) and the total

amount of expenses (the initial amount projected and the definitive amount obtained). Those budget reports are available to citizens and track the achievement of budgetary and financial sustainability.

TRLRHL (2004) and LOEPSF (2012) establish internal and external bodies for local budget auditing. Members of those bodies (mostly public servants) are selected by the Ministry of Finance and Public Administration (Royal Decree 424/2017, Art. 5). The Ministry fixes the control procedures, methodology, criteria and aims of the controlling bodies, which are obliged to submit an Intervencion General de la Administracion del Estado (General State Administration Intervention Report) on the budget of the local public government once a year (TRLRHL 2004, Art. 213). TRLRHL (2004, Art. 223) also provides for external control of the budget by el Tribunal de Cuentas (Court of Auditors).

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# 20 | Sweden

Christian Raffer, Nastasha Valesco

### Summary

The Swedish local level consists of legally independent counties and municipalities, which provide a significant and increasing share of public services. County councils are not superior authorities to municipalities. Sweden is characterised by a clear division of responsibilities that go hand in hand with a constantly growing degree of political and fiscal decentralisation. According to Swedish law, municipalities are responsible for sectors such as social services, childcare, primary and secondary education and utilities. County councils cover services in the area of health care. Together, they share the task of public transport.

Local governments implement nearly half of public revenue and spending. With its high relevance of self-sourced taxes, Sweden is an exception in Europe. Tax revenue derives almost entirely from local personal income tax. Even still, Swedish local governments were hardly affected by the financial crisis. However, since 2010, they have actively invested in infrastructure in order to meet the needs of a growing and ageing population. This has led to increasing debt levels, which may yet become a reason for national concern.

Since far-reaching autonomy is enshrined in the Swedish Constitution, local governments enjoy extensive fiscal freedom. Therefore, the Swedish local government sector can be characterised by the absence of fiscal rules. The central government has no formalised control mechanism to oversee the financial situation of individual local governments. Local governments are committed to sound financial management and face a balanced budget requirement, which is, however, hardly ever enforced. Moreover, there is no approval of local debt by the state. Loans are provided by the locally owned bank Kommuninvest. In the absence of formal supervision, the Ministry of Finance relies on local governments to signal and report financial distress. Annual budgets are subject to external ex post auditing. In recent decades, there have been cases of local government bailouts.

## 1 Administrative Structure

The Swedish administrative structure consists of two tiers: a central tier and a local-level tier. The latter is divided into county councils (Landsting or Regioner) and municipalities (Kommuner), which are not in a relationship of subordination (BBSD 2005: 4). Local public administration and its long-standing tradition of self-government plays a key role in Sweden. Furthermore, decentralisation and a clear division of responsibilities is the distinctive feature of Swedish public administration. Compulsory, voluntary and shared responsibilities are established in the constitution and by special laws. Within the last ten years, reforms of Swedish public administration have introduced changes to some municipalities' boundaries, new responsibilities associated with specific county councils, the strengthening of proportionality and subsidiarity between the two levels, and market-oriented reforms of public administration (Fölster and Sanandaji 2014; Fölster and Kreicbergs 2014).<sup>1</sup>

Central administration in Sweden is represented by the parliament (Riksdag) and the government (Council of Europe 2014). The Riksdag and the government establish national objectives for the activities of municipalities and county councils through law and ordinances. Moreover, central administration is also represented at the county level through the county administrative boards (Länsstyrelser), which ensure that the national goals are pursued by the counties (BBSD 2005: 4).

Principles of local public administration are laid down in the constitution and in the Local Government Act (Council of Europe 2014). Local self-government means that local authorities must be independent bodies, free to make their own decisions within certain limits. The legislation places municipalities and county councils, within local public administration, on an equal footing, even though county

<sup>1</sup> Some market-oriented reforms of the public administration (Fölster and Kreicbergs 2014): limits to public spending, privatisation of some activities within the municipality and county councils, increase in competition for local government services and strategies for cutting red tape.

FIGURE 20.1 Sweden – Administrative Structure

Central Level	State of Sweden	
Regional Level		
Local Level	21 county councils	290 municipalities

Source: own representation

TABLE 20.1 Sweden – Population of Local Government Areas, 2017

	Smallest	Largest	Average
Counties	Gotland (58,500)	Stockholm (2,300,000)	484,000
Municipalities	Bjurholm (2,500)	Stockholm (950,000)	35,000

Source: Statistika centralbyran

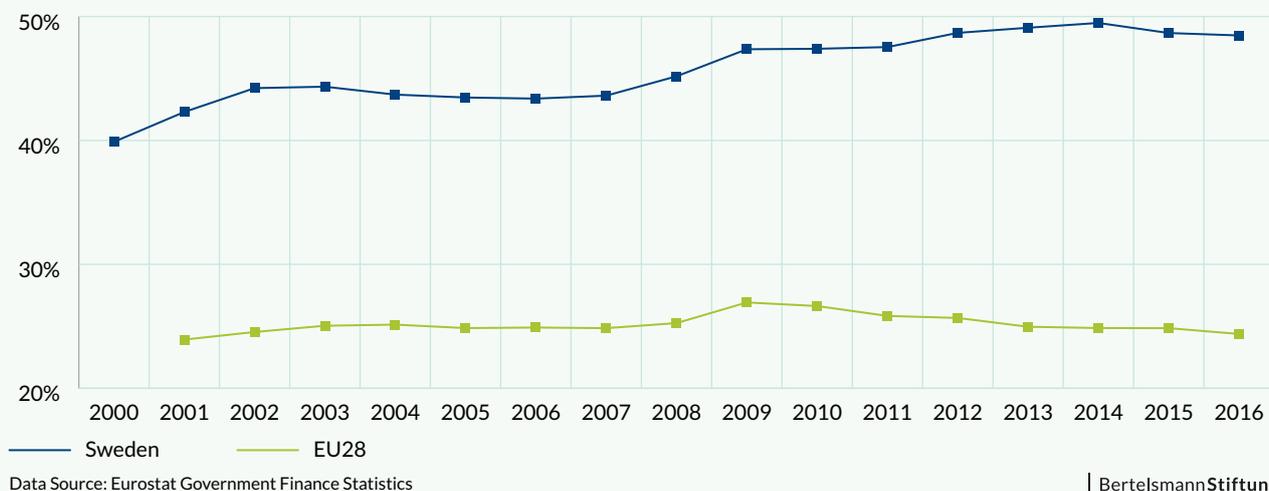
councils cover a larger geographical area and municipalities lie within counties. Local authorities have the right to levy taxes to carry out their tasks. Most local tasks are regulated by special legislation (BBSD 2005: 6). However, municipalities and county councils can also decide to provide various voluntary services. Finally, local authorities can issue their own local regulations.

Sweden has 21 county councils (UN 2006: 8). The number of inhabitants per county varies between 50,000 to more than 1.5 million. The main governing bodies at the county level are the County Council Assembly, the County Council Executive and the County Administrative Board, as the representative of the central state (BBSD 2005: 4). Within the Swedish administrative structure, county councils' compulsory responsibilities focus on health care (primary care, hospitals, outpatient (ambulatory) care, dental care and medical services) (OECD 2016; SALAR 2011: 5). Voluntary tasks relate to culture, education and tourism. Three county councils (Västra Götaland, Skåne and Halland) and one municipality (Gotland) have additional responsibilities, particularly in relation to regional development – for this reason they are called “regions” instead of county councils (SALAR 2018). Since Swedish counties are comparatively small, in 2016 a new committee was put in place to submit proposals to the government in terms of regional reforms (OECD 2017: 63). This step followed the intention of merging the 21 counties into six regions, with possible implementation in 2019 and 2023. However, according to national experts, these mergers are currently not politically feasible.

There are 290 self-governing municipalities (Kommuner) in Sweden (OECD: 2016). Half of them have less than 15,000 inhabitants. Eleven municipalities in Sweden have more than 100,000 inhabitants. Municipalities have compulsory, voluntary and shared tasks (SALAR 2011: 5). Compulsory municipal tasks are, among others, social services, education, building and planning issues, environmental and health protection, waste/sanitation, water/sewerage and emergency services. Voluntary tasks comprise leisure and culture,

FIGURE 20.2 Sweden – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



technical services, energy supply, streets/roads, building homes and business development. Public transport is a task shared with county councils. Municipalities are authorised to issue local regulations, which are mandatory within their borders in areas such as public order, traffic, planning and taxation levels (e.g. income tax). (BBSD 2005: 6).

The executive municipal committee and the municipal assembly are the two main bodies within a municipality (BBSD 2006: 9). The latter is the highest decision-making body. Municipal cooperation in order to join forces and provide services more efficiently is quite common (SALAR 2011: 5). Past local government reforms have generated privatisation of some municipal activities and therefore increased competition for local government services; moreover, the reforms have pushed coordination between different municipalities (Argento et al. 2010).

## 2 Revenue

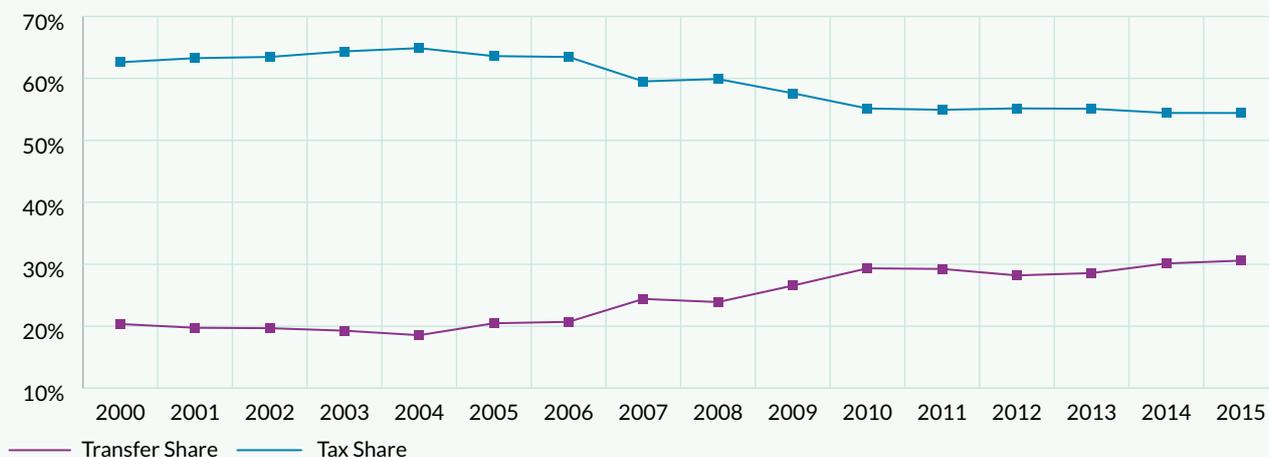
The predominant part of local (municipal and county) revenue comes from taxation and other locally generated funds (OECD 2016; S&P 2011: 4; Figure 20.3). With its high relevance of self-sourced taxes, Sweden is an exception in Europe. Grants account for less than one third of revenue. Local government revenue, as a share of nominal national GDP, has followed a moderately increasing path between 2000 (22.6%) and 2016 (24.5%) and was above the EU28 average over the whole period. This indicates the relative importance of the local level within Swedish administration.

From the perspective of local revenue, as a share of general government revenue, the relative importance of Sweden's local level becomes obvious (Figure 20.2). In 2016, nearly the half of public revenue was received by municipalities and counties. Over time, this share increased from a yearly average of 42.9% in 2000–2004 to a yearly average of 48.9% in 2012–2016. This development indicates an ongoing fiscal and service decentralisation in Sweden. Although being a unitary country, a huge and increasing part of public services is provided at local level.

Swedish local authorities' right to levy taxes is enshrined in the constitution (Chapter 14, paragraph 4). Shared taxes exist between counties and municipalities. There are no specific tax-sharing arrangements with the central government (ECoR 2018). Tax revenue at local level derives almost entirely from local personal income tax (PIT), which is self-sourced and levied independently of the national PIT. The tax base comprises incomes from salaries, wages, pensions, payments from health insurances and unemployment benefits (OECD 2016). Municipalities and county councils are free to decide on the tax rate and do so during the course of the budget procedure for the subsequent year (S&P 2011: 2). In 2017, the average "total municipal tax rate" was 32.12% on taxable earned income of physical persons (Statistics Sweden 2017). This rate consists of the municipal tax on personal income (20.75% in 2017) and the county council tax on personal income (11.36% in 2017). Municipal tax rate variation was significant with Vellinge at the bottom (29.19%) and Dorotea at the top (35.15%). In 2000, the average tax rate was 30.38%. Hence, the PIT rate has only increased moderately over time. Although the national

FIGURE 20.3 Sweden – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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parliament has the power to cap tax rates, no limit is currently set (OECD 2016). In 2013, PIT revenue made up 97% of total local tax revenue. The remaining 3% stemmed from property tax, which amounted to 0.4% of GDP in 2013 and is quite low in comparison internationally. Local taxes in total accounted for 63.5% of total local revenue in 2006 (Figure 20.3). This share decreased to 54.4% by 2015. It was still significantly above the EU28 average. Nevertheless, the shrinkage in relative terms implies that there are certain inherent limitations to increasing local PIT rates, which may be linked to municipal tax competition. At the same time, the ongoing decentralisation of service provision is accompanied by an increasing share of grants (Figure 20.3). Municipal and county tax revenues are collected by the central government for later allocation to the local government sector (Statistics Sweden 2006: 96).

Transfers from central government are allocated on a per capita basis as a lump sum through general or earmarked grants and include compensation for mandatory services based on ex ante decisions (OECD 2016). The decentralisation of tasks has to be followed by an appropriate amount of grants. This so-called “funding principle” is an agreement between the central government and the local authority association SALAR that is supposed to prevent local governments from resorting to tax increases to deliver new state-mandated public services (S&P 2011: 2). In the past, issues emerged with so-called “unfunded mandates”, hence not fully funded task decentralisation (Pierre et al. 2017: 40). Instead of full funding, the central government frequently negotiates the funding aspect of delegated tasks with the local governments and the local governments’ association SALAR. According to

national experts, the resulting insufficiency of transfers lies in the different calculation or even negligence of certain cost implications at the state level (Council of Europe 2014). A prominent example concerns the secondary school education system, which, at the time it was introduced at local level, ran temporarily in parallel with the old school system. However, the central government had not considered this simultaneity of the two systems when calculating the corresponding grants.

Equalisation transfers are enshrined in the Swedish constitution (OECD 2016). In its current form, the equalisation system can be traced back to 1966 (Statistics Sweden 2006: 100 ff.). A major reform was implemented in 2004 and came into effect in 2005. It combined equalisation with government grants into a system with complex calculation models (Council of Europe 2014). Although it is mainly state-funded, it is a mixture of vertical and horizontal equalisation. The number of net payers has been essentially reduced by the reform. In 2008, an audit of the system was aimed at identifying growth-detering factors and led to changes in 2012 and 2014, which ultimately benefited high-revenue local governments (OECD 2016). Since 2015, new measures are ongoing to correct this situation.

The current system comprises five components of which (1) the income equalisation grant, financed largely by the central government, is by far the most important one (Statistics Sweden 2006: 100 ff.; OECD 2016). Its intention is to neutralise tax disparities by a mainly vertical mechanism (top-down transfers). In addition, there is (2) a cost equalisation grant, which mitigates disparities in the cost of services provided.

This grant is not financed by central government but by the county governments and the municipalities themselves. (3) The structural grant is of a regional policy nature and (4) the transitional grant is for municipalities that would face an unreasonably large shortfall in grants/fees due to new regulation. Finally, there are (5) the adjustment charges payable by county councils and municipalities, which prevent transfers from exceeding central government commitments as a result of the other four parts of the equalisation mechanism. However, since the results may also undercut the central government's commitments, the adjustment charges may turn into a grant for local governments. In 2006, the municipalities receiving the most grants from the equalisation system were located in the southern and central parts of the country. Besides this general equalisation mechanism, there are further specific, mainly cost-related equalisation systems such as the one introduced in 2004 for municipal cost in accordance with the Act on Support and Service for Persons for Certain Functional Impairments (LSS) (Statistics Sweden 2006: 103).

Other local government revenue mainly derives from charges and fees (about 10% in 2013) for local services provided, such as child, elderly and health care (OECD 2016). Municipalities and counties have the freedom to set fees (except for primary schooling). Asset revenue makes up a negligible part of revenue.

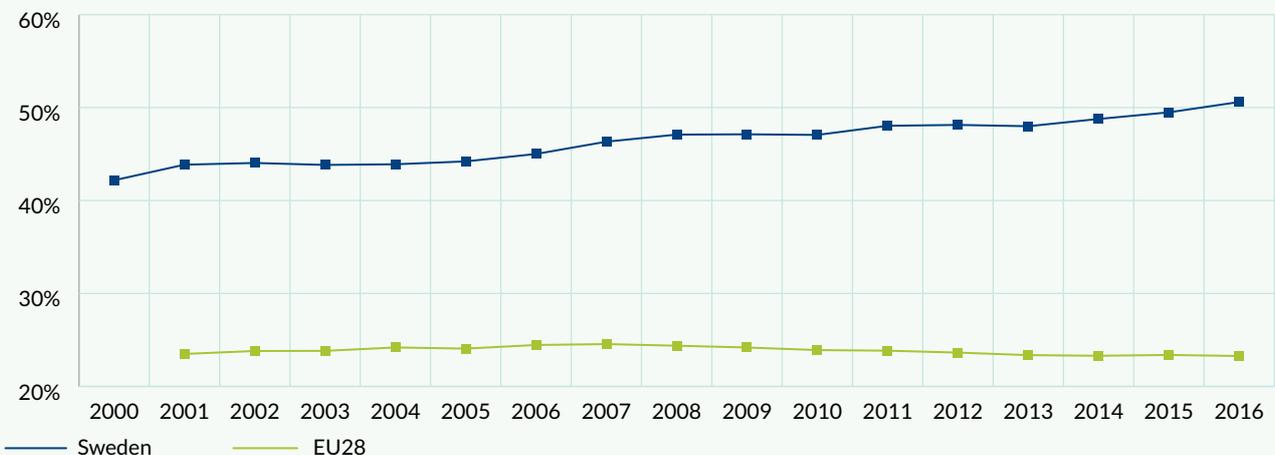
### 3 Expenditure

Swedish local governments provide many substantial public services (OECD 2016). This makes Sweden an immensely "unitary decentralised" country. The local expenditure share of total general government expenditure is far above the EU28 level (Figure 20.4) and even increased significantly from 2000 to 2016. In comparison, the average EU28 local expenditure share has been decreasing since 2007. In the period of 2000–2004, local governments' expenditure made up a yearly average of 43.6%. In the period of 2012–2016, it was 49%. Again, this shows the high degree of ongoing service and fiscal decentralisation in Sweden. In 2011, the regional and municipal levels provided two thirds of the nation's public services (S&P 2011: 2). Analysing expenditure as a share of nominal national GDP shows an average of 23.9% from 2000 to 2016. Local government expenditure exhibited stronger growth than GDP, ending up with a moderate increase. Although local government expenditure is at impressive levels compared to the EU28, the issue of unfunded mandates indicates that municipalities and counties are at least partly underfinanced in terms of the services they are obliged to provide.

The responsibilities of local governments are laid down in the 1991 Local Government Act (OECD 2016). The high relevance of social protection, health care and education is depicted by the relative shares of local government expenditure functions (Figure 20.5). All three functions are above the EU28 average. Municipalities and counties spent 26.9% on health-related services in 2015 (2006: 26.8%) and 20.5 percent

FIGURE 20.4 Sweden – Local Government Aggregate Expenditures

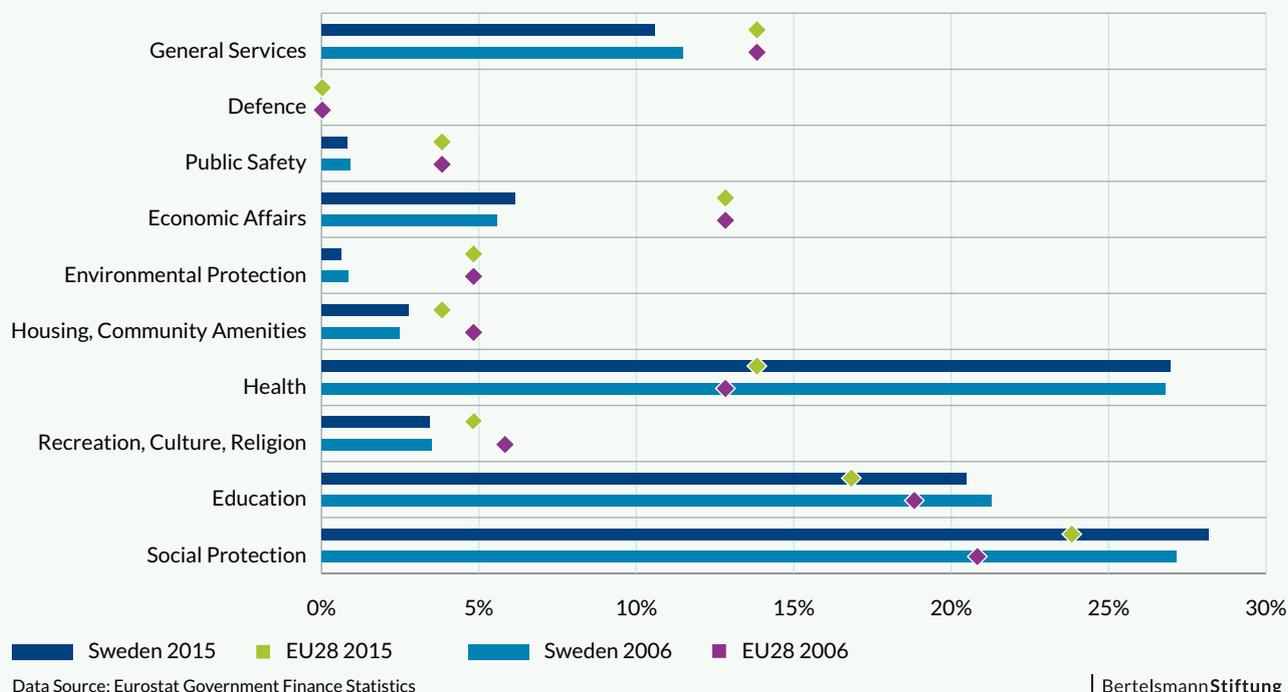
As Share of General Government Expenditures – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics, OECD Fiscal Decentralisation Database

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FIGURE 20.5 Sweden – Local Government Expenditures by Function  
As Share of Total Local Government Expenditures



on education (2006: 21.3%). The remaining functions remain beneath the EU28 average. A large part of expenditure relates to responsibilities mandated by national legislation (S&P 2011: 6).

Next to the high level of decentralisation, another characteristic of the Swedish public service provision is its high level of outsourcing (Statistics Sweden 2006: 94). Since the mid-1990s, it has become increasingly common to assign the provision of certain activities to external organisations. This applies to the areas of pre-schooling and school-aged child care, compulsory schooling, and care for the elderly. Nevertheless, these areas are still financed through public funds, making the Swedish local government sector unique in terms of its large corporate sphere (and the major asset values that exist within these companies) (Kommuninvest 2015: 4).

#### 4 General Fiscal Status

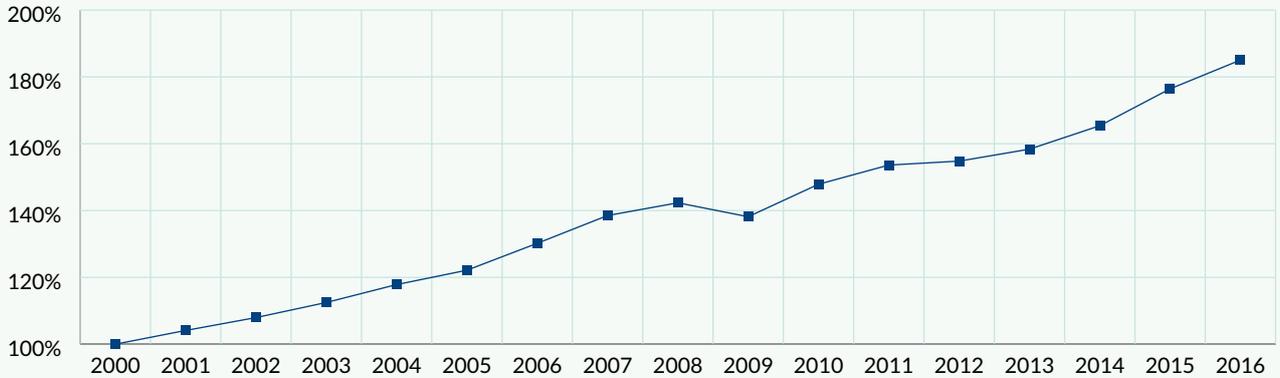
Despite the deteriorating debt situation in many European countries after the financial crisis, general government debt has been decreasing over time in Sweden. The 2000–2004 yearly average of 50.42% of nominal national GDP decreased to 42.16% for the period of 2012–2016. Local debt, as a share

of nominal national GDP, averaged 7.2% over the whole period. This, however, is above the EU28 average. Especially since 2010, local public debt, as a share of GDP, has been increasing – from 6.4% in 2010 to 10.5% in 2016. Naturally, this has been accompanied by increasing local government deficits since 2007 (Figure 20.7). 85% of the increases in borrowing since 2010 have been due to municipal (and not county) accumulation of debt (Kommuninvest 2017: 9 f.). Among municipalities, debt growth is concentrated among metropolitan municipalities and large cities with large municipal corporate groups and large amounts of housing property. Since both factors are major drivers of local-level debt accumulation, municipalities without housing companies are often virtually debt-free. In 2016, the three municipalities with the highest debt per capita were Linköping, Kumla and Trollhättan.

This picture becomes clearer in light of local-level public debt analysed as a share of general government debt (Figure 20.8). As can be seen, the local share of public debt in Sweden increased steadily and at a rapid pace from 10.5% in 2000 to 24.9% in 2016. This trend is counterbalanced by decreasing public debt levels at central level (2000: 57.1% of GDP; 2016: 32.4% of GDP). Hence, Sweden seems to be decentralising not only its public services but also its public debt. This development has been spurred on by the absence of intergovernmental

FIGURE 20.6 Sweden – Nominal Gross Domestic Product

Index: 2000 = 100

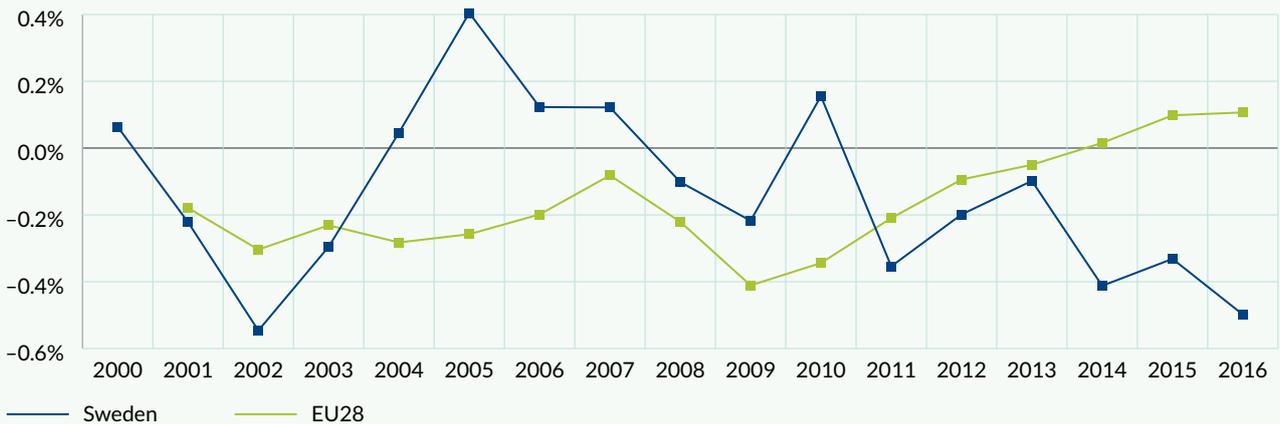


Data Source: Eurostat Government Finance Statistics

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FIGURE 20.7 Sweden – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016

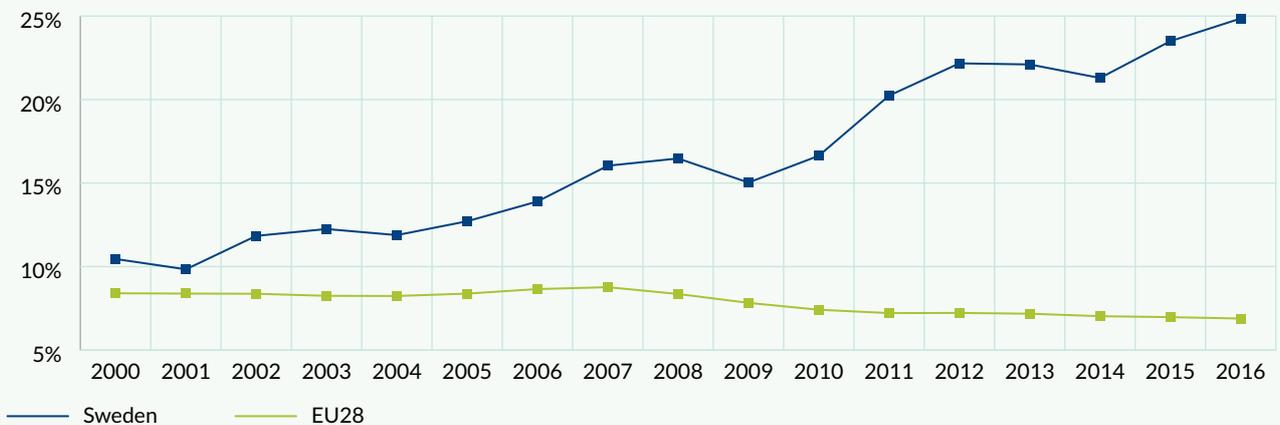


Data Source: Eurostat Government Finance Statistics

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FIGURE 20.8 Sweden – Local Government Aggregate Debt

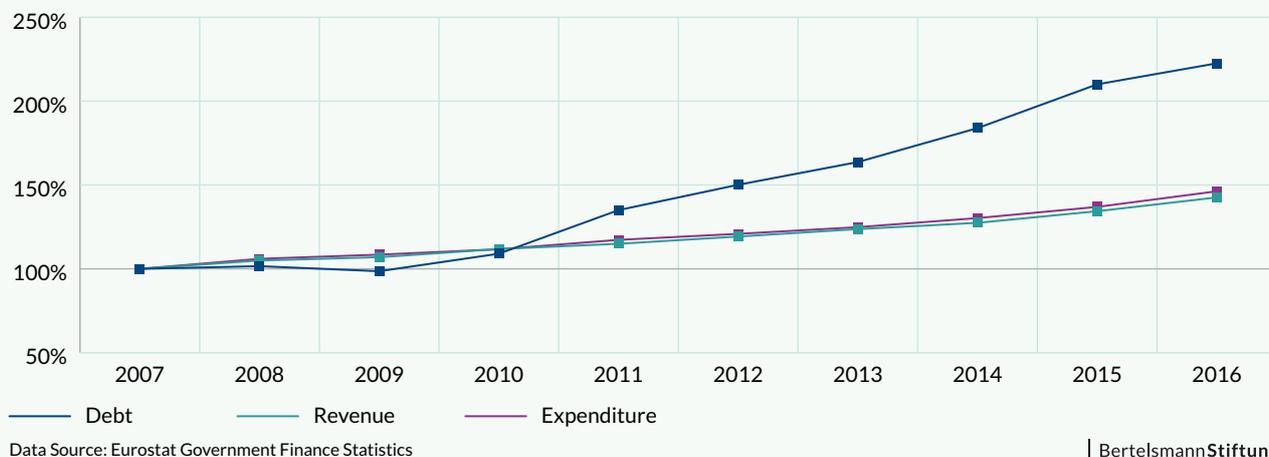
As Share of General Government Debt – From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

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FIGURE 20.9 Sweden – Post-Crisis Developments  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



debt regulation. Local governments in Sweden have the right to make autonomous decisions on their borrowing, without scrutiny or approval by the state (SALAR 2011: 9).

Rising local government borrowing is primarily driven by municipalities challenged with growing populations and high numbers of old and young people (Kommuninvest 2015: 3; Kommuninvest 2017: 3f.). Another source is the need for new schools and pre-schools due to recent immigration. In combination with the extensive renovation required for residential and commercial properties built between 1965 and 1975, this has driven investment in order to meet increasing welfare needs. Many local governments and affiliated public-sector companies have invested in infrastructure such as housing or health-care facilities. In 2017, local-level investment reached an unprecedented high. Although infrastructure investments, in principle, pay out in the future, the current development of debt bears certain risks. One issue is that debt-financed investments may be misallocated and therefore not pay out for the municipalities or their affiliated corporates. However, since the newly accumulated local-level debt concentrates on growth regions, affected municipalities may be economically strong enough to deal with such an eventuality. A second risk comes with the still very low interest rate levels for public debt, which leads to ever decreasing interest payments, although debt levels have been on the rise. This favourable trend may cause serious problems once interest rates rise again. It seems that the national discussion about local debt levels and their risks is just about to start (Kommuninvest 2017: 3). Long-term sustainability of local debt is an open question, especially when macroeconomic growth slows, tax bases stagnate or even diminish and the costs for the public

sector remain high due to labour shortages. It is reasonable to assume that all three of these scenarios can or will emerge in the upcoming years (Kommuninvest 2017: 4).

Swedish local-level debt is made up of loans and a significant and growing share of securities. Whereas in 2006, 79.7% of local public debt was held in loans, this share decreased to 65.7% by 2016. The share of securities increased from 20.3% to 34.4% – which is well above the EU28 average. This shows that issuing securities is becoming increasingly important for Swedish local governments, a phenomenon that is found mainly among the larger municipalities. Kommuninvest, the Swedish local government funding agency founded in 1986 and owned by Swedish local governments, is by far the largest lender to local governments (SALAR 2011: 10). In addition to Kommuninvest, the main commercial banks are also important lenders.

## 5 Effects of the Financial Crisis

Sweden has managed to shelter local budgets from any cuts during the economic crisis (Council of Europe 2014). The country is among that rare group of European member states which had no major fiscal distress in the years following 2007. Analogously, local authorities in Sweden have not been affected by the crisis, which can be seen by the sustained increases in revenue and expenditure in Figure 20.9. There are several reasons for this positive observation. At the start of the crisis, municipalities acted fast and cut employment in order to prepare for declining revenues. The central government responded by increasing general grants on a per capita basis.

The grants were paid out over three years but were (according to national experts) announced too late because municipalities had already implemented their cuts and the state grants thus contributed to high economic surpluses. The effect of the crisis was temporary and less severe than expected with municipal employment soon bouncing back. Hence, local-level debts in absolute terms did not react to the crisis. Although, from 2010 onwards, debt did start to rise. This, however, should not be understood as a reaction to the crisis but due to increasing infrastructure investments.

Swedish municipalities have certain means to cope with cyclical deteriorations. Since 2013, they have been able to build up “rainy day” funds in order to reduce the cyclicalities of their revenue (OECD 2016). These funds were introduced because of the chaos over the period of the financial crisis when municipalities made cuts to balance their budgets. Moreover, as soon as temporary imbalances (e.g. during economic downturns) do occur, increasing the local PIT rates is an option to boost revenues, which however, increases tax receipts with a certain time lag (S&P 2011: 2).

## 6 Fiscal Rules and Fiscal Oversight

The Swedish fiscal policy framework comprises three key elements: (1) a surplus target for the entire general government sector; (2) a central government expenditure ceiling set by the national parliament, also covering the pension system and (3) the requirement for local governments to maintain balanced budgets (Government Offices of Sweden 2017). Since 2017, there has also been a general government debt anchor of 35 % of GDP for Maastricht debt. This leaves the local government sector with a balanced budget rule. The central government has no formalised control mechanism for monitoring the financial situation of individual municipalities and counties (S&P 2011: 8). This, again, stresses the high degree of local self-governmental autonomy. A certain form of control is carried out via the ordinary audit procedure (SALAR 2011: 8). In addition, the Local Government Act subjects municipalities and county councils to “sound financial management” (Ministry of Finance 2017: 37 f.). Since 2005, local governments have set corresponding financial targets without being monitored by higher levels of government.

The balanced budget requirement was introduced into the Local Government Act by the bill “Den kommunala redovisningen” to strengthen the budget process at local level; it has been in place since 2000 (Government Offices of Sweden 2017; Statistics Sweden 2006). According to this requirement, municipalities and county councils must draw up budgets

in which income exceeds expenditure (Ministry of Finance 2017: 37). In each budgetary year, the local government must prepare a budget document for the subsequent three years (S&P 2011: 8). If deficits occur, the general rule is to set up an action plan (SALAR 2011: 8). The Municipal Act allows the local government to make up the deficit within three years unless there are good reasons for not doing so (Statistics Sweden 2006: 97; Dietrichson and Ellegard 2015: 5). The reasons can include the need for additional funds to cope with future revenue reductions / expenditure increases, if the deficit is caused by unconverted losses in stocks and bonds or if asset sales occurred at a loss but will reduce future expenditure. In reality, the balanced budget rule has created awareness for sound fiscal behaviour. Nevertheless, there are still numerous deviations throughout the sector (S&P 2011: 8). In the absence of sanctions for noncompliance, rule-breaking has no consequences for local governments.

Swedish local governments enjoy far-reaching rights when it comes to incurring debt (S&P 2011: 2). The Municipal Act restricts borrowing for speculative purposes only. However, there is no monitoring from central government. Linked to that, the so-called “golden rule” applies, which stipulates that borrowing is restricted to funding capital expenditure (OECD 2016). In the absence of state regulation, many local governments have taken idiosyncratic precautionary steps to limit operational risks (SALAR 2011: 9). For example, the majority of local governments have set limits on debts in foreign currency. In addition, borrowing is indirectly limited since all costs linked to the debt must be included in the balanced budget. Since 1992, local governments have needed to exercise “good financial management” in their activities (Statistics Sweden 2006). Since 2005, municipalities and county councils have set their own financial targets which are significant in relation to sound financial management (Ministry of Finance 2017: 37 f.).

Swedish local governments adhere to accrual-based accounting. Consolidated accounts are available for them and for affiliated companies (S&P 2011: 9). Along with (at least) one interim report, financial reporting is frequent. Following the Local Government Act, the budget for the following calendar year must be drafted by October and adopted by the assembly by November. If necessary, this deadline can be postponed until December. The budget has to contain a plan for activities and economic management, the next year’s tax rate and a balanced budget outlook. The budget is not exposed to any external oversight mechanism. Ex post, an annual report must be submitted to the council and to the auditors by mid-April of the following year. It must contain an administration report, an income statement, a balance sheet

and a cash flow analysis (SALAR 2011: 8). The accounts must be consolidated and encompass the operations conducted under separate legal entities such as publicly-owned enterprises. The annual statement must contain an assessment of whether the balanced budget requirement has been met and an evaluation of whether the requirement for sound financial management has been achieved (Ministry of Finance 2017: 37). Both the budget and the annual report must be made available to the public.

In the absence of formal supervision, the Ministry of Finance relies on local governments to signal and report financial distress (S&P 2011: 3 ff.). In the past, central government has extended support in these situations. Although there are no specific earmarked funds allocated for official bailouts, the central government has provided case-by-case financial support in severe situations, such as economic crises, one-off shocks to local labour markets or ailing municipal companies. Once a municipality or county has proven eligible for extraordinary support, it usually has to commit itself to recovery measures, such as cutting costs, increasing the tax rate or selling off assets. However, there is no right to being bailed out. The central government has also rejected local requests in the past.

One structured conditional bailout procedure occurred prior to the introduction of the balanced budget rule in 2000, when too many municipalities had not been able to establish a balanced budget (Dietrichson and Ellegard 2015: 5 ff.). Municipalities were free to apply and a special commission decided to increase revenue, if an applicant was eligible, on the basis of the structural situation, projected deficits, debt levels, etc. Each municipality had to develop a recovery plan on which the full payout of the bailout grant was conditional. The commission monitored the municipal actions during the programme period. Another historic circumstance with regards to the bailing out of municipalities ensued during the course of the property bust, beginning in the 1990s. Whereas the first programme led to a bailout of 36 municipalities in the year 2000, the second programme eased the fiscal situation of 52 municipalities between 1998 and 2005. According to national experts, these targeted bailout procedures are historical and presently not applied.

Due to local governments' special constitutional position and their right to levy taxes, they cannot declare bankruptcy (SALAR 2011: 11).

Local governments are not required to submit their budget to any government ministry for approval (S&P 2011: 8). Hence, the central level must simply rely on the fact that local

governments are complying with the accounting standards required by law. The year-end accounts (annual report) are subject to a formal audit, which is carried out by inhouse auditors appointed by the local council, with support from external professional auditors (Council of Europe 2014). Moreover, information on budget execution must be disclosed to the public. The auditors inspect whether the accounts are a true and fair reflection and whether the internal checks carried out within the relevant committees are sufficient. After the annual report has been analysed by the auditors, they state whether it can be accepted and the members of the executive board and other committees can be discharged from liability (SKoL 2014: 2 ff.).

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# 21 | Canada

Christian Person

## Summary

Canada is a federal state, consisting of a central, provincial and local level. Local governments are part of and subject to the ten provinces and three territories that form the provincial level. The local level consists of 5,162 municipalities, 143 regional governments and 2 supra-regional governments.<sup>1</sup> Local revenues basically rest on three pillars: intergovernmental transfers, tax revenues and user fees. Transfer dependency is quite high. With regards to own-source revenues, the property tax is the most important source of income for Canadian local governments. Municipalities are in charge of a wide range of services, with the most important services being infrastructure, transportation and public transport, policing and firefighting, public services, and education (school boards).

The general fiscal status of Canadian local governments is currently mixed and shows some signs of fiscal distress. In recent years, local governments (in sum) have regularly exhibited budget deficits. Nevertheless, the level of local indebtedness has remained rather low in comparison to the level of general government debt. However, local governments have a rather unfavourable revenue-side structure. They are strongly dependent on property tax revenue as their only relevant own-source income. As a consequence, revenue from

intergovernmental transfers is also very important for them. In addition, they are confronted with high infrastructure needs. Despite these structural deficits in local government finances, Canadian local governments weathered the economic downturn of 2008/2009 quite well. On the one hand, the property tax proved to be unresponsive to the development of the business cycle and, on the other, the higher levels of government reacted relatively quickly by increasing intergovernmental transfers to local governments, thereby stabilising their revenue side.

Fiscal oversight regimes in the provinces and territories are rather diverse, due to the federal structure of Canada. However, there are some commonalities. Local governments are generally obliged to adhere to a balanced budget rule. Long-term borrowing is only permitted for capital expenditure and not for operating expenses. Local governments must pay strict attention to borrowing rules; they are subject to intensive fiscal reporting and monitoring procedures as well as tight financial supervision by the provinces. If fiscal rules are broken, provincial oversight authorities can rely on different methods to bring the local budget back on track, some of which are fairly draconian (such as the appointment of an independent municipal administrator by the province or the dissolution of a municipality).

<sup>1</sup> In what follows, the terms "municipality" and "local government" are used interchangeably. If not stated otherwise, both terms refer to all three tiers of local government.

## 1 Administrative Structure

Canada is a federal state consisting of ten provinces and three territories at the provincial level (Figure 21.1). While the ten provinces have full constitutional authority, the three territories are under federal jurisdiction and have only limited authority, thus constitutionally they do not have their own level of government (Inwood 2012: 122; Parker 2015: 65).<sup>2</sup> According to section 92 (8) of the Federal Constitution (Constitution Act of 1867), the provinces have the authority to make laws relating to “Municipal Institutions in the Province”. Thus, regulation concerning local governments is exclusively within the jurisdiction of the provinces. Municipalities are “corporate entities with defined territories and delegated legal authority to enact bylaws relating to a range of government functions generally considered to be local in nature” (Sancton 2010: 131). As a consequence, municipalities are not recognised as a separate order of government (CLGF 2018: 48), but are part of and subject to the provinces<sup>3</sup> (Inwood 2012: 48), leading to a highly varied local government system. Due to the provincial authority in the regulation of local government, there is a high variance with regards to structure, functions, tasks and even the type of local governments between the provinces.

According to the Fiscal Management System of Statistics Canada, the Canadian federal office of statistics, the term “local government” comprises municipalities (e.g. cities, towns, villages, townships and counties) as well as associated autonomous boards, commissions, funds and school boards. However, this definition is not precise as sometimes the assignment of specific autonomous boards (such as health boards) or school boards at the provincial or local level is not clear at all (Sancton 2010: 131).

Thus, on the one hand, there are “classical” municipalities, which are in charge of a number (or all) local duties within a specific geographical area due to their role as a multi-purpose government. On the other hand, there also exist single-function or special-purpose governments (sometimes with their own elections, responsibilities and autonomous sources of revenue) that are responsible for only one specific task (for example, local commissions or boards for parks, social services, public health, policing, utilities, public transport and boards). These local government entities differ in terms of territory from “ordinary” municipalities as their sphere of influence can be, but need not necessarily be congruent with, the territory

<sup>2</sup> Territories are remote areas in the far north or islands with very limited population (about 120,000 in total according to the 2016 Census).

<sup>3</sup> Therefore, they are often termed “creatures of the provinces” (Thompson et al. 2014: 24).

FIGURE 21.1 Canada – Administrative Structure, 2016

Central Level	Federal Level
State Level	10 provinces and 3 territories
Local Level	2 supra-regional governments
	143 regional governments
	5,162 municipalities (census subdivision, around 3,600 local government councils thereof)

Source: 2016 Census; own representation

of the regular, multi-purpose local governments (for example, the municipalities). Instead, they may even overlap with the territories of different municipalities or be collectively funded by contiguous municipalities to fulfil certain duties jointly. In the last case, they are just a form of intermunicipal cooperation (Sancton 2010: 132).

While three provinces, British Columbia, Ontario and Québec, are characterised by a multi-tier local government system, including at least one regional tier, the other provinces and territories only have a single-tier local government system consisting of different types of municipalities with differing powers and responsibilities. British Columbia exhibits a two-tier system with regional districts and municipalities. The regional districts act as ordinary municipal governments in unincorporated areas of the province (for example, areas that do not belong to a specific municipality) and as an upper-tier government in those areas where municipalities exist. In the case of the latter, they are responsible for providing intermunicipal services and regional planning. Québec also has a two-tier system composed of regional county municipalities (performing similar tasks as in the case of British Columbia) and local municipalities. However, Québec has a third tier, for which, in regards to the metropolitan areas of Québec and Montréal, there exists a supra-regional local government body comprising the respective metropolitan communities. In contrast, Ontario is characterised by both single-tier and two-tier municipalities, whereby the latter are made up of an upper tier (the regional government) and a local tier (the local municipality) (CLGF 2018: 49; Sancton 2010: 132f).<sup>4</sup> In the other provinces and territories there is either no municipal government at all (unincorporated areas) or only one level of municipal government. Furthermore, the indigenous people of Canada (First nations, Inuit and Métis) have the right

<sup>4</sup> However, despite the existence of a second local government tier in Ontario and in Québec, in both provinces there are also areas with only one level of municipal government (Sancton 2010: 133).

of self-governance for their indigenous communities and groups (for example, in relation to tasks and duties such as government structure, land management, health care, child welfare, education, housing and economic development) within their respective territories. However, the self-government arrangements form a special type of local government that is not always subsumed under the header of local government (CLGF2018: 51).

Based on the Census of 2016<sup>5</sup> and applying the broad definition of Statistics Canada (that also considers unorganised subdivisions, for example, unincorporated areas and settlements of indigenous people but not boards, commissions and funds), Canada consists of 5,162 municipalities, leading to an average size of 6,810 inhabitants per municipality. If one were only to consider inhabited areas (thereby excluding around 300 units), this number would rise to 7,219 inhabitants per municipality. More than 70% of all Canadian municipalities have less than 2,000 inhabitants. Nevertheless, there is a huge range in the number of inhabitants in the municipalities, as Table 1 demonstrates. The largest city, Toronto, has 2,731,571 inhabitants. In contrast, there are a number of small villages with only five inhabitants. However, there are large differences between the provinces with regards to the number of municipalities as well as inhabitants. While the province of Québec is comprised of 1,285 municipalities (and 8,164,361 inhabitants), the territory of Nunavut only consists of 31 municipalities (and 35,944 inhabitants). If one focuses solely on local government councils of “ordinary” municipalities (excluding unorganised subdivisions and settlements of indigenous people, etc.) and upper-tier local governments, there are 3,598 local councils, 143 regional councils (in British Columbia, Ontario and Québec) as well as two supra-regional councils in Québec based on Census data from 2011 (for an overview, see CLGF 2018: 49).

Due to the federal structure of Canada, there is no uniform catalogue of tasks or duties that must be fulfilled by municipalities, as the provinces themselves decide on their own how such duties and tasks are to be distributed between the provincial and local government. Typical duties of local governments are the provision and maintenance of local infrastructure (roads, sidewalks, etc.), public transport, the regulation of taxis, the provision of recreational, cultural and sports facilities (such as parks, libraries and community halls), public services (water supply, sewage, garbage collection and waste disposal, electricity) or the planning and development of land use. In some provinces, local governments are also responsible for local policing, fire protection, social welfare and

5 <https://www12.statcan.gc.ca/census-recensement/2016/dp-pd/hlt-fst/pd-pl/comprehensive.cfm>.

TABLE 21.1 Canada – Population of Local Government Areas, 2016

	Smallest	Largest	Average
Municipalities	Various small villages (5)	Toronto (2,731,571)	6,810
Regional governments	Central Coast (3,319)	Greater Vancouver (2,463,431)	115,382
Supra-regional governments	Quebec Metropolitan Community (800,296)	Metropolitan Area of Greater Montreal (4,098,927)	2,449,612

Source: Statistics Canada (2016 Census); own calculations

health care. A special task is education (in particular primary and secondary schools), which is typically provided by (local) school boards (Sancton 2010: 133 f.; for an overview, see Tassonyi and Conger 2015: 4).

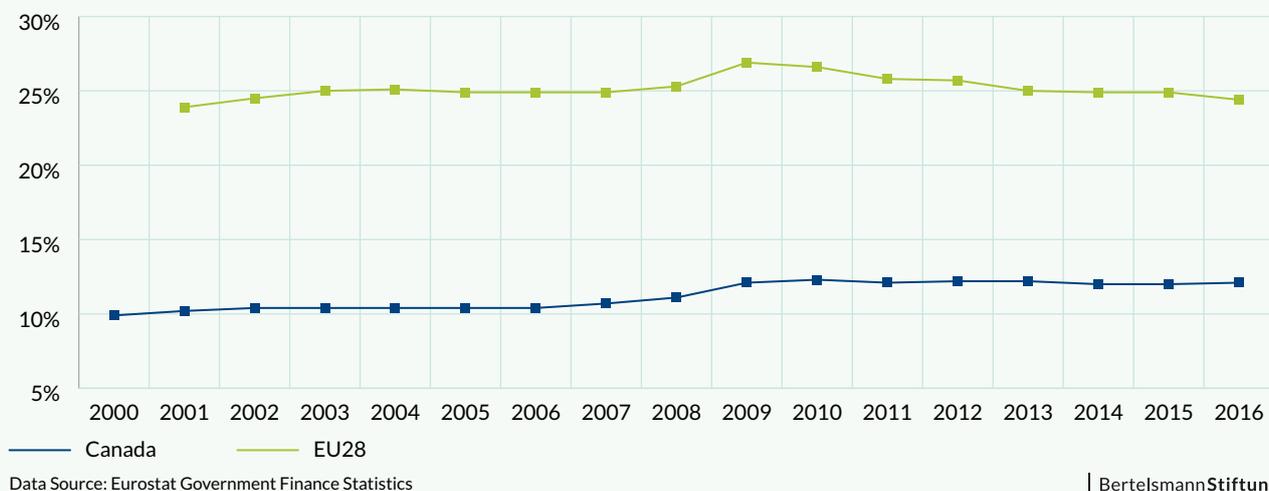
## 2 Revenue

In general, local government revenue represents about one tenth of total public revenue in Canada (Figure 21.3). Although in recent years the share of local governments in total public revenue has slightly increased from 10% to 12%, this seems to be low given the multifaceted duties and responsibilities of Canadian municipalities. In principal, municipal finance rests on three pillars: local tax revenue (almost exclusively derived from local property tax), user fees and charges from the sale of goods and services as well as intergovernmental transfers and grants from the federal or provincial governments. However, the fiscal importance of the respective revenue categories shows a large variation between the provinces (Miller 2014: 4; Thompson et al. 2014: 2). According to data from the OECD fiscal decentralisation database, revenue from intergovernmental transfers form the largest revenue category for local governments (around 42–47% of total local government revenue), followed by municipal tax revenue (39–42%) (Figure 21.2). Other revenue that predominantly consists of user fees and charges from the sale of goods and services (to a minor degree they also consist of property income or fines, penalties and forfeits) account for about 16–17% of local government revenue.

With regards to local taxation, the property tax (the only municipal tax levied in all provinces and territories) serves as the main source of local tax revenue and accounts for about 97–98% (!) of all local tax income. With a share of around two

FIGURE 21.2 Canada – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



fifths of the total local budget, it makes up about 60% of the municipalities' own-sourced revenue (Thompson et al. 2014: 27) and forms a cornerstone of municipal finance in Canada. With regards to property tax, municipalities have the right to determine the tax rate on their own in order to adjust their revenues to their expenditure needs (CLGF 2018: 52 f.). As a consequence of a lack of further taxation rights and the essential relevance of the property tax, Canadian municipalities have some of the highest property tax rates in the world (Miller 2014: 5). That said, although the property tax provides local governments with a stable income source, it has some serious disadvantages: on the one hand, it is highly regressive and, on the other, rates have to be adjusted regularly to keep pace with inflation<sup>6</sup> and/or growing municipal financial needs, which often provokes fierce opposition by the taxpayers (Miller 2014: 8 f.; Thompson et al. 2014: 27 ff.). However, the fiscal weight of the property tax shows high variation between the provinces and territories. According to self-calculations based on data from Statistics Canada,<sup>7</sup> in 2015 the share of property tax revenue for local governments in respect to total municipal revenues ranged from merely 8% in the territory of Nunavut to 67% in the province Nova Scotia. In principal, property tax revenue shares are much lower in the three territories than in the ten provinces.

6 The tax base of the property tax is the assessed value of a given property, which generally will reflect its market value. Although there are regular revaluations, assessed values sometimes lag behind the actual market values of the property due to time delays with regards to the assessment of the property (Thompson et al 2014: 27).

7 Statistics Canada. Table 10-10-0020-01 Canadian government finance statistics for municipalities and other local public administrations (x 1,000,000).

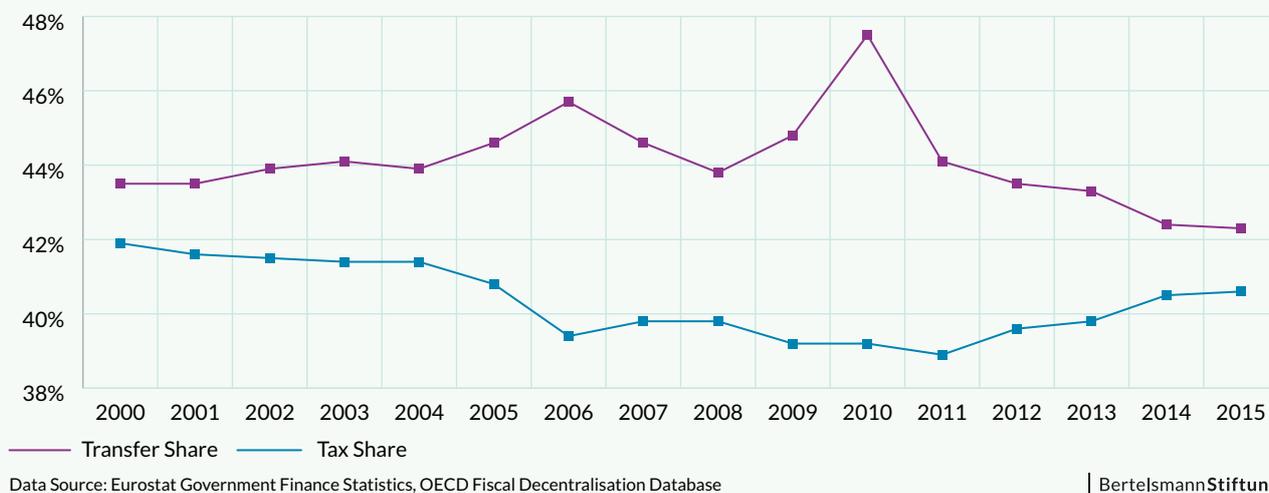
Besides the property tax, in some provinces local governments have a share in the provincial (personal or corporate) income tax (Manitoba) or in the provincial sales tax revenues (Saskatchewan and Manitoba). In addition, a share of the federal fuel tax is also transferred to municipalities. Some provinces also transfer a share of their provincial fuel taxes to local governments, while some large cities (Montreal and Victoria) or regions (Region of Greater Vancouver) are allowed to levy a local/regional fuel tax. In some, but not in all provinces, municipalities (or a subgroup of them) are allowed to levy land transfer taxes (charged on the sale of property), hotel and accommodation taxes, amusement taxes, advertisement taxes, poll tax, vehicle registration tax, tax increment financing, area improvement tax, etc. (Miller 2014: 11 ff.; for an overview, see Thompson et al. 2014: 26). Nevertheless, these other tax sources are typically only of minor importance for local governments (CLGF 2018: 52 f.).

Following local taxes, user fees and charges for goods and services (for example, public transport, water, parking and recreation) form the second largest own-sourced revenue stream for Canadian local governments (Thompson et al. 2014: 3) and are sometimes used as an alternative to taxation if cities are pressured to limit increases in property tax (Miller 2014: 5). Typical examples are development charges collected as a part of the approval process for a new development area,<sup>8</sup> parking fees or road use pricing in order to cover part of the costs of road construction and maintenance or to subsidise public transport (Miller 2014: 18 ff.; Thompson et al. 2014: 32 ff.).

8 The intention is to offset or reimburse part of the costs covered by municipalities for providing infrastructure needed for these developments (such as sewer, water, drainage systems and roads, etc.).

FIGURE 21.3 Canada – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



The third important revenue source is transfers from the federal or the provincial government. The provinces and territories mainly provide these transfers whereas central government transfers only play a minor role. While the provincial governments mostly assign special purpose grants or earmarked transfers (about 80% being conditional transfers compared to around 20% general purpose grants), federal transfers are more evenly distributed between both categories (CLGF 2018: 52 f.; Miller 2014: 6; Thompson et al. 2014: 34 f.). Federal transfers are, for example, fuel tax transfer, infrastructure grants, grants for the homeless and economic stimulus grants. Conditional transfers by the provinces are mainly provided for social services (in the province of Ontario), transportation (roads, public transport) or environmental (water, sewage and solid waste), while unconditional transfers are allocated on a per capita basis or by more complex equalisation schemes (Slack 2011: 9 f.). As the provision of grants and intergovernmental transfers is an area of responsibility of the provinces, there is a large variation with regards to the design of the grants and the local fiscal equalisation schemes as well as the fiscal weight of grants within the system of municipal finance. According to own calculations, based on data from Statistics Canada,<sup>9</sup> in 2015 the share of grant revenue of local governments in terms of total municipal revenue, ranged from a mere 6% in the province of British Columbia and 8% in Nova Scotia to 59% in the Northwest Territories. In principal, grant revenue shares are much higher in the three territories than in the ten

provinces. Moreover, as smaller municipalities, in particular, have below-average per capita revenue and thus difficulties in generating enough own-sourced revenues, they are typically more dependent on grants and transfers from higher levels of government (Thompson et al. 2014: 19).

### 3 Expenditure

The important role of Canadian local governments in the provision of public services is reflected in the share of local government expenditure in relation to general government expenditure (Figure 21.4). In 2016, public spending on local governments accounted for about 21% of total government expenditure. Moreover, between 2000 and 2016 local government spending as a share of total public spending exhibited an increasing trend and grew slightly from 19% (in 2000) to 21% (in 2016), thereby underlining the relevance of municipalities in the provision of local public goods and services.

Figure 21.5b shows local public expenditure by function as a share of total expenditure of local governments, initially without school boards. According to these numbers, the most important duties carried out by Canadian local governments are in the areas of public order and safety (e.g. policing, firefighting, regulatory tasks) as well as economic affairs (for example, communication, transportation and public transport, infrastructure, and public services), which both amount to around 20% respectively. Other important duties are environmental responsibilities (water purification and supply,

<sup>9</sup> Statistics Canada. Table 10-10-0020-01 Canadian government finance statistics for municipalities and other local public administrations (x 1,000,000).

FIGURE 21.4 **Canada - Local Government Aggregate Expenditures**  
As Share of General Government Expenditures - From 2000 to 2016

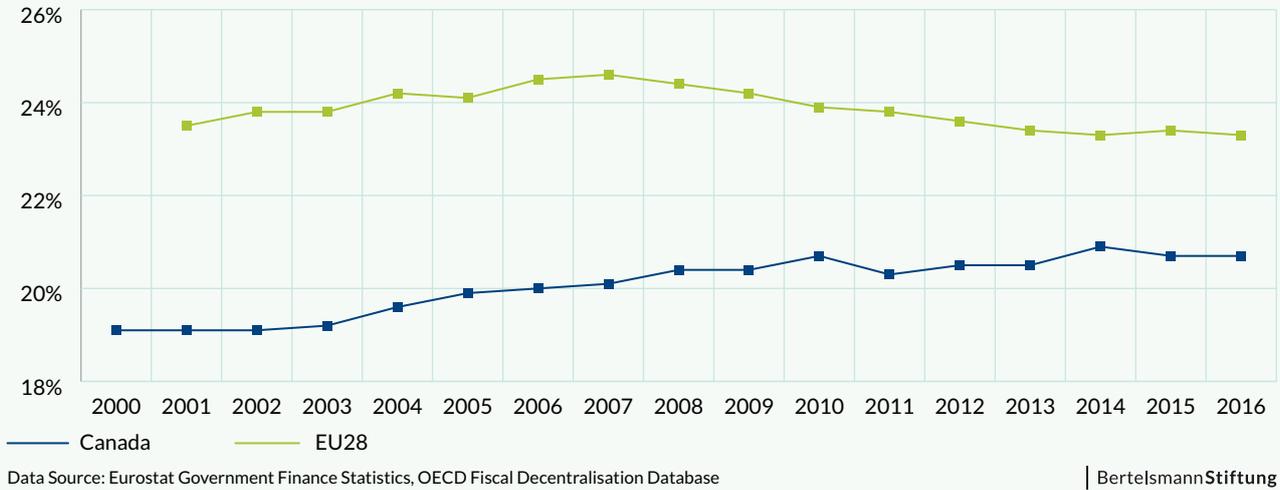


FIGURE 21.5A **Canada - Local Government Expenditures by Function (including school boards)**  
As Share of Total Local Government Expenditures

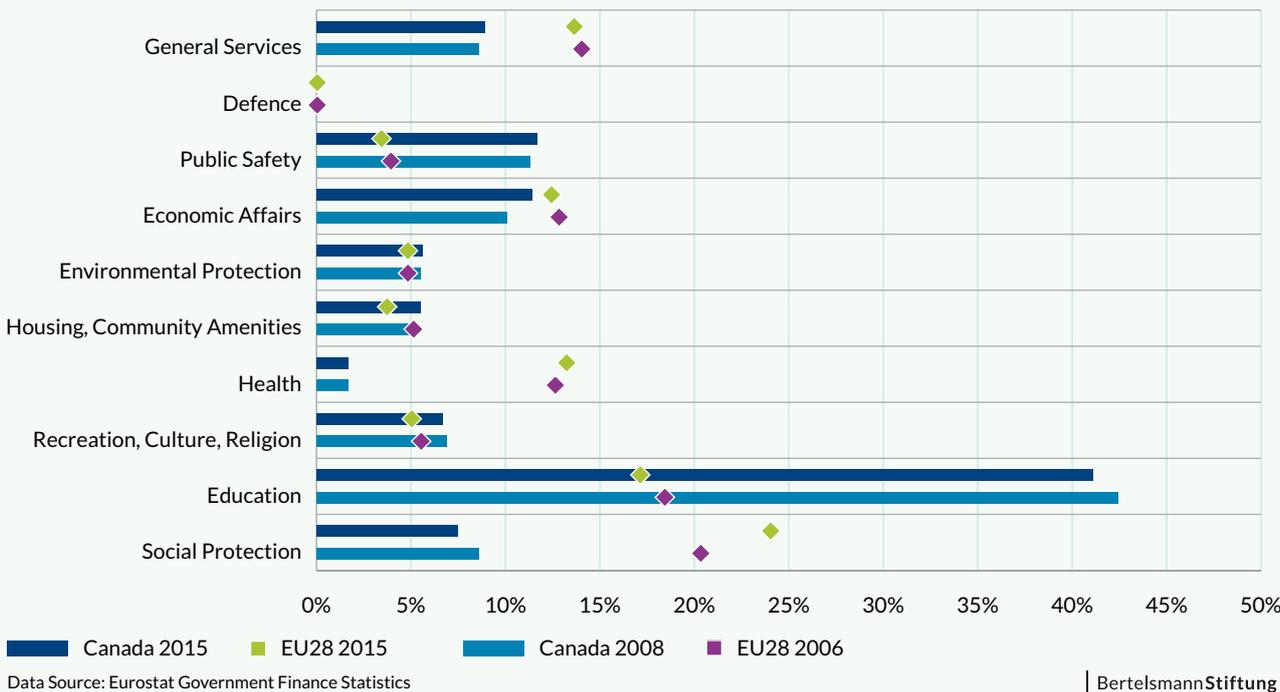
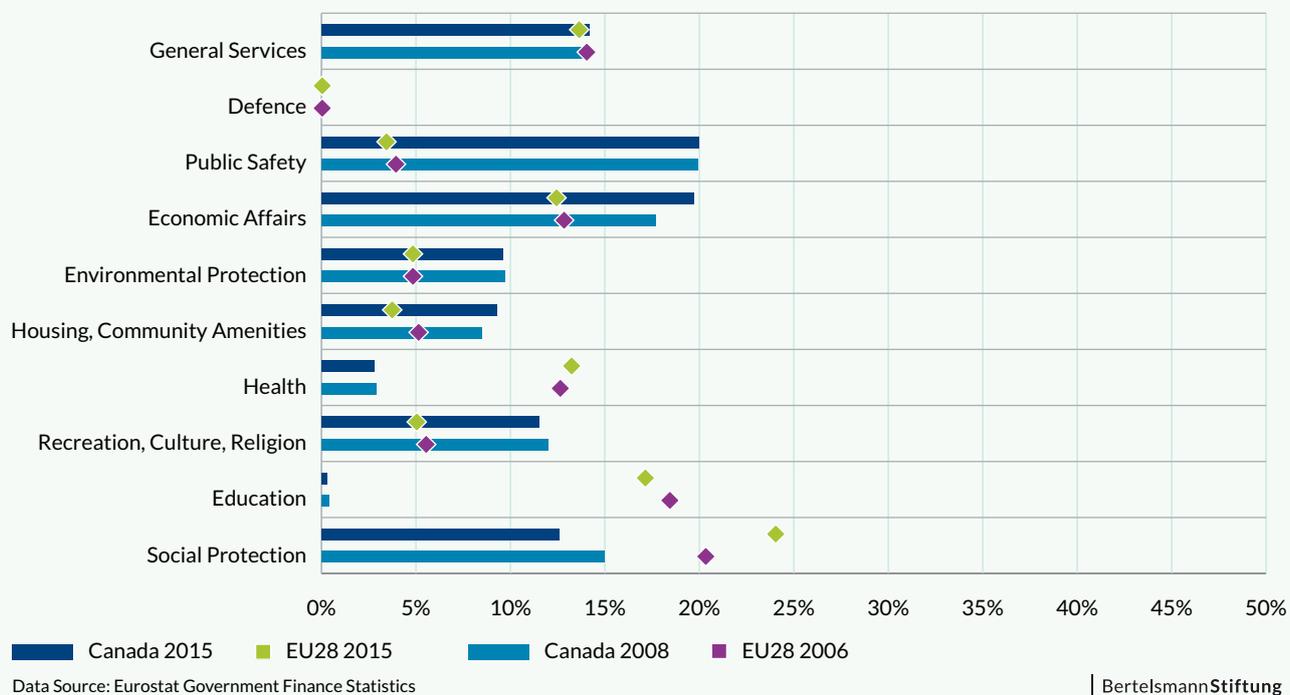


FIGURE 21.5B **Canada – Local Government Expenditures by Function (excluding school boards)**  
As Share of Total Local Government Expenditures



sewage collection and disposal, garbage and waste collection and disposal) and recreation, though with lower expenditure shares at around 10%. At least in some provinces, housing, social welfare and health care are also important duties. As long as one ignores school boards, spending for education plays no important role. In general, one can observe large differences between the provinces with regards to the importance of individual spending categories (Thompson et al 2014: 15). Over time, one can observe that the share of expenditure for public order and safety as well as environmental duties remained stable. While the share of spending on economic matters and housing increased slightly between 2008 and 2015, the opposite is true for social welfare spending and expenditure for recreation, culture and religion.

Moreover, in the future, it can be expected that spending on infrastructure, one of the most important and strongly growing responsibilities of Canadian local governments, will show further increases due to the ongoing growth of municipalities and the associated infrastructure expansion. Furthermore, in recent years, municipalities have not invested enough in their infrastructure, due to an insufficient fiscal endowment. As a consequence, much existing infrastructure is in need of repair, maintenance or replacement. This has led to a massive investment backlog with regards to public infrastructure,

which is estimated to amount to tens of billions of Canadian dollars (Thompson et al. 2014: 16).

A different pattern in respect to local spending emerges if one includes school boards (see Figure 21.5a). In that case, education becomes the dominant expenditure category. Around 40% of total local government expenditure is spent for educational purposes, if one also takes school boards into account. Furthermore, the share of spending for education is rather stable over time and decreases only minimally between 2008 and 2015 (about one percentage point).

## 4 General Fiscal Status

The current fiscal status of Canadian local governments is mixed and shows some signs of fiscal distress. As Figure 21.7 shows, between 2000 and 2016, local-level governments recorded aggregate budget deficits in most of the years under observation, even though the Canadian economy exhibited sound GDP growth rates of around 2–3% during these years in most cases. Thus, Canadian municipalities seemed to only partially profit from the booming economy. However, one can observe a slight recovery, as the aggregated local budget deficits in recent years were much lower than at the beginning

of the investigation period. Furthermore, despite the constant budget deficits of municipalities, local-level government debt is low and accounts for only 8–12% of total government debt (Figure 21.8). While at the beginning of the 2000s, local government indebtedness noticeably increased from 8% to 12% of total government debt (reaching its maximum in 2008) as a consequence of the relatively high aggregated local budget deficits at the beginning of the new millennium, in recent years, the share of local debt has slightly decreased again.

Despite these numbers, it is argued that municipalities have done rather well in terms of fiscal measures (with regards to the size of their operating deficit, amount of borrowing, size of reserves and local tax rates; see Slack 2011: 18), given the challenges with which they were confronted. On the one hand, in recent decades, the federal government and the provinces offloaded many duties and responsibilities to the local level (for example, social services, housing and policing) or raised standards for service provision and delivery (for example, drinking water or wastewater quality standards) without providing adequate and sufficient funding to refinance them. Instead, especially during the 1980s and 1990s, they even cut transfers to local governments (Thompson et al. 2014: 14 f.). On the other hand, municipalities were and are confronted with increasing costs due to urban sprawl, fragmented metropolitan areas, etc. Moreover, local governments lack a diversification of profitable revenue sources as they are strongly dependent on property tax revenue and user fees as Section 2 shows (Slack 2011: 17; Miller 2014: 1). Furthermore, their revenues are limited as they do not (or only in part) automatically increase with economic growth and inflation (leading to growing costs of service delivery) (Thompson et al. 2014: 14–15). As a consequence, the relative fiscal health of local-level government has been achieved at the cost of the overall health of the municipality: the state of municipal infrastructure as well as the quality of services provided locally were partly neglected and show clear potential for improvements (Slack 2011: 19). In light of increasing responsibilities as well as costs of service delivery, many municipalities are struggling to finance infrastructure and central municipal services in general. Therefore, different authors argue that Canadian local governments lack a sound financial footing in order to meet the growing demands of citizens for high-quality municipal services and infrastructure and conclude that local governments need more diversified and adequate revenue sources and revenue-raising instruments to match their expenditure responsibilities (Slack 2011: 30; Miller 2014: 1 f.; Thompson et al. 2014: 1).

## 5 Effects of the Financial Crisis

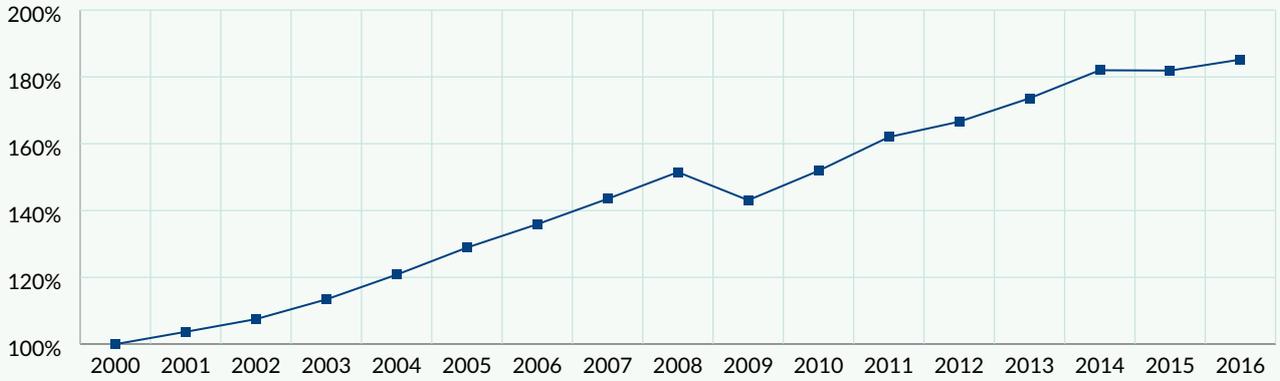
Like most OECD countries, Canada was hit hard by the global financial crisis. While exhibiting constant growth rates of about 2–3% before the crisis, economic development noticeably cooled in 2008 with a growth rate of only 1%. In 2009, when the global financial crisis was unfolding, Canadian GDP declined strongly and dropped by about 3%, although Canada was not in the epicentre of the crisis thanks to a rather prudent and sound banking system. Moreover, the unemployment rate increased by 2.3%, from 6% in 2007 to 8.3% in 2009, though this rise remained behind the hikes in the unemployment rate in earlier recessions (Champagne 2011: 312). Although Canada was rather reluctant at the beginning of the crisis in 2008, the Conservative minority government began to respond to and counteract the crisis in early 2009 by implementing an ambitious fiscal stimulus programme, Canada's Economic Action Plan. This step was pushed by pressure from the international community as well as a uniform coalition of the three opposition parties in Parliament (Champagne 2011: 309).

The stimulus package included a substantial infrastructure investment plan, support for industries (mainly the automotive industry, which was hit particularly hard by the crisis) and local governments, but also help for the unemployed and reductions in the tax burden on Canadian citizens. The stimulus plan was to reach a volume of 61.6 billion Canadian dollars, the bulk of which was to come from the federal government (47.2 billion dollars) and the rest from the sub-national governments (Champagne 2011: 316 f.). This fiscal stimulus was accompanied by a supportive monetary policy by the Canadian central bank, which massively lowered its key interest rate in order to support aggregate demand and boost economic development.

Consequently, Canada overcame the financial crisis quickly and the economy soon recovered (see Figure 21.6). Already in 2010 and 2011, the Canadian economy grew once again with rates of 3%. Thus, Canada showed a remarkable resilience in light of the financial crisis and weathered the economic downturn well. This fast, strong recovery following the crisis was not only caused by the ambitious fiscal stimulus programme and supportive monetary policy, but also by an impressive rise in commodity prices that lasted until 2014, a strong recovery in Canada's main trading partner, the USA, as well as the fact that Canada had had a sound, prudent banking system that was not as strongly exposed to the crisis as the banking sectors in other OECD countries due to Canada's stricter regulation (OECD 2016: 16).

FIGURE 21.6 Canada - Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 21.7 Canada - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2000 to 2016



Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 21.8 Canada - Local Government Aggregate Debt

As Share of General Government Debt - From 2000 to 2016

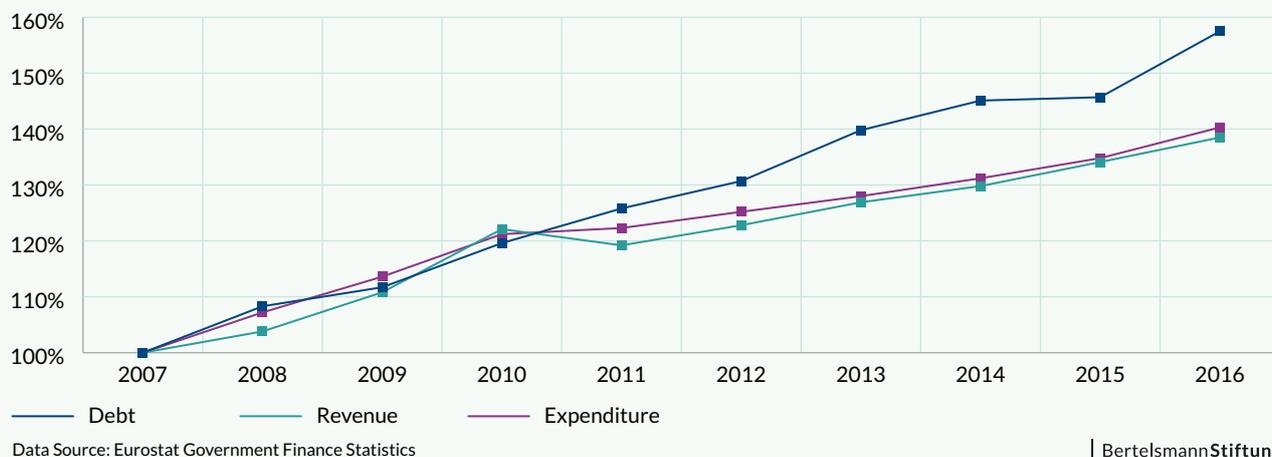


Data Source: Eurostat Government Finance Statistics

| BertelsmannStiftung

FIGURE 21.9 Canada – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



However, the fight against the repercussions of the financial crisis had a price and public finances deteriorated. Therefore, in order to restore its public finances after the crisis, the federal government of Canada soon implemented budget consolidation measures, thereby applying a three-fold approach. First, already in 2010, it began to gradually withdraw the exceptional stimulus measures that were implemented to fight the global financial crisis. Secondly, it implemented targeted programme spending cuts to dissolve the massive deficits in the federal budget. Thus, the fiscal consolidation plan focused strongly on expenditure-side measures. Thirdly, the Canadian government started a comprehensive efficiency review of the public administration (OECD 2015: 65).

The global financial crisis did not only affect the federal government, but also local governments. However, Canadian local governments weathered the economic downturn relatively well (Champagne 2011: 318 ff.). While the recession forced the aggregate local budget into the red, the magnitudes of the budget deficits in 2008 and 2009 were lower than at the beginning of the 2000s (i.e. a period that was characterised by a booming economy). Already in 2010, directly after the crisis, the aggregate local budget achieved a budget surplus once again. However, one has to admit that in the following years, the aggregate local budget was again characterised by deficits, although the magnitude of these deficits were lower than during the financial crisis (Figure 21.7).

There are different reasons why the magnitude of the budget deficit remained limited during the crisis years. To begin with, as Figure 21.9 indicates, even during the years of the financial crisis (2008 and 2009), local governments did

not experience a decrease in their revenue, as one might expect. Instead, even under these unfavourable economic conditions, local government revenue continued to grow. There are two reasons for this: first, the property tax as the main income source of local governments proved to be not very sensitive to the economic downturn, thereby guaranteeing local governments stable revenues over the business cycle. Even during the crisis years, property tax exhibited growth rates of 4–6%, basically equivalent to the years before the crisis. Secondly, during the crisis the federal and provincial governments strongly (but only temporarily) increased fiscal transfers to the municipalities (2008: +2%; 2009: +9%; 2010: +17%), thereby stabilising the revenue basis of local governments. However, at the same time, not only the revenue side, but also the expenditure side witnessed noticeable increases (2008: +8%; 2009: +5%; 2010: +5%) that could only partially be compensated by the stabilisation of the revenue side, although the rise of expenditure was rather limited, given the extent of the downturn and the magnitude of the crisis.<sup>10</sup> As a consequence of these developments on both the revenue and expenditure sides, not only the deficits had moved into the red, but also the indebtedness of local governments increased, a trend that has continued (Figure 21.9).

<sup>10</sup> Own calculations based on data from Statistics Canada. <https://www.fin.gc.ca/frt-trf/2017/frt-trf-17-eng.asp>.

## 6 Fiscal Rules and Fiscal Oversight

As local governments in Canada are legal subjects of their respective provinces and territories, all provinces have legal provisions concerning the regulation, approval, control and supervision of local government finances. However, due to the federal nature of Canada, these regulations exhibit some variation between the provinces. Nevertheless, there are commonalities among them. In general, local government finance, especially local budgeting as well as local borrowing and debt, is highly controlled and tightly constrained. Local governments face formal and hard budgetary constraints based on administrative fiat by the provinces: local revenue and expenditure decisions are tightly controlled, local borrowing is severely limited and needs provincial approval and intergovernmental grants by the provinces are in general designed as highly conditional, earmarked transfers. The emergence of a strict regulatory system after the Second World War (lasting until today) was mainly a response to the historic fiscal crisis of many local governments during the Great Recession of the 1930s, characterised by a wave of local defaults and insolvencies, amounting to about 10% of total local-level debt. In 1940, even a large city like Montreal defaulted and was put under financial supervision by the province for a couple of years (Bird and Tassonyi 2001: 84–85, 92 ff.).

All provinces exhibit a balanced budget requirement for their local governments. In principal, they are not allowed to run deficits in order to cover operating expenses (for example, current spending). In the case of short-term liquidity shortfalls during the budgetary year, they can borrow money on a short-term basis to bridge the liquidity gap but this debt has to be repaid during the budgetary year. Nevertheless, if a budget deficit does occur at the end of the budgetary year, it has to be financed and dissolved in the budget of the following year. In some provinces (such as Manitoba), in the case of budgetary deficits, ministerial<sup>11</sup> approval is necessary, to which may be attached any conditions that the minister considers necessary to address and dissolve the budget deficit in the near future. Long-term borrowing is subject to strict regulation and only allowed to cover capital expenditures, not current spending (Tassonyi and Conger 2015: 16; Miller 2014: 4 f.; Bird and Tassonyi 2001: 96).

Municipal borrowing capacities are limited by the provinces as borrowing often needs prior approval of the provincial government (in general or if certain thresholds are passed) or is

restricted to certain thresholds. Such thresholds are designed as a percentage of debt or debt servicing in relation to own-sourced revenues, general revenues (sometimes corrected for specific revenue streams such as capital transfers), assessed value of the real property of the municipality, operating expenditures, etc.<sup>12</sup> Beyond these thresholds, municipalities are not allowed to issue debt or they need specific approval by the provincial government. However, sometimes there are special rules for specific municipalities, especially large cities such as Toronto or Vancouver, which can establish their own rules, thereby needing ministerial approval for the respective by-laws (Thompson et al. 2014: 25; for an overview, see Tassonyi and Conger 2015: 17).

With regards to the borrowing process, municipalities face different borrowing options. While in some provinces, local governments can borrow on their own on the general bond market, from infrastructure banks or internal revolving funds, in other provinces they do not borrow on the private market but directly via other public corporations (e.g. provinces), via government-facilitated financing facilities such as municipal financing authorities (Thompson et al 2014: 41–42). These are centralised provincial lending agencies, which borrow on the capital market and lend those funds to municipalities. As these agencies are backed by the provincial governments and explicitly guarantee the local debt, they have high credit ratings and can borrow at lower interest rates. As a consequence, this procedure reduces the borrowing costs of municipalities, especially smaller ones, due to administrative savings as well as lower interest rates and lower transaction costs, compared to situations where municipalities would have to borrow on their own (Miller 2014: 24 f.). All in all, the existing strict borrowing rules lead to hard budget constraints for local governments but, at the same time, this improves their ability to borrow (due to high credibility in capital markets) as well as set incentives for the implementation of conservative financial management styles and pay-as-you-go policies with regards to capital financing (Tassonyi and Conger 2015:17).

Besides these strict rules in respect to deficits and borrowing, the budgetary process itself is also characterised by strict financial reporting and monitoring procedures. Some provinces (such as New Foundland and Labrador or New Brunswick)

<sup>11</sup> Typically, the Ministry of Municipal Affairs (or Local Government) is in charge of this task.

<sup>12</sup> For example, in the province of Ontario (with the exception of the City of Toronto, having its own regulation), as long as the debt charges of municipalities are lower than 25% of their own-sourced revenues, they need no approval by the province. Only if they pass the threshold, any further issuing of debt needs provincial approval. The province of Alberta has a debt limit of 150% of municipal revenues and a limit for debt charges of 25% of municipal revenues. If a municipality passes this threshold, any further issuing of debt needs approval by the Minister of Municipal Affairs (special rules apply to some cities such as Edmonton or Calgary) (Tassonyi and Conger 2015: 16).

have installed *ex ante* control procedures, whereby budget proposals have to be approved *ex ante* by the responsible ministry before they enter into force. The ministry can postpone the preparation, adoption or submission of the budget and require a revision of the budget proposal. Furthermore, all provinces have strict *ex post* financial reporting and monitoring procedures. Thus, municipalities are obliged to prepare annual financial statements and financial information, which have to be audited by professional auditors according to general methods of accounting and then presented in and reported to the council and sent to the ministries responsible. In general, the municipal council must appoint an approved auditor to review the books of the municipality. Approved auditors must be chartered professional accountants. Public as well as private-sector auditors are permissible. They must be external auditors; typically it is not permissible to appoint an employee of the respective municipality as an auditor (although there are some exceptions for large cities, which can also appoint an employee of the municipality as an auditor). In some provinces, municipalities also have the option to appoint an auditor from the Auditor General and his/her staff. Alternatively, local-government acts typically also allow for the possibility of a ministerial appointment of an auditor, if, for example, a council does not appoint an auditor at all, if it appoints a person who is not suitable, if the minister requests additional, special auditing reports or if it is considered necessary by the minister. Moreover, in most provinces, councillors are personally liable for financial transactions such as expenditure and borrowing that violate the rules of the respective Municipal Codes or relevant by-laws (for example, if councillors were to borrow in excess of debt limits without the permission of the ministry).

As local governments basically act as agents of the provinces (with regards to service provision and in fiscal terms), they can expect a bailout by their respective province in the case of economic or fiscal trouble. They benefit from an underlying implicit guarantee by the provincial governments that any municipality will meet its fiscal obligations in any case. Thus, it is typically assumed that Canadian local governments cannot go bankrupt (as in the case of Detroit).<sup>13</sup> However, the other side of the coin is the fact that Canadian municipalities are subject to strict control by the provinces over all aspects of local finance, as mentioned previously. Moreover, rescue by the province has its price: if a municipality faces serious fiscal deficits, the provincial government can take over some of its functions, place the municipality under financial supervision (thereby taking control of local finances) or require an adjustment of municipal boundaries or a municipal amalgamation. Additionally, the costs of the rescue have to be

borne locally. Consequently, local citizens, not creditors, have to pay for potential fiscal misbehaviour of local political or administrative leaders (Bird and Tassonyi 2001: 92, 99).

With regards to fiscal oversight over local government finances, Canadian provinces have rather large financial supervision rights. As the provinces have no written constitutions, there is no “home rule” for Canadian municipalities, for example, a set of provisions preventing provincial legislatures from interfering within municipal affairs: “Provincial legislatures can do whatever they want with local governments, including abolishing all of them all at once. This possibility applies even to municipalities that predate the provinces in which they are located” (Sancton 2010: 134). Therefore, the provinces have encompassing, in part even fairly draconian intervention rights with regards to municipalities (Siegel 2009: 37 ff.), leading to a tight and strict system of supervision and monitoring of municipal affairs. Oversight can be conducted by the ministry responsible for municipal affairs itself or by special institutions, quasi-autonomous and quasi-judicial bodies (Siegel 2009: 37). The majority of the provinces have municipal boards or commissions appointed by the provincial government that are responsible for reviewing specific local government actions such as capital expenditure, public borrowing or the enactment of local bylaws (CLGF 2018: 52).

If the province thinks that a municipal administration or council is not working in the interest of its residents or the responsible minister considers that a municipality is being managed in an irregular or improper manner, the oversight authorities have the right to initiate inquiries and investigations. They can recommend the provision of additional services or the adoption of certain measures and actions by the municipality and can direct the council or the administrative head of the municipality to take any measures the oversight authorities or minister consider proper under any given circumstances (CLGF 2018: 49, 52). If such orders by the minister or the oversight authorities are not carried out satisfactorily, the oversight agencies can intervene directly (for example, by repealing or amending certain actions of the municipality or by making decisions on behalf of the municipality). If a council does not fulfil its duties or if a municipality is in serious financial difficulties, the oversight authorities can appoint a municipal administrator as a supervisor (having all the powers and duties of the council) or dismiss the council (CLGF 2018: 49, 52). Under these circumstances, the municipality is put under supervision. Local decision-makers then need the approval of the supervisor for any financial transaction or any other matter affecting the administration of the affairs of the respective municipality. If the municipality fails to comply with the orders of the supervisor, the minister can issue orders directly. In the

13 <http://www.governing.com/columns/public-money/gov-municipal-debt-traps-nein.html>.

extreme case, the provincial government can suspend all local authority and take over the operation of the municipality. The independent administrator, who is only accountable to and under the control of the minister, will then act on behalf of the council and/or the chief administrative officer. The costs of the official administrator have to be paid by the municipality. However, this measure is only adopted under very extreme circumstances. For example, if a closure of a major company or industry causes a sudden and temporary but massive fall in tax revenue, so much so that a municipality is not able to collect sufficient property tax revenue, thus being basically without any relevant own-sourced revenue, then the ministry would provide funding and would take over the complete operation of municipal services, but only for a limited time until the economic and fiscal situation of the municipality improves. However, sometimes such a control phase can last for a significant time span. There are seldom more than a small number of municipalities under this kind of surveillance (Siegel 2009: 37 ff.).

If a municipality is on the brink of insolvency (or is de facto insolvent) and the Lieutenant Governor in Council of the respective province<sup>14</sup> considers it to be in the best interest of the municipality and its citizens and creditors that the municipality be dissolved, some local-government acts offer the possibility of dissolving the municipality and appointing a receiver. The receiver acts on behalf of the council or chief administrative officer, is subject to the direction of the minister and is responsible for the liquidation of the municipality, for example, to pay the municipality's liabilities and manage the process of its dissolution or to manage a potential amalgamation with another municipality.

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<sup>14</sup> The lieutenant governor is the representative of the English Crown (i.e. the Canadian head of state, which is currently Queen Elizabeth II) in a provincial jurisdiction. He/she is appointed on the advice of the Canadian prime minister and carries out the monarch's constitutional duties.



# 22 | Michigan (US)

René Geißler

## Summary

The State of Michigan is one of 50 member states of the United States of America (US). The US has a remarkably decentralised and uncoupled type of federalism and therefore states have very high degrees of autonomy. This also holds true for local government and local finances.

Michigan's local level is substructured into four types of general-purpose government (83 counties, 279 cities, 254 villages, 1,240 townships). In addition, there are about 1,000 special-purpose local governments, for instance for schooling. Michigan's local level is characterised by a large number of local governments with overlapping geographical boundaries, often with overlapping service responsibilities and taxation authority. Local governments are funded mainly by state grants and property taxes but also from user charges. Taxation authority is restricted in general. There is no fiscal equalisation.

Insufficient and under-diversified local revenue has been a big issue in Michigan for many years. State revenue sharing is declining and limited to the state's sales tax. Local governments rely heavily on property tax, which is also volatile and limited by law. Michigan's local finances have been worsening since 2001. The great recession of 2008 meant they took a further

and historically hard hit, with lasting impacts to property tax bases and public employment.

Michigan's local governments face a balanced budget requirement and need state approval to issue bonds. Michigan is one of a few US states where a bankruptcy regulation and an established system of financial oversight is in place. The state treasury implemented a system of supervisory fiscal indicators, the results of which are publicly available. The law on financial emergencies allows the state to conduct budgetary reviews and to appoint emergency managers to restructure local budgets. This process can end with a filing for bankruptcy which is meant to achieve a restructuring of local debt at sustainable volumes. Beyond this, there is a system of conditional emergency loans and a type of oversight by capital markets and ratings.

## 1 Administrative Structure

Michigan’s local level is characterised by a large number of local governments with overlapping geographical boundaries, often with overlapping service responsibilities and taxation authority (CRCM 2017: 2). There are four types of general-purpose local authorities, comprised of 1,856 entities. The entire state is structured into 83 counties, which are further subdivided into 553 municipalities (cities and villages) and 1,240 townships (US Census Bureau 2012). There are no cities with county rights. Only half of the general-purpose local governments have full-time employees (Fitzpatrick, Horner, Ivacko 2018: 3). Local autonomy and tradition rank very high in public and state politics. The state constitution protects the geographical structure of the counties, most of which were established in the 19th century. Therefore, not a single merger has been enforced by the state. Consolidation of townships, cities and villages is possible by local referendum but has hardly ever happened.

Beyond general-purpose local governments there are also those of special purpose, delivering single services such as water, sanitation or fire protection. Most relevant are the independent school districts (576 of them), which are local governments but are not coherent in their geography with municipalities. Historically, school districts have been widely funded by property taxes, having their own rights of taxation. By 1994, the state reformed this system fundamentally. Unlike most US states, the state of Michigan funds the lion’s share on a per pupil basis (sales taxes were raised and a new state education tax was introduced in this regard), showing equalisation effects between school districts. Still, there is limited room for setting property taxes but this flow of revenue is restricted to infrastructure and additional equipment. Residents of each school district elect a school district board.

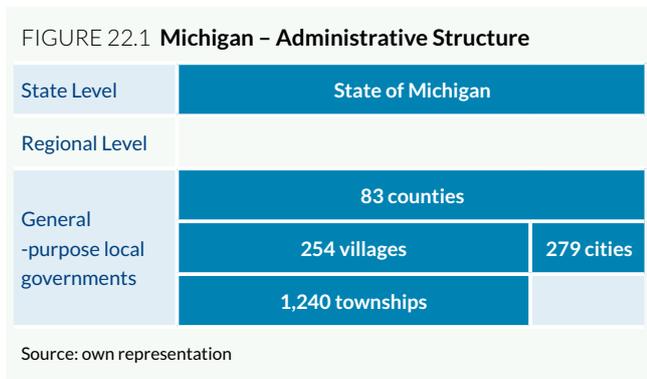


TABLE 22.1 Population of General-Purpose Local Governments, 2016

	Smallest	Largest	Average
County	Keweenaw (2,200)	Wayne (1,820,000)	120,000
City	Lake Angelus (300)	Detroit (714,000)	No data
Village	Turner (114)	Beverly Hills (10,300)	No data
Township	No data	Clinton (97,000)	400

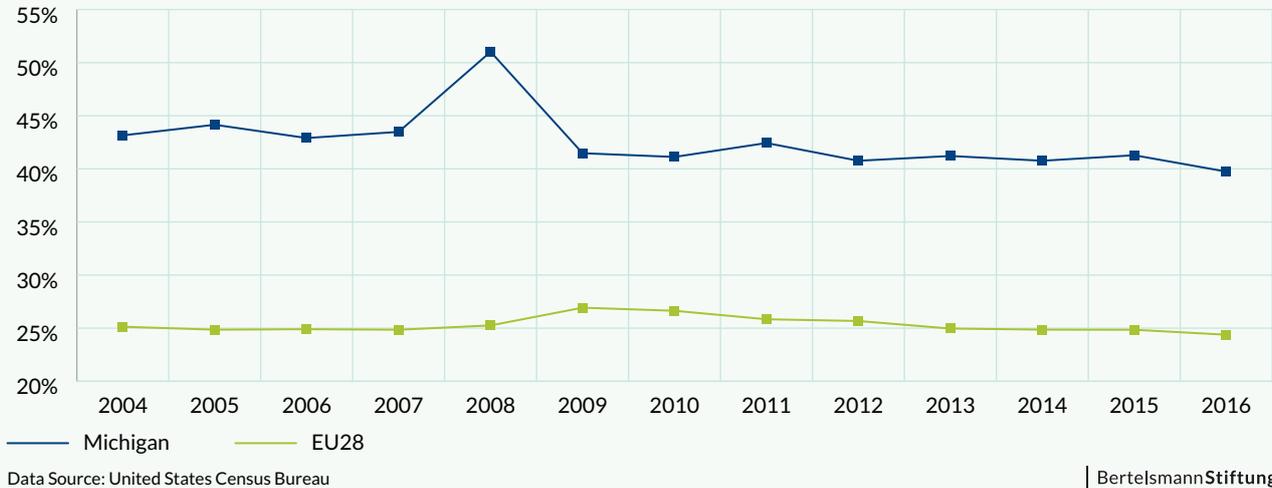
Source: Michigan Municipal League 2016

Counties are the primary administrative substructure of the state. Traditionally, counties have served as an outreach of the state. They act as agents of the state but hold their own legal identity as a local authority. In parallel, counties have their own policy-making power and carry out programmes benefitting their local population. Counties have limited authority when it comes to budget or ordinance-making powers. Beyond this, counties only carry out functions which the state has devolved. The County Board of Commissioners, elected by county residents, serves as the legislative body (CRCM 2017: 2). It is responsible for setting policy and providing legislative oversight and constituent services.

The group of municipalities subdivide into cities (279), villages (254) and townships (1,240) (MML 2016). A further aspect of differentiation is municipal constitutional rights. There are two kinds of municipalities, both existing in parallel. General law municipalities are limited in adopting their framework of governance. “Home rule” municipalities have higher degrees of flexibility in terms of governance and autonomy. Among the cities, almost all have “home rule” status. This structure, which developed historically, is somewhat complex and lacks transparency. Concrete functions and legal responsibilities need further examination and are not really observable at first glance.

Townships are the most basic and most limited form of government. Many of them do not employ full-time staff and some only have a handful of inhabitants. Contrary to this, cities are the most autonomous type, as they all fall into the category of “home rule”. Villages are in between, sharing powers with townships of which they consist. Townships cover the whole state (without cities). They are statutory bodies, providing a range of services, which are explicitly devolved by the state. A board of elected official governs each township

FIGURE 22.2 Michigan – Local Government Aggregate Revenue  
As Share of General Government Revenue – From 2004 to 2016



(clerk, treasurer, supervisor and two to four trustees). They have limited powers and autonomy. There are two kinds of townships in Michigan. As a basic principle, all townships are general law townships. Suburbanisation and population growth motivated the state government to upgrade some townships (138) in 1947. These “charter townships” carry out a larger range of services and have autonomy, especially when it comes to finance.

A township has to petition the State Boundary Commission to incorporate as a village or city. Since 1950, 13 townships have incorporated as cities (MML 2015: 10). Incorporation as a city removes an area from township government. Nonetheless, every city remains part of a county. In the case of incorporation as a village, existing townships remain. Those who live in a village still participate in township affairs and pay township taxes in addition to having their own village government. Villages are an intermediate level of government. They have most of the special powers of cities but not the duties the state demands.

Cities and villages cover a spectrum of services, typically roads and policing. The political and administrative head of these bodies is called the mayor in cities and the president in villages. In most cases, citizens directly elect these incumbents. A city has to deliver a broader range of services. For example, the city alone is responsible for assessing property and collecting taxes for county and school purposes, registering voters and conducting all elections within its boundaries.

Cities, villages and townships, have similar, but not identical, service and regulatory powers. The major difference lies in the full territorial integrity or control over the road system, which townships do not have. They are also limited in their powers of taxation and governance. Villages differ from cities in that they are not required to assess property for tax purposes or conduct state and national elections. Unlike cities, neither townships nor villages are permitted to levy a personal income tax.

## 2 Revenue

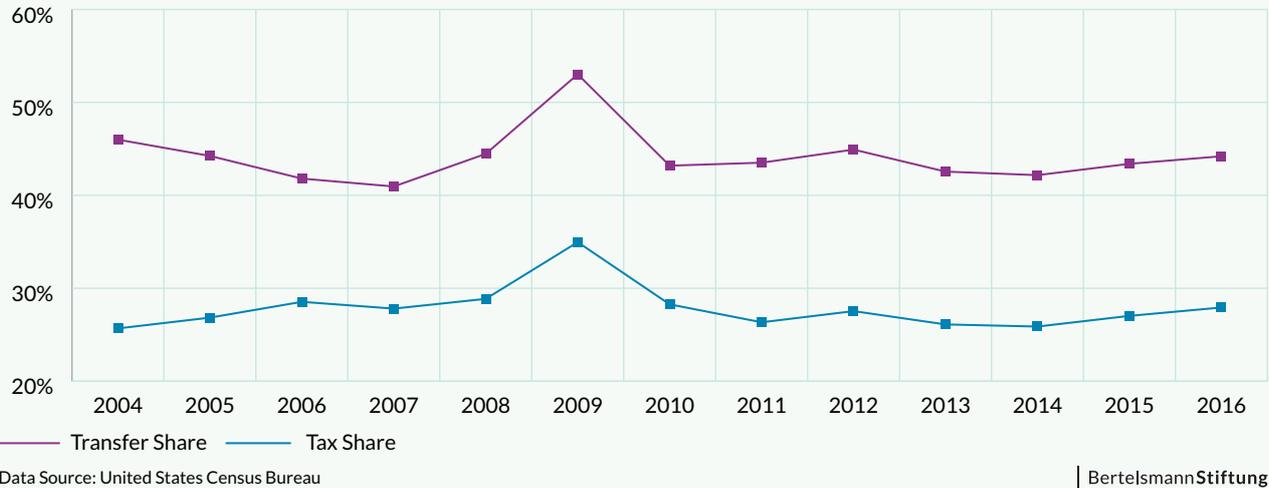
The local share of revenue from total state/local revenue is about 40% and has been very stable over time (Figure 22.2).<sup>1</sup> Beyond this, the structure of local revenue is also stable (Figure 22.3). The larger share is funded by grants. Local taxes make up about one quarter. Obviously, the local level is of high relevance for public services in Michigan.

When it comes to major sources of revenue, local property tax and state grants cover about two thirds of all local revenues. It should be noted that these numbers refer to all local governments, including special purpose authorities such as schools.

Local taxes in Michigan are derived almost completely from property tax (about 85%). Every type of local authority is authorised to levy a property tax, bearing the risk of overburdening citizens. As a consequence of this, state law

<sup>1</sup> The peak in 2008 is a statistical effect caused by a sudden decline in state revenue.

FIGURE 22.3 Michigan – Local Government Aggregate Transfers and Taxes  
As Share of Total Local Government Revenue – From 2004 to 2016



restricts the raising of property tax to maximum annual growth rates. The tax base of local properties is also regulated and restricted by state law (Klein and Schulz 2017: 9).

In general, Michigan's state legislation is very restrictive in respect to local taxes and, therefore, local governments miss out on revenue options. The state constitution does not allow local governments to impose further taxes on their own residents. Any new tax needs a state law and a public referendum in the respective local government area (CRCM 2018: 2).

When it comes to an additional local income tax, the right to impose such a tax is restricted to cities. In 2016, 23 cities raised a local income tax, which totals more than the property tax in those cities.

State revenue sharing is the second largest revenue source for Michigan's local governments.<sup>2</sup> Introduced in 1963, it obligates the state to redistribute shares of its sales tax revenues to local authorities according to their population. However, the system has proven to be an easy target for cuts by the state. After peaking in 2002, revenues constantly declined – by about one quarter in nominal terms by 2012 (Michigan Department of Treasury 2018: 6 f.). Federal grants are earmarked and meant to support particular functions (for example, education, health and roads).

<sup>2</sup> State revenue sharing is not common in the US. Only 18 out of 50 states have implemented such a system to support municipalities and counties (Fisher and Bristle 2012: 231 f.). Overall, there is no standardised model.

Citizens have to pay current charges for a range of services. Education, sewerage and hospitals are the largest of these. Given that the system of local government is complex, revenue structures vary widely. There is no system of fiscal equalisation.

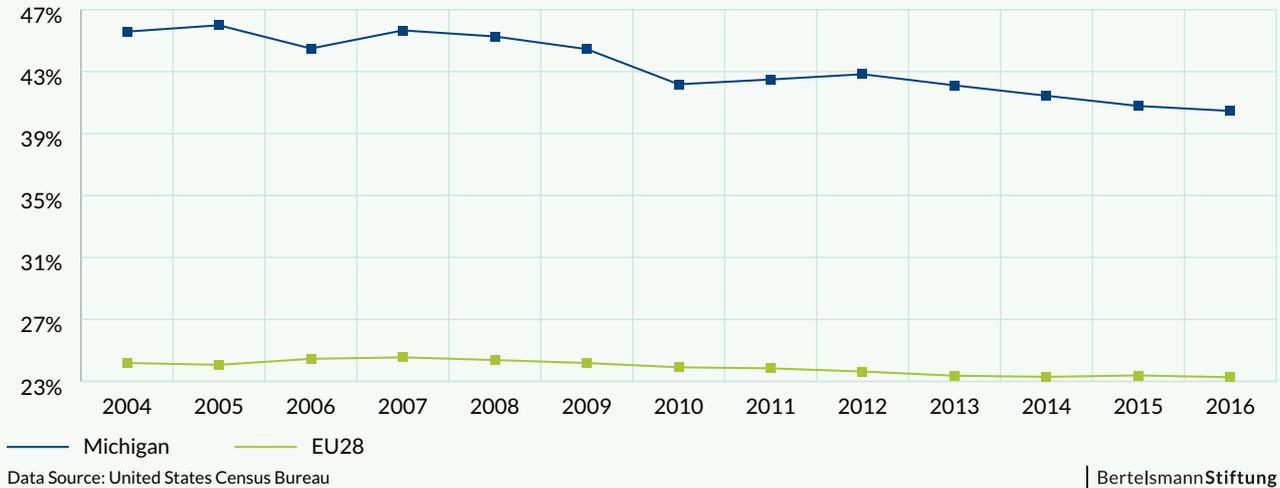
Insufficient and under-diversified local revenues have been a big issue in Michigan for decades (CRCM 2018). State revenue sharing is declining and limited to the state's sales tax. Local governments rely heavily on property tax, which is volatile and also limited by law. With such a mixture, local governments do not benefit from a growing economy and lack resources to fund necessary services in general.

### 3 Expenditure

In contrast to revenue, the share of local expenditure shows a declining trend over time (Figure 22.4). The reason for this trend is stronger growth in state expenditure. Whereas local expenditure has stagnated in absolute terms since 2009, state expenditure has grown by 11%.

Local expenditure in Michigan is dominated by education (Figure 22.5). Leaving this category to one side, a disproportionate function appears. In this case, social services rank highest, but with little difference compared to functions such as housing, public safety, transport, utilities and general expenditure. Over time, there has been hardly any major change in proportions among expenditure categories.

FIGURE 22.4 Michigan – Local Government Aggregate Expenditures  
As Share of General Government Expenditures – From 2000 to 2016



Once again, the expenditure structure of Michigan's local governments depends heavily on the type of local government and varies even within these subgroups. A calculation based on city data shows that almost half of local expenditure is spent on public safety issues (policing, fire-fighting and others; Klein and Schulz 2017: 7). In general, employment is the most relevant type of expenditure. Since the start of the financial crisis, employment has decreased, as have salaries and benefit packages (Michigan Department of Treasury 2018: 9 f.).

Since 2010, the general fund balance has shown some positive numbers (Figure 22.7). In parallel, the number of local authorities forced to implement a deficit elimination plan declined from 28 in 2011 to 14 in 2016. Taking into account the approximate number of 1,800 municipalities, this figure seems minimal. Nonetheless, the general fund deficit reached its maximum in 2012 at about \$520 million, accumulated by only three authorities (among them the cities of Flint and Detroit). By 2015, these deficits were already close to zero (Michigan Department of Treasury 2018: 17).

## 4 General Fiscal Status

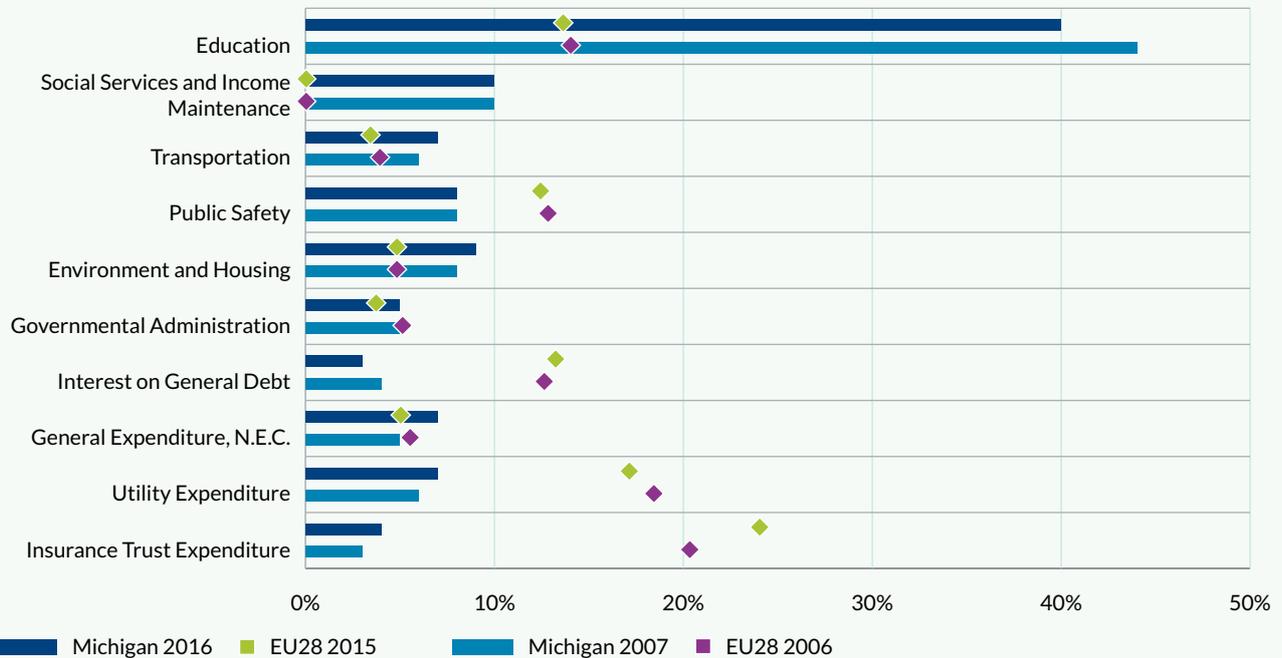
Michigan's local finances have been worsening for many years. The great recession of 2008 meant they took a further and historically hard hit. Although the economy has largely recovered, local levels overall have not yet been successful in this regard (Figure 22.6).<sup>3</sup> The fiscal impacts are long-term and have created a "new normal" for local governments (Martin, Levey, Cawley 2012). This "new normal" consists of constantly restrained revenue and expenditure, fewer public jobs having fewer benefits and hard decisions on which services to keep.

Property tax revenue values in 2016 were still below the pre-crisis level (Michigan Department of Treasury 2018: 5 f.). The same holds true for state revenue sharing and local employment. Still, in 2017, the number of local government employees per capita and salary levels were way below the US average (Fitzpatrick, Horner, Ivacko 2018: 2).

Looking at aggregate numbers, the financial situation has been improving within the last few years (Figures 22.7 and 22.8). Among other things, there is not one local authority in receivership anymore. Nonetheless, these aggregates mask disparities among local governments. The great recession has accelerated existing trends. The urban-rural divide is growing, meaning a redistribution of jobs and income away from the old industrial cities. Therefore, the cumulated fiscal figures tend to "whitewash" the reality in many larger cities. A number of cities have had to cut expenditure to a point called "service insolvency" (Klein and Schulz 2017); their functionality is in jeopardy. Many cities have lived through years of underfunded capital spending, which is hampering development. Another symptom of fiscal stress is a high level of unfunded legacy costs such as pensions and health care (Scorsone et al. 2016). Although fiscal conditions for a majority of local governments have been improving, about 9% assess themselves as being in fiscal stress (Horner and Ivacko 2017b). About 40% generate unsustainable growth rates in revenue and expenditure, putting them at constant

<sup>3</sup> Unemployment in the state of Michigan reached its maximum in mid-2009 at 15%. By 2016, it had fallen to below 5% (Bureau of Labor Statistics).

FIGURE 22.5 Michigan – Local Government Expenditures by Function  
As Share of Total Local Government Expenditures



Data Source: United States Census Bureau

| BertelsmannStiftung

risk in future economic downturns (Michigan Department of Treasury 2018: 14).

## 5 Effects of the Financial Crisis

The US was the root of the financial crisis, and the state of Michigan was its culmination. Due to its economic structure, dominated by car manufacturing, and its local budget revenue reliance on property taxes and state revenue sharing, the great recession affected Michigan's local governments to an exceptional extent (Korac, Saliterer, Scorsone 2018: 216).

Its impact was even harder, as Michigan had suffered an earlier regional recession in 2001, which it did not really recover from until 2008. State and local budgets have seen ongoing budgetary challenges. In reaction, the state government implemented a series of cuts in revenue sharing (Skidmore and Scorsone 2011: 363). Therefore, economic development and fiscal status were weak years before the financial crisis (CRCM 2013). Once again, GDP started falling in 2005 and showed another 8% loss in 2009 (Figure 22.6). Especially cities with automotive facilities experienced a series of mass layoffs by manufacturers. Total private sector employment declined by almost 10% within one year (CRCM 2013: 3).

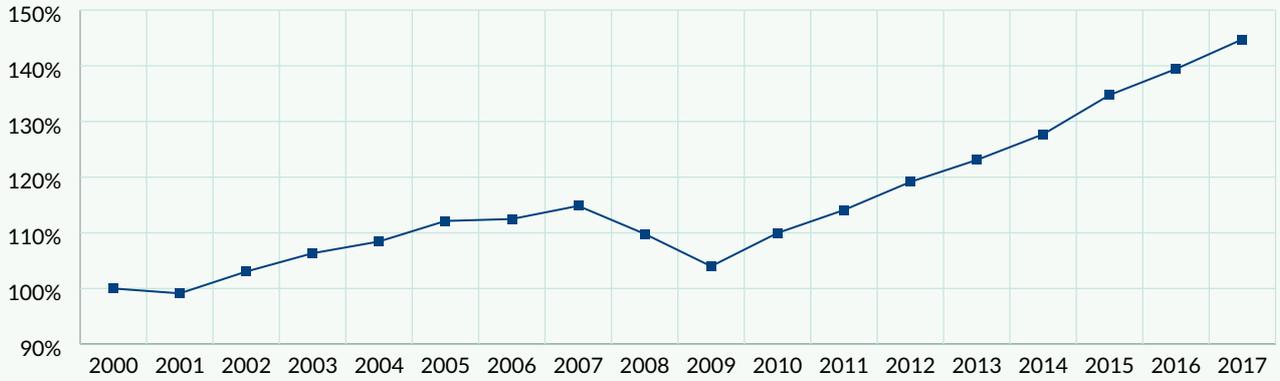
The unemployment rate doubled and rose to a peak of about 15% in mid-2009. All of this had impacts on public revenue. Nonetheless, for most of the local governments the impact was an indirect one.

When the housing bubble burst, taxable values collapsed. Between 2008 and 2012, the amount of taxable property values in Michigan declined by 18% (CRCM 2018: 2). In addition, state regulation hampered the recovery of property values and taxes by way of an annual maximum growth rate (Skidmore and Scorsone 2011: 363). Thus, local governments could not react by raising their own revenue streams but had to react by cutting expenditure. Given local tax regulation, there is a time lag before an economic recovery bolsters local budgets. Given its own budgetary difficulties, the state government cut revenue sharing by another 18% between 2008 and 2015 (Klein and Schulz 2017: 10). In the case of the 23 cities imposing local income tax, there was also a direct impact on the economic decline.

These trends in revenue were mirrored in trends with respect to local employment. After 2005, local employment fell, bottoming out in 2013 at -15% (CRCM 2013: 3). The most prominent case of urban fiscal crisis is the city of Detroit. Here, historical trends (manufacturing and segregation) and

FIGURE 22.6 Michigan - Nominal Gross Domestic Product

Index: 2000 = 100



Data Source: Bureau of Economic Analysis

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FIGURE 22.7 Michigan - Local Government Budget Balance

In Aggregate Terms - As Share of National GDP - From 2004 to 2016

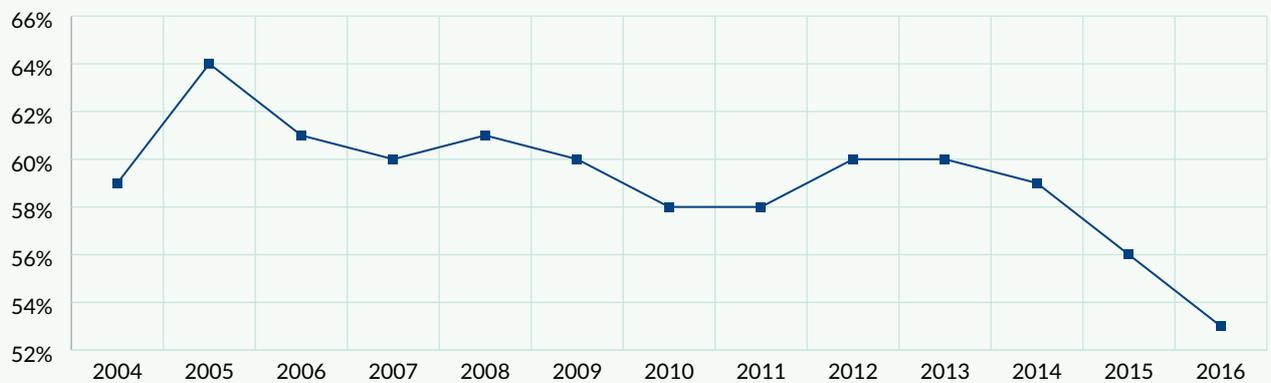


Data Source: United States Census Bureau

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FIGURE 22.8 Michigan - Local Government Aggregate Debt

As Share of General Government Debt - From 2004 to 2016

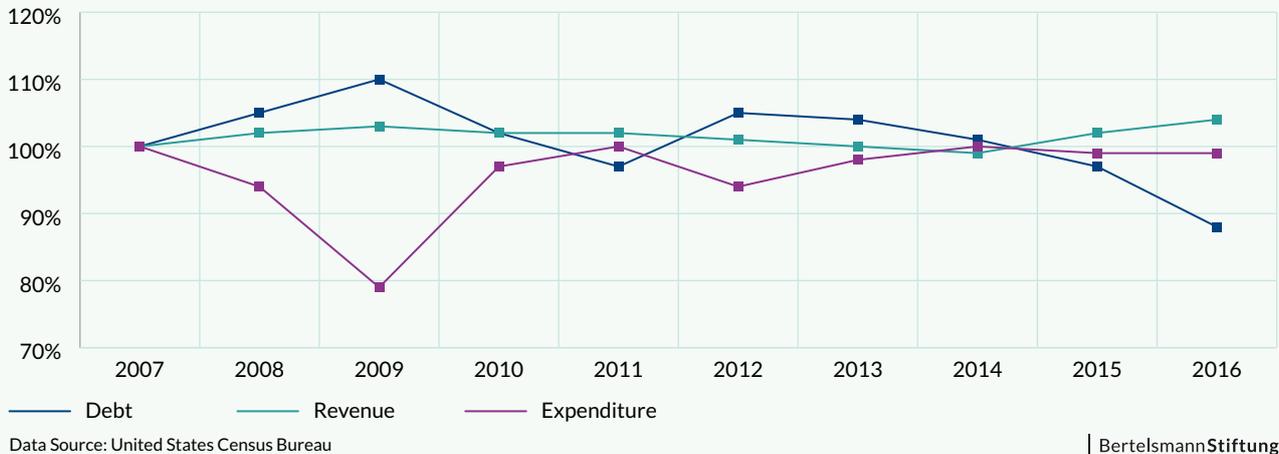


Data Source: United States Census Bureau

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FIGURE 22.9 Michigan – Post-Crisis Developments

Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



the great recession's impact (property values, income tax and shared revenue) cumulated in an unprecedented manner, ending with the city filing for bankruptcy in summer of 2013 (Geißler 2015).

On the regulatory side, some adoptions added to the financial crisis. Michigan is one of the states in which an elaborate system of fiscal supervision has been in place for decades. Against the background of growing financial stress, the respective Financial Stability and Choice Act was adopted in 2012, aiming to strengthen monitoring and crisis intervention.

Figure 22.9 shows the immense pressure on local budgets caused by the great recession. Revenue declined by 20% in 1990 by the Local Government Fiscal Responsibility Act (CRCM 2010 appendix A). Taking into account the effects of inflation, the revenue of local governments is still far below the pre-crisis level. Due to strict fiscal regulation, local governments could not react with unbalanced budgets or by increasing debt. Both indicators do not show striking upswings (Figure 22.7 and 22.9). The only option to react to revenue decline and balancing budgets was to cut expenditure. Once again, its nominal stagnation in contrast to inflation and growing public demand meant vast budgetary pressure and this could only be alleviated by making vast cuts. This is what some experts call "service insolvency" (Klein and Schulz 2017).

## 6 Fiscal Rules and Fiscal Oversight

Michigan's local governments are obligated to follow a balanced budget rule in their revenue accounts. In the case of deficits, local governments have to elaborate and implement

a deficit elimination plan (Michigan State Treasury 2018: 17). There are no formal debt limits or debt approvals by the state.

Michigan is one of the few states where bankruptcy regulation and an established system of financial oversight is in place (PEW 2013; Korac, Saliterer, Scorsone 2018: 211). To strengthen financial emergency intervention, the state treasury implemented a system of fiscal monitoring, first mandated in 1990 (Spreen and Cheek 2016: 726). This decision, a rare practice among US states, refers to a case of fiscal emergency in 1988, when, against the backdrop of a lack of legislation, a court had to decide on receivership. The first of the legislation was passed in 1988 and was shortly amended in 1990 by the Local Government Fiscal Responsibility Act (CRCM 2010 appendix A). Among other things, it defined a set of criteria to indicate fiscal emergencies. After some amendments and interruptions, the current system is called the Michigan Community Financial Dashboard and publicly presents crucial indicators for all local governments.

This legislation permits the state to execute external reviews to determine potential fiscal difficulties in the event that particular fiscal indicators reach critical values. Following this procedure, the state governor and the Local Emergency Financial Assistance Loan Board (LEFALB) can appoint an emergency manager (EFM) to surmount financial challenges. This board consists of the state treasurer, the director of the Department of Management and Budget, and the director of the Department of Energy, Labor and Economic Growth. By 2010, an emergency manager had been sent to eight general-purpose local governments.

The EFM is charged with developing and implementing a financial plan, which balances the budget and ensures compliance. If the EFM fails to revise the budget, he/she may request approval from the LEFALB to authorise the local government to file for bankruptcy.

In 2001, this legislation for intervention was adopted in a way so as to strengthen the position of the state treasurer and the emergency manager. Among other things, the emergency manager was permitted to file for bankruptcy, as happened in the case of the City of Detroit. This legal situation raised enormous public concern. A public referendum was held in 2012, successfully repealing it. In the autumn of 2012, the state passed a new version of the Local Financial Stability and Choice Act (Michigan State University 2017). Ever since, in cases of an approved financial emergency, a local government can choose from four options, among other things, hiring an EFM or filing for bankruptcy.<sup>4</sup> Although local officials see a number of shortcomings and possible improvements with this legislation, the relative majority of local officials are in favour of it (Ivacko and Horner 2017). In the middle of 2018, the last local authority was released from receivership. For the first time since 2000, no emergency manager has been in place.<sup>5</sup>

A crucial limitation of Michigan's system is its focus on local mismanagement causing fiscal emergencies (Sapotichne et al. 2015: 17 ff.). Another limitation is the EFM focus on short-term budget balance and cuts in obligations.

Another state instrument to prevent fiscal crisis is the use of emergency loans to bridge short-term liquidity needs. In 1980, the Emergency Municipal Loan Act was passed. Municipalities in stress can receive such loans under particular conditions. Among other things, the municipality applying has to prove it has a deficit for the current fiscal year despite maximum tax rates, is economically weak in general, is in receivership or has presented a recovery plan. As a consequence of receiving such loans, the municipality is put under strict supervision and has to report on a quarterly basis.

Capital spending is funded by issuing bonds, which are backed by either full credit or the taxation power of the issuer (general obligation bonds) or by revenues of a specific investment or source (revenue bonds). There is a federal tax-exempt status for municipal bond interest, making such bonds especially

lucrative for private households. In general, every local authority is allowed to issue bonds and every issuer needs to have a rating. Municipal bonds have considerably higher ratings than corporate bonds and, in addition, the lowest default rates (Moody's 2012). Although, there have been some defaults during the great recession, financial markets have exerted severe pressure to repay and, thereby, it can be viewed as one type of financial oversight.

In keeping with the idea of capital markets, there is the option of municipal bankruptcy (Chapter 9 of the Federal Insolvency Code). Its objective is to restructure debt burdens and to give local governments a fresh start. Of course, this is a theoretical argument and there is a range of negative countereffects for the respective local government. The implementation of Chapter 9 needs some additional state regulation, which does not exist in every state. PEW (2013: 8f.) presents a list of bankruptcy authorisations showing a wide variance in regulation. In the case of some states, the standard regulated situation is vague. Michigan was among the few having the appropriate state regulation in place. Nonetheless, the case of Detroit was the first to implement it. The implementation of a Chapter 9 procedure has the intention of restructuring local liabilities to get them to a sustainable level. Therefore, agreements have to be negotiated with various groups, such as bondholders, pensioners and employees. Finally, a judge must approve those agreements with regards to revising local budgets and does so if they are well-balanced between the parties involved.

There are some limitations with the process, making bankruptcy an inadequate mechanism to deal with financial emergencies. Among other things, it involves reducing liabilities, targeting employees, generating enormous consultancy fees and shrinking local services (Spiotto 2012: 770 ff.). In any event, Chapter 9 has become a reality in the aftermath of the great recession, but it remains very rare.<sup>6</sup> In contrast, states are not able to file for bankruptcy.

Every local government has to publish a financial statement within six months after each fiscal year's closure. A professional firm must audit this statement to provide proof of conformity with the state regulation.

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4 Beyond this, there is the option of reaching an agreement of consent or starting a neutral evaluation process.

5 The Detroit News: "Michigan: No emergency managers for first time since '00." <https://eu.detroitnews.com/story/news/local/michigan/2018/06/27/michigan-no-emergency-managers-first-time-since-2000/737947002/> (accessed December 2018).

6 Between 1970 and 2011, there were only three defaults out of 90,000 general-purpose local authorities (Moody's 2012: 7).

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# 23 | Switzerland

Christian Person<sup>1</sup>

### Summary

Switzerland is a federal state. Local governments are part of and subject to the 26 cantons. The local level consists of 2,222 municipalities. Tax revenues are their main income source, whereas inter-governmental fiscal transfers play a minor role. Thus, transfer dependency is low. Direct taxes from natural persons are the most important source of tax revenue, followed by direct taxes from companies. The individual municipal revenue composition as well as existing discrepancies in tax capacities and tax rates result mainly from the differing economic power of the municipalities. Municipalities are also in charge of a wide range of services. The most important tasks (in terms of share of expenditure) are education and social welfare.

Overall, the fiscal situation of Swiss municipalities is solid. Since the 1990s, many local governments have reduced local tax rates. Local-level debt (as a percentage of GDP) has decreased and is low. Nevertheless, in recent years there have been some fiscal challenges. Since 2009, local governments (in total) have exhibited (small) aggregate budget deficits as expenditure rose more strongly than revenue. This was partly caused by the financial crisis of 2008–2009, which temporarily affected municipalities by weakening their revenue development and leading to higher expenditure due to economic stimulus measures. Besides these temporary effects, local governments

also face a persistent, ongoing trend of rising expenditure with regards to social welfare, education and health. Moreover, local consolidation and recapitalisation measures with regards to the public pension funds of municipalities and the transition to the new accrual accounting system (HRM2) also put some pressure on local budgets. However, given their taxation autonomy, Swiss municipalities have the necessary instruments to deal with these challenges.

Fiscal oversight regimes in the cantons are diverse due to the federal structure of Switzerland. However, there are some commonalities. In all cantons, local governments are obliged to adhere to a balanced-budget rule, either on a yearly basis or from a mid-term perspective. Many cantons specify that budget deficits have to be dissolved within certain time frames and at specific rates. In most cantons, fiscal oversight is executed in a centralised manner and dominated by a backward-looking examination approach. Supervision predominantly examines the annual accounts of previous budget years. In some cantons, there are also reviews of budget proposals and financial plans. In the case of fiscal imbalances, the respective cantons will reject budget proposals and/or demand revision of the plans. If fiscal rules are broken, oversight authorities can rely on different methods (for example, repeal illegal actions by municipalities or place municipalities under forced administration) to bring the local budget back on track.

<sup>1</sup> I would like to thank Andreas Ladner for helpful comments on an earlier version of this chapter. All remaining errors are mine.

## 1 Administrative Structure

Switzerland is a federal state consisting of 26 territorial states, the Swiss cantons. In some cantons, administration subdivides into state districts (Figure 23.1). Local governments are part of and subject to the states. Article 50 (1) of the Swiss constitution grants political autonomy to the municipalities according to cantonal law. Thus, each canton decides on its own how responsibilities are to be distributed between the canton and its municipalities (Steiner and Kaiser 2013: 149). As the cantonal decision is guided by the principle of subsidiarity, Swiss municipalities have a large amount of autonomy and room to manoeuvre. They have a general responsibility with regards to municipal affairs. Hence, they can fulfil all tasks on their own that are linked to their territory, as long as task fulfilment is not assigned to the federal or state level or to special municipal corporations (Vatter 2016: 451; Ladner and Mathys 2018: 73 ff.).

The local level currently (01/04/2018) consists of 2,222 politically independent municipalities, so-called “inhabitant municipalities” (Einwohnergemeinde) or political municipalities. Affiliation to these municipalities is based on place of residence. Political municipalities are the only type of municipality that are strictly organised along territorial grounds and given general responsibilities (Vatter 2016: 452). In addition, there are other kinds of municipalities, mainly single-function governments responsible for special tasks such as schooling (Schulgemeinde), religious activities (Kirchgemeinde, Pfarrgemeinde) or the administration of certain assets and property rights (Bürgergemeinde, Korporationsgemeinde). These municipalities differ in terms of territory from the political municipalities (Steiner and Kaiser 2013: 150) as their sphere of influence may also, but need not be congruent with the territory of the political municipalities. Instead, they may overlap with the territories of different political municipalities. Due to their special status, these single-function governments are not considered within the representation below.<sup>2</sup>

In general, Swiss municipalities are small. More than half of them have less than 1,300 inhabitants, a fifth of them even less than 500 inhabitants (Vatter 2016: 452). Nevertheless, there is a huge range in the number of inhabitants within local government areas (Table 23.1). While the smallest municipality, Corippo, has only 14 inhabitants, Zürich, the largest city, has more than 400,000 inhabitants. In recent years, the number of municipalities has been reduced

FIGURE 23.1 Switzerland – Administrative Structure, 2016

Central Level	Federal Level
State Level	26 territorial states (cantons)
	143 state districts
Local Level	2,222 municipalities

Source: own representation

TABLE 23.1 Switzerland – Population of Local Government Areas, 2016

	Smallest	Largest	Average
Municipalities	Corippo (14)	Zürich (402,762)	3,681

Source: Federal Office of Statistics (31/12/2016)

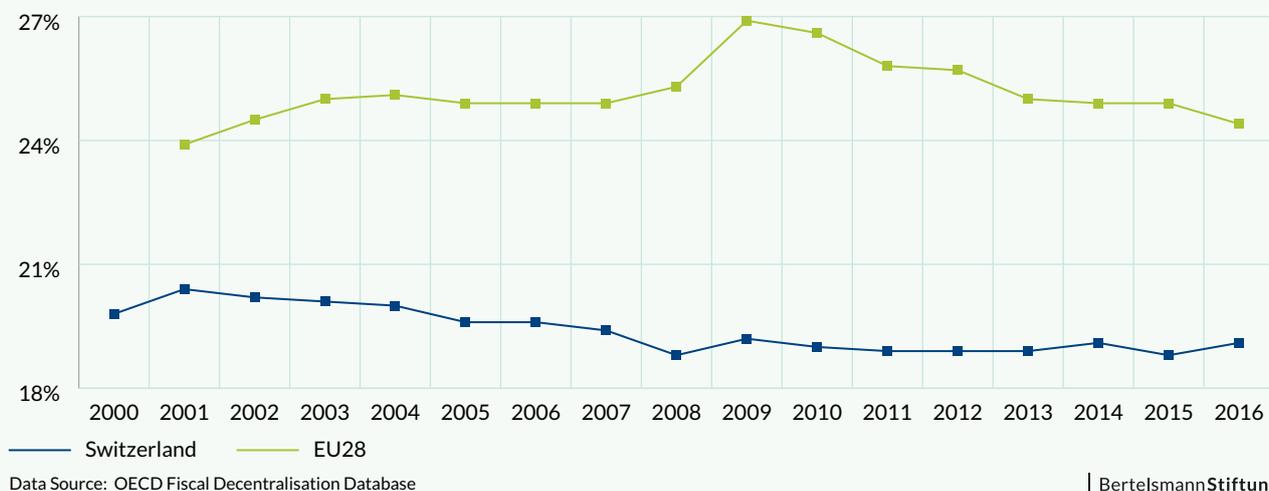
significantly, due to municipal mergers. With regards to these mergers, different goals can be identified: an increase in administrative efficiency, the reduction of costs, the realisation of economies of scale, difficulties of recruiting suitable staff for administrative or voluntary political positions in local governments, but also fiscal stress (Ladner and Mathys 2018: 178). Although there were some instances of forced municipal mergers, cantons typically try to avoid coercion. Instead, municipal amalgamations are to be conducted on a voluntary basis. Therefore, many cantons set fiscal incentives by giving additional transfers to municipalities eager to merge with other municipalities. Despite these mergers, insufficient fiscal and administrative power due to smallness still seems to be a problem for some of the municipalities. Thus, inter-municipal cooperation is widespread in Switzerland and has gained increasing significance in recent decades. On average, municipalities participate in ten inter-communal cooperation projects, mainly with regards to schooling and social welfare (Krumm 2013: 109; Steiner and Kaiser 2013: 162 ff.).

Due to Switzerland's federal structure, Swiss municipalities are responsible for many different tasks, partly devolved by the federal or state level (transferred tasks = übertragene Aufgaben), but mostly stemming from their constitutionally guaranteed right of self-governance (obligatory or voluntary self-governance tasks = pflichtige/freiwillige Selbstverwaltungsaufgaben). Municipal tasks comprise education (kindergarten, primary and secondary schools), social welfare and health care (social assistance, care for the elderly, tasks in relation to social security administration),

<sup>2</sup> In contrast to other countries, the local level in Switzerland consists only of one governmental tier. There is no uniform second (upper) tier across the whole country. Only some cantons have institutionalised a county level above the municipal tier.

FIGURE 23.2 Switzerland – Local Government Aggregate Revenue

As Share of General Government Revenue – From 2000 to 2016



public services (water supply, sewage disposal, waste disposal, electricity), public transport, road construction, regional/local planning, provision of sports/cultural facilities, local policing, civil defence and naturalisation<sup>3</sup> (Steiner and Kaiser 2013: 151; Ladner 2019: 29 f.). Most of the important tasks (in terms of share of expenditure) are education and social welfare (Krumm 2013: 112; Ladner and Mathys 2018: 127). In addition, municipalities have extensive rights with regards to tax collection and budgeting.

## 2 Revenue

Local government revenue represents one fifth of total public revenue in Switzerland (Figure 23.2), thereby reflecting the important role of municipalities in the provision of public services. However, in recent years local-level share of general revenue has slightly decreased. The main income source for municipalities is tax revenue, which forms 60% of total local-level government revenue (Figure 23.3). In addition, municipalities levy a range of charges and user fees for particular services such as utilities, public services, etc. Although their relative share of total local government revenue has been shrinking over the last decades, revenue from charges and user fees still constitute 18% of local government revenue. In contrast, transfer revenue from the federal or the state level is low (10–13%). Due to the low significance of inter-governmental grants, local-level transfer dependency is weak. Swiss municipalities exhibit high degrees

of fiscal self-reliance and autonomy. The strong role of the direct taxation of citizens at local level strengthens the bond between municipalities and their inhabitants and encourages the identification of citizens with their place of residence. As a consequence, Swiss municipalities are more accountable to their residents who are greatly interested in local affairs, especially in the fiscal behaviour of their municipalities.

Concerning its tax system, Switzerland is highly complex. On the one hand, the cantons have extensive responsibilities to regulate the collection of tax within their territories autonomously, which leads to heterogeneous tax structures between the states. On the other hand, all levels of government are involved in the collection of tax and have specific rights of taxation. However, municipalities are restricted in raising or setting tax rates, if such are legitimised by their canton.

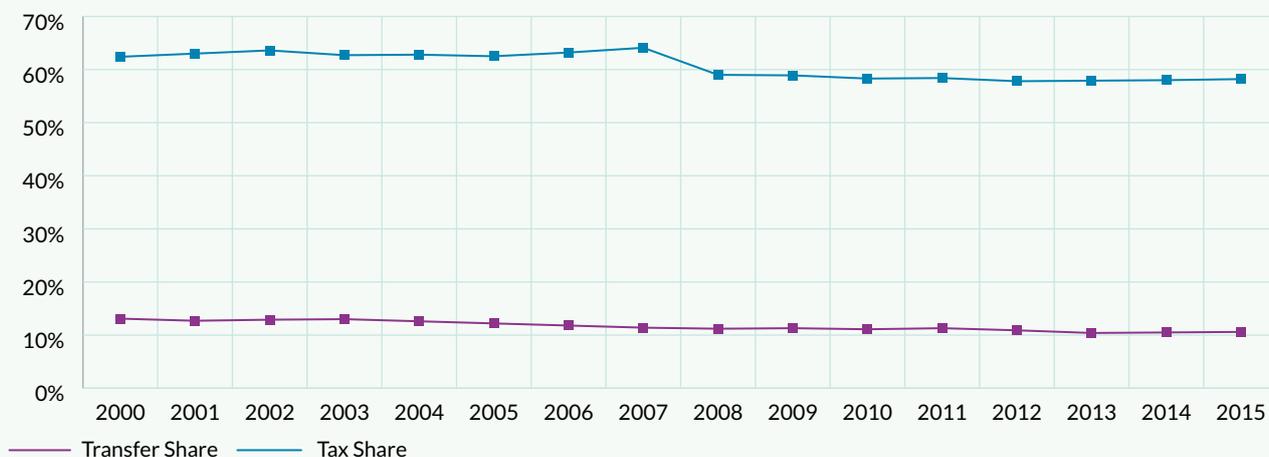
In all cantons, municipalities participate in the cantonal personal income tax and the wealth tax. Typically, local governments will levy a surcharge on the cantonal tax (e.g. they set a tax rate on the tax basis of the respective tax, whereby the tax base is predefined by the canton). Thus, these taxes are characterised by piggy-backing.

In some states, municipalities are allowed to levy a poll tax (besides personal income tax) on adults or those employed. Its volume, however, is low. Moreover, most states also levy a corporate income tax, taxing profits and company capital stocks (whereby cantons typically require a minimum tax ranging from 100 to 900 Swiss francs), on which municipalities levy a surcharge.

<sup>3</sup> Swiss municipalities are responsible for granting local citizen rights to foreigners.

FIGURE 23.3 Switzerland – Local Government Aggregate Transfers and Taxes

As Share of Total Local Government Revenue – From 2000 to 2015



Data Source: OECD Fiscal Decentralisation Database; OECD Government at a Glance Dataset

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Another typical (and mostly exclusive) local tax is the property tax on land and property<sup>4</sup> that is ordinarily levied by the municipalities themselves. In some states, however, the property tax is a cantonal tax. However, in such cases, municipalities do participate significantly in the tax revenue. Finally, municipalities may also levy a number of taxes based upon possession, consumption or excise (for example, a dog license fee, an entertainment tax, a visitors' tax or a tourism tax, etc.) (EFD 2016; Schweizerische Steuerkonferenz 2017).

To sum up, municipalities have a large amount of discretion about tax collection and the setting of specific tax rates in the case of surcharges on cantonal taxes, which explains the high significance of tax revenue in local government budgets.

In terms of their fiscal weight within the local tax system, direct taxes from natural persons (personal income tax, wealth tax, etc.) form the most important tax revenue sources. They account for 77% of total local tax revenue, followed by direct taxes on companies and other legal entities (corporate income tax, capital tax, etc.) at 15%. Further direct taxes such as property tax and taxes based on possession, consumption and excise play a minor role (fiscal year of 2015; own calculations based on data from the Fiscal Office of Switzerland; EFV 2017).

Moreover, one can observe great differences between the cantons and municipalities with regards to their fiscal capacities as well as the tax rates set by local governments

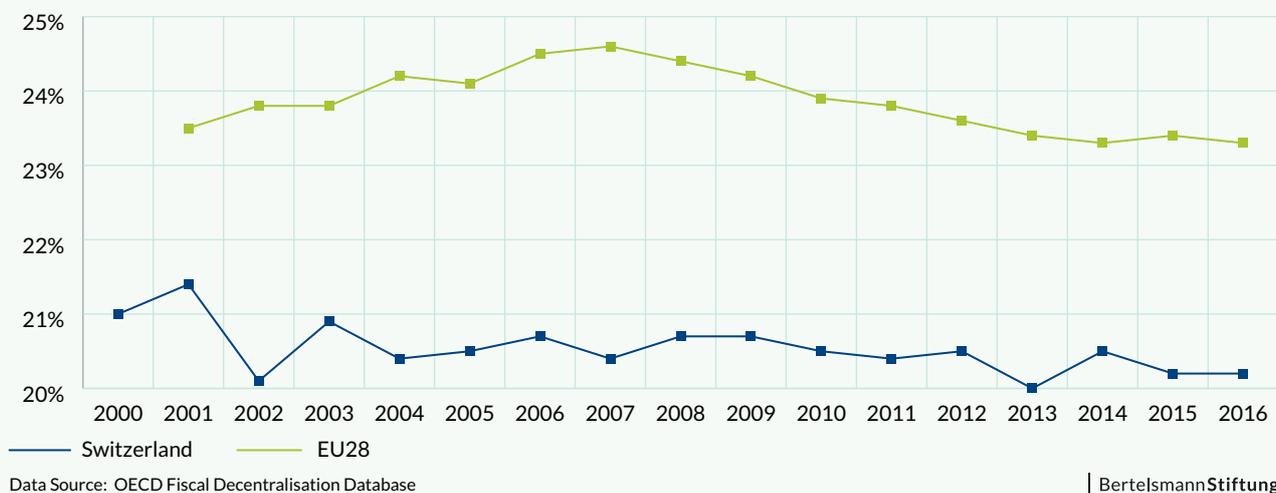
(as a consequence of the differing tax capacities and differing preferences in relation to the amount of public service provision) (Rühli 2013: 50 ff.; Ladner and Mathys 2018: 132 f.). The individual municipal revenue composition as well as the emergence of the aforementioned discrepancies in tax capacities and rates is, basically, a function of the differing economic power of the municipalities.

In order to address these discrepancies, all cantons have implemented fiscal equalisation schemes that give transfers to municipalities depending on their fiscal capacities and/or fiscal needs, to guarantee that local governments are able to fulfill their tasks and provide basic services at an acceptable level of quality. As the structure and amount of these grant systems can be decided upon by the states autonomously, equalisation schemes differ significantly. While some states separate revenue equalisation (for example, equalisation of differences in fiscal capacities) from expenditure equalisation (for example, equalisation of different fiscal needs or expenditure necessities), others mix both approaches, which leads to a higher level of complexity and lower transparency within these systems. Other differences comprise the relative weight of revenue or expenditure equalisation within the equalisation system (measured in terms of transfers assigned to each of these equalisation mechanisms), the degree to which the equalisation is financed by fiscal resources from the state government (vertical transfers) or by direct contributions from the municipalities (horizontal transfers), the degree of redistribution following from the equalisation process and the incentive effects (with regards to the effort in relation to tax collection and the willingness for municipal

<sup>4</sup> The tax base is the market value of the land and real estate. Liabilities associated with the property cannot be deducted. In addition, in some cantons, municipalities may also tax gains resulting from the sale of land and real estate.

FIGURE 23.4 Switzerland – Local Government Aggregate Expenditures

As Share of General Government Expenditures – From 2000 to 2016



mergers) associated with the equalisation scheme (Rühli 2013: 74 ff.).

### 3 Expenditure

The important role of municipalities in the provision of public services is also reflected in the share of local-level expenditure in relation to general government expenditure (Figure 23.4). Local-level, government expenditure forms 20–21% of total government expenditure, although its relative share has been slightly decreasing in recent years.<sup>5</sup> In absolute terms, however, the expenditure of municipalities is still growing.

As Figure 5 shows, the most important tasks fulfilled by Swiss municipalities are education (25% of local government expenditure) and social welfare (20%), followed by economic affairs (11–13%). Other municipal tasks sorted according to the COFOG<sup>6</sup> classification are less important, at least in fiscal terms. Overall, these expenditure structures are rather stable over time as the comparison of the data for 2006 and 2015 indicates.

In line with the evidence for local government revenue, one can also observe disparities between cantons and

municipalities when it comes to expenditure structures. Typically, economically weak cities show higher spending on welfare, while capital and investment spending is lower. Other differences in expenditure needs flow from the differing size of municipalities as well as their geographical and topographical conditions or variations in the socio-economic characteristics of their population, which implies different types of clients for public services. These inter-municipal differences result in significantly differing per capita costs of public service provision.

### 4 General Fiscal Status

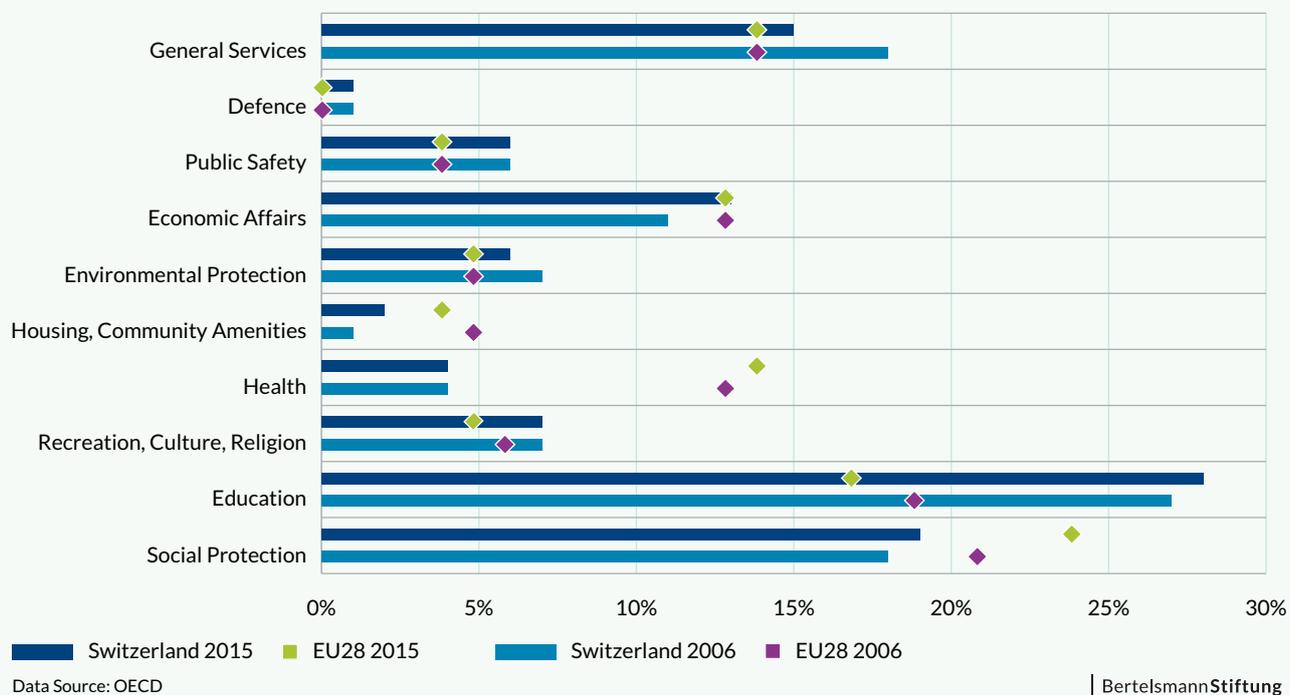
Overall the fiscal situation of Swiss municipalities is solid. Since the end of the 1990s, many local governments have been able to reduce their tax rates. Only recently, some of them had to raise taxes again to deal with fiscal challenges. Moreover, local-level debt (as a percentage of GDP) is quite low. Between 1990 and 2017, the local-level debt-to-GDP ratio decreased from 9.3% to 6.8% (although local debt increased in absolute terms). In total, this represents 20–25% of total government debt in Switzerland (Figure 23.8). In general, the budgetary situation of the majority of municipalities is sound and local indebtedness is not a huge problem. Nevertheless, in recent years there have been some fiscal challenges. The current aggregated fiscal situation of Swiss municipalities is characterised by slightly strained budgets (EFV 2017: 59). While during the 2000s, local-level governments (in sum) usually recorded annual budget surpluses (due to a booming economy), the fiscal stance of (at least some) municipalities has

<sup>5</sup> At the same time, the fiscal weight of the cantons has increased as some local tasks in the areas of social protection, schooling and health care were transferred to the cantons. In addition, some tasks in the areas of education and health care, for which cantons are responsible, have been expanded more intensively compared to other expenditure categories that are assigned to the local or the federal level.

<sup>6</sup> COFOG = Classification of the Functions of Government

FIGURE 23.5 Switzerland – Local Government Expenditures by Function

As Share of Total Local Government Expenditures



recently deteriorated slightly. Since 2009, the aggregate local-level government budget balance has been negative; thus, Swiss local governments (in total) are showing small budget deficits (Figure 23.7).<sup>7</sup> This deterioration was partly caused by the financial crisis of 2008–2009.

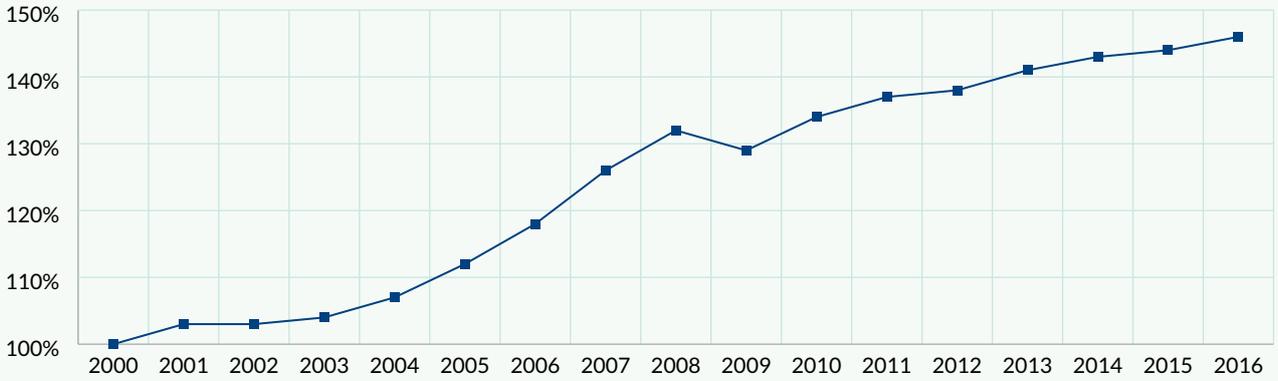
However, even after overcoming the financial crisis, the current good economic performance did not lead to a recovery of local government budgets throughout the whole country. Instead, according to different estimations, about 25% to 40% of Swiss municipalities are permanently in the red and confronted with budgetary consolidation pressure (Gilgen 2018: 56). Municipalities with fiscal problems are typically small or economically underdeveloped, structurally weak municipalities. In particular, municipalities in the cantons Valais and Jura struggle with fiscal problems. A disaggregated examination, however, reveals developments that are quite heterogeneous. While many municipalities achieve balanced budgets or even generate budget surpluses, others struggle with (in part severe) budget deficits. Thus, regionally, one can observe different trends with regards to revenue, expenditure and debt development.

<sup>7</sup> However, one has to bear in mind that in light of their tax autonomy, local governments are only partly interested in displaying budget surpluses as this arouses the desire for tax cuts.

There are different causes for these budgetary developments. On the one hand, in recent years regular expenditure has risen more strongly than regular revenue, resulting in budget deficits and increasing debt (Figure 23.9). Social spending and public expenditure on education has increased especially at a constant rate (EFV 2017: 59). Also, in the near future, above average growth has to be expected in the spending categories of education, social welfare and health (Gilgen 2018: 56). On the other hand, rising debt levels are a consequence of local consolidation and recapitalisation measures with regards to the public pension funds of municipalities and the transition to the new accrual accounting system (HRM2), which made it necessary to reevaluate balance sheet items and the assets of local governments. Although local-level government debt is rising, this development does not lead to increasing fiscal pressure because, at the same time, average interest rates have dropped significantly. Thus, municipalities have to pay less though they are accumulating more debt due to lower interest rates (Lengwiler and Grob 2018). However, if interest rates were to rise again at some future time, rising debt levels may pose a risk to the financial stability of some municipalities. Nevertheless, given their tax autonomy, Swiss municipalities have, in principle, the necessary instruments to deal with the aforementioned fiscal challenges.

FIGURE 23.6 Switzerland – Nominal Gross Domestic Product

Index: 2000 = 100

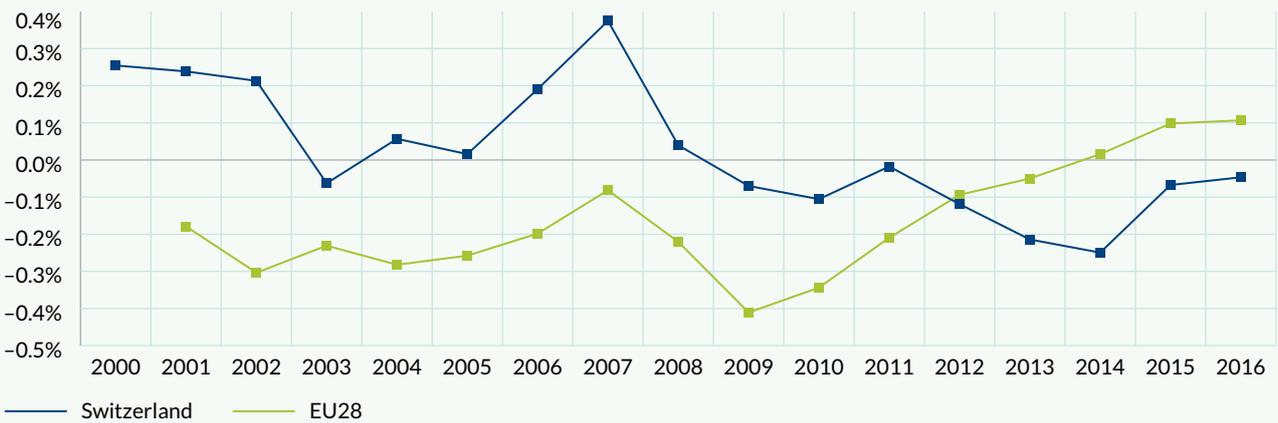


Data Source: OECD

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FIGURE 23.7 Switzerland – Local Government Budget Balance

In Aggregate Terms – As Share of National GDP – From 2000 to 2016

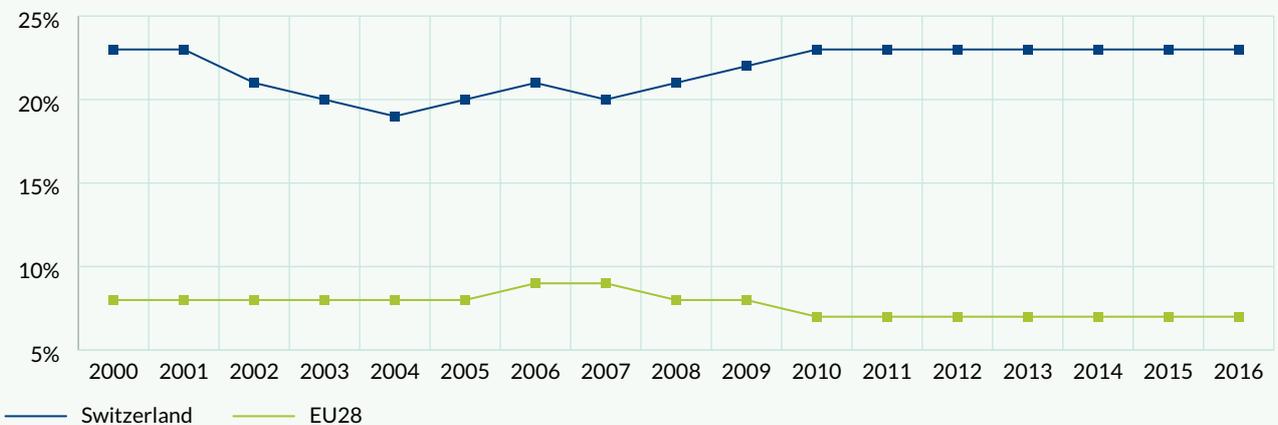


Data Source: OECD Fiscal Decentralisation Database

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FIGURE 23.8 Switzerland – Local Government Aggregate Debt

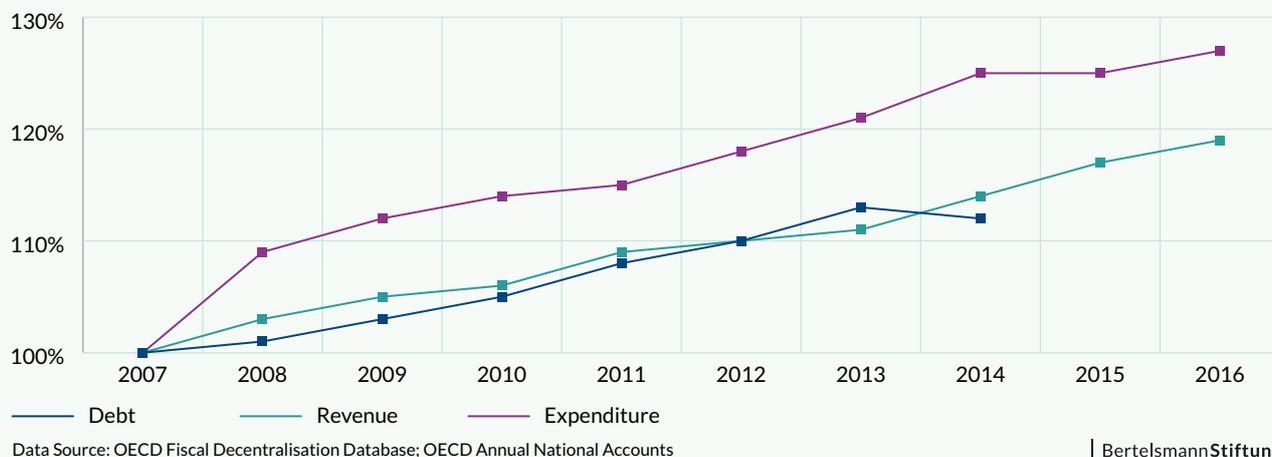
As Share of General Government Debt – From 2000 to 2016



Data Source: OECD Fiscal Decentralisation Database; OECD Government at a Glance Dataset

| BertelsmannStiftung

FIGURE 23.9 **Switzerland – Post-Crisis Developments**  
Of Major Fiscal Aggregates on the Local Level (Index: 2007 = 100)



## 5 Effects of the Financial Crisis

Due to its high degree of economic openness, export-orientation and the strong weight of the financial sector, the Swiss economy was hit quickly and noticeably by the great financial crisis of 2008–2009. In 2009, GDP dropped by about 2% (Figure 23.6). However, the state reacted strongly and quickly. On the one hand, the Swiss Central Bank lowered its key interest rates significantly to support aggregate demand and introduced a currency ceiling between the Swiss franc and the euro to prevent a massive appreciation of the franc that could have had severe negative implications for the economy.

On the other hand, central government and subnational governments implemented discretionary policy measures (specially targeted spending measures) to support the functioning of the automatic stabilisers and to boost the economy (Feuz 2012). Consequently, Switzerland overcame the financial crisis quickly and the economy soon recovered (Figure 23.6). Thus, Switzerland showed a remarkable resilience with respect to the financial crisis and weathered the economic downturn well. However, the fight against the crisis had repercussions on the state of public finances. Therefore, already in 2010, the Swiss government had developed a consolidation programme with consolidation measures amounting to 0.2% of GDP that was to begin in 2012 and guarantee compliance with the Swiss debt brake. In 2012, another budget consolidation programme was developed (entering into force in 2015). Both programmes focused on measures on the expenditure side (OECD 2015: 172).

The financial crisis did not only affect the central government, but also local governments. However, municipalities weathered the economic downturn well<sup>8</sup> because they had sufficient savings that could be used for stimulus measures. While the recession led to budget deficits, their magnitude was low. In 2009, the budget deficit was only –0.07% of the GDP, not much more than in earlier downturns (Figure 23.7). Nevertheless, the financial crisis had some repercussions on local finances. On the one hand, the revenue increase in 2009–2010 was significantly slowed in comparison to that of previous years, which were characterised by a booming economy (Figure 23.9). On the other hand, the growth on the expenditure side kept pace, as many municipalities did not react by introducing austerity measures (for example, cutting services), rather they implemented policy measures to stimulate the economy (deficit spending), e.g. by realising planned investments earlier. As a consequence, expenditure rose more than revenue, leading to the observable deficits (EFV 2011: 42).

<sup>8</sup> This was true even though they did not experience a massive increase in transfers from higher levels of government in reaction to the fiscal crisis, a pattern observable in other countries. Instead, in accordance with their high degree of fiscal self-reliance, municipalities had to deal with the economic shock on their own and could not expect much help from higher levels of government.

However, the degree to which municipalities reacted to the crisis varied amongst them, depending upon their size, degree of perception of the problem and geographical location<sup>9</sup> (Ladner and Soguel 2015). However, even after the Swiss economy had overcome the financial crisis, the booming economy did not fully materialise in a recovery of municipal budgets. Local governments' revenue increases lagged behind the ongoing expenditure developments (EFV 2012: 46), indicating persistent structural budget problems in (at least some) Swiss municipalities that cannot be explained solely by the repercussions of the financial crisis on local budgets.

## 6 Fiscal Rules and Financial Oversight

The federal constitution grants political autonomy (including fiscal autonomy) to municipalities. However, this guarantee finds restrictions in state law, as local governments are legally subject to the cantons. Consequently, all cantons have legal provisions concerning the regulation, approval, control and supervision of local government finances (Burret and Feld 2018: 679). Due to the federal nature of Switzerland, these regulations show huge variation between the cantons. Nevertheless, there are some commonalities.

In every canton, local governments are obliged to adhere to a balanced-budget rule, either on a yearly basis or from a mid-term perspective. Many cantons specify that budget deficits have to be dissolved within a certain time period (often within five years) and with specific rates (KAAG 2016: 25 f.).

Moreover, municipalities have the right to borrow money in order to fund capital spending (for example, investments) or to bridge short-term liquidity shortfalls, but borrowing can be subject to different restrictions (an obligation to obtain a permit from the canton and compliance with certain thresholds, etc.). Although municipalities have the right to issue bonds, the lion's share of local debt is funded through classic bank loans. In this regard, the cantonal banks play an important role while the importance of private banks has been shrinking in recent years. In contrast, refinancing by means of institutional investors or the issuing of bonds is of minor importance (Lengwiler and Grob 2018).

Furthermore, Swiss law does not explicitly stipulate the liability of the cantons in relation to local debt and thus provides for the possibility of insolvency by local governments. Until the well-

known bankruptcy of the little Swiss tourist village Leukerbad, in the canton of Valais in 1998, it was unclear if cantons were liable for the debt of their local governments. On the one hand, a federal law from 1947 relieved the cantons of any bailout obligation for their municipalities' debt as long as they did not explicitly deviate from this rule and stipulate a bailout duty in cantonal law. On the other hand, cantons have the duty of fiscal oversight over local government finances. If they do not comply with this obligation, they are liable for their lower-tier bodies. Based on this latter rule, many creditors have assumed that cantons are obliged to bail out local government debt to prevent municipal bankruptcy. Therefore, after the canton of Valais refused to assume the debt of Leukerbad and the municipality was no longer able to service its debt, the canton of Valais was brought to court by Leukerbad and by some of its creditors, who wanted to enforce a bailout from the canton. In 2003, the Swiss Supreme Court ruled that the cantons are under no obligation to bail out municipalities, leading to a credible no-bailout regime: "[...] after the landmark decision it was legally resolved that cantons were not liable for obvious unsustainable debt accumulation at the local level and the hitherto rather vague no-bailout clause became strongly binding and fully credible" (Feld et al 2017: 324).<sup>10</sup> As a consequence, Swiss municipalities cannot expect to be bailed out in the case of a severe financial crisis, as cantons will not repay their debt, thereby reflecting the high degree of fiscal autonomy and self-responsibility of Swiss communes.

Due to the federal structure of Switzerland, the systems of fiscal oversight over local government finances vary greatly between the cantons. Nevertheless, there have been attempts to coordinate fiscal oversight over municipalities across cantons within the Conference of the Cantonal Fiscal Oversight Authorities over Local Government Finances (Konferenz der kantonalen Aufsichtsstellen über die Gemeindefinanzen, KKAG). The KKAG prepares reports about cantonal fiscal oversight and formulates recommendations. However, following these recommendations by the cantons is not mandatory.

According to the KKAG recommendations, fiscal oversight over local government finances ought to achieve various goals (KKAG 2017: 3):

- Compliance with cantonal budgetary laws (control of legality = Rechtsaufsicht)
- Expedience and efficiency of task fulfilment (supervisory control = Fachaufsicht)

<sup>9</sup> Ladner and Soguel (2015) observe that the probability of reacting to the financial crisis was higher for municipalities in French-speaking Switzerland. This observation is explained by a difference in culture, in that people in French-speaking Switzerland are more in favour of state intervention, thereby ascribing to the state a greater role in the economy.

<sup>10</sup> An instructive description of the default of Leukerbad is given by Melly (2012).

- Careful management of public financial resources
- Transparent representation of the financial situation of a municipality (according to the principle of the “true and fair” view)
- Guarantee sound budgets (planning and accounting); prevention of undesirable developments and erroneous trends with regards to local public finances
- Ensure the provision of comparable data about the fiscal situation of municipalities according to specific reference numbers.

While pursuing these goals, supervision authorities must give regard to the principle of proportionality, for example, they have to weigh interventions by oversight authorities against the interests of municipalities worthy of protection. Therefore, the KKAG emphasises the role of local autonomy, as these goals cannot be achieved exclusively by oversight authorities. Instead, municipalities are primarily responsible for goal achievement (KKAG 2017: 3). In recent years, oversight has been slightly loosened in favour of more local self-responsibility (less controls and longer control intervals, etc.) (KKAG 2017: 2).

As a consequence, the KKAG has formulated the following rather general recommendations: First of all, cantons should regulate cantonal oversight over local public finances with regards to tasks and responsibilities of the oversight authorities. Oversight should be completed in a centralised manner. With regards to budget proposals and annual financial statements, cantonal law should require the duty to obtain a permit (*Genehmigungspflicht*) from the oversight authority or at least a disclosure requirement (*Anzeigepflicht*). Additionally, municipalities should be obliged to declare a standardised set of key performance indicators (KPIs) in relation to their fiscal position. Oversight authorities should have the duty to examine these proposals and statements with regards to their formal correctness, accuracy and completeness, compliance with legal provisions and the development of important KPIs (annual result, investment, debt, etc.). Secondly, the cantons should pass detailed regulations concerning the budgetary process, budget management and the preparation of the annual financial statement. Thirdly, the cantons should require internal control systems at the local level (internal auditing offices and external auditors, etc.) to reduce financial risks and secure compliance with budgetary law. Fourthly, cantons will provide advanced training for local government staff so that they are able to fulfill their tasks appropriately. Fifthly, the activity of the oversight authorities should be publicly and

transparently reported to make their actions comprehensible for the municipalities affected and the public. Finally, cantons should regularly publish statistics concerning local government finances with comparable data for all municipalities that can be used by oversight staff, municipalities and the public to evaluate the performance of local governments (KKAG 2017: 4 ff.).

However, despite the existence of the KKAG and its recommendations, oversight systems differ widely between the cantons, due to the general and non-binding character of these recommendations. A general trend of convergence towards a uniform system is not observable. Therefore, the following information can only provide an overview but cannot go into the details of every canton.

In the Swiss federation, all cantons except Appenzell Innerrhoden and Basel-Stadt have cantonal oversight over local government finances. Of these 24 cantons, 20 complete the oversight task in a centralised manner; only four cantons have a decentralised oversight structure. In all cantons (except Thurgau) political municipalities and other types of municipalities are subject to oversight. Only in Thurgau is there no institutionalised form of cantonal oversight over municipal budgets<sup>11</sup> (KKAG 2016: 4). With regards to the ministry in charge of supervision, there is also substantial heterogeneity: The supervision task is assigned to the Ministry of the Interior, the Ministry of Economics, the Ministry of Finance, the Ministry of Justice and Security, the State Chancellery or the Statistical Office.

The basic approach to the oversight task is, in all cantons, quite similar and dominated by an ex post, backward-looking examination of the fiscal behaviour of municipalities in recent budget years. The focus is on the development of local debt. While municipalities in all cantons are obliged to hand over their financial statements for the previous budget year (sometimes the reports from the auditing commissions or the external reviewers as well), budget proposals for the coming budget year have to be submitted in 18 cantons only (approx. 70%), the finance plans and the task plans in 12 cantons

<sup>11</sup> This reflects the high degree of local autonomy assigned to municipalities in Thurgau by the cantonal constitution, leading to weak oversight over municipalities. Nevertheless, there are two legal clauses giving the canton some general oversight responsibilities. First, according to Article 54 of the law on municipalities (*Gesetz über die Gemeinden*), the canton can intervene in municipal affairs in the case of rule violations. However, before this, the canton must give the municipality the opportunity to resolve the illegal situation on its own. Secondly, according to Article 12 of the law on fiscal equalisation between political municipalities (*Gesetz über den Finanzausgleich der politischen Gemeinden*), the canton can impose conditions on the fiscal behaviour of a municipality in the case of an unfavourable development in its fiscal affairs. However, before this, there must be an official hearing and a counselling session by the canton. If a municipality does not comply with these conditions, the canton can cut fiscal transfers.

only (50%). Concerning the submission of budget proposals and finance plans, the cantons usually do not distinguish between municipalities, but the rule is applicable to all local governments. Only a minority of the cantons request that budget proposals or financial plans have to be submitted only by municipalities which either receive fiscal equalisation transfers or exhibit a budget deficit. This indicates that the backward-looking examination is still of greater importance in comparison to the forward-looking, future-oriented review of budget proposals. Nevertheless, the significance of the future-oriented assessment is on the rise, as the number of cantons requiring the submission of budget proposals has doubled in comparison to 1999 (KKAG 2016: 14 f., 25 f.).

With regards to the backward-looking examination of local fiscal behaviour, oversight authorities typically check the completeness and formal correctness of financial statements, compliance with budget laws, audit reports from the auditing commissions and external reviewers, compliance with the balanced-budget requirement, cost recovery of tasks financed by user fees and the development of investments (capital spending) as well as the debt level. In about half of the cantons, these examinations take place annually. However, the other half of the cantons check these aspects (or parts of them) only every second to fourth year or even in longer cycles. Sometimes annual examinations are conducted only in a standardised manner, whereas on-site, in-depth-reviews are executed in longer cycles (for example, in the canton Aargau every seven years) or when they are necessary due to special circumstances or occasions (KKAG 2016: 16 ff.). In eight cantons, there are exceptions from these ordinary control routines, leading to more frequent and stricter controls for some municipalities, for example, if they receive fiscal equalisation transfers, if they exhibit budget deficits, if they have had fiscal problems in the past or if they have higher financial risks according to a separate risk assessment scheme (Rühli 2012: 85; KKAG 2016: 20).

Moreover, some cantons also conduct parallel examinations before or during the budgetary year. In two cantons, Gené and Jura, municipalities are obliged to obtain an authorisation from the oversight authority if they want to take a number of financial decisions (such as expenditure, borrowing, investments, granting of loans or issuing guarantees). In other cantons, municipalities have to obtain authorisation if they want to grant a loan, issue financial guarantees or borrow money, but only if they meet specific criteria (for example, if they receive fiscal equalisation transfers, if they want to fund investments by debt or if borrowing reaches a certain amount). Thus, there is no general approval of loans in all or most of the cantons, i.e. municipalities typically do not need permission from their cantons to borrow money (KAKAG 2016: 23 f.).

Concerning the review of the budget proposals (which is currently applied in 18 cantons according to the KKAG), the cantons do exercise their responsibility as they reject budget proposals and/or demand revision of the plans in cases of fiscal imbalances or budget deficits (Burret and Feld 2018: 679).

If the budget is not administered appropriately or in the case of rule violations, in all cantons, oversight authorities have the right to intervene. They can make dispositions requiring from municipalities a certain behaviour, they can attach specific conditions if they grant permission for particular financial decisions, they can repeal illegal decisions or actions taken by municipalities or, as a last resort, they can place a municipality under forced administration (*Zwangsverwaltung*), in which case, for example, representatives from the canton can act on behalf of the municipality in order to return to a state of legality. However, forced administration has taken place only sporadically within the last 20 years and typically not due to the financial problems of a municipality but due to the municipal council's lack of ability to act (KKAG 2016: 25 ff.). In the case of budgetary problems, oversight authorities will typically demand that municipalities work out an action plan on how to deal with and solve the problem. If the measures are not fruitful or if a municipality rejects this, oversight authorities can threaten local governments with taking the necessary actions on their own. As a final step, the oversight authority can implement the measures on its own (by making dispositions, for example, raising taxes or cutting expenditure) or in extreme cases, placing the municipality under forced administration and thereby restricting its right to self-government. The most prominent case of forced administration was the insolvency case of Leukerbad.

Moreover, all cantons collect, analyse and publish data about the fiscal situation of municipalities. This is either performed by the oversight authorities or by the relevant statistical offices. However, the extent of such data and their preparation differs widely between the cantons. While some cantons only publish special reports, others provide comprehensive databases. With regards to content, cantons differ in whether they only cover the financial statements of the municipalities or also the tax rates and harmonised key figures. Moreover, differences can also be seen concerning the time period (one year or several years) and the preparation of the data (simple presentation of data, verbal analysis, cartographical and visual representation) (Rühli 2012: 86; KKAG 2016: 31 f.).

Besides the cantonal oversight, in 22 cantons the financial statements and budgets of the municipalities are examined within the framework of an accounting control by local, organisationally independent auditing commissions (*Rech-*

nungsprüfungskommissionen)<sup>12</sup>. The auditors review the financial statements in form and content. Furthermore, in some cantons, these auditing commissions can optionally consult or delegate the task to external auditors from the public or the private sector. More than half of the cantons also require additional auditing by external reviewers (who are sometimes appointed by the cantonal administration) leading to double structures. However, external review is justified with reference to the increasing complexity of the auditing process. Nevertheless, the cantons still adhere to the idea of independent internal auditing commissions, as they are closer to the municipalities than the external reviewers or the cantonal oversight authorities, leading to greater knowledge about local circumstances and conditions, thereby allowing for quicker and more effective interventions, if necessary (KKAG 2016: 7). In general, the design and responsibilities of these auditing offices vary greatly between the cantons. In all of these cantons, the full financial statement is examined ex post, in the majority even single transactions are reviewed ex post. Additionally, in most of the cantons, there is also an ex ante examination of the whole budget proposal (also sometimes single transactions planned within the budget). In some cantons, the auditing commissions can also formulate amendments, demands for revision and alternatives to the budget (Rühli 2012: 89 ff.).

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<sup>12</sup> Members of these auditing commissions are typically elected by the people or by the executive of the municipality (Rühli 2012: 91).

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## Annex

## ANNEX 1 Financial Indicators of Local Levels in Europe

	Austria	Belgium	Bulgaria	Czech Rep.	Denmark	Estonia	Finland	France	Germany	Greece	Hungary
Local level revenue as share of national GDP	0,085	0,073	0,070	0,112	0,352	0,095	0,220	0,113	0,081	0,039	0,063
Local level revenue as share of general government revenue	0,172	0,143	0,199	0,279	0,666	0,236	0,407	0,213	0,181	0,077	0,141
Share of states transfers in local level revenues	0,628	0,466	NA	0,348	0,580	0,828	0,306	0,247	0,384	0,611	0,488
Local level tax revenue as share of total revenue	0,145	0,310	0,134	0,464	0,354	0,035	0,462	0,517	0,388	0,245	0,360
Local level expenditure as share of national GDP	0,085	0,071	0,063	0,102	0,349	0,094	0,224	0,111	0,080	0,035	0,060
Local level expenditure as share of general government expenditure	0,168	0,133	0,197	0,258	0,651	0,231	0,402	0,198	0,180	0,071	0,129
Local level budget balance as share of national GDP	-0,001	0,002	0,001	0,010	0,004	0,001	-0,004	0,001	0,002	0,003	0,003
Local level debt as share of national GDP	0,041	0,057	0,012	0,019	0,071	0,034	0,091	0,090	0,049	0,009	0,002
Local level debt as share of general government Debt	0,049	0,054	0,042	0,051	0,189	0,356	0,144	0,093	0,072	0,005	0,003

	Ireland	Italy	Netherlands	Poland	Portugal	Slovenia	Spain	Sweden	UK	Switzerland
Local level revenue as share of national GDP	0,021	0,145	0,139	0,131	0,061	0,084	0,064	0,245	0,097	0,074
Local level revenue as share of general government revenue	0,081	0,310	0,316	0,340	0,142	0,194	0,169	0,485	0,251	0,213
Share of states transfers in local level revenues	0,436	0,439	0,722	0,544	0,272	0,382	0,343	0,314	0,659	0,105
Local level tax revenue as share of total revenue	0,198	0,402	0,101	0,327	0,409	0,414	0,516	0,551	0,163	0,583
Local level expenditure as share of national GDP	0,020	0,143	0,138	0,129	0,057	0,082	0,058	0,250	0,101	0,074
Local level expenditure as share of general government expenditure	0,076	0,289	0,317	0,313	0,126	0,182	0,137	0,506	0,242	0,216
Local level budget balance as share of national GDP	0,001	0,003	0,001	0,003	0,005	0,002	0,006	-0,005	-0,004	-0,005
Local level debt as share of national GDP	0,015	0,079	0,080	0,039	0,057	0,019	0,029	0,105	0,046	NA
Local level debt as share of general government Debt	0,021	0,060	0,129	0,073	0,044	0,024	0,029	0,249	0,053	NA

All values: 2016 EUROSTAT

ANNEX 2 **List of national Experts**

This work would not have been possible without the kind support of many national experts. We address special thanks to them.

Country	Expert	Institution
Belgium	Jan Leroy	Municipal Association of Flanders
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